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TAX COMPLIANCE BEHAVIOUR OF INDIVIDUALS UNDER SELF ASSESSMENT SYSTEM

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Tax non-compliance has always been a major concern for all tax administrations, more so in a self assessment environment where it is dependent on voluntary compliance. In Malaysia, there is a dearth of empirical research on tax compliance in relation to the implementation of self assessment which only began in 2001 for corporations and 2004 for individual taxpayers. One of the objectives for implementing self assessment is to increase voluntary tax compliance.

As such, in a tax system based largely on voluntary compliance, understanding factors that affect compliance amongst individual taxpayers is of vital importance. This thesis integrates two important approaches, namely, the economic and behavioral approaches in examining factors affecting tax compliance. The factors examined include perceived probability of detection, prior tax audit, sanction perception, perception of fairness, perceived moral intensity and peer influence.

The data for this study were gathered by using a mail survey. Descriptive analysis and multivariate analysis were performed on the data to determine how the above

mentioned factors affect tax compliance behavior. The findings showed that four factors, namely, perceived probability of detection, sanction perception, perceived moral intensity and peer influence were found to have significant relationships with tax compliance. On the other hand, perception of fairness and prior tax audit were found to have insignificant relationships with tax compliance.

However, even though prior tax audit did not have a direct effect on tax compliance, it was found to be significantly associated with perceived probability of detection which is significantly related to tax compliance. This implies that prior tax audit has an indirect effect on tax compliance. Apart from prior tax audit affecting perceived probability of detection, another factor examined namely sanction perception was found to affect perceived probability of detection. In relation to perceived probability of detection and perceived moral intensity which had significant relationships with tax compliance respectively, the findings also indicated that both perceived probability of detection and perceived moral intensity had significant relationships with perception of fairness.

Understanding these relationships is important as it not only extends knowledge on improving tax compliance but also provides useful information for the revenue collection authorities in designing better tax policies.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Doktor Falsafah

PERLAKUAN PEMATUHAN CUKAI INDIVIDU DI BAWAH SISTEM TAKSIR SENDIRI

Oleh

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Ketidakpatuhan cukai merupakan satu perkara utama yang sering diberi perhatian oleh semua pentadbir cukai, lebih-lebih lagi di bawah persekitaran sistem taksir sendiri yang sangat bergantung kepada pematuhan sukarela. Di Malaysia, hanya terdapat segelintir kajian empirikal mengenai pematuhan cukai yang berkait dengan perlaksanaan taksiran sendiri yang hanya bermula pada tahun 2001 untuk syarikat dan tahun 2004 untuk pembayar cukai individu. Salah satu dari objektif perlaksanaan taksiran sendiri adalah untuk meningkatkan pematuhan cukai secara sukarela.

Justeru itu, dalam suatu sistem percukaian yang sebahagian besarnya bergantung kepada pematuhan sukarela, adalah sangat penting untuk memahami faktor-faktor yang mempengaruhi pematuhan di kalangan pembayar cukai individu. Tesis ini menggabungkan dua pendekatan penting iaitu pendekatan ekonomi dan pendekatan perlakuan dalam mengkaji faktor-faktor yang mempengaruhi pematuhan cukai. Faktor-faktor yang dikaji termasuk persepsi probabiliti dikesan,

pengalaman pernah diaudit, persepsi hukuman, persepsi keadilan, persepsi intensiti moral dan pengaruh kenalan.

Data kajian ini diperolehi dengan menggunakan borang soal selidik yang diedarkan melalui pos. Analisa deskriptif dan analisa "multivariate" dilakukan untuk menentukan bagaimana faktor-faktor tersebut mempengaruhi perlakuan pematuhan cukai. Hasil penemuan menunjukkan bahawa empat (4) faktor merangkumi persepsi probabiliti dikesan, persepsi hukuman, persepsi intensiti moral dan pengaruh kenalan mempunyai hubungan signifikan dengan pematuhan cukai. Manakala, persepsi keadilan dan pengalaman pernah diaudit didapati mempunyai hubungan yang tidak signifikan dengan pematuhan cukai.

Sungguhpun pengalaman pernah diaudit tidak mempunyai pengaruh secara langsung ke atas pematuhan cukai, ia didapati mempunyai hubungan signifikan dengan persepsi probabiliti dikesan yang mana mempunyai hubungan signifikan dengan pematuhan cukai. Ini memberi implikasi bahawa pengalaman pernah diaudit mempunyai pengaruh tidak langsung ke atas pematuhan cukai. Selain dari faktur pengalaman pernah diaudit mempunyai pengaruh ke atas persepsi probabiliti dikesan, faktor persepsi hukuman yang dikaji juga didapati mempengaruhi persepsi probabiliti dikesan. Merujuk kepada persepsi probabiliti dikesan dan persepsi intensiti moral yang masing-masing mempunyai hubungan signifikan dengan pematuhan cukai, hasil penemuan juga menunjukkan bahawa kedua-dua persepsi probabiliti dikesan dan persepsi intensiti moral juga mempunyai hubungan signifikan dengan persepsi keadilan.

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Pemahaman ke atas hubungan-hubungan ini adalah penting kerana ia bukan sahaja dapat memperluaskan pengetahuan mengenai pematuhan cukai malah dapat menyumbang maklumat kepada pihak berkuasa yang mengutip cukai dalam menggubal polisi cukai yang lebih baik.

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LIST OF ABBREVIATIONS

ATO	Australian Tax Office
GDP	Gross Domestic Product
IRB	Inland Revenue Board
IRS	Internal Revenue Service
LISREL	Linear Structural Relation
OAS	Official Assessment System
SAS	Self Assessment System
SEM	Structural Equation Modeling
SPSS	Statistical Package for the Social Sciences
TCMP	Taxpayer Compliance Measurement Program

CHAPTER 1

INTRODUCTION

1.1 Background of the Research

Tax non-compliance is an area of concern for all government and tax authorities, and it will continue to be an important issue that must be addressed. As stated by Andreoni, Erard and Feinstein (1998), "the problem of tax compliance is as old as taxes itself" (p. 818). Kasipillai (1997) noted that deliberate non-compliance is a perennial problem in many countries. It is a substantive problem that transcends cultural and political boundaries (Hasseldine and Li, 1999). Therefore, regardless of time and place, the main issue faced by all tax authorities is that it has never been easy to persuade all taxpayers to comply with the regulations of a tax system.

The issue of tax compliance is now likely to be a more significant aspect of tax policy, with developments such as the implementation of self assessment, the emergence of global economy and electronic commerce. These developments together with better informed and knowledgeable taxpayers may be viewed as providing more opportunities for non-compliance among taxpayers, and thus present greater challenges to the tax authorities.

Non-compliance with the tax laws may take a variety of forms. For example, non-compliance occurs when individuals and firms under-report their income, sales or over-claim deductions, exemptions or credits resulting in tax evasion or fail to file appropriate tax returns or to make tax payments in accordance with the tax laws. In

view of these, the tax authority or the government must take actions to ensure compliance with the tax law. It may therefore be necessary for some revenue authorities to rely on harsher enforcement regime to achieve a certain level of compliance.

The most frequent form of tax non-compliance is tax evasion. Tax evasion is an extreme form of non-compliance (James, Hasseldine, Hite and Toumi, 2001). According to Spicer (1975), tax evasion is defined as the reduction of tax liability by illegal or fraudulent means. It shares the basic component of other white collar crimes such as cheating, lying and theft. (Bergman, 1998). It should be distinguished from tax avoidance, which is the reduction of tax liability by taking advantage of provisions in the tax laws.

Non-compliance in the form of tax evasion is difficult to measure as it involves searching for incidents that are not necessarily detected by the revenue authorities (Hasseldine and Bebbington, 1991). There are two main approaches used to measure the magnitude of evasion, namely the microeconomic and macroeconomic approaches. The microeconomic approach involves measuring and analyzing the extent of evasion from tax audit procedures whilst the macroeconomic approach involves a comparison of statistics furnished by taxpayers with corresponding national statistics or data.

Tax compliance is important for many reasons. This is because non-compliance leads to a reduction in tax collections, which in turn affects public services received by the citizens, including compliant taxpayers. It also requires the

government to expend resources to deter non-compliance, to detect its magnitude and to penalise its practitioners. According to Brand (1996), it is less expensive to collect taxes through voluntary compliance than through the use of enforcement. The cost of tax administration is two-fold, comprising the cost of the agency needed to administer tax laws and the larger cost to the public and businesses of complying with them.

Non-compliance also alters the distribution of income in unpredictable ways, such as by shifting the costs of taxation from dishonest persons to honest taxpayers and also limits the capacity of the government to discharge its important functions. As such, non-compliance can contribute to feelings of unfair treatment and disrespect for the law. According to Clotfelter (1983), non-compliance not only causes loss of current income to the government but its existence also fosters disenchantment over taxes and poses a serious threat towards voluntary tax compliance by the majority.

Tax non-compliance has thus become a serious problem because it threatens both the integrity of income tax systems themselves, and more generally, the ability of citizens of a country to democratically determine what goods and services they wish to provide one another collectively through their government (Adhikari, 2002). Even though tax administrators may never be able to completely solve the problem of non-compliance, adequate efforts should and must be taken to ensure that they are moving in the right direction to increase tax compliance, even though the policies involved may be carried out slowly. There is no quick solution to the

non-compliance problem and this is a challenge that must be faced by all tax authorities.

1.2   Brief Overview of the Malaysian Tax System

The Malaysian income tax system has undergone a major change from the Official Assessment System (OAS) which was implemented from 1947 to 2000 to the Self Assessment System (SAS) which commenced in 2001. When first introduced, the SAS was implemented only on corporations until 2004, when it was extended to sole proprietors, partnerships, cooperatives and salaried workers. One of the objectives of implementing self assessment is to increase the level of tax compliance through voluntary compliance by the people, which is the main thrust of the system. As such, the implementation of SAS does have implications on compliance because under the SAS, taxpayers have more responsibilities as compared to what was required of them under the OAS.

Under the OAS, taxpayers were only required to complete and submit their income tax form together with the relevant supporting documents to the Inland Revenue Board (IRB) for computation of the amount of tax payable. The calculation of tax liability was done by the IRB and a Notice of Assessment would be sent to the taxpayer for making the due payment. However, under the SAS, it is the responsibility of the taxpayer rather than the IRB to compute the relevant tax liability. Moreover, supporting documents are not required when submitting the income tax form. These supporting documents are only required to be furnished when the taxpayer is being audited.

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Therefore, under the SAS, tax compliance is very much dependent on the honesty of the taxpayers in declaring their actual income and claiming the actual expenses in computing their tax liability. The most important method used to detect non-compliance in this context is through a tax audit. Tax audit involves making field visits to taxpayers' business premises to verify the information disclosed in their tax returns with the relevant accounting records and source documents. Taxpayers would be penalised on any discrepancy found in the process of the audit. However, tax audits cannot be carried out on each and every taxpayer in a year due to constraints in terms of time and manpower. The statistics on tax audits carried out in Malaysia on individual business cases from 2002 to 2006 are shown in Table 1.1.

Table 1.1
Tax Audit on Individual Business Files

Year	*Business Files	No. of Cases	Additional Tax (RM)	Penalty (RM)
2002	1,130,062	1,211	16,568,501	9,605,301
2003	1,132,592	1,584	30,055,941	15,757,786
2004	1,137,720	3,022	73,130,206	40,874,004
2005	1,314,006	4,901	123,134,230	70,078,296
2006	1,380,648	4,314	110,632,997	64,667,325

*Active Individual Business Files
(Source: IRB Annual Reports from 2002 to 2006).

Based on Table 1.1, it can be observed that the number of business files selected for audits is relatively low as compared to the number of existing business files. Despite the small proportion of cases selected for audits, large amounts of tax were discovered to be owed by the taxpayers. It is, however, difficult to ascertain

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whether this is the result of widespread tax non-compliance, i.e. tax evasion or successful targeting of errant taxpayers to be audited. Another reason for the above observation could be due to the capability or expertise of the tax officers in detecting non-compliance when carrying out an audit. In this regard, the perception of taxpayers or their perceived probability of being detected should they fail to comply with the tax laws would be of great importance to deter non-compliance.

According to the IRB Chief Executive Officer, the number of tax defaulters increased by almost 10 times within two years, from 25,160 in 2003 to 239,666 in 2005. (The Star, 2006). These offences included failure to submit returns, declaring false entries and others. As of May 2006, a total of 21,251 civil summonses were issued amounting to RM8.17 billion, including the amount of unsettled taxes due to the failure of taxpayers in making payment promptly.

A study carried out by Kasipillai (1997) in Malaysia suggested that tax evasion accounted for an average of around 20% of actual income tax collections over a 25 year period ending 31 December 1994. A currency demand approach was used to develop plausible estimates of the size of the hidden economy and tax evasion in Malaysia for the period between 1971 and 1994. The currency demand approach assumes that hidden economic transactions are undertaken in the form of cash payments and any increase in the hidden economy would therefore increase the demand for currency.

In another study by Schneider and Enste (2000), the size of the hidden economy in Malaysia was estimated to be in the range of 38% to 50% of Gross Domestic Product (GDP), between 1990 and 1993. Their calculation was based on the physical input (electricity) and currency demand approaches. Based on the physical input (electricity) approach, it is assumed that electricity consumption is the single best physical indicator of overall economic activity. As such, the hidden economy is estimated by computing the difference between the growth of official GDP and the growth of electricity consumption.

The above scenarios indicate that non-compliance is an important issue that calls for serious attention. Steps must be taken to minimise or control the widespread of non-compliance and at the same time, attempt to resolve the current non-compliance problem. In other words, there is a need to institute measures that not only enforce but must also foster voluntary tax compliance.

1.3   Problem Statement

Over the last two decades, tax compliance research has escalated especially in countries such as the United States, Australia, Netherlands and Sweden. Nevertheless, there are still some issues that are in need of further investigation. For example, research into the uncertainty effects of audits is continuing and clearcut conclusions are not easy or indeed feasible (Hasseldine, 1993). Issues on the effectiveness of tax audit as well as on alternative sanction mechanisms used by the tax authorities in influencing taxpayer reporting decisions still remain as research problems till today (Hasseldine, 2005). According to Andreoni et al.

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