Volume: 8 Issues: 47 Special Issue [April, 2023] pp. 248 - 258
International Journal of Accounting, Finance and Business (IJAFB)
eISSN: 0128-1844
Journal website: www.ijafb.com
DOI: 10.55573/IJAFB.084723

DO TAX INCENTIVES MAKE A DIFFERENCE? A CASE OF MALAYSIAN MANUFACTURING FIRMS

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Article history
Received date : 18-3-2023
Revised date : 19-3-2023
Accepted date : 2-5-2023
Published date : 15-5-2023

To cite this document:
S. Md Nasir, S. U. L, Mohd Yusof, N. A., & Chuen, L. C. (2023). Do Tax Incentives Make A Difference? A Case of Malaysian Manufacturing Firms. *International Journal of Accounting, Finance and Business (IJAFB)*, 8(47), 248 - 258.

Abstract:. *Tax incentives are an important part of Malaysia's investment promotion policies, and they are used to stimulate economic development. While tax incentives have helped Malaysia's manufacturing sector grow since the 1980s, the cost of these incentives has risen, making it even more important to weigh the benefits. As a result, the goal of this study is to determine if different types of incentives had varied effects on the performance of the incentivized company and if the government benefited in terms of income generated from employment through monthly tax deductions. This study examines all companies that claimed Reinvestment Allowance (RA), Investment Tax Allowance (ITA), and Tax Holiday (TH) between 2017 and 2019 using secondary tax panel data from the Inland Revenue Board of Malaysia (IRBM). According to the findings, RA is the most claimable incentive among manufacturing companies. This study also discovered that the type of incentives claimed has a statistically significant impact on firm performance and tax revenue collection from employment. Although there was a significant difference in profitability and tax revenue collection between companies that claimed ITA and those that claimed RA and TH, there was no difference in profitability or tax revenue collection between companies that claimed ITA and those that claimed RA and TH. As a result, RA and TH incentives made a difference in company and government revenue, which will be accepted as policy tools to achieve policy goals, such as assisting a firm's growth or creating better spillover to the country. Future research should consider using both financial and non-financial variables in their studies, as well as how this affects economic indicators such as foreign direct investment (FDI) and gross domestic product (GDP) growth.*

Keywords: *Effectiveness, Reinvestment Allowance, Investment Tax Allowances, Tax Holiday, Firm Performance.*

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Introduction

Globally, countries use tax incentives as promotional tools to encourage spending from both foreign and domestic investors. Tax incentives are fiscal incentives provided by the government to qualified taxpayers or potential investors in order to undertake a qualified project with a lower or no effective tax rate. While the effectiveness of tax incentives is debatable (Zolt, 2015), tax incentives have been widely used to achieve a variety of national goals, including assisting business growth. Continuous investment, whether foreign direct or domestic, is expected to have a significant impact on a country's economic growth, including job creation, economic development, and social well-being. Countries like Korea, Singapore, and China have successfully used tax incentives to attract foreign investment and, as a result, accelerate economic growth (Jun, 2018; Tanzi & Shome, 1992). In a similar effort, Singapore relied not only on tax incentives, but also on creating an investment-friendly environment in which they successfully established long-term relationships with investors and gained positive spillover (James, 2010).

Malaysia, like other emerging and advanced economies, uses tax and non-tax incentives as policy tools to encourage investment in specific sectors or regions, or to influence the nature of such investments (World Bank, 2006). Malaysia currently has over 100 different types of incentives at the national and regional levels (Mohd et al., 2017). It is widely acknowledged that tax incentives are costly due to the potential loss of revenue to the host country, despite the fact that they may or may not generate future revenue for the government (Singh, 2020). There are also concerns that too many incentives distort resource allocation by attracting rent-seeking investors seeking short-term profits. However, previous research has suggested that tax incentives may have significant positive spillover effects such as job creation, increased investment, and encouragement of local supply chains (Zolt,2015).

Malaysia had positioned itself as a country with significant advantages over other countries because of its low labour costs, infrastructure, and lack of a language barrier (PwC, 2012). However, because countries are currently competing for the same pool of investors, fast-changing technology in manufacturing sectors necessitates the government being more generous in order to attract high-tech and innovative MNCs. This will put pressure on developing countries like Malaysia, which may be at a disadvantage in terms of offering non-fiscal incentives. As a result, they will pursue tax incentives in order to attract technologically advanced investors while also encouraging domestic industry.

In the Malaysian manufacturing context, three main types of tax incentives are used to ensure that the Malaysian manufacturing sector continues to develop with continued productivity. The first incentive is tax holiday. A tax holiday in Malaysia is defined as income tax exemption granted as Pioneer Status (PS) under the PIA 1986 or granted under section 127(3)(b) of the Income Tax Act 1967. Tax holiday incentives target promoted activities and sectors by providing a partial or total income tax exemption for several years in order to attract foreign domestic investment or encourage domestic investment in these promoted areas based on commercial scale, prospects for future development, and Malaysia's national and strategic requirements. The second benefit is Investment Tax Allowances (ITA). ITA is the second major incentive provided by the Promotion Investment Act of 1986, and it is an alternative to PS. While PS provides a broad tax exemption based on statutory income, ITA provides firms with a tax deduction for qualifying capital equipment purchased during the incentive period. Finally, Reinvestment Allowances are the third incentive (RA). Reinvestment Allowance is a tax credit given to businesses that invest in expanding, modernising, automating, or diversifying their

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existing manufacturing or approved agriculture businesses. The allowance is granted for 15 years beginning with the first year of claim and is calculated at 60% of qualifying capital expenditure incurred and can be deducted against 70% of statutory income. RA has been extended a few times to encourage manufacturers who have exhausted their RA to continue investing in their businesses.

However, it is unknown which incentives are better suited to the needs of businesses and governments. Without properly assessing the effect of tax incentives on a firm's performance as well as how they benefit the country, tax incentive efforts may be vulnerable to abuse, destroying the tax base and budget revenue in the long run while having no significant effect on economic growth (Sinenko, 2016; Zolt, 2013). Thus, the purpose of this study is to investigate the effects of various types of incentives, namely the Reinvestment Allowance (RA), Investment Tax Allowance (ITA), and Tax Holiday (TH), on firm performance and government revenue.

Literature Review

Tax incentives and reduced tax rates are common all over the world, particularly in the East Asia and Pacific (EAP) region, where most countries prefer to use them. EAP countries are perceived as more generous in providing incentives ranging from 75% to 100%, as opposed to Economic Co-operation and Development (OECD) countries, which only provide incentives of up to 30%. (James, 2014). Countries in the ASEAN region tend to offer similar incentives to attract Foreign Direct Investment (FDI) or Domestic Direct Investment (DDI). Previous research has suggested that the region should conduct harmonisation and coordination of tax incentives within the region to avoid a race to the bottom (James, 2013; Mohd et al., 2017).

Previous studies have produced mixed results and recommendations when discussing the effect of various types of incentives on economic spillover, whether from the perspective of companies or the government. Singh (2020) is sceptical of what a country can achieve through tax incentives, pointing out that investment inflows from tax incentives may have a spillover effect that does not generate future revenue for the government. Because of the disruption to government revenue, Zee et al. (2002) agreed with Anwar (1995) that incentives were not cost-effective tools for attracting investment. It is consistent with the findings of Easson and Zolt (2012) that the government may continue to benefit from tax incentives when they are used to distort investment decisions by encouraging investment in areas where the company may not want to invest without incentives as a way to correct market failures. Such investment could result in positive externalities that the government desires, such as technology transfer, business expansion for domestic firms, increased employment, or investment in less developed areas of the country.

However, evaluating the effectiveness of a tax incentive is not solely based on the cost of the incentives borne by the government or the total direct investment that one country can attract using incentives. The government must be able to balance the likely cost and potential benefits of tax incentives, which must take into account factors such as increased revenue from increased investment, social implications such as job creation, infrastructure accessibility, tax foregone, and other indirect costs implicated by tax incentives (Steshenko & Tikhonova, 2018). Tax incentives policy can be perceived as effective if the government intervenes to lower taxes for a specific sector, encouraging capital investment that increases the sector's revenue and, as a result, generates employment, increases domestic spending, and improves access to better infrastructure (James, 2013).

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Development of Hypotheses

In terms of assessing the effectiveness of individual incentives, RA has emerged as one of the most important incentives for existing manufacturing firms to encourage additional capital reinvestment and to stimulate greater efficiency and productivity in the industry (Hamid et al., 2018). According to a 2015 World Bank study, RA is the most popular incentive among local manufacturing firms and is highly sought after by the chemical and mineral industries. Manufacturers also agree that RA was more effective than other incentive tools in strengthening business capacity. The government's decision to provide special RA to stimulate the economy during the pandemic 2020 is seen as bold and encouraging.

ITA worked similarly to RA in that it reduced the cost of capital by deducting these investments from their tax returns; however, previous research failed to demonstrate any effect of ITA in stimulating investment, particularly when compared to tax breaks (Klemm & Van Parys, 2012). In line with previous findings, House et al. (2017) discovered that ITA fails to provide any significant spillover effects due to a high reliance on importation of goods into the host country, which negatively affects the balance of trade. Nonetheless, the World Bank (2016) discovered that, like RA, ITA has a significant effect in reducing business cost of capital by 19% if companies are eligible to claim for the entire capital expenditure, or 9.5% if incentives are only given for half of the investment. Despite this, the investment behaviour of manufacturing firms is unaffected by ITA incentives when compared to RA incentives.

There are conflicting findings in determining the effectiveness of tax holidays in providing benefits to the country and firm performance. According to Klemm and Parys (2009), while lower corporate tax rates and longer tax holidays are effective in attracting FDI, they are ineffective in achieving the incentive's objectives of contributing to the host country's real economy growth. Similarly, Stausholm (2017) adopted a broader perspective with a longer observed period, holding the view that tax holidays are ineffective because they do not translate into real capital and economic growth. Nonetheless, his analysis discovered that when tax holidays become too long in duration, FDI inflows show decreasing patterns. Holland and Vann (1998) also stated that longer-term tax holiday periods can increase government costs by exposing tax planning schemes by incentivized firms. Gebremedhin and Saporna (2016) conducted a comparative study between 1998 and 2002 to investigate the effect of tax holidays on employment, manufacturing investment, and revenue aspects of incentivized firms, and they discovered that tax holidays help increase the performance of manufacturing firms in Ethiopia in all aspects.

Sarma (1986) agrees that ITA are effective at lowering the cost of capital, which indirectly increases firm profitability. According to Calitz et al. (2013), existing firms benefit from ITA or RA because they can shelter their existing income using tax incentives earned on new investment. However, Mauda and Saidu (2019) contend that ITA has no significant effect on firm performance when compared to other incentives. In contrast, the World Bank (2016) discovered that RA had a significant impact on manufacturing firm performance when compared to the services sector. Gebremedhin and Saporna (2016) discovered that tax holidays improve firm performance in Ethiopia. This finding is consistent with previous research, which indicates that RA and ITA benefit businesses by lowering taxable income (Easson & Zolt, 2012; Singh, 2020). Noor et al. (2016) concluded in their study that tax incentives that allow income to be exempted have a positive impact on firm performance. This is consistent with Mayende's (2013) findings that tax incentives have a high positive correlation with firm performance in

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terms of gross and value-added performance. As a result, the following hypothesis is proposed in this study:

H1: There is a significant difference in firm performance based on the types of incentives claimed.

The most common types of incentives offered by developing countries to encourage FDI or additional investment from existing taxpayers are RA, ITA, and TH (James, 2014; Muthitacharoen, 2016). FDI or additional investment is expected to have spillover effects such as increased domestic supply chain, technology transfer, resident spending power, and indirectly increased government revenue from taxes paid on jobs created. According to Easson and Zolt (2012), tax holidays are unlikely to be the most beneficial incentives to the government in the long run, but they do help businesses generate quick profits. Meanwhile, Ohaka and Dagogo (2015) proposed that RA gives the government better desired results because it encourages spending, which indirectly increases tax revenue. However, tax holiday incentives create unintended distortions and are costly to the government because constant monitoring is required to ensure all incentive conditions are met. There are also concerns that too many incentives may distort resource allocation by attracting rent-seeking investors with short-term profits, which will cost the government in terms of lost tax revenue (Anwar, 1995; International Monetary Fund, 2015; Jun, 2018). Nonetheless, Sari et al. (2015) discovered no evidence that TH has a negative impact on tax revenue in the Indonesian context. As a result, this study proposes:

H2: The types of incentives claimed have no effect on the employment tax revenue collected from incentivized firms.

Methodology

This study used secondary panel data based on information filed by a manufacturing company that claimed RA, ITA, and TH in their tax return for the period 2017-2019, which was obtained with permission from the Inland Revenue Board of Malaysian (IRBM). Due to the disparities in tax rates between small and medium-sized enterprises (SMEs) and large corporations, a total of 1,645 data were removed from the total of 4,690 obtained. After removing those with missing data and outliers, the total number of data used is 3,036.

The Findings

The Profiles of Manufacturing Companies

The demographic profiles of manufacturing companies are shown in Table 1. Between 2017 and 2019, 3,306 manufacturing companies claimed reinvestment allowance, investment tax allowance, or tax holiday. Local businesses account for 83.8% of the 3,306 claimants. It should be noted that all different types of incentives are equally offered to local and foreign companies, resulting in many more local companies benefiting from incentives offered than foreign companies. Foreign companies are entities that have more than 50% foreign equity. In terms of the types of incentives claimed, 89.4% of the 3,306 manufacturing firms claimed RA. The findings are consistent with the World Bank (2016) study. Meanwhile, 9.5% of manufacturing firms claimed TH, while 1.1% of manufacturing firms claimed ITA.

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Table 1: Profiles of Manufacturing Companies

Demographic Profile	*N = 3,306*	Percentage (%)
Ownership		
Foreign	493	16.2
Local	2,543	83.8
Type of Incentives Claimed		
Reinvestment Allowance	2,714	89.4
Investment Tax Allowance	34	1.1
Tax Holiday	288	9.5

Table 2 shows that firms incentivized with RA, ITA, or TH have an average ROA ratio of.088 or 8.8% from their business, with the highest ROA recorded being 90% and the lowest being -44%. While only 1,345 of the 3,036 companies reported monthly tax deductions from employment. The average revenue collected from employment is RM161,773 from 1,345 companies, indicating a significant disparity between the maximum revenue collected (RM4,221,482) and the minimum (RM197 per year).

Table 2*:* Descriptive Analysis

	N	Minimum	Maximum	Mean	Std. Deviation
ROA_Ratio	3036	-.44	.90	.0881	.10065
MTD	1345	197	4221482	161773.92	292485.032

The Effects Of Tax Incentives Claimed On Firm Performance And Government Revenue

A one-way Analysis of Variance (ANOVA) was used to compare the effects of claimed tax incentives on firm performance. Table 3 shows that the F-value is significant at the.05 confidence interval, indicating that the firm's performance differs significantly depending on the types of incentives claimed. As a result, H1 is acceptable. Levene's test, on the other hand, yielded insignificant results when analysing Monthly Tax Deduction, indicating that the variance is homogeneous. Table 4 shows that at a 5% level of significance, an F-value of 4.658 with a p-value of.010 indicates that there is a significant difference in the mean of tax revenue collected from employees of incentivized firms between three different types of tax incentives. As a result of this finding, H2 can be accepted.

Table 3: Levene's Test

Variable	Levene Statistic	df1	df2	Sig.
ROA_Ratio	8.062	2	3033	<.001
Log_MTD	.283	2	1342	.763

Table 4: One Way ANOVA (MTD)

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	3.727	2	1.863	4.658	.010
Within Groups	536.834	1342	.400		
Total	540.560	1344			

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Unfortunately, the test results presented in Tables 3 and 4 only indicate that there is a significant difference in ROA and tax revenue across various forms of incentives, but do not specify which incentive type is responsible for the difference. In order to examine all possible combinations of incentive groups in this study, post hoc tests (Bonferroni) consisting of pairwise comparisons will be utilised.

Table 5: Multiple Comparisons for ROA_Ratio

(I) Type of Incentives	(J) Type of Incentives	Mean Difference (I-J)	Std. Error	Sig.	95% Confidence Interval	
					Lower Bound	Upper Bound
RA	ITA	-.00019	.01732	1.000	-.0417	.0413
	TH	-.02655*	.00622	<.001	-.0414	-.0116
ITA	RA	.00019	.01732	1.000	-.0413	.0417
	TH	-.02636	.01820	.443	-.0700	.0172
TH	RA	.02655*	.00622	<.001	.0116	.0414
	ITA	.02636	.01820	.443	-.0172	.0700

Notes:
Dependent Variable: ROA_Ratio
Post Hoc: Bonferroni Method
*. The mean difference is significant at the 0.05 level.

At the 0.05 level of significance, Table 5 demonstrates that different types of incentives differ considerably from one another. The result demonstrates a difference in the firm's performance per incentive group, with a p-value of.001 and a confidence level of 95% indicating that only RA is substantially different from TH. This suggests that the firm performance of firms claiming RA and TH differs from one another, but has no influence on firms claiming ITA. Thus, it means that companies may observe a considerable difference in performance when claiming RA or TH, allowing them to determine which incentives worked best for them.

Table 6: Multiple Comparisons (MTD)

(I) Type of Incentives	(J) Type of Incentives	Mean Difference (I-J)	Std. Error	Sig.	95% Confidence Interval	
					Lower Bound	Upper Bound
RA	ITA	.10890	.15019	1.000	-.2511	.4689
	TH	-.17084*	.05821	.010	-.3104	-.0313
ITA	RA	-.10890	.15019	1.000	-.4689	.2511
	TH	-.27974	.15899	.236	-.6608	.1014
TH	RA	.17084*	.05821	.010	.0313	.3104
	ITA	.27974	.15899	.236	-.1014	.6608

Notes:
Dependent Variable: Log_MTD
Post Hoc: Bonferroni Method
*. The mean difference is significant at the 0.05 level.

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At the.05 level of significance, Table 6 reveals which form of incentive differs significantly from the others, with the mean difference highlighted by an asterisk. Hence, the findings show that RA and TH differ substantially. In a larger sense, tax holidays and reinvestment incentives have varying effects on the tax income generated from rewarded employees. Policymakers can use this information to assess which incentives benefit both taxpayers and the government. Similarly, this study found that the use of ITA had no influence on the employment-related revenue collected. The result shows that policymakers may decide to provide incentives at a lower cost to the government because it would not have a significant impact on employment-generated tax income.

Discussion

This study aims to determine if different types of incentives had varied effects on the performance of the incentivized company and if the government benefited in terms of income generated from employment through monthly tax deductions. This study hypothesises that the effect on a company's performance will vary based on the type of incentives claimed. This study found, using One-Way ANOVA, that the sort of incentives claimed had a statistically significant effect on a company's performance. ROA of a corporation claiming RA is drastically different from that of a company claiming TH. Yet, there was a statistically significant difference in performance between companies that claimed ITA and those that did not. This may be due to the fact that, compared to companies claiming RA and TH, the majority of ITA claims are made by newcomers.

This study will evaluate, through Hypothesis 2, the effects of incentives that provide additional benefits in addition to enhancing incentive-based company performance. According to Steshenko and Tikhonova (2018), the efficacy of tax incentives can also be examined from the government's perspective by determining if the incentives achieve the stated goals. This is congruent with a research by James (2014), in which he suggested that the government should implement tax incentives as tools to promote economic growth from a variety of angles, including employment, social development, and regional development. It was revealed that enterprises using RA and TH generated drastically different tax revenues. Perhaps this is because RA-encouraged businesses are more mature and have a greater number of employees earning more than RM3,500 who are subject to taxation. TH-incentivised firms and ITS-incentivised companies earn significantly different amounts of tax income from their employees. Certain TH incentives are contingent on the employment of managerial, technical, and supervisory (MTS) personnel, which may contribute to this condition. To be eligible for awards, a business must possess a minimum number of MTS. This set of workers is often taxed at a higher rate, resulting in additional tax income from the rewarded company's workforce contributions.

Conclusion

In conclusion, it is plausible to conclude that RA and TH are the most dependable and suitable incentives for the incentive corporation and the government. Politicians may aim to maximise the use of RA and TH as incentives to drive economic growth because they are the most sought-after incentives for manufacturing enterprises and the most advantageous for both corporations and the government. As suggested by the World Bank (2016), the government may reform the incentive system by providing outcome-based incentives. The new incentive scheme gives investors confidence in the tax benefits and provides the government with measurable long-term objectives. The government may also decide to forego front-loaded incentives in favour of rewarding companies for their sustained performance (Bartik, 2017).

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However, this study has drawbacks that can be addressed in a future study, such as the lack of data on the effectiveness of various forms of Malaysian business incentives. The vast bulk of prior research has concentrated on country-level data, with only a few studies concentrating on firm-level data. Because the government gives so many distinct forms of tax exemptions, it is also difficult to differentiate tax holidays based on their intended incentive effect. For instance, tax holiday data includes all exclusions under Sections 127(3)(b) and 127(3A) of the Income Tax Act of 1967, not only investment-related incentives. Regardless of the rationale, the amount of exemption claimed by a corporation reduces the company's financial burden; therefore, it can be used to measure the impact on performance. In estimating the ROI, the study did not take into consideration additional government support. Under MIDA, manufacturing businesses, especially domestic ones, are eligible for tax incentives and grants, both of which are essential to lowering a company's cost of capital and, consequently, its return on investment (ROI). Government grants will be reported by firms on their tax returns, but as a lump sum of tax-exempt revenue.

Yet, the breadth of tax incentive effects is expansive, thus there are more dimensions of tax incentive efficacy that can be studied. This approach can only provide a general knowledge of the relationship between tax incentives and corporate performance due to its limitations. This is done without taking into account other non-financial elements that may impact the efficiency of tax incentives. Therefore, it is recommended that future research incorporate both financial and non-financial indicators when evaluating the efficacy of tax incentives, such as a company's profile, which may drive the incentives to become more effective in assisting a company's performance, as well as government targets such as board committee membership or equity ownership. Future studies may also investigate the impact of incentives on the tax base, whether they generate expansion or contraction. Prior research has rarely touched on this topic, presumably due to a lack of understanding of tax collection procedures. It may also be owing to restricted access to data on tax revenue, which includes both direct and indirect tax.

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Volume: 8 Issues: 47 Special Issue [April, 2023] pp. 248 - 258
International Journal of Accounting, Finance and Business (IJAFB)
eISSN: 0128-1844
Journal website: www.ijafb.com
DOI: 10.55573/IJAFB.084723

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