

EXPLORING THE RELATIONSHIP BETWEEN TAX COMPLIANCE COSTS AND COMPLIANCE ISSUES IN MALAYSIA

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ABSTRACT

This study estimates the income tax compliance costs, and measures possible noncompliance behaviour, from a business managerial perspective in Malaysia. The findings reported in this paper are part of a larger nationwide mail survey into corporate Malaysian small and medium enterprises (SMEs) under the income tax self-assessment system. The findings show that a relatively greater number of SMEs are being compliant in terms of income reporting and accuracy in their deductions. The investigation into the relationship between the size of tax compliance costs and likely compliance behaviour indicates no statistical significance. Possible reasons for these findings are presented.

I. INTRODUCTION¹

The potential importance of compliance costs in influencing compliance behaviour has been recognised in tax compliance literature.² Nonetheless, the relationship between compliance costs and taxpayer behaviour remains unidentified.³ This study applies behavioural research methods to investigate the links between taxpayer compliance research and tax compliance costs research in the context of small and medium enterprises (SMEs) in Malaysia. Over the last decade, an increasing recognition of the importance of SMEs has been evident in Malaysia, particularly in 2005 through the establishment of the National SME Development Council (NSDC). SMEs have played an important role in the economic growth of Malaysia. In 2005, SMEs comprised around 99 per cent of all enterprises in Malaysia, contributed almost 48 per cent of the total value-added of business establishments and around 65 per cent of total employment.⁴ Considering the importance of SMEs and the large contribution of corporate income tax from SMEs to Malaysian income tax revenue,⁵ this study is confined to corporate SMEs.

Given this background, the paper explores the relationship between tax compliance costs and compliance behaviour in Malaysia. This study is indeed timely as the fully implemented self-assessment regime in Malaysia, introduced in 2001, relies heavily on the tax compliance behaviour of taxpayers. The findings reported in this paper are part of a larger mail survey into Malaysian SMEs. The paper is organised as follows. Part II highlights key concepts and definitions adopted in this paper. Parts III and IV discuss prior major tax compliance and tax compliance costs studies respectively, both from an international perspective. Part V considers earlier tax compliance and tax compliance costs studies in Malaysia. Part VI discusses the method and findings of this study, focusing on

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1 The support of the Small and Medium Industry Development Cooperation of Malaysia with regards to the survey is greatly acknowledged. The authors also thank participants of the Inaugural Applied Law and Policy Symposium held at Curtin University for their helpful comments.

2 Betty Jackson and Valerie Milliron, 'Tax Compliance Research: Findings, Problems, and Prospects' (1986) 5 *Journal of Accounting Literature* 125; John Hasseldine, 'Linkages between Compliance Costs and Taxpayer Compliance Research' in Chris Evans, Jeff Pope and John Hasseldine (eds), *Taxation Compliance Costs: A Festschrift for Cedric Sandford* (2001) 3, 3.

3 Hasseldine, above n 2, 9; Maryann Richardson and Adrian Sawyer, 'A Taxonomy of the Tax Compliance Literature: Further Findings, Problems and Prospects' (2001) 16 *Australian Tax Forum* 137.

4 National SME Development Council, *Small and Medium Enterprise (SME) Annual Report 2005* (2006).

5 For example, the average income tax collected from the corporate sector for the period between 2004 and 2007 was 70 per cent of federal income tax revenue: Treasury Malaysia, *Economy Report: 2007/2008* (2008).

the relationship between compliance costs and compliance behaviour. Discussions and implications are presented in Part VII. Part VIII provides a conclusion.

II. KEY CONCEPTS AND DEFINITIONS

A. Tax Compliance

Tax compliance, in simple terms, means compliance with tax reporting requirements, namely that the taxpayer files all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the tax laws, regulations and court decisions applicable at the time the return is filed.⁶ This definition takes into account both intentional and unintentional noncompliance.⁷ Noncompliance, on the other hand, signifies failing to meet tax reporting requirements. Noncompliance represents the most inclusive conceptualisation with respect to the failure to meet tax obligations.⁸ Other terms used to describe tax noncompliance include tax cheating, evasion, errors and misreporting.⁹ Tax evasion, in lay terms, means hiding taxable income from the tax authority.¹⁰ Tax evasion is used interchangeably with noncompliance in the literature despite some differences, particularly with reference to intention. Tax evasion involves some elements of fraudulent conduct accompanied by a real intention on the part of the taxpayer to wilfully or deliberately mislead, deceive or conceal from the tax authority the intention to pay less tax than is actually owed. In Malaysia, noncompliance may take a number of forms: failure to submit a tax return, understatement of income, overstatement of deductions and failure to pay assessed taxes by the due date.¹¹ However, this study considers two main types of noncompliance behaviour noted in the tax literature,¹² namely understatement of income and overstatement of deductions.

B. Tax Compliance Costs

Compliance costs of taxation are costs incurred by taxpayers, in addition to their tax liability, in conforming to the tax requirements. Cedric Sandford, Michael Godwin and Peter Hardwick defined compliance costs as those costs incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given tax structure.¹³ For a business, the compliance costs include the cost of collecting, remitting and accounting for tax on the products or profits of the business, and on the wages and salaries of its employees, together with the cost of acquiring the knowledge to enable this work to be done, including knowledge of their legal obligations and penalties, and the associated overhead costs, including costs of storing records as required by the tax authorities.

Compliance costs of taxation include three major components: money costs, time costs, and psychological costs to the taxpayers.¹⁴ The money or financial costs refer to an amount

6 Jeffrey Roth, John Scholz and Ann Witte, *Taxpayer Compliance: An Agenda for Research* (1989) 21.

7 Carol Fischer, Martha Wartick and Melvin Mark, 'Detection Probability and Taxpayer Compliance: A Review of the Literature' (1992) 11 *Journal of Accounting Literature* 1.

8 Karyl Kinsey, 'Survey Data on Tax Compliance: A Compendium and Review' (Working Paper No 84-2, Taxpayer Compliance Project, American Bar Association, 1984) 2.

9 Susan Long and Judyth Swingen, 'Taxpayer Compliance: Setting New Agendas for Research' (1991) 25 *Law and Society Review* 637.

10 David Pyle, *Tax Evasion and the Black Economy* (1989) 111.

11 John Baldry and Jeyapalan Kasipillai, 'Malaysia: Income Tax Enforcement' (1996) 2(9) *Asia-Pacific Tax Bulletin* 268, 268-72.

12 The tax literature strongly emphasises the need for a separate analysis of the various forms of noncompliance; see, eg, Long and Swingen, above n 9, 664; Richardson and Sawyer, above n 3, 224.

13 Cedric Sandford, Michael Godwin and Peter Hardwick, *Administrative and Compliance Costs of Taxation* (1989) 10-12.

14 Ibid 11-12; Jeff Pope, Richard Fayle and Dong Ling Chen, *The Compliance Costs of Public Companies' Income Taxation in Australia: 1986/87* (1991) 7; Jeff Pope, Richard Fayle and Dong Ling Chen, *The Compliance Costs of Companies' Income Tax in Australia* (1994) 3; Cedric Sandford and John Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (1992) 6. Compliance costs are also categorised into their nature or types, either computational or planning. Computational costs are mostly routine, calculative and accrued on a yearly basis. In

spent on tax professionals (i.e. tax agents, accountants, investment advisers and legal practitioners) and expenses relating to taxation guides, books, communication and other incidental costs. On the other hand, time costs are incurred in keeping records of tax information, completing the tax form or preparing tax details for tax professionals, as well as time spent in dealing with the tax authorities. Psychological costs refer to the effects upon a taxpayer having to deal with his/her tax affairs, such as the anxiety of handling complex tax matters. However, in practice, prior studies tended to ignore psychological costs as they are difficult to estimate. Further, psychological costs are perhaps less relevant to corporate SMEs as compared to individual (including self-employed) taxpayers. Hence, the current study estimates both internal time costs and money costs, but does not estimate psychological costs to taxpayers.

Additionally, Sandford, Godwin and Hardwick recognised cash flow benefits and managerial benefits as offsets to compliance costs.¹⁵ Consequently, the term ‘net compliance costs’ was used to represent compliance costs after they were offset by benefits such as cash flow benefits and managerial benefits. Since managerial benefits cannot be easily measured, the researcher normally deducts only the cash value benefits to arrive at net compliance costs.¹⁶ Benefits arising from tax deductibility are also used to offset compliance costs by some researchers.¹⁷ The current study focuses on gross tax compliance costs and, thus, does not estimate any possible offsetting benefits of tax compliance.

C. Small and Medium Enterprises

This study adopts the definition of SMEs approved by the NSDC in 2005. This definition of SMEs is based on two criteria: either the number of full-time employees or the annual sales turnover. The SME definition for those sectors is shown in Table 1:

Table 1: SME Definition by Sectors and Criteria¹⁸

Sectors	Criteria ^a	
	Employees	Annual turnover ^b
- Manufacturing - Manufacturing-related	≤ 150	≤ RM25 million
- Services - Primary Agriculture	≤ 50	≤ RM5 million

^a Either one of the criteria to be met.

^b Exchange rate RM2.39 = A\$1.00 (29 January 2009, Bank Negara Malaysia).

The NSDC also further categorised SMEs into four main sectors: manufacturing, manufacturing-related services, services (including information and communications technology), and primary agriculture.

III. PREVIOUS TAX COMPLIANCE STUDIES

Concern about voluntary tax compliance has led to numerous studies on tax compliance issues, particularly regarding income tax. Comprehensive reviews of prior major tax

contrast, planning costs relate to additional efforts taken by taxpayers to legally minimise their tax liability, particularly in the longer run.

15 Sandford, Godwin and Hardwick, above n 13, 13-14.

16 Sandford and Hasseldine, above n 14, 7.

17 Maarten Allers, *Administrative and Compliance Costs of Taxation and Public Transfers in the Netherlands* (1994) 38-40; Chris Evans et al, *A Report Into the Taxpayer Costs of Compliance* (1997); Binh Tran-Nam and John Glover, ‘Tax Reform in Australia: Impacts of Tax Compliance Costs on Small Business’ (2002) 5 *Journal of Australian Taxation* 338.

18 National SME Development Council, *Definitions for Small and Medium Enterprises in Malaysia* (2005) 3 <http://www.smeinfo.com.my/pdf/sme_definitions_ENGLISH.pdf> at 16 January 2009.

compliance studies are provided by Betty Jackson and Valerie Milliron,¹⁹ and Maryann Richardson and Adrian Sawyer.²⁰ Jackson and Milliron provide a comprehensive review of 43 tax compliance studies carried out between the 1970s and 1985. Richardson and Sawyer, in a similar way, provide a comprehensive review and synthesis of more than 130 tax compliance studies published from 1985 to 1997 and, most importantly, provide discussion on the progress made following Jackson and Milliron's suggestions. Both papers consider the key tax compliance variables, methods employed, and issues and theory involved, and also raise the issue of conflicting results arising from different approaches.²¹

Interestingly, tax researchers have noted that tax compliance studies have predominantly centred on the income tax compliance of individual taxpayers,²² particularly individuals without a business. As the current study is limited to corporate taxpayers, the remainder of this section focuses on corporate taxpayers. The literature review reveals that there are at least five tax compliance studies that are relevant to corporate tax compliance.²³

The first empirical evidence on corporate income tax noncompliance was provided by Eric Rice.²⁴ Rice used the 1980 Taxpayer Compliance Measurement Program (TCMP) database provided by the US Internal Revenue Service (IRS). Rice found no evidence to link corporation size with tax compliance. It should be noted that Rice's study was confined to medium-sized corporations. As a result, Nipoli Kamdar argues that further work is necessary before drawing any conclusions on the determinants of corporate noncompliance.²⁵ Kamdar conducted a time series analysis by utilising the standard theoretical model of compliance, extended to include a couple of variables, to examine the extent and determinants of corporate income tax compliance. The basic compliance model assumes that the amount of income reported by a taxpayer is a function of true income, marginal tax rates, probability of detections for companies, penalties for noncompliance, and other socioeconomic features. Kamdar found that audit rates and profits have a positive and significant effect on compliance, suggesting that greater audit coverage could lead to a substantial rise in tax revenues.²⁶ Despite the fact that corporate tax evasion was not prevalent in his study, he emphasised that corporate compliance improvement could result in significant revenue increases.²⁷

In other studies, Lillian Mills noted that the IRS audit adjustments increase as book-tax differences increase, which indicate possible noncompliance.²⁸ In her preliminary analysis, she measured the book-tax differences in two ways, i.e. pre-tax book income less taxable income and federal tax expense less tax declared on the return. Later, in 1998, the book-tax differences were also measured by using the US deferred income tax expense, particularly

19 Jackson and Milliron, above n 2.

20 Richardson and Sawyer, above n 3.

21 The detail of tax compliance studies is not considered here. Interested readers should refer to a comprehensive review of tax compliance literature, especially: Jackson and Milliron, above n 2; Richardson and Sawyer, above n 3. Fischer, Wartick and Mark, above n 7, also provide a review of past tax compliance research, but confined to the influence of detection probability on taxpayer compliance.

22 Nipoli Kamdar, 'Corporate Income Tax Compliance: A Time Series Analysis' (1997) 25 *Atlantic Economic Journal* 37, 37; Long and Swingen, above n 9, 665; Eric Rice, 'The Corporate Tax Gap: Evidence on Tax Compliance by Small Corporations' in Joel Slemrod (ed), *Why People Pay Taxes: Tax Compliance and Enforcement* (1992) 125, 126.

23 Michelle Hanlon, Lillian Mills and Joel Slemrod, 'An Empirical Examination of Corporate Tax Non-compliance' (Working Paper No 1025, University of Michigan, 2005); David Joulfaian, 'Corporate Income Tax Evasion and Managerial Preferences' (2000) 82 *The Review of Economics and Statistics* 698; Lillian Mills, 'Book-tax Differences and Internal Revenue Service Adjustments' (1998) 36 *Journal of Accounting Research* 343; Rice, above n 22; Kamdar, above n 22. It should be noted that preliminary results of Mills appeared as 'Corporate Tax Compliance and Financial Reporting' (1996) 49 *National Tax Journal* 421.

24 Rice, above n 22.

25 Kamdar, above n 22, 39.

26 *Ibid* 46.

27 *Ibid*.

28 Mills, 'Book-tax Differences and Internal Revenue Service Adjustments', above n 23. Mills refers to book-tax differences as the differences between accounting income and taxable income. She asserts that the book-tax differences act as a possible sign of noncompliance.

for public companies. Her observations also implied that the lower effective tax rate was evident in firms that spend relatively higher amounts on tax planning compliance costs.

Another study using corporate TCMP data was conducted by David Joulfaian.²⁹ Joulfaian argued that managerial preferences might determine corporate compliance behaviour. Managers' understatement of personal income tax was used as a proxy of managerial preferences.³⁰ Joulfaian concluded that noncompliant firms are more likely to be managed by executives who have failed to comply with their personal income tax than are compliant firms. As a result, he urged future researchers to incorporate managerial preferences as one of the determinants of corporate tax compliance.³¹

More recently, Michelle Hanlon, Lillian Mills and Joel Slemrod explored the relationship between corporate noncompliance and corporate characteristics.³² Tax deficiencies proposed by the IRS upon audit were mainly used as a measure of noncompliance. Firm size, industry, foreign ownership, multinationality, and public or private companies were among the corporate characteristics assessed in their study. Larger firms were found to be more noncompliant than smaller firms. However, medium-sized businesses had the lowest rate of noncompliance, suggesting that the statistical curve of corporate tax noncompliance was U-shaped. It is surprising that medium-sized business were more compliant than small business. Hanlon, Mills and Slemrod acknowledged that such an inconsistent pattern has to be connected with the opportunity for noncompliance.³³ As for other characteristics of companies, foreign-controlled companies are more compliant than domestic companies, multinational and private companies have a greater deficiency relative to non-multinational and public companies respectively, and the overall industry effects are significant too.

In another development, Slemrod argued that the tax situation of both companies and owners is closely related, and urged researchers to analyse these simultaneously.³⁴ He also predicted a similar relationship between compliance costs and noncompliance, and presumed that tax complexity led to noncompliance.³⁵ Slemrod also discussed the extent and nature of corporate tax noncompliance and provided some economic perspectives on the compliance behaviour of corporate taxpayers.³⁶ He also discussed ways in which an economic perspective can contribute to the policy debate about corporate noncompliance.

IV. PREVIOUS TAX COMPLIANCE COSTS STUDIES

The development of earlier research into tax operating costs has been discussed in terms of three phases by Sandford: a North American phase; a European phase; and an international phase.³⁷ Recently, Chris Evans, in reviewing prior studies regarding taxation operating costs, has highlighted that there are at least 100 published studies into compliance costs, administrative costs or both.³⁸ Evans added that more than 60 of these have been published since 1980.

The first study on taxation compliance costs was carried out by Robert Haig in 1935,³⁹ using a mail survey sent to large corporations and covering all federal and state taxes in the US. In the UK, a modern and exhaustive study on compliance costs was carried out by

29 Joulfaian, above n 23.

30 Ibid 698.

31 Ibid 701.

32 Hanlon, Mills and Slemrod, above n 23.

33 Ibid 27.

34 Joel Slemrod, 'Small Business and the Tax System' in Henry J Aaron and Joel Slemrod (eds), *The Crisis in Tax Administration* (2004) 69, 83.

35 Ibid 93.

36 Joel Slemrod, 'The Economics of Corporate Tax Selfishness' (2004) 57 *National Tax Journal* 877.

37 Sandford, Godwin and Hardwick, above n 13, 27-34.

38 Chris Evans, 'Studying the Studies: An Overview of Recent Research into Taxation Operating Costs' (2003) 1 *eJournal of Tax Research* 64.

39 Robert Haig, 'The Costs to Business Concerns of Compliance with Tax Laws' (1935) 24 *Management Review* 323, cited in Sandford, Godwin and Hardwick, above n 13, 27.

Sandford.⁴⁰ Sandford mainly surveyed responses from individuals, including the self-employed, regarding personal income tax. He found that the proportion of compliance costs is highest for self-employed taxpayers and is evidence of the presence of regressivity. In Australia, pioneering work on the compliance costs of major federal taxes was conducted by Jeff Pope, Richard Fayle and Mike Duncanson.⁴¹ A review of Pope's study on companies indicates that, generally, compliance costs in Australia were found to be regressive, and higher than for UK companies. The remainder of the Australian studies were conducted by Ian Wallschutzky and Brian Gibson,⁴² Chris Evans et al,⁴³ Nthati Rametse and Jeff Pope,⁴⁴ CPA Australia,⁴⁵ Chris Evans,⁴⁶ Binh Tran-Nam and John Glover,⁴⁷ Chris Evans, Binh Tran-Nam and Bev Jordan,⁴⁸ and John Glover and Binh Tran-Nam.⁴⁹ As for small business, it was noted that specific studies tend to focus on the Goods and Services Tax (GST).⁵⁰ Nonetheless, most studies on business operating costs are not specific to any one sector, but take account of all business segments.⁵¹ In Asia, a couple of business tax compliance costs studies were conducted in Singapore,⁵² and were subsequently followed by similar studies in Hong Kong⁵³ and Malaysia,⁵⁴ all of which focused on the corporate sector. Another recent Asian study was conducted in India.⁵⁵

One noteworthy aspect is the prevalence of a fixed cost effect irrespective of business size. Nearly all the studies above indicate that business tax compliance costs fall heavily on smaller firms as a percentage of tax paid or turnover, either considered for a single type of tax or at the aggregate level for all types of business taxes.

V. EARLIER TAX COMPLIANCE AND TAX COMPLIANCE COSTS STUDIES IN MALAYSIA

Despite growing problems of tax noncompliance and evasion in Malaysia, very few studies have been carried out and not much is known about the extent and determinants of such

40 Ibid.

41 Jeff Pope, Richard Fayle and Mike Duncanson, *The Compliance Costs of Personal Income Taxation in Australia: 1986/87* (1990); Pope, Fayle and Chen, *The Compliance Costs of Public Companies' Income Taxation in Australia: 1986/87*, above n 14; Pope, Fayle and Chen, *The Compliance Costs of Companies' Income Tax in Australia*, above n 14; Jeff Pope, Richard Fayle and Dong Ling Chen, *The Compliance Costs of Employment Related Taxation in Australia* (1993); Jeff Pope, Richard Fayle and Dong Ling Chen, *The Compliance Costs of Wholesale Sales Tax in Australia* (1993).

42 Ian Wallschutzky and Brian Gibson, 'Small Business Cost of Compliance' (1993) 10 *Australian Tax Forum* 527.

43 Evans et al, above n 16.

44 Nthati Rametse and Jeff Pope, 'Start-up Tax Compliance Costs of the GST: Empirical Evidence from Western Australian Small Businesses' (2002) 17 *Australian Tax Forum* 407.

45 CPA Australia, *Small Business Survey Program: Compliance Burden* (2003) <http://cpaaustralia.com.au/cps/rde/xbcr/SID-3F57FECB-97AB042C/cpa/survey_compliance_burden.pdf> at 16 January 2009.

46 Chris Evans, *The Operating Costs of Taxing the Capital Gains of Individuals: A Comparative Study of Australia and the UK, with Particular Reference to the Compliance Costs of Certain Tax Design Features* (PhD Thesis, University of New South Wales, 2003).

47 Binh Tran-Nam and John Glover, 'Estimating the Transitional Compliance Costs of the GST in Australia' (2002) 17 *Australian Tax Forum* 499.

48 Chris Evans, Binh Tran-Nam and Bev Jordan, 'Assessing the Potential Compliance Costs/Benefits of the Tax Value Method' (2002) 17 *Australian Tax Forum* 33.

49 John Glover and Binh Tran-Nam, 'The GST Recurrent Compliance Costs/Benefits of Small business in Australia: A Case Study Approach' (2005) 1 *Journal of the Australasian Tax Teachers Association* 237.

50 CPA Australia, above n 45; Glover and Tran-Nam, above n 49; Rametse and Pope, above n 44; Tran-Nam and Glover, above n 47; Wallschutzky and Gibson, above n 42.

51 Evans, above n 38, 69.

52 Mohamed Ariff, Alfred Loh and Ameen Ali Talib, 'Compliance Costs of Corporate Income Taxation in Singapore, 1994' (1995) 8 *Accounting Research Journal* 75; Mohamed Ariff, Zubaidah Ismail and Alfred Loh, 'Compliance Costs of Corporate Income Taxation in Singapore' (1997) 24 *Journal of Business Finance and Accounting* 1253.

53 Samuel Chan et al, 'Compliance Costs of Corporate Taxation in Hong Kong' (1999) 25(4) *International Tax Journal* 42.

54 Alfred Loh et al, 'Compliance Costs of Corporate Income Taxation in Malaysia, 1995' (1997) 9(1) *Pacific Accounting Review* 27; Mustafa Hanefah, Mohamed Ariff and Jeyapalan Kasipillai, 'Compliance Costs of Small and Medium Enterprises' (2001) 4 *Journal of Australian Taxation* 73.

55 Saumen Chattopadhyay and Arindam Das-Gupta, 'The Income Tax Compliance Cost of Indian Corporations' (National Institute of Public Finance and Policy, 2002).

problems, particularly since the implementation of the self-assessment regime in Malaysia in 2001. A review of the literature reveals that there have been 17 studies,⁵⁶ either partly or wholly related to compliance behaviour. These primarily focus on income tax, with two exceptions⁵⁷ both related to local government taxes.

Out of 15 studies on income tax compliance behaviour, only one has solely focused on individuals with business income (either self-employed or partnership),⁵⁸ while the other five studies had some respondents with a business income (mostly self-employed).⁵⁹ One or two sought responses respectively from accountants, tax agents or tax professionals, and tax officers.⁶⁰ In terms of research methods employed, a survey approach, particularly employing mail questionnaires, seems to be widely used in Malaysian studies. The first study was conducted by Siti Mariam Che Ayub.⁶¹ However, she focused on the perceptions of tax officers and tax agents towards the tax administrative system and evasion determinants of individual taxpayers in Malaysia.

A study by Mustafa Hanefah was probably the first that looked into the tax compliance behaviour of the Malaysian individual taxpayer, including the self-employed.⁶² Hanefah investigated the efficiency and productivity of the Malaysian tax administrative system, predominantly in the official assessment system (OAS), with a view to implementing a self-assessment system (SAS) in Malaysia. As part of his research, he studied perceptions of the income tax administration system, tax fairness, and the tax law complexity of personal income tax. To achieve this, he adapted the expanded model of taxpayer compliance developed by Carol Fischer, Martha Wartick and Melvin Mark.⁶³ Meanwhile, other Malaysian studies partly examined a few factors and did not make comprehensive attempts to examine compliance behaviour.⁶⁴ Similar to trends in compliance behaviour research elsewhere, Malaysian studies also focused on individual taxpayers. Little attention has been paid to business taxpayers and, surprisingly, none to the corporate sector or other entities as taxpayers.

Compliance costs, similar to compliance behaviour, have also long been ignored in Malaysia. Prior literature indicates that, to date, there are only three published studies on the costs of compliance in Malaysia. The first study, conducted by Alfred Loh et al in 1995, examined the income tax compliance costs of public listed companies in Malaysia.⁶⁵ The second study, conducted by Mustafa Hanefah, Mohamed Ariff and Jeyapalan Kasipillai in 2000, focused on SMEs.⁶⁶ The third study was conducted by Muzainah

56 Refer to Appendix A for a full list of prior tax compliance studies.

57 Nor Aziah Abdul Manaf, *Land Tax Administration and Compliance Attitudes in Malaysia* (PhD Thesis, Nottingham University, 2004); Mahamad Tayib, *The Determinants of Assessment Tax Collection: The Malaysian Local Authority Experience* (PhD Thesis, University of Glamorgan, 1998).

58 Mottiakavander Ramasamy et al, 'Factors Influencing Compliance Behaviour of Small Business Entrepreneurs' (2003) 12(1) *Tax Nasional* 20.

59 Mustafa Hanefah, *An Evaluation of the Malaysian Tax Administrative System and Taxpayers' Perceptions towards Assessment Systems, Tax Law Fairness, and Tax Law Complexity* (PhD Thesis, Universiti Utara Malaysia, 1996); Jeyapalan Kasipillai, *Aspects of the Hidden Economy and Tax Non-compliance in Malaysia* (PhD Thesis, The University of New England, 1997); Jeyapalan Kasipillai et al, 'Are Malaysian Taxpayers Prepared for the Self Assessment System?' (1999) September *Tax Nasional* 9; Mohani Abdul, *Income Tax Non-compliance in Malaysia* (2003); Ern Chen Loo, 'Determinants of Individual Taxpayers' Compliance Behaviour: Experience of the Transition from the Pre to Post Self Assessment in Malaysia' in Michael Walpole and Margaret McKerchar (eds), *Further Global Challenges in Tax Administration* (2006) 201; Gioak Faa Sia et al, 'Determinants of Individual Tax Compliance: A Comparative Study on Compliant and Non-compliant Taxpayers' (Paper presented at the 20th Annual Australasian Tax Teachers' Association Conference, Hobart, 23-25 January 2008).

60 See Siti Mariam Che Ayub, *Tax Administration Reform for the Malaysian Inland Revenue Department with an Adaptation of the Voluntary Compliance Function* (DPA Dissertation Thesis, Golden Gate University, 1994); Kasipillai, *Aspects of the Hidden Economy and Tax Non-compliance in Malaysia*, above n 59; Veerinderjeet Singh, *Tax Compliance and Ethical Decision-making: a Malaysian Perspective* (2003); Abdul, above n 59.

61 Che Ayub, above n 60.

62 Hanefah, above n 59.

63 Fischer, Wartick and Mark, above n 7.

64 See, eg, Jeyapalan Kasipillai, Norhani Aripin and Noor Afza Amran, 'The Influence of Education on Tax Avoidance and Tax Evasion' (2003) 1 *eJournal of Tax Research* 134; Ramasamy et al, above n 58; Loo, above n 59; Jeyapalan Kasipillai and Hijattullah Abdul-Jabbar, 'Gender and Ethnicity Differences in Tax Compliance' (2006) 11(2) *Asian Academy of Management Journal* 75.

65 Loh et al, above n 54.

66 Hanefah, Ariff and Kasipillai, above n 54.

Mansor, Natrah Saad and Idawati Ibrahim in 2001.⁶⁷ This study was probably the first conducted under the SAS regime. However, it does not measure compliance costs in monetary terms; instead it focuses on the relative increase in time spent on various tax compliance activities. In addition to these three studies, a study by Noor Sharoja Sapiei and Mazni Abdullah is probably the first regarding tax compliance costs of individual taxpayers.⁶⁸ However, the study only estimated tax compliance costs, partially in monetary terms and the remainder in time spent. A summary of the major findings of these Malaysian compliance costs studies is shown in Table 2.

Table 2: Earlier Income Tax Compliance Costs Studies in Malaysia

Author(s) (year)	Respondents (year of study)	Main outcomes
Loh et al, (1997)	Public listed companies (1995)	<ul style="list-style-type: none"> • Average compliance costs per public listed company were RM68 836 with 72% of the compliance costs external in nature. • Compliance costs decrease as company size increases. • Computation costs (61%) form major portion of compliance costs.
Hanefah, Ariff and Kasipillai (2001)	SME companies (1999)	<ul style="list-style-type: none"> • Average compliance costs per SME company were RM21 964, with 75% of the costs derived internally. • Computation costs form 59%, while the remaining (41%) were planning costs. • Compliance costs are four times more regressive than listed company.
Mansor, Saad and Ibrahim, (2003)	SME companies (2002)	<ul style="list-style-type: none"> • The major source of increase in compliance costs (measured in terms of relative increase of time spent) was time spent with tax agents (78.83%), followed by time spent in learning tax law changes (55.4%).
Sapiei and Abdullah (2008)	Individuals, including self- employed (2007)	<ul style="list-style-type: none"> • The average time spent on compliance activities by individual taxpayer was 70.6 hours per annum. • The average financial cost per taxpayer was RM187.90. • A large majority of taxpayers (71%) prepared their own tax return.

Due to their methodological similarities, it is useful to compare the results of the first two studies. It is evident that the compliance costs, measured in terms of internal and/or external costs of large and SME companies, were totally in contrast.⁶⁹ Hanefah, Ariff and Kasipillai also observed that the fixed cost effect of compliance costs is substantially greater for SMEs compared to the public listed companies studied by Loh et al.⁷⁰ Nonetheless, an analysis by Ariff and Pope shows that the tax compliance costs incurred by Malaysian companies, either large or small firms, are substantially low compared with other Asia-Pacific countries.⁷¹ It is also interesting to note that, in contrast to compliance behaviour studies, tax compliance costs studies in Malaysia have tended to emphasise the corporate sector rather than the individual taxpayer.

The current study contributes to this area by comprehensively studying both compliance costs and compliance behaviour under the self-assessment regime and, most importantly, in the context of the corporate SME taxpayer.

67 Muzainah Mansor, Natrah Saad and Idawati Ibrahim, 'The Self-assessment System and Its Compliance Costs' (2004) 2(1) *National Accounting Research Journal* 1.

68 Noor Sharoja Sapiei and Mazni Abdullah, 'The Compliance Costs of the Personal Income Taxation in Malaysia' (Paper presented at The Eighth International Business Research Conference, Dubai, 27-28 March 2008).

69 Hanefah, Ariff and Kasipillai, above n 54, found that SMEs rely on internal resources to comply with the tax laws. On the contrary, large companies depend on the use of external advisers: Loh et al, above n 54.

70 Loh et al, above n 54.

71 Mohamed Ariff and Jeff Pope, *Taxation & Compliance Costs in Asia Pacific Economies* (2002).

VI. METHOD AND FINDINGS

This study employed a traditional large-scale mail survey. The survey was conducted in 2007 with the support of the Small and Medium Industries Development Corporation (SMIDEC) and relates to the financial year and/or tax year 2006. The survey population involved SME companies in peninsular Malaysia that were registered with the SME information portal.⁷² The net population of the study was 9669 companies after excluding SMEs in the primary agriculture and mining sectors, which have a low number of representatives.⁷³ The survey questionnaire was mailed to a representative random sample of 1300 SME companies from five business sectors: manufacturing, manufacturing-related, services, construction and other.

The survey questionnaire adapted and built upon both prior tax compliance behaviour⁷⁴ and compliance costs studies.⁷⁵ Prior to the actual survey, a pilot study was conducted via personal interviews among tax professionals, tax academics and SMEs. Following pilot interviews, a few modifications were made to the questionnaire. The final survey questionnaire was prepared in English and another translated version was made available in the Malay language.⁷⁶

A. Response Rate and Profile of Small and Medium Enterprises

Out of 1300 questionnaires sent, a total of 175 useable questionnaires were returned, which represents an overall response rate of 16 per cent after allowing for out-of-frame responses. Despite many of Sandford's recommendations being adopted into the current study in order to improve the response rate,⁷⁷ the number of responses received is considered low. Nonetheless, it is broadly comparable to a number of tax studies in Asia-Pacific countries, including Malaysia.⁷⁸ Having acknowledged the low response, non-response bias was measured, but a fairly similar response between respondents and non-respondents was found.⁷⁹ The profile of respondents is shown in Table 3.

72 This portal is managed by the Secretariat to the National SME Development Council (NSDC) and is publicly accessible: SMEinfo <<http://www.smeinfo.com.my>> at 16 January 2009. There is no comprehensive list of company taxpayers publicly available in Malaysia. The directory was considered as the best available list of the SME population, for it is based on the new standardised national SME definition: see above Part II(C). Small and medium enterprises in eastern Malaysia were excluded due to a possible postal delay.

73 For more details on the population and sample of the study, see Hijattulah Abdul-Jabbar and Jeff Pope, 'The Effect of the Self-assessment System on the Tax Compliance Costs of Small and Medium Enterprises in Malaysia' (2008) 23 *Australian Tax Forum* 289, 295.

74 For further detail on the measurement of compliance behaviour, see below Part VI(C).

75 Compliance cost estimates broadly build upon the approach in Pope, Fayle and Chen, *The Compliance Costs of Companies' Income Tax in Australia*, above n 14. See Abdul-Jabbar and Pope, above n 73, for key details of the approach adopted and also see below Part VI(B).

76 The respondents were given the option of responding to either version.

77 Cedric Sandford (ed), *Tax Compliance Costs: Measurement and Policy* (1995) 378-379, highlighted as many as 17 considerations in this specific area of tax compliance costs to improve the rate and quality of the responses. Unfortunately, due to the constraints faced, mainly funding-related, the current study was able to consider 12 elements only. The authors gratefully acknowledge the financial assistance provided by Curtin Business School.

78 For example: 14 and 17 per cent in Loo, above n 59, and 22 per cent in Hanefah, Ariff and Kasipillai, above n 54, both in Malaysia; 15.1 per cent in Hong Kong in Chan et al, above n 53; 26 per cent in Singapore in Ariff, Ismail and Loh, above n 52; 16.9 per cent in Australia in Pope, Fayle and Chen, *The Compliance Costs of Public Companies' Income Taxation in Australia: 1986/87*, above n 14. A response rate of 1.15 per cent in the Indian Corporation study by Chattopadhyay and Das-Gupta, above n 55, is perhaps the lowest response reported in the tax compliance costs literature.

79 Non-response bias was measured by two approaches: first, by employing wave analysis; and, secondly, by comparing the responses to a key question in both the full questionnaire survey and a single-question postcard survey.

Table 3: Summary of Sample Characteristics

	Number of Respondents^a	Percentage^b
Business Sector		
Manufacturing	37	21.1
Manufacturing-related Services	32	18.3
Services	77	44.0
Construction	27	15.4
Other ^c	2	1.1
Business Length		
Less than 2 years	8	4.6
2 to 5 years	30	17.1
More than 5 years	137	78.3
Number of Staff Employed		
4 or less	35	20.0
5 to 19	85	48.6
20 to 50	40	22.9
51 to 150	14	8.0
151 or more	1	0.6
Turnover Level		
Less than RM250 000	37	21.1
RM250 000 to RM999 999	48	27.4
RM1 000 000 to RM4 999 999	46	26.3
RM5 000 000 to RM9 999 999	17	9.7
RM10 000 000 to RM24 999 999	14	8.0
RM25 000 000 or more	13	7.4
Estimated Tax liability		
No tax	42	24.4
RM1 to RM99 999	102	59.3
RM100 000 or more	28	16.3
Overall	175	100.0

^a Total respondents of less than 175 for some sections is due to missing cases.

^b Total percentage of less than 100 for some sections is due to rounding.

^c The actual response received from this sector was 25, but was reclassified using the respondent's remark of their specific business nature.

As shown in Table 3, the most responses came from the service sector (44 per cent), followed by manufacturing (21 per cent) and manufacturing-related (18 per cent). As for length of business, the vast majority of respondents are assumed to have tax-related experience since they have been in business for more than five years (78 per cent) or for at least two years (17 per cent). Almost half of the respondents employ between five and 19 staff members. In terms of turnover, 75 per cent of the SMEs are in the first three levels, with relatively more respondents with turnover between RM250 000 and RM1 million (27 per cent) and between RM1 million and RM5 million (26 per cent). In addition to these business characteristics, the survey requested respondents to estimate their tax liability. The vast majority of SMEs (84 per cent) estimated their 2006 tax liability as either none (24 per cent) or up to RM100 000 (60 per cent).

B. Compliance Cost Estimate

This compliance cost estimation mainly follows similar approaches used by earlier studies in Australia, Malaysia, Singapore and Hong Kong.⁸⁰ The mean compliance costs of Malaysian SME companies in 2006, by cost component,⁸¹ are summarised in Table 4.

Table 4: Mean Compliance Costs of Malaysian Small and Medium Enterprises by Component – 2006

Cost Component	Mean Compliance Costs (RM)
Internal Costs	4863 (52%)
External Costs	3786 (41%)
Additional Costs	646 (7%)
Overall	9295 (100%)

Average compliance costs per SME company were RM9295. Around half the average compliance costs were internal time spent and around two-fifths were direct monetary costs paid to external advisors solely on tax activities. The internal time costs were calculated as the total of time costs of four different categories of staff within the business, namely manager/accountant, accounting staff, administrative staff, and other staff. This amount was computed by multiplying annual time spent on tax activities by their respective hourly wage rate. Additional compliance costs (non-staff) accounted for seven per cent. These additional costs were mainly related to printing, stationary, postage, communication and, to a small extent, travelling costs. In terms of cost nature, the computational and planning costs ratio was recorded at 74 per cent to 26 per cent. These breakdowns were computed based on the estimated percentage given by the respondents for both internal and external tax compliance work.

The 2006 estimate (RM9295) shows that compliance costs of SME companies are over 50 per cent lower compared to the 1999 pre-SAS study (RM21 964).⁸² The income tax simplification measures taken by the Inland Revenue Board (IRB), a period of relative stability in both the economic climate and tax system for the past six years or so, and the likely removal of high start-up compliance costs are among major possible reasons for this significant decline in the compliance cost estimate.⁸³ Notwithstanding the above, the ratios of both external to internal costs and computational to planning costs increased, as would be expected under an SAS regime. More importantly, the usual fixed cost effect on smaller firms remains a key issue for business tax policymakers.

C. Noncompliance Behaviour

Two types of noncompliance are measured in this study — underreporting of income and overstating deductions. The tax compliance literature has largely acknowledged the difficulties and challenges faced in measuring tax compliance behaviour.⁸⁴ Despite this, three methods were employed in previous studies, namely tax audits, self-reports, and experimentation.⁸⁵ Tax audits are return oriented, and the latter two are taxpayer oriented. From a methodological point of view, each of these methods has its own strengths and weaknesses, depending on the types of behaviour measured. However, no support exists to

80 Pope, Fayle and Chen, *The Compliance Costs of Companies' Income Tax in Australia*, above n 14; Hanefah, Ariff and Kasipillai, above n 54; Ariff and Pope, above n 71.

81 A series of questions relevant to compliance cost estimates is available upon request to the authors.

82 Hanefah, Ariff and Kasipillai, above n 54. The inflation rate in Malaysia, as measured by the consumer price index increase, over the period 1999 to 2006 was around 2 per cent per annum, except for 3.0 and 3.6 per cent respectively in 2005 and 2006: Treasury Malaysia, above n 5; Treasury Malaysia, *Economy Report: 2003/2004* (2004); Treasury Malaysia, *Economy Report: 2004/2005* (2005); Treasury Malaysia, *Economy Report: 2005/2006* (2006); Treasury Malaysia, *Economy Report: 2006/2007* (2007).

83 See Abdul-Jabbar and Pope, above n 73 for a more detailed explanation.

84 Long and Swingen above n 9; John Hasseldine and Zhuhong Li, 'More Tax Evasion Research Required in New Millennium' (1999) 31 *Crime, Law and Social Change* 91; Benno Torgler, *Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis* (2007).

85 Long and Swingen, above n 9.

suggest that one method is better than the other.⁸⁶ As a result, Susan Long and Judyth Swingen urged tax researchers to focus on specific types of noncompliance behaviour. Overall, self-reporting is the most common method employed in tax compliance research.⁸⁷ Self-reporting is often carried out either by requiring responses to self-reported evasion behaviour,⁸⁸ hypothetical tax scenarios⁸⁹ and/or both.⁹⁰ Recently, from another perspective, Benno Torgler identifies the issue of measuring compliance behaviour in a single question or a series of questions.⁹¹ Throughout his research on tax compliance, he has used a single question to measure tax morale in several non-US countries. Despite a possible bias in a single type of question, he argued that associated problems with the development of a series of questions, such as complexity, is possibly reduced. More importantly, he highlighted the benefits of focusing on specific tax compliance behaviour.⁹²

Recognising this contextual background, the current study adopted a self-reporting approach, measuring two specific types of noncompliance behaviour via two independent hypothetical tax scenarios. Both tax scenarios dealt with a self-employed business situation⁹³ and required both indirect and direct responses for each scenario.⁹⁴ The respondent's view was used as a proxy for managerial preferences in the SMEs. For an indirect (i.e. third person) response, respondents were asked to judge the probability of noncompliance behaviour of the person (third person) described in the scenario. As for a direct (first person) response, respondents were asked to indicate the extent of their agreement and/or disagreement, via a five-point Likert scale, between strongly disagree (1) and strongly agree (5), to the possible action of noncompliance behaviour of the person described in the scenario. The higher scores indicate noncompliance behaviour and lower scores indicate otherwise.

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- 86 Henk Elffers, Henry Robben and Dick Hessing, 'Under-reporting Income: Who is the Best Judge — Tax-payer or Tax Inspector?' (1991) 154 *Journal of the Royal Statistical Society: Series A — Statistics in Society* 125. See Long and Swingen, above n 9, for a comprehensive discussion of all three approaches.
- 87 Hasseldine and Li, above n 84; Long and Swingen, above n 9; Elffers, Robben and Hessing above n 86; Fischer, Wartick and Mark, above n 7. However, in the context of the corporate taxpayer, its seems all five earlier studies conducted in the US were based on IRS audit data: Hanlon, Mills and Slemrod, above n 23; Joulfaian, above n 23; Mills, 'Book-tax Differences and Internal Revenue Service Adjustments', above n 23; Rice, above n 22; Kamdar, above n 22; Mills, 'Corporate Tax Compliance and Financial Reporting', above n 23.
- 88 Hank Elffers, Russell Weigel and Dick Hessing, 'The Consequences of Different Strategies for Measuring Tax Evasion Behavior' (1987) 8 *Journal of Economic Psychology* 311; John Hasseldine, Steven Kaplan and Lori Fuller, 'Characteristics of New Zealand Tax Evaders: A Note' (1994) 34 *Accounting and Finance* 79; Michael Wenzel, 'Motivation or Rationalisation? Causal Relations between Ethics, Norms and Tax Compliance' (2005) 26 *Journal of Economic Psychology* 491.
- 89 Ian Wallschutzky, 'Possible Causes of Tax Evasion' (1984) 5 *Journal of Economic Psychology* 371; John Hasseldine and Peggy Hite, 'Framing, Gender and Tax Compliance' (2003) 24 *Journal of Economic Psychology* 517; George Violette, 'Effects of Communicating Sanctions on Taxpayer Compliance' (1989) 11(1) *Journal of the American Taxation Association* 92.
- 90 John Hasseldine, 'Gender Differences in Tax Compliance' (1999) 3(2) *Asia-Pacific Journal of Taxation* 73; Paul Webley, Michaela Cole and Ole-Petter Eidjar, 'The Prediction of Self-reported and Hypothetical Tax-evasion: Evidence from England, France and Norway' (2001) 22 *Journal of Economic Psychology* 141; Michael Wenzel, 'The Impact of Outcome Orientation and Justice Concerns on Tax Compliance: The Role of Taxpayers' Identity' (2002) 87 *Journal of Applied Psychology* 629.
- 91 Torgler, above n 84.
- 92 Ibid 9.
- 93 Prior studies tend to provide a hypothetical scenario in the context of the self-employed, additional cash income or work-related expenses. As for the self-employed, see, eg, Steven Kaplan, Kaye Newberry and Philip Reckers, 'The Effect of Moral Reasoning and Educational Communications on Tax Evasion Intentions' (1997) 19(2) *Journal of the American Taxation Association* 38; Erich Kirchler and Boris Maciejovsky, 'Tax Compliance within the Context of Gain and Loss Situations, Expected and Current Asset Position, and Profession' (2001) 22 *Journal of Economic Psychology* 173. As for additional cash income, see, eg, Violette, above n 89; Hasseldine and Hite, above n 89. For work-related expenses, see Peggy Hite and Gary McGill, 'An Examination of Taxpayer Preference for Aggressive Tax Advice' (1992) 45 *National Tax Journal* 389; Wenzel, above n 88. Arguably, noncompliance is often widespread in these circumstances, mainly in a self-employed situation: Wallschutzky, above n 89; Violette, above n 89. Since the current study involves the tax behaviour of the business sector, the self-employed context seems more appropriate.
- 94 A combination of both direct and indirect measures to mitigate the sensitive nature of such research was recommended by Kaplan, Newberry and Reckers, above n 93. The direct response was of primary use, but the indirect response was sought first to mitigate the sensitive nature of the questions. As expected, the direct and indirect responses were positively correlated. Hence, the direct response was used in the current study. The earlier Malaysian study also used a similar response category. See, eg, Kasipillai et al, above n 59; Ramasamy et al, above n 58.

The hypothetical scenarios are reproduced in Appendix B, with each scenario involving a single transaction of RM10 000 worth of gross consideration. Specifically, for the underreporting scenario, respondents were presented with a situation whereby a self-employed taxpayer is considering not reporting his/her cash sale of RM10 000 as part of his/her business income. As for overstating deductions, respondents were given a situation where a self-employed taxpayer is considering claiming the costs of repairing a personal vehicle that is not used in his/her business. It is worth emphasising that the legal tax treatment of both situations was stated in both scenarios. It was also stated that, almost certainly, the IRB would not audit them. Both of these statements were included in order to control for the perceived probability of detection and audit.⁹⁵ The result is shown in Table 5.

Table 5: Respondents' Views towards Noncompliance Behaviour

	Understatement of Income		Overstatement of Deductions	
	Number of Respondents	Percentage	Number of Respondents	Percentage
Strongly Disagree	61	35.5	41	23.8
Disagree	41	23.8	30	17.4
Neutral	39	22.7	50	29.1
Agree	22	12.8	31	18.0
Strongly Agree	9	5.2	20	11.6
Total	172 ^a	100.0	172 ^a	100.0 ^b

^a N equals 172. There were three missing values.

^b Does not add up to 100 due to rounding.

Table 5 shows that almost 60 per cent of the respondents indicated that they either 'strongly disagree' or 'disagree' with the possible action of underreporting behaviour, suggesting more compliant behaviour. Another 23 per cent were indifferent. Overall, respondents were inclined towards compliance. As for overstating deductions, around 41 per cent of the respondents indicated that they either 'strongly disagree' or 'disagree' with the possible action of overstating deductions, suggesting compliant behaviour. About 29 per cent were indifferent. The remaining 30 per cent tended to support overstating deductions. Broadly, relatively more respondents (60 per cent) were compliant in reporting behaviour compared to overstatement of deductions (41 per cent). Nonetheless, an overall mean score of 2.28 and 2.76 (out of 5) for income underreporting and overstating deductions respectively indicates that the large majority of SMEs are likely to show compliant or neutral behaviour.

Further, respondents were asked to indicate their view on the possibility of not complying with only part of the RM10 000 stated for both scenarios (refer Appendix B, question c). The specific amount was not stated but left to the respondent to judge, which mathematically could be worth less than RM10 000. Respondents were given three options (yes, no and unsure) on the likely noncompliance of the person stated in the scenario. The results of the possible partial noncompliance are shown in Table 6.

⁹⁵ The approach is similar to that of Hasseldine, above n 90; Hasseldine and Hite, above n 89.

Table 6: Respondents' view towards partial Noncompliance Behaviour

Possibility of noncompliance	Partial Understatement of Income		Partial Overstatement of Deductions	
	Number of Respondents	Percentage	Number of Respondents	Percentage
Yes	41	23.8	52	30.2
No	66	38.4	72	41.9
Unsure	65	37.8	48	27.9
Total	172 ^a	100.0	172 ^a	100.0

^a N equals 172. There were three missing values.

Table 6 indicates that the highest percentage of respondents, i.e. 38 per cent and 42 per cent for understating and overstating behaviour respectively, rejected the possibility of partial noncompliance. On the other hand, nearly 24 per cent and just over 30 per cent of the respondents said that there was a possibility of partial noncompliance behaviour for income understating and deduction overstating behaviour respectively. In contrast to noncompliance involving the full amount of the gross transaction (refer Table 5 above), relatively more respondents were likely to comply in terms of partial deductions rather than partial income reporting. The result is as expected since partial noncompliance, mainly with regards to deduction, could be exposed to a much higher risk of detection during tax audit. As for income reporting, some caution is necessary as 'unsure' responses in the sample were about equal to compliant SMEs (both 38 per cent).

D. Relationship between Compliance Costs and Compliance Behaviour

The relationship between mean compliance costs and compliance behaviour was assessed. For this purpose, those SMEs who responded 'strongly disagree' and 'disagree' were categorised as compliers, SMEs who indicated 'strongly agree' and 'agree' were categorised as noncompliers and the 'neutral' responses maintained as indifferent.⁹⁶ Table 7 presents the mean compliance costs by both the underreporting of income and overstating of deductions respectively.

Table 7: Mean Compliance Costs by Type of Noncompliance Behaviour

	Understatement of Income	Overstatement of Deductions
	Mean (RM)	Mean (RM)
Complying SMEs	9620	9293
Noncomplying SMEs	10 269	9389
Neutral	7424	9010
Overall ^a	9239	9239

^a The costs are less than the overall compliance costs reported in Table 4 due to three missing values.

Table 7 shows that complying SMEs with likely reporting behaviour tend to have lower compliance costs (i.e. RM9620) than those with likely noncomplying behaviour (i.e. RM10 269). Surprisingly, those with neutral responses have the lowest costs. The results seem to suggest that SMEs with higher compliance costs possibly tend to not comply in terms of income reporting. However, mean comparisons by way of t-test does not indicate any

⁹⁶ The recoding is necessary so as to address low responses in the 'strongly agree' category. See Table 5 for actual responses. A number of previous studies, both internationally (see, eg, Webley, Cole and Eidjar, above n 90; Torgler, above n 84) and in Malaysia (see, eg, Hanefah, above n 57; Kasipillai et al, above n 59; Abdul Manaf, above n 57), have used this approach in analysing responses.

significant association between compliance costs and understatement of income.⁹⁷ On the contrary, no clear trends in compliance costs are noticeable in the case of overstating deductions, suggesting about the same as the overall mean compliance costs regardless of their tax behaviour. The statistical t-test⁹⁸ suggests a lack of a significant relationship between overstatement of deductions and compliance costs.

Similarly, the relationship between compliance costs and compliance behaviour was also investigated for noncompliance involving part of the RM10 000. A similar finding was observed in terms of partial noncompliance as shown in Table 8.

Table 8: Mean Compliance Costs by Partial Noncompliance Behaviour

	Understatement of Income	Overstatement of Deductions
	Mean (RM)	Mean (RM)
Complying SMEs	7794	8884
Noncomplying SMEs	10 609	9690
Neutral	8760	8948
Overall ^a	9239	9239

^a The costs are less than the overall compliance costs reported in Table 4 due to three missing values.

Table 8 indicates that likely complying respondents with regard to both reporting and deduction behaviour have lower compliance costs than those who are likely not to comply. Possible reasons for this trend are discussed in the following section, Part VII.

Overall, having observed a lack of a statistically significant relationship between compliance costs and possible compliance behaviour independently, for both compliance situations,⁹⁹ it is important to analyse noncompliance behaviour at the SME level. For this purpose, only respondents with likely compliance behaviour with regard to both underreporting and overstating situations are categorised as complying SMEs. Noncomplying SMEs are those respondents with noncompliance to one or both situations. Additionally, there are also SMEs who chose to be indifferent for both noncompliance situations. Compliance costs by these classifications are summarised and presented in Table 9.

Table 9: Mean Compliance Costs by Both Noncompliance Behaviours

	Mean (RM)	Number of Respondents
Complying SMEs	9776	60
Noncomplying SMEs	9233	88
Neutral	7919	24
Overall	9239 ^a	172

^a The costs are less than the overall compliance costs reported in Table 4 due to three missing values.

Table 9 shows that although complying SMEs seem to have relatively higher compliance costs than noncomplying SMEs, the margin is reasonably small, i.e. less than six per cent. However, the result is somewhat contrary to the earlier compliance costs analysis by specific types of noncompliance,¹⁰⁰ which indicates relatively lower compliance costs for reporting behaviour. Nonetheless, the statistical t-test also suggests no association between compliance costs and compliance behaviour at the SME level.¹⁰¹ Thus the study does not

97 At the five per cent significant level.

98 At the five per cent significant level.

99 Whether measured for the full (i.e. RM10 000) and/or part of the amount for each tax situation.

100 See Tables 7 and 8.

101 At the five per cent significant level.

indicate any significant relationship between compliance costs and likely compliance behaviour.

Apart from comparing mean compliance costs by compliance behaviour, it is also possible to measure the overall relationship between compliance costs and compliance behaviour by way of correlation analysis. For this purpose, responses received were left in the original form of a five-point Likert scale. The correlation coefficient for income underreporting behaviour and deductions overstating behaviour are +0.002 and +0.009 respectively, suggesting a very weak direct association between compliance costs and both noncompliance behaviours. This suggests that an increase in compliance costs would probably lead to noncompliance behaviour. Though the direction of both relationships is as expected, the study fails to provide any statistical significance.

VII. DISCUSSIONS AND IMPLICATIONS

This research suggests that there is no association between compliance costs and the likely tax compliance behaviour. There are several possible explanations for this finding. The study focuses on SMEs only, which are homogeneous in nature. As discussed earlier, Rice found no relationship between firm size and tax compliance of medium-sized corporations in the US. On the other hand, Hanlon, Mills and Slemrod found larger firms were less compliant than smaller firms and medium-sized businesses had the lowest rate of noncompliance, suggesting that corporate tax noncompliance was U-shaped. Thus, it is possible that there may be a significant association between compliance costs and compliance behaviour among different business sizes, i.e. small, medium and large. Arguably, the present study is more robust as it analysed data at the disaggregate level.

Further, this paper focuses on the bivariate analysis between compliance costs and compliance behaviour, without taking into account the combined effect of other factors, such as perception towards a number of tax aspects, including tax fairness, tax complexity, tax rate, tax morale and other businesses characteristics (including size, as stated above). Prior studies, mostly in the context of individuals, including business taxpayers, have examined the determinants of tax compliance behaviour by incorporating a number of factors in their studies.¹⁰² A multivariate analysis may be useful, but such analysis is beyond the focus of this paper and, thus, not considered further.

A lack of relationship between compliance costs and likely compliance behaviour is also possibly due to a number of reasons, including methodological aspects of the current study. First, as the current study involves a sensitive area of taxation, it is not known to what extent the respondents were honest in demonstrating their possible compliance behaviour. Secondly, the survey is specifically addressed to a person who is expected to have financial and accounting knowledge in the company. However, the extent to which the survey was completed by them is not known. Thirdly, compliance costs are derived based on estimates gathered through self-reporting surveys. As largely acknowledged in the literature, compliance cost estimates are merely a measure of the magnitude of compliance costs.¹⁰³ Valuation of internal time is a possible area of error. This study categorises staff into four groups: manager/accountant, accounting staff, administrative staff and other staff. The borderline between income tax compliance work and other work may not be easily understood by respondents. Further, it is possible that respondents were not able to recall their internal time spent correctly. It is likely that the other two cost components of compliance costs (i.e. external and additional costs) are much more straightforward monetary costs to estimate.

¹⁰² For a complete review, see especially Jackson and Milliron, above n 2; Fischer, Wartick and Mark, above n 7, Richardson and Sawyer, above n 3; Torgler, above n 84.

¹⁰³ Sandford, Godwin and Hardwick, above n 13; Sandford, above n 77.

Fourthly, the survey questionnaire used in the current study may not be able to measure compliance behaviour perfectly,¹⁰⁴ or it may be interpreted differently by the respondents. This includes the wording of questions, in particular the hypothetical tax scenarios, and the value attached to a transaction. There may be a need for more types of transactions and scenarios. Nonetheless, this may significantly affect the response rates and the quality of the responses, particularly in mail surveys. The current study integrates tax compliance costs and tax behaviour into a single study, and in this regard is one of the first of its kind. The generalisability of the results into SME companies in other tax jurisdictions may be subject to further study; more importantly, additional caution is necessary as different measures apply in defining the SME sector.

VIII. CONCLUSION

This paper explores the relationship between tax compliance costs and compliance behaviour in the context of corporate SMEs in Malaysia. The study extends the scope of taxpayer compliance research to the area of corporate income taxation, and the survey used builds upon previous tax compliance studies of individual and business taxpayers. It is possibly the first of this nature and, more importantly, was carried out in the context of SAS.

This paper has shown average income tax compliance cost estimates of RM9295 per SME companies for the tax year 2006. As for compliance behaviours, this study, at least as measured by two independent hypothetical tax scenarios, shows that comparatively more SME companies are compliant towards reporting behaviour rather than to the correctness of their deductions. This finding also indicates that noncompliance through overstatement of deductions probably needs further attention in the Malaysian SME context. The findings of this study did not indicate any statistically significant relationship between tax compliance costs and the compliance behaviour of SMEs, measured both in terms of noncompliance type and/or at the SME level. The findings, therefore, are likely to be useful to tax policymakers when designing strategies to encourage and improve compliance. Despite no evidence being found of a relationship between tax compliance costs and compliance behaviour, the IRB could continue its effort to further simplify business income tax as this would enhance voluntary tax compliance. The simplification of the income tax system is also expected to eventually minimise tax compliance costs.

Despite the limitations discussed earlier, this study is likely to act as a base for future compliance research as no prior empirical studies have specifically explored the relationship between compliance costs and compliance behaviour. It is important, however, for the results to be interpreted with some caution as the survey is based on hypothetical tax behaviours. It is possible that actual behaviour may differ from the current study for a number of reasons. For example, the amount of money involved may have some influence on possible behaviour. Therefore, future studies could be extended to include a range of amounts and other types of tax evasion behaviours, and consider large companies and self-employed taxpayers. Future research to analyse compliance behaviour through other methods, mainly tax audits, and/or experiments, is strongly recommended as well.

¹⁰⁴ It must be emphasised that the survey measured attitudes towards potential tax behaviour, rather than actual tax behaviour.

APPENDIX A: REFERENCE LIST OF TAX COMPLIANCE STUDIES IN
MALAYSIA 1994 – 2008

(in chronological order)

Che Ayub, Siti Mariam, *Tax Administration Reform for the Malaysian Inland Revenue Department with an Adaptation of the Voluntary Compliance Function* (DPA Dissertation Thesis, Golden Gate University, 1994).

Hanefah, Mustafa, *An Evaluation of the Malaysian Tax Administrative System and Taxpayers' Perceptions towards Assessment Systems, Tax Law Fairness, and Tax Law Complexity* (PhD Thesis, Universiti Utara Malaysia, 1996).

Kasipillai, Jeyapalan, *Aspects of the Hidden Economy and Tax Non-compliance in Malaysia* (PhD Thesis, The University of New England, 1997). Also partly published as: Kasipillai, Jeyapalan, and Baldry, Jonathan, 'What Do Malaysian Taxpayers Know?' (1998) February *Malaysian Accountant* 2; Kasipillai, Jeyapalan, 'Overview of Malaysian Tax System: An Examination of Deliberate Non-compliance' (1999) June *Akauntan Nasional* 44; Kasipillai, Jeyapalan, Baldry, Jonathan and Rao, Prasada, 'Estimating the Size and Determinants of Hidden Income and Tax Evasion in Malaysia' (2000) 8(2) *Asian Review of Accounting* 25.

Tayib, Mahamad, *The Determinants of Assessment Tax Collection: The Malaysian Local Authority Experience* (PhD Thesis, University of Glamorgan, 1998).

Kasipillai, Jeyapalan et al, 'Are Malaysian Taxpayers Prepared for the Self Assessment System?' (1999) September *Tax Nasional* 9.

Singh, Veerinderjeet, *Tax Compliance and Ethical Decision-making: A Malaysian Perspective* (2003).

Abdul, Mohani, *Income Tax Non-compliance in Malaysia* (2003).

Kasipillai, Jeyapalan, Aripin, Norhani and Amran, Noor Afza, 'The Influence of Education on Tax Avoidance and Tax Evasion' (2003) 1 *eJournal of Tax Research* 134.

Ramasamy, Mottiakavander et al, 'Factors Influencing Compliance Behaviour of Small Business Entrepreneurs' (2003) 12(1) *Tax Nasional* 20.

Kasipillai, Jeyapalan, Mat Udin, Noraza and Zainol Arifin, Zaimah, 'How Do Moral Values Influence Tax Compliance Behaviour? Findings from a Survey' (2003) June *The Chartered Secretary Malaysia* 10.

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APPENDIX B: HYPOTHETICAL TAX SCENARIOS

Scenario 1: Underreporting of Income

Read the following and kindly indicate your opinion (by way of a tick) to the following scenario based on your experience:

Mr A, a self-employed businessman, is considering not including a cash sale of RM10 000 as his business income in his 2006 tax return. Legally, the cash receipts of RM10 000 should be included as business income. However, he is almost certain that the tax authority will not audit him and would not know if the amount is not reported.

- a) What is the probability that Mr A will **not** report the RM10 000 of cash sale on his business income?

10%	20%	30%	40%	50%	60%	70%	80%	90%	100%

- b) Taking into account all known and likely business circumstances, to what extent do you agree with Mr A's possible action of not reporting the cash sale of RM10 000 as his business income?

Strongly Disagree 1 2 3 4 5 Strongly Agree

- c) Would he be likely to report only part of the RM10 000 as business income?

Yes No Unsure

Scenario 2: Overstatement of Deductions

Read the following and kindly indicate your opinion to the following scenario based on your experience:

Mr B, a self-employed businessman, had incurred RM10 000 to repair his personal van. In preparing his 2006 tax return, he is thinking about claiming the costs of repair as if the van was used in his business. Legally, such a claim is not allowable, but he is almost certain that he will not be audited and that the tax authority would not be able to detect the deduction.

- a) What is the probability that Mr B will claim the RM10 000 cost of repair as his business deduction?

10%	20%	30%	40%	50%	60%	70%	80%	90%	100%

- b) Taking into account all known and likely business circumstances, to what extent do you agree with Mr B's possible action of claiming RM10 000 as his business deduction?

Strongly Disagree 1 2 3 4 5 Strongly Agree

- c) Would he be likely to deduct only part of the RM10 000 as a business deduction?

Yes No Unsure