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Effective tax rates and the "industrial policy" hypothesis: evidence from Malaysia

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Abstract

Studies on effective tax rates (ETR) and firm size in the non-U.S. context are next to non-existent, with the Kim and Limpaphayom study (1998) being the sole exception. Moreover, no detailed analysis has been performed to study the link between industrial sectors and ETR. Based on a hand-gathered sample of Malaysian firms trading in the Kuala Lumpur Stock Exchange in 1990–1999, this paper examines the association between ETR and a set of possible factors using a regression analysis. There is evidence to suggest that manufacturing firms and hotels pay significant lower effective tax in Malaysia between 1990–1999. In addition, it appears that large Malaysian firms do not suffer a "political cost" as indicated by a negative and significant relation between firm size and ETR. Finally, more efficient Malaysian firms pay lower effective tax. The results are consistent with the "industrial policy" hypothesis developed in this paper based on an examination of the Malaysian context. These results from a large developing country (e.g., Malaysia) can be used to compare with existing results from a large developed country (e.g., U.S.).

Keywords: Effective tax rates; Industrial policy; Political costs; Sector effects; Firm Size

1. Introduction

The issue of effective tax rates (ETR) paid by firms has generated an ongoing dialogue in the U.S. in recent years (e.g., Kern and Morris, 1992; Kim and Limpaphayom, 1998; Porcano, 1986; Salamon and Siegfried, 1977; Wilkie and Limberg, 1990; Zimmerman, 1983). Implicit in these studies is the shared concern that U.S. firms, because of their size, may pay more or

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less than their fair share of tax. In contrast, the relation between industrial sector effects and ETR, while investigated in a number of studies (e.g., Gupta and Newberry, 1997; Kern and Morris, 1992; McIntyre and Nguyen, 2000; Omer, Molloy and Ziebart, 1993; Zimmerman, 1983) is often treated as a subsidiary issue and an adjustment factor. Given that these studies are from the U.S. context, the relevant questions for international accounting research are related to whether U.S.-based ETR findings can be generalized to institutional environments significantly different from those of the U.S., such as East and Southeast Asia. What factors explain ETR for non-U.S. firms? Can the results from the U.S. firms be extended to non-U.S. and, especially, non-western firms?

Studies of sector effects on ETR in the non-western context are non-existent. So are the studies of size effects on ETR, with the sole exception being the study by Kim and Limpaphayom (1998). Do ETR differ across industrial sectors and/or according to firm size for non-U.S. firms? If they differ, what may be the underlying reasons? The Kim and Limpaphayom study (1998), based on firms from Hong Kong, Korea, Malaysia, Taiwan, and Thailand in the period from 1977 to 1992, provides initial evidence of a negative relation between ETR and firm size for firms in East and Southeast Asia. While the Kim and Limpaphayom study (1998) does not address the issue of sector effects because of data unavailability, it nonetheless identifies it as "very important" (1998, p. 66) for non-western firms primarily because of the long standing "industry policy" in these countries to promote certain sectors.

Given the explicit industry policy, it is not surprising that various benefits, including tax benefits, may be given to "strategic" firms and sectors in order to promote both economic and social goals including: protecting domestic sectors from foreign competition, increasing exports, enhancing efficiency or competitiveness, and fostering high-tech development. One result of the policy is that selected firms and sectors are in a naturally good position to influence and lobby the government for favorable treatments such as tax treatments. While the merits of the policy to pick "winners" is subject to debate, such a policy provides the rationale and the context in which to examine the possible link between ETR and industrial policy, i.e., the "industrial policy" hypothesis.

This paper contributes to the currently sparse literature on ETR in the non-western context by investigating the link between ETR and sectors and between ETR and size in Malaysia. The contribution is relevant to international accounting research in at least three ways. First, the study of ETR in Malaysia is in fact a part of a collective *comparative* study because our Malaysian/non-western results are studied in comparison to the existing U.S./western results. Second, the comparative component of our investigation is non-trivial because it is based on a genuine policy difference between developing countries such as Malaysia and developed countries like the U.S. Specifically, the policy difference in our study takes the form of a long standing industrial policy in Malaysia to promote large firms as well as firms in the manufacturing sector (e.g., Alavi, 1996) and, since 1990, in the tourism sector (e.g., Malaysia Institute of Accountant and Malaysian Institute of Taxation, 1990; Price Waterhouse, 1996). Third, one implication of the industry policy to foreign investors is the *effective* tax incentives provided by the government for investing in the manufacturing sector and, to a lesser extent, the tourism sector.

Our study should provide insights regarding the possible reasons that may explain ETRs in Malaysia and other similar developing countries and, more importantly, why these reasons may