CUSTOM ACTIVITIES ON FOREIGN DIRECT INVESTMENT INFLOWS INTO MALAYSIA

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UNIVERSITI SAINS MALAYSIA

2025

CUSTOM ACTIVITIES ON FOREIGN DIRECT INVESTMENT INFLOWS INTO MALAYSIA

by

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Thesis submitted in fulfilment of the requirements for the degree of Doctor of Philosophy

January 2025

ACKNOWLEDGEMENT

I would be grateful to Allah SWT for providing me the opportunity to complete my Ph.D. and for guiding me through this long and difficult road. There were some challenges in carrying out this study. However, several people have helped me in the completion of this research. My heartfelt thanks and gratitude go to my supervisor, Assoc. Prof. Dr Tajul Ariffin Masron, for his valuable time, understanding, and guidance that helped me meet the standards for this thesis. Without his assistance, I would not have been able to complete this study according to the requirements. I greatly appreciate his efforts in assisting me by providing valuable information for this study. A very special gratitude goes out to all my family especially to my husband, Dr Mohd Hafez Kamarudin, my mother, Aripah Che Deraman, my father, Tengku Razali Tuan Hasan, my mother-in-law, Haminah Md Zain, my father-in-law, Kamarudin Ahmad, and my seven kids, Hazeq, Nurin, Harez, Solehah, Suraya, Syiffa and Hazeem for supporting me. They gave me a lot of help when needed. Besides, they always make me calm and advise me when there was time that I almost give up. My gratitude also goes to the RMCD, which supplied the facilities and help during data gathering. Special thanks to my colleagues and friends who assisted me with this project. They also provided me with suggestions, opinions, and assistance in finishing this study. Thank you for your encouragement, patience, and suggestions in supporting me with this endeavour. Finally, I would like to thank everyone who helped me complete this research, whether directly or indirectly. Without your assistance, I would never have been able to complete this thesis. This piece of victory is dedicated to all of you. Alhamdulillah.

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LIST OF ABBREVIATIONS

ADF	Augmented Dickey-Fuller
AEO	Authorized Economic Operator
AEOI	Authorized Economic Operator index
AFT	Aid for Trade
AFTA	ASEAN Free Trade Agreement
AIC	Akaike Information Criterion
AKFTA	ASEAN-Korea Free Trade Agreement
AP	Approved Permit
APEC	Asia-Pacific Economic Cooperation
ARDL	Autoregressive Distributed Lag
ASEAN	Association of Southeast Asian Nations
BG	Bank Guarantee
CAI	Custom Activities Index
CBF	Custom Bonded Factory
CPTPP	Comprehensive and Progressive Agreement for the Trans-Pacific Partnership
D-8	Developing Eight
DEKS	Duty Excise
DEXP	Duty Export
DIMP	Duty Import
DFS	Duty Free Shop
ECM	Error Correction Model
ECT	Error Correction Term
EPF	Export Processing Factory
EPZ	Export Processing Zone
EU	Europe Union
FCZ	Free Commercial Zones
FDI	Foreign Direct Investment
FIZ	Free Industrial Zone
FMF	Federated Malay States
FTA	Free Trade Agreement
FTZ	Free Trade Zone

FZ	Free Zone
FZI	Free Zone Index
GBA	Public Bonded Warehouse
GBAI	Public Bonded Warehouse Index
GBP	Private Bonded Warehouse
GBPI	Private Bonded Warehouse Index
GDP	Gross Domestic Product
GNP	Gross National Product
GST	Goods and Services Tax
ICD	Inland Container Depot
ICDI	Inland Container Depot Index
IMMEX	Maquila and Export Services Industry
IPC	International Procurement Centre
IPR	Inward Processing Relief
IRBM	Inland Revenue Board of Malaysia
ITI	Indirect Tax Index
K1	Customs Form Number 1
K8	Customs Form Number 8
KBC	Kedai Bebas Cukai
KBCI	Duty Free Shop Index
LMW	License Manufacturing Warehouse
LMWI	License Manufacturing Warehouse Index
LVEH	Levy Vehicle
MAFTA	Malaysia Australia Free Trade Agreement
MCFTA	Malaysia Chile Free Trade Agreement
MEEPA	Malaysia-European Free Trade Association Economic Partnership Agreement
MICECA	Malaysia India Comprehensive Economic Cooperation Agreement
MIDA	Malaysian Investment Development Authority
MITI	Ministry of International Trade and Indutry
MJEPA	Malaysia Japan Economic Partnership Agreement
MNZFTA	Malaysia New Zealand Free Trade Agreement
MNC	Multinational Company
MNE	Multinational Enterprise
MoF	Ministry of Finance

MPC	Malaysia Productivity
MPCEPA	Malaysia Pakistan Closer Economic Partnership Agreement
MTFTA	Malaysia Turkey Free Trade Agreement
OECD	Organization for Economic Co-operation and Development
OLI	Ownership, Location, Internalization
OLS	Ordinary Least Square
OPR	Outward Processing Relief
PCA	Principal Customs Area
PCC	Processing under Customs Control
PEKEMA	Association of Malay Importers and Traders of Motor Vehicles of Malaysia
PKFZ	PK Free Zone
PKM	PEKEMA
PKMI	PEKEMA index
PP	Phillips-Perron
PTA	Preferential Tariff Agreement
RBD	Bleached and Deodorized
RCEP	Regional Comprehensive Economic Partnership
RDC	Regional Distribution Centre
RMCD	Royal Malaysia Customs Department
RTA	Regional Trade Agreement
SEI	Shadow Economy Index
SEZ	Special Economic Zone
SMG	Smuggling
SST	Sales and Services Tax
TAG	Trade Agreement
TAGI	Trade Agreement Index
TEV	Tax Evasion
TFI	Trade Facilitation Index
TRD	Trade
UNCTAD	United Nations Conference on Trade and Development
UNECE	United Nations Economic Commission for Europe
USD	United State Dollar
VAT	Value Added Tax
VATI	Value Added Tax Index

VLI	Vehicle Levy Index
WCO	World Customs Organization
WTO	World Trade Organization

AKTIVITI KASTAM KE ATAS ALIRAN MASUK PELABURAN LANGSUNG ASING KE DALAM MALAYSIA

ABSTRAK

Aliran pelaburan asing langsung (FDI) ke Malaysia telah mengalami penurunan, walaupun ia menduduki tempat ketiga dalam Indeks Daya Tarikan FDI di kalangan negara-negara Asia. Peranan kastam yang bertindak sebagai pemungut cukai tidak langsung, fasilitator perdagangan dan penguatkuasa undang-undang tetap terlepas pandang hubungan antaranya terhadap FDI. Justeru itu kajian ini mengkaji peranan kastam sebagai pemungut cukai tidak langsung (cukai import, cukai eksport, cukai penggunaan, cukai eksais dan cukai kenderaan), penyedia fasilitator perdagangan (AEO, FZ, LMW, 14(2), KBC, GBA, GBP, PKM, ICD dan TA), dan penguat kuasa undang-undang (penyeludupan dan pengelakan cukai) dari tahun 1999 hingga 2018, menggunakan teknik ARDL. Penemuan menunjukkan bahawa cukai import dan cukai penggunaan memberi kesan negatif terhadap FDI, manakala cukai eksport, cukai eksais, dan cukai kenderaan memberi impak positif. Kemudahan perdagangan seperti ICD, GBA, dan LMW memberi kesan negatif kepada FDI, manakala ekonomi bayangan juga menghalang aliran FDI. Pembuat dasar boleh menggunakan wawasan ini untuk menarik lebih banyak FDI dengan mengurangkan cukai import dan cukai penggunaan sambil mengekalkan pendapatan dari cukai eksport, cukai eksais, dan cukai kenderaan. Mereka perlu menyempurnakan tawaran kemudahan perdagangan untuk seimbangkan pendapatan dan tarikan FDI, dan memastikan undang-undang dan peraturan yang telus untuk menghilangkan ketidakpastian dan kecenderungan, dengan itu membina persekitaran yang lebih baik untuk FDI di Malaysia. Selain itu kajian ini juga menyumbang kepada penambahbaikan teori FDI di Malaysia dengan mengintegrasikan

elemen cukai tidak langsung, fasilitasi perdagangan dan ekonomi bayangan di bawah peranan kastam.

CUSTOM ACTIVITIES ON FOREIGN DIRECT INVESTMENT INFLOWS INTO MALAYSIA

ABSTRACT

FDI inflows into Malaysia have been declining, despite its third-place ranking on the FDI Attractiveness Index among Asian countries. The roles of customs that act as indirect tax collector, trade facilitator and law enforcer remain overlooked the interplay between it towards FDI. Hence this study examines customs' roles as indirect tax collector (import duty, export duty, consumption tax, excise duty and vehicle levy), trade facilitator (AEO, FZ, LMW, 14(2), KBC, GBA, GBP, PKM, ICD and TA), and law enforcer (smuggling and tax evasion) from 1999 to 2018, using the ARDL technique. Findings indicate that import duty and consumption taxes negatively affect FDI, whereas export duty, excise duty, and vehicle levy have positive impacts. Trade facilitation measures like ICD, GBA, and LMW negatively influence FDI, while the shadow economy also hampers FDI inflows. Policymakers could use these insights to attract more FDI by reducing import and consumption taxes while maintaining revenue from export duty, excise duty, and vehicle levy. They should refine trade facilitation offers to balance revenue and FDI attraction, and ensure transparent laws and regulations to remove uncertainty and bias, thus fostering a more favourable environment for FDI in Malaysia. This study also contributes to improving the theoretical of FDI in Malaysia by integrating the elements of indirect taxes, trade facilitation and the shadow economy under the role of customs.

CHAPTER 1

INTRODUCTION

1.1 Introduction

Foreign Direct Investment (FDI) can be defined as a cross-border investment from the originated country to another country. According to the OECD (1996), foreign direct investment (FDI) is defined as the attempt of a resident entity of one economy (the direct investor) to establish a long-term stake (long-term connection) in a company that is a resident of another economy (the direct investment enterprise). When the resident entity setting up the foreign affiliate in another country, the entity will be known as Multinational Enterprise (MNE) or Multinational Company (MNC), other words for the FDI that used interchangeable in the field. Protsenko (2004) states that there are two categories of FDI which are horizontal FDI and vertical FDI (backward oriented and forward oriented). Horizontal FDI was classified if the MNE or MNC produce the products or services same as the originated country while the vertical FDI produce one of the products or services in the chain of the production either act as suppliers (backward oriented) to the originated country or as the customers (forward oriented).

FDI, together with portfolio investments and other flows such as bank loans, constitutes one of the three constituents of international capital flows (Protsenko, 2004). Across the years since 1978 until the years of 1995, the composition of international capital flow had changed more towards the FDI and portfolio investment as shown in the Figure 1. The FDI increase from 11% to 16% and 20% from 1978 to 1995 across the years.

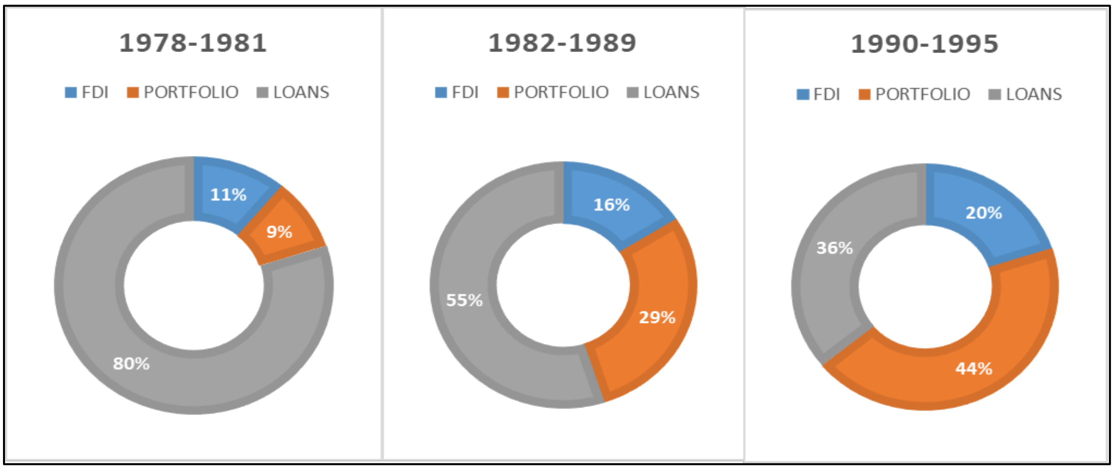

Figure 1.1: Composite of capital inflow

Sources: Bosworth & Collins (1999).

Nowadays, FDI consider as important capital flow as shown in Figure 2 where the FDI become equal to or more compared to bank loans and portfolio investment for the years of 2014 until 2018.

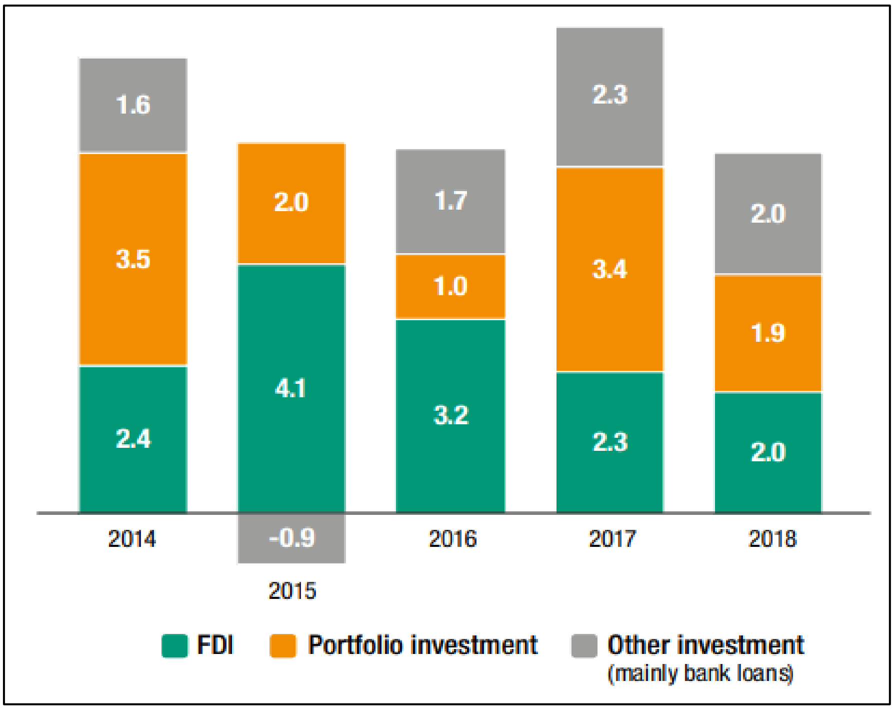

Figure 1.2: Global cross-border capital flows (as % of GDP)

Source: UNCTAD (2019).

FDI has a vital role in cross-border capital flows and is a key component in international economic integration by establishing solid and long-term ties between economies. Foreign Direct Investment (FDI) is often regarded as a crucial component that drives economic expansion (Ghazi et al., 2017; Mohanasundaram & Karthikeyan, 2015; Cambazoglu & Karaalp, 2014; Raluca & Alecsandru, 2012), has a substantial influence on poverty alleviation and boosts employment opportunities (Beloucif et al., 2020). This is because FDI is an important financing source in host countries that provides foreign capital, improve management skills, and create job opportunities, transfer of technology between countries, promotes international trades, especially import and exports through access to foreign markets, improves domestic economic competitions (Protsenko, 2004; Raluca & Alecsandru, 2012) and knowledge (Cambazoglu & Karaalp, 2014).

In the globalization age with the rapid growth of technology and the internet, the foreign investors start to move from developed country to the developing country due of several reasons (Pomfret, 2016). Malaysia is one of the emerging countries that profit from this shift. The FDI inflows trends in Malaysia from the year 1990 can be consider as exciting as highlighted in Figure 1.3 due to the changing of the economic landscape in Malaysia from the first economic sectors (i.e., based on natural resources like fishermen, farmers, and miners) into second economic sectors (i.e., manufacturing) and currently towards the third economic sectors (i.e., servicing like education, and health). The first economic sector comprises the gathering and harvesting of natural resources directly from the Earth; this includes industries such as agriculture, forestry, fishing, mining, and hunting. The main contributors of first economic sectors are farmers, fishermen, miners, loggers, and other individuals directly involved in resource extraction. The second economic sector processes raw resources obtained from the first sector. This comprises manufacturing and construction activities that convert raw resources into final commodities. The main contributors of second economic sectors are factory workers, manufacturers, builders, and individuals involved in industrial and construction processes. Meanwhile, the third economic sector is focused on providing services. This includes a wide range of services such as education, healthcare, finance, transportation, and entertainment. The emphasis is on delivering intangible goods and services. The main contributors of third economic sector are teachers, doctors, bankers, retail workers, information technology professionals, and anyone involved in the provision of services. Kohlhagen (1977) states that the significant rise of foreign investments into the manufacturing sector had an important part in driving the economy's growth from an agricultural-based system to an industrialized one.

Figure 1.3: FDI inflows trends in Malaysia

Source: World Bank (2021).

In addition, FDI trends in Malaysia are on the right track when Malaysia was ranked number three in the FDI attractiveness index among Asia countries for the year of 2019 as shown in Table 1.1.

Table 1.1: FDI attractiveness index of selected Asian countries in 2019

Country	Attractiveness Index	Country	Attractiveness Index
China	0.84	Philippines	-0.01
Thailand	0.84	Sri Lanka	-0.21
Malaysia	0.63	Cambodia	-0.43
Indonesia	0.31	Bangladesh	-0.49
Vietnam	0.25	Myanmar	-0.50

South Korea	0.14	Pakistan	-0.74
India	0.12	Laos	-0.75

Source: World Bank (2019).

Malaysia also has consistently ranked among the top 25 countries worldwide for ease of doing business from year 2006 to 2020. The most notable achievement was in 2014 when Malaysia secured the 6th position, as depicted in Figure 2 below

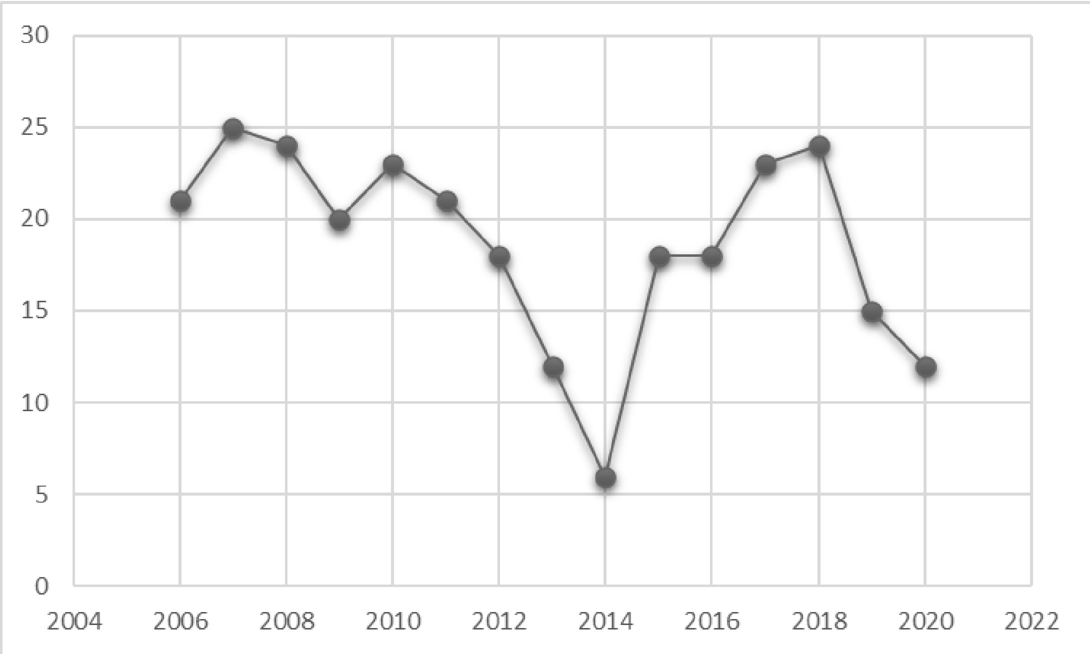

Figure 1.4 Ease of doing business ranking Malaysia from 2006 until 2020.
Source: World Bank (2006 - 2020).

1.2 Background of Study

Malaysia is among the nations endowed with abundant natural resources, but the economic landscape of Malaysia had been changed from year to year from first economic sector to third economic sector. This study focused on the Royal Malaysia Customs Department (RMCD) because the roles of RMCD in the FDI cannot be denied. RMCD is under the administration of Ministry of Finance Malaysia (MoF) responsible to contribute to the Malaysia's revenue every year. The trends of the Malaysian revenue are in the increasing trends for the past 4 year from 2012 until 2019 as shown in Figure 1.4.

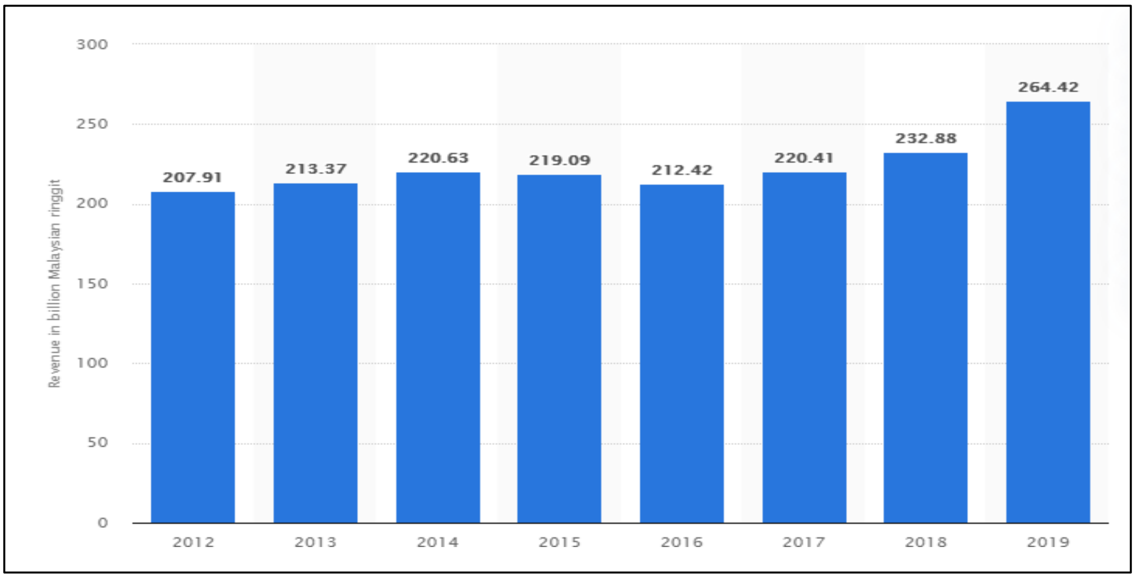

Figure 1.4: Total government revenue in Malaysia (in billion RM)

Source: Statista (2021).

RMCD is responsible to deal with the investors, especially multinational corporations (MNCs) given its role as an intermediary between the investors and government. There are three main job scopes of the RMCD, which are the tax collector, trade facilitator and law enforcer. One of the RMCD job scopes is in charge of collecting Malaysia's indirect taxes. In Malaysia, there are direct and indirect tax as shown in Figure 1.5. Direct tax is the tax when the taxpayers directly pay to the government such as personal property tax, corporate tax, income tax, and real property tax. While indirect tax is the tax paid indirectly to the government through other organizations such as duty import, export duty, consumption tax, excise tax, vehicle levy and windfall profit levy as it can be seen in the Figure 1.5 below. Usually, direct tax in Malaysia is collected through the Inland Revenue Board of Malaysia (IRBM) while the indirect tax is collected through the RMCD as the tax authorities.

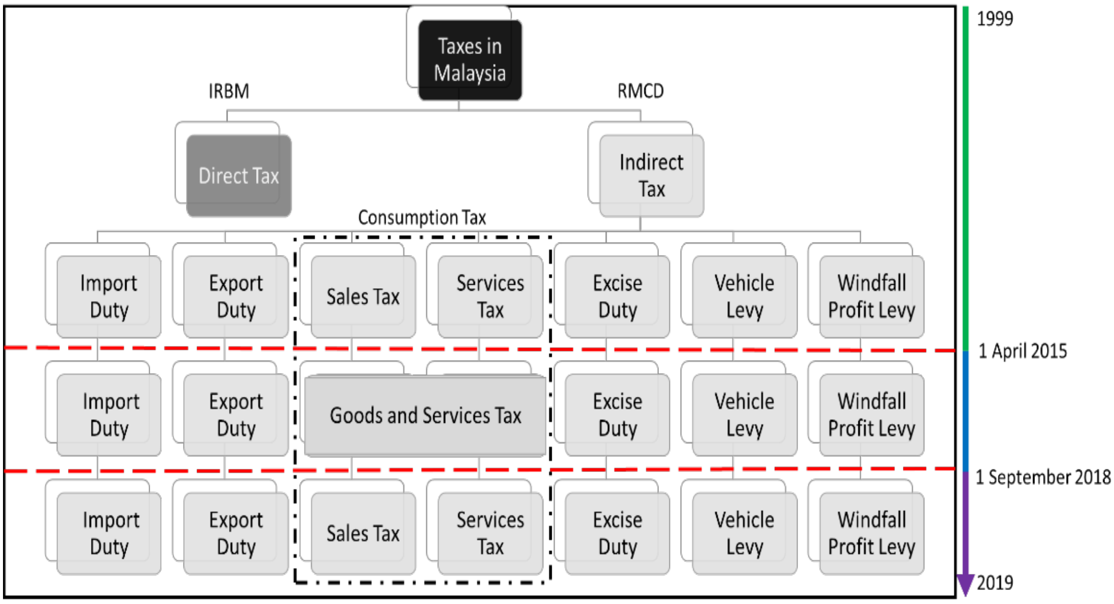

Figure 1.5: Indirect tax structure in Malaysia from 1999 until 2019.

Source: Author's own illustration from compilation of information from RMCD (1999-2018).

Within the period of 20 years, the tabulation of the indirect tax can be referred at Figure 1.6 below in the forms of index. The index's trends were varying from one indirect tax to another. Import duty and export duty were under the same acts which are Customs Act 1967 and shows a different trend throughout the years. While the consumption tax showing a dramatic increase in the year 2015 until 2017 and decreases dramatically in the year of 2018. During that time, there was a significant change in the consumption tax, with sales and services tax (SST) imposed under the Sales Tax Act of 1972 and the Service Tax Act of 1975 prior to 1 April 2015. It was replaced by Goods and Services Tax (GST) under the Goods and Services Tax Act of 2014 till August 31, 2018. On September 1, 2018, the GST was replaced by the sales and services tax (SST) under the Sales Tax Act 2018 and the Service Tax Act 2018 until present. Meanwhile, the Excise Duty show an average increasing for the past 20 years. Excise duty was implemented under the Excise Act 1976. The last indirect tax covers in this study are the vehicle levy where the implementation of this act was under the Goods Vehicle Levy

Act 1983. The trends were in the consistent trends except in the year 2002 and 2018.

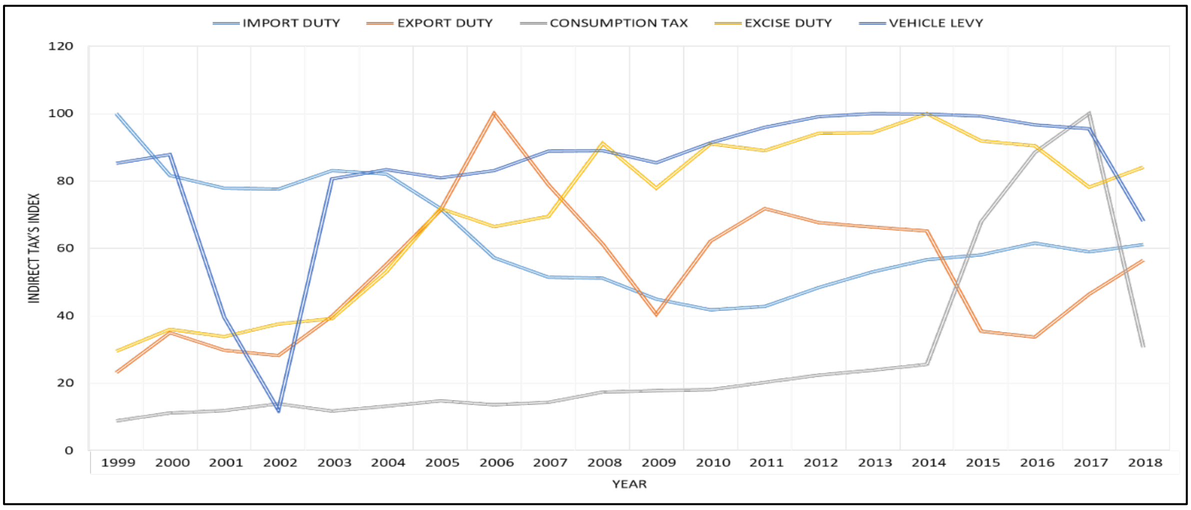

Figure 1.6: Indirect tax' indices in Malaysia.

Source: RMCD (1999-2018).

Other than responsible for the collection of the indirect tax in Malaysia, RMCD also become the intermediaries between the investors with the government which facilitate the best facilitation towards the foreign investors. Numerous trade facilitations were offered by the RMCD to lure FDI into Malaysia and spur economic growth. The facilitation provided by the RMCD was around 10 facilitations. The facilitation was Authorized Economic Operator (AEO), Free Zone (FZ), Free Trade Agreement (FTA), License Manufacturing Warehouse (LMW), Duty Free Shop (DFS) and Treasury Exemption (TE), Inland Container Depot (ICD), public bonded warehouse (GBA), private bonded warehouse (GBP) and PEKEMA bonded warehouse. Those who eligible for each trade facilitation provided by the RMCD usually will enjoy the faster clearance during import and export, reduce cost through tax incentives, improving the connectivity of logistic through dry port and enhancing efficiency of supply chains through warehousing.

Last but not least, RMCD also act as the enforcement agency to make sure the act, rules, regulation, and orders under the customs jurisdiction was followed. As a result, the customs enforcement group will focus on their core mission of combating smuggling efficiently and effectively to guarantee that all rules and regulations administered by the RMCD are fully adhered to. Throughout the years, the most products that always considered as the high-risk products are vehicles, cigarettes, drugs, liquor, textiles, tiles, fireworks and a few others. For the past 11 years, the number of cases of smuggling and fraud that enforcement team had combat was increased from year to years as shown in the Table 1.2 below.

Table 1.2: The summary of smuggling and fraud case (in million RM) in Malaysia

	Number of Cases	Total Products Value	Total Tax
2008	4052	169.27	287.95
2010	5657	507.68	515.15
2012	6881	602.9	435.04
2014	5944	726.58	437.66
2016	6737	446.87	854.05
2018	6799	554.03	828.74

Source: RMCD (various years)

Other than that, there is compliance team that responsible for the tax evasion. The auditing team will perform a systematic audit of the licensees/importers to guarantee that the tax and customs duties are collected properly. In the past 20 years, the structure of compliance team had changed several times according to the changed in the acts and regulation. For the past 12 years, the amount of total tax collected through the audited file was increased dramatically as shown in Table 1.3 below.

Table 1.3: Summary of audited file in Malaysia

	Number of Audited File	Total Tax Collected (million RM)
2008	2080	60.613
2010	2739	69.498
2012	3695	163.872
2014	3833	440.326
2016	3912	779.947
2018	8519	1153.953

Source: RMCD (various years)

1.3 Problem Statement

Basically, FDI inflows into Malaysia were high until before the wake of 1997 financial crisis. Since then, until 2010, the performance has been a bit dismal, but sign of recovery can be seen in the early 2010s. With exception of 2016, the inflows of FDI into Malaysia are generally kept on declining as seen in the Figure 1.3. This downward trend of FDI inflows was also somewhat surprising considering that Malaysia has consistently ranked among the top 25 countries worldwide for ease of doing business from year 2006 to 2020. The most notable achievement was in 2014 when Malaysia secured the 6th position, as depicted in Figure 1.4. Furthermore, Malaysia holds the third position in the FDI attractiveness index among Asian countries, following China and Thailand. Among items included in the measurement of FDI attractiveness are wages, transportation cost, size of the domestic manufacturing industry, country's overall investment climate and the condition of the domestic regulatory environment in supporting business operations.

However, despite these rankings, Malaysia still lags other ASEAN countries such as Singapore, Indonesia, Vietnam, and Thailand in terms of FDI inflows (Cochrane & Mukherjee, 2019). The variations in these trends in Foreign Direct Investment (FDI) prompt inquiries for both policymakers and academia regarding the next critical determinant influencing FDI inflows into Malaysia. Hence, several researches have been conducted regarding the FDI in Malaysia, where Yusop & Roslan (1994) reveal the determinants of FDI in Malaysia were gross national product (GNP), net external reserves, interest rates, manufacturing output/GNP, current profits of foreign-controlled enterprises in Malaysian manufacturing, and total banking system assets. Abdul Karim and Fleming (2012) investigate the effects of market demand, labor productivity, socioeconomic development, and the establishment of industrial estates on FDI. Meanwhile Hamood et al. (2014) identify education, market size, exchange rate, inflation rate and infrastructure while Tusher (2020) identify exchange rate, market size and infrastructure act as the determinants for attracting FDI.

However, the identified determinants do not comprehensive since there is still a lot of others determinant like taxation (Andoh & Cantah, 2020; Nasution, 2020; Nguyen et al., 2020), political stability (Ledyaeva, 2009; Solomon, 2011; Bellinger & Son, 2019), corruption (Habib & Zurawicki, 2002; Brada et al., 2019) and shadow economy (Ali & Bohara, 2017; Huynh et al., 2020; Bayar et al., 2020).

This study focuses on the RMCD because the roles of RMCD in the FDI cannot be denied. Firstly, RMCD responsible for the collection of the indirect tax in Malaysia where Andoh & Cantah (2020), Nasution (2020) and Nguyen et al. (2020) state that tax influenced FDI. Secondly, RMCD also becomes the intermediary between the investors with the government which facilitates the best facilitation towards the foreign investors, especially the tax incentives facilitation, faster clearance, and logistic efficiency through several facilities. Domazet et al. (2020) and Nasution (2020) also identify tax incentives as one of the determinants of the FDI. Third, RMCD acts as the law enforcer that responsible for combating smuggling and tax evasion where smuggling and tax evasion recognized as contributing factors to the shadow economy, influencing FDI (Bayar et al., 2020).

Nevertheless, existing literature has largely overlooked the interplay between Foreign Direct Investment (FDI) inflows, indirect tax, trade facilitation, and the shadow economy. Consequently, all three factors—indirect tax, trade facilitation, and the shadow economy—will collectively be considered as customs activities to examine their impact on FDI, especially given the observed downtrends in Malaysia.

One possible area of improvement could be on changing the tax systems to be more favorable to MNEs or MNCs. Theoretically, FDI will inflow into countries with a better taxation system (Moray et al., 2019). In Malaysia, the major change in indirect tax happened on consumption tax in 2015 where the sales and services tax (SST 1972) were replaced by Goods and Services Tax (GST) in 2015. Unfortunately, the GST was replaced again in 2018 by sales and services tax (2018) due to the political change. Is that the policies restructured and implemented especially indirect tax to make Malaysia favorable to FDI become the causes of the FDI downtrends in Malaysia? Indirect tax, particularly, consumption tax such as GST, has received relatively less attention compared to direct tax, as highlighted by Chong et al. (2019). While there is an abundance of literature on the determinants of Foreign Direct Investment (FDI), there remains a notable gap in the exploration of the impact of consumption tax, particularly the Goods and Services Tax (GST). Although Moray et al. (2019) identifies that there is no significant effect of indirect tax on FDI in India, their study only focuses on the indirect tax (consumption tax) on automobile industries. Moreover, the data used is the projected data, and not the exact data. Hence, this study aims to examine the effect of indirect tax, to be represented by several taxes such as import duty, export duty, consumption tax, excise tax, and vehicle levy on FDI inflows into Malaysia.

Malaysia is one of the countries that offers several trade facilitations in order to compete with other countries to attract the FDI through faster clearance (AEO), reduce cost through tax incentives (FZ, LMW, TE, DFS, FTA), improving connectivity of logistic through dry port (ICD) and enhancing efficiency of supply chain through warehousing (GBA, GBP, PEKEMA). Customs acts as the trade facilitator as Klemm and Parys (2009); Yildiz (2013); Chimilila, Sabuni and Benjamin (2014) determine one of the FDI determinant is trade facilitation. While nearly all countries, including Malaysia, provide trade facilitation to attract Foreign Direct Investment (FDI), it is essential to consider that trade facilitation may introduce security risks and diminish government revenue, a primary source of governmental funds. Over time, the Royal Malaysian Customs Department (RMCD) has consistently enhanced trade facilitation, offering expedited clearance, increased tax incentives, and improved logistics and supply chain support to industries. Nonetheless, government revenue continues to rise, even as the FDI trends display a declining trajectory. The questions arise is that the trade facilitation offers by the Malaysia government especially the RMCD may affect FDI inflows as Malaysia become the country that provides a competitive trade environment for the FDI? Hence, this study conducted in more holistic way includes all the AEO, FZ, LMW, TE, DFS, FTA, ICD, GBA, GBP and PEKEMA rather than only AKFTA as conducted by Oh and Kyophilavong, (2014) and tax incentives as conducted by Rochananonda (2006).

Shadow economy as a crucial FDI's determinant (Deilami, 2010; Nikopour et al., 2009; Davidescu & Strat, 2015). The issues of smuggling and tax evasion was identified as one of the shadow economy's causes that effects the FDI (Bayar, et al, 2020). One of the primary functions of customs is to serve as enforcers and auditors, specifically addressing issues related to smuggling and tax evasion by licensees or importers. The shadow economy disrupts market functions, acting as a phenomenon that erodes the formal economy by capitalizing on opportunities arising from non-synchronization and indecision, infiltrating any gaps left open by the formal economy (Mara, 2011). Regrettably, constructing a robust theoretical model and obtaining precise empirical information about underground activities, particularly within the subset of the shadow economy, proves challenging. This difficulty arises as individuals involved in these activities intentionally seek to remain unidentified (Kanniainen et al., 2004). For economists, assessing the origins and causes of the shadow economy poses a challenging endeavor (Schneider & Torgler, 2007; Torgler et al., 2010). Despite the absence of clear official indicators, an extensive body of literature has endeavored to estimate the shadow economy, alternatively referred to as the informal or underground economy, over the last three decades (Schneider & Torgler, 2007; Gupta & Abed, 2002). Due to that, this study was unique as it will use RMCD's official indicators as shadow economy represents by total amount of the tax collected by the enforcement team (smuggling) and compliance team (audited file). Theoretically, shadow economy had bidirectional effects on FDI in a host country. Okada & Samreth (2014), Davidescu & Strat (2015) and Jones & Temouri (2016) state that investors exhibit a tendency to invest in developing economies characterized by unclear legislation, elevated levels of corruption, and the presence of tax havens while Castro & Nunes (2013); Tanzi & Fund, (2014); Fahad, (2016), reveal that elevated levels of shadow economies might deter FDI owing to the unacceptably high business environment uncertainty stemming from inadequate control and corruption. Thus, this study seeks to investigate the impact of the shadow economy on FDI in

Malaysia, utilizing data from both smuggling and tax evasion activities obtained from the Royal Malaysian Customs Department (RMCD).

1.4 Research Questions

This study aims to address three key research questions. These questions aim to provide a comprehensive understanding of the factors influencing FDI in Malaysia.

i. What is the implication of indirect tax on FDI in Malaysia?
ii. What is the effect of trade facilitation on FDI inflows into Malaysia?
iii. Does the shadow economy affect FDI inflows into Malaysia?

1.5 Research Objectives

The objective of this study is to examine the effect of customs activities—specifically indirect tax, trade facilitation, and the shadow economy—on FDI inflows into Malaysia. This overarching goal is further broken down into three specific sub-objectives. These objectives aim to provide a comprehensive understanding of how customs-related factors influence foreign direct investment in Malaysia.

i. To analyze the role of indirect tax on FDI inflows into Malaysia.
ii. To investigate the effect of trade facilitation on FDI inflows into Malaysia.
iii. To examine the implications of the shadow economy on FDI inflows into Malaysia.

1.6 Scope of Study

This study focuses on Malaysia economies only because the indirect tax in Malaysia unique especially the consumption tax. The indirect tax in this study focused under the RMCD jurisdiction only. In addition, although there are another new two taxes imposed in Malaysia under the RMCD jurisdiction which are the tourism tax under the tourism tax act 2017 and excise tax on the Sugar-Sweetened Beverages under the excise Act 1976, these two taxes were not included in this study. This is because these two taxes are still new in Malaysia where the implementation of the tourism tax is on 1st September 2017 while for the Sugar-Sweetened Beverages is on 1st July 2019. The study utilizes 20 years of data from 1999 to 2018 that is reported in the RMCD annual report for each of the indirect tax. Secondly, for the trade facilitation, the scope of the study limited to the facility offers by the RMCD only, not included the tax incentives provided by the IRBM for the direct tax. While for the shadow economy variables used the measurement from the RMCD data for the smuggling and tax evasion only not included the others measurement.

1.7 Significance of Study

This study has a significance towards practice when the result of this study will benefit a few parties like Malaysia government agencies, specifically the Ministry of Finance (MoF) through RMCD by improving the taxation system from time to time in order to attract the foreign investors and achieve the vision and mission of the organization in order to become world class customs. The increasing numbers of foreign investors invest in Malaysia would benefit the economic growth of the country. Other than that, this study also would open the eyes of the politician in Malaysia about the effect of indirect tax in Malaysia and will give clearer pictures about it.

Other than practice, this study also significant towards body of knowledge. The study regarding tax on FDI previously more focusing on the direct tax except a few studies like (Desai & Hines, 2003); Beck & Chaves, (2012); Moray et al., (2019). Although there are a few studies related to the indirect tax, this study was necessary due to the freshness of the data and the comprehensiveness of the indirect tax in Malaysia. This study used all the 5 different indirect taxes under the RMCD rather individually rather than as group like study conducted by Desai et al. (2002). Beck & Chaves (2012) only measure consumption tax as the indirect tax while Moray et al. (2019) only investigate the indirect tax from the angle of the automobile industry. Moreover, this study significance to the policy makers, especially government of Malaysia, Ministry of Finance and RMCD itself to understand all the trade facilitation offered and implemented in Malaysia that should be carefully decided because trade facilitation offers may reduce the government revenue; It has become a dilemma to the customs administration to balance the trade facilitation with the revenue. In additions, this study contributes the new official indicators of the shadow economy as the indicators of shadow economy is difficult to estimate (Torgler et al., 2009; Abed & Gupta, 2012).

The integration of a few studies (indirect tax, trade facilitation and shadow economy) in one proposed model will create a new knowledge in investment itself. A new setting of target population in this study also may contribute towards new findings. In addition, this study can benefit other researchers, especially in the field taxation, trade facilitation, shadow economy, economic and investment from viewing the FDI from the other angles and filling gaps in the existing knowledge.

1.8 Key terms

1.8.1 Indirect tax

Indirect tax is the tax paid indirectly to the government through other organizations such as manufacturer, importer, exporter, traders, sellers or any others organizations.

1.8.2 Export duty

Export duty is a levy imposed on goods intended for removal from Malaysia, whether transported by land, sea, air, or any other means, or placed in a conveyance for the purpose of exiting Malaysia. The ad valorem rates of export duty span from 0% to 15%, contingent on the classification of the goods.

1.8.3 Import duty

Import duty is a tariff imposed on goods intended to be brought into Malaysia, whether transported by land, sea, air, or any other means. The ad valorem rates of import duty vary from 0% to 50%, contingent on the classification of the goods.

1.8.4 Consumption tax

Consumption tax is a levy imposed on the consumption of goods or services, which transitioned from Sales and Services Tax (SST) to Goods and Services Tax (GST) and subsequently back to SST. The rates and mechanisms have varied in accordance with the imposed legislation.

1.8.5 Excise tax

Excise tax is applied to specific goods imported into or produced in Malaysia at the point of manufacturing rather than at the point of sale. The goods subject to excise tax include liquor, cigarettes, tobacco and tobacco products, motor vehicles, playing cards, and mahjong tiles.

1.8.6 Vehicle levy

The vehicle levy is a charge imposed on all goods vehicles departing from or entering Malaysia, along with related and incidental matters.

1.8.7 Trade facilitation

Trade facilitation in this study refers to trade facilitation provided by or control by the RMCD through faster clearance (AEO), reduce cost through tax incentives (FZ, LMW, TE, DFS, FTA), improving the connectivity of logistic through dry port (ICD) and enhancing efficiency of supply chains through warehousing (GBA, GBP, PEKEMA).

1.8.8 AEO

The Authorized Economic Operator is a secure supply chain program established by the Royal Malaysian Customs Department (RMCD) under the SAFE Framework Standards (FoS). It aims to facilitate trade by offering benefits and incentives to trusted traders, fortifying supply chain security against potential threats, and promoting compliance with customs and trade regulations.

1.8.9 FZ

A Free Zone (FZ), which includes Free Industrial Zone (FIZ) and Free Commercial Zone (FCZ), is a component of the Special Economic Zone or Export Processing Zone, as termed in other countries. A Free Zone is a specified geographic area within a country that grants exemptions from customs duties, taxes, and specific regulations, thereby promoting trade and investment. Free zones typically offer infrastructure, logistics support, simplified administrative procedures, and access to a skilled workforce.

1.8.10 LMW

Licensed Manufacturing Warehouse (LMW) allows companies to avail themselves of customs duty relief and consumption tax exemptions when processing imported goods and exporting the finished products. While sharing similar objectives with Free Zones (FZ), LMW provides greater flexibility in selecting the location within Malaysia, as opposed to being confined to specific gazette areas.

1.8.11 TE

Treasury Exemption (TE) is a privilege that entails duty and tax exemption on goods, bestowed by the Ministry of Finance Malaysia under Section 14(2) of the Customs Act 1967, Section 10 of the Sales Tax Act 1972, and Section 11(2) of the Excise Act 1976. This exemption is designed to lower procurement costs for raw materials, components, machinery, equipment, and accessories that are not available locally. The primary objectives are to foster the development of export-oriented local industries and decrease production costs to enhance competitiveness in international markets.

1.8.12 DFS

DFS, or Duty-Free Shopping, enables international travellers and businesses to enjoy savings on goods at airports and travel hubs. In Malaysia, there are five types of duty-free shops categorized based on their location, which can be in airports, border areas, seaports, cities, or within the country. Duty-free shops, as defined under section 65D of the Customs Act 1967, refer to any licensed place for warehousing and selling dutiable goods without duties. The establishment of duty-free shops aims to boost the tourism industry in Malaysia, particularly targeting foreign tourists.

1.8.13 FTA

A Free Trade Agreement (FTA) is a pact that establishes preferential treatment in each market for the countries involved, with the aim of reducing trade barriers and fostering economic integration among the participating nations. FTAs come with tax exemptions. There are two main types of FTAs: bilateral trade agreements and multilateral trade agreements, sometimes called to as Regional Trade Agreements (RTAs). This study focuses on seven bilateral trade agreements between Malaysia and Japan (MJEPA), Pakistan (MPCEPA), New Zealand (MNZFTA), India (MICECA), Chile (MCFTA), and Turkey (MTFTA). Additionally, there are ten multilateral agreements within the Association of Southeast Asian Nations (ASEAN) with Australia, China, Hong Kong, Japan, India, New Zealand, and the Republic of Korea, dating back to 1992. Three other multilateral FTAs include the Developing Eight (D-8) Preferential Tariff Agreement (PTA), the Regional Comprehensive Economic Partnership (RCEP), and the Comprehensive and Progressive Agreement for the Trans-Pacific Partnership (CPTPP). Meanwhile, the Malaysia-European Free Trade Association Economic Partnership Agreement (MEEPA) is currently under negotiation.

1.8.14 ICD

The Inland Container Depot (ICD), also recognized as a dry port in other countries, is an inland terminal situated within a country, regardless of whether it has seaports. ICDs furnish handling and storage services for containerized or empty cargo, facilitating import and export activities. These depots are equipped with fixed installations that provide services for the handling and temporary storage of various types of goods under customs control.

1.8.15 GBA

A Public Bonded Warehouse (GBA) is a secure storage facility where imported goods can be stored without the obligation to pay import duties, taxes, and other charges. These goods can remain in the warehouse until they are either exported or released for domestic consumption. The facility is open to any depositors.

1.8.16 GBP

A Private Bonded Warehouse (GBP) is a secure storage facility where imported goods can be stored without the need to pay import duties, taxes, and other charges. These goods can remain in the warehouse until they are either exported or released for domestic consumption. Importantly, a private bonded warehouse is exclusively for the storage of the goods of the entity that owns the facility and is not open for the storage of goods belonging to other entities.

1.8.17 PEKEMA

PEKEMA bonded warehouse is specifically to store the dutiable vehicles in the warehouse without payment of import duties, taxes, and other charges until they are either exported or released for domestic consumption. The operators must register under Association of Malay Importers and Traders of Motor Vehicles of Malaysia (PEKEMA) and have an Approved Permit (AP) from Ministry of International Trade and Industry (MITI).

1.8.18 Shadow economy

Shadow economy in this study refers to the illegal activities (smuggling) that are under the RMCD’s enforcement team and tax evasion under the RMCD’s auditing team.

1.8.19 Smuggling

Smuggling refers to the illicit activity of transporting, importing, or exporting goods, products, or items across national borders or within a country's territory without adhering to the prescribed customs procedures. This includes not complying with obligations such as paying customs duties or taxes, and disregarding legal regulations or restrictions, particularly for illegal and hazardous goods. Smuggling typically entails circumventing government controls, tariffs, or import/export restrictions with the aim of evading law enforcement and attaining financial advantages.

1.8.20 Tax Evasion

Tax evasion constitutes an illegal act or non-compliance with tax regulations through various methods, including not declaring or non-reporting income, undervaluing assets, misreporting financial information, making false entries, and engaging in fraudulent activities. It involves individuals intentionally providing inaccurate information on their tax returns or employing dishonest tactics to reduce the amount of taxes owed, actions that are against the law.

1.9 Organization of Study

To address the research questions and objectives outlined earlier, the study is organized into five chapters. Chapter one introduces the topic of Foreign Direct Investment (FDI) and provides background information on the Royal Malaysian Customs Department (RMCD). This is followed by a discussion of research problems, questions, objectives, the scope of the study, significance, and key terms. Chapter two conducts a theoretical review of the basic theory of FDI, followed by an empirical review focusing on market size, trade, and customs activities influencing FDI. The roles of customs, including details on taxation, trade facilitation, and the shadow economy, are also explored. In chapter three, methodological information such as empirical model specification, measurement methods, estimation procedures, and data sources is presented. Chapter four unveils the results of the analysis and provides a discussion of the findings obtained from the empirical analysis. The final chapter, chapter five, offers a summary of the study, recommendations for practice, limitations of the study, and suggestions for future research.