PERSONAL INCOME TAX NON-COMPLIANCE IN MALAYSIA

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EXECUTIVE SUMMARY

A modern tax system was first introduced into the Federation of Malaya by the British in 1947. This was subsequently repealed and replaced by the *Income Tax Act 1967*, which came into effect on 1 January 1968. Subsequently, the Inland Revenue Board (IRB), formerly known as the Inland Revenue Department (IRD), was created as the government agency that has the responsibility for collecting income taxes for Malaysia. As with other tax collecting agencies, it has to deal with the problem of income tax non-compliance.

It is important to combat income tax non-compliance, for if it becomes widespread it can have a major impact on the structure of prices, on the effectiveness of macroeconomic policy and on the trust of taxpayers that the government is concerned with distributional justice. Various strategies have been introduced by the IRD/IRB to overcome this problem and, while there is some literature, there has as yet been no comprehensive study of this income tax non-compliance for Malaysia. This research is being undertaken to make some contribution to filling this gap. The study begins by reviewing the literature on the various dimensions of tax non-compliance and examining some of the initiatives that have been introduced by the Australian Tax Office (ATO). It then attempts to document the extent of income tax non-compliance in Malaysia, to analyse the main characteristics of income tax non-compliance in that country and to propose some improved strategies for overcoming this problem.

In addition to the use of published or unpublished statistical data collected by others, this analysis of income tax non-compliance in Malaysia makes use of two types of data collected by the author. The first is referred to as the *file data*, where details are recorded of 507 taxation files of individuals identified as non-compliant by the IRB. The second is referred to as the *interview data*, which records the results of an interview survey by the author of the views of fifteen taxation officers in each of four branches of IRB concerning non-compliance.

The Extent of Income Tax Non-Compliance in Malaysia

In exploring the extent of non-compliance in Malaysia for the years of 1995, 1996 and 1997, we adopt three different types of analysis. First, the *gap approach* measures the dollar value of non-compliance in terms of income unreported. The second type of analysis approaches non-compliance in terms of the filing of annual tax returns by registered taxpayers. Lastly, the third assesses the views of experienced taxation officers regarding the seriousness of this problem in Malaysia.

The Income Tax Gap Approach

In the *gap approach*, the gap between a measure of taxable income derived from the national accounts data for gross national income and total taxable income as assessed by the IRB gives the estimated dollar value of non-compliance for the whole system. Besides estimating the rate of non-compliance in Malaysia using this approach, we also estimate the rate of non-compliance in Australia and review work done by Park (2000, pp. 12-22) for the U.S. Department of Commerce on personal income tax non-compliance in the U.S. This enables us to compare and contrast this problem in Malaysia, Australia and the U.S.

The resulting estimates of the taxable income gap for Malaysia for the years 1995-97 range from RM75.3 billion in 1995 to RM99.1 billion in 1997; in proportional terms they lie between 47.2 per cent and 49.4 per cent of the derived taxable income to the IRD/IRB in the three years under study. That is, *about 48 per cent of derived taxable income is not captured in reported taxable income in Malaysia.* In contrast, the estimates of the income tax gap for Australia for the years 1994/95, 1995/96 and 1996/97 lie between A$14.1 billion and A$24.8 billion, or between 3.8 per cent and 7.1 per cent of its derived taxable income. Thus the estimates prepared for these two countries, using a similar methodology, suggest that the income tax gap is very much higher in Malaysia than in Australia, in proportional terms. This conclusion that the Malaysian gap is relatively high is reinforced by estimates from the U.S. Department of Commerce, that in the U.S. the gap in terms of personal income is 10-12 per cent of derived taxable income.

There are two potential reasons for a low ratio of actual to derived taxable income. One is *coverage*: the possibility that the coverage of the taxation law is

limited, so that a significant proportion of derived taxable income is not legally liable for tax. The other is *non-compliance*: the possibility that a significant proportion of derived taxable income, while legally liable for tax, is subject to non-compliance and does not in fact lead to tax being paid. Based on an interim analysis of the question of the coverage of the Malaysian income tax system, it is evident that the coverage of that system is much lower than in Australia and other developed countries. In part, this difference is due to the current stage of development of the Malaysian economy, but it is also partly due to specific features of Malaysia's economic and fiscal strategy.

The finding that only about 52 per cent of derived taxable income, estimated primarily from national accounting sources, is captured in reported taxable income in Malaysia compared to about 95 per cent for total income tax in Australia, is a very striking one. Hence it can be regarded as highly likely that both of the possible explanations – low coverage and a high level of non-compliance – are significant contributing factors to the outcome. It has not been possible to quantify the relative contributions of low coverage and high non-compliance to the explanation of the high income tax gap. Thus this high gap, while providing a strong indicator of a substantial level of income tax non-compliance, does not lead to a quantitative estimate of this level. Hence we proceed to some other methods to throw light on the extent of income tax non-compliance in Malaysia.

Information from Filing of Tax Returns
The second approach measures the extent of failure to file annual tax returns among registered taxpayers who have been issued with the annual tax return forms. Subject to various qualifications, the gap between the annual tax return forms issued and the completed annual tax returns provides a measure of the failure to file annual tax returns. The results show that on the average 29.1 per cent of total registered taxpayers failed to file their annual returns and 27.8 per cent of individual registered taxpayers failed to file their annual tax returns in the years of 1995, 1996 and 1997. In 1997 over 800,000 issued forms, or 30.5 per cent of the total, were not returned. As for individual taxpayers, over 700,000 or 30.4 per cent of issued forms in 1997 were not retuned. Among companies and

other organisations the non-return rate in 1997 was 30.9 per cent. While there are many reasons other than tax non-compliance for failure to return annual tax forms to the IRB, the high non-return rate of issued forms constitutes powerful evidence of persistent income tax non-compliance in Malaysia.

The Views of Tax Officers

The third approach is to seek the views of experienced income tax officers regarding the seriousness of this problem in Malaysia. A survey of 60 tax officers in four branches of the IRB found that *85 per cent* of our respondents were of the opinion that income tax non-compliance in Malaysia is either at a serious or very serious stage.

Conclusions

In spite of the various limitations addressed in the text, the three indicators that are studied in Chapters Six and Seven all point to a similar conclusion, that the level of income tax non-compliance in Malaysia is high. About 48 per cent of derived taxable income is not included in reported taxable income in Malaysia, by comparison with about 5 per cent for Australia. While variations in income tax coverage explain a significant part of this difference, much must also be due to lower compliance levels in Malaysia. Over 800,000 issued tax forms, or 30.5 per cent of the total issued, were not returned in the form of income tax returns in Malaysia during 1995 - 1997. Again, while other factors explain part of this high non-return rate, it remains powerful evidence of persistent income tax non-compliance. Finally, 85 per cent of a group of sixty experienced tax officers interviewed were of the opinion that income tax non-compliance in Malaysia is either serious or very serious. Thus, while this research has not been able to provide a firm quantitative estimate of income tax non-compliance in Malaysia, it does provide a number of strong and consistent indicators that the level of non-compliance is high.

Characteristics of Income Tax Non-Compliance

The analysis undertaken of the various characteristics of income tax non-compliance in Malaysia relies heavily on the *file data* (recorded information for 507 tax files, being all of the omission files for four IRB offices for the years in question) and the *interview data* (interviews with 60 tax officers). These sources

have different limitations and sometimes give somewhat different emphases, but a broadly consistent picture of the characteristics of income tax non-compliance in Malaysia emerges from them both.

Types of Non-Compliance

In terms of the type of non-compliance, in a rating of the views of the tax officers the highest total score was received by under-declaring income, followed by failing to declare income, inflating expenses or over-claiming deductions. Income is under-declared from a given source when some but not all income received from that source is declared, while there is failure to declare income when none of the income received from that source is declared. Thus according to our respondents, the order of importance of the different types of omission are as follows:

1. Under-declaring income
2. Failing to declare income
3. Inflating expenses
4. Over-claiming deductions.

But the differences in rating were relatively small, and each type of omission was seen as significant. The main differences between the results of analyses of the file data and the views of the tax officers are two-fold. Relative to the findings from the file data, the tax officers rate failure to declare income as less important and inflating expenses as more important. However, based on their personal experience (more than 80 per cent of them have worked with the IRB for more than ten years) our respondents were of the opinion that taxpayers tend to under-declare their income to a significant degree. But they also agree that inflation of expenses was an important form of non-compliance.

Individual Characteristics of Persons Engaged in Non-Compliance

A strong and highly consistent picture of the dominant characteristics of those involved in income tax non-compliance in Malaysia emerges from this analyses of the file data and the interview data. Non-compliance is especially concentrated in

- Older persons, those aged over 50 years,
- Men rather than women,

- Individuals on higher incomes over RM50,000 per annum, and
- Individuals with income from sources other than wages and salaries.

While there is distinct evidence of non-compliance among other groups, the concentration in individuals with these characteristics is very marked. Thus, for example, 97.8 per cent of tax evaded in the omission sample was due to men rather than women, 95.6 per cent was in the higher income groups and over 99 per cent was associated with individuals with income from sources other than wages and salaries.

Reasons for Non-Compliance

The reasons for non-compliance according to the tax officer respondents, in order of importance, are as follows:

1. Taxpayers' intentional evasion
2. Tax preparers playing an important role in the omission of income by taxpayers
3. Taxpayers taking advantage of the loopholes in the Income Tax Legislation
4. Taxpayers' ignorance of the income tax law
5. Taxpayers practicing evasion because of financial strain

The income tax officers of the IRB were of the opinion that taxpayers evade their income taxes because they have their own intention to do so. Our analysis of the reasons for non-compliance provided by taxpayers found guilty of non-compliance was consistent with this conclusion - a very large proportion provided either no reason or implausible excuses.

Improved Strategies for Combating Non-Compliance

When the extent of income tax non-compliance has been estimated and it is revealed that the country is currently facing a serious problem of income tax non-compliance, and when the characteristics of those who are more likely to be involved in such problems are known, then the final step is to enforce suitable and effective strategies. The strategies that we would like to recommend to the IRB are mainly focusing on its ability to improve its efficiency, to be a more effective

and adaptive organisation, and hence to increase the confidence of the community in its capabilities. Suggestions are made in eight areas.

Adopting a proper enforcement and practice uniformly in all branches of IRB

Various piece of evidence have been presented in this thesis to suggest that income tax non-compliance is a substantial problem. However, only a small number of taxpayers have been found guilty of evading their taxes. Our respondents are also of the opinion that the activities that are currently undertaken by the IRB are still inadequate to combat income tax non-compliance in Malaysia. Particularly attention needs to be given to the detection of tax evasion in Kuala Lumpur.

As for failure to submit annual tax returns, the IRB should take actions such as publicising in the mass media the consequences for failing to notify the change of address to taxation authority. The Income Tax Law on withholding employees' taxes will not be effective if the IRB does not act firmly on those employers who failed to remit their employees' taxes and punish accordingly those who have found guilty in evading their taxes. The IRB should properly implement the current enforcement practice uniformly in all of its branches.

We also would recommend that the IRB adopt a better system of penalty and sanction, to encourage taxpayers to settle their tax arrears quickly and to discourage them from using legal challenges to delay payment of taxes which have been correctly assessed. Hence the sanctions and penalties should be levied promptly, should not be excessive but be determined on a percentage basis instead of being a fixed amount. At the same time, the IRB also should give a good example to taxpayers, by not delaying taxpayers' refund, and should try to improve its administrative procedures, especially in dealing with taxpayers' objections or appeals, which can influence taxpayers' compliance decisions. Thus, it is recommended that the IRB should strengthen the current enforcement system, as well as introducing new approaches in controlling this problem. The IRB also should improve its current administrative procedures and adopt a better penalty system.

Working closely with third parties

Tax enforcement is a behavioural problem and its success depends on group cooperation. Thus the IRB should work together with intermediaries in enforcing voluntary compliance. The IRB administration should be effective in dealing with this problem by strengthening its linkage with other organisations, for example by making agreements with employers or other organisations that always deal with public.

With the introduction of *Self-Assessment System*, more taxpayers will be expected to turn to tax professionals for assistance as mirrored in Australia (as discussed in Chapter Five). As a consequence, tax practitioners are in a position to exert a strong and direct influence on the compliance and tax administration process. Hence it is wise for the IRB to tackle these tax professionals, work hand in hand with them, in addition to amending *Income Tax Legislation*, to close some possible loopholes that might be exploited by them. If their roles go beyond the obligation to serve their taxpayers' interests, then introducing preparer penalties is an option.

Adopting modern methods and skilful staff in detection activity

Currently the IRB depends on traditional methods of information collection from various resources, such as obtaining information through local knowledge, press reports, assessment branches, informers, and the application of a means test. These methods are not efficient ones, and hence the IRB should upgrade its methods of detection.

It would be of great significance for the IRB to adopt modern tools of detecting tax evaders, such as using computer analysis on the basis of *Discriminant Function Formulas* or DIF, as adopted by the IRS in generating a probability of recoverable tax revenue. In terms of improving the efficiency of the lodging of tax returns, the IRB could adopt *Electronic Lodgment Service.* This would also be of great help in detecting tax evaders, and is currently being used by the ATO. An *on-line operations system*, linking various organisations to the IRB, would be of great help in detecting abnormal amounts of payment made by taxpayers, compared to their declared income in their annual tax returns. IRB also should consider adopting the approach, used by the ATO, of *Key Abnormal Tax Agent*

Evaluation (KATE), for detecting tax practitioners whose clients' returns vary significantly from the average of those of other tax practitioners in the same region.

Modern technology requires skilful staff to operate the systems. Thus the IRB should provide special training for its staff before adopting this modern technology. Organisational success also depends on staff capabilities and their skills in handling this problem effectively. Thus it is wise for the IRB to conduct leadership program in improving its staff skills in coping with various issues related to this problem.

In relation to cash economy tax evasion, the IRB should consider forming a *Cash Economy Task Force*, as done by the ATO, to study this problem thoroughly and to provide suitable strategies in dealing with taxpayers such as hawkers, small traders and food stall owners. As suggested by our respondents, business registration office also could play its role in improving income tax compliance, whereby it should also include proof that the clients have been registered or contacted with the IRB in approving their business licences.

Introduction of new income tax procedures for benefit-in-kind incomes
Regarding the benefit-in-kind incomes, the IRB could introduce *Fringe Benefits Tax* as adopted by the ATO, which has been discussed in Chapter Five of this research study. As seen in Chapter Six, the IRB should also assess and tax partnership and trust incomes separately, as done by the ATO, for the current procedures of taxing fringe benefits, partnership and trust incomes under individual taxpayers have several weaknesses as discussed in that chapter.

Improving tax knowledge/education among the public
Tax education is necessary in increasing public awareness about taxation, especially regarding taxation laws, the necessity of taxation for the development of the country, in disseminating information such as where the collected taxes have been channelled and so forth. It is also useful to educate taxpayers or potential taxpayers regarding taxation and their share of responsibility to the country. This could be in the form of dialogues, seminars or with cooperation of Ministry of Education in introducing it as a subject in upper secondary schools or

college levels. Punishing ignorant taxpayers should not be the aim of the IRB. Only the 'hardcore' that have the intention to evade their taxes should be punished accordingly.

Introduction of new rules and regulations in respect of tax professionals

New regulations, such as permitting only registered tax preparers to represent taxpayers and the introduction of new rules regarding lawyers who have been found guilty in not complying with the IRB rules and regulations, are required. These could involve submitting their names to the Bar Council, so that necessary actions could be taken by this Council on its members, based on the mutual agreement with the IRB to combat income tax non-compliance.

The IRB also should be firm with the offence committed by these practitioners if they were found committing fraud in the process of preparing their clients' accounts. They should be punished heavily and this should be made known to the public, as a lesson to others. They could be black listed and their names published in the IRB annual report.

Amendments to income tax law

Our respondents also suggest that the IRB should simplify the income tax law, so that it could be uniformly interpreted by all income tax officers, hence leading to uniform practice in all branches of the IRB. Amending of income tax law also enable to close any loopholes that might provide opportunities for tax avoidance and evasion is also required. Successful reduction of opportunities for non-compliance may permit more effective allocation of enforcement resources. Additionally, if targeted properly, reducing opportunities for non-compliance can also increase public support for tax compliance.

Upgrading research and development

Finally, besides expecting taxpayers to do their part, the IRB also should study its weaknesses and try to upgrade or improve them. It could be helpful for the IRB to measure or estimate tax evasion in Malaysia every year, so that it could compare its performance from time to time, and this could lead to more efficient allocation of resources. It should also study various methods of reducing the costs of compliance and of simplifying the income tax law. Careful analysis of the

environment in which it operates is equally important, for this is an essential part of the development of successful business strategies.

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Abbreviations/acronyms

ABA = American Bar Association
ABS = Australian Bureau of Statistics
AGI = Adjusted Gross Income
ATO = Australian Taxation Office
BEA = The U.S Bureau of Economic Analysis
CATA = Commonwealth Association of Tax Administrators
CPAs = Chartered Public Accountants
CSA = Child Support Agency
DIF = Discriminant Function Formulas
ELS = Electronic Lodgment Service
EPF = Employees' Provident Fund
EU = European Union
EWH tax evasion measurement = Elffers, Weigel and Hessing tax evasion measurement
FBT = Fringe Benefits Tax
GAO = General Accounting Office, US
GDP = Gross Domestic Product
GNI = Gross National Income
GNP = Gross National Product
GOS = Gross Operating Surplus
HE = Hidden Economy
INB = Individual non-business
IOB = Interest on Outstanding Balance
IRB = Inland Revenue Board
IRC = Internal Revenue Code
IRD = Inland Revenue Department
IRS = Internal Revenue Service, U.S
ITA = Investment Tax Allowance
KATE = Key Abnormal Tax Agent Evaluation
LB&I = Large businesses and internationals business line
LFS = Labour Force Survey
MIDA = Malaysian Industrial Development Authority
MPPC = Taxpayer's Service Week in Malaysia
NFPEs = Non-Financial Public Enterprises
NIPA = National Income and Product Account
NNI = Net National Income
OG group = Other groups or non-salary earners
PAYE = Pay As You Earn
PPS = Prescribed Payment System
RA = Reinvestment Allowance
R&D = Research and Development

RPS = Reportable Payments System
SBI = Small business income
SECA = Self-employment taxes
SEE = Survey of Employment and Earnings
SGATAR = Study Group on Asian Tax Administration and Research
SG group = Salary earners group
STD = Schedular Tax Deduction
TCMP = Taxpayer Compliance Measurement Program
TFN = Tax file number
TIA = Taxation Institute of Australia
UK = United Kingdom
US = United States
VAT = Value added tax
VRPs = Voluntary Reporting Percentages

CHAPTER ONE

Introduction

1.1 Introduction to Malaysia

Malaysia consists of peninsular Malaysia with an area of 131,573 sq. km., and Sabah, Sarawak and Wilayah Persekutuan Labuan with an area of 198,068 sq. km. Its population of 21.67 million (Dept. of Statistics, 1997, pp. 2, 37) is characterised by two broad categories, bumiputera (natives) and non-bumiputera (non-natives). The former comprises the largest percentage of the total population, more than 56 per cent. The Malay, non-Malay bumiputera or Malay-related, and aborigines Orang Asli form the bumiputera community.

The Malays include the Javanese, Bugis, Minangkabau in West Malaysia and the Bajau of Sabah. The non-Malay bumiputera are mainly found in Sabah and Sarawak. They are the Iban, Bidayuh or Land Dayaks, Melanau, Kenyah, Kayan and Bisayah, who live in Sarawak. The Kadazan or Dusun, Murut, Kelabit, and Kedayan are found in Sabah. Racially, these bumiputeras originate from the same roots. However, in West Malaysia, the aborigines comprising of more than 62,000 people that include the Negritos, Senoi and Proto-Malay are spread out in small groups throughout its eleven states. The Chinese, Indians and others form the non-bumiputera community. They are distributed throughout West Malaysia (also known as Peninsular Malaysia) and East Malaysia, which consists of Sabah and Sarawak (Hock, 1991, pp. 117, 118). Basically, the Chinese are descendants of immigrants who had left the shores of mainland China and are the predominant group in the non-bumiputera community. They constituted about 34 per cent and 46 per cent of the population in West and East Malaysia respectively in 1980. The Indians, also of immigrant ancestry, are mainly found in West Malaysia. The others, comprising the Arabs, Sinhalese, Eurasians and Europeans, are found throughout Malaysia.

According to the Seventh Malaysia Plan (1996, pp. 109-111), the manufacturing sector forms the highest employment sector, which registered rapid output growth,

accounted for about one quarter of total employment and generated about 49 per cent of net employment creation during 1991-95. The strong demand for labour in this sector, which was growing at 9.0 per cent per annum during this period, coupled with industrial restructuring towards higher value-added products and activities, resulted in labour shortages not only at the production level but also at the skilled and semi-skilled levels. The services sector accounted for about one-half of total employment and about 42 per cent of total job creation during 1991-95. The major contributors to employment in this sector were the finance subsector, and the wholesale and retail trade, hotels and restaurants subsector and the other services subsector, which together created 443,500 jobs. Employment in the construction sector grew at an average rate of 9.2 per cent per annum and accounted for about 19 per cent of total job creation. Employment in the agriculture sector declined by 3.6 per cent per annum, as a result of a slower growth of output and increasing mechanisation in the sector. The decline in agricultural employment translates into a reduction of an estimated 309,300 jobs during 1991-95. This sector continued to face labour shortages as local labour moved into other economic sectors because of better prospects and wages.

Currently, there are about 2.3 million active taxpayers registered on the Inland Revenue Board (IRB) tax roll consisting of individual taxpayers, corporations, partnerships, trusts, clubs and associations, and joint ventures.

1.2 The Malaysian Tax System and Tax Non-Compliance

The basis of the current tax system was introduced by the British into the Federation of Malaya in 1947 and is based on R.B. Heasman's report (Singh, 1997, p. 4; Asher, Ismail and Datuk Kamal Salih, 1994, p. 83). This was in the form of the *Income Tax Ordinance 1947*, which was subsequently repealed and replaced by the *Income Tax Act 1967*. This latter Act came into effect on 1 January 1968. Thus the current tax system of Malaysia has its roots in the British system. The 1967 Act consolidated the three laws of income taxation which were then in existence in parts of Malaysia: the *Income Tax Ordinance 1947*, which was only applicable to Peninsular Malaysia; the *Sabah Income Ordinance 1956*, which was only applicable to Sabah; and the *Sarawak Inland Revenue Ordinance 1960*, which was applicable to Sarawak only. Since the formation of Malaysia in 1963, these three separate taxation laws

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continued to be in existence until the introduction of the *Income Tax Act 1967* (Singh, 1997, p. 4).

The administration of taxation in Malaysia is under the supervision of the Ministry of Finance, and the Head Office is in Kuala Lumpur. However, the *Inland Revenue Board Act 1995*, which came into force on 1 March 1996, established the Inland Revenue Board (IRB), replacing the Inland Revenue Department (IRD), to act as the Government's agent in the administration, assessment, collection and enforcement of the payment of, inter alia, income tax and real property gains tax (Kheong, 1997, p. 2). It is headed by a Chief Executive/Director General who is assisted by three Deputy Directors General and a number of Heads of Sections. These officers have most of the statutory responsibilities for the administration of the tax laws.[1]

The taxation *assessment* function of the IRB has been decentralized. There are 34 assessment branches of which 25 of them were situated in the Peninsular of Malaysia, 5 branches were found in Sabah and 4 branches were in Sarawak as at year-end 1997. The taxation *collection* function has been centralized. The Kuala Lumpur branch is collecting for the whole of peninsular Malaysia, while the Kota Kinabalu branch is collecting for the Sabah and the Kuching branch is collecting for the state of Sarawak.

Based on the *Economic Report 1996/1997*, published by the Ministry of Finance, about 81 per cent of the Federal Government's revenue for 1996 came from taxes, of which direct taxes accounted for nearly 44 per cent of the total revenue. Direct taxes include taxes on income, real property gains tax and stamp duty.

As in other countries, Malaysia suffers from revenue loss due to the problems of income tax non-compliance and income tax evasion. On average, about 30 per cent of all taxpayers fail to submit their annual returns to the Inland Revenue Department, and more than 12,000 each year face prosecution for failing to file complete returns (Mahfar, 1994; IRD, 1992a). This low level of tax compliance is thought to come from a number of factors. Mahfar listed four main factors. First, the public has traditionally maintained a reactive role in regard to taxes, because the law was administered by the British government before Malaysia gained its independence, and tax rates were maintained at very high levels (Commonwealth

Association of Tax Administrators [CATA], 1989). Second, Malaysia is burdened by low levels of tax literacy (ABA, 1989; Chelvathurai, 1990, pp. 594-599). Mikesell (1974, pp. 615-624) argues specifically that literacy establishes limits for types of taxes that can be considered and Chelvathurai (1990) suggests that complicated forms could not be used where literacy levels are low, particularly in developing countries. Moreover, the size of the potential tax base is determined by the nature of the economy within the taxing jurisdiction, for example, the resources, socio-demographic patterns, and geographic structure (Wai, 1962, pp. 428-447). Third, most small businesses and self-employed individuals deal in cash transactions and do not keep proper records (Soos, 1991; ABA, 1989). This can lead them to under-estimate their receipts and to inflate business expenses, which may include personal expenses. Fourth, Malaysia changes its tax laws every year in response to the constant changes in the economy, ensuring that the tax system will promote economic growth and broaden the tax base. Thus the income tax laws are becoming more complex and less comprehensible to the general public.

Non-compliance occurs when persons or organisations liable for tax: (a) fail to file returns; (b) under-report income; (c) over-state deductions; and (d) fail to pay the correct amount of tax (see Surrey, 1958; Kaldor, 1963; Allingham and Sandmo, 1972; Spicer and Lundstedt, 1976; Clotfelter, 1983; Goode, 1981; Witte and Woodbury, 1985; Spicer, 1986; American Bar Association [ABA], 1988; Soos, 1991). Some scholars draw distinctions among different terms used to refer to tax non-compliance, such as tax cheating, evasion, errors and misreporting, while others seem to use these terms interchangeably. However, it is difficult to distinguish among types of tax non-compliance: at one extreme, there are the serious criminal tax evasion schemes; at the other, there are simple under-reporting and over-reporting errors (Long and Swingen, 1991). It is difficult to understand the deviant aspects of taxpayer decisions without first understanding the factors that influence compliance. The choice between compliance and non-compliance may only be a matter of opportunity, convenience, or even interpretation of the law (Allingham and Sandmo, 1972; Klepper and Nagin, 1989a, 1989b).

As a developing country, it is very important for Malaysia to increase its revenue while maintaining the tax rates at a low level to foster its economic growth.

Therefore an increase in revenues through a reduction of tax evasion and avoidance is one of the options for achieving higher revenue while maintaining low tax rates. In line with the Finance Minister's 1999 budget speech, the IRB would be made more efficient and transparent through "reformation and the level of integrity of the administration of IRB would assist in preventing tax evasion and revenue loss" (p. 25). Thus the government is concerned with tax evasion and avoidance for two principal reasons: it harms the interests of the general public, and it harms the means by which the state can look after the interests of the general public (Cowell, 1990, pp. 45, 46).

The interests of the general public are broadly represented by goals for achieving social justice and efficiency in pursuing economic policy. However, the activity of tax evaders may frustrate the pursuit of each of these two objectives. In terms of social justice, the rich may be more able to avoid tax while the poor have to pay their share, which offends one's sense of distributional justice. Some principles of equity are being violated. In terms of efficiency, the administrative costs of enforcing taxes can be increased by the uncertainty caused by the game of "*hide and seek*" in dealing with these tax evaders.

Tax evasion also can have a major impact on the structure of prices and incomes, and can distort the effectiveness of macroeconomic policy. It can erode the tax base and, in some circumstances, make the effect of alterations in tax rates indeterminate and unpredictable. The apparent elasticity of labour supply and public revenue with respect to tax rates may have less to do with conventional factors such as work disincentives, than with the inducement to conceal income and productive activity. The observed unemployment figures may be unreliable indicators of the economy's performance if a substantial proportion of workers are in the black economy.

1.3 Previous Findings on Tax Non-Compliance in Malaysia

Currently there are only two published research studies that have been conducted in Malaysia regarding income tax non-compliance. The two are outlined below. One concerns tax ethics and taxpayers attitudes, whilst the other is in regard to the analysis of aspect of the Malaysian income tax system that promote tax avoidance amongst taxpayers.

1.3.1 Findings about tax ethics and taxpayer attitudes among the Malaysians

Sabri (1993) found in his survey sampling in the Kuala Lumpur and Petaling Jaya areas that although respondents did not condone tax cheating, they believed that it was fairly widely practiced.

In the 7-point Likert-type scale ranging from 1 (Strongly disagree) to 7 (Strongly agree), it was found that the respondents generally disagreed with the following statements: tax evasion is not a serious offence (mean score was 2.50); taxpayers need not voluntarily give information about illegal activities (mean score was 2.71); and using tax loopholes is acceptable (mean score was 2.96). Meanwhile respondents agreed with the statement that tax cheaters should be reported to the government (mean score was 5.65). Hence the respondents felt that tax cheating is a serious offence and they have an obligation to report tax cheaters to the authority, and using tax loopholes to avoid paying taxes is morally wrong. However, they were quite neutral with regard to the following statements: the main thing in dealing with the Income Tax Department is not to get caught (mean score was 3.67); one should be fined but not jailed for tax cheating (mean score was 3.97); and, the average taxpayer should not be expected to obey all his tax obligations because of the loopholes favouring the rich (mean score was 3.97). It can be seen that the respondents were neutral on the type of penalty for tax cheating. They were probably reluctant to make a stand on the penalty issue because they may have to face penalties if their illegal acts are discovered.

On the behavioural dimensions, Sabri (1993) adopted the Song and Yarbrough's scale to measure aspect of tax ethics (1978, pp. 442-452). Respondents were asked to guess the proportion of taxpayers who committed a given set of tax related offences. They were asked to respond on a 5-point scale from 0 to 4 where: (0) don't know, (1) very few people, (2) a few people, (3) some people and (4) most people, commit the offence in question. The type of offences and their mean score were as follows: (1) not reporting some income (mean score was 2.70); (2) over-claiming business expenses (mean score was 2.64); (3) falsifying supporting documents (mean score was 2.15); (4) not filing a tax return (mean score was 2.15); (5) not providing complete information (mean score was 2.15); and (6) not replying to letters from the tax authorities (mean score was 2.20). Thus Sabri found that an

average the individuals surveyed believed that these offences were committed by more than a few people.

Sabri found that the attitudinal dimension of tax ethics was negatively correlated to the behavioural dimension. This means that those with strong attitudes against tax evasion tend to believe that others comply with the law. On the other hand, those who have low scores tend to believe that others cheat in filing their tax returns. He also found that there were significant differences in attitudinal tax ethics among demographic groups by sex, age, occupation, household income and educational background. Female respondents had a slightly higher level of tax ethics than male respondents. The highest level of tax ethic scores was found among the respondents aged between 30 to 39, followed by aged 50 years or more and the third aged ranged between 40 to 49. Respondents aged 29 and below had the lowest level of tax ethics. It was also found that respondents in the public sector had the highest level of tax ethics, compared to respondents employed in the private sector and self-employed. In terms of monthly household income, it was found that higher income respondents (monthly personal income above RM6000) had a higher level of tax ethics compared to low income respondents (income below RM1000 had the lowest). Respondents with a higher level of education tend to have a higher level of tax ethics. However, there were no significant differences in level of attitudinal tax ethics among the demographic groups by race and marital status.

In terms of tax knowledge, the scale was developed by the researcher to assess the respondents' tax knowledge and experience. They were asked in closed and open-ended questions about tax regulations and the questionnaires were designed to assess respondent's perception of and readiness for the self-assessment system of income tax. The tax knowledge scores of the respondents ranged from as low as 0 to as high as 12 against a maximum possible score of 16. In terms of age, respondents aged 30 to 39 had the highest score, followed by those aged 40 to 49. Respondents below 29 years of age had the lowest score. The mean tax knowledge score was 7.38. This indicates that the Malaysian public is not well informed about taxation. When asked whether they are interested in learning more about the Malaysian income tax system, only 33.9 per cent gave a positive answer.

Regarding the administrative efficiency of the taxation office, the respondents rated the department as fairly efficient with a mean score of 3.14, where the score lies between 1 to 4, with 1 marking extremely inefficient and 4 marking highly efficient. However, the respondents criticised the government bureaucracy and denounced it for alleged inefficiency. They also expressed their dissatisfaction with the dissemination of public information on taxation.

Since the findings reviewed above are based on convenience sampling among the Malaysians who live in Kuala Lumpur and Petaling Jaya, they cannot be generalized to the taxpayers of Malaysia as a whole. Further, Sabri (1993) explored the tax ethics and attitudes of Malaysian taxpayers and not the characteristics of those who fail to comply with the taxation office. Thus it is one of the aims of this research to study these characteristics intensively, by extracting the non-compliance files in different regions (Zones) of Malaysia. Further, Sabri's self-administered interviews could affect the response obtained, especially in terms of obtaining an honest answer to sensitive questions due to the presence of the interviewer. Thus this research is undertaken to study the characteristics of these non-compliants by referring to their personal income tax files instead of interviewing them. Further, some Malaysian income tax officers were also being interviewed, to draw on their personal experience regarding these non-compliants. Thus there will be some supporting evidence for studying the characteristics of those who fail to comply.

1.3.2 Income tax avoidance in Malaysia

Wallschutzky and Singh (1995) explored the Malaysian Income Tax Legislation and found some loopholes in it that might contribute to income tax avoidance in Malaysia. Major loopholes that they discussed are as noted below.

1.3.2.1 Discrepancy between law and compliance

Wallschutzky and Singh (1995, pp. 42-71) argued that, although there is an anti-avoidance provision (s 140) and some specific provisions like s 65, paragraphs 38, 39, 40, and 62 to Schedule 3 of the *Income Tax Act 1967* to deter avoidance, there is a gap where some people manage to squeeze through. These provisions give various powers to the revenue authority to inspect records, have access to premises, request information and impose penalties where incorrect information or returns have been

lodged. Section 82 of the *Income Tax Act 1967* requires every taxpayer carrying on a business to keep and retain sufficient records to enable the IRB to ascertain income or loss from his/her business. Further, a duplicate copy of every receipt issued must be made within 60 days of each transaction. It is also stated that the Director General of the Inland Revenue may specify by statutory order (or by a written notice to a taxpayer) the form of records to be kept, the manner in which they shall be kept and retained, the form of receipts to be issued, duplicate receipts to be retained, and the manner in which the receipts shall be issued or retained. The issue of receipts may be dispensed with if automatic cash registers are used. However, s 82(4) states that the Director General may waive all or any of the provisions regarding the keeping of records and the issuing of receipts. Thus there is a gap in the income tax legislation that might be exploited by some groups of taxpayers regarding their record keeping and issuing receipts. The existing discrepancy between law and compliance in adequacy of record-keeping requirements might lead to arbitrary assessment, corruption and a general disregard of the law.

Generally, individuals carrying on businesses are not required to submit audited accounts with their tax returns except for limited companies (which are mandatory for all companies incorporated under the *Companies Act 1965*). Hence, this might offer a loophole and be exploited by the former to their advantage.

Under the Malaysian *Income Tax Act 1967*, benefits-in-kind income such as motorcars and related benefits, living accommodation, household furnishings, apparatus and appliances, gardeners, domestic servants and so forth are taxable. However, some might escape paying taxes due to the failure of their employers to declare this income provided to their employees, for they are not certain of the valuation of such benefits. This could be due to the lack of guidelines and the lack of effective monitoring by the taxation office, giving the impression that this income is not important to report. As suggest by Wallschutzky and Singh (1995), a fringe benefit tax may need to be considered by the IRB for this type of income.

1.3.2.2 Withholding tax requirements and PAYE
The withholding tax requirements only apply to the non-residents. However, it does apply to residents in the case of interest income that is paid or credited by various deposit-taking institutions such as banks, finance companies and cooperative

societies (Wallschutzky and Singh, 1995, pp. 42-71). The Malaysian personal tax deduction provisions are therefore inadequate for not only are they not based on income as it is earned but they rely on information provided by the taxpayer. Elsewhere PAYE (with the exception of the UK) systems generally are based on deducting tax as it is earned in the current year. Hence such arrangements have the added safeguard of third party (employers) involvement in determining how much tax is to be deducted. Under the Malaysian system, if employees make false returns by way of overclaiming deductions, they have the added incentive of lower tax instalments in the subsequent year. Thus failure to deduct tax at source might increase the scope for evasion.

The PAYE system has been operating in Sabah and Sarawak since 1968. It had never been applied to Peninsular Malaysia before 1 January 1995. Instead, deduction directives were issued to employers, specifying the amount of tax payable per the previous notice of assessment. However, the schedular PAYE) tax deduction scheme applicable in Sabah and Sarawak has been modified and extended to cover Peninsular Malaysia with effect from 1 January 1995 for taxpayers who commenced employment anytime after or on this date. However, all others in Peninsular Malaysia who commenced their employment before this date began operating PAYE system in 1999. The Schedular Tax Deduction Scheme or STD is a system whereby payment of tax is effected through a scheme of deductions from the monthly remuneration of each person receiving employment income. It is made in accordance with a schedule, which stipulates the relevant amounts of tax to be deducted and remitted to the IRB each month. Thus this issue identified by Wallschutzky and Singh has been substantially addressed.

1.3.2.3 Detection of evasion

Investigation officers from all investigation and intelligence centres throughout the nation carry out prevention and detection activities. The selection of cases for investigation is done manually and involves information obtained through local knowledge, press reports, assessment branches, informers, and application of a means test. These methods as noted by Wallschutzky and Singh (1995), were not the most efficient ones hence it was recommended that the IRB should upgrade its information system for selecting cases for audit.

Wallschutzky and Singh (1995) also found that from 1981 to 1991 the number of cases that had been finalised by the Investigation Branch had increased by 1.78 times whereas the tax and penalties recovered therefrom had increased by 3.44 times. This could indicate that the Inland Revenue should continue to emphasise this activity or, on the other hand, it might indicate that, notwithstanding a greater number of cases being finalised, taxpayer compliance (as measured by tax and penalties recovered) is getting worse. Further, they suggest that the Inland Revenue Board should not only continue enforcement activity but also must be *seen to be pursuing* enforcement activity, so that it can increase taxpayers' perception of, and their awareness of, the level of enforcement.

1.3.2.4 Adequacy of the penalty structure

Penalties can be imposed by the IRB under the provisions of the *Income Tax Act 1967*. Although the severity of the penalties varies with the nature of the offence, the amount of the penalty is frequently based on the discretion of the Director General (as the law only stipulates maximum penalties). Similarly, if a taxpayer has been successfully prosecuted in the courts, the court has the discretion to determine the fine to be imposed. The Director General also has the power to compound offences before the case is due for prosecution in court. In practice, the maximum amount of penalty is usually not imposed. This reveals some weaknesses in the Malaysian penalty provisions, particularly the fact that the maximum penalties are in currency of fixed amounts. Some drawbacks are as follows:

1. over time, they lose their significance as they are eroded by inflation, and
2. it might not be possible to discriminate adequately between large and small offences.

Further, Wallschutzky and Singh (1995) recommend a better system of penalties that would be based on the percentage of tax that was not paid or, alternatively, fixed dollar amounts could be indexed to account for inflation.

1.3.2.5 Administrative procedures

Wallschutzky and Singh (1995) argued that there are unbalanced administrative procedures whereby the department imposes strict time limits whenever a taxpayer is required to act and no corresponding time limits are imposed on the Director General. They also pointed out that if income tax is not paid within the stipulated

time limits, a penalty is imposed. On the other hand, if the department delays refunding any amount due to the taxpayer, no penalty (in the form of interest) is imposed. Additionally, it has been established in a number of court decisions that, once an assessment has been issued, the tax assessed must be paid notwithstanding an appeal. Regarding appeals, especially to the Special Commissioners of Income Tax (if the taxpayer is dissatisfied with the Director General's decision on his objection), in practice it is not a speedy process and it may remain unresolved for a considerable period of time. All of these weaknesses on the part of the department could have an impact on taxpayers that can influence their compliance decisions.

1.4 Aims and Methods of the Current Research

1.4.1 General aims

As previously noted, Wallschutzky and Singh have explored the Malaysian Income Tax Legislation and found several loopholes that might contribute to income tax avoidance in Malaysia (as discussed above). However, they did not address the scale of income tax non-compliance nor the characteristics of those who exploit these opportunities. Thus the main aim of the research undertaken for this thesis is to fill this gap, by assessing the extent of income tax non-compliance in Malaysia and document the characteristics of those involved in non-compliance. Some strategies for overcoming this problem, that are being utilised by some advanced countries in combating income tax non-compliance and may be of some value in Malaysia, are also suggested. Some empirical evidence is gathered from the Australian Taxation Office (ATO) to strengthen this argument, and to suggest ways of learning from their experience in overcoming this problem in Australia.

1.4.2 Specific aims

There are three main specific aims of this study:

1. *To assess the extent of income tax non-compliance in Malaysia, using analyses based on national accounts data, detailed data on individuals who have failed to comply (omission records) and a survey of the income tax officers (interview data).*

2. *To study some characteristics of individuals who did not comply with the income tax law and some of the factors contributing to this problem, by using the omission records and interview data.*

3. To suggest some improvement strategies by studying some weaknesses of the current enforcement. Interviewing income tax officers and reviewing compliance strategies in Australia.

1.4.3 Five components of methodology

There are five components of the methodology involved in the empirical part of this study to achieve these aims. The first three components are related to assessing the extent of income tax non-compliance in Malaysia and the fourth approach is used to identify some characteristics of individuals who have failed to comply with the income tax law. The fifth component is related to examining the weaknesses of the current enforcement of the IRB and to identifying ways to overcome this problem.

Component 1 – the gap approach

This approach relates taxable income as reported by the taxation authorities to a measure of taxable income derived from other sources, normally the national accounts. The difference between the two estimates of taxable income can, in appropriate circumstances, be used to assess the total dollar value of income tax non-compliance, using the methodology detailed in Chapter Six. The essence of the gap methodology for assessing the level of tax non-compliance is to derive an estimate of a measure of taxable income (either total taxable income or personal taxable income) from national accounting sources, and to compare this estimate with the figure for the equivalent taxable income variable as reported in the official taxation statistics. The former measure is referred to as *derived taxable income,* while the latter measure is termed *reported taxable income.* Given certain conditions, the difference between these two measures can be considered as a broad indicator of the level of tax non-compliance.

Applications of the gap method to the U.S. and Australia are also discussed in Chapter Six, to provide some guide to the conclusions that can be drawn from the application of this method to Malaysia. One important issue which arises in the application of this method to Malaysia was that of the coverage of the tax system – the extent to which potential taxable private income is in fact liable for tax under Malaysian tax law – and this is also examined in Chapter Six.

Component 2 - Non-compliance among registered taxpayers

Each year the Malaysian IRB issues tax forms to individuals and organisations listed on its master files as liable for income tax. Thus another approach to assessing the level of income tax non-compliance that is used is an analyses of failure in submitting annual returns in the years of 1995-1997 in Malaysia, among all registered taxpayers and other individuals that have been issued with annual income tax returns in these three years. In particular, the method involves collecting and analysing data on:

1. the total number of return forms issued by the IRB for the year of 1995, 1996 and 1997, and

2. the total number of completed return forms received by the IRB for these years.

The resulting analysis is reported in Chapter Seven.

Component 3 – Estimating the seriousness of income tax non-compliance through income tax officers

As part of the data collection for this research, fifteen income tax officers from each branch of four different branches of IRB, i.e. from Pulau Pinang (representing northern part of Malaysia), Kuala Lumpur (representing central part of Malaysia), Johor Bahru (representing southern part of Malaysia) and Kota Kinabalu (representing East Malaysia), were interviewed regarding the seriousness of income tax non-compliance in Malaysia. This was part of a broader survey of other views and attitudes, directly particularly to the characteristics of individuals who did not comply and the reasons for non-compliance. The views of tax officers on the extent of non-compliance is used in Chapter Seven as a further indicator.

Component 4 - Studying a profile of income tax non-compliance in Malaysia

There are two aspects of the methodology used to study the characteristics of individuals who do not comply. The first is through studying the IRB records on individuals found to have failed to comply (the omission records or file data) and the second is through the interviews of income tax officers (interview data).

A sample of individual tax evaders' files that have been found guilty of evading their income taxes in the years of 1995, 1996 and 1997 was chosen from four different branches of the IRB of Malaysia (addressed here as file data). These four

different branches are chosen based on their geographical location in Malaysia and on the fact that the total number registered taxpayers in these areas are much higher than in other areas. They are as follows: Kuala Lumpur branch, representing central part of Malaysia; Pulau Pinang branch, representing northern part of Malaysia; Johore Bahru branch, representing southern part of Malaysia, and Kota Kinabalu Branch, representing East Malaysia. The nature of omission reported in each file is noted and analysed in Chapter Eight of this research study.

The other method used to understand the characteristics of individual who did not comply is through interviews of income tax officers (addressed here as interview data). Tax officers who were especially experienced in dealing with non-compliance were chosen, in the expectation that their views would be most well informed. The results of this analysis are presented in Chapter Eight of this research study.

Component 5 - Studying some weaknesses of the IRB in overcoming income tax non-compliance, and suggesting some strategy improvements to overcome this problem
A range of methods are employed during the empirical study to identifying the *effectiveness* of the current approach of the IRB to combatting non-compliance. These effectiveness include an examination of the success rate of audit activity and of the adequacy of the penalty system, which are included in Chapter Nine.

In considering improvement strategies, the study draws on those emerging from a review of the literature on measures taken to address non-compliance by other income tax authorities, such as the ATO (Australia) and the IRS (U.S.). These are discussed in Chapter Nine of this study. Some suggestions that have been made by the respondents (income tax officers), and by Wallschutzky and Singh (1995), Mahfar (1994), and Sabri (1993) are also considered. Some weaknesses of the current taxing procedures of the IRB are also highlighted, and compared with the current taxing practice of the ATO. However, the recommended strategy improvements were not empirically tested for their effectiveness.

1.5 Chapter Development

A review of the literature for other countries, on the nature and extent of income tax non-compliance and on ways of measuring it, is provided in Chapter Two. This chapter also discusses the importance of studying income tax non-compliance for

policy makers and economists. Chapter Three explores the overseas literature on the characteristics of persons who do not comply, concentrating on their age, gender, income level and income source. It also discusses some literature on possible causes of income tax non-compliance, such as financial strain, income tax complexity and the direct influence of tax preparers on the compliance process.

Chapter Four reviews the literature on strategies used in overcoming income tax non-compliance, such as preventive actions, strategies to change taxpayers' attitudes and some positive approaches in some advanced countries. Some preventive actions explored are audit plans, withholding of taxes, sanctions and preparer penalties. There are four main strategies in changing taxpayers' attitudes which have been discussed in the literature. They are as follows: reinforcing positive attitudes by introducing reward systems or acknowledging those who had been audited without a single adjustment; informing taxpayers about the use made of the revenue collected; raising awareness of the importance of good service among tax office staff, and publicising the benefits to existing and potential taxpayers of the increased range of goods and services which could be made available through increased tax revenue.

Chapter Five discusses the taxation system in Australia, giving a special reference to individual taxpayers. This chapter also explores some policies adopted by the Australian Taxation Office (ATO) such as the introduction of the Self-assessment System and Fringe Benefits Tax (FBT), the Prescribed Payment System (PPS) and the Pay-As-You-Earn (PAYE) System. In terms of technology, it explores the Electronic Lodgement Service (ELS), Key Abnormal Tax Agent Evaluation (KATE) and control of non-filers. In improving the relationship between the community and the tax office, the ATO launched the Taxpayers' Charter. This chapter also explores enforcement and punishment, and the role of marketing within the ATO in combating income tax non-compliance. It also covers action being taken by the ATO in upgrading its staff, such as staff development and training.

Chapter Six introduces data sources from the national accounts in Malaysia and in Australia. It also describes types of income assessed by the revenue offices in these two different countries. Further, it analyses direct taxes in Malaysia, and discusses the results on the extent of income tax non-compliance in Malaysia and Australia using the *gap approach* based on national income accounts and taxation statistics. It

then compares the results between these three different countries and gives some possible explanations on the difference found. In interpreting these results, its necessary to explore the coverage of the income tax system in Malaysia.

Chapter Seven discusses indication of the extent of income tax non-compliance based on Component 2 and the views the seriousness of income tax non-compliance through income tax officers of the IRB (Component 3). The results from these two different approaches are drawn with the findings in Chapter Six.

Chapter Eight analyses the characteristics of individuals who do not comply through file data and interview data. It then discusses the results of the characteristics of those involved in income tax non-compliance, derived from data gathered from four different branches of the IRB. Age level, gender, income level and income source are the characteristics studied. Possible reasons for non-compliance, such as financial strain and the use of a tax preparer in filling the form, are also examined. Some views of and potential strategies that have been suggested by, the income tax officers are also presented in this chapter.

Chapter Nine analyses aspects of the current enforcement practices of the IRB. It explores some of the weaknesses through analysis of the tax officer surveys, the post mortem of a survey carried by the IRB during Taxpayers' Service Week in 1997, past studies done by Wallschutzky and Singh (1995), and some analysis of the nature of taxable income procedures of the IRB compared to the ATO. It also discusses some strategies to overcome these weaknesses. These improvement recommendations are based on respondents' suggestions and some reviews from advanced countries' experience in tackling such problems especially from Australia and the U.S.

CHAPTER TWO

Review of Literature on the Extent of Non-Compliance

2.1 Introduction

Research into income tax non-compliance focuses on two major areas: taxpayers and taxation authorities. Research focusing on taxpayers attempts to determine factors that might contribute to a decision to evade the law, while research focusing on taxation authorities attempts to formulate government strategies aimed at increasing the amount of tax revenue collected. This research covers both areas: the individual taxpayers of Malaysia and the income taxation authority, with the aims of (a) determining factors which contribute to decisions to evade the law and (b) attempting to recommend strategies to cope with this problem in Malaysia.

This chapter is divided into three sections. Section One discusses the definition of income tax non-compliance and differentiates between intentional and unintentional non-compliance. It further elaborates on intentional non-compliance, which is the focus of this research. Non-compliance consists of two parts: evasion and avoidance. The difference between these two terms is that in avoidance, taxpayers manipulate the legal loopholes (the gaps found in the Malaysian Income Tax Legislation as explored by Wallschutzky and Singh as discussed in Chapter One), which is within the law and implies certainty on the part of taxpayers, whereas the opposite is true for evasion. Evasion can be further subdivided into evasion with fraud and evasion without fraud, depending whether fraud is committed in the process or otherwise.

Section Two explores some of the literature related to the extent of income tax non-compliance, the causes of income tax non-compliance and the importance of measuring income tax non-compliance, with some examples from a number of countries. It also discusses various measurements that have been used to assess the extent of income tax non-compliance such as the gap approach, the expenditure-income discrepancy method and the Elffers, Weigel and Hessing (EWH) tax-evasion measurement. With the gap approach, the difference between an income

estimate derived from national accounts data and the total income reported by taxpayers is used to estimate the dollar value of income tax non-compliance. With the expenditure-income discrepancy method, analysis of expenditure patterns is used to throw light on concealed or understated income. The EWH tax-evasion measurement is a strategy which documents the occurrence of individual returns and the self-reports of taxpayers concerned, suggesting that obtaining accurate self-reports of sensitive information, such as evasion, is difficult, for taxpayers are more concerned about prosecution.

Section Three summarises some related findings on the extent of income tax non-compliance in a number of countries. It also considers why this problem has attracted attention from policy makers and economists and why some researchers have been led to look into this problem more seriously.

2.2 Non-Compliance

Researchers have often used the term "non-compliance" to characterise the intentional or unintentional failure of taxpayers to pay their taxes correctly, and the term will be used in this way in this study. Unintentional non-compliance is the failure of a taxpayer, or of an intermediary acting on behalf of the taxpayer, to remit the proper amount of tax to the authorities, perhaps on account of the complexity, vagaries, or even contradictions in the tax legislation or tax administration procedures (Kesselman, 1994, pp. 62-84). It may arise from inadequate effort by the taxpayer or intermediary to ascertain its obligations. It may also stem from the complexity of tax provisions and the difficulty of applying them to the more complex situations of the real world. Long and Swingen (1991, pp. 639-683) reported that almost one in six US federal income tax returns contained errors, with more of these errors resulting in the taxpayers paying too much rather than too little tax. This could be due to ignorance when interpreting tax provisions which require guidance from the taxation authority. Intentional non-compliance can be divided into two types of activity: tax evasion and tax avoidance. These are discussed below.

2.2.1 Evasion and avoidance

One common characteristic of evasion and avoidance is the manipulation of a person's affairs to reduce tax liability. However, in tax avoidance the manipulation of personal affairs is done within the law but in evasion it is done illegally. Tax avoidance refers to avoiding the payment of taxes through using legal loop-holes and financial dispositions such as profiting from more favourable capital gain taxation instead of personal income taxation (Wärneryd and Walerud, 1982, pp. 187-211). Once the manner in which taxes are being avoided has been detected, the problem may be overcome by refining the legal provisions and their interpretation by amending the legislation (Silvani, 1994, pp. 274-305). This kind of underpayment of taxes is sometimes engaged in by large taxpayers who have trained professionals to advise them on the interpretation of legal provisions. Gunn (1979, pp. 733-767) differentiates between tax evasion and avoidance as one "evades" taxes by avoiding payment without avoiding liability, while the other who avoids liability "avoids" the tax. According to Cowell (1985, pp. 163-193) "avoidance" in its strict sense implies certainty on the part of the taxpayer at the time when decisions are made about the deployment of assets and on the report to the tax authority. However, "evasive" activities are taken to involve a decision or decisions made under uncertainty with respect to the taxpayer's eventual tax liability. With respect to income taxes, evasion behaviour typically occurs because taxpayers either under report income or exaggerate deductible expenses when filing their returns (Loftus, 1985, pp. 35-39; Wallschutzky, 1984, pp. 371-384). Thus avoidance in this research refers to the arrangements of a person's affairs, correctly reported, so as to reduce tax liabilities within the letter of the law but to a level lower than the limit of the law. Thus there is often dispute about whether or not something is tax avoidance. On the other hand, evasion involves deliberately misreporting the nature of one's income or undertaking other activities inconsistent with the letter of the law to reduce tax payable.

Silvani (1994, pp. 274-305) places evasion into two categories: evasion with fraud and evasion without fraud. A taxpayer guilty of evasion with fraud commits tax evasion through fraudulent actions such as forging or falsifying records, which might go beyond the scope of taxation and into the area of criminal offences. However, evasion without fraud is engaged in by those under reporting their taxes

without committing fraud (like forging or falsifying records) in the process. Silvani also suggests that the strategies used in imposing penalties for these two types of evaders are also different. For evasion with fraud, the strategy should rely on the imposition of very stiff penalties; some countries impose prison terms. The penalty should be very severe and should be made public because it must serve as a deterrent. The chief goal here is not to punish the person guilty of committing fraud in order that he or she should not do it again, but to make an example of that person. The process of combating tax evaders without fraud, should dissuade them from engaging in this behaviour again. The purpose is not to punish the tax evader in order to make an example of him or her but to prevent repeat offences, thus the penalty is not so severe.

2.3 Extent of Non-Compliance

Researchers have extensively studied income tax non-compliance. Gaining a better understanding of why people do not accurately report their incomes and fully pay taxes due is obviously of interest to policy makers. The elements indicated as causes of tax evasion are extremely varied including economic factors, psychological attitudes and administrative and legal determinants. According to Oldman and Holland (1971), measurement of tax evasion can lead to more efficient allocation of resources. Such measurement provides information on tax evaded and the groups of taxpayers who are more inclined to evade tax. Hence, it is easier for income tax officers to target a particular group of taxpayers and put extra effort into fighting evasion. Evasion measurement is also important for the continuous evaluation of success or failure of enforcement programs.

Income tax non-compliance, its extent and characteristics, has been the subject of numerous studies in many countries. Such studies usually attempt to estimate the size of the irregular or underground economy whose existence is primarily motivated by tax evasion. The underground economy is defined by Tucker (1982, pp. 315-322) as the sum of those legal and illegal transactions involving cash, cheques, or the bartering of goods or labour detected by conventional statistics. It can operate under many disguises, from household activity and tradesman activity, through to the more controversial areas of tax evasion; from hidden company

perks and bribes to the hard-core world of drugs, prostitution, and gambling. The growth of the underground economy can be attributed to a number of factors operating in the legal economy. As Tanzi states: "The two main factors that create an underground economy are taxes and restrictions, and either is sufficient alone to bring about an underground economy" (1980, p. 34).

Based on the above quotation, it can be seen that even if there are no restrictions on activities, taxes alone can force some activities underground so that they are unrecorded and escape tax liability.

Among those factors associated with taxes are (Tucker, 1982, pp.315-322):

1. the growth of government regulations, prohibitions and reporting requirements which encourage firms and individuals to avoid the associated costs and problems of legal employment;
2. the imposition of taxes which encourage activities to go "underground" to avoid payments that seem disproportionately high when compared with the income earned;
3. a high inflation rate, which has pushed individuals into higher tax brackets, and provided an incentive to seek alternative sources of income that are not detected by the taxman, and
4. the knowledge that loopholes exist in the present laws that encourage people to try to "buck the system".

The underground economy accounts for a significant proportion of current marketplace activity and covers a wide range of people. Since the existence of such activities is inherently concealed, indirect methods must be used for estimation, thus resulting in highly variable figures (Kesselman, 1994, pp. 62-84). Gutmann was the first to use monetary statistics as an indirect measure of the underground economy in the United States. In any economic transaction, only currency or cheques are used as the final medium of exchange. Gutmann's basic premise is that all underground activities avoid the use of cheques and rely on currency for transactions. Gutmann (1977, pp. 26-27) considers the ratio of currency, C, to demand deposits, D. The argument is that an increasing C/D ratio reflects the greater relative use of cash as the hidden economy grows. Adapting Gutmann's approach, the Commercial Bank of Australia estimated that the underground economy in Australia during 1978/79 was nearly $11 billion in Australia, or 10.6 percent of gross domestic product (Tucker, 1982, pp. 315-322). The drawbacks of this approach are that the results are sensitive to the base year

chosen and that there are many factors which may influence the holding of cash relative to the total money supply. There is a need for accurate measurement of the total volume of transactions and an assumption of a constant transactions ratio (see Cagan 1958); Garcia 1978; Garcia and Pak 1979).

Hepburn (1992, pp. 54-62) adopted the approach used by Tanzi (1982) to develop an econometric model to explain variation in the currency ratio, defined as the ratio of currency, C, to total money, M2. The currency ratio (C/M2) is modelled as being a function of real per capita income (Y), the nominal interest rate (R), the percentage of household income accounted for by wages and salaries (W), a taxation variable (T), and a lagged dependent variable [$(C/M2)_{-1}$]. Estimation using ordinary least squares and annual data for the above variables over the period 1949-50 to 1989-90 yielded the following results (t-statistics are given in parentheses and the interest rate variable was excluded as it was found to be insignificant in prior regressions):

$$(C/M2)_t = -0.090453 - 0.00089217Y_t + 0.19147W_t + 0.0040336T_t$$
$$\quad (-2.701) \quad\quad (-5.5159) \quad\quad (4.488) \quad\quad (4.049)$$
$$+ \; 0.86151(C/M2)_{t-1}$$
$$(10.469)$$

R^2 0.929, Adj.0.920, Durbin's t-statistic-1.404, RESET 0.409, LM 17.059, No. of observations: 40.

Hepburn (1992, pp. 54-62) used the model to obtain estimates of the model's predicted currency ratio for each year. By substituting zero for the tax variable, a prediction of currency holdings in the absence of income taxation is obtained. Subtracting this tax-free estimate of currency holdings from the first estimate gives a measure of taxation-induced currency holdings. The total amount of income or productive activity being financed by taxation-induced currency holdings can then be estimated. The key assumption made is that the relationship between the taxation-induced currency holdings and the cash economy is the same as that between the legal component of M2 (the legal money supply used for transactions) and measured GDP. The cash economy can be calculated as taxation-induced currency holdings (TC) multiplied by the velocity of circulation (V):

Cash Economy = TC.V
V = GDP/(M2 − TC)

The velocity of circulation of illegal money in the hidden economy is assumed to be the same as for legal money in the observed economy. Hepburn also noted that to the extent that illegal cash is hoarded by tax evaders, the estimated velocity may be higher than the actual velocity of circulation in the cash economy. He found that the cash economy, as a percentage of measured GDP in Australia in the period from 1959-60 to 1988-89, has grown steadily, and in 1989-90 was 7.3 percent of GDP. As noted by Pulle (1998, pp. 44-49) in the Budget Review 1998-99, the Australian Bureau of Statistics or ABS estimated that the cash economy could have ranged from 3.5 per cent to 13.4 per cent of GDP in Australia. In 1998-99 the cash economy could therefore have ranged from $20.3 billion to $77.7 billion and on the basis of revenue expectations in the 1998 Budget, the revenue lost would have ranged from $5.1 billion to $19.4 billion in Australia in 1998-99.

The underground economy also leaves traces in the spheres of income and expenditure. The most obvious variant of this approach is to deduce the size of the hidden economy from the estimated amount of tax fraud. Its size can be deduced from the difference between the GNP as estimated from the income side, which is mainly based on tax reports and the expenditure side, which is independently calculated by undertaking household and industrial surveys on the value of goods and services purchased (see Macafee, 1980). For the national accountant, the word "hidden economy" might be taken to consist of the error between his published measure of economic activity and the "true" figure which is the target of his measurement. The ABS identifies the following areas as constituting the principal sources of understatement of GDP (AGPS, 1981, pp. 158-159).

The major area of understatement on the income side is considered to be income of unincorporated enterprises which is difficult to estimate accurately because of understatement of income reported to the Taxation Commissioner (the major source of data). On the expenditure side there are three major areas of known understatement deduced from inadequate data sources, viz:

1. No estimate has been included of the expenses associated with the sale of dwellings and other buildings and land, e.g. legal fees, real estate commission, and stamp duty.

2. No estimate has been included in capital expenditure on private dwellings to cover those alterations and additions which either do not require a local government permit or for which the owner does not obtain the requisite permit.

3. No estimate is included in private final consumption expenditure for expenditure on illegal goods and services, e.g. no allowance is made for the purchase of illicit drugs or payments relating to illegal gambling and prostitution.

Further as noted by Carson:

> ....income that is not reported on tax returns does not necessarily escape GNP. This point is particularly important because it was often missed in early work on the underground economy; it was mistakenly assumed that, because income tax return information is one of the sources used to estimate GNP, unreported income on income tax returns was unmeasured income in GNP. (1984, p. 4)

Bhattacharyya (1990) estimated the hidden economy for the United Kingdom to be 3.8 per cent of GNP in 1960, peaking at 11.1 per cent in 1976, and averaging about 8 per cent in 1984. However, a British Inland Revenue analysis reported by Chote (1995) suggests that the hidden economy may be 6-8 per cent of GDP. In addition, Giles (1998, pp. 93-110) has undertaken a comprehensive study to measure the extent of the hidden economy or HE in New Zealand, exploring some of its determinants, its responsiveness to fiscal instruments and investigating the size of the associated tax gap in that country. His research revealed a clear and statistically significant link between high taxes and the size of the underground economy. Giles and Caragata (1996) also show that successive reductions in the effective tax rate reduces the ratio HE/GDP, though not uniformly. The hidden economy in New Zealand has been growing over time relative to GDP, ranging from 6.8 per cent in 1968 to 11.3 per cent in 1994, and averaging 8.8 per cent over 1978 to 1994 (Giles, 1998). Giles (1997) has shown that tax-related prosecution can have a significant effect on the hidden economy in New Zealand, which correlates with the finding of Cebula on the underground economy in the United States (1997, pp. 173-185). Based on ordinary least squares estimates on data generated for the period 1973-94, Cebula found that the maximum marginal personal income tax rate raises the size of the underground economy. In addition, the size of the underground economy in the U.S. during this period was found to

be a decreasing function of both the percentages of tax returns audited and the penalties imposed by the IRS on unpaid taxes.

Tax non-compliance is a growing national problem. The Swedish Riksskatteverk (tax office) estimated that during the 1970s between 8 per cent and 15 per cent of income was not declared (Hansson, 1980, pp. 395-602). For Italy, the estimates range from 10 per cent (De Grazia, 1980) to 33 per cent as reported by Martino (1980). Kaldor (1956, p. 104) estimates that annually a non-salary income of Rs 576 crores evades tax in India and that amount of income tax lost through tax evasion is more of the order of Rs 200-300 crores. In Britain, estimates have indicated that the equivalent of 7.5 per cent of Britain's GNP escapes legitimate taxation. There is also evidence that 17 per cent of the taxable income in Belgium remains undeclared (Lewis, 1982).

Feige (1979, pp. 5-13) used the "transactions approach" or the currency demand, whereby changes in the size of the hidden economy can be judged from movements in the demand for currency, i.e. notes and coins in circulation. He found that the U.S. shadow economy lay between 13 per cent and 22 per cent of GNP in 1976, and between 26 per cent and 33 per cent of official GNP in 1978. Aigner, Schneider, and Ghosh (1988, pp. 297-334) reported that estimates of the irregular economy of the United States, as a proportion of the total economy, ranged widely from 4 per cent (Park 1979) to 33 per cent (Feige 1979) of GNP. The IRS (1979) calculated that in 1976, between 5.9 per cent and 7.9 per cent of income was not reported to the tax authority. Additionally, the General Accounting Office or GAO reports that the IRS has estimated that taxpayers do not pay voluntarily more than $100 billion annually of taxes due on income sources.[2] This *income tax gap*, defined by the GAO as the "difference between income taxes owed and those voluntarily paid", indicates significant non-compliance and the extent of the challenge that the IRS faces in finding ways to reduce the tax gap. This growing interest in tax avoidance has led to increased funding for the research in this area of study. For example, it was estimated that the tax gap was $81.5 billion for 1981, an amount that exceeded the federal deficit for that year (IRS, 1983). The IRS also estimated that the income tax gap for individuals reached as high as $95 billion for tax year 1992 (GAO, 1997). Thus,

the Internal Revenue Service, the American Bar Association, and the public accounting firm of Arthur Young & Co. have all committed thousands of dollars to tax compliance research (Jackson and Milliron, 1986, pp. 125-165).

A link between tax avoidance and evasion and defective official statistics is provided by the obvious incentives to mis-report (Trengove, 1985, pp. 85-95). These incentives exist whenever the information sought is to be used in a way that will affect the circumstances of the individual(s) providing it. The most concrete example is the reporting requirements imposed by systems of taxation where failure to report, or mis-reporting, is a means of altering tax liability.

2.3.1 The importance of non-compliance

Research on income tax non-compliance has attracted policy makers and economists since tax non-compliance can disrupt the forecasted economic performance of a country and thus may lead to the failure of its economic policies. It may also have major implications for the legal economy in terms of monetary and fiscal policy, income distribution and productivity. Many of the policies introduced to correct perceived adverse economic trends subsequently prove to be ineffective, at least partly because of the growth of the underground economy and the consequent distortion in the recording of statistics relating to macroeconomic variables such as employment, growth and inflation, savings and consumption, and productivity (Tucker, 1982, pp. 315-322).

2.3.1.1 Employment

Employment statistics cover individuals in the labour force. However, those who are only employed in the underground economy may be excluded from statistics, thus resulting in understated employment levels. At the same time, unemployment statistics can be overstated by including those people who work in the underground economy and who have no intention of working in the legal economy, yet register as unemployed so as to receive benefits. Hence, an element of "disguised employment" distorts these statistics. This causes policymakers, aiming at full employment, to plan on the basis of incorrect assumptions.

Official employment statistics also conceal "disguised unemployment." This refers to: (1) people who work in a family business or other capacity at less than their full potential, because they are unable to find more suitable employment; (2) those who would like to work but are precluded from registering for unemployment benefits because of an employed spouse; and (3) (mostly young) people who elect to continue their education rather than register as unemployed.

Any such disguised unemployment does not neutralise, and may be more than offset by, the disguised employment in the underground economy. In any case, both situations distort employment statistics.

2.3.1.2 Growth and inflation

If the underground economy is growing faster than the legal economy, economic resources shift from the latter to the former. Since the rate of economic growth is only measured in the legal economy, actual economic performance is understated. At the same time, inflation in the total economy may be overstated. Workers in the underground economy do not pay tax and are, as a result, may well be prepared to accept lower wage rates than those in the legal economy. Suppliers of other inputs are also avoiding government-induced costs and are prepared to accept lower prices for goods and services produced. Both the level of prices, and the rate of price increase in the underground economy, may be therefore lower than in the legal economy, raising the possibility that the officially recorded inflation rate overstates the true position.

2.3.1.3 Savings and consumption

Since part of the income from which savings and consumption is drawn is underground income, and excluded from official calculations, economic data concerning savings and consumption are understated.

2.3.1.4 Productivity

Additional problems are also caused by those who are employed in both the underground and the legal economies. Their productivity is lowered because they are tired on the job, or prone to frequent absenteeism. As a result, they are also more prone to accidents and risking dangerous procedures.

2.3.1.5 Inequity

Non-compliance also may lead to inequity in the burden of taxation as explained below.

An exchange relationship exists between the taxpayer and the government. The taxpayer forgoes a portion of purchasing power in the private market in return for government benefits, including goods and services and, perhaps, some non-material sources of satisfaction, such as a sense of belonging or affiliation. However, if the public feels increasingly overtime that taxes are unfairly imposed, it is increasingly likely to evade paying taxes. Using survey data collected from 1960-1980, consisting of information on tax rates and estimates of tax evasion, Etzioni (1986, pp. 177-185) found that tax evasion increased during this period, as did the percentage of Americans who considered taxes to be unfair, even though tax rates remained stable. Further, he also found that Americans who were presumed to have the least incentive to cheat were the most likely to consider taxes unfair. As found by many researchers (e.g. Spicer, 1986, pp. 13-20; Wahlund, 1992, pp. 657-677) the burden is heavier on the earning class and honest taxpayers. Non-compliance may also influence income distribution depending upon the income classes or groups that benefit most from tax evasion. People choose occupations where tax evasion or tax avoidance may provide an easier, better possibility of avoiding payment of taxes. Non-compliance also may accumulate black money on a large scale, which upsets the forecasted economic growth of a country as discussed above. Thus serious study of this problem is very important as in the introduction of strategies to overcome the problem while enhancing voluntary compliance among taxpayers.

2.3.2 Measurement of income tax non-compliance

In estimating the extent of income tax non-compliance, Herschel (1978, pp. 232-268) in his quantitative research in Argentina, proposed a gap approach to detecting income tax evasion. It was found that gross income according to tax returns was only 21.5 per cent of the total according to the national accounts (60.7 billion/281.9 billion Argentinian pesos). (Like one examimer, I can't understand this – suggest clarify or delete. PJS)

2.3.2.1 The gap approach

National accounting and other data are used to estimate, after appropriate deductions, the total taxable income for various groups. These can then be compared with the taxable income declared by taxpayers to the taxation authority. When income data are available, it is possible to estimate potential, actual, and evaded income tax liabilities by income class. The value of this approach is limited to the extent to which the authorities compiling the national accounts data have better sources of information than those contained in taxpayer declarations. This may often be the case with government and business records, financial institution records and so on.

Herschel found for Argentinians that evasion is highest in the middle-income group when expressed as a percentage of potential tax, but on the other hand, considering the absolute amount of tax evasion, the greater part is concentrated in the higher income brackets (1978, pp. 232-268). This implies that the tax authorities should concentrate their efforts against evasion in the higher or middle income groups. However, Allingham and Sandmo (1972, pp. 323-338) reported that the effort to detect tax evasion has to be concentrated on high or low reported income, since these groups of taxpayers evade their income tax the most. Thus the most effective policy to be followed is not certain.

2.3.2.2 Expenditure-income discrepancy method

This method can be applied to the entire economy or on a disaggregated basis on the assumption that although incomes may be concealed or understated, expenditures will eventually show up somewhere (Cowell, 1990, p. 19). The discrepancy between the income data (after relevant deductions) and the

expenditure sides of GDP (either for the entire economy or on disaggregated basis) give an "unexplained difference or residual" that provides some clues to the size of the hidden economy. Although it is subject to measurement error, the evidence of extraordinarily high expenditures relative to income, especially at disaggregated level, can be used to identify those groups of individuals or households that may be active in the black economy. Thus the behaviour of these groups can be analysed and used to derive an estimate of concealed income.

There are three major weaknesses involved in estimating the aggregate income of the national accounting level (see for instance, Macafee 1980): (i) There are errors in both estimates of aggregate income; (ii) there are errors due to differences in the statistical coverage; (iii) the national income estimates are not always completely independent of the tax data based income estimates, that is, income not captured by tax authorities may also not appear in the national income data. According to some researchers (Albers, 1974; Feige, 1980a, 1980b; O'Higgins, 1980) the discrepancies among the various income estimates must be regarded as the lower boundary for unreported income.

Table 2.1 below shows the estimates in terms of national income for the size of the underground economy based on the traces left in the form of "unexplained residuals" for a number of countries.

Table 2.1 Unexplained differences in national income measures, various countries and years

Country	Year	Estimate of size (per cent)	Author
United States	1948	9.4	Park (1979)
	1958	6.8	
	1968	5.5	
	1977	4.0	
United Kingdom	1970	1.0	O'Higgins (1980)
	1972	1.1	
	1975	1.8-2.4	
	1978	2.5-2.9	
Denmark	1964/65	12.4	Økonomiske Råd
	1970/71	10.0	(1967, 1977)
	1974/75	6.0	
Sweden	1978	4.6	Hansson (1980)
Federal Republic of Germany	1968	8.9	Albers (1974)
Belgium	1965	18.6	Frank (1972, 1976)
	1966	19.6	
	1970	18.9	
France	1965	23.2	Roze (1971)

Source: Frey and Pommerehne in 'The Underground Economy in the United States and Abroad' edited by Tanzi (1982, p. 17).

2.3.2.3 Elffers, Weigel and Hessing (EWH) tax-evasion measurement

The EWH tax-evasion measurement (1987, pp. 311-337) was the first to address the issue of the relationship between officers' classification and self-reports of taxpayers (Elffers, Robben and Hessing, 1992, pp. 545-567). It demonstrated a strategy capable of documenting the occurrence of an individual's tax-evasion behaviour as seen by the tax inspectorate from tax returns, combined with the self-reports of the taxpayers concerned, while protecting individual anonymity.

2.3.2.3.1 Officers' classification

A procedure was developed to identify individuals who were tax evaders and non-evaders from the 1981 and 1982 tax records in the Netherlands:[3]

a) Evaders: to be classified as a tax evader an individual's tax return had to fulfil two criteria. First, the tax return for both 1981 and 1982 were evaluated as requiring corrections of at least 500 guilders. Second, two different tax officials were independently asked to judge whether or not the instances of undisclosed income or unwanted deductions were ambiguous (e.g. may have resulted from inadvertent errors) or were "clearly reproachable" (exhibited fraudulent intent as evinced by third party documentation of unreported income or failure to justify

deductible expenses when previously confronted). Only those individuals whose returns from both of the years under consideration were judged "clearly reproachable" were retained in the tax evader category; and

(b) Non-evaders: This category included individuals whose returns for both 1981 and 1982 were judged to require no corrections whatsoever after both the routine review given all tax returns and two independent audits. This two-stage criterion set a stringent standard: less than 50 per cent of the taxpayers whose 1981 and 1982 returns had gone unchallenged by the routine reviews, retained "non-evader" status after being subjected to the multiple audit procedures.

Using the above criteria 342 tax evaders and 342 non-evaders were identified by the Office of the Tax Inspectorate. Once the pool of 684 potential respondents was identified, the chief of the Office of the Tax Inspectorate sent the individuals' names, addresses, telephone numbers, and coded information regarding the evaluation of their tax returns to a bonded third party or a notary (a specialised lawyer) in this case. He then sent each of the potential respondents a letter asking for their cooperation in a scientific study of citizens' attitudes towards the Dutch tax system and assured them that the anonymity of their responses would be guaranteed. Those willing to participate returned a card to the notary and a convenient date for interview was set. The interviewer also explained that the notary would supply the research team with coded information regarding any tax violations by the respondent during 1981 and 1982. In this context, three issues were stressed: (a) the Tax Inspectorate was legally constrained from using such information to re-open individual cases or increase any respondent's chances of a future audit; (b) the procedures assured that the Tax Inspectorate could never determine which of the potential respondents had opted to participate in the research; and (c) neither the Tax Inspectorate, the notary, nor the research team would ever have simultaneous access to respondents' names, tax records and self-reports.

Following the above explanations, the interviewer asked the respondents to sign a consent form permitting the notary to release the coded information on the past tax corrections to the research team. When the interview was completed, the consent form and the answer sheet were sealed in an envelope and mailed to the notary.

The notary checked the consent form, attached the coded tax information to the respondents answer sheet, removed the respondent's name from both of the latter two documents and mailed them to the researchers. When all of the interviews were completed, the Tax Inspectorate mailed the decoding key for the tax information directly to the researchers. Of the 684 persons who were initially contacted by the Tax Inspectorate, 155 (23 per cent) signed the consent form and completed the interview. Given this attrition rate, it could be argued that those individuals agreeing to participate in the research were those whose past behaviour had been most impeccable. Conversely, those who had something to hide opted out. Elffers et al. (1987, pp. 311-337) gave three reasons, however, for arguing that the 155 respondents included in this study faithfully represented those in the initially designated subject pool. First, nearly all the attrition resulted from failing to return the card that indicated a willingness to be interviewed. Only two respondents dropped out: one emigrated before he could be interviewed and the other refused to sign the consent form. Among the 529 non-participants, there was only one refusal when he was informed of the parameters of the study. Second, those individuals ultimately designated as tax evaders were as likely to agree to participate as the non-evaders: 46 per cent of the 155 respondents were identified as having evaded taxes according to the criteria previously described. Third, participating and non-participating tax evaders were quite similar with respect to the amount of corrections assessed against their 1981 and 1982 tax returns.

2.3.2.3.2 Self-reported tax evasion

At the end of the interview respondents were asked whether he or she had under reported his/her income or any unwarranted deductions in his/her 1981 and 1982 tax returns. A score of '0' indicated that the respondent denied evading taxes by under reporting income or unjustifiable deductions in both years, a score of '1' indicated acknowledgment of tax evasion for one of the two years, and a score of '2' indicated acknowledgment tax evasion in both years.

Despite the safeguarding of respondents' anonymity (which should have minimised the effect of impression management) the results showed that the documented and self-reported tax evasion did not correspond at all. The correlation between self-reported evasion and documented evasion was 0.06, and

-0.03 for the relation between self-reporting and the amount of taxes paid back. There were inconsistencies between the self-report and official data in 45 per cent of cases and as predicted there was less inconsistency in the non-evader group, where 25 per cent reported some misrepresentation of income or deductions, than in the evader group, where 69 per cent denied evading taxes in either year. Evasion was usually denied even by the most flagrant evaders defined as those whose audits resulted in corrections of more than a thousand guilders in both 1981 and 1982 and of whom more than 70 per cent denied misrepresenting income or deductions in either year. EWH believed that various measures were targeted at one common core concept of tax evasion, but such factors as differences in knowledge levels, perspectives and purposes between tax officers and taxpayers have no perfect correlation. The possibilities in respect to the divergence of these two measures might be due to the contrast group design used, where more trust should be placed in the officially documented behaviour.

Partial replications of these results were also obtained by Kinsey (1988) who carried out a secondary analysis of an IRS-sponsored survey in the U.S. She found that although no match was identified between the measures of attitudes, subjective norms, and personality variables as in EWH measurement, she was able to construct scales that corresponded well using the self-reported audit outcome. The respondents who reported having paid more taxes as a result of a tax examination were treated as 'officially defined' tax evaders, while those who admitted non-compliance in the previous five years were treated as self-reported evaders. The results obtained were comparable to EWH. The attitude and subjective norm measures correlated with self-reported evasion and not with self-reported audit outcome, while the tolerance of illegal behaviour was correlated with self-reported audit outcome and not with self-reported evasion. Kinsey concludes that the findings of EWH are robust, and documented tax evasion should not be the benchmark by which other forms of measurement should be assessed.

The above findings suggest that obtaining accurate self-reports about personally sensitive information such as evasion is difficult, especially from the evaders who are more concerned about prosecution. As argued by Webley, Robben, Elffers and

Hessing (1991), although non-compliance is a social construction, it is not just that; taxpayers are, after all, making decisions and acting upon them.

2.4 Summary

Income tax non-compliance consists of intentional and unintentional non-compliance. Unintentional non-compliance may arise due to the complexity of tax provisions, which might lead to the failure of the taxpayer to remit the proper amount of tax, or from other factors. Intentional non-compliance can be divided into tax evasion and tax avoidance. Tax evasion occurs when taxpayers either under report income or exaggerate deductible expenses when filing their returns. On the other hand tax avoidance refers to avoiding the payment of taxes through using loopholes in the Income Tax Legislation.

Income tax non-compliance is a growing national problem. In the United States for example, the IRS reported that voluntary compliance had declined in the 1970s and 1980s and billions of dollars were lost due to tax evasion. The cash economy as a percentage of GDP declined in the 1950's, but it increased steadily in the 1960's and registered up to 7.8 per cent at the end of 1980's in Australia. Sweden, Italy, India, France, Britain and Belgium also suffered from this problem in the 1950's to 1980's.

Income tax non-compliance has attracted several researchers interested in determining the size of the irregular or underground economy caused primarily by tax evasion. Research into income tax evasion has also attracted policy makers and economists, for its existence can disrupt the forecasting of a country's economic performance that may lead to a failure of its economic policies and disruption of income distribution and productivity. Non-compliance may distort the recording of statistics relating to macroeconomic variables such as employment, growth and inflation, savings and consumption. It may also results in inequity in the burden of taxation whereby the burden is heavier on salaried classes and honest taxpayers. Productivity is lowered, especially for those moonlighting. Thus it is important for the taxation authority to estimate the extent of income tax non-compliance in the country. It should target the group of taxpayers that are more inclined to evade paying taxes so that it can measure its performance from time to time and channel

its efforts to this particular group of taxpayers and hence achieve a more efficient allocation of resources. It should also take various precautions and undertake strategies to combat this activity.

Various methods have been applied in estimating the extent of income tax non-compliance. Among them are the gap approach, the expenditure-income discrepancy method and the EWH tax-evasion measurement. Both the gap approach and the expenditure-income discrepancy methods make use of the national accounts data. The difference is that in the gap approach, the income side of the national account data is compared with the total amount of income that has been reported to the taxation office after relevant deductions have been considered. While in the expenditure-income discrepancy method, the expenditure side of GDP is used instead. As for the EWH tax-evasion measurement, this demonstrates the individual's tax evasion behaviour as seen by the tax inspectorate from tax returns, combining this with the self-reports of the taxpayers concerned, while protecting individual anonymity. There are some weaknesses in adopting the above mentioned approaches. In the first two approaches, i.e. the gap approach and the expenditure-income discrepancy method, because they make use of the national accounts data in obtaining the "gap" and the "unexplained difference or residual" that might estimate the size of non-compliance. There are errors involved in estimating the aggregate income of the national accounts data, and its statistical coverage is not always completely independent of the income tax data. As for the EWH tax-evasion measurement, it is very difficult to obtain truthful self-reports on evasion especially from tax evaders who are more concerned about prosecution, thus more trust should be placed in officially documented behaviour.

CHAPTER THREE

Review of Literature on Some Factors Influencing Income Tax Non-Compliance

3.1 Introduction

One of the most common theoretical accounts of tax evasion/non-compliance is the rational maximising model. In this model, the human being is seen as a rational calculator, concerned with maximising his or her own utility (Allingham and Sandmo, 1972; Lewis, 1982). Thus most attention is placed on the individual person (see Chang, Nichols and Schultz, 1987). The economic approach to the whole issue of income tax non-compliance is founded on the analysis of the behaviour of the individual non-compliant. How the individual perceives his/her economic opportunities to be affected by the tax code and by the instruments of tax enforcement is particularly relevant. It is commonly assumed that there are cultural differences with respect to how taxes are perceived by the population of different countries (see Strümpel 1969; Schmölders 1970). Therefore this research is being undertaken to study some of the demographic variables and to isolate some possible factors that may have influenced behaviour, for example, in Malaysia.

This chapter contains six major sections, the first four sections highlight demographic variables such as age, gender, income level and income source of non-compliants studied previously by researchers in other countries. However, none of these research studies were conducted in Malaysia. Thus this research is being undertaken to investigate whether similar results (or the opposites) are true for Malaysian taxpayers.

Section Five discusses some possible factors that may influenced taxpayers to not comply with income tax law such as financial strain, complexity of the law and the use of tax preparers as reported previously by other researchers. Thus, this research will explore reasons given by Malaysian taxpayers for failing to comply with the Income Tax Regulations. The last section summarises this chapter.

3.2 Age

Table 3.1 below shows some major findings regarding the relationship between age and income tax non-compliance.

Table 3.1 Findings on the relationship between age and income tax non-compliance

Characteristic	Authors	Key findings
Age	Spicer and Lundstedt (1976)	Relationship between age and level of non-compliance was indeterminate.
	Tittle (1980)	Negative link between age and income tax non-compliance.
	Spicer and Becker (1980)	No significant relationship between age and compliance.
	Warneryd and Walerud (1982)	Negative link between age and income tax non-compliance.
	Clotfelter (1983)	Middle-aged group was found less likely to comply.
	Wallschutzky (1984)	Evaders came from older group than the non-evader group.
	Wahlund (1992) Wearing and Headey (1997)	Negative link between age and income tax non-compliance.

Source: Author's collection from literature review.

Some researchers have found a negative link between age and income tax non-compliance (Tittle, 1980; Warneryd and Walerud, 1982, pp. 187-211; Wahlund, 1992, pp. 657-677; Wearing and Headey, 1997, pp. 3-17). However, some did not find any relationship between these two variables (Spicer and Lundstedt, 1976, pp. 295-305; Spicer and Becker, 1980, pp. 171-175).

In his survey research, Tittle (1980) suggests that the negative relationship between age and non-compliance is attributable to both lifecycle variations and generation differences. Young taxpayers are more willing to take risks and are less sensitive to sanction (a lifecycle variation). He has also found that strong community cohesion experienced during childhood may reduce tax evasion and other illegal behaviour later on in life. This also reflects social and psychological

differences which can be attributed to the period in which the subjects were raised (a generation difference).

In their survey of 426 Swedish male adults in 1981, Warneryd and Walerud (1982) found that multivariate analyses of the data indicated that younger people were more prone to tax evasion. They explained that this might be due to younger taxpayers having more opportunity for tax evasion than older people in general. Opportunity means that the taxpayer is self-employed, is moonlighting without withholding tax, or is otherwise able to control his income. It may also mean that the probability of the evasion being detected is judged to be low (Warneryd and Walerud, 1982). Since younger persons increase their earnings considerably and are more likely to have part-time jobs or to moonlight compared with older people, this group also has shown more negative attitudes than those of the average age and also displayed a lenient attitude to tax crimes.

Wahlund (1992) also found the same trend of evasion in a Swedish survey, where younger people evade taxes more than older people. He reasoned that younger people are less negative towards tax evasion than older people, they judge the risks of tax evasion to be smaller than older people, they have more opportunities to evade taxes, and they are less "socialistic" than older people. According to his model, high marginal tax rates result in aversion to taxes. Increased aversion to taxes makes a person adopt a more lenient attitude towards tax evasion. The latter causes the person to use the available actual opportunities for evading taxes. All this leads in turn to more tax evasion.

Similarly, Wearing and Headey (1997) in their random sample of respondents in Melbourne found that there is a negative correlation between age and propensity to evade taxes. Older persons are less likely to evade taxes.

However, Spicer and Lundstedt (1976) in their 1974 survey one hundred and thirty middle and upper income households from two suburbs in a large metropolitan area in central Ohio, found that the relationship between age and the level of non-compliance was indeterminate. Increasing age appears to be related to lower tax resistance but the tax evasion index was not statistically significant with age with a 5 per cent of significance level. Given the control of opportunity factors such as

self-employment, income level, and the proportion of income received in salaries, wages, or pension, these results may reflect differences in the extent to which norms reflected in the law are internalised by different age groups. Consequently, Spicer and Becker (1980) in their experimental approach using fifty-seven University of Colorado (Colorado Springs) students as their subjects, found that there was no significant relationship between age and compliance. In explaining these two findings, Jackson and Milliron (1986, pp. 125-165) proposed that for researchers who used a limited subset of the population (e.g. Spicer and Lundstedt, 1976 whose sample is restricted to middle and upper income groups of two suburbs of Central Ohio), a lack of significant results may be attributable to a wide range of restrictions. The lack of variability in the restricted variable tends to reduce the significance of the overall relationship. While in the case of using students as their subjects (e.g Spicer and Becker, 1980), the lack of significance may be due to statistical errors. Since a sample is a subset of a larger population, if errors are made, the sample does not give reliable estimates of the population.

Unlike the above findings, Clotfelter's result was a plausible one since he uses a rather large sample size (1983, pp. 363-373). Clotfelter used data from the IRS Taxpayer Compliance Measurement Program. The sample includes approximately 47,000 individual tax returns for 1969. The TCMP survey consists of extensive audits of a stratified random sample of the taxpaying population of the U.S. It was found that the youngest and oldest segments of the population had the highest degree of compliance. Thus this infers that the middle age group was found less likely to comply.

On the contrary, Wallschutzky (1984, pp. 371-384) in his survey population of "evaders" and "non-evaders" in Australia, found that age was significant at the 5 per cent level of these two groups. Evaders tended to be older when compared with the non-evader group.

3.3 Gender

In modern societies such as those in western countries, the traditional role of the father as the main bread winner and major decisions maker, has given way to changing roles as more women work outside the home. Both men and women play

equally important roles in raising the family and it is not unusual for the wife to work and earn a living while the husband does all the housework. However, in Asian countries most of the major decisions are made by the husband wishes. Hence the husband always plays an important role in earning a living, either solely or helped by his wife in raising a family. In these countries, it is rather abnormal for the wife to be the sole breadwinner in the family, since it is against the culture and even the beliefs of some religions.

Based on the above situations, it is important to study whether males and females particularly in Malaysia, behave as in western countries regarding income tax non-compliance. Table 3.2 below provides some major findings regarding the relationship between gender and income tax non-compliance.

Table 3.2 Findings on the relationship between gender and income tax non-compliance

Characteristic	Authors	Key findings
Gender	Vogel (1974) Mason and Calvin (1978)	Males less compliant than females.
	Friedland, Maital and Rutenburg (1978)	Females were less compliant than male subjects.
	Tittle (1980)	Males less compliant than females.
	Grasmick, Finley and Glaser (1984)	A new generation of independent non-traditional women may be closing the compliance gap between men and women with regard to tax evasion.
	Kinsey and Grasmick (1993)	Women comply more than men.
	Hite (1997)	Females without college degree tended to be compliant & males without college degrees were non-compliant. On the other hand, females with college degrees tended not to comply & males with college degrees tended to comply.

Source: Author's collection from literature review.

The majority of studies including those of Vogel (1974, pp. 499-513), Mason and Calvin (1978, pp. 73-83), Tittle (1980) and others found that males were less compliant than females. In his research in Sweden, Vogel (1974) reasons that men think themselves to have better illegal opportunities than do women, perhaps

providing an indication of a more aggressive gender role. Similarly, Tittle in his research in a U.S. community (1980) suggests that the relationship between gender and deviance is also attributable to both lifestyle variations and generation differences. Traditionally, Tittle argues, females have been identified with conforming roles, moral restraints and lead more conservative life patterns. This in turn promotes tax compliance. However, Grasmick, Finley, and Glaser (1984, pp. 703-718) in their studies in the U.S. indicate that a new generation of independent, non-traditional women may be closing the compliance gap between men and women with regard to tax evasion. Further, Kinsey and Grasmick (1993, pp. 293-325) analysed attitudes toward tax compliance in data from 1979, 1985, 1987, and 1988 surveys in the U.S. On controlling for the direct influence of income and education in a large pooled sample size, gender tended to correlate with compliance, with women complying more than men. It is important here to note that the gender effect remains only after controlling other factors. However, interaction effects were not examined.

While Hite (1997, pp. 155-180) in a telephone survey of 566 randomly selected participants in a mid-western state, found that females without college degrees tended to be compliant but males without college degrees generally were non-compliant. In contrast, males with college degrees had a tendency to comply while females with a college degree tended not to comply. Hite also concludes that the aggressive behaviour of college-educated females is prevalent among high incomes. On the other hand, the aggressive behaviour of males without college degrees is magnified for those who usually have a balance due at tax filing time.

There may also be some interactions between gender and the compliance variable "probability of detection". Richards and Tittle (1981, pp. 1182-1199) noted that women's perception of likelihood of arrest for tax evasion is significantly higher than men's. They attribute this to the fact that girls are more closely monitored by their parents which leads to a greater stake in conformity and a greater perception of visibility. However, if parents tend to make fewer distinctions based on sex when rearing their children, this difference may be expected to be less.

On the contrary, Friedland, Maital, and Rutenburg's experimental study of 15 undergraduate Israeli students indicated that females were less compliant than

male subjects (1978, pp. 107-116). Since their study was based on a small sample size, their results could not be generalised. Further, as Webley and Halstead raised regarding the degree to which the experimental situation parallels taxpayers' decisions in natural settings (1986, pp. 87-100), they found that when the situation was defined as a "problem" rather than as a "game" subjects optimised more efficiently. More importantly, in their post-experimental interviews, it was revealed that most people saw the situation as a game, and only a minority saw it as a tax-declaring situation or as an optimising situation. This suggests that experimental evidence cannot be generalised especially when their external validity is doubtful.

In terms of the relationship between gender and the amount of tax evaded, Friedland, Maital and Rutenburg (1978) found that males evade a greater percentage of their taxes than females, holding other variables constant a finding, which was later supported by Spicer and Becker (1980).

3.4 Income Level

Income level, usually defined as adjusted gross income (AGI), consists of taxable sources of income as reported on the annual tax return. AGI is a measure of the individual income tax base and it has a positive correlation with income tax rates, hence it is linked directly to tax payments. Table 3.3 below shows some past research studies and their findings regarding the relationship between income level and income tax non-compliance.

Table 3.3 Findings on the relationship between income level and income tax non-compliance

Characteristic	Authors	Key findings
Income level	Frank and Dekeyser-Meulders (1977)	High-income professionals practice extensive tax evasion in Belgium.
	Mason and Lowry (1981)	Middle-income earners were more compliant than high and low- income earners.
	Wallschutzky (1984)	Higher income earners are more prone to evade their taxes.
	Witte and Woodbury (1985)	Middle-income earners were more compliant than high and low-income earners.
	Christian and Gupta (1993)	Income level is negatively correlated with tax evasion.
	Wearing and Headey (1997)	Lower occupational status, earn less and without family responsibilities tend to evade taxes more.

Source: Author's collection from literature review.

Based on Table 3.3 above, it can be deduced that the research examining correlations for income with compliance has been inconsistent. Jackson and Milliron (1986, pp. 125-165) reported that the mixed results could be a result of the range of incomes the sample represents. For example, Christian and Gupta (1993, pp. 72-93), who examined taxpayers with taxable incomes of less than US$50,000, found that income was negatively correlated with tax evasion. On the other hand, Witte and Woodbury's finding on analysing 1969 data from randomised taxpayer audits, was that middle income earners were more compliant than higher income earners (1985, pp. 1-14). They specified middle income earners as being those who earn US$30,000 adjusted gross income or less. The correlation of higher income with non-compliance is consistent with the Arrow-Pratt assumption that risk aversion decreases as income increases (Witte and Woodbury, 1983, pp. 1-13). Non-compliance is expected to increase with income, given the assumption that risk aversion decreases as income rises. Thus, higher incomes are expected to increase aggressive levels of income reporting. However, Witte and Woodbury (1985, pp. 1-14) also found that better educated areas with large student populations have generally low levels of compliance, which might

explain knowledge of evasion opportunities. As found by Chang (1984), subjects who know more about tax laws are more inclined to play the audit lottery, a finding that appears to support the importance of the aspect of education on taxpayers. Mason and Lowry (1981, pp. 73-83), and Witte and Woodbury (1985, pp. 1-14) concluded that middle income taxpayers are most compliant and both low and high-income level taxpayers are relatively non-compliant, which supports Allingham and Sandmo's research (1972, pp. 323-338). Jackson and Milliron (1986) explain that under a progressive income tax rate structure, higher level taxpayers realise a greater dollar return by evading, but this return may have less economic utility. Lower income taxpayers have less stakes in society and thus have less to lose if apprehended, but lower income taxpayers may also be in less of a position to incur these risks because of a relatively high marginal utility associated with the potential penalties. Jackson and Milliron also noted that increases in the non-taxable base of taxpayers may have the effect of removing more taxpayers from tax rolls. This may have the effect of reducing the opportunities and necessity for evasion by taxpayers in the low and high-income strata, but it also causes problems because these people are more difficult to track administratively. Jackson and Milliron (1986) also gave two plausible analytical arguments for the noted empirical differences. First, all past research appears to have been conducted using linear models. Depending on the database used, dominance by either low or high-income level taxpayer non-compliance may mask non-compliance at the opposite end of the spectrum. If the relationship between income level and compliance is really curvilinear, as Witte and Woodbury suggest, then using a linear model will understate the correlation coeffeicient with the result that the relatively non-compliant but weaker end of the spectrum is ignored or that a finding of no significant relationship is reported, even though one exists. Another plausible explanation supports the "no significance" findings and involves a closely related compliance variable. It is possible that the observed income level compliance variation is more properly attributed to differences in the type of income earned by the different income groups. Frank and Dekeyser-Meulders's study of Belgian taxpayers found that the propensity to evade taxes varied according to income level, income source and occupation (1977, pp. 67-78). Only high-income professionals apparently had the opportunity to practice extensive evasion in the Belgian system. Perhaps what the

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study reveals is that the opportunity to evade is related to the type of income derived and that the motivation to evade is related to the taxpayer's marginal rate of tax. This also could explain the findings of Mason and Lowry (1981) and Witte and Woodbury (1985) whereby both low and high income taxpayers may derive more of their income from sources that are not subject to information reporting such as self-employment and thus have greater opportunity for evasion than middle-income taxpayers whose incomes are subject to withholding involved in salaries or wages.

Similarly, Wallschutzky (1984, pp. 371-384) in his survey of "evaders" and "non-evaders" among Australians, found that evaders tend to have slightly higher incomes. This may be explained by the rational maximising model. One may expect those with a high locus of control and a greater sense of economic agency to be more effective maximisers. Consequently, they will be both more sensitive to constraints on their economic activity. Thus higher earners are more prone to evade taxes. Being sensitive to constraints and possessed of economic agency, the rational maximiser is not only prone to evade taxes but is particularly inclined to do so if the government exercises restraint by "interfering" in the economy.

However, Wearing and Headey (1997, pp. 3-17) in their survey in Melbourne found that those of lower occupational status who earn less and are without family responsibilities tend to evade taxes more. The high negative correlation with occupational level may reflect two things in particular. First, the ability of those in lower status occupations to work "black" or for cash in hand. Secondly, the greater opportunities for legal tax minimisation available to those on higher incomes, allowing them to reduce their effective rate of tax without breaking the law.

Based on the above results, income tax non-compliance varies across groups of individuals but the directions are uncertain, because there are other factors which have to be taken into consideration. Different people have different personalities, some are risk takers and others are risk averse. In terms of ethics, different people have different moral values or ethics. It also depends on individuals' level of perceptions of fairness and equitable tax rate structures, different levels of peer influence and other interactions as well.

3.5 Income Source

This refers to the type or nature of the income item. The IRS data have shown that income subject to withholding tax and income subject to information reporting by the employers to the taxation office (such as salaries, wages) have the highest compliance ratios (IRS, 1983). As for wages, salaries and dividends, the payers have a legal obligation to report to the authorities and must withhold estimated income taxes and transfer them to the tax authorities. As for other types of income, there is no reporting obligation on the part of payers. Thus salaries and dividends are less likely to be evaded compared with other types of income.

As noted by the General Accounting Office (GAO, 1997), the IRS data show that compliance is highest under tax withholding, a little lower without withholding but with information reporting to IRS, and much lower when neither system is in place.

The sectoral concentration of tax evasion can be seen from an Internal Revenue Service (IRS) study, conducted in 1978 for the U.S. Congress. The study was based on a sample of workers classified as "independent contractors" and therefore not subject to source withholding of tax. This group constitutes workers in the cash and underground economy with the greatest opportunities for tax evasion. Payers are required to file "1099" information returns to the IRS for payees receiving over $600 but are not required to supply a copy to the worker. The study found that over 40 per cent of payers failed to comply in filing the required returns. Surprisingly, fully half of the industries had zero compliance rates exceeding 50 per cent; in those industries more than half of payees reported none of their independent contractor receipts. There is also wide variation across industries in the per cent of total compensation reported, ranging from 43.5 per cent for taxicabs to 98.3 per cent for insurance. Thus it can be seen from the IRS results, as tabulated in Table 3.4 below, that certain industries are clearly much more prone to income tax evasion than others, even for a type of payment relatively vulnerable to evasion.

Table 3.4 Industries and the rate of compliance in the U.S.

Industry	Percent of compensation reported	Per cent of payees with		
		Full compliance	Partial compliance	Zero compliance
Taxicabs	43.5	32.4	2.9	64.7
Logging & timber	52.1	22.9	7.6	69.5
Warehousing	54.0	16.0	4.0	80.0
Restaurants & bars	58.5	33.1	8.0	58.9
Real estate construction	63.7	31.3	6.0	62.7
Trucking	66.7	40.9	4.9	54.2
Direct sales	68.8	51.0	5.7	43.3
Home improvement	70.2	39.8	4.6	55.5
Other	72.5	45.0	4.1	50.7
Franchise operations	73.0	38.2	10.0	51.7
Other sales	74.1	48.2	4.7	47.1
Consulting	76.3	55.6	3.2	41.3
Entertainment	77.9	54.0	4.0	41.9
Real estate	89.5	75.1	4.7	20.2
Barber/beauty shops	90.0	73.3	6.7	20.0
Medical/health services	90.1	67.4	4.6	28.0
Exempt organisations	97.8	76.1	2.2	21.7
Insurance	98.3	89.9	4.0	6.2
All industries	76.2	48.2	4.9	46.9

Source: U.S. Congress (1979, p. 24).

There is also a relationship between sources of income and voluntary reporting percentages (VRPs). According to Kesselman (1994, pp. 62-84) voluntary reporting percentages or VRPs are the proportions of true incomes that were actually reported by taxpayers without any enforcement action. This relationship can be seen in the results from the Taxpayer Compliance Measurement Program (TCMP) of the U.S. Internal Revenue Service in 1983. Kesselman noted that for those types of income sources that allow expense deductions, VRPs are reported on both gross and net income bases. Wages and salaries, which were subject to both source withholding and information reporting, had the highest VRP. Types of incomes allowing deductions displayed some of the lowest compliance rates. Farm proprietors even had a negative VRP for net income, since they reported negative net incomes whereas they had substantial positive net incomes. Similarly, Joulfaian and Rider (1998, pp. 675-687) in their research using pooled 1985 and

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1988 TCMP data, found that differential taxation, due to self-employment taxes (SECA), plays an important role in explaining the observed disparity in voluntary reporting compliance among sources of self-employment income.

Table 3.5 Findings on the relationship between income source and income tax non-compliance

Characteristic	Authors	Key findings
Income Source	Clotfelter (1983)	Incomes allowing deductions displayed the lowest compliance rates.
	Wallschutzky (1984)	- Self-employed, independent trades or farming have the greatest opportunity to evade tax. - Self-employed/employ others agree that avoidance & evasion activities are acceptable and practise them.
	Cowell (1985)	A person's evasion opportunities to evade tax are improved by diverting work effort into areas not subjected to withholding.
	Yaniv (1990)	A taxpayer may evade taxes by declaring part of his higher-taxed income as stemming from lower-taxed source.
	Wahlund (1992)	Self-employed evade taxes the most.

Source: Author's collection from literature review.

Several other researchers also have found a significant relationship between income tax non-compliance and income source. Among them were Clotfelter (1983, pp. 363-373), Wallschutzky (1984, pp. 371-384; 1985), Cowell (1985, pp. 163-193) and Wahlund (1992, pp. 657-677) as shown in Table 3.5 above.

Clotfelter (1983) used the data set from the Taxpayer Compliance Measurement Program (TCMP) survey for 1969 that consists of extensive audits of a stratified random sample of the taxpaying population of the U.S. He grouped the tax returns into three classes: 1) Non-business returns; 2) Non-farm business returns; and 3) Farms returns. Non-compliance was defined as the difference between reported income and the amount of income that the IRS auditors determined was due. Those who were over-compliant (reported too much income) were treated as honest.[4] He found that in each of ten categories of tax returns, it was apparent that the tendency to under-report far exceeds the tendency to over-report income. Taxpayers reporting too little income outnumbered those reporting too much by at

least four to one in each class. It was assumed that reporting mistakes were random and the number of over-reporters were taken as an estimate of the expected rate of honest mistakes on the under reporting side. From this, he concluded that between 20 per cent to 58 per cent of taxpayers were evading taxes. In addition, he found that the average understatement of taxable income in every class was larger than the amount of overstatement. He also found that for each group of taxpayers, both the marginal tax rate and the level of after-tax income have significant effects on individual under reporting. The elasticity of expected under reporting with respect to after-tax income varies from 0.292 for non-business returns to 0.656 for farm returns. The elasticity of the marginal tax rate varies from 0.515 for non-farm businesses to 0.844 for non-business returns. While for non-farm businesses, the tax rate elasticity for understated adjusted gross income ranges from 3.7 in the low income group to 1.2 in the high income group, the overall elasticity for these business returns is only 0.5. Clotfelter concluded that tax compliance rates vary widely among income sources and deductions from income. Types of incomes allowing deductions displayed some of the lowest compliance rates. Wages were found to be fully reported in the aggregate in 1969, with under reporting being offset by over reporting. Interest and dividends ranked next in overall compliance rates with 98.3 per cent and 97.5 per cent respectively.

Factors that may explain those high -reporting values are: 1) Wages are usually withheld by employers, and information on all three are reported to the IRS; and 2) High rates of compliance for wages, interest, and dividends may be due to the simplicity of reporting them accurately on tax forms. Clotfelter also found that among non-business returns, under statements are greater for married couples, but marital status is insignificant for the business and farm returns. In both business classes, under reporting is significantly higher for the youngest group of taxpayers than those of age 65 and older.

Wallschutzky (1984), in a survey of Australian taxpayers, found that both evaders and non-evaders agreed that the greatest opportunity for evading tax exists with those who derive their livelihood from self-employment, independent trades, or

farming. Those whose source of income is dependent on wages or salaries, which are subjected to withholding tax, have the least opportunity to evade taxes.

In September 1984, Wallschutzky conducted a wide scale survey on attitudes and opinions about taxation by using mailed questionnaires to a sample of 750 New South Wales residents (1985). He found that the self-employed/employ others not only more frequently agree that avoidance or evasion activities are acceptable but they are also more likely to undertake avoidance and evasion practices.

Cowell (1985) in his analytical studies of tax evasion, expanded Allingham and Sandmo's (1972) classic economic model to account for tradeoffs between legal income, which is subject to withholding, and illegal income which is difficult for tax authorities to detect, and leisure. This model recognises that rather than concealing a portion of income, a person's evasion opportunities are improved by diverting work effort into areas that are not subjected to withholding or information reporting. This model assumes that switches in economic activity may be induced by the structure of tax rates, penalties and detection probabilities.

In his survey of Swedish taxpayers, Wahlund (1992) reported that self-employed persons evade taxes somewhat more than others. They do this because they perceive they have more opportunities to evade taxes than others do and they are more "conservative" than others towards the tax system enforcement.

Beside the above findings, Yaniv (1990, pp. 327-337) reported that a taxpayer receiving income from different sources may evade taxes by declaring part of his higher-taxed income as stemming from a lower-taxed source. The rationale for adopting such a practice rather than purely under-reporting one's higher taxed income is twofold. First, the former may be considered a less serious offence, being subject to a lighter penalty. Second, attempting to enjoy the benefits of under-reporting by consuming in excess of one's declared (net) income might attract the attention of the tax authorities. Thus, to avoid this risk, the taxpayer undertakes a costly laundering. Adhering to income source misreporting eliminates this problem since every dollar of income consumed is fully (yet not truly) reported. This type of misreporting actual income source composition is usually common in countries that have differential taxation between different

source of income. As in the U.S. and the U.K's former tax structures, capital income was taxed at a differentially higher rate than labour income. As a result, this encourages the taxpayer to evade taxes by declaring part of capital income (higher taxed) as stemming from labour source (lower-taxed).

3.5.1 Cash transactions

For independent contractors engaged in professional and business activities, incomes often are not received from others but are directly created, as differences between gross receipts and allowable expenses, in the process of rendering services or selling goods. Collusion between the providers and receivers of services, aimed at evading the payment of taxes, is not only possible, but occurs often, because of the nature of transaction. This collusion between providers and receivers benefits both parties. It benefits the purchaser through a reduction in the cost of the service and the provider through a reduction in the income declared since it is difficult to trace.

3.5.2 Occupation and socio-economic considerations

Vogel's Swedish data (1974) shows that self-employed taxpayers are more likely to agree that tax revenue is used unwisely, that the burden of taxes is too high and that the fiscal exchange rate is unfavourable. The Eurobarometer survey's result shows that the self-employed in all four countries surveyed (France, Britain, West Germany and Denmark) were less keen on seeing welfare services expanded than were employees. In fact in Britain and Denmark the majority of the self-employed favoured reducing tax even if welfare services and social security programs had to be cut. A persuasive explanation is that the self-employed have higher tax-compliance costs (Sandford, 1973; Godwin, 1976), and consequently the burden on them, in terms of time as well as money, is too great. Because of these heavier compliance costs, tax also becomes more "visible"; and even among the fiscally well informed, the tax side of the fiscal connection is by far the more salient.

3.6 Factors that May Influence Income Tax Non-Compliance

There are several other factors that may influence income tax non-compliance. These include the sociological, psychological and economic factors. One example for each of the category will be explored below. Financial strain will represent the

economic factors, complexity represents psychological factors and the use of a tax preparer represents sociological factors.

3.6.1 Financial strain

Table 3.6 below provides some findings regarding the relationship between financial strain and income tax non-compliance.

Table 3.6 Findings on the relationship between financial strain and income tax non-compliance

Characteristic	Authors	Key findings
Financial Strain	Vogel (1974)	Improved economic status also evade tax more than deteriorated ones.
	Warneryd and Walerud (1982)	Financial strain is not a significant factor for taxpayer to practice tax evasion.
	Webley and Halstead (1985)	Perception of economic deterioration is only one way that strain may be conceptualised.
	Besley, Preston and Ridge (1997)	Economic hardship may have been a factor in poll tax non-compliance in England.

Source: Author's collection from literature review.

Intuitively, a person experiencing more financial strain is more prone to practise tax evasion than someone with less economic strain. However, Vogel (1974, p. 507) found that those who reported an improvement in economic status also reported practising tax evasion more than those who reported a deterioration in economic status. He concluded that a change in economic status could sometimes be a consequence rather than a cause of tax evasion.

Similarly, Warneryd and Walerud's results in a telephone survey of 426 Swedish male adults indicated that financial strain was not a significant factor in evading taxes (1982, pp. 187-211). Further, the results of a laboratory experiment by Webley and Halstead (1986, pp. 87-100) suggest that perceptions of deterioration of economic circumstances is only one way that "strain" may be conceptualised.

However, Besley, Preston and Ridge (1997, pp. 137-152) in their investigation of poll tax compliance in England found that economic hardship may have been a

factor in poll tax non-compliance since the indicators of unemployment have a consistently positive effect on non-compliance.

3.6.2 Complexity

Psychologically, a student will ignore or neglect difficult questions/complex questions compared with simple ones. Applying this situation to the tax system, there is a greater tendency for taxpayers to comply with Income Tax Regulation if it is simple and clear. Table 3.7 below provides some past research regarding the relationship between complexity and income tax non-compliance.

Table 3.7 Findings regarding the relationship between complexity and income tax non-compliance

Characteristic	Authors	Key findings
Complexity	Westat (1980)	Complexity aggravates taxpayer uncertainty and acts to deter non-compliance.
	Clotfelter (1983)	Complexity of returns was associated with more under reporting non-business returns, but no significant effect for business returns.
	Milliron (1985)	Complexity had a significant effect on reporting but the directional impact was mixed.
	Long (1988) Slemrod (1989)	A very strong relationship between the complexity of reporting requirements and errors detected by audit.
	Beck and Jung (1989) Scotchmer and Slemrod (1989)	Uncertainty in tax administration is a deterrent to evasion.
	Alm, Jackson and McKee (1992)	Noise increases compliance and in others it reduces it.
	Brand (1997)	Complexity in the law contributes to non-compliance and burden.

Source: Author's collection from literature review.

There seems to be a general belief that simplifying the tax code and reducing its complexity increases compliance, but several analytical studies suggest that the opposite may be true (Beck and Jung, 1989; Scotchmer and Slemrod, 1989; Alm,

Jackson and McKee, 1992). The general theme of these papers is that random noise in the system makes the pay-off for tax evasion more uncertain (Bardsley, 1994). Risk averse taxpayers will wish to reduce uncertainty. Thus uncertainty in tax administration is a deterrent to evasion.

There has been conflicting hypotheses regarding the effect of complexity on compliance. Westat (1980, pp. 29-30) theorised that complexity aggravates taxpayer uncertainty, which in turn acts to deter non-compliance. However, Clotfelter (1983, pp. 363-373) claimed that in his analysis of individual returns of TCMP audit procedures, the presence of several different tax forms – and thus complexity of returns, was associated with more under-reporting among non-business returns, but there was no significant effect for business returns. Again, Milliron (1985, pp. 794-816) found that complexity had a significant effect on reporting, but the directional impact was mixed because of interactions with two other compliance factors: perception of fairness and opportunity for evasion. Voluntary compliance is enhanced when the rights of taxpayers are respected, for example when the tax agency collects a fair share of income tax from all taxpayers, and when the perception that the tax office is very active in combating non-compliance is very high, thus the opportunity for escape from detection is small. As a result, people voluntarily comply.

On the other hand, several researchers report that risk-averse taxpayers wish to reduce uncertainty, thus uncertainty in tax administration is a deterrent to evasion (Beck and Jung, 1989; Scotchmer and Slemrod, 1989; Alm, Jackson and McKee, 1992). However, the empirical evidence is mixed. Alm et al. (1992) report from an experimental study that in some cases noise increases compliance and in others it reduces it. Klepper and Nagin (1989a) also report mixed results from a study of audit data.

Brand (1997, pp. 413-419) believes that complexity in the law contributes to non-compliance and burdensomeness. Lack of clear-cut language, the need for extensive guidance, interpretations, rules, and regulations, all contribute to less compliance. It also makes difficult to administer the law hence creating opportunity for intentional non-compliance and increases unintentional non-compliance. Similarly, Long (1988) reports that there is a very strong association

between the complexity of reporting requirements and errors detected by audit. Slemrod (1989, pp. 3-27) confirms this in his review of complexity, compliance costs and tax evasion.

Complexity and compliance costs

A tax system may be complex and thus involve greater compliance costs for many reasons and in many ways, such as, the compliance costs arising from the need to make the tax base more accurately reflect taxpayers' relative taxpaying ability. Such compliance costs may arise on account of more complex rules. These include rules that attempt to distinguish more precisely between deductible business expenses and non-deductible personal expenses, or rules that include a range of fringe benefits in income. The complexity of tax rules may also influence the level of compliance. The simpler the rules or the tax code, the more certain the results in applying it and thus fewer opportunities exist for disagreements over the "fine points" of tax law, hence there is less chance for exploitation by those who are expert in this field such as the tax practitioners.

In his survey of Swedish taxpayers, Vogel (1974, pp. 499-513) concluded that taxpayers usually need more tax structure information than that provided by the tax forms in order to complete their returns. Important misunderstandings were revealed and lack of awareness of possible deductions was noticeable. He claimed that the feature of the Swedish tax collection system is a set of complicated return forms, of which the average taxpayer must complete from two to four annually. The number and nature of regulations applicable, the legal language used and the alleged confusing layout of the forms have been heavily criticised.

Kaplow (1995, pp. 135-150) emphasised that the immediate costs of complexity cannot be measured by looking solely at the rules themselves. More visible tax information promotes higher compliance. The primary source of compliance cost involves taxpayers' behaviour, often involving record keeping, so estimates of incremental paperwork costs are usually more probative than counts of the number of pages of rules. Good records and other types of paper trails also lead to better results when the tax administrators audit a return or take some other enforcement action. Similarly, the difficulty of an audit will usually depend upon problems of

verifying the details of taxpayer behaviour rather than challenges of understanding the rules themselves.

Slemrod (1988, pp. 61-65) has identified three different aspects of the tax system with respect to cost of compliance. The classifications are as follows:

(1) Unpredictability or uncertainty

Risk averse or conservative taxpayers are more likely to reduce or abandon tax evasion and to report more taxable income unless they substitute tax avoidance for evasion. Uncertainty also may lead taxpayers to hold the tax system in low esteem and therefore comply less stringently.

(2) Difficulty

The more difficult it is to comply with the legal requirements, the more likely it is that the taxpayer will not complete his or her annual return, and will hold the tax system in low esteem. Alternatively, taxpayers may comply but completely ignore or use guesswork about certain aspects of the tax system. However, Lempert (1988, pp. 68-71) noted that the complexity of the law might lead taxpayers to make greater use of agents, thereby increasing compliance.

(3) Manipulability

Taxpayers invest some resources such as time and agents' fees into reducing taxable income legally. These potential gains however depend upon the marginal tax rate.

3.6.3 Tax preparers

Tax practitioners or preparers generally have greater technical knowledge, professional experience and familiarity with the administration of the tax law relative to ordinary taxpayers. Thus there is a tendency for taxpayers to shift the burden of accurate filing of returns to tax practitioners or preparers. As a consequence, tax practitioners are in a position to exert a strong and direct influence on the compliance and tax administration processes (Erard, 1993, pp. 163-197). Table 3.8 below provides some key findings on the relationship between the use of tax preparers and income tax non-compliance.

Table 3.8 Findings on the relationship between the use of tax preparer and income tax non-compliance

Characteristic	Authors	Key findings
Tax preparers	Westat (1980)	More audit adjustments from use of paid preparer than self-prepared returns, regardless of the type of return.
	Wallschutzky (1985)	Professional tax advisers make people more likely to avoid their taxes.
	Dubin, Graetz, Udell and Wilde (1989)	There is a linkage between taxpayer use of preparers and non-compliance.
	Klepper, Nagin (1989c)	Preparers play a mixed role in the compliance process.
	Erard (1993)	The use of CPAs and attorneys is associated with increased tax non-compliance.

Source: Author's collection from literature review.

Two general roles for tax preparers in the collection process are as providers of services and also as providers of information (Reinganum and Wilde, 1991, pp. 163-181). Dubin, Graetz, Udell and Wilde (1989) provided evidence that suggests a linkage between taxpayer use of preparers or practitioners and non-compliance. IRS data of the Taxpayer Compliance Measurement Program or TCMP 1979 individual return indicates that 44.2 per cent of the individual returns filed in 1979 were self-prepared, and that these returns accounted for 22.8 per cent of detected non-compliance. Returns prepared with third-party assistance accounted for 55.8 per cent of filings and 77.2 per cent of the detected non-compliance. Among returns prepared with third-party assistance, however, under-reported tax was not uniformly distributed. Only 10.6 per cent of all taxpayers used a tax practitioner, yet their returns accounted for 32.5 per cent of under-reported tax. A total of 34.7 per cent used other paid preparers accounting for 40.9 per cent of under-reported tax. The remaining 10.4 per cent used non-paid assistance accounting for 3.7 per cent of under-reported tax. However, Klepper and Nagin (1989c, pp. 167-194) provided empirical evidence related to the mixed roles played by tax preparers in the compliance process. On the one hand they appear to contribute to non-compliance by helping taxpayers exploit ambiguous features of the tax code. On the other hand, however, they appear to enforce legally unambiguous features of

the tax code and also to act as important conduits for communicating tax agency enforcement priorities.

Similarly, Wallschutzky (1985), in his mailed survey in New South Wales, discovered that in relation to tax avoidance, 84 per cent of respondents thought that professional tax advisers would make people more likely to access tax schemes which exploited loopholes in the laws.

Although a few preparers who dealt with lower income taxpayers reported that they were viewed as government agents, Westat (1980, p. 81) reported that most preparers believe they are viewed by their clients as advocates. Consistent with this view of preparers as advocates, an analysis of tax return data by the IRS shows more audit adjustments occurred on paid preparer returns than self-prepared returns, regardless of the type of return.

The availability of tax preparers undoubtedly reduces many informational and computational barriers to tax compliance, however, the results gathered by Erard (1993, pp. 163-197) indicate that their use, particularly the use of CPAs and attorneys, is associated with increased tax non-compliance, which may have negative implications for both tax equity and tax efficiency.

The U.S. Treasury Department believes that an erosion of tax preparers' perceptions of their reporting responsibilities has substantially contributed to taxpayer non-compliance (1986). Recognising that tax preparers play an important role in taxpayer non-compliance, Congress has enacted various sanctions aimed at tax return preparers.

3.7 Summary

In searching for suitable strategies, some characteristics associated with this non-compliance such as: gender, income level, income source and age group require study. In addition, analysis of the reason or reasons for these groups to behave as they do is necessary.

Most of the studies reviewed above found that young taxpayers, males, high-income earners and the self-employed are most likely to evade taxes. On the other

hand some studies did not find any relationship. The findings on possible causes of income tax non-compliance especially financial strain and complexity were rather mixed because of interaction with other compliance factors such as perception of fairness and opportunity for evasion were not considered in these studies (Milliron, 1985, pp. 794-816). However, most researchers reported that tax preparers help taxpayers in exploiting ambiguous features of tax codes that contributes to non-compliance.

CHAPTER FOUR

Review of Literature on Some Strategies in Overcoming Income Tax Non-Compliance

4.1 Introduction

This chapter explores some strategies for improving tax administration efficiency and for overcoming income tax non-compliance that have already been introduced in some advanced countries. Basically it comprises of three sections: the first section discusses tax policy and successful tax reform explored by some researchers, giving its definition, and providing the benchmarks for addressing the tax issues in this research. The second section discusses tax enforcement mechanisms, whose success is dependent on group cooperation. This section also examines taxpayers' attitudes and behaviour which are important factors possibly contributing to income tax non-compliance. There are five mechanisms discussed in this section: 1) strategies to assist in changing attitudes; 2) positive approaches; 3) withholding of taxes and information reporting; 4) detection and punishment; and 5) simplifying the tax system. Finally the last section summarises the argument of this chapter.

4.2 Tax Policy and Reform

The trend towards tax reform in Asian and Pacific countries has been evident since the late 1970s and has accelerated since the mid 1980s. Jenkins (1990) noted that at least 25 major tax reform exercises were undertaken between 1984 and 1990. However, the immediate motivation and context for undertaking tax reform vary from country to country. In those countries facing such fiscal problems such as large and persistent fiscal deficits, high inflation, low levels of compliance, problems with administrative efficiency, and excessive reliance on a single category of taxes such as those on international trade or on excises, the immediate motivation and context are fairly obvious. Further, the role played by the government in responding to changes in the world economy, including globalisation of economic activities, is inevitably important.

In principle, the characteristics of a "good" tax system are fairly clear. It should be efficient, it does not distort economic decision-making and its administrative and compliance costs should not be excessive (James and Nobes, 1992, Chapter 3). Successful tax reform can be defined as a change to the tax system that results in the final outcomes intended by government. However, it is a complex matter since the tax system is used to achieve a wide range of frequently changing objectives, some explicit, others perhaps less so (James, 1997, pp. 205-226). The tax system is also subjected to pressure for change in particular areas. The importance of a careful analysis of the environment in which an organisation operates is widely recognised as an essential part of the development of a successful business strategy. Similarly, it is just as important to consider carefully the environment in which any tax system is expected to operate. In analysing the tax environment, it is useful to look not only at the current position but also at likely future developments as has been done by James and Wallschutzky (1995).

According to Silvani (1994, pp. 274-305) tax administration also should be "effective" in enforcing voluntary compliance. Tax administration will be effective if it is able to deal with the following key shortfalls.

(1) Reduce the number of unregistered taxpayers that originate in the gap between potential taxpayers and registered taxpayers.

(2) Stop filing taxpayers that refer to the difference between registered taxpayers and those who file returns. These taxpayers have failed to submit their annual returns to the taxation authority hence failed to declare their annual income.

(3) Tax evaders that refer to the gap between the tax reported by taxpayers and the potential tax according to the law.

(4) Delinquent taxpayers that refer to the difference between the amount of taxes that taxpayers report owing, or that the tax administration may eventually assess, and the tax actually paid by taxpayers.

Similarly, Tanzi and Pellechio (1995) address tax administration reform by describing briefly the causes for inefficient tax administration, identifying the essential elements of successful reform, and presenting measures to improve the tax administration. The common strategy is to focus administrative resources on problems in the tax collection system through promotion of voluntary taxpayer

compliance and adoption of a logical sequence of procedures for efficiently identifying and handling instances of non-compliance. Besides voluntary compliance, Goode (1981, pp. 249-275) also stresses the absence of wealthy groups with enough power to block tax measures that they consider a threat to their position. This pressure could be applied not only to legal changes in order to increase tax due but also to administrative resolutions to fight evasion.

4.3 Enforcement

The primary role of the tax administration is to collect income taxes through facilitating and inducing voluntary compliance. Generally, all taxpayers have an incentive to misrepresent their activities which have tax implications, in order to reduce or eliminate their tax liability. For this reason, no tax structure can stand alone without an enforcement mechanism supporting it. A theory of optimal tax systems must encompass not only the choice of tax rules but also the methods by which they are enforced (Slemrod, 1990, pp. 157-178). Tax enforcement is a behavioural problem. This means that the ability of a tax administration to influence taxpayer behaviour is very much linked to its ability to read and feedback overviews of this behaviour and of the changing environment in which it operates. In this context, some understanding of taxpayers' differing perceptions of taxation itself is important. Its success depends on cooperation between both parties. Hence its success depends on how the system of taxation is perceived by taxpayers for example, in terms of equity among all taxpayers, and the government-taxpayer relationship, and whether the amount of tax paid is worth the welfare that they receive in return from the government. The tax administration can make up not only for individual resistance but for the hostility of the whole group or of everybody concerned. There is less resistance from taxpayers when they know that all taxpayers are charged fairly and that those who fail to declare or escape paying taxes are punished accordingly. Hence the taxation authority should be active in detecting tax evaders besides imposing a fair share of income tax, on all levels of income, in all types of income earned. Thus the taxation authority should minimise loopholes in the income tax legislation that may be enjoyed by only certain groups of taxpayers. In the long run, by keeping tax laws within the limit of the enforceable, there will be little leeway for evasion or insecurity on the part of the taxpayer as well as for administrative arbitrariness. In contrast, any gap

between law and reality is bound to foster alienation, perceptions of inequity and refusal to cooperate. Thus the taxation authority should properly enforce the income tax regulations and its legislation so that the public will be confident about its enforcement. As for the government-taxpayer relationship, the taxation authority could play its role by disseminating all information regarding taxes collected and how they have been channelled through various channels that are discussed below.

Enforcement is one aspect of tax administration and it includes prevention and positive approaches. It must be seen as the means through which the objective of facilitating and inducing voluntary compliance is achieved, not as an end in itself.

Taxpayers' attitudes and behaviour

It is very important for tax administrators to understand taxpayers perceptions towards income tax, so that the taxation office can provide suitable strategies in enhancing voluntary compliance besides introducing effective strategies in combating non-compliance. Thus it should explore human attitudes and behaviour, people's likes and dislikes and ways to improve negative perceptions of the income tax office.

Two important influences on human behaviour are attitudes and needs. Attitudes are defined by Assael as "learned predispositions to respond to an object or class of objects in a consistently favourable or unfavourable way" (1984). Understanding taxpayers' attitudes both towards the Tax Department and the payment of tax is critical, thus the IRB has to develop strategies which will enable it to influence or change these negative attitudes to positive attitudes towards compliance. Based on United States survey data collected in 1974, Spicer and Lundstedt (1976, pp. 295-305) developed and tested four hypotheses to analyse the issue of tax non-compliance. They concluded that taxpayer decisions to comply are closely related to two factors: the degree of perceived coercion and the perception of inequity in the fiscal system. In this context, tax authorities need to take remedial action against unfavourable attitudes toward the fiscal system by introducing taxpayer education programs aimed at existing and potential taxpayers. Dean, Keenan and Kenney (1980, pp. 28-44) conducted a study in 1977

on a sample of 424 adults in Scotland to analyse taxpayer attitudes towards income tax evasion. He identified five factors that affect taxpayer decisions: (a) the level of taxation and the worth of government expenditures; (b) tax equity; (c) the probability of detection; (d) moral perceptions; and (e) economic considerations. The result showed that taxpayers will evade tax when they feel the general level of taxation is high. The results, based on two variables of probability of detection and moral perceptions, support Allingham and Sandmo's (1972) model.

Spicer and Becker (1980, pp. 171-175) examined the relationship between tax evasion and perceived inequities in tax systems. They suggest that taxpayers hold general perceptions and attitudes concerning the equity of their own and other's exchange relationships with government, and that these perceptions and attitudes are relevant to the tax evasion decision. The analysis suggests that taxpayers' utility functions are interdependent so that the utility derived from tax evasion depends on the taxpayer's sense of equity regarding his relationship with the government. It is hypothesised that the amount of taxes evaded increase for victims of fiscal inequity but decrease for beneficiaries of fiscal inequity. The results of their experiment support this hypothesis.

Another factor affecting behaviour is needs. Needs are inner motivational states which can be aroused by either internal cues or external stimuli (Coleman and Freeman, 1997, pp. 311-336). Examples of internal cues are thirst or hunger while external stimuli consist of three types. They are as follows:

(1) Social influences of peer pressure as researched by Wallshutzky (1995) confirm that compliant behaviour is influenced by peer group attitudes, which is also significantly supported in the Spicer and Lundstedt study (1976, pp. 295-305) and the Besley, Preston and Ridge study in 1997 (pp. 137-152).

(2) Personal experience: Taxpayers' personal experience with the income tax officers is critically important in influencing their attitudes towards compliance. If taxpayers have negative personal contact with the income tax officers, this may linger in their memories or even provoke them not to comply with the Income Tax Law. On the other hand, positive

assistance to reduce tax by legitimate means may generate a change in taxpayers' attitudes, which in turn may produce a change in behaviour thus resulting in a greater tendency for them to comply with the law.

(3) Information: It has been recognised that one way of assisting taxpayers in understanding and complying with the law is by providing them with guidance, for example, in the form of a Tax Pack and information booklets. Coleman et al. (1997) in their research in Australia have ascertained that many small business taxpayers do not adequately understand the benefits of many of the legitimate tax shelters available to them (pp. 311-336).

4.3.1 Strategies to assist in changing attitudes

It is necessary for the taxation authority to develop strategies to change taxpayers' attitudes towards voluntary compliance. Marketeers use adaptive strategies in inducing new purchasers to try a product or to encourage existing users to increase their consumption or to try a new product (Assael, 1984). IRB officers can use similar tactics in enhancing voluntary compliance. There are four types of adaptive strategies:

(1) Reinforcing positive attitudes among existing users of a brand.

A large percentage of taxpayers are compliant as established by Wallschutzky (1995) and Nazir, Lowes and Letza (1995). Coleman and Freeman (1997, pp. 311-336) recommended that some acknowledgment or reward system needs to be introduced to encourage continued compliant behaviour, especially for the honest taxpayer who had been audited without a single adjustment which should be compensated for loss of time.

(2) Attracting new users to an existing brand by emphasising the positive benefits of the brand.

Many researchers (for example Wallschutzky, 1985; Nazir et al. 1995; Coleman and Freeman 1997 and others) have agreed that if there was feedback to taxpayers on the allocation of tax collected, this would have a positive effect on voluntary compliance. Thus it is wiser for IRB officers to inform taxpayers about government uses of revenue collected to increase the range of goods and services available for taxpayers own benefits.

(3) Positioning new products and services to meet the needs of existing users.

The IRB can raise awareness among its staff of the importance of good service. It could educate the existing taxpayers and develop a positive on-going helpful relationship apart from making taxpayers understand tax law so that they will comply voluntarily as it costs less to collect revenue if they understand the law rather than if they must be forced to comply. As Wegner and Wallacher (1977) suggest, the IRB should create positive attitudes about payment of tax and the fact that taxes provide public goods and welfare benefits.

(4) Positioning new products to satisfy the needs of new and emerging markets.

The government needs to publicise the benefits to the existing taxpayers and the potential taxpayers of the use of tax revenue in increasing the range of goods and services available to the public.

Some activities being conducted by the IRB to increase public awareness regarding their responsibility to pay income tax are, for example, conducting street surveys and placing a fortnightly column in a local newspaper "Income Tax & You." A street survey is conducted at the beginning of each year, whereby groups of IRB officers make surprise checks on taxpayers' business premises particularly in strategic business areas with the aim of improving taxpayers' business record keeping as well as enlarging the tax base. "Income Tax & You" is a fortnightly question and answer column which involves an IRB representative and a daily newspaper *The Star* in the northern region of Malaysia. The public relations officer of Pulau Pinang Branch answers income tax queries forwarded by readers.

4.3.2 Positive approaches

Traditionally, the government relies on penalties to overcome the problem of non-compliance. The reliance on penalties has been based on the relationships specified in deterrence theory which assumes that there is a perceived likelihood of apprehension and a severe but fair penalty for an offence (Rossi and Grasmick, 1985, pp. 79-101). Ross (1984, pp. 21-35) found that if the sanction was not considered appropriate, it may not be imposed, and the deterrence theory would not be effective. In his study of tax attitudes in several European countries, Schmölders (1970, pp. 300-306) concluded that citizens are likely to be extremely

resentful of tax systems where extensive enforcement is used. This resentment can lead to additional non-compliance.

4.3.2.1 Service approach

Taxpayers are the heart of the taxation office business, thus it is of great importance for it to provide quality service to its "clients" besides increasing client awareness of matters relating to taxation.

Wirth (1994, pp. 63-84) in his field experiment aimed at determining the impact of certain service initiatives used by the Australian Taxation Office (ATO) auditors on taxpayer compliance behaviour, found that the study supports the effectiveness of a service approach in improving taxpayer compliance. In general, the survey results appear to support the view that taxpayers saw the Lismore Project (which was conducted in the Lismore region of New South Wales) in a favourable light. Most taxpayers surveyed indicated that they believed the project was about "helping taxpayers" and "administering" the law fairly, rather than "maximising" revenue or "catching tax cheats". Using a service approach also enables the auditors to identify non-compliance problems in an industry and to devise and implement an education and information campaign to highlight the issues. Thus through a combination of broad service initiatives and personal contacts, what appears to be a high level of recognition, acceptance and change in reporting behaviour can be achieved. The project also highlights the valuable role that intermediaries, such as tax practitioners and industry associations, can play.

Similarly, the IRB of Malaysia introduced Taxpayer's Service Week (or MPPC) in 1988. Since the response from the public was very good, it has implemented this activity yearly whereby officers of the IRB open service counters for one week at shopping malls, banks or any other places that might have a greater number of potential taxpayers. This usually takes place a month before the closing date of the annual returns lodgment. This program is undertaken mainly to bring non-filers into the system besides "going direct to the public" and providing information or taking notes on any suggestion or objection. The counters operate between 8.00 am to 10.00 pm everyday except Sunday when they operate from 9.00 am to 2.00 pm.

(a) Payment through the bank system

Payment of taxes through any Bank Bumiputra throughout the nation was introduced in 1995. This not only provides further convenience for taxpayers in paying taxes but also encourages punctuality of payment (IRD, 1995).

(b) Drive-in payment counter

This service was created to overcome the problem of traffic congestion caused by the lack of parking bays at the Collection Branch Payment Counter office, which poses a problem more to taxpayers who only need to settle their tax liabilities. The counter is located at Jalan Duta, Kuala Lumpur and began its operation in mid-November 1994. It is limited to accepting income tax payments by cheque (IRD, 1994, p. 58).

4.3.2.2 Public education program

A public education program that promotes some positive aspects of the Inland Revenue authorities can affect taxpayer attitudes, and better attitudes may lead to less non-compliance in the future. It is a challenge to encourage and promote taxpayer attitudes that will enhance the voluntary payment of taxes. This is essential to create awareness and a sense of responsibility among taxpayers (Witte and Woodbury, 1985, pp. 1-14; ABA, 1988, pp. 329-392; Roth, Scholz and Witte, 1989). It is especially important in developing countries, as in Malaysia, where illiteracy rates are high. Chelvathurai stressed that this program should be used to educate the general public, so that the tax laws can be understood easily (1990, pp. 594-599). According to Nagin (1990, pp.7-22), taxpayer education and assistance provided by tax agencies can reduce compliance costs to taxpayers.

Mason (1987) conducted surveys in Oregon (U.S.) to analyse the linkages among mass media exposure, interpersonal discussion and fear of sanctions for individuals, and the joint contribution of their effects on compliance with income tax laws. He develops a communication model that includes endogenous variables such as mass media exposure, personal discussion and sanction fear, as well as exogenous variables such as age, income, differential opportunity and education. According to Mason, content analysis of the media's attention to tax issues is important to describe more precisely the nature of messages received by the general public. His study showed that: the communication variables (mass media

and personal discussion) are related to sanction fears as deterrence theorists have hypothesised. Those heavily involved in personal discussion, however, have low fear levels. Fear of sanctions, however, is related to compliance. Those with low fear levels admit they evade their taxpaying responsibilities (Mason, 1987, pp. 246-258). This study also indicates that variables, such as age and income levels, are positively related to mass media exposure.

Using TCMP data for 1969, Witte and Woodbury (1985) indicate that attitudes have an important effect on compliance. Their findings suggest that the IRS's educational efforts will increase compliance for all groups, but for small-business owners the effect is not significant.[5] Hence the taxation authority needs to use some other means of combating non-compliance among small business such as the use of audits.

To increase public tax knowledge, the IRB has conducted mass media communications that include broadcasts through radio and television, publications in newspapers, income tax leaflets, lectures and briefings, the IRB calendar, an internet web-site (http://www.hasilnet.org.my) and a telecommunications InfoLine 600-837-888 (IRB 1997a, p. 17).

The taxpayer education program will be effective if it focuses on populations in which compliance rates are low, such as self-employed persons, and small and medium scale businesses (Mahfar, 1994). The program also must cover new and potential taxpayers, including high school and college students (Spicer and Lundstedt, 1976; Witte and Woodbury, 1985; ABA, 1989).

Mahfar (1994) has proposed a taxpayer education program for use by the government of Malaysia, as part of its ongoing effort to improve its fiscal efficiency and reduce non-compliance. The proposed program contains three important components, namely the organisational arrangements, modes of communication and special programs. It is recommended that a special unit be established within the IRB to be solely responsible for the program. Second, a variety of approaches could be utilised to communicate with taxpayers. These approaches include printed materials such as pamphlets, newsletters, leaflets; the use of the media through radio, television, magazines and counters in giving

information and student tax programs that provide tax education and competitions on taxation among students. Third, a special program, the Problem Resolution Program should be promptly established to provide assistance to taxpayers having problems dealing with the IRB. Such a program can maintain a close relationship between the IRB and taxpayers thus demonstrating a more favourable attitude and behaviours toward the taxation system. Mahfar incorporates the best features from similar programs in selected developed countries into his proposal. However, some modifications of these features have been recommended by him to suit the local environment of Malaysia.

The prevention approach, such as detection, apprehension, and prosecution of non-compliant taxpayers and intermediaries, is another method to combat income tax non-compliance. Intermediaries are private-sector entities who are required to submit withholding taxes and/or to provide information reports to the government; examples are employers and payers of interest, dividends, and pensions (Kesselman, 1994, pp. 62-84). Hence intermediaries can ease compliance for taxpayers by withholding and remitting client taxes and also by simplifying the government's tax administration.

4.3.3 Withholding of taxes and information reporting

The withholding of taxes at the source of income is the most basic of all compliance techniques and it increases the costs of evasion to the taxpayer. It is widely used in developed and developing countries for collecting revenue with minimal use of administration resources. A popular mechanism is wage withholding, commonly known as pay-as-you-earn (PAYE), in which employers are withholding agents for personal income tax payable on the earnings of their employees (see van der Heeden, 1994). This shifts the tax administration's monitoring responsibilities from a large number of individual taxpayers to a smaller number of employers, thus achieving a more efficient focusing of administrative resources (Tanzi and Pellechio, 1995). While information reporting involves information provided by the payer to the taxation office either by withholding/without withholding the tax at the source of income other than wages on behalf of the payee. As noted by Tanzi and Pellechio (1995) taxes can also be withheld on sources of income other than wages by collecting from the payer

rather than the payee with the same efficiency gains. This includes payments of interest by banks, dividend payments by companies to stockholders, interest and dividend payments by mutual funds, and other similar payments. The following examples prove the positive effect of withholding taxes and of information reporting requirements. For the tax year 1992, the wage earners whose wages were subject to tax withholding (the most systematic method for making income visible to IRS) were estimated to have reported 99 per cent of their wages. Additionally, 98 per cent of them reported their interest income and 92 per cent their dividend income, most of which is subject to tax-information reporting but not tax withholding requirements (GAO, 1997). In contrast, the IRS estimates that self-employed individuals who formally operate businesses other than farms, report about 68 per cent of their business income, which is neither subject to withholding nor necessarily covered by information reporting. Finally, self-employed informal suppliers, who are even less likely to have income reported to the IRS on information returns, report an estimated only 19 per cent of their business income.

As for 1981 and 1987, Table 4.1 below also shows that in the United States, compliance has been highest for wages and salary. This type of income is subject to deduction at the source. Interest income experienced the next highest rate of compliance because it was subject to information reporting. On the other hand, the informal supplier income had the highest rate of non-compliance among these incomes for it was not subject to either deduction at the source nor to information reporting. This suggests the importance of tax withholding and information reporting.

Table 4.1 Compliance rates for different classes of income for the United States 1981 and 1987 (percentages)

Type of income	1981	1987
Wages and salaries	94	97
Interest	86	80
Capital gains	58	85
Informal supplier income	20	11

Source: Income Tax Compliance Research: Estimates for 1973-81, Internal Revenue Service, US Government Publishing Service, Washington, Table III, July 1983; and Income Tax Compliance Research: Supporting Appendices to Publication 7285, Publication 1415, US Government Publishing Service, Washington, Table D 16, July 1988.

Similarly, the American Bar Association or ABA (1988) recommends that a tax withholding system be considered an important device to reduce the opportunity for non-compliance. IRS statistics show that taxpayers who are subject to withholding report on time and pay over 97 per cent of the taxes due on their income compared with those not subject to withholding who report and pay only 78 per cent (IRS, 1992).

Two major forms of withholding exist: exact withholding without obligatory filing of an end-of-year tax return (the British system) and approximate withholding with obligatory end-of-year filing (the American system). Despite its lower load of returns, the former is considered more costly to administer than the latter. However, the latter is believed to be more evadable, as it allows for the evasion of non-withheld taxes simply by failing to file an end-of-year return. Nonethelessly, exact withholding is not immune to tax evasion because a wage earner may choose to split work efforts between several jobs, failing to inform employers (as the law requires) that he or she is also employed elsewhere. Consequently, each employer treats him or her as a single job holder and the employee enjoys lower tax brackets and also gains multiple tax allowances for personal attributes in excess of his or her true entitlement.

The IRB adopted Schedular Tax Deduction (STD) whereby the deduction of tax by employers from employees' monthly remuneration is based on a schedule that predetermines the amount of tax to be deducted. Thus it adopted the American system of withholding of taxes. For taxpayers who commenced employment anytime before 1 January 1995, the deductions made from their current remuneration are for settlement of tax on income received in the preceding year and not on income received in the current year. Taxpayers who commence employment on or after 1 January 1995 pay tax as they earn (PAYE) meaning the tax deduction made goes towards the tax to be raised in the following year.

A scheme for compulsory payment of tax by instalments was introduced to cover companies, self-employed individuals, clubs, associations and trusts effective from 1 January 1989 (IRD, 1992b). These taxpayers were directed to make five bimonthly instalments starting from January and February. However, they could

request variations of instalment payments if the estimates were not considered acceptable.

However, based on Yaniv evidence, the taxation authority cannot rely totally on the employers or intermediaries as its agents in withholding taxpayers' income taxes. Yaniv (1992, pp. 312-321) seeks to evaluate the extent of collaboration between employees and employers in a tax withholding system with regard to tax compliance. He points out that one of the weaknesses in a tax withholding system is the taxpayer's opportunity to cooperate with his or her employer to manipulate the tax laws. For example, an employer might agree to withhold less than the actual taxes due, in exchange for the employee's agreement to accept less than the free market wage rate, which is common in cash economy transactions such as restaurants, hawkers etc. Another example of employer-employee collusion is the widespread use of non-taxable fringe benefits. Thus it is important for tax agencies, as part of their strategy in combating non-compliance, to focus on the issue of dishonesty among employers and others who act as collection agents in a tax withholding system. According to Soos (1991, p. 183), "withholding agents must deduct the correct amount of tax, remit it to the government, file periodic returns, and account to taxpayers for the tax withheld". He also suggests that self-employment income should be subjected to tax withholding, because the self-employed have more opportunity for non-compliance. This supports the view that the taxation authority also has to enforce some deterrent strategies such as detection and punishment.

4.3.4 Detection and punishment

One explanation for compliance stresses that the threat of detection and punishment is responsible for compliance. This theory stems from the economics-of-crime approach, based upon traditional expected utility theory of tax evasion by Allingham and Sandmo (1972, pp. 323-338). An individual, by understating taxable income, receives the reward of a lower tax liability if the evasion is undetected, and pays a penalty if the evasion is detected. The decision will depend on the chances of being caught and on the individual's attitude toward risk. Hence detection and punishment are two main instruments used by the tax authorities to overcome income tax non-compliance.

4.3.4.1 Audit plan

In a modern tax system it is crucial for taxpayers to believe that if they engage in fraudulent actions there is a reasonable chance they will be caught and appropriately penalised. It is also important that taxpayers be confident that their competitors are paying the same taxes so they may compete fairly. This requires that an effective audit program be carried out by the tax administration.

In a number of empirical, experimental studies of US taxpayer behaviour, the influence of the probability of audit on compliance decisions has been found to be highly significant (e.g. Smith and Kinsey, 1987, pp. 639-663). Madeo, Schepanski and Uecker (1987, pp. 323-342) in their modelling of taxpayer compliance using tax professionals as subjects, found that the probability of audit was the most significant factor affecting adopted tax positions on contentious tax issues. Thus audit plays an important role in combating income tax non-compliance. As found by Wallschutzky and Singh (1995), very few investigation cases were finalised by the Malaysian taxation authority from 1981 to 1991, represented by a low of 0.009 of one per cent in 1986 to a high of 0.022 of one per cent in 1991. Hence the IRB has to make extra effort in upgrading its investigation work in order to be effective in combating non-compliance. Even if a tax administration is very effective in registering taxpayers and detecting stop-filers or delinquent taxpayers, the administration's overall effectiveness will be low if auditing is not effective in discouraging evasion. Silvani and Baer (1997) reasoned that the tax administration is able to detect stop-filers and delinquent taxpayers through computerised or

mechanical means, while for detecting evasion or the under reporting of taxes, auditing (intelligence and investigation) is required. For example, in Peru, in spite of the fact that the tax administration's effectiveness has continued to increase, whereby its tax collection has grown steadily as a percentage of GDP from 6.0 per cent in 1990 to about 14.1 per cent of GDP in 1996, a plateau has been reached. Further increases in collection will depend on the tax administration's ability to focus its effort on audit. On the other hand, Denmark, which has a strong and sophisticated audit program, has a compliance rate among the highest in the world – reaching more than 95 per cent for the value added tax (VAT).[6]

The main goal of auditing is to persuade taxpayers that evasion does not pay. Silvani (1994) suggests that this can also be provided in an audit plan (pp. 274-305). This can be achieved by the tax administration if it can show the taxpayer that it has the information and the operational ability to punish taxpayers if they evade taxes. Further, Silvani also recommends that the administration devise enforcement programs whose chief purpose is to let the taxpayer know that the tax administration has information on certain economic transactions such as imports, leases, purchases, sales, and payments for professional services. This is to demonstrate to a significant number of taxpayers, before they commit tax evasion, that the tax administration processes data on their economic transactions. This information will then be used to detect evasion. Audit rates are important and they can be reinforced by additional, less costly interventions such as information matching, public information, taxpayer assistance, and education (Brand, 1997, pp. 413-419).

As found by Witte and Woodbury (1985), audit strategy is effective on small-business owners, but only has a small effect on other groups of taxpayers such as middle-income wage and salary workers. Hence audit strategy could be adopted especially to recover tax evasion which involves cash transactions that can be easily falsified (ABA 1989; Soos 1991).

Tanzi and Pellechio (1995) suggest that an audit plan should represent a strategy to detect violations as efficiently as possible using the different types of audit with the resources available to the tax administration. The plan should also specify how many of the different types of audit should be conducted each year in each local

tax office, with the proportions varying based on the registration of new taxpayers, business developments, and the results of previous audits. The plan should reflect an analytic approach to increasing the probability of detection. Specific strategies would likely vary from year to year.

1. Audit Selection

Although most empirical studies have focused on the probability of detection, nevertheless improved understanding of the audit selection process is also important in improving audit selection methods.

Among researchers who have explored this area are Erekson and Sullivan (1988), Alm, Bahl and Murray (1993), and Erard and Feinstein (1996). Erekson and Sullivan (1988) found that the audit selection rules followed by the IRS in the low-income non-business classes appear to be quite different from the rules followed for other classes.

Alm et al. (1993) conducted studies of tax audit programs obtaining tax return information for a random sample of Jamaican taxpayers. The sample consisted of 932 taxpayers for tax year 1980, none of whom was subjected to audit for that year, and both tax return information and audit results for an additional 148 taxpayers, each of whom was subjected to audit for one of the tax years 1980, 1981, or 1982. Alm et al. also estimated the structural econometric models of the audit selection process and found that reports of capital income or a large tax liability are associated with a greater chance of audit in Jamaica.

Erard and Feinstein (1996) obtained information about Federal and Oregon state tax returns and audits for several different audit classes for the tax year 1987. Their data contain tax return information for a stratified random sample of more than 43,000 households, including information from Form 1040 and most supplemental schedules. Approximately 6,500 of these households were placed in a business audit class, while 2,000 were placed in a farm audit class. The data include audit results for the approximately 4,500 households in the sample subjected to a Federal audit and the approximately 3,000 households subjected to a state audit. Erard and Feinstein report that several line items are important in

explaining audit selection in the non-business class that they analyse, but that few line items are important in the business and farm classes they analyse.

Both studies of Alm et al. (1993), and Erard and Feinstein (1996) also concluded that the tax agencies that they studied possess private information not recorded in the available tax return data, which plays an important role in audit selection.

In the United States, although some of the returns are selected manually for investigation, most are chosen through a computer analysis on the basis of "discriminant function formulas" or DIF that generate a probability of recoverable tax revenue (Morgan, 1990; Payne, 1993). For instance, a return that included claims for allowable deductions that were very high in relation to declared income would generate a high DIF score.

Currently, the selection of cases for investigation and audit is done manually by the IRB. It involves information obtained through local knowledge, press reports, assessment branches, informers and the application of a means test. Some of the investigation and audit strategies that have been introduced by the IRB are discussed below.

A special intelligence and investigation unit has been set up in all branches of the IRB to track down people who evade their taxes. In the selection of cases for investigation, emphasis is placed on reports by informers and information gathered through various sources including intelligence work performed by investigation officers. Every IRB branch has its own investigation and intelligence centre. Investigation officers from all investigation and intelligence centres throughout the nation carry out prevention and detection activities. They deal in cases involving back duty of more than RM10,000. The back duty enquiry carried out is done thoroughly, comprehensively and persistently. The cases that may require investigation fall into four groups:

(a) *Disclosure by the taxpayer himself*

These may include cases of all degrees of gravity from an intimation of mere error to a solemn confession of deliberate fraud. The nature of the disclosure and the circumstances in which it is made may be factors to be taken into

account in determining the extent of investigation required and the basis of settlement.

(b) *Allegations by an informer*

An informer's motive is seldom a pure one and his information and allegations are usually vague and exaggerated. He or she cannot, however, be ignored.

(c) *Discovery from departmental sources*

The majority of cases falls into this group and arises in the course of examination of returns, accounts, or in the light of information received.

(d) *General sources of information*

Available to the Taxation Department are lists such as those of registrars of companies, lists of payment made to contractors by Government Departments and Armed Forces, lists of timber licences issued by the Forestry Department and details of trade licences provided by Town Boards and Municipalities and so forth.

2. Field audit

The IRB also has set up an external audit division in aligning its structure and strategies along client segments that allows continuous learning about its clients and their behaviour especially among corporate and business taxpayers. Training and guidance programs are held by expert and experienced investigation officers and delivered to officers selected for the audit team. Apart from being given an opportunity to examine the actual books and records at the taxpayers' premises and of gaining a better understanding of how the various businesses are conducted, audit activities are able to identify persons who do not disclose the true incomes, or, if carrying on a business are submitting returns that are not based on reliable accounting books and records. The IRB introduced this program in 1991 to overcome income tax non-compliance. Its main objective was to improve compliance, as well as to encourage voluntary compliance. The main focus is placed on company cases as well as individual cases in line with their contributions to the total revenue collected in the system. Field audits are carried out for cases involving less than RM10,000.

3. Street Survey

Street surveys were introduced in 1995. They are mainly conducted to deal with businessmen. Officers are required to randomly check the business accounts of businessmen in a chosen area. They then provide a report on every business premise they have visited to the income tax administration. These reports are enclosed in the businesses respective income tax files and checked by income tax officers for any understatement of income.

4.3.4.2 Sanctions

A good system of sanctions and penalties is an indispensable tool for enforcing compliance. As part of the assessment of the tax administration, the effectiveness of sanctions and penalty systems in encouraging taxpayers to voluntarily comply with their tax obligations should be evaluated. As noted by Silvani and Baer (1997), a guiding principle in the design of a good system of penalties and sanctions should be to encourage taxpayers to settle their tax arrears quickly and to discourage them from using legal challenges to delay the payment of taxes which have been correctly assessed. In achieving these objectives, they argued that the sanctions and penalties:

(a) should be levied promptly once a liability has been established;

(b) should not be excessive; and

(c) should, however, be higher than the prevailing market interest rates – the prime or LIBOR rate plus a spread. This assumes that penalties are determined on a percentage basis instead of being a fixed amount. In general, experience has shown that it is preferable for penalties to be defined as a percentage of the total outstanding amount of taxes in order to facilitate adjusting penalty rates for inflation.

Conflicting evidence has been found by researchers regarding the importance of different types of sanctions and interactions. Among them are Minor (1978, pp. 21-45), Tittle (1980), Grasmick and Scott (1982, pp. 213-220).

Minor (1978) and Tittle (1980) found no difference between legal sanctions and interpersonal sanctions. On the other hand, Grasmick and Scott (1982) found that interpersonal sanctions were more effective.

Another conflicting issue is the relationship between reported tax evasion and the severity of sanctions. Spicer and Lundstedt (1976, pp. 295-305) Schwartz and Orleans (1967, pp. 274-300), Witte and Woodbury (1985, pp. 1-14) are among the researchers that have explored this area.

Spicer and Lundstedt (1976) in their survey in the United States found that there is no significant relationship between reported evasion and sanctions. Conversely, Schwartz and Orleans (1967) and Witte and Woodbury (1985) found that there is a significant relationship between the severity of the sanctions and reported evasion among high-income self-employed individuals. Schwartz and Orleans (1967) examined the comparative effectiveness of the threat of legal sanctions and appeals to conscience. They obtained tax compliance figures for three groups of taxpayers namely a group threatened with legal sanctions, a group where appeal to conscience was employed and a control group. All members of these groups were interviewed about political and tax issues a month before they lodged their tax return. The questions that they were asked were themselves the experimental manipulation. They stressed either sanctions or personal responsibility. The tax records showed a mean change in income declaration of $181 in the "threat" group, $804 in the conscience group and $87 in the control group. The sanctions group also increased their claims for tax-deductible allowances, which suggests that threats may actually increase tax avoidance or evasion. However, within each group, the threat of legal sanctions were most effective for the upper class and the better (but not the best) educated. Appeals to conscience had more effect on the best and least educated employees. Schwartz and Orleans (1967) found marginally significant (p<0.10) results for a moral approach over legal sanctions. Their results are weakened argues by Hite (1997), because the dependent variables were the averages of groups of taxpayers. Actual tax return information was used, but analysis based on the group mean does not allow for an examination of the specific types of individuals who were and were not affected by moral strategies. Nonetheless, some support was provided for encouraging moral ploys.

Consistent with Schwartz and Orleans's findings, Grasmick and Scott (1982) conducted a survey in which they found that the threat of guilty feelings (which they equated with Schwartz and Orleans's appeal to conscience) was a greater

deterrent to tax evasion than threats of stigma or legal sanctions. They concluded that the most effective strategy to deter non-compliance would be a policy that increased the public's sense of moral duty to comply. They cautioned, however, that a mass moral appeal could have a negative impact because it would inadvertently inform others that cheating is a viable alternative. Their reasoning was based on the results of a classroom experiment conducted by Tittle and Rowe (1973) who found that cheating increased after a moral plea to comply was given by the teachers. Only five of the 107 subjects refrained from cheating. This suggests that some other message must have inadvertently been sent which encourage or approved cheating. Grasmick and Scott (1982, pp. 213-220), citing the Tittle and Rowe study, concluded that the statistical inference from their study on the effectiveness of appeals to conscience may not hold in practice because the norm moved towards tax evasion rather than towards tax compliance.

Strümpel (1969) and Schmölders (1970) forewarned that taxpayer willingness to comply can be jeopardised by enforcement systems that are too strict. Moreover, the American Bar Association Commission on Taxpayer Compliance (ABA 1987) noted that even if enforcement programs were maximised, the IRS would collect only one-third of the individual tax gap through enforcement programs. Similarly, Pyle (1991, pp. 163-198) argued that an important role was played by sanctions and penalties in creating incentives for individuals to engage or not to engage in tax evasion. According to him, research shows that lower penalties which are applied more consistently are more effective in deterring evasion than high penalties applied fairly infrequently.

Silvani and Baer (1997) suggest that in ensuring that the sanctions and penalty system is effective, sanctions and penalties should be easily applied by tax administrators to non-complying taxpayers. To achieve this, penalties should be relatively mild, since the application of lesser penalties does not require, as a rule, a lengthy administrative and judicial process. The sanctions and penalties should be designed to change the behaviour of the average taxpayer, which requires that sanctions be applied to the largest possible number of non-complying taxpayers. This is particularly relevant for countries with high levels of non-compliance (this would refer to countries with a tax gap of over 20 per cent).

4.3.4.3 Preparer penalties

Over 40 per cent of all individual taxpayers use professional preparers in the U.S. (Department of the Treasury, 1985, p. 85) and even greater proportion of complex returns are filed by these tax preparers (Jackson and Milliron, 1986, pp. 125-165). Among these preparers, a significant proportion are qualified to represent clients before the Internal Revenue Service. The American Bar Association Commission on Taxpayer Compliance refers to these individuals as tax practitioners. Like preparers, practitioners can prepare and sign returns, but the term is used to distinguish them from preparers who cannot represent clients during Internal Revenue Service audits and other enforcement actions.

Although the availability of tax practitioners undoubtedly reduces many of the informational and computational barriers to tax compliance, they also possess the means to exert an extraordinary influence on the tax compliance process. Their knowledge of tax rules, enforcement procedures and also expertise enables them to assist their clients in exploiting opportunities for tax non-compliance. The United States Treasury Department believes that erosion of practitioners' perceptions of their reporting responsibilities has substantially contributed to taxpayer non-compliance (U.S. Department of Treasury 1986). Realising that tax return preparers play an important role in taxpayer non-compliance, the Congress has enacted various sanctions aimed at tax preparers. The two most commonly cited preparer penalties are: I.R.C. §6694, the understatement of taxpayers' liability; and I.R.C. §6695, other penalties with respect to the preparation of tax returns (Reckers, Sanders and Wyndelts, 1994, pp. 14-20). Both of these penalties apply to an income tax return preparer, who is defined in the I.R.C. as a person who prepares any tax return for compensation (I.R.C. §7701(a)(36)). By definition, these two penalties do not apply to practitioners who merely give tax advice on contemplated actions and who do not prepare any portion of the return or its supporting statements (Tres. Reg. §301.7701 – 15(a)(2)). However, the penalty for aiding and abetting understatement of tax liabilities, I.R.C. §6701, applies to any persons:

1) who aid, assist, procure or advise with respect to the preparation or presentation of a return;

2) who know that the information will be used in any material matter arising under the tax laws; and

3) who know that an understatement of tax liability will result (I.R.C. §6701 (a)).

As noted by Shapiro (1986), this penalty can be levied on tax practitioners, however, proving that a practitioner has met all three requirements would be difficult for the IRS.

Previous researchers like Schnee, Bindon and Ellis (1987, pp. 21-30), Jackson, Milliron and Toy (1988, pp. 333-341), and Milliron and Toy, (1988, pp. 84-104) have found that preparer penalties may not be effective in altering practitioners' behaviour. These findings are based solely on opinions or beliefs elicited from tax practitioners. Jackson et al. (1988) found that while practitioners considered preparer penalties to be very serious, they believed that penalties were only moderately effective. Similarly, Milliron and Toy (1988) found that CPAs were overwhelmingly negative about preparer penalties and their effectiveness. They reasoned that this could be due to the practitioners' attitudes toward penalties and their self-interest in this area. The survey respondents of Schnee et al. (CPA tax practitioners) likewise indicated that they would make only slight concessions in their practice because of recent increase in preparer penalties. In contrast, Milliron's (1988) interviews of "Big Eight" tax managers and partners concluded that preparer penalties were one of the important or essential factors influencing tax return preparation decisions.

Reckers, Sanders and Wyndelts (1994, pp. 14-20) argued that characteristics of the client may also influence the judgements and decisions of tax professionals. They have classified two major services that tax practitioners provide – tax advice (classified as judgements) and signing tax returns (classified as choices). Consequently, they have proven that preparer penalties were effective in reducing CPAs' aggressiveness in signing returns but failed to influence the aggressiveness of CPAs in giving advice to a client. In their research, Reckers et al. (1994) defined the importance of the client as value in terms of revenue generating potential for the professional and his or her accounting firm.

As found in the audit literature, it is argued that clients generating large revenues become more economically important to an accounting practice, and client financial leverage (auditor financial dependency) may influence auditors' judgements (SEC 1979). McGill's findings (1988) suggest that CPAs consider a client's importance in limited situations. The preferences of more important clients in selected circumstances have a larger influence on tax professionals' judgements than the preferences of less important clients. As reasoned by Reckers et al. failure to consider client importance and failure to distinguish between advice (judgements) and signing tax returns (choices) may explain some of the mixed results previously found regarding the influence of client aggressiveness. As Einhorn and Hogarth (1981) and Slovic, Fischhoff and Lichtenstein (1982, pp. 21-36) found, judgments and decision choices may not be consistent. A judgement is an evaluation of a situation, whereas choice is a selection of an action from two or more options. Judgements may aid in making choices among alternatives, yet they are not necessary or sufficient for choices. In fact, at the time a choice is made, judgement may very well be ignored. As suggest by Einhorn and Hogarth (1981), a choice can be made that is contrary to one's better judgement.

Further, in a study of audit partners, Schultz and Reckers (1981) found that subjects' responses varied significantly between conditions in which they were asked to render financial reporting "advice" to a fellow partner versus conditions in which they were cast as the engagement partner "signing off" on the audit opinion. Further, the potential influences of preparer penalties and client importance may interact. As argued by Graetz and Wilde (1985), from a cost-benefit perspective, sanctions against certain behaviour can be expected to be effective deterrents when the "cost" of sanctions are greater than the "compensation" received for unacceptable behaviour. Therefore, for tax return preparer penalties to be effective Reckers et al. (1994) suggest that the "cost" of the penalties must be perceived to be greater than the "compensation" for minimising a client's tax liability. Thus as the importance of the client increases, the "compensation" from the client also increases. Hence, from a cost-benefit perspective, client importance may progressively mitigate the effectiveness of preparer penalties. They also believed that there is a difference between advice decisions and signing decisions. To advise only and not to prepare or sign the

return may be perceived by tax preparers as involving less risk and responsibility compared with signing the returns. They concluded that increased penalties may prove to be effective in improving compliance provided that the sanctions are not idle threats. The sanctions can be idle threats either because the "cost" of the sanction is small or because of the enforcement that is necessary to deter practitioners' aggressive tax behaviour. They also suggest that for sanctions to be effective deterrents, tax practitioners must be aware of their existence. Another plausible explanation for the differences in the effectiveness of penalties in their study could be due to tax professionals being less aware of the penalties applicable to tax advice (I.R.C. §6701 as discussed earlier) and more aware of tax return preparation penalties as the researchers suggest.

One of the factors that contributes to an increase in the usage of tax preparers by taxpayers is the complexity of the tax system.

4.3.5 Simplifying the tax system

Silvani and Baer (1997) stress that the tax administration should be simple from the taxpayer's point of view, keeping annual returns and procedures as simple as possible to encourage compliance. Long (1988) reports that there is a very strong association between the complexity of reporting requirements and errors detected by audit. Slemrod (1989) confirms this in his review of complexity, compliance costs and tax evasion. Thus there is a general belief that simplifying the tax code and reducing its complexity would increase compliance.

In helping to simplify tax administration, the information required on the tax forms should be kept to a minimum and be readily available from the taxpayers' books and records. Denmark, Canada, and New Zealand are among the many countries that have introduced simplified tax return forms in order to facilitate their use by taxpayers. Silvani and Baer (1997) also noted that simplifying the tax system leads to a reduction in taxpayers' costs in complying with their tax obligations. Compliance costs, like administrative costs, can be reduced by such measures as imposing a single rate (in the case of the VAT), defining a reasonable registration threshold and reducing exemptions. Exemptions increase bookkeeping requirements and raise the cost of compliance. In some cases, compliance costs

can be reduced through final withholding on transactions like payment of interest, dividends, and salary bonuses as discussed earlier.

Simplifying the Tax System is also important to facilitate tax administration and reduce costs. This could enhance the effectiveness and efficiency of the tax administration (Bird and Casanegra de Jantscher, 1992; Bird, 1990; Mansfield 1987; Tanzi, 1981; Tait, Graetz, Eichengreen 1979). According to Silvani and Baer (1997), a tax system with few taxes, a limited number of rates for each tax, limited exemptions, and a broad base has proven, in the context of many developing countries, to be much easier to administer and to result in higher compliance levels than a complex system.[7]

In achieving a better compliance rate and improving the effectiveness and efficiency of the tax administration, the taxation authority also should tackle some of its weaknesses regarding laws, regulations and administration.

Cutting out tax loopholes

Cutting out tax loopholes is necessary especially in business taxation to allow fair competition to take place. Ambiguity in the Income Tax Legislation may promote certain group of taxpayers especially those who are expert in this field like tax practitioners, to exploit these loopholes to their advantage.

A code of conduct approved by the Council of Economic and Finance Ministers of the European Union (EU), or ecofin, on Business Taxation (Primarolo, 1999, pp. 24, 25) covers laws, regulations and administrative practices that take in "the nominal tax rate, the tax base or any other relevant factor" as stated in its resolution whose object was to tackle harmful tax competition within the EU. This was necessary in order to combat distortions of the single market and prevent excessive tax losses as well as to encourage the evolution of taxation in an employment-friendly way. The code outlines five issues to be addressed in determining whether measures are harmful:

• whether advantages are given only to non-residents, or for offshore transactions;

• whether advantages are ring fenced from the domestic market;

- whether advantages are given without any real economic activity and substantial economic presence within the member state;

- whether the rules for measuring profit within a multinational group depart substantially from internationally accepted principles; and

- whether measures lack transparency.

As quoted by Britain's Paymaster General, Primarolo,

> Tackling unfair tax practices is an important part of creating a single market in Europe. Of course comparisons are frequently complex, not least because of the different ways in which tax concessions can be made, but I am hopeful that our work will help to set a framework in the EU in which fair competition can take place. (1999, p. 25)

Some tax avoidance occurs because of defects in the wording of specific provisions. Other forms of avoidance occur because of more fundamental weaknesses in the tax system or in how it is administered. Some of loopholes that are found in the Malaysian Income Tax Legislation as explored by Wallschutzky and Singh (1995) are discussed below.

(a) Opportunities to split income with others

Income splitting has advantages if it is possible to transfer income to others who pay less tax. This is especially important under a progressive rate structure where high-income earners transfer income to lower income earners. Hence the greater the progression and/or the greater the disparity in income levels between transferor and transferee, the greater the advantage. For example, it is possible for any savings by the husband and wife to be invested in the name of the spouse with the lowest income.

(b) Opportunities to convert potentially taxable receipts into non-taxable receipts

Under Malaysian Income Tax Law, a non-resident taxpayer is subject to tax in respect to income accruing, arising, or derived from Malaysia. Hence if a non-resident has offshore income, it is free from Malaysian income tax if it is brought into Malaysia. As for resident taxpayers, their offshore income is taxable if and only if it is being remitted into Malaysia. Thus, a resident taxpayer can enjoy his offshore income by not remitting it into Malaysia.

(c) Exemptions from the tax base

Notable exemptions from the tax base include:

* capital gains (except for gains on disposable of real property);

* donations received by approved charitable institutions;

* pensions upon retiring from employment;

* income of an approved pension/provident fund;

* scholarships;

* retirement gratuities, compensation for loss of employment and restrictive covenants;

* business profits enjoying tax incentives such as pioneer status and investment tax allowance;

* royalties up to RM20,000 per annum received from academic and literary works;

* certain types of interest income such as interest on government bonds and savings interest;

* benefit of employee's leave passage; and

* employee's medical and dental benefits.

Malaysian taxpayers have the opportunity of swapping some of their taxable income for non-taxable income, making their effective rate much lower, hence paying less taxes. In addition, there are some benefits-in-kind income that are granted by employers to their employees that are not included in the employees' pay-slips as the employers are not certain of the valuation of such benefits. This may be due to lack of guidelines and lack of effective monitoring by the taxation office, giving the impression that it is not important to report this income. As suggest by Wallschutzky and Singh (1995), a fringe benefit tax may need to be considered by the IRB for this type of income.

4.4 Summary

A good tax system should be efficient, should not distort economic decision-making and should not have excessive compliance cost. It also should be effective in enforcing compliance and being able to deal with non-compliance. The primary role of the taxation office is to collect income taxes through facilitating voluntary compliance. Hence understanding taxpayers' attitudes, behaviour and their

perceptions towards income tax is particularly important so that effective strategies can be channelled to respective groups of taxpayers. Some of the external stimuli that can affect taxpayers' behaviour are social influences such as peer group attitudes, taxpayers' personal experience of the taxation authority and information regarding taxation. Hence tackling these sources may improve compliance decisions.

In combating income tax non-compliance, the taxation authority should search for suitable strategies. It should study whether non-compliance is due to the failure of its current system in regard to enforcement, complexity of income tax laws, loopholes in the income tax legislation or lack of mass media coverage. Tax enforcement is a behavioural problem hence its success depends on group cooperation. Intermediaries can ease compliance for taxpayers by withholding and remitting their taxes and the taxation authority should be able to cut out tax loopholes to prevent any harmful tax competition especially in business taxation. It should be pro-active in disseminating tax information to the public so that they understand the tax laws and comply voluntarily.

Another possible cause of non-compliance originates from taxpayers; for example their attitudes, financial constraints or being influenced by someone else such as tax preparers or peer groups. When all of these factors are known, it will be much easier to target groups of taxpayers and apply appropriate strategy or strategies to make them comply at the same time as enhancing voluntary compliance. In adopting strategies, the IRB can examine strategies that have been applied successfully to overcome this problem in advanced countries.

Income tax administrative enforcement discussed in this chapter examines five of the main approaches in combating non-compliance besides enhancing voluntary compliance. They are as follows:

> 1) *Strategies to assist in changing attitudes.* Several researchers have explored this area and suggest that the taxation authority could adopt marketeers' strategies by reinforcing positive attitudes such as introducing an acknowledgment or reward system and giving feedback to taxpayers regarding the use of revenue collected by the government. This could be done by developing an ongoing helpful relationship

between taxpayers and income tax staff in addition to publicising the uses of the tax revenue collected to provide extra ranges of goods and services to taxpayers.

2) *Positive approaches*. Several researchers have found that taxpayers are more likely to be more resentful if extensive enforcement is used, hence positive approaches are being recommended. Two main strategies have been discussed in this chapter. They are the service approach and education programs. The service approach is implemented by providing quality service to taxpayers and giving direct information to them, taking notes on any suggestions or objections in upgrading the current service. Providing an easy method of payment of income tax is an example of providing good service to taxpayers. According to Mahfar (1994), public education programs are effective if they are focused on population groups in which compliance rates are low. However, according to Witte and Woodbury (1985) this method is not as effective as a deterrent method with small business owners or cash transaction evaders. Mason (1987) found that the communication variables are related to sanctions, hence the taxation authority could place more stress on sanctions and on the consequences of not complying with its legislation through the mass media, newsletters, and income tax leaflets.

3) *Withholding of taxes*. One example is PAYE, when employers act as withholding agents for personal income tax on earnings of their employees. Information reporting however, involves payers providing information to the taxation office either by withholding/without withholding the tax at the source for income like interests and dividends. However, some researchers argued that this method is not totally effective because some taxpayers (payees) might collude with their employers or payers. Hence, they also recommend deterrent methods such as punishment or sanctions.

4) *Detection and punishment*. Three methods were discussed in this chapter: audits, sanctions and preparer penalties. Most researchers have found that the probability of audit is highly significant in combating non-compliance especially among non-wage earners. Witte and Woodbury (1985) concluded that this method is not as effective with

salary/wage earners as it is with small business owners. It is very important for the taxation authority to be very efficient and effective in detecting income tax evaders. It can detect them through an analysis of annual tax returns either manually or chosen on the basis of "discriminant function formulas" or DIF as used by the IRS. While most studies revealed that a good sanction system should be levied promptly, not be excessive, be applied consistently, and be higher than market interest rates. As for preparers penalties, most researchers found that preparer penalties may not be effective in altering practitioners' behaviour because of their self-interest in this area. However, Reckers et al. (1994) argue that the clients' importance and the difference between advice decisions and signing decisions are important in determining the effectiveness of this strategy. They suggest that the "cost" of the penalties must be perceived to be greater than the "compensation" for minimising a client's tax liability and that these tax practitioners must be aware of the existence of the sanctions.

5) *Simplifying the tax system.* Several researchers reported that simplifying the tax code and reducing its complexity would reduce the costs of compliance and hence increase the level of income tax compliance. Reducing reporting requirements also results in the detection of fewer errors during audit, hence the administrative costs of compliance are decreased. Thus simplifying the tax system benefits both taxpayers and the taxation office.

CHAPTER FIVE

Taxation System in Australia

5.1 Introduction

This chapter focuses on the Australian Taxation Office (ATO) as a role model of tax collecting agent outside Malaysia. It is divided into five sections. Section Two introduces the ATO, its core business mission and the various challenges it needs to overcome, particularly that of gaining community support.

Section Three explores the nature of the individual taxpayers registered with the ATO which can be categorised into three groups: clients categorised as individual non-business (INB) who form the majority of individual taxpayers; large businesses and internationals (LB&I) business line; and small business income (SBI).

Section Four explains some policies adopted by the ATO to enhance voluntary compliance, and to strive for productivity and efficiency, which are designed to improve the relationship between the community and the ATO. It also discusses some preventive actions undertaken by ATO in combating non-compliance in Australia.

Section Five describes the most recent proposal made by the Taxation Institute of Australia (TIA) for the establishment of two boards to provide a channel for consultation on major policy and to oversee the Australian Taxation Office.

Section Six summarises various strategies being undertaken by the ATO to achieve its core business mission, to face various challenges besides overcoming income tax non-compliance in Australia and the recent proposal made by TIA to ensure that the tax system is responsive to the changing business and tax environment.

5.2 The Australian Taxation Office

The Australian Taxation Office or ATO is the office that is responsible for the collection of income tax in Australia. Its head office is located in Canberra, with branch and regional offices in various states. Its operations are supervised by the Commissioner of Taxation.

The core business mission of tax administration in Australia is always focused around the following three statements (ATO, 1997a, pp. 1-20):

- to collect the revenue, properly payable, so as to fund services and support for the people of Australia;
- to assist the payment of child support between payers and payees for the benefit of children, whether by Child Support Agency (CSA) collection or support for self administration; and
- to support the provision of retirement income for the people of Australia.

The above mission statements demonstrate that the ATO holds a particular 'niche' in the community and Australia's system of government. This 'niche' can be described as its collective insight into the whole system and its concern to safeguard the interests of the whole community. In accentuating this latter point, safeguarding of the interests of the whole community should be contrasted with the particular client interest that are held by taxpayers, their representatives or client groups. Thus the challenge for the ATO is to achieve:

- increased compliance;
- reduced compliance costs;
- community confidence; and
- an efficient and adaptive organisation.

Community support

In particular the challenge to gain community support has resulted in a much more open and accountable administration. The need for this support has led to innovations such as forums for liaison with tax professionals and representative groups and active participation through the media. The ATO is moving cautiously to provide analysis and commentary on the operation of the Taxation system to

increase community understanding about its own system (ATO, 1997a, pp. 1-20). It has developed a consultation with the community about the rights and obligations of the community. Standards of service and accessible complaints mechanisms are also created through these charters. Access to a well functioning complaints mechanism turns a burden into an opportunity for change and improvement. The most significant steps in building a strong relationship with the community are the creation of a Taxpayers' Charter and a Child Support Charter.

5.3 Individual Taxpayers in Australia

In 1996-97, 9.9 million individual taxpayers lodged returns, representing 54 per cent of the total population of Australia (ATO 1998). Individual's incomes are derived from a wide variety of sources. The most common sources are salary and wages. In 1996-97, the majority (78 per cent) of individuals received income from salary and wages. This income accounted for 74 per cent of all individuals' income. While a large proportion of the population had interest income (58 per cent), this represented only 3 per cent of total income.

Individual taxpayers may be clients of the individual non-business (INB), small business income (SBI) or of the large business and international (LB&I) business line. INB clients are those taxpayers who receive most of their income from salary and wages, Australian government pensions and benefits, or investments, and who do not have any business income or deductions. As for business income, if gross income is equal to or greater than $10 million, then the individual is a client of the LB&I business line. However, if gross business income is less than $10 million, then the individual is a client of the SBI business line. The majority of individual taxpayers registered with the ATO are clients of the INB business line which accounts for 74 per cent (ATO, 1998).

Taxpayers are concentrated in the 30-49 year age group, in terms of total number of people, income received and net tax paid. This age group forms 44 per cent of the total taxpayer population. Males are over represented in the taxpayer population (54 per cent) when compared with the total population (50 per cent). This reflects the levels of participation in the labour force by men and women in Australia.

Interestingly, the level of income also varies widely according to geographic location. People of similar incomes tend to live in the same general areas. In 1996-97, the area with the highest average taxable income was postcode 2027 in Sydney (ATO, 1998).

5.4 Some Policies Adopted by the ATO

The ATO adopted some policies to improve its efficiency and relationship with its clients.

5.4.1 Self-assessment and fringe benefits tax (FBT)

The ATO has the policy of encouraging and facilitating voluntary compliance, thus it adopted self-assessment in 1986. The ATO also has introduced full self-assessment for companies in 1990 (ATO, 1991).

Self-assessment is defined by Marshall, Smith and Armstrong as "the administration of the tax regime where the assessment of a taxpayer's tax liability is based largely on information provided voluntarily by the taxpayer" (1997, pp. 9-15). It has moved to a system of self-assessment so that the tax returns of most taxpayers are not subject to technical scrutiny before assessment. Instead, taxpayers calculate their own taxable income but do not enclose payment with their tax return. In fact, the way the system works, most taxpayers receive a refund, but if they are due to pay more they are billed by the ATO and given a month to pay. Hence the administrative emphasis has shifted to post assessment checking, including audit activity.

The philosophy underlying the move to self-assessment by the ATO was that the traditional approach to processing income tax returns (i.e. a scrutiny of every return to check for technical and mathematical accuracy, calculation of tax payable, etc.) was perceived to be an ineffective and inefficient method of ensuring compliance with tax law. This new tax regime is predicated on a fair, honest and voluntary reporting of tax liability. It imposes on taxpayers an obligation to maintain appropriate records and to exercise reasonable care in reporting matters affecting tax liability. The essence of the "self-assessment" of tax administration is the explicit shift from the revenue authority to taxpayers of

the assessment stage in revenue collection for much of the information upon which the assessment is based is collected, sorted, categorised and presented by taxpayers (Cooper, 1995, pp. 99-124). This in turn permitted the redeployment of the resources of the revenue authority into the post-assessment audit of the veracity and accuracy of taxpayers' assessments and was undertaken because of the findings that allocating the assessment of tax stage to the revenue authorities was not cost-effective.

Under self-assessment principles, uncertainties arise in establishing appropriate facts, and the proper evaluation of authority in support of tax reporting positions assumes fundamental importance. As a result, more taxpayers, in an era of increased enforcement penalties, are turning to tax professionals for assistance (Mazur and Nagin, 1987; Collins, Milliron and Toy, 1990). In 1992, approximately 72 per cent of taxpayers in Australia sought professional assistance to prepare returns, especially those with the most complex tax situations (Marshall et al., 1997, pp. 9-15). This compares with only 20 per cent in 1980 when the old regime still prevailed.

Fringe Benefits Tax (FBT) is specifically levied on non-cash employment benefits provided by employers to their employees. This income is often omitted, or not fully taxed due to the difficulties faced by the employers in evaluating "the value" of benefits given to their employees. Prior to 1 July 1986, in Australia, such benefits were to be included in employees' assessable income (Wallschutzky, 1993). As a result, more and more employers and employees took advantage in their salary packaging of these deficiencies, to minimise tax liability. This led to an unfair share of the income tax burden being taken by those who did not or could not take advantage of such salary packaging. Instead it was decided to introduce a tax on employers in respect of the fringe benefits provided to employees or to their associates. The impetus behind the Australian fringe benefits tax was the increasing trend towards non-cash fringe benefits becoming a greater part of employee compensation packages (Kreiser, Butcher and Jowitt, 1997, pp. 77-84).

Fringe benefits taxpayers self-assess their liability for fringe benefits tax annually and specify this in their returns as paid by their employers (Marks, 1991, p. 3). It is not an allowable deduction for income tax purposes.

The ATO has found that there is a high level of complexity in the application of FBT law and the estimated cost of compliance for FBT is relatively high (ATO, 1999, p. 13). Thus it has taken a number of initiatives to improve its administration of FBT in recent years, such as the establishment of FBT Business Teams and the use of national projects and research to assess compliance risks. In enhancing its FBT administration, the ATO is currently putting in place several key strategies. These include: the introduction of a compliance model which is designed to focus appropriate compliance and regulatory activity according to the nature of the particular taxpayer; increased attention to the need to gain a thorough knowledge of the FBT taxpayer base; and a greater emphasis on taxpayer education to improve compliance.

Table 5.1 below provides some information regarding total taxes, fees and fines collected for the years 1983-84 to 1988-89.

Table 5.1 All levels of Australian government – taxes on income and employers' payroll taxes (A$ million)

	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Taxes, fees and fines	56,544.1	66,068.2	73,199.6	82,498.4	93,889.3	105,607.2
1Taxes on income	29,622.4	35,307.9	39,388.7	45,358.6	51,278.7	58,425.7
11 Individuals	24,691.5	29,288.6	32,713.8	38,061.7	41,887.3	47,537.3
12 Enterprises	4,464.7	5,485.6	5,979.4	6,538.8	8,573.1	9,990.8
13 Non-residents	466.2	533.7	695.6	785.1	818.3	897.6
2 Employers' payroll taxes	2,815.8	3,109.7	3,419.7	4,238.8	4,936.6	5,921.3
21 General taxes (payroll tax)	2,796.5	3,082.8	3,393.0	3,703.1	4,058.9	4,903.9
22 Selective taxes (stevedoring industry charges)	19.3	26.9	26.8	24.0	25.9	27.7
23 Fringe benefits tax	-	-	-	511.7	851.9	989.7

Source: ABS on 1988-89 taxation revenue Australia, p. 6.

Total taxes, fees and fines have increased tremendously. As for taxes on income, there is an increase in total income tax collected of about 19 per cent and 33 per cent for the years of 1984-85 and 1985-86 respectively (year 1983-84 is taken as a base). However, when self-assessment was introduced in 1986, an increase in total income tax collected of approximately 53 per cent, 73 per cent and 97 per cent was recorded for the years of 1986-87, 1987-88 and 1988-89 respectively (year 1983-

84 is taken as a base). Thus the percentages of total taxes on income have increased tremendously since the introduction of self-assessment.

As for the introduction of FBT, the employers' payroll taxes increased about 10 per cent and 21 per cent for the years of 1984-85 and 1985-86 respectively (year 1983-84 is taken as a base). However, with FBT's introduction in 1986, the employers' payroll taxes increased tremendously at approximately 51 per cent, 75 per cent and more than 100 per cent for the years of 1986-87, 1987-88 and 1988-89 respectively with 1983-84 is taken as a base. Thus it can be concluded that the introduction of self-assessment and FBT increased the collection of income taxes and employers' payroll taxes compared with those years before these strategies were introduced.

Revenue raised by FBT has steadily risen since its introduction in 1986. For example in 1986-87, the ATO reported revenue collections of $52.9 billion (cash basis), and FBT revenue in this period was $535 million (cash basis) representing only 1 per cent of the ATO's revenue collections. However, in 1997-98, the ATO collected tax revenue of $110.3 billion (accrual basis) with FBT revenue in this period of $3.3 billion (accrual basis), representing some 3 per cent of total ATO tax revenue collected (ATO, 1999, p. 23). Thus FBT has succeeded in raising revenue collection in Australia. The ATO also noted that tax agents play an important role in FBT, as they have significant coverage of the taxpayer population and therefore play a key role in ensuring tax compliance. For example, in the 1998-99 financial year, 76 per cent of FBT taxpayers lodged their returns through tax agents, accounting for 47 per cent of the revenue collected. Twenty-one tax agents prepared returns relating to 58 per cent of the revenue lodged by tax agents (ATO, 1999, p. 37).

5.4.2 Prescribed payment system (PPS) and pay-as-you-earn (PAYE) system

In many tax systems it is common for tax to be deducted at source for wages and salary, though it is not common in respect of other types of income. However, in Australia, certain classes of income are subject to withholding tax arrangements including income derived by contractors operating in particular industries such as building, transport and cleaning (the Prescribed Payment System). The PPS was introduced in 1983 to check evasion in contract and sub-contract work, especially

in the building and construction industry (Sandford, 1992, pp. 22-32). Tax is required to be deducted from intra-industry payments, irrespective of whether the payee is an individual, partnership or company. While salary and wages have tax withheld by employers under the pay-as-you-earn (PAYE) systems (Nolan, 1993, pp. 69-72). Income from which tax is withheld is subject to information reporting by payers so that payments can be matched against amounts disclosed in returns. The main source of revenue for the ATO has come from PAYE tax for the past ten years. In the 1997-98 financial year, it collected $66.2 billion (ATO, 1998, p. 11) from this source.

Table 5.2 Tax collected by the Prescribed Payments System

Year	No. of payees	A$ million	Percent of total tax collected
1983-84	289,091	251[a]	0.7
1984-85	311,405	412	1.0
1985-86	318,185	515	1.1
1986-87	357,220	765	1.5
1987-88	457,830	958	1.6
1988-89	580,123	1308	1.9
1989-90	747,000	1734	2.3
1990-91	631,000	1358	1.8

[a] This sum is for a part year (17/24).

Source: Commissioner of Taxation Annual Report, 1983-84 to 1990-91.

Table 5.2 above shows the total amount of tax collected by the PPS for the period of 1983-84 to 1990-91 in Australia. The industries covered were those where compliance had been low. Based on the number of payees who registered and the amount of tax collected, the system has been highly successful. This system identified some 30,000 taxpayers who had not previously been lodging returns (Wallschutzky, 1993, pp. 129-151).

5.4.3 Tax file number (TFN)

Tax systems are not successful unless taxpayers can be identified. Identification systems often allocate unique numbers to taxpayers who are then required to use these numbers when lodging returns or participating in transactions involving income. Payees were required to quote their tax file number. Non-lodgers generally did not have a file number and could not quote file numbers. They had the option of obtaining file numbers (and subsequently lodging returns) or having tax deductions at a higher rate. There has been a greater incentive for taxpayers in Australia, since 1989, to obtain and quote their tax file numbers. Table 5.3 below

shows the range of circumstances where taxpayers are rewarded for having and quoting tax file numbers.

Table 5.3 Consequence of failure to quote a tax file number

	Tax file number	No tax file number
Recipient of a Prescribed Payment (from 1/7/89)	Tax deducted at 20%	Tax deducted at 48.25%[a]
Employees (from 1/1/90)	Tax deducted at varying marginal rates ranging from 20% to approximate 48.25% when 'salary or wages' reaches approximate A$700 per week	Tax deducted on all 'salary or wages' at 48.25%[a]
Unemployment and sickness beneficiaries (from 8/1/90)	Entitled to benefits	Not entitled to benefits
Age and invalid pension (from 1/1/91)	Entitled to benefits	May not be entitled to benefits
Investors' interest-bearing accounts[b] (from 1/7/91)	No tax deducted	Tax deducted at 48.25%[a]
unfranked dividends	No tax deducted	Tax deducted at 48.25%[a]

Notes:
[a] Or at prevailing maximum marginal rate (including Medicare levy).
[b] Subject to a de minimis rule, set initially at interest of A$120 per annum.
Source: Wallschutzky 1993, p. 138.

In July 1991, the ATO introduced Stage 2 of the Tax File Number (TFN) system. The expanded use of a unique tax file number for each taxpayer may serve the purpose of combating tax evasion (Sandford, 1992, pp. 22-32). Taxpayers who do not quote their TFN to their bank have tax withheld from the interest they earn. Thus, it encourages taxpayers to disclose their interest income in their annual returns.

5.4.4 Technology

The ATO is also continuing to strive for productivity, efficiency and service gains through the use of technology and better work practices. It has adopted the Electronic Lodgement Service (ELS) that has improved returns turnaround by nearly half of the individual clients and has enabled a reduction of staff in the ATO by approximately 700 (ATO, 1991).

The ATO also has introduced Centralised Automated Document Dispatch from two sites instead of sixteen locations (previously), which has enabled it to double the throughput of individual assessments at peak times.

5.4.4.1 The electronic lodgement service

The Electronic Lodgement Service was implemented nationally in Australia in 1990. By 1991/92 over half of all individual tax returns were submitted electronically (Commissioner of Taxation, 1992, p. 6) and by 1992/93 the figure was almost 60 per cent (James, 1997, pp. 205-226). In 1996-97, 71 per cent of tax returns were lodged through the electronic lodgment service (ATO, 1998). It was found that the cost of processing an electronically filed return was much less compared with that of a paper return. The electronic return only cost three cents, whereas the costs of a paper return was 72.5 cents (CCH, 1988). It was also found that the error rate in electronically filed returns was a mere 3 per cent, compared with a rate of 17-20 per cent on paper returns. The benefits of electronic filing are seen to include rapid tax rebates and the fact that the computer program will check returns for mathematical and also certain theoretical errors before they are lodged. James and Wallschutzky (1993) also reported that there might also be other considerable benefits as discussed below.

A major opportunity created by the computerisation of tax returns is the ability of the tax office to undertake far more sophisticated analyses than was previously possible, for example in identifying areas where potentially large amounts of tax were being evaded over many small transactions. It is also possible to detect such practices even if this is being done on a frequent and systematic basis. One approach is to analyse the tax returns submitted by different tax practitioners. The Australian Taxation office uses Key Abnormal Tax Agent Evaluation or KATE that allows it to detect tax practitioners whose clients' returns vary significantly from the average of those of other tax practitioners in the same region (James, 1997, pp. 205-226). KATE can highlight areas where there appears to be something unusual going on. Another enhancement to KATE involves dividing a tax agent's client base into small, medium and large client segments and then applying ratio analysis by industry classification.

5.4.4.2 Electronic record-keeping

Tax authorities throughout the world want organisations to maintain record, regardless of form or media, to be true and accurate, legible, accessible, and retained for as long as they are needed for tax purposes. However, electronic records pose certain risks not generally encountered with manual, paper-based record keeping. The main features of Australia's DTR 97/D4, Income Tax: Electronic Record keeping (Stephens, 1999, pp. 69-71) are subject to:

(i) inadvertent destruction or corruption as is any digital information;

(ii) unauthorised tampering, which may compromise their integrity as true and accurate records; and

(iii) obsolescence of the operating systems used to process them, due to the constant upgrading or changing of computer systems over time.

DTR 97/D4 also sets forth provisions prescribing the characteristics of electronic record keeping systems required to make computerised accounting systems sufficient for tax purposes.

5.4.4.3 Control of non-filers

For small business taxpayers, detection of non-filers is usually based on information obtained from third parties which indicates the receipt of income or the accumulation of wealth implying the need for lodgement of a return (Nolan, 1993, pp. 69-72). The information is obtained on commuter mediums, usually tape, to facilitate matching with ATO information assisted by the tax file system. However, a great deal of information is processed manually.

According to the ATO's research, it was found that small business proprietors in Australia are often not very literate in tax matters and have low management skills (Nolan, 1993, pp. 69-72). They do not keep good accounting records. Given these factors, together with common perceptions that the burden of tax on them is high and that there is a lack of confidence in the tax system, there are major risks of non-compliance through understatement of income, over-claiming of business expenses and other deductions or by failing to account for amounts of tax withheld from customers and employees. Because of poor financial record maintenance in the small business sector, a campaign of record retention audits is being applied to reinforce the need for good record-keeping practices to assist both business

management and tax compliance. Record-keeping audits also identify some non-filers. Prosecution in the courts or administrative penalties applied under offence provisions in the tax law are used against offenders.

5.4.5 The taxpayers' charter

The taxpayers' charter is an integral part of the ATO's day-to-day operations. It was formally launched in July 1997 and was designed to improve the relationship between the community and the ATO (Commissioner of Taxation, 1998). It also helps to reinforce community confidence in the ATO's operations. The charter lists and explains taxpayers' legal rights and main obligations, lists and explains other standards that taxpayers can expect to be observed and sets out the ATO's standards for delivering particular transactions, such as the time frame in which an assessment is to be processed. It provides access to a properly functioning complaints mechanism which turns a burdensome situation into one of opportunity to change and improve.

5.4.6 Enforcement and punishment

The system of controls within the ATO, that is, the enforcement or punishment policies (e.g. audit activities, penalty provisions), preventive controls (e.g. withholding systems of taxation collection), and administrative efficiency in detecting under-reporting practices, is a significant contributing factor to the level of taxpayer non-compliance (Strader and Fogliasso, 1989, pp. 39-46). Ultimately, it is likely that these controls will also have an impact on tax agents' perceived expectations that unethical tax practices will be detected by the ATO. Although, in Australia, the penalties are imposed on the taxpayer, the tax practitioner is likely to feel the impact of these penalties in the form of damage to client relationships and damage to professional reputation.

The *Income Tax Act* stipulates that only registered tax agents may demand or receive a fee for preparing an income tax return or for transacting business on behalf of a taxpayer in income tax matters. The Acts regulatory regime also requires that tax agents obtain a licence to practise, which takes the form of registration subject to certain education and experience criteria set by the Tax Agents' Board (Marshall, Smith and Armstrong, 1997, pp. 9-15). Interestingly, there is no other country with a formal requirement for registration of all tax return

preparers or their equivalents. It is pertinent that in Australia for 1990/91, tax agents accounted for the completion of 71 per cent of all personal income tax returns (Taxation in Australia, 1993, p. 317). Further, Boucher noted that 26 per cent of tax agents' agencies generate 93 per cent of the tax revenue processed through tax agents (1991, p. 16). Realising the important roles played by these tax agents, the ATO has undertaken several research surveys of agents in order to assess professional relationships, client satisfaction and progress towards meeting the authorities' objectives, usually by consultants upon the ATO's behalf (ATO, 1992). The ATO has introduced initiatives to create a more dynamic and effective partnership with tax practitioners by capturing their real-time input issues at the regional and national levels (Commissioner of Taxation, 1998, p. 35). These initiatives included:

- an agreement between the ATO and professional bodies to work together to develop an information/assistance package and related programs to help tax practitioners to understand compliance issues better, which was recommended to tax practitioners through a joint communique from the ATO and the professional bodies;

- working together to draft a new Regulatory Framework for Tax Practitioners;

- establishing national liaison forums to examine specific issues such as lodgment and fringe benefits tax;

- establishing and maintaining national panels, comprising academics, business specialists and subject experts to advise the ATO on issues such as public rulings, Tax Pack and the Taxpayers' Charter;

- convening special, one-off meetings on high priority issues such as compliance programs;

- establishing a register of specialist consultants who can be engaged quickly to assist in the resolution of significant issues;

- establishing regional ATO/tax practitioner forums and liaison groups to help identify unintended or adverse consequences that may result when ATO policies are implemented, and to advise on policies that may not work on a practical level, in which participants also play an important role in identifying issues that should be brought to the attention of the

National Tax Liaison Group or the National ATO/Tax Practitioner Forum; and

- better communication strategies.

5.4.6.1 Policies adopted to combat non-compliance

Some policies adopted by the ATO to overcome tax avoidance and evasion in Australia are as follows.

1. Anti-avoidance provisions

The Commissioner has the power under s 224 to impose penalty tax. This penalty is 50 per cent of the difference between the tax properly payable and the tax that would have been payable if the anti-avoidance provision had not been applied. However, when a taxpayer has a reasonably arguable position, the level of the penalty is reduced to 25 per cent (Lehmann and Coleman, 1996, p. 1191).

2. Taxation offences

A taxpayer is convicted under Section 8C for the failure to comply with requirements under the taxation law and Section 8D for the failure to answer questions when attending before the Commissioner, or failing to produce a book, paper, record or other related document. Section 8E is related to penalties for conviction under s 8C or 8D (Lehmann et al., 1996, pp. 1191, 1192).

- First offence – maximum fine of $2000

- Second offence – maximum fine of $4000.

- Third and subsequent offences – maximum fine of $5000 and or imprisonment for 12 months.

Section 8M prescribes the penalties for offences against making false or misleading statements to taxation officers or omitting something from a statement so that it becomes false or misleading (s 8K), or keeping accounts or records in such a way that they do not correctly explain the matters or transactions etc to which they relate (s 8L)(Lehmann et al., 1996, p. 1192).

- First offence – maximum fine of $2000.

- Second or subsequent offences – maximum fine of $4000.

(a) Record keeping requirements

Where taxpayers fail to keep adequate records, it is difficult to establish their proper tax liability. Hence good record keeping should be encouraged by advising taxpayers that by keeping good records they are less likely to be audited or that audits are less likely to be intrusive. However, there is a greater chance that poor record keepers will be audited or experience more intrusive audits. As suggested by Wallschutzky (1993, pp. 129-151), other penalties for poor record keeping could include fines or even denial of deductions. Since 1 July 1986, the Australian tax system has contained substantiation requirements for work related expenses and for car expenses. In essence these require taxpayers, who want to claim deduction for these items, to keep receipts for such expenses and to keep log books in respect of car travel. Failure to keep receipts or log books can mean denial of the relevant deduction, even though the expenses may actually have been incurred. These provisions were introduced to correct a deficiency in the law which, while specifying the type of expense which qualified for deduction, failed to specify what level of proof was required to substantiate claims.

(b) Denial of deductions

Since 19 September 1985, the Australian tax system has denied deductions for entertainment expenses since taxpayers exploit or are likely to exploit this particular provision, hence the tax office can deny deductions for this types of expenditure (Wallschutzky, 1993).

3. Liability of tax agents for false returns.

To engage in tax avoidance, taxpayers usually require professional help from bankers, lawyers or accountants. In August 1980, the Australian Society of Labour Lawyers was formed and one of its initial public statements condemned lawyers who devoted their talents to devising tax minimisation schemes and judges who upheld such schemes (Wallschutzky, 1982, pp. 122-124). Similarly, in September 1980, Wallschutzky (1982) noted that the Australian Institute of Chartered Accountants issued a "Proposed Statement of Taxation Standards" which took a

harsh line against members who promoted tax avoidance schemes. The proposed standard, was passed, and is mandatory and members who fail to observe it are liable to investigation and disciplinary action.

In a random sample of 750 taxpayers in New South Wales, Wallschutzky (1986, pp. 31-33) found that professional tax advisers were seen as influencing people's likelihood to evade their taxes. Hence the extent to which professional bodies for accountants and lawyers have ethical rules prohibiting members from assisting taxpayers in undertaking tax avoidance arrangements, can have an important impact on the proliferation of avoidance schemes. Wallschutzky (1993, pp. 129-151) suggested that if necessary, governments can encourage professional bodies to adopt ethical standards. Alternatively, governments can make it a statutory offence to promote certain types of schemes or to aid or abet taxpayers entering into such schemes. Under s 8T, the Commissioner has remedies against tax agents who invent or inflate claims but an essential element of the offence under s 8T is the existence of a guilty intent (mens rea)(Lehmann et al., 1996, p. 1199).

Wallschutzky (1993, pp. 129-151), Wallschutzky and Singh (1995, pp. 42-71) argued that if penalties are to be effective, they must be perceived as penalties and the following principles need to apply. Where possible, penalties should be expressed as a percentage of the tax which taxpayers sought to evade and the penalty for late payment should at least equal "*market rates*" of interest. The Australian Government decided to replace the disparate late penalty arrangements in legislation administered by the Commissioner of Taxation with an "Interest on Outstanding Balance" (IOB) charge (Commonwealth of Australia, 1998). The IOB reflects interest rates and employs the weighted average yield of the 13-week Treasury note topped up with an eight percentage point uplift factor. This uplift factor takes the charge above commercial interest rates and is a deterrent to taxpayers using taxation debts as a form of business finance. The charge is calculated on a compounding basis and based on the relevant 13-week Treasury note yield, the current IOB charge is in the order of 13 per cent. The existing penalties carry simple interest rates of between 16 and 20 per cent depending on the type of tax. The new interest charge was applied from 1 January 1999 and

transitional arrangements that would provide for late penalties across all taxes to a simple effective rate of 13.5 per cent.

The Budget Review 1998-99 also announced that "Failure to Notify" penalty. Taxpayers who fail to correctly notify the Commissioner of Taxation when an amount is due were required to pay a "Failure to Notify" penalty. The penalty is calculated at the rate of 8 per cent per annum and replaces the flat rate culpability penalties, ranging from 20 per cent to 200 per cent for failure to remit deductions by the due date. As for the penalty for failure to lodge annual source deduction reconciliations, a penalty is imposed of $10 per week for each week annual reconciliations are not lodged by withholders of source deductions. The maximum penalty is $200 and applies where documents are 20 weeks late or more.

4. Publishing of name of tax evaders in the annual report

ATO publishes the name of individuals who are convicted of evading taxes in its annual report of the national tax office (Wallschutzky, 1984, pp. 371-384).

5. The formation of Cash Economy Task Force.

There is a general recognition that the cash economy is substantial and represents a significant challenge to the integrity of the tax system. The ATO formed the Cash Economy Task Force in November 1996 to examine the nature of the cash economy, to determine what the likely compliance issues were, and to develop a recommendation on the additional steps that the Australian Taxation Office needed to address evasion in the cash economy (Commonwealth of Australia, 1998). The Task Force defined the "cash economy" as "income that is not recorded in the books from which the tax return is prepared" and presented its first report in May 1997 where it suggested that the ATO needed to work with tax practitioners, industry and community groups to develop effective solutions. Since this definition of the cash economy was wide enough to include a wide range of practices, the ATO has decided to focus its attention initially on cash income derived from business and employment, whether legal or illegal in nature. The Commissioner of Taxation responded to this report by announcing the implementation of a range of initiatives, which included the redeployment of field resources, by increasing the ATO's staff presence in cash industries and by developing Task Force initiatives. The ATO endorsed national projects relating to

the cash economy in the following industries: Building and Construction; Clothing; Fruit and Vegetables; Prescribed Computer Goods; Restaurants and Cafes; Road Transport; and Taxis.

In its second report titled "Improving Tax Compliance in the Cash Economy" published in April 1998, the Task Force noted that the ATO had increased its field presence threefold in businesses with significant cash dealings, including those to which the Prescribed Payments System (PPS) and the Reportable Payments System (RPS) applied. This report also recorded that an ATO Corporate Survey of taxpayer attitudes to the taxation system, which is conducted every six months through AC Nielsen-McNair, showed that there was widespread acceptance in the community that not paying tax on cash income was alright.

5.4.6.2 Audits

Under the self-assessment method, the ATO audits a percentage of all returns lodged. It targets special groups such as large companies which, are paying tax at a low rate or employ contract employees. Lehmann et al. (1996, p. 1201-1203) describe these three types of audits as below.

1. Complex audits

These audits are directed towards large corporations. They focus on financial transactions and international transactions.

2. Business audits

A business audit may involve a complete check of the taxpayer's arrangements or focus on specific issues such as fringe benefits tax. It is structured to be completed in the minimum time, commensurate with achieving a high level of cost effectiveness. Audits of individuals and partnerships usually involve the preparation of a source and application of funds statement, and a reconciliation of that with incomes returned and movements in assets. Audits of private companies are usually centred on an examination of specific deduction or income items that appear to warrant verification.

3. Primary audits

These audits deal with three main groups:

1) Desk audits of salary and wage earners, small businesses, and taxpayers who have negative gearing arrangements.

2) Income matching in which the Tax Office compares its externally obtained data with information supplied by taxpayers in their returns.

3) Obligations to deduct at the source. The Tax Office checks whether the employers have properly withheld PAYE deductions or fulfilled obligations under the prescribed payments system.

5.4.6.3 Post audit critique

The post audit critique is a team review mechanism that contributes to the development of best audit practices (ATO, 1995). This stage is used to critically examine all aspects of the audit such as to ascertain whether objectives were fulfilled, tactics adopted were soundly based and how the next audit could be more effectively carried out. The results of the critique are then forwarded to the National Office for evaluation and input into a national database in order to share best practice with all the branches.

The audit case was subject to a Quality Assurance Review, by an independent committee, in order to improve the quality of audits by identifying and communicating best practices, by eliminating unproductive activities and by sharing all the experiences.

5.4.6.4 An Eliot Ness-style strategic intelligence network

This was established by the Australian Tax Office to monitor new methods of avoidance and act on them quickly, before they became established and were widely promoted. Its tax commissioner, Mr. Carmody said the ability of the tax office to pursue cases was at risk if promoters of avoidance schemes, including large accounting firms were able to use the courts to screen clients from the Tax Office's attention (Macleay, 1998).

5.4.7 The role of marketing in the ATO

The Commissioner of Taxation's Annual Report 1989-90 (1990) acknowledged the new direction to be taken by the ATO:

> By setting service as the theme for the year, I aimed to raise awareness of the importance of good service among staff and the community. Service makes sense: it

costs less to collect revenue if people understand tax law and comply voluntarily than if they make mistakes or must be forced to comply.

Marketing anticipates and measures the needs or desires of a particular group and then responds with goods or services that meet those needs (Boyd and Walker, 1990). It acknowledges the importance of building relationships within an exchange system. The ATO regards taxpayers as customers and has added a service dimension to its delivery systems (Coleman and Freeman, 1997, pp. 311-336). Examples include: the establishment of consultative groups; electronic lodgment of returns; information pamphlets; education and media campaigns; school kits and the tax pack information product. As well as concentrating on customer service, the ATO has acknowledged the need both to improve customer service and public perception of it (Coleman and Freeman, 1994, pp. 347-367). From the late 1980s, the ATO has acknowledged the need to improve its service to its clients. The approach undertaken by the ATO consists of a combination of help and enforcement. The ATO is also committed to improving the technical and managerial skills of its staff who are encouraged to undertake studies in the ATAX program funded by the ATO.

ATO also has undertaken customer satisfaction research. This is important because it not only provides further information about customers' needs, but it also provides feedback on how customers perceive the quality of the service they receive (McNeil, 1993).

5.4.7.1 Market research

Realising the importance of understanding its customers, the ATO has used qualitative research as well as quantitative modelling. It has also acknowledged the need to do research into different segments of the market (Bird, 1992). This affects the type of marketing strategies which the ATO develops to improve compliant behaviour.

Although the ATO potentially deals with all taxpayers who are engaged in producing income, when applying strategic marketing principles there are various factors the ATO has considered. The first step the ATO has taken is to define various market segments (Coleman and Freeman, 1994, pp. 347-367) resulting in the following categories.

- Large and medium businesses. Those businesses with an annual turnover of $5 million or more;

- small businesses, small companies, trust, partnerships and sole traders; and

- non-business individuals, that is taxpayers who do not have business income.

The ATO also has acknowledged that the risks to revenue vary greatly between market segments. Within each of these segments the issue is to find a basis for heterogeneity in relation to their response to marketing activities. As suggested by Coleman and Freeman (1994, pp. 347-367), specific marketing proposals should be directed to different segments. Small business is so diverse and the cultural background of small business people is so varied that a strategy which is successful with one group may completely repel another. Users of market research have become increasingly aware of the need to understand the culture of a market segment because the values and attitudes of taxpayers are products of their cultural background.

5.4.7.2 Measurement and analysis of voluntary compliance

Market research and analysis from audit activity is used to direct resources towards assisting small businesses to achieve improved voluntary compliance. Based on the ATO's research, small business proprietors are often not well literate in tax matters and have low management skills (Nolan, 1993, pp. 69-72). The major concerns of small business operators are factors that affect their day-to-day livelihood, such as the high rate of business failures, interest rates, economic conditions and the burdens of location and compliance with government regulations. They generally work long hours and often operate businesses that handle considerable amounts of cash. Many of these small proprietors often do not keep good accounting records. Given these factors, together with common perceptions that the burden of tax on them is high and that there is a lack of confidence in the tax system, Nolan (1993) claimed that there were major risks of non-compliance through understatement of income, over-claiming of business expenses and other deductions or by failing to account for amounts of tax withheld from customers and employees. To address these risks, a balanced mixture of help and enforcement activities is adopted by the ATO. A well designed audit activity combined with the publication of interpretive rulings and other information to

inform taxpayers of what the law requires of them were developed whose primary aim was to encourage voluntary compliance and detect non-compliance (Nolan, 1993).

5.4.8 Staff development and training

The ATO has generous study leave provisions which assist staff to undertake part-time study, including study towards degrees in accountancy, law and economics (Bird, 1994, pp. 123-151). It also conducts a program of Continuing Professional Development in utilising both internal and external presenters.

ATO staff are also encouraged to participate in the development programs that it offers directly, or through the Public Service Commission. In particular there are a number of programs which allow ATO officers to take up placements in private sector organisations such as in large accounting firms, enabling them to gain a better commercial understanding.

5.5 Administrative Reform Proposed for the ATO by the TIA

The Taxation Institute of Australia (TIA) has recently made a proposal for two boards to oversee the Australian Taxation Office based on a view that tax administration should be more responsive to the changing business and tax environment (Dirkis, 1999, pp. 42-46). The boards would have two distinct roles whereby each board would have a different focus, different responsibilities and different members. There would be representatives of the taxpaying community on each board, as well as representatives of other government departments besides the Treasury and the ATO. Public interest should be protected by ensuring that both boards would give advice directly to the Treasurer or the Prime Minister, where considered necessary.

The first board or the Taxation Policy Review Board would focus on taxation policy formulation and development. It should be strong, independent and provide a strong consultative forum. Proposals will be received, challenged and debated constructively. While the other board or the Taxation Administration Review Board would focus primarily on improving the administration of the tax law. This board would oversee the administration of the ATO, and recommend

improvements where necessary. It should be answerable to the Parliament, and be constituted as an advisory board.

5.6 Summary

The ATO acts as a government agent for the collection of income tax in Australia. Its core business missions are: a) to collect proper revenue and provide proper service, b) to assist payment of child support; and c) to support the provision of retirement income for the people of Australia.

Individual taxpayers of Australia consist of individual non-business income (INB), small business income (SBI) and large business and international (LB&I) business line. Among these individual taxpayers, most of them are concentrated in the age group of 30-49 years and males outnumber females.

Various strategies have been adopted by the ATO to overcome income tax non-compliance in Australia. They could be placed in five categories as follows:

1. Enforcement and punishment. This includes withholding of taxes, auditing suspected taxpayers, formation of cash economy task force, introduction of self-assessment and fringe benefits tax or FBT, Prescribed Payment System (PPS) and Pay-As-You–Earn System (PAYE), introduction of various sanctions, and penalties involving taxpayers and tax preparers.

2. Technology. The introduction of ELS and computerised methods to detect tax evaders. For detecting tax practitioners whose clients' returns vary significantly from the average of those other tax practitioners in the same region it uses KATE.

3. Dissemination of information. The ATO disseminates tax information through tax pack, Taxpayers' Charter, dialogues with tax practitioners and making agreement with professional bodies to work together to develop information/assistance regarding compliance issues.

4. Conduct market research. Realising the importance of understanding its customers, the ATO has used qualitative research as well as quantitative modelling. It has also acknowledged the need to research different segments of the market that would affect choices of marketing strategies, which the ATO needs to develop to improve compliant behaviour.

5. Staff development. The ATO provides staff development and training to gain a better commercial understanding besides organising market research to understand better the needs of its clients. The recent proposal made by TIA to create two advisory boards to deal with policy development and tax administration are crucial in ensuring that the tax system is responsive to the changing business and tax environment.

CHAPTER SIX

The Gap Approach to the Measurement of Tax Non-Compliance

6.1 Introduction

The purpose of this chapter, and of the next chapter, is to assess the extent of tax non-compliance in Malaysia. Non-compliance is by definition difficult to measure, because it involves individuals and firms concealing the true level of their assessable income, whether intentionally or inadvertently. This difficulty is especially marked in a developing country such as Malaysia, where taxation law, statistical collections and taxation enforcement are less well established than in developed countries such as the U.S. or Australia. However, these very facts may imply that it is even more important to develop some broader indications of the level of non-compliance for selected developing countries.

The approach used in this chapter to assess the extent of tax non-compliance in Malaysia involves the application of a quantitative indicator of the level of non-compliance which has been used in a number of other countries. Although this approach is far from perfect, but it may give some indication of the scale of non-compliance in Malaysia.

Applications of the gap method to the U.S. and Australia are also discussed in this chapter, to provide some guide to the conclusions that can be drawn from the application of this method to Malaysia.

6.2 Description of Malaysian Information Sources

In order to understand the methodologies that have been adopted in estimating the extent of income tax non-compliance and their application to Malaysia, some Malaysian information sources used in undertaking the analyses outlined in this chapter (and also in Chapter Seven) are briefly reviewed in this initial section. Data sources for the U.S. and Australian estimates using the gap approach are outlined in the relevant sections.

6.2.1 Data sources from the national accounts

The system of national accounts in Malaysia is based on the concepts and methodology outlined in the publication entitled "A System of National Accounts, 1968", of the United Nations Statistical Office. Estimates of GDP by kind of economic activity in Malaysia, in constant prices, rely extensively on volume indicators of production. These indicators are used to extrapolate base year value added by sectors and sub-sectors. Current monthly/annual statistics for agricultural production and output of the manufacturing, mining and other service sectors form the basis for computation of the appropriate volume indices. For producers of government services, the value added is derived from preliminary estimates of expenditure obtained from the Accountant General's office (Dept. of Statistics Malaysia; 1997). More recently, expenditure estimates have also been provided (Dept. of Statistics Malaysia; 1999a), but the income based estimates of the components of GDP, which are most useful for estimates of tax non-compliance, are not yet available for Malaysia. These and related issues are discussed further in Section 6.4 below.

6.2.2 Taxable income

Information concerning taxable income that has been extracted from the data sources of the Internal Revenue Board of Malaysia (IRB) is referred to here as reported taxable income. It includes all kinds of earnings from all residents and non-residents which are taxable in Malaysia, and hence covers:

- Income from business, trade or profession.

- Employment income: salary, wages, remuneration, fees, leave pay, commission, allowances, bonus, gratuities and benefits (whether in money or otherwise).

- Income from investments/savings – mainly dividends and interest, but only in certain circumstances capital gains.

- Rateable value of living accommodation provided by the employer.

- Payments from an unapproved pension fund with respect to employers' contributions.

- Compensation received by employees on termination of their jobs.

As for resident taxpayers, all income earned in Malaysia and all income received in Malaysia is taxable, while for non-residents only the income earned in Malaysia is taxable (IRB 1998a). Hence income tax in Malaysia is territorial whereby tax is imposed only on income that has a Malaysian source. Where its source is outside Malaysia, income is taxable only if it is remitted into Malaysia by resident taxpayers only. However, if its source is outside Malaysia and this income is not remitted by resident taxpayers into Malaysia, this income is tax-free (Singh, 1995).

6.2.3 Analysis of direct taxes in Malaysia

Direct taxes, such as income tax, are a major source of Government revenue. Companies and cooperatives are the main contributors to direct taxes followed by individuals in the years of 1995, 1996 and 1997. The breakdown of tax components is as shown in Table 6.1 below.

Table 6.1 Tax components of direct taxes in 1995, 1996 and 1997

	Net collection in RM billions		
Tax components	1995	1996	1997
Companies and cooperatives	14.3	16.8	17.4
Individuals	6.0	6.5	6.9
Real property gains tax	0.4	0.5	0.4
Stamp duty	2.7	2.7	1.2
Estate duty	0.006	-	-
Petroleum	2.4	3.9	4.0
Other taxes	0.01	0.01	0.01
Total	25.8	30.4	29.9

Source: IRD/IRB Annual Reports for 1996 (p. 82), 1997a (p. 16) and 1998b (p. 16).

A total of RM25.8b, RM30.4b and RM29.9b of direct taxes were collected for 1995, 1996 and 1997 respectively. The highest component of direct taxes comes from companies and cooperatives and individuals come in second place for all these three years under study. As for estate duty taxes, no taxes have been levied in this area from year 1996 onwards.

In ensuring the success of the revenue collection process, there is a need to formulate a prevention system to maintain compliance at a high level. In the *Malaysia Income Tax Legislation*, it is mandatory for all companies incorporated under the *Companies Act 1965* to submit audited accounts to the taxation authority. For other companies and individual taxpayers, the Director General

may require audited accounts to be produced if the accounts or records produced are insufficient for ascertaining taxable incomes. For IRB, investigation and intelligence activity plays an important role not only in the collection of tax but also to prompt taxpayers to be conscious of their tax responsibility and to step forward voluntarily to declare their actual income.

6.3 The Gap Approach to Taxation Non-Compliance: Methodology and International Estimates

This approach relates taxable income as reported by the taxation authorities to a measure of taxable income derived from other sources, normally the national accounts. The difference between the two estimates of taxable income can be used to assess the total dollar value of income tax non-compliance, using the broad methodology discussed below.

6.3.1 The gap methodology

The essence of the gap methodology for assessing the level of tax non-compliance is to derive an estimate of a measure of taxable income (either total taxable income or personal taxable income) from national accounting sources, and to compare this estimate with the figure for the equivalent taxable income variable as reported in the official taxation statistics. The former measure we refer to as *derived taxable income*, while the latter measure might be termed *reported taxable income*. Given certain conditions, the difference between these two measures can be considered as a broad indicator of the level of tax non-compliance.

One of these conditions is that the derived and reported taxable income variables are conceptually equivalent. In the estimates prepared by the U.S. Department of Commerce (see Section 6.3.2 below) the focus is on personal taxable income, and considerable effort is put into ensuring that the derived and reported estimates are conceptually comparable. In the Australian and Malaysian estimates reported in Sections 6.3.4 and 6.3.5 below, the focus is on aggregate taxable income. In these two cases also, an important issue is the conceptual comparability of the derived and reported taxable income variables.

Another condition is that the national accounting sources used in generating derived taxable income have access to data sources (such as statistical surveys and company statistics) in addition to taxation data. In most countries taxation statistics are one of many sources used in compiling the national accounts estimates. But clearly the national accounts can provide evidence on tax non-compliance only to the extent that they draw on additional sources of information. Indeed, as the measure of non-compliance is generated as the difference between derived and reported taxable income, it will be particularly sensitive to errors, omissions or other data problems in the national accounts.

A third condition, which will be important in considering the Malaysian case, is that there is high coverage by taxation law of the private incomes reported by the national accounts. Where the level of coverage is an issue, a measured gap between derived and reported taxable income may as much reflect low coverage as in high rate of non-compliance. This is, of course, an example of the need to align closely the conceptual basis of both sets of estimates.

6.3.2 The U.S. estimates for personal income taxation

In seeking to assess the extent of income tax non-compliance for Malaysia, it is useful to compare Malaysian estimates with the latest research done using a similar approach for the U.S. and with estimates using comparable methodology for Australia. As both the U.S. and Australia are developed countries, while Malaysia is a developing country, this may enable us to compare the estimated extent of personal income tax non-compliance between developed countries (the U.S. and Australia) and Malaysia, an example of a developing country. It will also enable us to get a sense of the reliability of methods applied to the U.S. and Australia before they are applied to Malaysia.

The U.S. Bureau of Economic Analysis (BEA) prepares estimates of personal income as an integral part of preparing the U.S. National Income and Product Accounts, whereas the U.S. Internal Revenue Service (IRS) prepares estimates of adjusted gross income (income net of deductions) from its taxation records. The methodology adopted by the BEA is to adjust its measure of personal income to make it as close as possible conceptually to the IRS measure, and to treat the difference between the two measures of adjusted gross income ('the AGI gap') as

a broad indicator of the level of non-compliance by individuals with the Federal tax code.

The BEA's starting estimate of personal income contains both income reported to the Internal Revenue Service and unreported income. As noted by Park (2000, pp. 12-22), it contains taxable, partly taxable and non-taxable income. This personal income comes from a wide range of sources, such as from participation in current production and from both government and business transfer payments. It is calculated as the sum of wage and salary disbursements, other labour income, proprietors' income with inventory valuation and capital consumption adjustments, rental income of persons with capital consumption adjustment, personal dividend income, personal interest income, and transfer payments to persons after deducting personal contributions for social insurance.

On the other hand, the estimate of adjusted gross income (AGI) from the IRS contains only taxable sources of income net of specific adjustments as reported to the IRS. It represents the sum of all total income (including all income received in the form of money, property and services which is not tax exempted), less a specific set of adjustments authorised by legislation. However, it excludes all tax exempt income, such as interest on tax-exempt State and local government bonds, voluntary contributions to thrift savings plan and non-taxable social security benefit payments. It is estimated on the basis of unaudited tax returns that are not adjusted for misreporting.

Thus the BEA needs to adjust its measure of personal income to make it as far as possible conceptually comparable with the AGI measure of the IRS. This involves primarily deducting from personal income items of such income not included in taxable income (such as non-taxable transfer payments, imputed income and certain classes of investment income) and adding back some items of AGI not included in personal income. The result of this exercise is a BEA-derived estimate of AGI, and the difference between the two measures is the AGI gap. Details of these adjustments can be found in Table 6.4.

However, the AGI gap also contains some errors, such as

    (i)   errors in the source data,

(ii) errors in the IRS measure of total AGI and its components (since the estimates are based on a probability sample) and

(iii) errors in reconciliation items.

Further, reflecting the construction of the personal income measure, the BEA-derived AGI estimates include both explicit and implicit adjustments for tax return misreporting or non-compliance. Explicit adjustments are made for the effects of tax return misreporting on the source data used to prepare the estimates of wage and salary disbursements, non-farm proprietors' income, royalty income and personal interest income. Implicit adjustments are made for some components of personal income because the source data are from payers of the income. BEA believes that the explicit and implicit adjustments for misreporting account form a major part of the AGI gap.

Park (2000, pp. 12-22) concludes that the AGI gap can be considered a rough indicator of the dollar value of income tax non-compliance by individuals. Using this approach estimates of the gap between AGI-BEA derived income and AGI-IRS derived income for the years of 1996 and 1997 have been calculated as shown in Table 6.2 below. Similarly, Park also estimates the AGI gap and the relative AGI gap for the years of 1959-97 as shown in Table 6.3 below.

Table 6.2 Derivation of adjusted gross income and AGI gap, U.S., 1996 and 1997 (billions of dollars)

	1996	1997
1. Personal income (national accounts)	**6547.4**	**6951.1**
2. Less: Portion of personal income not included in AGI	**2373.8**	**2498.4**
3. Non-taxable transfer payments	842.3	870.1
4.Other labour income except fees	487.5	498.2
5. Imputed income in personal income	264.3	293.0
6. Investment income of life insurance carriers and pension plans	366.7	394.9
7. Investment income received by non-profit institutions or retained by fiduciaries	59.9	60.0
8. Differences in accounting treatment between NIPA's and tax regulations, net	79.9	87.4
9. Other personal income exempt or excluded from AGI	273.2	294.8
10. Plus: Portion of adjusted gross income not included in personal income	**978.0**	**1151.2**
11. Personal contributions for social insurance	280.4	298.1
12. Gains, net losses, from sale of property	249.5	338.2
13. Taxable pensions	311.6	341.0
14. Small business corporation income	89.3	100.7
15. Other types of income	47.1	73.2
16. Plus: Inter-component re-allocation	**0**	**0**
17. Equals: BEA-derived AGI	**5151.6**	**5604.0**
18. AGI of IRS (as reported)	**4536.0**	**4973.6**
19. Plus: Inter-component re-allocation	**0**	**0**
20. Adjusted gross income of IRS (reallocated)	**4536.0**	**4973.6**
21. Adjusted gross income gap	**615.6**	**630.3**
22. AGI gap (proportion of BEA derived AGI)	12.0%	11.2%
23. Addendum: Misreporting adjustments included in personal income	**299.1**	**311.5**

Source: Park (2000, pp. 14, 15).

Table 6.3 The BEA and IRS measures of AGI, AGI gap and relative AGI gap, 1959-97 (per cent)

Year	BEA-derived AGI	IRS AGI	AGI gap	Relative AGI gap (per cent)
1959	339.1	305.1	34.0	10.0
1960	351.4	315.5	36.0	10.2
1961	365.8	329.9	36.0	9.8
1962	387.8	348.7	39.1	10.1
1963	409.2	368.8	40.4	9.9
1964	442.2	396.7	45.6	10.3
1965	479.8	429.2	50.6	10.5
1966	521.7	468.5	53.3	10.2
1967	555.4	504.8	50.6	9.1
1968	609.3	554.4	54.9	9.0
1969	663.3	603.5	59.7	9.0
1970	699.3	631.7	67.6	9.7
1971	744.8	673.6	71.2	9.6
1972	825.5	746.0	79.5	9.6
1973	926.1	827.1	99.0	10.7
1974	1005.4	905.5	99.8	9.9
1975	1048.0	947.8	100.2	9.6
1976	1169.1	1053.9	115.2	9.9
1977	1297.6	1158.5	139.1	10.7
1978	1469.6	1302.4	167.1	11.4
1979	1658.5	1465.4	193.1	11.6
1980	1831.6	1613.7	217.9	11.9
1981	2016.3	1772.6	243.7	12.1
1982	2094.7	1852.1	242.6	11.6
1983	2225.7	1942.6	283.1	12.7
1984	2473.3	2139.9	333.4	13.5
1985	2629.9	2306.0	323.9	12.3
1986	2848.3	2481.7	366.6	12.9
1987	3125.4	2773.8	351.6	11.2
1988	3415.8	3083.0	332.8	9.7
1989	3658.6	3256.4	402.3	11.0
1990	3813.2	3405.4	407.8	10.7
1991	3864.4	3464.5	399.9	10.3
1992	4108.3	3629.1	479.2	11.7
1993	4260.0	3723.3	536.7	12.6
1994	4485.7	3907.5	578.2	12.9
1995	4766.4	4189.4	577.0	12.1
1996	5151.6	4536.0	615.6	12.0
1997	5604.0	4973.6	630.3	11.2

Source: Park (2000, pp. 14, 15).

The estimated AGI gap for the U.S. data increases steadily from \$34 billion in 1959 to \$630.3 billion in 1997, but most of this increase reflects the growth in personal income over that time. The relative AGI gap, measured against the BEA-derived AGI (in per cent) has been fairly constant, ranging from a low of 9.0 per cent (in 1968 and 1969) to a high of 13.5 per cent (in 1984) of the BEA

derived AGI. Thus it can be concluded that the relative AGI gap for the years of 1959 to 1997 ranges between 9 per cent to 13.5 per cent of the BEA derived AGI. Since the early 1980s it has fluctuated in a fairly narrow range about an average of approximately 12 per cent.

6.3.3 Data sources for Australia

The Australian Bureau of Statistics (ABS) provides estimates of GDP at current prices derived from the production, income and expenditure approaches. In practice in Australia, GDP is estimated mainly using the income and expenditure approaches (Pulle, 1998, pp. 43-49). The income side of the Australian National Accounts is broadly comprised of three aggregates (Comisari, 1997, pp. 35-53). They are as follows:

1. Gross operating surplus or GOS;
2. Wages, salaries and supplements; and
3. Net indirect taxes.

However, wages, salaries and supplement form the largest part of GDP, comprising about 50 per cent of GDP. Wages and salaries are mainly derived from two ABS surveys, the Survey of Employment and Earnings (SEE) and the Labour Force Survey (LFS). The Gross Operating Surplus or GOS component required for the income approach is based on information obtained from taxation statistics and other information available to the ABS. Taxation statistics, made available by the Australian Taxation Office (ATO), are based on information provided in tax returns. As such they suffer from the deficiency that they will not include income understated in those returns nor the income of persons who do not file tax returns. In addition, the so called "hidden economy" can be an important influence in terms of measuring rates of economic growth over time, particularly when changes in taxation legislation result in previously undisclosed income being recorded.

Hence the ABS makes an allowance in the national accounts for the effect of understatement of income, to avoid recording an artificial increase in GDP because of such changes (Comisari, 1997, pp. 35-53). The current system used to adjust for the understatement of business income in taxation statistics evolved from initial estimates of the revenue foregone through understatement of business

income in tax returns which were produced by the ATO and included in the June 1985 Draft White Paper, *Reform of the Australian Tax System*. So, any difference will largely reflect the assumptions made by the ABS about the extent of non-compliance, rather than an objective assessment of its magnitude.

Academic studies have estimated that the hidden cash economy of Australia could range from 3.5 per cent to 13.4 per cent of its GDP.[8] However, the ABS has provided information to Victoria University concerning the assumptions made in the national accounts about the extent of unreported income, namely that the adjustment for non-reported income was of the order of $6 billion in 1998/99 and a similar proportion of GDP in earlier years (Sheehan, 2000). Based on this information, the extent of the unreported income adjustment in the Australian National Accounts is estimated to be as shown in Table 6.4 below.

Table 6.4 Unreported income adjustment, Australia National Accounts, 1994-95 to 1998-99

Year	GDP (A $m)	Extent of non-compliance as assumed by the ABS (A $billions)
1998/99	591 546	6.0
1996/97	540 379	5.5
1995/96	520 669	5.3
1994/95	498 113	5.1

Source: Author estimates based on information from the Austalian Bureau of Statistics.

6.3.4 Estimates for Australia: The overall taxable income gap

Methodology

The total level of income that is potentially taxable in an economy can be considered as made up of income accruing to national citizens in three parts:

- income arising from economic activity, whether in the home economy or abroad,

- income arising from increases in the value of assets held by citizens, and

- income arising from taxable benefits to persons paid by the government.

Estimates of income arising from economic activities, that is from the creation, production and distribution of goods and services, can be obtained from the national accounts, which are designed to measure such productive activities. However, several elements of income arising from economic activity are not taxable. These include income accruing to public sector organisations or other

non-taxable bodies, income in respect of which deductions are allowed by the tax authorities and income which is not subject to tax as exempt income. The Australian national accounts also impute a rental income to the owner occupiers of dwellings, being the implicit income equivalent of the services that they obtain from living in that dwelling. This imputed income is of course not taxable.

On the other side, the national accounts do not measure the increase in the value of assets and hence do not provide any estimate of taxable income arising from capital gains. The national accounts provide an estimate of income from economic activity; they do not provide an estimate of income arising from the increased value of assets. Nor do they provide a reliable estimate of that element of benefits paid to persons which is taxable.

In recognition of these facts, in this section we approach the issue of measuring non-compliance in Australia through the gap approach by focusing on estimates of *taxable income from economic activity*. That is, we estimate taxable income from economic activity from national accounting sources and compare that with an estimate of the same variable from taxation sources. The latter estimate is obtained by excluding income arising from capital gains and benefit payments from the recorded measure of taxable income. This methodology means the exclusion of non-compliance in relation to capital gains and benefit income from the resulting measure of tax non-compliance.

The specific methodology to be used (subject to the availability of data) in applying the gap approach to estimating tax non-compliance at the aggregate level is as follows:

<u>Derived Taxable Income From Economic Activity</u>

Gross national income
Less:
    Imputed income from dwelling rent
    Depreciation (consumption of fixed capital)
Adjusted net national income
Less:
    Income accruing to non taxable (public) enterprises
Adjusted net private income
Less:
    Deductions allowed against taxable income (other than depreciation)

Derived taxable income from economic activity

Reported Taxable Income From Economic Activity

Total taxable income reported by taxation authorities
Less:
    Capital gains included in gross income
    Benefit payments included in gross income

Reported taxable income from economic activity

Income Tax Gap

Derived taxable income from economic activity
Plus:
    Allowance made in national accounts for non-reporting of income
Less:
    Reported taxable income from economic activity

Income tax gap.

Derived Taxable Income from Economic Activity

Table 6.5 below provides the calculations involved in deriving, for Australia, taxable income arising from economic activity from national accounting sources for the years of 1994/95, 1995/96 and 1996/97.

Table 6.5 Estimates of taxable income arising from economic activity, Australia, 1994/95, 1995/96 and 1996/97 (A $billions)

Year	1994/95	1995/96	1996/97
Gross National Income	**456.3**	**488.9**	**512.9**
Less:			
Consumption of fixed capital	76.9	80.6	82.4
Inputed income from dwelling rent	17.7	19.2	21.2
Adjusted Net National Income	361.7	389.1	409.3
Less:			
Income of public non-financial corporations[1]			
Gross operating surplus	21.3	19.4	19.6
Less:			
Consumption of fixed capital	9.1	6.9	6.5
Net income	12.2	12.5	13.1
Adjusted Net Private Income	**349.5**	**376.6**	**396.2**
Less:			
Deductions as allowed by the ATO on:			
Individuals	6.5	13.1	13.6
Derived Taxable Income Arising from Economic Activity	**343.0**	**363.5**	**382.6**

[1] In excluding public sector income, which is non-taxable, only income of public non-financial corporations is considered. In the Australian national accounts the net income of general government is set at zero, with gross income being set equal to the consumption of fixed capital (see ABS 1999 Table 2.14, p. 54). The income of public financial corporations is excluded due to unavailability of the data.
Source: Author estimates based on ABS and ATO data (see text).

In calculating Adjusted Net National Income (NNI) for Australia for the years of 1994/95, 1995/96 and 1996/97, the starting point is Gross National Income or GNI. Consumption of fixed capital or depreciation (excluding general government and public sector enterprises) is then deducted for these years, as is the imputed income for dwelling rent for owner occupiers. These data are extracted from the national income accounts at current prices (ABS, 1999, Table 1.12 p. 32). In deriving Adjusted Net Private Income, a further adjustment is made for the net income of public non-financial corporations, obtained by subtracting their consumption of fixed capital from the gross operating surplus of non-financial corporations (ABS, 1999, p. 46). This consumption of fixed capital by public non-

financial corporations is estimated on the basis that 80 per cent of their net saving consists of depreciation or the consumption of fixed capital (ABS, 1999, p. 46).

Taxable income arising from economic activity is derived by taking from Adjusted Net Private Income the deductions that have been allowed by the ATO in the respective years, other than for depreciation, which has already been covered. Deductions as allowed by the ATO were extracted from the publication *Taxation Statistics* for each of the three years. (ATO, 1996, Table P2, p. 7; ATO, 1997b, Table 3.2 p. 16; ATO, 1998, Table 3.3 p. 16). Only tax deductions in relation to individuals are considered here, because of the difficulty of estimating the extent of business tax deductions which are additional to the allowances made in the national accounts to calculate gross operating surplus of companies.

Reported Taxable Income from Economic Activity

Within the Australian Tax Office, individual taxpayers may be clients of the individuals non-business (INB), small business income (SBI) or large business and international (LB&I) business lines. If gross income is equal to or greater than $10 million, then the individual is a client of the LB&I business line. If gross income is less than $10 million and there is business income, then the individual is a client of the SBI line. However, the majority of the individual taxpayers, accounting for about 74 per cent of all taxpayers, are clients of the INB business line (ATO 1998, p. 14). INB clients are those taxpayers who receive most of their income from salary and wages, Australian government pensions and benefits, or investments, and who do not have any business income or deductions. As for the companies, they are clients of either the small business income (SBI) business line or the large business and international (LB&I) business line. Companies which have total income less than $10 million and which are not public companies are classified as small businesses and are administered by the SBI business line. Public companies operating as bodies corporate are also clients of the SBI business line. Companies which have total income greater than $10 million, or which are public companies not operating as bodies corporate, are classified as large businesses and are administered by the LB&I business line (ATO 1998, p. 56). Consistent with this organisation of the ATO, the data in

Table 6.6 are assembled in terms of individuals, small businesses and large businesses.

Table 6.6 provides the results of the calculation deriving reported taxable income arising from economic activity based on reported income to the ATO, which includes the gross incomes of individuals (non-business), small businesses and large businesses. These incomes come from individual taxpayers, companies, partnerships and trusts, and funds.

Individual taxpayers and corporate taxpayers are the two main contributors to total taxable income as assessed by the ATO. It was noted that in the three years under study, individual taxpayers (consisting of individuals with non-business income, with small business income and with large business income) outstripped corporate taxpayers (companies with small and large business income) in terms of total taxable income as assessed by the ATO. The other contributors are partnership, trusts and fund incomes.

Taxable income from individuals non-business was extracted from the ATO publication *Taxation Statistics for 1995/96, 1996/97* and *1997/98* (Table P2, p. 7; p. 15 and p. 14) respectively. The taxable income of small businesses for these years was also extracted from these publications Table P4 (p. 7) for 1994/95. Taxable income for small businesses (excluding INB income) for 1995/96 and 1996/97 was derived from Tables 4.4 and 4.5 (pp. 34, 35) for both years. The derivation involves separating the non-business income of individuals from small business income by use of the data in these tables. This separation is not possible for 1994-95. Taxable income of large business (Table P4, p. 8, Table 5.4, p. 41 and Table 6.3 p. 50) for 1994/95, 1995/96 and 1996/97 respectively.

Table 6.6 Taxable income declared to the Australian Taxation Office, 1994/95, 1995/96 and 1996/97 (A $billions)

Year	1994/95	1995/96	1996/97
Taxable Income as declared by:			
1. Individuals: non –business*	197.1	254.0	263.8
2. Small businesses	80.1	31.8	30.9
3. Large businesses	59.3	84.0	96.4
Total Declared Taxable Income	**336.5**	**369.8**	**391.1**
Less:			
Capital gains income	5.2	6.3	9.5
Benefit income	4.0**	4.6	4.5
Australian Government pensions	4.0**	4.2	4.5
Total Gross Income from Economic Activity	**323.3**	**354.7**	**372.6**

* Note: Business income of individuals in INB is included in line 2 in 1994/95, but for 1995/96 and 1996/97 it is included in line 1.
** Estimated value by the author.
Source: Author estimates based on ABS and ATO data (see text).

In deriving total taxable income from economic activity, income from capital gains, benefits and Australian Government pensions has been deducted, as the national accounts do not however measure these incomes and hence the estimates of derived taxable income from economic activity do not include these items. Total taxable capital gains income for the years of 1995/96 and 1996/97 was extracted from Taxation Statistics (ATO, 1997b, Table 11.1 p. 79 and ATO 1998, Table 12.1, p. 93), while total net capital gains for 1994/95 were extracted from Taxation Statistics (ATO, 1996, a sum of net capital gains from Tables P2 and P3, p. 7 and Table P4 p. 8). As for benefits given by the government to individuals and Australian Government pensions, the figures were extracted from the same publication (ATO, 1997b, Table 3.1 p. 15 and 1998, Table 3.2 p. 15).

Income tax gaps in Australia

The income tax gap for Australia for the years of 1994/95, 1995/96 and 1996/97 is derived by subtracting the reported taxable income arising from economic activity from taxation office (ATO) from the derived taxable income arising from economic activity from national accounting sources (ABS). Since the ABS has made allowances of about one percent of GDP for the effect of the hidden cash economy in Australia, these allowances (as tabulated in Table 6.4) have been

added back to get the derived taxable income from the national accounts. The resulting estimates are summarised in Table 6.7 below.

Table 6.7 Income tax gaps, Australia, 1994/95, 1995/96 and 1996/97 (A $billions)

Year	1994/95	1995/96	1996/97
Taxable income from economic activity (national accounts)	343.0	363.5	382.6
Add back: ABS allowance for unreported income	5.1	5.3	5.5
Derived taxable income (national accounts)	**348.1**	**368.8**	**388.1**
Reported taxable income from economic activity (declared to ATO)	323.3	354.7	372.6
Income tax gap	24.8	14.1	15.5
Per cent of derived taxable income	**7.1%**	**3.8%**	**4.0%**

Source: Estimates of the author, derived from Tables 6.4, 6.5 and 6.6.

Based on these calculations, the income tax gap for Australia for the years of 1994/95 to 1996/97 ranges from A$14.1 billion in 1995/96 to A$24.8 billion in 1994/95. While these are large numbers, they represent modest proportions of derived taxable income in these three years, from 3.8 per cent in 1995/96 to 7.1 per cent in 1994/95, with an average for the three years of 5.0 per cent. While these estimates must be treated with considerable caution, for the reasons noted in Section 6.3.1 above, they do suggest that tax compliance is relatively high in Australia, and that the taxation compliance programs of the ATO have been relatively successful.

6.3.5 Lessons of the gap approach estimates for the U.S. and Australia

One of the main reasons for exploring, in this study, examples of the gap approach to assessing the level of taxation non-compliance in the U.S. and Australia is to test the applicability of this method in developed countries with fairly sophisticated data systems. This test could be expected to throw light on the applicability of this approach to a developing country such as Malaysia, where statistical information systems are not so well developed.

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Three conclusions emerge from the analyses of this Section. One is that this method does seem to give sensible and consistent results for the two developed countries. In the case of the U.S., where the use of the technique is most advanced and the data sources in relation to personal income are most detailed, the method generates a consistent and slowly changing estimate of the adjusted gross income gap over a period of nearly forty years. Secondly, the value of this method in assessing the level of tax non-compliance depends substantially on the quality and availability of data, especially national accounts data drawn from sources separate from the national taxation collections. Thirdly, these two conclusions suggest that such a method might well throw light on the level of tax non-compliance in Malaysia, but that the specific results of any Malaysian estimate may be heavily qualified by issues concerning data availability. It is on this basis that we proceed to apply the gap approach to Malaysia.

6.4 Estimating the Overall Taxable Income Gap for Malaysia

6.4.1 Calculating the taxable income gap

Gross domestic product or GDP can be measured in three theoretically equivalent ways, namely as the sum of value added, as the sum of final expenditures and as the sum of incomes. However, in Malaysia, the Department of Statistics compiles annual GDP estimates using the sum of value added and the sum of final expenditure approaches. This is a major initial limitation in applying the gap approach to Malaysia, as it is the income approach to the national accounts which has provided much of the data used in the U.S. and Australian estimates above. It is also a reason why, in applying the gap approach to Malaysia, we follow the Australian estimates above and seek to estimate the gap in overall taxable income. The detailed income data required are not available to attempt to replicate the U.S. exercise on personal income.

However, the Malaysian national accounts do include an estimate of the Gross National Income (GNI) of Malaysia for the years of 1995, 1996 and 1997. GNI is a measure of the total income, before adjusting for the consumption of fixed capital, accruing to all Malaysian residents in the years in question. This is our starting point, and we have extracted GNI for Malaysia for these years based on

the national accounts figures (Department of Statistics, Malaysia; 1999a, Table 2(a), p. 7).

In making the adjustments to GNI to obtain an estimate of derived taxable income arising from economic activity for Malaysia (c.f. Table 6.5 for Australia) the first issue is depreciation or the consumption of fixed capital. There are no data on the consumption of fixed capital available for Malaysia. To make an estimate, we have assumed that the ratio of the consumption of fixed capital to GNI in the Australian data is also applicable to the Malaysian data. This assumption can only be regarded as providing an order of magnitude estimate, as the capital structures of the two economies may differ significantly.

The second adjustment required in line with the methodology of Table 6.5 is to exclude income accruing to non-taxable (public) enterprises. While the national accounts for Malaysia do not provide such information, estimates were provided to the author by the Ministry of Finance, Malaysia. Non-Financial Public Enterprises (NFPEs) are public sector agencies undertaking the sale of industrial and commercial goods and services. NFPE's includes statutory bodies, Government-owned and/or Government controlled companies and agencies owned by statutory bodies, whereby Government or a public-sector agency controls more than 50 per cent of total equity. However, only non-taxable income (that of enterprises owned wholly by the government) has been considered here. This income is deducted in Table 6.8, to derive a measure of net private income.

Finally, taxable income from economic activity in these three years is derived by subtracting all the deductions as allowed by the IRD/IRB (other than depreciation) for the respective years. Table 6.8 below provides the calculations estimating the total derived taxable income from economic activity in Malaysia for the years of 1995, 1996 and 1997.

Table 6.8 Estimates of taxable income arising from economic activity, Malaysia, 1995, 1996 and 1997 (RM billions)

Year	1995	1996	1997
Gross National income (GNI)	212.1	241.9	266.8
Less:			
Depreciation (consumption of fixed capital)	37.0	39.9	42.9
Net National income	175.1	202.0	223.9
Less:			
Income accruing to non taxable (public) enterprises	2.2	2.7	3.2
Net Private Income	172.9	199.3	220.7
Less:			
Deductions as allowed by the IRD/IRB (other than depreciation)	13.4	11.8	13.6
Derived taxable income from economic activity	159.5	187.5	207.1

Source: Author estimates based on data from the IRB Statistics and the Ministry of Finance (see text).

As for taxable income as reported to IRD/IRB for the years of 1995, 1996 and 1997, the data are extracted from IRD/IRB 1995, 1996 and 1997 Taxation Statistics and are listed as in Table 6.9 (IRD, 1996; IRB 1997b; IRB 1998c).

In deriving reported taxable income from economic activity for individuals in Malaysia for the years of 1995, 1996 and 1997, total deductions as allowed by the IRD/IRB for the respective years were deducted from the total amount of income as reported to the IRD/IRB.

Capital gains income (except real property gains income) and government pensions are not taxable in Malaysia, so that adjustments for these factors are not included in Table 6.9 other than for real property gains. Real property gains and estate duty incomes should be deducted from the total income in deriving reported taxable income from economic activity, but there are substantial problems with data availability. These two types of direct taxes are assessed manually, and the IRD/IRB only provide information on the total amount of tax collected by these taxes for the years in question. Thus the total amount of taxable income for these two types of direct taxes is not available to be deducted from the total of income as reported to the IRD/IRB.

Table 6.9 Taxable income declared to the IRD/IRB, 1995, 1996 and 1997 (RM billions)

Year	1995	1996	1997
a) Individuals – gross income	49.4	47.0	53.9
Less: Total deductions allowed to individuals	13.4	11.8	13.6
Individuals – taxable income	36.0	35.2	40.3
b) Taxable trust income	0.3	0.3	0.3
c) Taxable clubs and associations	0.06	0.09	0.1
d) Taxable Hindu joint family income	0.001	0.001	0.001
e) Taxable companies income	50.1	61.9	69.5
f) Taxable cooperatives income	0.1	0.2	0.2
Total taxable income	86.6	97.7	110.4
Less: Estimated taxable income on real property gains and estate duty	2.4	2.9	2.4
Reported taxable income from economic activity	84.2	94.8	108.0

Source: Author estimates based on data from IRD/IRB taxation statistics (1996, p. 4; 1997b, p. 4 and 1998c, p. 4).

As seen in Table 6.1 earlier, estate duty was only collected prior to 1996, because this source of income was only taxable prior to 1 Nov. 1991. Thus, the amount of tax collected in 1996 was in relation to income of estate duty earned before this date. As for real property gains income, it contributed about one per cent of the total direct taxes in 1995 and 1997 and about two per cent in 1996. Thus in considering the effects of the real property gains income in the above calculations of the gaps, we have to estimate the total taxable income of this income based on the amount of taxes collected in these three years. The tax rates imposed by the IRB on disposal of the assets on or after 27 October 1995 are as in Table 6.10 below.

Table 6.10 Tax rates for disposal of real property gains income for Malaysia

Category of disposal	Company (per cent)	Individuals & other person (per cent)
Disposal within 2 years	30	30
Disposal within 3rd. year	20	20
Disposal within 4th.year	15	15
Disposal within 5th. Year	5	5
Disposal within 6th.year	5	NIL

Source: Inland Revenue Board of Malaysia.

The total amount of tax on real capital gains tax collected in the years of 1995, 1996 and 1997 amounted to RM 0.4 billions, RM 0.5 billions and RM 0.4 billions respectively (IRD/IRB 1996, p. 82; 1997a, p. 16; 1998a, p. 16). Assuming that the timing of property disposal was such that this tax was assessed at the average rate of about 17 per cent (see Table 6.10), the approximate taxable income in respect of real property gains would be about RM 2.4 billions, RM 2.9 billions and RM 2.4 billions in the years of 1995, 1996 and 1997 respectively. These amounts are deducted from total taxable income to derive reported taxable income from economic activity in Table 6.9.

Table 6.11 Income tax gap, Malaysia in 1995, 1996 and 1997 (RM billions)

Year	1995	1996	1997
Derived taxable income from economic activity	159.5	187.5	207.1
Reported taxable income from economic activity	84.2	94.8	108.0
Income tax gap	75.3	92.7	99.1
Gap as proportion of derived taxable income	47.2%	49.4%	47.8%

Source: Estimates of the author, derived from Tables 6.8 and 6.9.

The resulting estimates of the taxable income gap for Malaysia for the years 1995-97 are shown in Table 6.11. In value terms they range from RM 75.3 billion in 1995 to RM 99.1 billion in 1997; in proportional terms they lie between 47.2 per cent and 49.4 per cent of the derived taxable income to the IRD/IRB in the three years under study. *That is, about 48 per cent of derived taxable income is not captured in reported taxable income in Malaysia.* By comparison, the estimates of the income tax gap for Australia, for broadly the same three years, lie between A$14.1 billion and A$24.8 billion, or between 3.8 per cent and 7.1 per cent of its derived taxable income (Table 6.7). Thus the estimates prepared for the two countries, using a similar methodology, suggest that the income tax gap is very much higher in Malaysia than in Australia, in proportional terms. The

explanation of this fact is the main issue that we now address in the remainder of this chapter.

6.4.2 Comments on the gap approach used for Malaysian and Australian data

Before considering the broader factors involved in the explanation of the very high income tax gap in Malaysia, some more technical matters need to be noted. No adjustments have been made in the Malaysian data for official estimates of non-compliance, because the Department of Statistics of Malaysia does not consider the presence of the hidden cash economy in estimating its GDP as does its Australian counterpart. On the other hand, the ABS has made an allowance in the Australian National Accounts for the understatement of income in each year, as noted above.

Some assumptions, and inevitably some errors, have been introduced in estimating the income tax gaps for both Australian and Malaysian data. These cannot be entirely avoided, given the limitations of data from the national accounts and taxation offices. As mentioned earlier, in the case of Australian data, we have ignored the income of public financial corporations in deriving the taxable income arising from economic activity (based on the national accounts), as the data are not available. Further, we have assumed that the consumption of fixed capital by public non-financial corporations is 80 per cent of their net saving, because we do not have the data on consumption of fixed capital by these corporations in the three years under study.

For the Malaysian estimates, we have estimated the total amount of taxable income arising from real property gains income in deriving the taxable income from economic activity, because direct data are not available. These type of income is assessed manually by the IRD/IRB. It does not keep records on taxable income in respect of real property gains, but only keeps records on total tax collected. Furthermore, we also have estimated the consumption of fixed capital (depreciation) for Malaysia in the above data based on the assumption of the same ratio of consumption of fixed capital to GNI as is revealed in the Australian data. We made such an assumption because there is no estimate of the consumption of fixed capital available in the Malaysian data. Hence there are some possible errors

which have been introduced in estimating the above income tax gaps for both Australian and Malaysian data. But the differences in the proportional income tax gaps for Malaysia and Australia (and also for Malaysia and the U.S., by implication from the personal income measures for the US noted above) are so substantial that these and other errors and assumptions will not distort this central finding.

6.5 Interpreting the Taxable Income Gap – Coverage or Non-Compliance

6.5.1 Interpreting the taxable income gap

The estimates provided above imply that only about 52 per cent of derived taxable income in Malaysia is in fact subject to tax, by comparison with about 95 per cent for Australia. This in turn means that a very substantial part of Malaysia's potential taxing capacity is unutilised, by comparison with the position in Australia, and hence that, for a given level of government expenditure, tax rates on income currently subject to tax are higher than might otherwise be the case.

There are two potential reasons for a low ratio of actual to derived taxable income. One is *coverage*: the possibility that the coverage of the taxation law is limited, so that a significant proportion of derived taxable income is not legally liable for tax. The other is *non-compliance*: the possibility that a significant proportion of derived taxable income, while legally liable for tax, is subject to non-compliance and does not in fact lead to tax being paid. Given the focus of this thesis on non-compliance, it is important to form some view on the extent to which coverage rather than non-compliance provides an explanation for the very high level of the taxable income gap in Malaysia. Thus we investigate the issue of coverage in the next two sections. The discussion must inevitably be brief, and coverage is a topic that could be the subject of a full additional study.

6.5.2 Coverage of personal income taxation

The available evidence suggests that, relative to developed countries such as Australia, the coverage of personal income taxation in Malaysia is quite low. This is, of course, to be expected in a developing countries, where corporate income taxes tend to be more important than taxes on personal incomes, while the reverse

is true in developed economies (Burgess and Stern, 1993). We do not here examine the coverage of personal income tax in Malaysia relative to that in other developing countries.

One simple indicator of the coverage of the personal income tax system is the ratio of the number of taxable individuals to the number of employed persons. This indicator should, of course, be treated with care, for many factors other than the level of employment affect the number of individuals paying tax. Thus in Australia, for example, many individuals not working but living on retirement incomes or incomes from assets are subject to tax. It should also be remembered that coverage in terms of individuals is very different to coverage in terms of income, for if many persons on low incomes are not required to pay tax the aggregate income foregone may be modest. In addition, in Malaysia it is possible for a married couple to elect to be taxed as a household (combined assessment), while this is not possible in Australia. Nevertheless, the figures shown in Table 6.12 are striking. For the three years under study, the average ratio of the number of taxable individuals to the number of persons employed was 17.5 per cent in Malaysia and 97.6 per cent in Australia. By this measure, the coverage of personal income tax is much lower in Malaysia than in Australia.

Table 6.12 Ratio of taxable individuals for Malaysia and Australia for the three years under study

Country	Malaysia			Australia		
Year	1995	1996	1997	1995	1996	1997
No. of employed individuals ('000s)	7645	8400	8569	8218	8320	8316
No. of taxable individuals ('000s)	1547	1275	1459	7861	8200	8200
Ratio (%)	20.2%	15.2%	17.0%	95.7%	98.6%	98.6%

Source: Malaysia: *Taxation Statistics*, various years and International labour Office 1998, p. 108; Australia: ATO, *Taxation Statistics*, various years and ABS Labour Statistics (August data) for various years.

In large part, this low coverage in Malaysia can be explained by the structure of the income tax system, relative to the structure of the incomes of Malaysian households. In 1995 the average household income in Malaysia was RM24,084 (Department of Statistics, 1997) and it is likely that, as is common with most national income distributions, the median income was significantly below the

mean. Thus we can conclude that in 1995 considerably more than 50 per cent of Malaysian households had incomes of less than RM24,000.

Table 6.13 Selected personal income tax deductions allowable, Malaysia, 1998

Type of deductions	Amount allowed (RM)
1. Self and Dependent	5000
2. Disabled Individual	5000
3. Disabled Wife	2500
4. Fees for education in scientific technology or vocational (Max)	2000
5. Medical expenses for parents (Max)	5000
6. Medical expenses on serious diseases individual, spouse and children (Max)	5000
7. Purchases of basic supporting equipment for disabled person (Max)	5000
8. Wife/Wives	3000
9. Child relief @ RM800	(No limit number of child).

Source: IRB 1998a, p. 183.

The Malaysian income tax system includes a relatively generous set of deductions (or 'reliefs'), a tax free threshold of RM2500 and a number of rebates. Some of the available deductions are shown in Table 6.13. If we assume that median household income in Malaysia in 1995 was RM20,000, then deductions for the husband, wife and (say) three children alone would amount to RM10,400, or 51 per cent of median income. Taken together with the RM2,500 threshold, 63.5 per cent of median income is already not subject to tax. In many cases, the availability of further deductions may mean that no income is subject to tax.

In a recent publication, the Malaysian IRB has given a hypothetical example of the tax position of a family (IRB 1998a, pp. 152, 153). The husband is an employee and receives a salary of RM 18,000 per annum, while paying RM 3,500 for Employees' Provident Fund (EPF) and insurance. His wife is a housewife but she receives rental income of RM 2,000 from a house (given to her by her father). They have four children, all below 18 years of age, and claim RM950 for medical expenses for the husband's parents. The wife elects for combined assessment. The broad outline of the resulting tax assessment is shown in Table 6.14. The key point is that this family, with an income of RM20,000, close to the median household income in

1997, is not subject to tax, after consideration of deductions, the tax free threshold and rebates.

Table 6.14 Example of tax computation for household with combined assessment in Malaysia for year 1997

		RM
Total income		**20,000**
Less: Deductions		
Personal	5000	
Medical expenses for parents	950	
Wife	3000	
Children (RM800 x 4)	3200	
E.P.F. and Insurance Premium	3700	
Total Deductions		15,850
Chargeable Income		**4,150**
Tax on first RM2500		0
Tax on RM 1,650 @ 2%		33
Income Tax Chargeable		**33**
Less: Rebates		
Self	110.00	
Wife	60.00	(Restricted 33)
Total Tax Payable		**Nil**

Source: Inland Revenue Board of Malaysia 1998a, pp. 152-3.

In addition to these deductions and rebates against personal income, the Malaysian income tax system provides for a range of exemptions of types of personal income from tax, more generous than those in Australia. Section 127 of the *Malaysian Income Tax Act* empowers the Minister of Finance to declare exemptions from income tax and states that the income specified in Part 1 of schedule 6 shall be exempt from tax. Some of them include:

- Donations received by approved charitable institutions.

- Pensions upon retiring from employment.

- Compensation for loss of employment and restrictive covenants.

- Certain types of interest income, such as government bonds and savings certificates.

- Income of an approved pension/provident fund.
- Scholarships;
- Retirement gratuities;
- Business profits enjoying tax incentives, as discussed below in the case of companies.

Capital gains (except for gains on the disposal of real property) are also exempt for tax in Malaysia, as noted above. Real Property Gains Tax is charged on gains arising from the disposal of real property situated in Malaysia or of interest, options or other rights in or over such land as well as the disposal of shares. However, as also noted earlier in the chapter, income from capital gains is not captured in the measure of derived taxable income estimated from national accounts data.

6.5.3 Coverage of company taxation

As a developing country, Malaysia provides several tax incentive programs, both direct and indirect, such as in the manufacturing, agriculture and tourism sectors. These are provided primarily under the *Promotion of Investments Act 1986, Income Tax Act 1967, Customs Act 1967, Sales Tax Act 1972* and *Excise Act 1976*. In a range of respects they are more generous than those in Australia. Many of these also have the effect of exempting income from tax, and hence reducing reported taxable income, rather than lowering the rate of tax.

The direct incentives are designed to grant partial or total relief from the payment of corporate income tax for a limited period of time, while the indirect incentives are given in the form of exemptions from import duty, sales tax and excise duty. Some of the direct incentives provided by the Malaysian Government are discussed below (Malaysian Industrial Development Authority [MIDA], 1999, pp. 1-22).

6.5.3.1 Incentives for the manufacturing sector

The major incentives for companies in the manufacturing sector are the Pioneer Status and Investment Tax Allowance (ITA) and Reinvestment Allowance (RA). Eligibility for either Pioneer Status or Investment Tax Allowance is determined according to priorities, termed as 'promoted activities' or 'promoted products', as determined by the Minister of International Trade and Industry.

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A company granted *Pioneer Status* enjoys partial exemption from the payment of income tax. It will only have to pay tax on 30 per cent of its statutory income. The period of tax exemption is five years, commencing from the Production Day as determined by the Minister of International Trade and Industry. There is also an added incentive for companies that are located in the States of Sabah, Sarawak, the Federal Teritory of Labuan,[9] and the designated "Eastern Corridor" of Peninsular Malaysia (covers Kelantan, Terengganu, Pahang and the district of Mersing in Johor), whereby they have to pay tax only on 15 per cent of their statutory income during the tax exemption period of five years.

A company granted an *Investment Tax Allowance* (ITA) is given an allowance of 60 per cent in respect of qualifying capital expenditure incurred within five years from the date on which the first qualifying capital expenditure is incurred. The allowance can be utilised to offset against 70 per cent of the statutory income in the year of assessment. Any unutilised allowance can be carried forward to subsequent years until the whole amount has been used up. The balance of 30 per cent of the statutory income will be taxed at the prevailing company tax rate. As with Pioneer Status, there is also an added incentive for companies located in the States of Sabah, Sarawak, the Federal Territory of Labuan[9] and the "Eastern Corridor" of Peninsular Malaysia. They are granted an allowance of 80 per cent in respect of the qualifying capital expenditure incurred. The allowance can be utilised to offset against 85 per cent of the statutory income in the year of assessment.

A *Reinvestment Allowance* (RA) is granted to manufacturing companies which have been in operation for at least 12 months and incur qualifying capital expenditure for the expansion of production capacity, modernisation and upgrading of production facilities, and diversification into related products and automation of production facilities. The RA is in the form of an allowance of 60 per cent of capital expenditure incurred by the companies. The allowance can be utilised to offset against 70 per cent of the statutory income in the year of assessment. Any unabsorbed allowance is allowed to be carried forward to the following years until it is fully utilised. An RA will be given for a period of five (5) years beginning from the year the first reinvestment is made. The RA can only

be claimed on completion of the qualifying project i.e. after the building is completed or when the plant/machinery is put to operational use. However, assets acquired from the reinvestment cannot be disposed within two years of reinvestment.

6.5.3.2. Incentives for high technology companies

High technology companies are defined as companies engaged in promoted activities or in the production of promoted products in areas of new and emerging technologies. They must fulfil the following criteria:

Local research and development (R&D) expenditure to gross sales should be at least 1 per cent on an annual basis. However, companies are allowed a period of three years from the date of operation/commencement of business to comply with this requirement. The percentage of science and technical graduates to total workforce should be at least 7 per cent.

High technology companies are eligible for the following incentives:

1) Pioneer Status with full tax exemption at statutory income level for a period of five years; or

2) Investment Tax Allowance of 60 per cent on qualifying capital expenditure incurred within a period of five years. The allowance can be offset against the statutory income for each assessment year without any restriction.

6.5.3.3 Incentives for strategic projects

Strategic projects are generally defined as projects involving products/activities of national importance. They usually involve heavy capital investments with long gestation periods; have high levels of technology and are integrated; generate extensive linkages and generally have significant impact on the economy. Such projects are eligible for the following incentives:

1) Pioneer Status with full tax exemption at statutory income level for a period of 10 years; or

2) Investment Tax Allowance of 100 per cent on qualifying capital expenditure incurred within a period of five years. The allowance can be

offset against the statutory income for each assessment year without any restriction.

6.5.3.4 Incentives for the agricultural sector

Under the Promotion of Investments Act 1986, the term "company" in relation to agriculture includes agro-based cooperative societies and associations, and sole proprietorships and partnerships engaged in agriculture. Companies producing promoted products or engaged in promoted activities are eligible to apply for Pioneer Status and for the Investment Tax Allowance.

In enabling agricultural projects to enjoy greater benefits, the Malaysian Government has broadened the definition of qualifying capital expenditure to include the following:

A) The clearing and preparation of land;

B) Planting of crops;

C) Provision of plant and machinery used in Malaysia for the purposes of crop cultivation, animal farming;

D) Aquaculture, inland or deep-sea fishing and other agricultural or pastoral pursuits;

E) Construction of access roads including bridges, the construction or purchase of buildings (including those provided for the welfare of persons or as living accommodation for persons) and structural improvements on land or other structures which are used for the purposes of crop cultivation, animal farming, aquaculture, inland fishing and other agricultural or pastoral pursuits. Such roads, bridges, buildings, structural improvements on land and other structures should be on land forming part of the land used for the purpose of such crop cultivation, animal farming, aquaculture, inland fishing and other agricultural or pastoral pursuits.

In view of the time lag between start-up of the agricultural project and processing of the produce, integrated agricultural projects are eligible for an ITA for an additional five years for expenditure incurred for processing or manufacturing operations.

6.5.4 Coverage of the Malaysian income tax system

Thus, while this discussion of coverage is far from complete, it is evident that the coverage of the Malaysian income tax system is much lower than in Australia and other developed countries. In part, this difference is due to the current stage of development of the Malaysian economy, but it is also partly due to specific features of Malaysia's economic and fiscal strategy.

It is apparent from the figures on different types of taxable income analysed above, (Table 6.9) that the IRB in Malaysia depends more on corporate income taxes than on individual income taxes, while the reverse is true for the ATO. Hence this confirms the finding of Burgess and Stern (1993, pp. 762-830) that corporate income taxes are more important than taxes on the incomes of individuals in developing countries, while in developed countries taxes on incomes are more important. They argued that the constraints on raising revenue through personal income taxation in developing countries are many, including problems of measurement, administrative capability, low literacy, and poor accounting. An economic structure dominated by agriculture and small-scale (often unregistered) enterprises makes personal income difficult to trace, and hence to tax these incomes (see Musgrave 1969; Goode 1984; Bird and Oldman 1990). As a result, revenue from this source in developing countries tends to accrue largely from taxes on the wages of employees in public-sector enterprises and foreign corporations to whom tax laws can be more easily applied. Collection from such a narrow base, often at high rates, creates resistance which is apparent in the experience of a number of countries (see Gillis 1989; Tanzi 1991). On the contrary, in industrial countries, wage and salary employment is more widespread and the capability to tax earned incomes outside this net, for example those of self-employed persons is greater. This partly explains the greater importance of individual income taxation in revenue for developed or industrialised countries.

6.6 Conclusion

The central finding of this chapter is that the income tax gap in Malaysia, calculated in terms of a methodology validated by its application to Australian and US data, amounted to about 48 per cent of derived taxable income. That is, only about 52 per cent of derived taxable income, estimated primarily from

national accounting sources, is captured in reported taxable income in Malaysia. This is very much lower than the comparable figures of about 95 per cent for total income tax in Australia and of about 88 per cent for personal income in the U.S. Indeed, it is so low that it must be regarded as highly likely that both of the possible explanations – low coverage and a high level of non-compliance – are significant contributing factors to the outcome.

While some aspects of the low coverage of the Malaysian income tax system, relative to that in Australia and other similar countries, have been documented in this chapter, it has not been possible to quantify the relative contributions of low coverage and high non-compliance to the explanation of the central finding of this chapter. Thus the finding that only 52 per cent of derived taxable income in Malaysia is subject to tax provides a strong indicator of a substantial level of income tax non-compliance, but does not lead to a quantitative estimate of this level. Thus in the next chapter we consider other indicators of the level of tax non-compliance in Malaysia.

CHAPTER SEVEN

Other Approaches to Assessing the Level of Tax Non-Compliance in Malaysia

7.1 Introduction

Chapter Six presented the gap approach in an attempt to measure the extent of income tax non-compliance in Malaysia and Australia. In principle, this approach enables one to compare the level of income tax non-compliance between these two different countries on a broad perspective. It was found that the proportion of potential taxable income on which tax is paid is much lower in Malaysia compared with Australia, and that this is likely to be due to both the low coverage and to a significant level of non-compliance with that tax regime. It was not possible, however, to derive a quantitative measure of the level of non-compliance, and hence of the relative importance of non-compliance and low-coverage. Hence this chapter uses other methods to throw light on the extent of income tax non-compliance in Malaysia.

Two specific approaches are used in this chapter. Firstly, the failure to submit annual tax returns to the IRB is used as a quantitative indicator of the level of non-compliance. Secondly, the other specific approach used involves surveying the opinions of taxation officers about the extent of non-compliance in this country. Each of these approaches is far from perfect, but together they may give some more direct indication of the level of this problem in Malaysia.

7.2 Description of the Personal Income Tax System in Malaysia

Peninsular Malaysia has a "preceding year" basis of assessment. The basis year refers to the calendar year immediately preceding a year of assessment. The year of assessment runs from 1 January to 31 December annually. Thus for instance the Year of Assessment 1998 refers to the 12 months from 1 January 1998 to 31 December 1998. The basis year for the Year of Assessment 1998 is the 12 months from 1 January 1997 to 31 December 1997. This means that the profits or income received in 1997 will be assessed in the Year of Assessment 1998. In Sabah and

Sarawak, the pay-as-you-earn or PAYE system has been operating since 1968. Based on the 1999 budget decision announced by the Finance Minister 1 in October 1998, the Peninsular Malaysia began operating in PAYE system in 1999.

7.2.1 Income tax returns and related offence

Income tax return forms are issued to taxpayers in late January of each year under Section 77(1) of the *Income Act 1967* (Act 53). The IRB issues the annual tax returns based on its master lists, which include:

A. Past registered taxpayers, addressed to the latest address that the IRB has on its records,

B. Voluntarily declared taxable taxpayers.

C. Names of non-registered taxpayers that have been compiled by a special unit of IRB in each of its assessment branches (*IV Unit*), whose main duty is to collect any information regarding payments received by these taxpayers, and are individuals likely to be taxable and but whose names do not appear in the lists. For example information may be obtained from lists of contract payments made by some organisations to its contractors.

D. Names provided by an employer unit (*EIV Unit*) in each of the IRB assessment branches, which is responsible for registering new tax file number for non-registered employees through cooperation with their employers.

These annual tax return forms must be duly completed and returned with business accounts (if any) to the IRB within 30 days from the date indicated on the return forms or such extended period as agreed by the Director General. Under Section 77(2) taxpayers who have not received returns within three months of a given year must, within 14 days of April, inform the IRB of the same. An offence is committed under the Income Tax Act 1967 if taxpayers

A. fail (without reasonable excuse) to submit a completed tax return within the appropriate time limit (as in para 1.7);

B. (without reasonable excuse) to give notice of chargeability to tax within the appropriate time limit (as in para 1.5).

Persons or organisations which receive a form are required to submit a return even though in their assessment their income is not sufficient to make them subject to tax.

Notify chargeability to tax

If a taxpayer is taxable and has never received any income tax return before, he or she must notify the chargeability to the nearest IRB office and request an income tax return. Similarly, if a taxpayer already has an income tax file but has not received an income tax return by 31 March in the year, he or she must immediately write in to the IRB office (which issued the last return) for a return for the relevant year. As a registered taxpayer, he or she must also inform the IRB office of any change in the address within three months from the date of change.

An offence is committed by a taxpayer if he or she does any of the following actions:

   A. Makes an incorrect tax return by omitting/understating income.

   B. Gives incorrect information in matters affecting the tax liability of oneself or some other person.

   C. Attempts to leave the country without payment of tax, when certificates have been issued to prevent the person from leaving the country for non-payment of outstanding taxes.

   D. Obstructs any authorised officers of IRB in carrying out his or her duties.

   E. Fails (without reasonable excuse) to comply with a notice asking for certain information as required by the IRB.

If a taxpayer commits an offence, he or she can be prosecuted or subject to a penalty. On conviction he or she can be liable to a fine or/an imprisonment and in some instances to a special penalty. However, an offence also can be compounded by the IRB office that issued the summon if the taxpayer manage to give satisfactory reason/reasons for his or her failure to comply.

The type of annual tax returns mailed to taxpayers depend on the nature of income they receive. Altogether there are five types of annual tax returns issued to various categories of taxpayers. They are as categorised below:

   1) Form BE for individual taxpayers who receive only employment income.

2) Form B for individual taxpayers who receive employment income and other incomes or individual taxpayers with business income.
3) Form C for companies.
4) Form C1 for co-operative societies and
5) Form T for trust/estate/body of persons such as the Hindu Joint Family.

Thus there are two types of forms to be completed by personal taxpayers, (BE and B) one of which has to be completed by a given individual taxpayer according to the character of his or her income source. Individual taxpayers are registered within the IRB under two different groups. They are the SG group (salary earners), while the OG group (other groups) includes company directors, self-employed taxpayers or non-salary earners. Hence the SG taxpayers are mailed with either Form BE or B, while the OG taxpayers are mailed only with Form B. Hence the type of form mailed to individual taxpayers could be summarised as below:

Form BE   – specifically for one source income earners of salaries or wages income only, and these taxpayers are registered under SG group.

Form B   – business income with or without salary or wages income, investment income with or without salary or wages or business income. This type of form is mailed to either SG group (salary earners with other income or incomes) or OG group.

7.3 Failure to Return Annual Tax Forms among Registered Taxpayers

Using this distinctive aspect of the Malaysian tax system, it is possible to obtain some indication of the extent of income tax non-compliance is by referring to registered taxpayers who fail to submit their annual tax returns to the taxation authority. Every year the IRB issues income tax annual returns to registered taxpayers that are likely to be taxable, based on information contained in its master lists (see Section 7.2.1 above).

At the end of January to February of each year, the IRB issues annual tax returns to its registered taxpayers and other identified individuals or organisations in stages. If taxpayers do not receive their annual tax returns by 1 March in each year, they are required to contact the IRB branch that handles their income tax file

or contact the nearest IRB branch for further information. As for new taxpayers who need to register with IRB, they can do this by contacting with nearest IRB branch. The annual tax returns are issued to taxpayers enabling them to report their annual income, and enclose necessary documents pertaining to their income, to the IRB Office within 30 days from the date indicated on their annual tax returns.

Some of these annual tax returns might not be returned for the following reasons:

1) Taxpayers might have moved to another place without informing the IRB of their new address, either intentionally or unintentionally.

2) Taxpayers, while liable for tax, might have forgotten to fill in the forms and return them to the IRB.

3) Taxpayers do not want to declare their income to the IRB, and hence wish to avoid paying their income taxes.

Thus the reasons for the failure to lodge the annual tax returns include both intentional and unintentional failure of taxpayers, liable for tax, to submit their completed annual income tax returns to the IRB. In this regard this failure to return the forms is an indicator of non-compliance. But other factors, not involving non-compliance, may also play a role.

7.3.1 Failure to lodge annual returns in 1995, 1996 and 1997 – all taxpayer types

We first consider the total number of failures to lodge annual tax returns for all individuals and organisations that have been issued with the annual income tax returns. Hence the type of returns under consideration include Form BE, Form B, Form C, Form C1 and Form T.

Table 7.1 Failure to return issued forms

Year	Total number of forms issued	Total number of forms received	Number not returned	Proportion not returned
1995	2,451,896	1,769,981	681,915	27.8%
1996	2,628,000	1,866,982	761,018	29.0%
1997	2,629,933	1,828,126	801,807	30.5%
Total	7,709,829	5,465,089	2,244,740	29.1%
Mean	2,569,943	1,821,696	748,247	29.1%

Source: IRD/IRB Annual Reports 1996,p. 17; 1997a p. 15 and 1998a p. 16.

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Table 7.1 above shows total number of annual returns (known as return forms in Malaysia) issued by the IRB and total number of completed return forms received by the IRB for the years of 1995, 1996 and 1997 for all taxpayers registered in the IRB. It includes forms issued to individuals, trust, clubs and associations, Hindu Joint Family, companies and co-orperatives. The proportion not returned indicates the extent of failure to submit annual tax returns by all registered taxpayers and other identified individuals and organisations in Malaysia for the years of 1995,1996 and 1997. From Table 7.1 it can be seen that the percentage of failure to submit the annual tax returns was 27.8 per cent in 1995, 29.0 per cent in 1996 and 30.5 per cent in 1997. It could be deduced that on the average about 29 per cent of all registered Malaysian taxpayers (and other identified individuals and organisations) have failed to submit their annual tax returns for the years of 1995, 1996 and 1997. There is a small increase (of approximately one percentage point) in the non-return rate in each year under study.

This non-return rate is high, with about 800,000 forms sent out but not returned in 1997. As noted, there a number of reasons other than non-compliance for non-return – failure to receive the form, mistakes in IRB identification, failure to return because in fact non-taxable, and so on. Nevertheless, such a high and persisting non-return rate is another indicator of income tax non-compliance in Malaysia.

7.3.2 Non-compliance in 1995, 1996 and 1997 for individual taxpayers of the IRB

We now turn to consider individual taxpayers for the years of 1995, 1996 and 1997. As noted above, there are two different groups of taxpayers classified under this category. They are the OG and SG groups, with two different annual tax return forms mailed to them, according to the nature of income they receive. Sole-proprietors and self-employed individuals including company directors are registered under OG group (Other Groups) and the annual tax returns mailed to them are known as Form B (indicated as Form B [OG] in the table below). Individuals with employment and other incomes are registered under SG group (Salary Group) and the annual tax returns mailing to them are also Form B (indicated by Form B [SG] in the table below). Individuals with employment

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income only are also registered under SG group. However, their annual tax return is known as Form BE and indicated as Form BE (SG) in the table below.

Table 7.2 Failure to return issued forms among individual taxpayers

Type Of returns	Year	Number of forms issued	Number of forms received	Number not returned	Proportion not returned	Average Proportion not returned
Form B (OG)	1995	750349	579108	171241	22.8%	23.1%
	1996	784629	597587	187042	23.8%	
	1997	781686	603420	178266	22.8%	
Form B (SG)	1995	738212	543817	194395	26.3%	24.8%
	1996	449268	344828	104440	23.3%	
	1997	498679	374921	123758	24.8%	
Form BE (SG)	1995	677449	454462	222987	32.9%	35.4%
	1996	1096169	719134	377035	34.4%	
	1997	1047263	640865	406398	38.8%	

Source: Unpublished documents from IRD/IRB of Malaysia record.

Table 7.2 above indicates that annual non-return rates for annual tax returns by individual taxpayers ranges between 22.8 per cent to 38.8 per cent across the taxpayer types over the period 1995-97. Among these groups of individuals, taxpayers with employment income only, whose annual tax returns use Form BE, have the highest mean rate of non-compliance, followed by SG group with Form B and finally the OG group. As discussed in the literature review in Section 4.3.3 in these years employees' income taxes are being withheld by their employers either under the Schedular Tax Deduction (STD) scheme (whereby regular deductions are made in relation to the prior year's income – applying in Peninsular Malaysia 1995-1998) or the Pay As You Earn (PAYE) scheme (applying in Sabah and Sarawak and those who commenced employment anytime on or after 1 January 1995). Thus this could be a possible reason that these taxpayers might not return their annual tax return forms. They might have misunderstood that they do not have to fill in their annual tax returns because their employers have withheld their income taxes. However, they are still required to fill in their income tax annual returns because the taxes withheld by their employers were merely based on estimation.

Again pointed out in Section 7.3.1 above, the IRB will only issue annual tax returns to those taxpayers who are likely to be taxable based on their past records. Not all of these annual tax returns would have been successfully received by all

individual taxpayers. Thus these non-return rates actually measure the gap between the number of individuals that have been issued with annual tax returns (rather than those that actual received them) and those complied by submitting their annual tax returns to the IRB.

Table 7.2 also shows that on average OG taxpayers have the lowest rate of non-compliance in submitting their annual completed returns. This could be so because most of OG taxpayers hire tax preparers in filing their income tax returns, and will be discussed further in Section 8.3.6. Nevertheless this fact does not mean that OG taxpayers are the most compliant among these individual taxpayers. Rather, the fact that there is a non-return rate about 23 per cent in spite of widespread use of tax preparers suggests that many in this group do indeed avoid tax. As discussed below, most of our survey respondents (income tax officers of the IRB) were of the opinion that the OG taxpayers are more prone to income tax avoidance and tax evasion due to the nature of their income, which is not withheld by employers compared to SG taxpayers. Thus they were of the view that there are more self-employed individuals or specifically OG taxpayers not included in the taxation system. Hence it may be of great significance if the IRB could introduce a withholding tax on all contractors and subcontractors, as done on Prescribed Payment System (PPS) of the ATO. This could impact strongly on tax evasion by this group of individual taxpayers.

The total number of annual tax return forms issued for all types of returns to individual taxpayers (Form BE and Form B) in 1995 was about 2.17 million, rising to 2.33 million by 1997. The total number of annual tax return forms received in 1995 was 1.58 million rising to 1.62 million in 1997. Thus the total number of annual tax forms not returned was 588,623 in 1995, rising to 708,422 or 30.4 per cent of the total in 1997. Table 7.3 below summarises these results.

Table 7.3 Total rate of non-return in submitting annual tax forms among individual taxpayers

Year	Total forms issued	Total forms received	Total forms not returned	Proportion total forms not returned
1995	2,166,010	1,577,387	588,623	27.2%
1996	2,330,066	1,661,549	668,517	28.7%
1997	2,327,628	1,619,206	708,422	30.4%

Source: Author's calculations derived from Table 7.2.

Table 7.4 Total rate of non-return in submitting annual tax forms among companies and other organisations

Year	Total forms issued	Total forms received	Total forms not returned	Proportion total forms not returned
1995	285,886	192,594	93,292	32.6%
1996	297,934	205,433	92,501	31.0%
1997	302,305	208,920	93,385	30.9%

Source: Author's calculations derived from Table 7.1 and Table 7.3.

Conclusions and implications

While there are many reasons other than non-compliance for failure to return annual tax forms to the IRB, the high non-return rate of issued forms must be taken as an indicator of significant levels of income tax non-compliance in Malaysia. In 1997 over 800,000 issued forms, or 30.5 per cent of the total, were not returned. For these wage and salary earners issued Form BE, the non-return rate was 38.8 per cent. For individuals with business income with or without salary, investment income with or without salary or business income with issued Form B, the non-return rate was 22.8 per cent in spite of the widespread use of tax preparers. Among companies and other organisations the non-return rate in 1997 was 30.9 per cent. While part of these high non-return rates can be explained by other factors, they constitute powerful evidence of persistent income tax non-compliance. This system is also costly and somewhat ineffective for the IRB, which could step up existing activities, or organise new activities, to overcome the low return rates. It could stress the importance of informing the IRB regarding the changes in address by taxpayers, to minimise unintentionally failure to submit the completed annual tax returns, and also stress the consequences of failing to submit the annual tax returns to taxation authority. IRB also could use various means to educate taxpayers, especially wage and salary earners, regarding their responsibility to fill in their annual tax returns even though their income taxes have been withheld by their employers.

7.4 Views of Taxation Officers about Non-Compliance in Malaysia

Another approach to gauging the extent of income tax non-compliance in Malaysia is by interviewing income tax officers of the IRB concerning this issue. Thus this section provides the results on views of the extent of income tax non-

compliance in Malaysia obtained through the interviews – other results of these interviews will be provided in Chapter Eight.

Sixty income tax officers from four different branches of IRB were face-to-face interviewed and their opinions regarding this problem were extracted and tabulated as in Table 7.5 below. We were very careful in choosing the respondents to match with the ones who had raised the omission or investigation in the file data. The respondents were chosen selectively because we were trying to get a clear picture of the reason or reasons given by these taxpayers for their failure to declare their true income. We were of the opinion that the respective officers who had raised the omission cases or involved in the investigation cases would know better than those who were not so involved. They would know better the reasons why these particular taxpayers failed to declare their true incomes, for these taxpayers could give several excuses in their personal files to escape from severe penalties from the IRB. Hence, their opinions are valuable in getting the real reason, especially in cases in which taxpayers give several excuses for failing to declare their true incomes, or offer no reason. Thus all of our respondents have experience in raising omission cases. Table below indicates that a substantial majority of the respondents were of the opinion that income tax non-compliance in Malaysia is at a serious stage.

Table 7.5 Response on the seriousness of income tax non-compliance in Malaysia

Branch	Very serious	Serious	Not serious	No. of respondents
Kuala Lumpur	2	12	1	15
Johor Bahru	3	10	2	15
Pulau Pinang	2	10	3	15
Kota Kinabalu	2	10	3	15
Total	9	42	9	60
Percentage	15%	70%	15%	100%

Source: Primary interview data collection for this research.

Seventy per cent of the respondents were of the opinion that income tax non-compliance in Malaysia is at a serious stage, while an equal percentage of fifteen per cent were of the opinion that income tax non-compliance in Malaysia is very serious stage and that it is not serious. Overall, 85 per cent of the respondents from these four different branches of IRB were of the opinion that income tax non-compliance in Malaysia is either serious or very serious stage. The responses were highly uniform across the four branches, with a slight higher reading for Kuala Lumpur, where 14 out of 15 officers surveyed (93.3 per cent) were of the view that non-compliance is either serious or very serious.

7.5 The Extent of Income Tax Non-Compliance – Limitations and Conclusions

In seeking different indicators of the extent of income tax non-compliance in Malaysia, we have performed three different approaches in Chapters Six and Seven. These involved estimating the taxable income gap between derived and reported taxable income (the gap approach), estimating the rate of non-return of the annual tax form and obtaining the opinion of income tax officers on the seriousness of this problem in Malaysia. Each of these methods has its limitations, as noted in the appropriate sections.

In spite of these and other limitations addressed earlier, the three indicators which have been studied in Chapters Six and Seven all point a similar conclusion, that the level of income tax non-compliance in Malaysia is high. About 48 per cent of derived taxable income in Malaysia is not included in reported taxable income in Malaysia, by comparison with about 5 per cent for Australia. While variations in income tax coverage explain a significant part of this difference, much must also be due to lower compliance levels in Malaysia. Over 800,000 issued tax forms, or 30.5 per cent of the total issued, were not returned in the form of income tax returns in Malaysia in 1997. Again, while other factors explain part of this high non-return rate, it remains powerful evidence of persistent income tax non-compliance. Finally, 85 per cent of a group of sixty experienced tax officers interviewed were of the opinion that income tax non-compliance in Malaysia is either serious or very serious.

Thus, which this research has not been able to provide a firm quantitative estimate of income tax non-compliance in Malaysia, it does provide a number of strong and consistent indicators that the level of non-compliance is high. The two remaining chapters explore some characteristics of those individuals who fail to comply (Chapter Eight) and examine strategies for increasing the rate of income tax compliance in Malaysia, drawing in part on the experience of the Australian Tax Office, reviewed in Chapter Five.

CHAPTER EIGHT

A Profile of Income Tax Non-Compliance in Malaysia

8.1 Introduction

Chapter Six and Seven explored the extent of income tax non-compliance, using quantitative indicators as well as surveying the opinions of taxation officers regarding this problem in Malaysia. While a definitive, quantitative estimate of the level of tax non-compliance could not be obtained, several indicators showed that this is a serious problem in Malaysia. Hence, this problem cannot be ignored by the IRB, and indeed by the Malaysian Government, in pursuing its objective of implementing an effective, just and fair tax management system.

Thus further study of the types of non-compliance that are most popular among taxpayers, analysis of the demographics of evaders and an exploration of some reasons for non-compliance may be assistance in devising strategies and plans to overcome this problem. The main aim of this chapter is to provide some of these analyses, by using the file data and interview data as discussed below.

8.2 Description of File Data and Interview Data

In addition to the use of published or unpublished statistical data collected by others, this analysis of tax non-compliance in Malaysia makes use of two types of data collected by the author. The first is referred to as the *file data*, where details are recorded of 507 taxation files of individuals identified as non-compliant by the IRB. The second is referred to as the *interview data*, which records the results of a survey by the author of the views of fifteen taxation officers in four branches of IRB concerning non-compliance.

The samples used in both cases involve a non-probability purposive type of sampling. That is, no attempt is made to select a random sample of taxpayers or taxation officers, but individuals with certain known characteristics were selected.

We used this type of sampling in respect of the file data because we would like to select only individuals who have been found guilty of evading their income taxes in the years of 1995, 1996 and 1997. As for the interview data, we also chose non-probability purposive sampling whereby only those respondents who were knowledgeable regarding tax non-compliance would be included. This in turn could allow a more informed investigation regarding the reasons for income tax non-compliance in Malaysia.

The consequence of using a non-random sampling approach is that great care must be taking in generalising any conclusions from the sample data to a broader population.

File data

There are 507 files in the sample. These consist of 415 files for non-salary taxpayers (OG files) and 92 files for salary group taxpayers (SG files) from four different branches of IRB. Table 8.1 below shows the distribution of the non-compliance files under study in this research. Since we have taken all of the available files for individuals that have been found guilty of evading income taxes in the years of 1995, 1996 and 1997 from these four different branches of IRB, it can be concluded that the OG files outnumbered the SG files in the file data in the offices in question.

Table 8.1 File data: Distribution by IRB branch and type of taxpayer

IRB Branch	OG files	SG files	Total
Kuala Lumpur	120	3	123
Johore Bahru	64	0	64
Pulau Pinang	84	6	90
Kota Kinabalu	147	83	230
Total	415	92	507

Source: Author collection from IRB records.

Interview data

As discussed in Chapter Seven, fifteen income tax officers from each of these four different branches of IRB - a total of sixty tax officers - were chosen to be interviewed regarding income tax non-compliance in Malaysia. Table 8.2 below

shows their gender distribution and working experience with the IRB. As shown in Table 8.2, slightly more than half of the officers were female and over 80 per cent had more than ten years experience.

Table 8.2 Interview data: Distribution of officers interviewed, by IRB branch, gender and working experience

IRB Branch	Male	Female	Working experience		
			< 5 yrs.	5 to 10 yrs.	> 10 yrs
Kuala Lumpur	6	9	2	3	10
Johore Bahru	7	8	1	-	14
Pulau Pinang	5	10	-	1	14
Kota Kinabalu	9	6	2	1	12
Total	27	33	5	5	50

Source: Author collection from IRB records.

8.3 Types of Non-Compliance among Individual Taxpayers

There are various ways for taxpayers to omit or evade their share of income taxes. They can inflate their expenses in their annual business accounts, over-claim their deductions in their annual income tax returns, and under-declare or even fail to declare their incomes in their annual tax returns. Thus one of our aims in this research study is to determine the most common type of omission among Malaysian taxpayers.

There are two methods of examining the types of non-compliance among individual taxpayers in Malaysia, as noted above. First, by extracting the nature of non-compliance committed by the taxpayers found guilty in the file data. The second is through interviewing income tax officers based on their working experience with the IRB.

8.3.1 Types of non-compliance obtained from file data

Table 8.3 below provides data on the types of non-compliance gathered from file data.

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Table 8.3 Nature of omission from file data

Nature of omission	Type of file		Total no. of cases	Percentage
	SG	OG		
Failed to declare income/s	90	255	346	68.2%
Under-declared income/s	2	152	154	30.4%
Over-claimed expenses	-	6	6	1.2%
Over-claimed deductions	-	1	1	0.2%
Total	92 SG	415 OG	507	100%

Source: Primary file data collection of this research.

Whether an omission is treated as failing to declare incomes or as under-declaring incomes depends on the sources of income that were declared by taxpayers. If the omitted income came from a source of incomes which had already been declared by the taxpayer in his or her annual tax return, we regard the omission as one of under-declaring income. However, if the omitted income has not been reported at all by the taxpayer in his or her annual tax return, then we regard the omission as failing to declare income. Over-claiming expenses or inflating expenses is usually related to the preparation of business accounts, while over-claiming deductions or reliefs is related to the preparation of annual tax returns.

Only one type of non-compliance was extracted per taxpayer. However, if a taxpayer has committed more than one type of non-compliance, the type of non-compliance that has resulted in the greater loss of income tax was taken to avoid confusion.

The significance of the above table is that the OG taxpayers exceed SG taxpayers more than threefold in the file data. Since we have considered all of the guilty files in the years of 1995, 1996 and 1997 that were available in these four different branches of IRB, it can be concluded that more OG taxpayers than SG taxpayers were found guilty of evading their income taxes in these branches. This could be due to the policy adopted by the IRB to go after taxpayers who have more opportunity for evasion and avoidance. Additionally, no income taxes have been withheld for this group of taxpayers. Hence by pursuing this group of taxpayers the IRB could induce an awareness on the part of OG taxpayers regarding the importance of declaring their true incomes.

Based on the above table, most common type of omission is failing to declare income. The second most common type is under-declaring income. Among SG files (salary earners' income tax files) involved in omission, more than 97 per cent are involved in failing to declare their incomes and less than 3 per cent involved in under-declaring their incomes. None of these SG files involved over-claiming expenses and over-claiming deductions. However, more than 61 per cent of OG files involved in the omission failed to declare income, and more than 36 per cent of OG omission files involved under-declaring their income. Hence based on file data, both types of files show that the most common type of omission is failing to declare income.

Individuals with non-salary income are those taxpayers registered under OG files. They are sole-proprietors, self-employed, or companies' directors. They tend to under-declare their income, relative to salary earners, partly because of the nature of their income. Since the amount of wage and salary income received by SG taxpayers is specified in their annual income statements by their employers, none is so declared for OG taxpayers. However, taxation officers can trace additional income not reported by OG taxpayers through other sources such as contractors, sub-contractors, company files or information from clients. Hence, information from third parties plays an important role in detecting tax non-compliance among OG taxpayers.

8.3.2 Views on types of non-compliance

The second method of determining the most common type of non-compliance committed by Malaysian taxpayers is by interviewing income tax officers of the IRB. Our respondents were asked to fill in the attached form (Appendix 1) and the results were analysed by the author.

In order to find the most common type of omission during the interview session, our respondents were given 4 options (as in Table 8.4 below) and were asked to arrange them in their order of importance. Scores were given according to their views: the type of omission judged most important (number 1) was scored at 4 points, the

second in the list received 3 points, third was given 2 points and last received only 1 point. Thus the total number of scores for the different types of omission that our respondents have come across were gathered as in Table 8.4 below. In interpreting this table, it should be noted that, if all types of omission were ranked equally by the tax officer, each would receive 25 per cent of the total score.

Table 8.4 Response on the common nature of income tax omission

Branch	Failed to declare	Under-declared	Inflated expenses	Over-claimed Deductions	Total
Kuala Lumpur	41	52	40	17	150
Johor Bahru	38	51	45	16	150
Pulau Pinang	48	51	34	17	150
Kota Kinabalu	52	45	33	20	150
Total no. of scores	179	199	152	70	600
Percentage	29.83%	33.17%	25.33%	11.67%	100%

Source: Primary interview data collection of this research.

Table 8.4 above shows the nature of omission versus total number of scores from four different branches of IRB. The highest total score (33.2 per cent of the total) was received by under-declaring income, followed by failing to declare income, inflating expenses or over-claiming deductions. Thus according to our respondents, the order of importance of the different types of omission are as follows:

1. Under-declaring income,

2. Failing to declare income,

3. Inflating expense and

4. Over-claiming deductions.

The main differences between the results of analyses of the omission data (Table 8.3) and the views of the tax officers (Table 8.4) are two-fold. Relative to the findings from the omission data the tax officers rate failure to declare income as less important and inflating expenses as more important. Indeed, in Table 8.4 inflating expenses receives 25.3 per cent of the total scores, whereas for only 1.2 per cent of the omission files was of the main type. The difference between Tables 8.3 and 8.4 could be attributed in part to the ranking methodologies used, and especially to the

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fact that only one type is included in Table 8.3 for each file. However, our respondents, based on their personal experience (whereby more than 80 per cent of them have worked with the IRB for more than ten years) were of the opinion that taxpayers tend to under-declare their income so that they will pay less income taxes and that inflation of expenses was an important form of non-compliance.

8.3.3 Implications obtained from the review of types of non-compliance

IRB officers should pay more attention to business accounts prepared by taxpayers or their accountants, for this group of taxpayers have more opportunities to misrepresent their true incomes compared to salary earners. Non-salary earners (taxpayers registered under OG income tax files) also have more opportunities to practice tax avoidance by over-claiming their expenses or deductions. Hence they tend to under declare their incomes compared to salary earners. As for salary earners it was found that 97.8 per cent of the omission files involved failure to declare income. This income could be their additional income, besides their primary employment income.

8.4 Characteristics of Individuals Engaged in Income Tax Non-Compliance

Study of the characteristics or demographics of taxpayers who involved in this problem will enable the authorities to channel most of their efforts or strategies to the groups of taxpayers who are more likely to be involved.

Some characteristics of individuals that have been involved in income tax non-compliance in the years of 1995, 1996 and 1997 that are studied here are age level, gender, income level and income source. These characteristics were chosen because they are associated with the problem under investigation (income tax non-compliance) and can be extracted from the omission files for these three years.

8.4.1 Age level

We have categorised age level into three categories, as below:

    i.   Young taxpayers, whose age is between 15 to 29,

ii. Middle-aged taxpayers, whose age is between thirty to fifty and

iii. Old taxpayers, whose age is above fifty.

In comparing the incidence of a non-compliant with this characteristic in the non-compliant population to a distribution of such characteristic of population in Malaysia, we should make the comparison with the population of taxpayers of different age levels registered with the IRB. However since the data on different age levels registered with the IRB are not available, we make the comparison with different age levels in the labour force of Malaysia, based on Labour Force Survey Report 1998 (Department of Statistics Malaysia, 1999b).

8.4.1.1 Description of gender distribution in the labour force

Table 8.5 below shows the percentage distribution, by age levels and gender, of the population data for the years of 1995, 1996 and 1997.

Table 8.5 Percentage by gender of the labour force

Age level	Age 15 to 29		Age 30 to 50		Age above 50	
Sex	M	F	M	F	M	F
1995	31%	36%	64%	61%	5%	3%
1996	31%	35%	64%	61%	5%	4%
1997	31%	35%	64%	62%	5%	3%
Total	31%	35%	64%	61%	5%	4%

Source: Extracted from Labour Force Survey Report Malaysia 1998 (p. 25).

They are uniformly distributed in these three years, whereby a total of 64 per cent of the male labour force is concentrated in the age 30 to 50, while a total of 61.3 per cent of female labour force is in this age group. The next largest age level of the labour force is in the age range between 15 to 29, where a total of 31 per cent and 35.3 per cent of male and female workforce respectively are found. The smallest age group in terms of age is found in the age above 50, where a total of 5 per cent of the male workforce and 3.3 per cent of female workforce are found in this age level.

8.4.1.2 Possibility that a tax evader comes from different age groups and gender in a tax evading population from file data

Table 8.6 Distribution of age levels and gender of the file data

Year	Age level	Age 15 to 29		Age 30 to 50		Age above 50		Total	
	Gender	M	F	M	F	M	F	M	F
1995	No. of taxpayers	12	1	89	15	47	3	148	19
1996	No. of taxpayers	20	10	99	22	35	2	154	34
1997	No. of taxpayers	11	4	80	24	29	4	120	32
Total	Total no. of taxpayers	43	15	268	61	111	9	422	85
	Total percentage	10.2^1	17.6^2	63.5^1	71.8^2	26.3^1	10.6^2	83.2^3	16.8^3

*Note: M = Male
       F = Female
[1] Share of all males, [2] share of all females and [3] share of total persons.
Source: Primary file data collection of this research.

Table 8.6 above depicts the distribution of gender and age level of income tax non-compliants gathered from four different branches of IRB for the years of 1995, 1996 and 1997. Thus, for example, there are a total of 167 income tax non-compliants (148 males and 19 females) in the year of 1995. Among the total of male non-compliants in this year, 12 of them were aged between 15 to 29 (8.1 per cent), 89 of them were aged between 30 to 50 (60.1 per cent) and the remaining of 47 were aged above 50 (31.8 per cent). Hence according to Table 8.6 above, it can be deduced that the larger number of tax evaders from the sample were aged between 30 to 50 for both sexes, here defined as middle-aged taxpayers. As seen in Table 8.5 earlier, 64 per cent and 61 per cents of male work force and female workforce are found in this age level respectively. Thus the results based on file data are consistent with the distribution of the workforce. Based on the omission and investigation files from these four different branches of IRB that have been finalised in the years of 1995, 1996 and 1997, it can be concluded that the total percentage of male and female taxpayers aged between 30 to 50 exceeds sixty percent. The total of 63.5 per cent of the male tax evaders aged between 30 to 50 exceeds, more than six times, of those

male tax evaders whose aged 15 to 29 and more than twice of those male tax evaders whose aged above fifty in the sample. As for female tax evaders, there are a total of 71.8 per cent of the female tax evaders aged between 30 to 50, which is four times the share of those female tax evaders aged 15 to 29 and more than six times the share of female tax evaders whose aged above fifty in the sample. But the interpretation of these age shares in the file data can only be correctly made in the content of the labour force shares in Table 8.5. Perhaps the central messages of Tables 8.5 and 8.6 are that older taxpayers are more highly represented in the omission data than in the labour force, especially for man, while younger taxpayers are less represented, also especially for men. Thus, for example, males aged over 50 account for 26.3 per cent of the males in the omission data but only 5 per cent of the labour force, while for men aged 15-29 years account for only 10.2 per cent of males in the omission data but constitute 31 per cent of the labour force. Similar, if less pronounced, trends are evident for females. Thus, from this analyses, it would seem that non-compliance is more common among older taxpayers, but less common among younger ones, the would be suggested by workforce shares.

The result is somewhat in contrast to Sabri's measurement of tax ethics among the Kuala Lumpur and Petaling Jaya respondents. He showed that respondents aged between 30 to 39 had the highest level of tax ethics, respondents above 50 years old were the second, followed by respondents of aged 40 to 49. Those respondents aged below 29 had the lowest level of tax ethics (1993). This difference might be due to the different nature of the research studies undertaken. Sabri's research was based on taxpayers' attitude measurement, while this research is specifically done to determine the characteristics of income tax non-complier. The decisions of older taxpayers not to comply with the IRB could be due to some of the other factors as identified by Dean, Keenan and Kenney (1980) such as (a) the level of taxation and worth of government expenditures, (b) tax equity, (c) the probability of detection, (d) moral perceptions and (e) economic considerations. In particular, it is likely that older taxpayers had both greater incentive and more opportunity to become involved in income tax non-compliance.

8.4.1.3 Age group in relation to total income omitted, total tax evaded and penalty imposed

Table 8.7 below shows mean income omitted, mean tax evaded and mean penalty imposed by the IRB on each age level of taxpayers from the file data sample. Those aged above 50 were found to evade twice the total amount of income taxes compared to those aged between 30 to 50, and almost 10 times the amount of income and tax evaded by the aged group of below 30. However, their tax penalties were correspondingly greater - they were penalised about 3 times as much as of those aged between 30 to 50 and nine times as much as those aged below 30. Thus the order of income tax non-compliance and the amount of total income omitted, total tax evaded and penalty imposed in descending order is as below:

1. Older taxpayers (aged above 50)
2. Middle-aged taxpayers (aged between 30 to 50) and
3. Young taxpayers (aged below 30).

Table 8.7 Relationship between mean of total income omitted, mean tax evaded and mean penalties imposed and age levels

	Age level	Mean in RM
Total income omitted	Below 30	55,500
	Between 30 to 50	242,500
	Above 50	530,000
Total tax evaded	Below 30	20,200
	Between 30 to 50	85,600
	Above 50	218,500
Total penalty imposed	Below 30	12,600
	Between 30 to 50	38,300
	Above 50	111,700

Source: Primary file data collection of this research.

Thus, as well as having a higher incidence of non-compliance, older taxpayers evade a much higher average level of tax. If the RM146.6 million of total income omitted in the 507 files under consideration, older taxpayers accounted for RM63.6 million or 43.4 per cent, in spite of accounting for only 23.7 per cent of the files. If the total tax evaded of RM55.6 million, they accounted for 47.1 per cent. Many older taxpayers have accumulated their wealth and have established themselves

compared to younger taxpayers, and some may be willing to take the risk of non-compliance when only a small proportion are detected.

8.4.2 Gender

There are again two ways of determining the gender of taxpayers that are most likely to evade their income taxes. As before, the first method is by analysing the gender of tax evaders (from their personal income tax files) for the years of 1995, 1996 and 1997, while the other is through interviewing income tax officers.

8.4.2.1 Gender distribution in the labour force

Table 8.8 Percentage by gender of the labour force, Malaysia, 1997

Gender	M	F
1995	66%	34%
1996	66%	34%
1997	66%	34%
Total	66%	34%

Source: International Labour Office, Yearbook of Labour Statistics 1998, p. 108.

As before, the labour force is used as reference group against wish to assess the gender distribution of tax evaders. In some respects it would have been more appropriate to use the gender distribution of taxpayers as the reference group. However, these figures are not available in a useful form, given the prevalence of combined assessment in Malaysia. As Table 8.8 shows, 66 per cent of persons in the labour force are male and 34 per cent female, and these proportions are steady over the three years shown (International Labour Office, Yearbook of Labour Statistics, 1998, p. 108).

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8.4.2.2 Gender of tax evaders obtained from file data

Table 8.9 Percentage distribution of the gender of tax evaders from file data

Year		Male	Female	Total
1995	No. of taxpayers	148	19	167
	Percentage of taxpayer	88.6%	11.4%	100%
1996	No. of taxpayers	154	34	188
	Percentage of taxpayers	81.9%	18.1%	100%
1997	No. of taxpayers	120	32	152
	Percentage of taxpayers	78.9%	21.1%	100%
Total	Total no. of taxpayers	422	85	507
	Total percentage	83.2%	16.8%	100%

Source: Primary file data collection of this research.

Table 8.9 above indicates that males account for between 78.9 per cent to 88.6 per cent of tax evaders in the omission data, and females account for between 11.4 per cent to 21.1 per cent, in the three years under analysis. Thus based on the file data alone males are about five times more likely than females fail to comply with the IRB.

However, these figures need to be seen in comparison with the reference group (the distribution of the gender in the labour force). Even after this comparison, it could be deduced that females are under-represented. However, this could be due to the fact that the women's income might have been assessed under the husbands' income for combined assessment, hence it is a responsibility of the husband to declare his wife's income in the annual tax return. If the husband fail to do so correctly, under the *Malaysian Income Tax Law* the penalties would be imposed under the husband.

8.4.2.3 Views of income tax officers on gender of tax evaders

Sixty income tax officers were interviewed (fifteen from each branch of these IRB) regarding their personal experience in working with the IRB. They were required to choose the gender of taxpayers that are mainly involved in tax evasion as enclosed in Appendix 1. The results are tabulated as in Table 8.10 below.

Table 8.10 Results based on interview with IRB officers regarding gender of tax evaders

Branch	Male	Female	Total no. of respondents.
Kuala Lumpur	15	0	15
Johor Bahru	15	0	15
Pulau Pinang	15	0	15
Kota Kinabalu	13	2	15
Total	58	2	60
Percentage	96.7%	3.3 %	100 %

Source: Primary interview data collection of this research.

Table 8.10 indicates that 96.7 per cent of our respondents agreed that the gender of a tax evader from a population of tax evaders would be more likely to be male than female. Only two officers, or 3.3 per cent of the income tax officers, were of the opinion that the gender of a tax evader is often female. Hence using this approach also suggests that the gender of the income tax non-compliant is much more likely to be male in a population of tax evaders.

Based on the above results it can be deduced that males are more likely to be non-compliant than females in a population of tax evaders, which supports the findings of Vogel (1974), Mason and Calvin (1978) and Tittle (1980). This result also agrees with Sabri's result (1993) from his tax ethics survey, whereby male respondents were found to have slightly lower level of tax ethics than the females.

8.4.2.4 Gender in relation to total income omitted, total tax evaded and penalty imposed

Table 8.11 below shows the mean for income omitted, mean tax evaded and mean penalty imposed for the found guilty tax evaders for both genders in these four different branches of IRB for the years of 1995, 1996 and 1997.

Table 8.11 Relationship between gender and total income omitted, tax evaded and penalty imposed

	Gender	Mean in RM
Total income omitted	Males	338,200
	Females	42,200
Total tax evaded	Males	129,000
	Females	11,800
Total penalty imposed	Males	61,800
	Females	6,500

Source: Primary file data collection of this research.

Based on the above table, it can be deduced that the mean of total income omitted by males was eight times greater than that of females, and resulted in a tax loss more than ten times greater than that of females, with the penalty more than nine times greater than that of females. Indeed, 97.3 per cent of total income omitted and 97.8 per cent of tax evaded were due to males. Hence it can be deduced that, at least based on this sample, that males fail to disclose more income and evade more taxes than females. This result is in agreement to Friedland, Maital and Rutenburg's experimental study of 15 undergraduate students (1978, pp. 107-116) and Spicer and Becker (1980) in their experimental approach using human subjects.

8.4.3 Income level

We have categorised income levels into three categories. They are as follows:

i. Low-income level – taxpayers whose chargeable income is less than RM12,000 annually,

ii. Middle-income level – taxpayers whose chargeable income is equal to or exceed RM12,000 but less than RM50,000 annually,

iii. High-income level – taxpayers whose chargeable income is equal to or exceed RM50,000 annually.

Again we use two methods in determining the income level of taxpayers that are inclined to evade their income taxes.

8.4.3.1 Description of reference data for income level – all individual taxpayers

Table 8.12 Income levels of Malaysian taxpayers

Year		Below RM12,000	Between RM12,000 to RM50,000	Above RM50,000
1995	Number of taxpayers	556,702	859,787	122,265
	Percentage of taxpayers	36.2%	55.9%	7.9%
1996	Number of taxpayers	338,021	800,073	128,731
	Percentage of taxpayers	26.7%	63.1%	10.2%
1997	Number of taxpayers	363,864	896,772	154,377
	Percentage of taxpayers	25.7%	63.4%	10.9%
Total	Total number of taxpayers	1,258,587	2,556,632	405,373
	Total percentage of taxpayer	29.8%	60.6%	9.6%

Source: Taxation Statistics of the IRD/IRB for the years of 1996, 1997 and 1998.

The data on the chargeable income distribution of all individual taxpayers were extracted from IRB taxation statistics for the years of 1996, 1997 and 1998, as tabulated in Table 9.12 above. Based on the these data, the possibility that an individual taxpayer comes from low-income level ranged from 25.7 per cent to 36.2 per cent for the three years in question, that for middle-income level ranged from 55.9 per cent to 63.4 per cent and that high-income level ranged from 7.9 per cent to 10.9 per cent. Thus over the three years, on average the proportion of taxpayers in the low-income level was 29.8 per cent, that in the middle-income level was 60.6 per cent and that of the high-income level was 9.6 per cent. The changes in the shares over the period mainly reflect the growth in income over this time.

8.4.3.2 Income levels of tax evaders obtained from file data

Table 8.13 below summarises the results on income levels of tax evaders extracted from omission and investigation files of the four different branches of IRB for the years of 1995, 1996 and 1997 (file data).

Table 8.13 Results based on file data on income level from four different branches of IRB

Year		Below RM12,000	Between RM12,000 to RM50,000	Above RM50,000
1995	Number of taxpayers	8	102	57
	Percentage of taxpayers	4.8%	61.1%	34.1%
1996	Number of taxpayers	10	105	73
	Percentage of taxpayers	5.3%	55.9%	38.8%
1997	Number of taxpayers	7	98	47
	Percentage of taxpayers	4.6%	64.5%	30.9%
Total	Total number of taxpayers	25	305	177
	Total percentage of taxpayer	4.9%	60.2%	34.9%

Source: Primary file data collection of this research.

Based on file data, the proportion of tax evaders with chargeable income below RM12,000 is 4.9 per cent, the proportion between RM12,000 to RM50,000 is 60.2 per cent and the proportion above RM50,000 is 34.9 per cent.

In comparing file data and reference data for different income levels, it is in consistent that the middle-income level has the highest percentage compared to other income levels. However, it is found that file data gives the high-income level in second place after the middle-income level. On the other hand, based on the reference data as in Table 8.12, the high-income level is in third place. It should be noted that this effect is strong – only 9.6 per cent of all taxpayers had chargeable incomes over RM50,000 but 34.9 per cent of those in the omission data were in this income band. This could be due to the policy adopted by the IRB to go after high-income earners compared to low-income earners, because it will get better payoff. This is an issue to which we will return below.

This result appears to contradict to the findings of Mason and Lowry (1981), and Witte and Woodbury (1985), whereby they concluded that middle income taxpayers are most compliant and that both low and high income level taxpayers are relatively non-compliant in comparison. But it is consistent with a general view in many countries that tax non-compliance is higher at higher income levels.

8.4.3.3 Views of income tax officers on income levels of tax evaders

The results of the interviews with income tax officers produced a similar version. The respondents were asked to arrange taxpayers' annual income levels in the order that is the most common in evading their income taxes. Then scores were given to these responses, with 3 points to the most common level, 2 points for the second most common and only 1 point given for the income level selected as least likely to income tax non-compliance. The results of aggregating the scores are as follows:

Table 8.14 Interview results with income tax officers regarding income levels of tax evaders

Branch	Below RM12,000	Between RM12,000 to RM50,000	Above RM50,000	Total
Kuala Lumpur	17	34	39	90
Johor Bahru	17	30	43	90
Pulau Pinang	15	34	41	90
Kota Kinabalu	22	35	33	90
Total no. of scores	71	133	156	360
Percentage	19.7%	37%	43.3%	100%

Source: Primary interview data collection of this research.

Table 8.14 indicates that the respondents were of the opinion that high-income earners evade tax the most (43.3 per cent of the total score), followed by middle-income with 37 per cent of the total score and finally the low income earners with only 19.7 per cent. Thus the respondents were of the opinion that high-income earners would be the most non-compliant among these three groups in a tax evading population. This result is also consistent with Christian and Gupta's result (1993).

Interestingly, Sabri's result indicates that respondents with higher income had a higher level of tax ethics compared to lower income earners (1993). This difference, which might appear to contradict the finding of a relatively high level of non-compliance at high income levels, could be explained simply that these higher income earners know what the tax authority expects from them (as in Sabri's result), but acting to the contrary. Another possible explanation is that they practice tax avoidance, which they think is legal and difficult to detect by taxation authority. The third explanation could be attributed to IRB practices: that it concentrates its

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strategies more on higher income earners whereby it could get better payoff compared to lower income earners.

Some errors might occur in generalising these results, for not all individuals have declared their true income to the IRB and also their activities could not be detected by the IRB. Additionally, the sample population here excludes those who fail to register with the IRB. Furthermore, only small percentages of the population have been investigated or audited by the IRB. So our analysis is based on a small proportion of the individuals involved in tax non-compliance.

8.4.3.4 Income levels in relation to total income omitted, total tax evaded and total penalty imposed

Table 8.15 below shows the mean for income omitted, mean tax evaded and mean penalty imposed by the IRB for the low, middle and upper income tax evaders from these four different branches of IRB in the years of 1995, 1996 and 1997.

Table 8.15 Relationship between total income omitted, tax evaded and penalty imposed and income levels

	Income level	Mean
Total income omitted in RM	Low	9,200
	Middle	54,000
	Upper	729,000
Total tax evaded in RM	Low	492
	Middle	7,800
	Upper	298,000
Total penalty imposed in RM	Low	325
	Middle	4,000
	Upper	143,000

Source: Primary file data collection of this research.

The order of importance of different income levels in evading their mean income, mean tax and mean penalty imposed by the IRB in descending order are as follows:

1. Upper-income level taxpayers,
2. Middle-income level taxpayers and
3. Low-income level taxpayers.

Indeed, upper income groups account for 88.5 per cent of all income omitted and 95.6 per cent of all tax evaded in the omission data files.

8.4.4 Income source

The fourth characteristic that has been analysed is income source. The IRB has categorised individuals' files according to their sources of income. There are two types of files registered for individual taxpayers, namely OG files and SG files as explained below.

8.4.4.1 Income sources in relation to file type

The OG taxpayers are the sole-proprietors, self-employed or companies' directors, while SG taxpayers are mainly employed individuals whose income tax has been deducted monthly by their employers, either under "Pay As You Earn" Scheme (PAYE) or under Schedular Tax Deduction Scheme (STD). Unlike SG taxpayers, most of taxpayers under OG group are mainly sole-proprietors and self-employed individuals who paid their taxes according to the arrangement that they have made with the IRB's representatives. It could be on instalment basis or one lump sum, except for those who are also employed, whereby their taxes are also being withheld from their employment income either under STD or PAYE schemes, as discussed in Chapter Four of this research study.

8.4.4.2 Reference data for income sources of individual taxpayers

The reference data we used as comparison for income source is the distribution of the number of these two types of files that are currently active in the whole of IRB. Table 8.16 below shows the distribution of these two types of files.

Table 8.16- Distribution of total active files in the whole of IRB

Year		OG File	SG File	Total
1995	No. of files	750,349	2,153,873	2,904,222
	Percentage of files	25.8%	74.2%	100%
1996	No. of files	784,629	1,994,705	2,779,334
	Percentage of files	28.2%	71.8%	100%
1997	No. of files	781,686	2,044,621	2,826,307
	Percentage of files	27.7%	72.3%	100%
Total	Total no. of files	2,316,664	6,193,199	8,509,863
	Percentage of total files	27.2%	72.8%	100%

Source: Taxation Statistics of the IRD/IRB for the years of 1996, 1997 and 1998.

Altogether 27.2 per cent of all currently active individuals' files over 1995-97 belonged to OG taxpayers and 72.8 per cent belonged to SG taxpayers. Thus there are about 2.7 times as many SG files in the IRB compared to OG files.

8.4.4.3 Income source obtained from file data

The distribution by file type of the sample of tax evader files under study is as in Table 8.17 below.

Table 8.17 Classification of file data according to their file types

Year		OG File	SG File	Total
1995	No. of files	144	23	167
	Percentage of files	86.2%	13.8%	100%
1996	No. of files	154	34	188
	Percentage of files	81.9%	18.1%	100%
1997	No. of files	117	35	152
	Percentage of files	77%	23%	100%
Total	Total no. of files	415	92	507
	Percentage of total files	81.9%	18.1%	100%

Source: Primary file data collection of this research.

It was found that based on file data, there were a total percentage of 81.9 per cent of total non-compliants' files belong to OG taxpayers, while only 18.1 per cent of these files belong to SG taxpayers. Hence there were more than four times more OG tax evaders than SG tax evaders in the file data, even though there are nearly three times more SG than OG files among the total taxpayer group (Table 8.16). The non-compliance seems to be especially concentrated on OG taxpayers. Since these groups of taxpayers have several means of cheating the tax authority – such as falsifying their business accounts or failing to declare some of their incomes - thus

the IRB concentrates its action against this group of taxpayers. Some of its activities to counter evasion include undergoing field auditing and investigating these taxpayers to recover back duty. The knowledge that the IRB is active in these activities will not only lend to recovery of duty or tax lost, but will also act as a deterrent to those who are ready or inclined to evade their due liabilities.

As observed by Warneryd and Walerud (1982), and Wallschutzky (1984), self-employed perceive more opportunities for tax evasion. Hence the above results confirmed their observations. They are also in agreement with Sabri's tax ethics results (1993), whereby self-employed persons were found to have the lowest level of tax ethics, which could be a possible cause of the above result. Another factor that might contribute to such result could be a lower level of tax literacy, as found in the post analysis of a survey conducted by the IRB in 1997. In this survey, self-employed or OG group taxpayers were found to be less well informed or too dependent on tax agents, compared to salary earners or SG taxpayers (will be discussed in Chapter Nine of this research study).

8.4.4.4 Income source in relation to total tax omitted, tax evaded and penalty imposed

Table 8.18 below shows the distribution of the mean income omitted, mean of tax evaded and mean of penalty imposed on these two different types of files that were found guilty in evading their taxes from four different branches of IRB for the years of 1995, 1996 and 1997.

Table 8.18 Types of files in relation to mean income omitted, mean tax evaded and mean of penalty imposed

	OG files (N = 415)	SG files (N = 92)
Mean income omitted in RM	351,200	6,400
Mean tax evaded in RM	133,400	877
Mean penalty imposed in RM	64,100	549

Source: Primary file data collection of this research.

Table 8.18 shows that the mean income omitted from OG files is more than fifty four times than that from SG files, and the mean tax evaded is more than one-hundred and fifty two times than the SG files. As a result, they were penalised more than one-hundred and sixteen times than the SG taxpayers. Thus, in terms of income omitted and tax evaded it could be deduced that the OG taxpayers have been evaded more income taxes than the SG taxpayers.

A strong and highly consistent picture of the dominant characteristics of those involved in income tax non-compliance in Malaysia emerges from this analyses of the file data and the interview data. Non-compliance is especially concentrated in

- Older persons, those aged over 50 years,
- Men rather than women,
- Individuals on higher incomes over RM50,000 per annum, and
- Individuals classified to OG files.

While this is distinct evidence of non-compliance among other groups, the concentration in individuals with these characteristics is very marked. Thus, for example, 97.8 per cent of tax evaded in the omission sample was due to men rather than women, 95.6 per cent was in the higher income groups and over 99 per cent was associated with OG files.

One important qualification to these results should be noted, however. Both sets of data – the omission files from four tax offices and the files resulting from the interviews of officers who have worked on these files – are intimately involved with the activities of the IRB. Thus, to a degree which must remain uncertain, these striking results may reflect the prevailing views and policies of the IRB rather than the actual reality of income tax non-compliance.

8.5 Factors that Might Influence Income Tax Non-Compliance

Studying the factors influencing income tax non-compliance is as important as studying the characteristics of those involved in income tax non-compliance. Here, however, we confine attention to some limited information on the reasons why taxpayers fail to comply. This section is specifically being allocated for analysis of this issue.

8.5.1 Reasons for non-compliance

As in previous sections of this chapter, two sources of information are available for studying the reasons of non-compliance. First, data can be extracted from the files that have been found guilty of evading their taxes in the years of 1995-1997, and the second source is the results of interviewing income tax officers.

8.5.1.1 Reasons for non-compliance extracted from file data

Every file involved in evading income tax in the years of 1995, 1996 and 1997 was scrutinised for the reason or reasons given by taxpayer for failing to declare his or her income in the annual tax return. Several reasons have been extracted from these files – with one main reason being extracted from each file.

Let   Ignorance - ignorance of income tax law

       Preparer - tax preparer's faults

       Excuses - forget to declare/careless/ account not yet prepared

       No reasons - no reasons given

       Clerk - wrongly prepared by the clerk

       Others - reason/s other than above

The results obtained are as summarised in Table 8.19 below.

Table 8.19 Summary on reasons given for income tax non-compliance based on file data

Years	Reasons Extracted						Total
	Ignorance	Preparer	Excuses	No reason	Clerk	Others	
1995	27	8	32	100	0	0	167
1996	19	7	39	120	2	1	188
1997	30	1	26	95	0	0	152
Total	76	16	97	315	2	1	507
Percentage	15%	3.2%	19.1%	62.1%	0.4%	0.2%	100%

Source: Primary file data collection of this research.

Reasons given by tax evaders when they were detected by the income tax authority in the years of 1995-1997, in their order of importance, are as follows:

1. No reasons given;
2. forget to declare/careless/ account not yet prepared;
3. ignorance of income tax law;
4. tax preparer's faults;
5. wrongly prepared by the clerk and
6. other reasons than the above.

It can be seen from Table 8.19 that 62.1 per cent of all taxpayers found guilty of evasion did not give any reason for their failure to declare their true incomes. In addition, 15 per cent pleaded ignorance of tax law and 19.1 per cent gave excuses such as that they forgot to declare income sources or made careless errors. Thus the 96.2 per cent of taxpayers in these three categories gave limited or no reasons for their evasion. Given that the IRB already had concrete information to go after these taxpayers, especially those files under investigation and intelligence centres of the IRB, it could be deduced that many tax evaders that have been found guilty in the years of 1995-1997 had a deliberate intention to evading their taxes, and were just giving excuses for failing to do so.

8.5.1.2 Reason of non-compliance in relation to total income omitted, total tax evaded and total penalty imposed

Table 8.20 below shows the mean value of income omitted, mean tax evaded and mean penalty imposed on different reasons given by tax evaders for failure to declare their income or incomes in their annual tax returns.

Table 8.20 Relationship between total income omitted, tax evaded and penalty imposed and reasons of non-compliance based on file data

	Reason	Total (N)	Mean (in RM)
Total income omitted	Ignorance	77	22,700
	Preparer	16	372,800
	Excuses	96	11,200
	No Reasons	315	436,400
	Clerk	2	38,300
	Others	1	9,900
Total tax evaded	Ignorance	77	4,500
	Preparer	16	157,200
	Excuses	96	1,600
	No Reasons	315	166,300
	Clerk	2	11,200
	Others	1	985
Total penalty imposed	Ignorance	77	3,024
	Preparer	16	86,165
	Excuses	96	1,166
	No Reasons	315	79,081
	Clerk	2	7,247
	Others	1	591

Source: Primary file data collection of this research.

Examining the reasons given in terms of other characteristics of the files is also revealing. As we have seen, more than 62 per cent (315 files out of 507 files) failed to give reasons for their failure to declare their true income. Table 8.20 shows that the files where no reason was given were larger than average, resulting in omission on average of more than RM400,000 of their income. This in turn led to an average of more than RM166,000 income tax loss and penalties on average of more than RM79,000. This 'no reason' files accounted for 93.9 per cent of total income loss, again suggesting the prevalence of intentional non-compliance. It is also notable that the average income loss 'preparer' files is high.

Interestingly, although this 'no reason' ranks first in the list in terms of mean income omitted and mean tax evaded, it comes second in terms of mean penalty imposed by the IRB. Files for which tax preparers' faults were cited as the reason attracted the highest average penalty. It is possible that the IRB penalised those taxpayers who gave their reason as tax preparer's fault, so as to discourage them from hiring unethical tax agents who might have helped them to falsify their yearly business accounts.

8.5.1.3 Viewing income tax officers' opinions on reasons of non-compliance
The second method concerns the interview of income tax officers.

The rate of penalty imposed by the IRB officers is guided by the *Malaysian Income Tax Law*, whereby the more offences one has committed, the heavier the penalty will be. However, some consideration would be given to taxpayers who have appealed to the officers involved, with the approval of the Director General of the IRB. This appeal will be based on reasons given by taxpayers on their failure to declare their incomes and on the recommendations made by these officers. Hence these officers play important role in determining the rate of penalty imposed on these non-compliants, and in the process gain insight into the real reasons for non-compliance.

The respondents were asked to arrange the reasons of non-compliance (as in Appendix 1) in their order of importance. Scores were given, with 5 points to the top reason in the list, 4 points to the second in the list, 3 points to the third in the list, 2 points to the fourth in the list and 1 point to the last reason in the list. The results are tabulated as in Table 8.21 below.

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Table 8.21 Scores on interview of income tax officers regarding reasons for non-compliance

Branch	Ignorance	Intention	Loopholes	Strain	Preparer	Total
Kuala Lumpur	57	80	76	40	83	336
Johor Bahru	68	78	76	58	69	349
Pulau Pinang	70	88	69	50	86	363
Kota Kinabalu	62	78	67	49	59	315
Total no. of scores	257	324	288	197	297	1363
Percentage	18.9%	23.8%	21.1%	14.4%	21.8%	100%

Source: Primary interview data collection of this research.

One notable feature of Table 8.21 is that each of the five reasons offered attracted significant scores, with the reasons getting the highest scores being intentional evasion (23.8 per cent of total points), tax preparers (21.8 per cent) and use of loopholes (21.1 per cent).

Reasons for non-compliance according to respondents in their order of importance are as follows:

1. Taxpayers' intentional evasion.
2. Tax preparers play important role in the omission of income among taxpayers.
3. Taxpayers taking advantage of the loopholes in the Income Tax Legislation
4. Taxpayers' ignorance of the income tax law.
5. Taxpayers practice evasion because of financial strain.

Again the income tax officers of the IRB were of the opinion that taxpayers evade their income taxes because they have their own intention to do so. Thus this confirmed the results in Section 8.5.1.1 above. In relation to the use of tax preparers, it was found in Section 8.5.1.1, using file data, that for only 3.2 per cent of the files involved in evading taxes was the fault of tax preparer cited as the reason. But in this section, the respondents were of the opinion that tax preparers also play important role in the omission of the income tax. The difference might be due to the samples taken, for not all files that had been falsified by tax preparers have been detected and some of these taxpayers did not reveal the real situation.

They may not have revealed the real situation because they were afraid that the IRB would investigate the problems thoroughly, and this would cost them more. Tax preparers or tax practitioners possess the means to exert an extraordinary influence on tax compliance process. Their knowledge of tax rules and enforcement procedures far exceeds than that of ordinary taxpayers, and they also possess the expertise to assist their clients in exploiting opportunities for tax non-compliance. Furthermore, individuals carrying on a business in Malaysia (except incorporated companies) are not required to submit audited accounts with their annual tax returns. Thus small traders and those with a high proportion of cash transactions, like restaurant owners and hawkers, are most likely do not keep proper business records and are totally dependent on their tax preparers. As suggested by Radcliffe Commission (1955, United Kingdom) evasion can begin with careless record keeping.

In line with the findings of Vogel (1974), Warneryd and Walerud (1982), financial strain was not an important factor in evading taxes for 85.6 per cent of our respondents were not of opinion that financial strain is an important factor in evading taxes as depicted in Table 8.21.

8.5.2 The use of tax agent

IRB has a list of approved tax agents for taxpayers to refer to if they have any problem or problems regarding taxation. However, there are some unapproved tax agents who operate to help taxpayers and who charge them at a much lower rate. Usually their correspondence with IRB is without letter heads, as though the letter was written by the taxpayer. They dare not reveal themselves so that the IRB cannot detect their activities.

Based on our results obtained from file data there is a relationship between tax agent service and total income omitted, total tax evaded and total penalty imposed by the IRB.

Among this sample of tax evaders, only 182 of them making used of approved tax agents and the remainder (325) did not use a tax agent or used an unapproved tax agent in lodging their annual tax returns instead. Thus only 36 per cent of these taxpayers making use of approved tax agents and 64 per cent were not. Hence only modest number of taxpayers in the sample hired approved tax agents. However, the use of unapproved tax agents on income tax non-compliance could not be determined by the IRB, unless it was revealed by the taxpayers.

Table 8.22 below shows the mean value of income omitted, mean tax evaded and mean penalty imposed on taxpayers who did not use tax agent's service (no tax agent) and used tax agent's service (tax agent) in the file data. These data are quite separate from the reasons given for evasion – they concern simply whether, in the files in question, a tax preparer was used.

Table 8.22 Relationship between total income omitted, tax evaded, penalty imposed and the use of tax agent

	Use of tax agent	Total (N)	Mean (in RM)
Total income omitted	No tax agent	325	91,553
	Tax agent	182	640,499
Total tax evaded	No tax agent	325	15947
	Tax agent	182	276,061
Total penalty imposed	No tax agent	325	6,554
	Tax agent	182	134,720

Source: Primary file data collection of this research.

Based on the Table 8.22, it could be seen that there was a big difference in the mean income omitted, mean tax evaded and mean penalty imposed between those taxpayers who used tax agents and those who did not hire tax agents. The total number of files using tax agents is about half of those who did not hire tax agent,

but the mean of total amount of income omitted by these files was more than seven times of those who did not use tax agents. About 80 per cent of total income omitted in these files were in cases in which tax agents were used. The mean tax evaded in preparer files was more than seventeen times, and the mean penalty was more than twenty times, that in those files not using tax agents. But the larger taxpayers will use tax preparers, so that there will be a natural income bias.

8.6 Conclusions and Limitations

The most common type of non-compliance based on file data is failing to declare income followed by under-declaring income. The opposite is true based on interview data. The difference could be attributed in part to the ranking methodologies used, and especially to the fact that only one type of non-compliance was extracted from file data. However, over-claiming expenses and deductions were found only in the OG (non-salary earners) files. Thus the IRB officers should pay more attention to the business accounts prepared by taxpayers or their accountants, for this group of taxpayers have more opportunities to misrepresent their true income compared to salary earners or taxpayers registered under SG files due to the nature of income that they receive. As for salary earners, they might have not reported their additional sources of income (other than employment income), hence modern technology like on-line cash transactions with other organisations or departments could be a useful tool to detect such activities by detecting the abnormal amount of payments made by taxpayers when compared to their declared amount of income in their yearly annual tax returns.

In organising its activities, the IRB should target those who are more inclined to evade their income taxes the most. Based on the above results it should target these groups of taxpayers: middle-aged groups, male taxpayers, high-income and middle-income earners, self-employed or taxpayers registered under OG group.

Tax agents were found to have helped taxpayers to evade more taxes compared to those who did not hire tax agents. Hence the IRB should organise seminars to tax agents, cultivating their sense of responsibility in preparing their clients' accounts

besides informing them of possible consequences that they have to face like publishing their names in the IRB annual reports (as done in Australia), or terminating their business licence with the help of business registration department if after several reprimands, they were still found to continue helping their clients in evading their income taxes. Another alternative is to advice OG taxpayers to select only good reputation tax agents in preparing their annual business accounts, instead of being penalised heavily by the IRB.

The above findings in relation to file data and interview data only hold true for the sample collected hence could not be generalised for the whole population because of the following reasons:

(i)   the files were not randomly sampled and

(ii)   the interview carried was very selective.

By assuming that such findings hold true for all non-compliance population, hence the above findings would give some ideas regarding the characteristics of these non-compliants and the reasons why they fail to comply with the IRB. It should be noted that this study's results would only reflect the demographic of tax evaders neglecting tax avoiders who are difficult to detect by the taxation authority. These non-compliants' characteristics and causes of non-compliance were extracted from the individuals' files who have been found guilty in evading their income taxes from four different branches of IRB in the years of 1995-97 besides interviewing some income tax officers. Thus these results will not give any tax attitudes or perceptions of the Malaysian taxpayers regarding the *Malaysian Income Tax System*.

In studying the characteristics of non-compliants and the reasons why they failed to comply, since the study was conducted in four different branches of IRB, thus the sample of taxpayers were only limited to the total number of omission and investigation cases that have been finalised in the years of 1995, 1996 and 1997 from these four different branches of IRB that have been recorded in the books of omission and listed in the books of files under investigation. Furthermore, not all files from these branches were being audited or investigated. Only suspected

taxpayers were subjected to these activities. However, by studying the demographics of these tax evaders, at least the IRB has a basis in targeting this particular group of taxpayers in channelling its effort to combat non-compliance. Further, by studying reasons of non-compliance, the taxation authority can enforce proper strategies in overcoming this problem.

In comparing the pattern of income tax non-compliance from *file data* to the population of Malaysia, since the characteristics like genders and age levels among taxpayers in Malaysia were not available in the IRB record, thus we used the labour force survey report 1998 instead. Since the survey population of the labour force survey was defined to cover persons who lived in private living quarters and hence have excluded persons residing in institutions such as hotels, hostels, hospitals, prisons, boarding houses and military barracks. Hence the population (reference) data for these demographics is also restricted to the population coverage of the labour force survey. As a result, this might introduce some errors in comparing the findings to the reference. It would be of great help if the IRB keep these demographic records for future researchers to explore this area of study.

CHAPTER NINE

Enforcement Analysis and Strategy Recommendations

9.1 Introduction

Studying income tax non-compliance will be incomplete without proposing some strategies to overcome this problem. In proposing strategies, it will be useful to highlight some of the major weaknesses in existing system, and to gather some strategies that have been introduced by other taxation offices, especially the ATO in Australia and the IRS in the U.S. to counter such problems in their own countries.

This chapter consists of three sections. Section Two analyses the current enforcement system of the IRB. It explores some of the weaknesses, drawing an information gathered from our respondents, from the survey carried during Taxpayers' Service Week in 1997, from past studies done by Wallschutzky and Singh (1995) and from our analysis on the nature of taxable income procedures of the IRB compared to the ATO. Some of the weaknesses of the current enforcement system include its detection rate, which is very low, and its method of selection cases for detection which is not efficient. Further, the IRB places stress on penalties but its penalty system is inadequate to change the behaviour of average taxpayers.

This section also discusses some major loopholes in the *Malaysian Income Tax Legislation* that have been addressed by Wallschutzky and Singh (1995), and which promote income tax avoidance. As discussed in Chapter Six, currently partnership and trust incomes are assessed separately but are taxed under individual taxpayers' income tax files. This will contribute to inefficiency in collecting taxes for these incomes. With fringe benefit income, IRB relies on individual taxpayers to report this in their annual income tax returns, or it is reported by their employers in the employees' annual income statements. Thus they may introduce room for employers to collude with their employees in not reporting fringe benefit income in their employees' annual income statements.

Section Three discusses some strategy improvement recommendations to overcome these weaknesses. It discusses in eight main areas. They are as follows: 1) adopting proper enforcement practice uniformly in all of IRB branches; 2) working closely with third parties; 3) adopting modern facility and skilled staff and strengthening detection activity; 4) introducing of new tax procedures; 5) improving tax knowledge/ education among the public; 6) introducing new rules and regulations; 7) amendment of its income tax law and 8) upgrading its research and development. Section Four summarises the conclusions of this chapter.

9.2 Analysis on the Current Enforcement System

The enforcement system of the IRB plays an important role in combating income tax non-compliance. Hence we have analysed some of major activities that have been conducted by the IRB in overcoming this problem, such as audit/investigation activity, the penalty system and exposure of some major loopholes in the *Malaysian Income Tax Legislation* that might promote income tax avoidance. We also have analysed the post-mortem of a Taxpayers' Service Week survey that had been conducted by the IRB in 1997 and some weaknesses revealed in the analysis of taxable incomes and of the taxing procedures of the IRD/IRB, compared to the ATO (as discussed in Chapter Six).

9.2.1 Detection activity

Detection activity plays an important role in determining taxpayers' behaviour towards non-compliance; hence it's important role in combating non-compliance. As argued by behavioural scientists, taxpayers' perceptions of the level of this activity are vital in controlling tax evasion. Hence we have explored it in two main areas: a) estimating percentage of taxpayers being caught and b) the method of selection for detection.

9.2.1.1 Estimating percentage of tax evaders being caught

Estimating the percentage of tax evaders being caught by the taxation authority is indirect way of measuring the rate of detection, for we do not have complete data regarding the frequency of this activity conducted by the IRB nor on the total number

engaged in non-compliance. However, this analyses enables one to draw some conclusion about IRB enforcement in overcoming this problem.

The total number of taxpayers that had been caught evading their income taxes in the years of 1995, 1996 and 1997 from four branches of the IRB of Malaysia is compared with total number of registered individual taxpayers in these three years in the respective branches in Table 9.1 below.

Table 9.1 Estimated percentage of tax evaders in four different branches of IRB

Branch of the IRB	Year	No. of registered individual taxpayers*	No. of tax evaders detected	Percentage of tax evaders (%)
Kuala Lumpur	1995	736316	42	0.0057
	1996	720250	54	0.0075
	1997	705444	27	0.0038
Johore Bahru	1995	144178	20	0.0139
	1996	172304	25	0.0145
	1997	181079	19	0.0105
Pulau Pinang	1995	187627	32	0.0171
	1996	166176	33	0.0199
	1997	158619	25	0.0158
Kota Kinabalu	1995	126326	73	0.0578
	1996	96655	76	0.0786
	1997	98580	81	0.0822
Total		3493554	507	0.0145

Source: Primary data collection of this research (file data) and IRD/IRB Taxation Statistics 1996, 1997 and 1998 (*population data).

The percentage of tax evaders that had been caught from these four branches of IRB for the years of 1995, 1996 and 1997 is very small, being approximately 0.0145 per cent or about one taxpayer in 7000. On average, the Kota Kinabalu IRB Branch had the highest number of detected tax evaders with 0.07 per cent, and Kuala Lumpur has the lowest number detected tax evaders with 0.006 per cent in these three years. These differences are substantial, ranging from one in 1200 in Kota Kinabalu to one in 26,000 in Kuala Lumpur. For the years under study, 1996 has the highest number of detected tax evaders with 0.016 per cent and 1997 has the lowest with 0.013 per cent. Thus variations between the years is small, but only small proportion of taxpayers have been caught in evading their income taxes.

Implication

This result implies that the activities carried by the IRB in combating taxpayer non-compliance is still very limited for only about one in 7000 of its registered taxpayers were found guilty in evading their income taxes. This low detection rate seems to be especially acute in Kuala Lumpur. Most of them (as found in Chapter Eight of this research study) failed to give good reasons for doing so. This implies that many intentionally evade their taxes and take the risk of being caught, for the detection rate is low. As a result, this might encourage other taxpayers to take the risk in not declaring their true income. As noted by Smith and Kinsey (1987, pp.639-663), Madeo, Schepanski and Uecker (1987, pp.323-342), the probability of audit was a most significant factor in combating income tax non-compliance. Hence the IRB should step up this activity to increase taxpayers' perceptions of the risk of detection. Not only must the IRB do more, but it also must be seen to be doing more to increase taxpayers' perception that they are at greater risk in not complying with the IRB.

This analysis has some limitations, which should be noted although they do not affect the central conclusion. They are as follows:

The total number of taxpayers being audited or investigated from these four different branches of IRB were not available, for the IRB only keeps records on the taxpayers found guilty for its future reference. Hence the percentage of found guilty taxpayers from those investigated or audited could not be determined. In estimating the percentage of tax evaders, it is only limited to the total number of registered taxpayers in these four different branches of IRB. Furthermore, not all tax evaders from these four different branches were successfully detected by the IRB. Additionally, the total number of files available was restricted to those individuals' files that have been found guilty and have been recorded in the record books of omission and listed in record books of the investigation branches of these four branches of IRB. Moreover, some of these omission cases were not recorded in the record books of omission, especially the SG cases (taxpayers with employment income or incomes). Thus file data only covers the recorded cases of detected non-compliance, ignoring the unrecorded ones.

9.2.1.2 Method of selection for detection

Currently, selection cases for investigation and audit are done manually by the IRB. It involves information obtained through local knowledge, press reports, assessment branches, informers and the application of a means test.

These methods are not the most efficient ones available for the detection of possible non-compliance, and hence the IRB should upgrade its information system in selecting cases for audits. An on-line operations system, linking various organisations to the IRB, would be of great help to detect abnormal amounts of payment made by taxpayers, compared to their declared income in their annual tax returns. It would also be of great significance for the IRB to adopt modern tools of detecting tax evaders, such as using computer analysis on the basis of *Discriminant Function Formulas* or DIF, as adopted by the IRS in generating a probability of recoverable tax revenue. In terms of improving the efficiency of the lodging of tax returns, the IRB could adopt *Electronic Lodgement Service.* This would also be of great help in detecting tax evaders, and is currently being used by the ATO. Similarly, IRB also could adopt *Key Abnormal Tax Agent Evaluation* (KATE), that would allow it to detect tax practitioners whose clients' returns vary significantly from the average of those of other tax practitioners in the same region. This was discussed in Chapter Five.

9.2.2 Penalty system

The penalty system adopted by the IRB also may affect the rate of compliance among its taxpayers. For example, the total level of penalties imposed by the IRB may provide important factor in containing the total number of non-compliants in any year.

9.2.2.1 Increase reliance on penalty

Data gathered from four different branches of IRB are summarised as in Table 9.2 below.

Table 9.2 Investigation and omission cases from four branches of IRB

Year	No. of cases	Amount of additional tax (X)	Amount of penalty imposed (Y)	(Y/X) %
1995	167	18,740,881	2,923,936	15.60%
1996	188	21,106,287	7,709,897	36.53%
1997	152	15,579,816	9,137,831	58.65%

Source: File data collection of this research.

This table suggests that the IRB has been increasing its rate of penalty (measured as the ratio of the penalty imposed to the amount of additional tax collected) more than three-fold from 1995 to 1997. Thus it could be deduced that the IRB has emphasised on punishment as a vehicle to improve compliance among its taxpayers. The increased reliance on penalties has been based on the relationships specified in deterrence theory. The theory assumes that there is a perceived likelihood of apprehension and that there is a severe but fair penalty for the offence (Rossi and Grasmick, 1985). However, there is the possibility of a backlash effect as noted by Schmölders (1970). Citizens are likely to be extremely resentful of tax systems where extensive enforcement is used. As observed in the percentage of non-compliance among registered taxpayers in submitting annual tax returns for the whole of the IRB (as in Table 7.1), it is in an increasing in manner. The mean rate of non-compliance in submitting annual tax returns among individual taxpayers in these three years is also in an increasing in manner (as in Table 7.3). Thus the IRB should also consider some other alternatives to increase the rate of compliance for the goal of tax administration is to foster voluntary tax compliance. Penalising tax evaders or going after delinquent taxpayers are not themselves the main objective of tax administration. It should also explore some positive approaches to increasing taxpayer compliance such as emphasising where taxpayers can get help.

9.2.2.2 Adequacy of the penalty structure

The adequacy of the penalty structure also may affect the rate of compliance. If it is not properly enforced the objective of changing taxpayers behaviour from non-compliance to compliance might not be achieved.

Currently, the severity of the penalties varies with the nature of the offence and the amount of penalty is frequently based on the discretion of the Director General of the IRB (as the law stipulates maximum penalties). Similarly, if a taxpayer has been successfully prosecuted in the court, the court has the discretion to determine the total fine to be imposed. Furthermore, the Director General also has the power to compound offences before the case is due for prosecution in court. In practice, the maximum amount of penalty is usually not imposed. This reveals some weaknesses in the Malaysian penalty provisions, particularly the fact that the maximum penalties are in currency of fixed amounts. Some drawbacks of this penalty system, as discussed by Wallschutzky and Singh (1995), are as follows:

1. Over time they lose their significance, as they eroded by inflation and

2. It might not be possible to discriminate adequately between large and small offences.

They recommend that a better system of penalties would be one based on a percentage of the tax that was not paid or alternatively, fixed dollar amounts could be indexed to account for inflation. As noted by Silvani and Baer (1997), a guiding principle in the design of a good system of penalties and sanctions should be to encourage taxpayers to settle their tax arrears quickly and to discourage them from using legal challenges to delay the payment of taxes which have been correctly assessed. In achieving these objectives, they recommend that the sanction and penalties:

1. Should be levied promptly once liability has been established.

2. Should not be excessive; penalties should be relatively mild since the application of lesser penalties does not require, as a rule, a lengthy administrative and judicial process.

3. The cost to the taxpayer of delay paying should however, be higher than the prevailing market interest rates – the prime or LIBOR rate plus a spread. This assumes that the penalties are determined on a percentage basis instead of being fixed amount.

Experience has shown that it is preferable for penalties to be defined as a percentage of the total outstanding amount of taxes (also recommended by Wallschutzky and

Singh in the above), in order to facilitate adjusting penalty rates for inflation. The sanctions and penalties should be designed to change the behaviour of the average taxpayer, which requires that sanctions be applied to the largest possible number of non-complying taxpayers.

9.2.3 Loopholes in the income tax legislation

Income tax legislation is important in determining whether it provides loopholes otherwise to be exploited by some taxpayers to their advantage. Cutting out tax loopholes is necessary, especially in the business taxation. This is necessary to allow fair competition to take place. Ambiguity in the income tax legislation might promote certain groups of taxpayers, especially those who are expert in this field (like tax practitioners), to exploit these loopholes. Some of the loopholes in the *Malaysian Income Tax Legislation* are as discussed below.

9.2.3.1 Discrepancy between law and compliance

Wallschutzky and Singh (1995) argued that although there is an anti-avoidance provision (s 140) and some specific provisions like s 65, paragraphs 38, 39, 40, and 62 to Schedule 3 of the *Malaysian Income Tax Act, 1967* to deter avoidance, there is a gap where some people manage to squeeze through. Section 82 of the *Income Tax Act, 1967* requires every taxpayer carrying on a business to keep and retain sufficient records to enable the IRB to ascertain income or loss from his or her business. However, under s 82(4) the Director General may waive all or any of the provisions regarding the keeping of records and the issuing of receipts. Hence this provides a gap in the income tax legislation that might be exploited by some groups of taxpayers regarding their record keeping and issuing receipts. Hence the IRB should amend its legislation to close this loophole.

9.2.3.2 Benefits-in-kind income

Under the *Malaysian Income Tax Act 1967*, benefits-in-kind income such as motorcars and related benefits, living accommodation, household furnishings, apparatus and appliances, gardeners, domestic servants and so forth is taxable under individual's income tax file. This income will be reported by the employers in

taxpayers' annual income remuneration, which will be submitted to the IRB by the employees together with their annual income tax returns. However, some of these taxpayers might have escaped paying taxes, due to the failure of their employers to declare this income. Perhaps because they are not certain of the valuation of such benefits. This could be due to the lack of guidelines and effective monitoring by the IRB, giving the impression that this income is not important to report. As suggest by Wallschutzky and Singh (1995), a fringe benefit tax may need to be considered by the IRB, to be levied on the employers (as is current practice for the ATO) for this type of income.

9.2.3.3 Withholding tax requirements

The withholding tax requirements for all income only apply to the non-residents. However, they do apply to residents in the cases of interest income that is paid or credited by various deposit-taking institutions such as banks, finance companies, and cooperative societies (Wallschutzky and Singh, 1995). As for salary earners, their taxes have been withheld by their employers either under PAYE or Schedular Tax Deduction or STD as discussed in Chapters One and Four of this research study. Thus the Malaysian personal tax deduction provisions are not adequate, especially for non-salary earners for it relies on information provided by taxpayers in their annual income tax returns. The practice followed by the ATO is for certain other classes of income to be subject to withholding tax arrangements, including income derived by contractors operating in particular industries such as building, transport and cleaning. This is achieved under the *Prescribed Payment System* or PPS, as discussed in Chapter Five of this research study.

9.2.3.4 Opportunities to split income with others

Tax avoiders can practice income splitting if it is possible to transfer income to others who will pay less tax. As discussed in Chapter Four, this is especially important under a progressive rate structure, where high-income earners can transfer income to lower income earners. In the case of husband and wife, it is possible for any savings by the husband and wife to be invested in the name of the spouse who earns less. Similarly, shares and other investments can be bought and sold in that person's name. Since the

IRB income tax rate structure is progressive in nature, hence it is important for the IRB officers to be alert and ask for proof in dealing with such income to avoid income tax avoidance.

9.2.3.5 Opportunities to convert potentially taxable receipts into non-taxable receipts

Under *Malaysian Income Tax Law*, a non-resident taxpayer is subject to tax in respect to income accruing, arising, or derived from Malaysia. Hence if a non-resident had offshore income, it would be free from Malaysian income tax if it is brought into Malaysia. As for resident taxpayers, their offshore income will be taxable if and only if it is being remitted into Malaysia. This implies that a resident taxpayer can enjoy his offshore income by not remitting it into Malaysia. He also will be able to enjoy the use of this income, such as by purchasing offshore assets or using it as collateral for loans that are made to him in Malaysia. Hence, as suggested by Wallschutzky and Singh (1995), the *Malaysian Income Tax Law* needs to be amended to ensure that Malaysian residents are taxed on worldwide income as and when it is derived.

9.2.4 Analysing weaknesses exposed in the post mortem of Taxpayers' Service Week's survey

Taxpayers' Service Week was first introduced in 1991. Every year the IRB opens its counters for one week in various places that are accessible to the public in all branches of IRB (as discussed in Chapter Four of this research study). IRB also conducted a survey during Taxpayers' Service Week (MPPC) in 1997. The total number of respondents to this survey was 4,215. The highest percentage of the respondents was employees or the SG group (86 per cent) and followed by sole-proprietors or OG group (9 per cent). This difference could be due to the nature of communication with IRB. Usually, taxpayers from OG group are represented by tax agents or accountants and seldom use Taxpayers Service Week as do SG group taxpayers. The main findings of the above survey were as follows:

1. For all categories of respondents, about 29 per cent of the respondents did not know their responsibility to contact the taxation office if they were taxable and did not receive their annual returns by 14 April each year.

2. About 86 per cent of the respondents knew their responsibility to inform the taxation office regarding any changes in address.

3. About 83 per cent of SG group and only 73 per cent of OG category understood that they have to submit their annual tax returns although currently they are taxed under Schedular Tax Deduction (STD) Scheme.

4. About 82 per cent of SG group taxpayers understand that it is an offence not declaring all of their income to taxation office, while only 73 per cent comes from OG group understood this fact.

Several inferences could be extracted from the above survey. They are as follows:

1. Not all Malaysian taxpayers are tax literate, thus the IRB could take some further actions to overcome this problem. The IRB should be more aggressive and pro-active in upgrading tax knowledge among the public, especially regarding their responsibility in declaring their incomes and the consequences they face if they fail to do so. This could take place via the mass media, distributing pamphlets and establishing regional tax forums and liaison groups.

2. In comparing SG and OG group taxpayers, the OG category has less knowledge and is too dependent on tax agents, and are thus not well-informed about taxation. Thus the IRB should concentrate on this particular group in conducting its activities.

9.2.5 Weakness in the assessment procedure

As seen in Chapter Six, partnership and trust incomes are being assessed separately by the partnership/trust unit of the Assessment Branches of the IRB. At the same time, these taxpayers are also required to estimate their partnership/trust income in their annual income tax returns. Hence, for these taxpayers income tax will be first assessed according to their declared income in their annual income tax returns and finalised when the information regarding their partnership/trust income being received from partnership/trust unit of the IRB. Hence, these incomes are assessed under individuals income tax files, by contrast with the present practice of the ATO. It will be more efficient for the IRB to assess these incomes separately (as done by the ATO), for it takes time for the information from partnership/trust unit to reach

taxpayers' personal income tax files and some of them might be lost/misplaced and even wrongly enclosed during filing time.

9.2.6 Weaknesses highlighted by our respondents and their suggestions

As noted earlier, we also have conducted a survey among the Inland Revenue Board officers in these four different branches of IRB. Fifteen income tax officers were chosen from each branch. The respondents were chosen based on those who have raised the omission cases or involved in the investigation of the files in the "*file data*". They were given the opportunity to comment/ give some possible causes of non-compliance and some suggestions to improve this problem. Some comments that have been forwarded by the IRB officers are as follows:

1. Ineffectiveness and slow enforcement by the IRB in regard to those who involved in income tax non-compliance.

2. Street surveys should be introduced in some branches, such like Johor Bahru, so that many others who are liable to tax should be registered and pay their share of tax.

3. IRB was slow in liasing with employers and other groups.

4. The lack of an up-to-date, centralised Collection System makes taxpayers feel reluctant to pay tax.

5. Shortage of manpower and equipment to detect potential taxpayers.

6. The requirement for business licence approval should include proof that the person has been registered and contacted IRB.

7. IRB should be firm when imposing penalties for intentional tax evasion.

8. IRB should be firm in taxing benefits-in-kind incomes, for some firms fail to declare these incomes in their employees' annual income statements and hence their employees did not pay their taxes on these incomes.

Besides the above comments, the respondents also give some useful suggestions. Some suggestions that have been forwarded by them are as listed below:

1. Immediate actions, as provided under the law, should be taken on income tax non-compliance and this should be made public, so as to provide a good lesson to the public.

2. The IRB should employ skilled, efficient officers in the enforcement or prosecution divisions.

3. Steps should be taken to educate taxpayers, especially starting from college or university level, in regard to income tax law, and also cultivating their sense of responsibility and moral obligation to this country by disclosing the importance of their taxes for the development of this country.

4. Dialogues should be held to inform taxpayers of the current taxation system.

5. An increased the level of public awareness should be sought, especially through mass media and posters should be placed at strategic public areas.

6. By linking up all government agencies and departments, hence tax evaders could easily be traced.

7. IRB should strengthen field audit teams.

8. A simplification of tax law is essential to increase tax compliance.

9. Full examination of accounts, involving a personal approach or a visit to business premises and designed to test the accuracy of the information supplied, should be engaged.

10. A critical and detailed investigation of books and the proprietors' financial affairs should be undertaken where fraud is suspected or discovered.

11. As for cases with lawyers, since they are very well informed about income tax regulations, their names should be submitted to the Bar Council so that their license will not be renewed if they fail to comply with the IRB rules and legislation.

12. Regulations should be made whereby only registered and approved tax preparers are eligible to represent taxpayers, to avoid these tax preparers taking advantage of innocent taxpayers.

9.2.7 Weaknesses in the administrative procedures

As pointed out by Wallschutzky and Singh (1995), there are unbalanced administrative procedures whereby the IRB imposes strict limits whenever a taxpayer is required to act but there are no corresponding time limits imposed on the Director General. They argued that if income tax is not paid within the stipulated time limits, a

penalty is imposed. On the other hand, if the IRB delays refunding any amount due to taxpayer, no penalty (in the form of interest) is imposed. Additionally, it has been established that in a number of court decisions that once an assessment has been issued, the tax assessed must be paid notwithstanding an appeal. Regarding appeals, especially to the Special Commissioners of Income Tax (if the taxpayer is dissatisfied with the Director General's decision on his objection), in practice it is not a speedy process and it may remain unresolved for a considerable period of time. All of these weaknesses on the part of the IRB would have an impact on taxpayers that can influence their compliance decisions. Hence, the IRB also could play its part by improving its administrative procedures, especially in dealing with tax refunds, objections and appeals from taxpayers.

9.3 Discussion on Strategies Recommendation

Based on the weaknesses discussed above, we would like to propose some strategies to overcome these weaknesses, besides taking into considerations the comments made by our respondents.

As seen in Chapter Six, the percentage of estimated extent of income tax non-compliance in Australia and the U.S. appears to be very much smaller than the extent of non-compliance in Malaysia. Thus it could be inferred, in part, that the ATO and the IRS are superior to the IRB in combating this problem. As a result, we would like to suggest some strategies that have been adopted by the ATO and the IRS in combating this problem, that are not currently adopted by the IRB. Some other useful strategies also could be extracted from some advanced countries, as discussed in Chapter Four, and can also be gathered from the suggestions that have been proposed by our respondents.

Since clients are the hearts of its business, the strategies recommended are of "Client Service Focus". This requires increasing awareness of the importance of courteous and quality service among staff and the community. Quality service makes good sense, as it costs less to collect revenue if people understand the tax laws and comply voluntarily than if they make mistakes or forced to comply.

Our strategy improvement suggestions can be categorised into eight categories as follows:

1. Adopting a proper enforcement practice uniformly in all of its branches.
2. Working closely with third parties.
3. Adopting modern facility and skilful staff and strengthening detection activity.
4. The introduction of new tax procedures.
5. Increased emphasis on tax education.
6. Introduction of new rules and regulations.
7. Amendment of income tax law and
8. Upgrading of IRB research and development.

9.3.1. Adopting a proper enforcement and practice uniformly in all branches of IRB

Various piece of evidence have been presented in this thesis to suggest that income tax non-compliance is a substantial problem. However, only a small number of taxpayers have been found guilty of evading their taxes. As found in Table 9.1 above, only 0.0145 per cent of tax evaders were found guilty in evading their income taxes in the years of 1995,1996 and 1997 from four different branches of IRB. This implies that the IRB has not done enough to combat non-compliance. Our respondents are also of the opinion that the activities that are currently undertaken by the IRB are still inadequate to combat income tax non-compliance in Malaysia. Particularly attention needs to be given to the detection of tax evasion in Kuala Lumpur.

As for failure to submit annual tax returns, the IRB should take some actions, such as publicising in the mass media the consequences for failing to notify the change of address to taxation authority. This also could highlight the importance of submitting their annual tax returns to taxation authority, for some taxpayers still do not understand their role as taxpayers. Some of the respondents were of the opinions that the IRB was slow in liasing with hawkers and employers; this might cause these taxpayers to continue evading their taxes and the latter delay in remitting the withheld taxes to the IRB. The Income Tax Law on withholding employees' taxes will not be effective if the IRB does not act firmly on those employers who failed to remit their

employees' taxes and punish accordingly those who have found guilty in evading their taxes. Similarly, the IRB also has not paid serious attention to the benefit-in-kind incomes, hence some firms have failed to declare these incomes in the employees' annual income statements. Thus some employees failed to declare their benefit-in-kind incomes, which results in an imbalance in the burden of tax, whereby only honest employees who declared these type of incomes paid more than those who failed to declare in their annual tax returns. Hence there is a loophole that should be considered seriously by the IRB management. As for non-registered taxpayers, the IRB could highlight their role to notify chargeability to tax to the IRB and the consequences they have to face if they fail to do so.

The IRB should properly implement the current enforcement practice uniformly in all of its branches. As found in Table 9.2, different branches of IRB impose different rates of penalty on tax evaders. Thus there is a gap in interpreting the Income Tax Law, especially on evasion. The respondents also have suggested that the IRB should be firm in imposing penalties for intentional tax evasion and should take prompt action in liasing with hawkers. They also recommended that a full examination of accounts should be undertaken involving a personal approach or a visit to business premises designed to test the accuracy of the information supplied, especially where fraud is suspected or discovered.

We also would recommend that the IRB adopt a better system of penalty and sanction, as suggested by Silvani and Baer (1997), to encourage taxpayers to settle their tax arrears quickly and to discourage them from using legal challenges to delay payment of taxes which have been correctly assessed. Hence the sanctions and penalties should be levied promptly, should not be excessive but be determined on a percentage basis instead of being a fixed amount. At the same time, IRB also should give a good example to taxpayers, by not delaying taxpayers' refund, and should try to improve its administrative procedures, especially in dealing with taxpayers' objections or appeals, which can influence taxpayers' compliance decisions. Thus, it is recommended that the IRB should strengthen the current enforcement system, as

well as introducing new approaches in controlling this problem. The IRB also should improve its current administrative procedures and adopt a better penalty system.

9.3.2 Work closely with third parties

Tax enforcement is a behavioural problem and its success depends on group cooperation. Thus the IRB should work together with intermediaries in enforcing voluntary compliance. The IRB administrative should be effective in dealing with this problem by strengthening its linkage with other organisations like making agreements with employers or other organisations that always deal with public. The IRB also will be able to function more effectively and more efficiently with a strong cooperation from employers by withholding of taxes such as *PAYE* and *PPS* as practiced by the ATO. The current system of STD whereby the amount payable is pre-determined by the taxation authority directed to the employers based on the previous year earning is changed to the current year earning withheld by the employers and the contractors for payment of taxes of their employees and sub-contractors.

As seen in Chapter Three, tax practitioners play important roles in enhancing voluntary compliance by disseminating income tax knowledge to their clients and explain the rules and regulations that are expected by the taxation authority. Thus, it is wise for the IRB to tackle these practitioners and work closely with them to understand the problem of non-compliance that are currently faced by their clients. The IRB is also encourage to work hand in hand with other organisations especially regarding their information through computer on-line of large amount of cash transactions replacing the traditional information through letters, which takes time to process or might be lost during filing time.

With the introduction of *Self-Assessment System*, more taxpayers will be expected to turn to tax professionals for assistance as mirrored in Australia (as discussed in Chapter Five). As a consequence, tax practitioners are therefore in a position to exert a strong and direct influence on the compliance and tax administration process (Erard, 1993). Hence it is wise for the IRB to tackle these tax professionals, work hand in hand with them besides amending *Income Tax Legislation*, closing some possible

loopholes that might be exploited by them. If their roles go beyond the obligation to serve their taxpayers' interests, then introducing preparer penalty is an option.

9.3.3 Adopting modern facility/skilful staff and strengthening detection activity

Currently the IRB depends on traditional methods of information from various resources like obtaining through local knowledge, press reports, assessment branches, informers, and the application of a means test. These methods are not efficient ones hence the IRB should upgrade its methods of detection. It would be beneficial for the IRB to adopt various methods that have been adopted by the ATO and the IRS in detecting tax evaders in Australia and the U.S. It could adopt the *Self-Assessment System* that has been practiced by the ATO in improving its assessment activity besides imposing on taxpayers an obligation to maintain appropriate records and reasonable care in reporting matters. It is of great importance for them to obey the rules properly for their tax liability information would determine whether they would be liable to post-assessment audit activity or otherwise. The current "tick and flick" processing of returns is time consuming and cost ineffective hence less productive. However, we would like to suggest to the IRB to increase taxpayers' income tax knowledge before imposing such system, for it would be unfair and would become a burden to taxpayers. It would be of great significance for the IRB to adopt modern tools of detecting tax evaders, such as using computer analysis on the basis of *Discriminant Function Formulas* or DIF, as adopted by the IRS in generating a probability of recoverable tax revenue. In terms of improving the efficiency of the lodging of tax returns, the IRB could adopt *Electronic Lodgment Service*. This would also be of great help in detecting tax evaders, and is currently being used by the ATO. An *on-line operations system*, linking various organisations to the IRB, would be of great help to detect abnormal amounts of payment made by taxpayers, compared to their declared income in their annual tax returns.

IRB also should adopt approach as use by the ATO in *Key Abnormal Tax Agent Evaluation* (KATE) in detecting tax practitioners whose clients' returns vary significantly from the average of those of other tax practitioners in the same region as discussed in Chapter Five of this research study.

Modern technology require skilful staff to operate the system, thus the IRB should provide special training for its staff before adopting this modern technology. The organisational success also depends on its staff capabilities and their skills in handling this problem effectively. Thus it is wise for the IRB to conduct leadership program in improving its staff skills in coping with various issues related to this problem.

Detection of tax evaders is vital in combating income tax non-compliance. Hence it is important for the IRB to be aggressive in detecting tax evaders and abusive avoiders by adopting several activities that have been conducted in some advanced countries besides strengthening its current enforcement. Non-compliance becomes a problem due to lacking in facility to detect tax evaders more effectively instead of depending on traditional means of detecting tax evaders. Detection of tax evaders is also important in enhancing voluntary compliance. As reported by Witte and Woodbury (1985), audit strategy is effective in combating non-compliance among small business owners or cash transaction tax evaders. Further, a number of researchers also have found that the probability of audit on compliance decisions has been found significant (Smith and Kinsey, 1987; Madeo, Schepanski and Uecker, 1987). Hence the IRB could use this strategy in combating income tax non-compliance among small business owners, stall owners and so forth. This strategy also must be seen actively activated in detecting tax evaders, hence they will be at higher risk if not complying to the IRB.

In relation to cash economy tax evasion, the IRB should form a *Cash Economy Task Force* as done by the ATO to study this problem thoroughly and provide suitable strategies in dealing with these taxpayers like hawkers, small traders and food stall owners. As suggested by our respondents, business registration office also could play its role in improving income tax compliance whereby it should also include proof that the clients have been registered or contacted with the IRB in approving their business licences.

The audits will be more effective if the IRB could target those who are more inclined to evade their taxes. This could be done by segmenting the present taxpayers into three groups as follows:

1. Most incline to evade their taxes with the current tax enforcement and regulation.

2. Most unlikely to evade their taxes with the current tax enforcement and regulation.

3. Others who do not include in (1) and (2) above.

This categorisation could be done based on taxpayers' past history on taxation and research conducted by the Research and Development (R&D) section of the IRB. Audits activities will be conducted based on these segmentations and will be reviewed from time to time based on their performance.

9.3.4 Introduction of new income tax procedures

Regarding the benefit-in-kind incomes, the IRB could introduce *Fringe Benefits Tax* as adopted by the ATO, which has been discussed in Chapter Five of this research study. As seen in Chapter Six, the IRB should also assess and tax partnership and trust incomes separately as done by the ATO, for the current procedures of taxing fringe benefits, partnership and trust incomes under individual taxpayers have several weaknesses as discussed earlier.

9.3.5 Improving tax knowledge/education among the public

Tax education is necessary in increasing public awareness about taxation especially regarding taxation laws, the necessity of taxation for the development of the country especially in disseminating information like where the collected taxes have been channelled and so forth. It is also useful to educate taxpayers or potential taxpayers regarding taxation and their share of responsibility to the country. This could be in the form of dialogues, seminars or with cooperation of Ministry of Education in introducing it as a subject in upper secondary schools or college levels. Punishing the ignorant taxpayers is not the aim of the IRB. Only the 'hardcores' that have the intention to evade their taxes should be punished accordingly.

In disseminating tax knowledge to taxpayers, the IRB could enclose *tax pack* together with the annual tax returns or organising seminars to the public about rules and regulations that are expected by the IRB in filling in their annual tax returns. It could also stress various consequences that they have to face for failing to obey such regulations or failing to declare all or part of their incomes. This is very important for the main aim of the IRB is to punish the delinquent taxpayers instead of punishing the ignorant ones. As suggested by our respondents, IRB also could increase the level of public awareness through local mass media and some posters by placing them at strategic public areas. The Ministry of Education also could play its role by introducing taxation as a compulsory subject to the upper secondary level for these students are the potential taxpayers. The syllabus should include the past statistics of taxpayers' revenue that have been channelled by the government in developing this country. Many researchers have agreed that if they were feedback to taxpayers on the allocation of tax collected, this would have a positive effect on voluntary compliance. It also should include various tax laws so that it could educate them and encourage them to comply voluntarily.

It is also recommended that the IRB should held dialogues with the public as suggested by our respondents to inform taxpayers of the current taxation system. The dialogues also will be helpful if attended by tax agents whereby the IRB could stress the importance of tax practitioners in helping taxpayers to comply and remind them of their responsibilities besides getting feedback from them on various issues regarding income tax compliance.

As found by Mason (1987), communication variables are related to sanction fears, as deterrence theorists have hypothesised that variables such as age and income levels are positively related to mass media exposure. Hence, it is wise to have mass media advertisement that focusing on adults viewers that stress more on consequences of not complying *to Income Tax Rules and Regulation.*

9.3.6 Introduction of new rules and regulations

New regulations like permitting only registered tax preparers to represent taxpayers and the introduction of new rules regarding lawyers who have been found guilty in not complying with the IRB rules and regulations by submitting their names to the Bar Council, so that necessary actions could be taken by this council on its members based on the mutual agreement with the IRB to combat income tax non-compliance.

The IRB also should be firm with the offence committed by these practitioners if they were found committing fraud in the process of preparing their clients' accounts. They should be punished heavily and made known to the public, as a lesson to others, black listing them and publishing their names inside the IRB annual report.

While in dealing with professionals like lawyers or tax agents, the IRB should act firmly by submitting their names to the BAR Council or registration office if they fail to comply so that their business licence cannot be renewed.

9.3.7 Amendment of income tax law

Our respondents also suggest that the IRB should simplify the income tax law so that it could be uniformly interpreted by all income tax officers, hence practising uniformly in all branches of the IRB. Amending of income tax law also enable to close any loopholes that might provide opportunities for tax avoidance and evasion as addressed by Wallschutzky and Singh (1995, pp. 42-71). Successful reduction of opportunities for non-compliance may permit more effective allocation of enforcement resources. Additionally, if targeted properly, reducing opportunities for non-compliance also can increase public support for tax compliance.

The amended income tax legislation and standard practices have to be issued to ensure certainty and uniformity. Tax law changes and implications will have to be very clearly communicated to the public. As suggested by Wallschutzky and Singh (1995), the IRB should introduce Fringe Benefits Tax to those benefit-in-kind incomes provided by employers to employees by withholding it at source on behalf of

their employees, so that less chances for these benefits receivers to escape paying their share of tax.

9.3.8 Upgrading its research and development

Besides expecting taxpayers to do their parts, the IRB also should study its weaknesses and try to upgrade or improve them. It could be helpful for the IRB to measure or estimate tax evasion in Malaysia every year so that it could compare its performance from time to time, and would lead to more efficient allocation of resources as suggested by Oldman and Holland (1971). It should also study various methods in reducing costs of compliance and simplify income tax law, hence practising uniformly in all branches of the IRB. Careful analysis of the environment in which it operates is equally important for this is an essential part of the development of successful business strategies as suggested by James (1997, pp. 205-226), James and Wallschutzky (1995).

9.4 Summary

Strategies improvement are recommended based on the analysis of the weaknesses of the current enforcement, administrative procedures, its income tax legislation and its clients, Malaysian taxpayers. In return it will also promote efficiency, and be more effective in dealing with income tax non-compliance in this country.

The IRB should enforce a proper enforcement and practice uniformly in all of its branches. We also suggest that the IRB to improve its penalty system besides exploring positive approaches like disseminating tax knowledge through dialogues, tax pack or introducing income tax as a subject to upper secondary schools, colleges with cooperation from Ministry of Education. It should also improve its administrative procedures especially regarding income tax refunds, objections and appeals from taxpayers.

Detection activity is important in controlling income tax non-compliance. Hence we also suggest that the IRB should use modern technology like the introduction of *Electronic Lodgement Service* (ELS), DIF and KATE in improving its case selection

for audits besides strengthening its audit activity. Audit activity also must be seen actively activated in detecting tax evaders, thus they will be at higher risk if not complying to the IRB.

In overcoming income tax avoidance, the IRB should amend its *Income Tax Legislation* closing all loopholes and clearly communicated to the public. It will be more efficient and more effective if the IRB introduces FBT and levied on employers, taxing partnership and trust incomes separately as currently practice by the ATO. It should also introduce new rules and regulations concerning tax preparers and lawyers. Only registered tax preparers are allowed to represent taxpayers and those non-compliant lawyers' names will be submitted to the Bar Council.

Achieving equity is important in every tax system. Hence the tax burden should be shared equally among all taxpayers. Hence we also suggest that the IRB could introduce *Prescribed Payment System* or PPS for self-employed taxpayers as currently practice by the ATO. The IRB should strengthen its linkage with other organisations especially those who always deal with the public. It is also advisable for the IRB to work closely with tax preparers, understanding compliance problems that are currently faced by their clients. Lastly, the IRB also should upgrade its research and development, which would lead to more efficient allocation of resources besides analysing the environment in which it operates.

NOTES

[1] The tax laws are as follows: the Income Tax and Supplementary Income Tax Act, 1967; the Petroleum (Income Tax) Act, 1967; the Promotion Investment Act, 1986; the Real Property Gain Tax Act, 1965; the Cinematograph Film Hire Duty Act, 1965; the Stamp Ordinance, 1949; and the Estate Duty Enactment, 1941.

[2] Income tax gap estimates released in 1988 and 1996 have excluded unpaid income taxes owed from illegal activities such as drug dealing and prostitution. IRS tax gap estimates in 1979 and 1983 included such an estimate. Since then, IRS researchers have decided that the data and methodology for reliably making this estimate are lacking.

[3] It should be noted that the tax returns examined did not represent a random sample of residents of Rotterdam. There were two separate pools of returns were initially selected for review. One of these pools was comprised of residents for whom no corrections or additional taxes had been assessed in the normal course of review for either 1981 or 1982. The non-evader group, then represent the "cleanest" subset of this category: individuals whose returns, after two additional line-by-line audits, were still found to require no corrections with respect to undeclared income or unjustified deductions. By contrast, the second pool was composed entirely of persons who had already been charged with evading taxes during both of the years under consideration and whose cases had already been settled, unprotested prior to the beginning of the study.

[4] Webley et al. (1991) argued that there are three limitations for this type of evasion measurement. They are as follows:
1.It assesses only those instances of evasion that can be detected by auditors and may be difficult for them to discover certain forms of unreported income such as income from moonlighting and cash-only businesses. Obviously there is no information on taxpayers who did not file returns.
2.There is no way of distinguishing between deliberate evasion and unintended errors on individual level.
3.TCMP data has very limited information about personal variables because of anonymity and it is not possible to explore the social and psychological factors associated with non-compliance.

[5] According to ABA (1989), one of the problems is that small-business activities involve cash transactions which can easily be falsified (see also Soos, 1991).

[6] In countries like Austria, Denmark, and the Netherlands, auditors tasks are greatly facilitated by easy access – via laptop computers to a range of computerised information, including the tax laws and regulations and all data from the taxpayers' accounts. Auditors can access information from the taxpayer master file regarding import and export shipments (volume and value), invoices, sales to customers, and purchases from suppliers.

[7] Many countries have introduced or are in the process of introducing fundamental tax policy and/or tax administration reforms aimed at simplifying the tax system and improving compliance levels during the 1980s and 1990s, including practically all the Latin American countries, many African countries (Benin, Chad, Côte d'Ivoire, Gabon, Guinea, Mali, Niger, Senegal, South Africa, Togo, Uganda), and Korea, the Philippines, and Indonesia, among others.

[8] Extracted from Hepburn, Glen of the Department of Economics, University of Melbourne in 'Estimates of Cash-based Income Tax Evasion in Australia' in the Australian Economic Review, 2nd Quarter 1992. GDP for 1994/95, 1995/96 and 1996/97 are $474,646 millions, $508,806 millions and $532,204 millions respectively.

[9] Only applicable to the hotel and tourist industry.

Appendix 1

Please tick (✔) question 1 to 6 once only.

1. My gender

1. Male	
2. Female	

2. I am working with the IRB of

1. Kuala Lumpur	
2. Pulau Pinang	
3. Johore Bahru	
4. Kota Kinabalu	

3. I have been working with the IRB for .... years.

1. Below 5 years	
2. 5 to 10 years	
3. More than 10 years	

4. Evasion is common among .... taxpayers.

1.Male	
2. Female	

5. I would classify that income tax non-compliance in Malaysia is ....

1. very serious.	
2. serious.	
3. not serious.	

Please arrange questions 7 to 9 in their order of importance, e.g. 1 being the most important and 4 is the least important and so on.

6. The most common nature of omission that I have come across:

Nature of omission	Rank
Failed to declare income	
Under-declared income	
Inflate expenses	
Over-claimed relief	

7. The taxpayer's annual income-level that most common in evading their taxes:

Income-level	Rank
Below RM12,000	
Betweem RM12,000 and RM50,000	
Above RM50,000	

8. Income source that is common in evasion:

Income source	Rank
Business income	
Rental income	
Interest	
Other – please state below	

9. Please indicate your level of agreement along the 7-point Likert-type scale ranging from 1 (Strongly agree) to 7 (Strongly disagree) for the following causes of income tax non-compliance:

A. Taxpayers' ignorance of the Income Tax Law.
1.   2.   3.   4.   5.   6.   7.

B. Taxpayers' intentional evasion.
1.   2.   3.   4.   5.   6.   7.

C. Taxpayers taking advantage of the loopholes in the Income Tax Legislations.
1.   2.   3.   4.   5.   6.   7.

D. Taxpayers practice tax evasion because of financial strain.
1.   2.   3.   4.   5.   6.   7.

E. Tax preparers play important role in the omission of income among taxpayers.
1.   2.   3.   4.   5.   6.   7.

10. Do you have any other cause or causes of income tax non-compliance (beside the above) that you always encounter in your daily work? If yes, please state the cause or causes of non-compliance below in their order of importance (where 1 stands for the most important, 2 stands for less important and so forth. If no, you can skip this section and go to question number 11.

Causes of non-compliance given in their order of importance.

1.

2.

3.

11. Do you have any suggestion or suggestions to overcome the income tax non-compliance in Malaysia? Please write your suggestion or suggestions below.

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Please check that you have answered all the questions and thank you for your participation in this project.

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