

CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

In this chapter, this study undertakes a review of the theoretical and empirical literature of tax compliance that discusses the factors and variables which contribute to tax compliance or non-compliance as well as the various approaches or suggestions to increase compliance among taxpayers. Even though the literature on tax compliance has experienced explosive growth in the past 25 years, the vast majority of this work has focused on individuals and on compliance with the personal income tax rather than on indirect taxes compliance and compliance with other taxes.

Thus, this study attempts to focus on indirect taxes compliance in which the scope is limited to the Customs duties and Service tax. Since there is limited literature on compliance in indirect taxes, this study also employs the literature on direct taxes. It must be noted also that most of the literature on tax compliance are work of researchers in developed countries like United States and United Kingdom. In Malaysia, the only known researches on tax compliance are Loh et.al (1997), Kassipilai (1997), Marina (1997), Karrupiah (2001) and Abdul, M. (2001).

Kassipilai (1997) argued that both researchers and policy makers are becoming increasingly aware that non-compliance of tax laws is a behavioural problem that seriously threatens the capacity of government to raise revenue. Abdul, M. (2001) found that it was important for tax administration to understand taxpayers' perceptions towards income tax, so that the tax office can provide suitable strategies in enhancing voluntary compliance besides introducing effective strategies in combating non-compliance.

First, it would be useful to provide a brief distinction between tax non-compliance, tax evasion and tax avoidance though in the literature of tax compliance, most writers define non-compliance to include both evasion and avoidance. This seems to put extraordinary pressure on the definition of compliance.

2.2 DEFINITION OF TAX COMPLIANCE, TAX EVASION AND TAX AVOIDANCE

The definition of compliance given by Roth et.al (1989) is:

“Compliance with reporting requirements means that the taxpayers files all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the internal revenue Code, regulations and court decisions applicable at the time the return is filed”.

While James and Wallschutzky (1995) define compliance in terms of the degree to which the taxpayers comply with the tax law and administration without the need for enforcement activity. Thus, non-compliance might be defined simply as the failure of taxpayers to act in accordance with the statutory requirements or intentions of tax law and administration without the application of enforcement activity. It has been said that the degree of non-compliance can be measured in terms of the tax gap i.e. the difference between actual revenue and that which would be received if there were 100% compliance. James and Wallshutzky also emphasize the importance of timing, even though the late payment of tax liability will satisfy the tax gap measure, they do not represent full compliance.

It seems that there is no generally accepted definition of taxpayer compliance, however the definition given by Roth et al clearly encompasses both intentional and unintentional non-compliance. Kinsey (1985) has defined non-compliance as the failure, intentional or unintentional of taxpayers to meet their obligations. In some instances it may result from inadvertent memory lapses, calculation errors or inadequate knowledge of tax laws. By contrast tax evasion is a more

restrictive term that excludes unintentional non-compliance resulting from memory lapses, calculation error, inadequate knowledge of tax laws and the like.

Tax evasion can be defined as "Acts in contravention of one law to reduce or totally eliminate tax liability that he or she will be bound to pay". For example, omitting income, over claiming deduction, failing to lodge a return, false invoices, payments in cash and hidden bank accounts. Brown (1983) noted that tax evasion is immoral as it is illegal.

Tax avoidance on the other hand is legal and uses the tax loopholes in the law in order to reduce tax liability. Tax avoidance is the achievement of a similar end by means which are within the law. However according to Wallschutzky (1984), tax avoidance can be within the letter of law and within the spirit of the law or it can be within the letter of law but against the spirit. In other words, tax avoidance may be of the acceptable or unacceptable kind. Nevertheless it can be concluded that whether there are intentional or unintentional non-compliance or different from the legal point of view, they have similar results that cause a reduction in government revenues.

Tax evasion has wide consequences to governments as it not only causes losses in current revenue but also fosters threat to voluntary compliance (Clotfelter, 1983). Researchers and tax administrators believe that voluntary compliance is a prime element of an efficient tax system whereby it fosters citizen's respect for the government and the tax administrative system (Rowen, 1969; Wallschutzky, 1991).

2.3 FACTORS AFFECTING NON-COMPLIANCE

Fisher, Warwick and Mark (1992) noted that much of the research on taxpayer compliance is based upon a financial interest model derived from Becker's (1967) economics of crime approach. This approach assumes that individuals maximize the expected utility of the evasion by weighing the uncertain benefits of successful evasion against the risk of detection and punishment. According to this model, the tax rate, detection probability and penalty structure determine the monetary cost of compliance which drives compliance behaviour.

However empirical research suggests that determinants of taxpayer compliance are far more numerous than implied by financial interest model and that the relationship among these variables are not straightforward. A comprehensive review of the compliance literature identified 14 key variables that have been commonly addressed by researchers and linked to measures of taxpayer compliance (Jackson and Milliron, 1986). These variables can be broadly categorised into four types.

1. Demographic (e.g. age and gender)
2. Those that proxy for non-compliance opportunity (e.g. education, income level, income source and occupation)
3. Attitudinal (e.g. ethics, perceived fairness of tax system, peer influence)
4. Structural (e.g. complexity of tax system, sanctions, tax rates and detection probability)

A knowledge of these factors or determinants would be useful in pinpointing areas or situations where non-compliance is more likely and adopting the proper measures to address them. Most of the attention in the compliance literature has been devoted to why some taxpayers do not comply rather than why others do so. Loftus (1985) noted that to appreciate the problem of tax evasion in a policy context, tax authorities need to know not only how people cheat and by how much but also why they cheat. Tackling the policy problems

of tax evasion requires at least some understanding of the factors underlying the individual's decision to pay or evade his taxes. (Singh, 1996)

Demographic factor

Personal characteristics of taxpayers like age and gender are found to affect evasion behaviour. Mason and Calvin (1978) found that taxpayers who were young males with low income and believed their chance of getting caught was low was the highest to engage in evasion behaviour.

Source of income and occupation

Source of income refers to the type or nature of the income item while an occupation is generally defined as an individual's employment or earnings activity. From the study by Madeo et al (1987) it was shown that the source of income is a critical variable in deterring compliance. Evidently, taxpayers are much more likely not to report income they feel cannot be traced than income which is subjected to third party reporting.

Findings from past research shows that the self employed and others whose income are not subject to withholding tax and those who are of higher educational levels have greater opportunity to evade taxes by hiding their incomes. (Vogel, 1974; Mason and Calvin, 1978; Groenland and Veldhoven, 1983)

Tax ethics

Taxpayer ethics is a nebulous concept to define. Ethics are generally understood to describe moral principles or values held by individuals. (Jackson and Milliron, 1986). Song and Yarbrough (1978) define tax ethics as "the norms of behaviour governing citizens as taxpayers in their relationship with the government".

Even though it is difficult to observe the relationship between tax attitudes and behaviour, numerous researchers have asserted the importance of attitudes on taxpayer compliance behaviour (Spicer, 1986; Milliron and Toy, 1988 and Hite, 1988). According to Etcheberry (1992, p.307) if people believe that tax evasion is unethical, tax compliance will be high despite low odds of being detected or low penalties. For this reason, government as well as social, religious and political organisations should take it upon themselves to ensure that tax evasion is considered unethical.

Perceived fairness of tax system

The perception about the fairness of the tax system also determines willingness to pay taxes. Jackson and Milliron (1986) classified tax fairness into 2 dimensions. One dimension appears to involve the equity of the trade (the benefits received for the tax dollars given). The other dimension appears to involve the equity of the taxpayer's burden in reference to that of other individuals. Taxpayers are less compliant when they perceive the tax system to be unfair.

Spicer and Becker (1980) found that the amount of taxes evaded increases when people are told that their tax burden is higher than that of the rest of the group. A survey conducted by Hite (1986) found that 95% of the taxpayers in US thought their taxes were too high compared to the benefits and services they received from the federal government.

Peer influence

It has also been noted that non-compliance is positively related to the taxpayer's knowledge of other people practicing evasion. Peers can be loosely defined as a taxpayer's associates. These associates may be reasonably expected to include friends, relatives, acquaintances and co-workers (Jackson and Milliron, 1986).

Several studies showed that people's compliance was correlated with their estimate of other people's non-compliance (Bosco and Mittone, 1997; De Juan, Lasheras and Mayo, 1994; Kaplan and Reckers, 1985; Webley, Robben and Morris, 1988). According to Wenzel (2001), taxpayers might perceive or hear about others violating tax laws and assume they do so because they endorse the norm that some degree of tax non-compliance is acceptable, while they themselves may be noncompliant mainly out of conformity with this norm.

Complexity of tax laws

Complexity of the tax laws may deter people from fully understanding their responsibilities and the procedures for compliance. In certain cases, even tax enforcers are confused by such complexity causing incomplete, improper or conflicting application of tax laws. Most of the compliance literature suggests that if the tax laws are made simple so it can be understood by all taxpayers then it would encourage voluntary compliance on the part of taxpayers.

In the Hite study (1986), 76% of respondents reported the tax system was complex. Other researchers also agreed that a possible factor to tax evasion behaviour is the complexity of the tax legislation. (Milliron, 1985; Madeo, Shepanski and Uecker, 1987; Beck and Jung, 1989)

Tax rate

Several researchers have examined the association between tax rates and taxpayer non-compliance. However findings from prior empirical researches offer a mixed result that increasing the tax rates either has a negative or positive effect on compliance. Boylan and Sprinkle (2001) observe that the positive or negative relationship between tax rates and compliance depends upon the manner in which taxable income is obtained (endowed or earned). They find that when income is endowed, participants respond to a tax rate increases by reporting less taxable income. In contrast, when income is earned, participants respond to a tax rate increases by reporting more taxable income.

A survey carried out by Milliron(1988) revealed that a majority of certified public accountants viewed a reduction in the tax rates to be the most important feature for increasing compliance. Findings from Alm et al. (1990) shows that individuals will increase their tax compliance if tax rates are lower. A study by Friedland et al. (1978) also found that an increase in the tax rate increases both the probability of underreporting of income and the level of underreporting.

There is a direct relationship between the level of duties and the extent of smuggling. If the duties are low, the gains from smuggling are limited and a low tariff country has virtually no smuggling problem. (Due, 1988). Fisman and Wei (2001) study the responsiveness of tax evasion to the tax rates by comparing the values that China reports as import from Hong Kong with what Hong Kong reports as exports to China. The findings show that tax evasion occurs mostly at higher tax rates. They found on average, a 1% increase in the tax rate is associated with a 3% increase in evasion.

Probability of being detected

Findings from Mason and Calvin (1978) show that the highest correlation with admitted evasion was perceived probability of not being caught. Schmolders (1970) found that a very weak control system where the probability of detecting evasion was very low resulted in a deterioration of taxpayers' attitudes. However if the control system was too tight (i.e. compliance was only achieved with oppressive administration), it achieved its goal only at the expense of heavy confrontation with taxpayers. Schmolders works on the intensity of confrontation indicated that greater fear of being caught might increase taxpayers' willingness to comply, on the other hand, but might also reduce the cooperation. The precise effect of increased confrontation with taxpayers might cause some taxpayers to comply rather than evade and it might cause others to evade rather than to comply.

Spicer and Hero (1985) also found that the experience of being audited appeared to improve compliance. This was also supported by the study carried out by Webley, Morris and Amstutz (1985) that a higher audit probability produced less evasion.

A study on indirect tax evasion by Marelli (1984) shows that the degree of interdependence between (1) the quantity produced and the amount of tax evaded; (2) the entrepreneur's decisions concerning both shifting and evasion of tax depends on the shape of the function of the probability of being detected. The results show that the entrepreneur evades the tax if he can and then shifts it onto consumers just as if he were not evading it.

Murray (1995) in his study on sales tax compliance also suggests that taxpayers with the greater opportunities to reduce their tax liabilities exploit these opportunities to their advantage. Murray noted that firms with higher levels of true gross sales might be expected to be less compliant due to firm scale and broader opportunities to underreport. The larger the scale of the firm's operation as measured by true gross sales, the greater the degree of taxpayer underreporting.

2.4 IMPROVING TAX COMPLIANCE

Prior tax compliance literature suggests that evasion or compliance is attributable to both economic and psychological factors which complement one another. In order to combat tax evasion or promote compliance, the government should implement policies and programs covering both economic and psychological responses (Hasseldine and Bebbington, 1991). Abdul, M. (2001) noted that 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.

Most taxation authorities around the world employ a mix of enforcement activities to encourage tax compliance. Among the responses to tax evasion that are being practiced all over the world include: audits, penalties and sanctions, use of informers, taxpayers education and services, amnesty program and positive incentives.

Despite all those factors, the taxpayer's behaviour to comply may also be motivated by religious, moral, cultural or social values. Pounder (1984) noted that compliant taxpayers maybe influenced by a sense of civic responsibility or social justice, by the benefits derived from the improvement in the amenities provided by the state or they may be motivated by fear of penalties that may be imposed for failure to comply. It may also be that taxpayers are motivated by any combination of factors such as those and some may be dauntingly motivated by any one of them.

Audits, penalties and sanctions

The principle underlying the attainment of compliance through enforcement and punishment is general deterrence (Blumstein, 1983). Deterrence theory predicts that as the levels of detection risk and penalty sanctions increase, compliance should also increase. By imposing sanctions or penalties on violators who are caught, the government is sending a message to others who are contemplating a violation that they too may suffer a similar fate.

While some evidence suggests that there is a positive relation between these factors and compliance, several researchers have concluded that the results are mixed (Witter and Woodbury, 1985; Roth et al., 1989; Fisher et al., 1992). According to Witter and Woodbury (1985), there was a relationship between the severity of sanctions and compliance but only for a specific group of taxpayers (those who had high incomes and were self employed). This suggests that we need to know much more about individual differences in the personal consequences of penalties and how those penalties are perceived.

Roth et al. (1989) conclude that there may be an interactive effect between detection risk and penalty sanctions on tax compliance. He suggests that increases in penalty sanctions may increase compliance when the perceived probability of detection is sufficiently high. The result of an individual and company being investigated too has shown that taxpayers generally disclose higher income after investigation. The consequences of the fear of being caught and punished for cheating is a strong deterrent and has helped create a favourable climate for increasing compliance. Affluent taxpayers as well as members of their families would be embarrassed by public knowledge of conviction for tax evasion.

Findings from a study by Sour (2002) show that increasing the probability of audit always increase compliance that is consistent with the Allingham and Sandmo model but penalty rates only increase compliance to a certain level. According to the traditional model of tax compliance by Allingham and Sandmo, taxpayers choose how much income to report on their tax returns by solving a standard expected utility maximization problem that trades off the tax savings from underreporting true income against the risk of audit and penalties for detected non-compliance. In this framework, both the threat of penalty and audit make people pay their taxes.

Carnes and Englebrecht (1995) noted that policymakers should consider methods by which perception of detection risk can be increased. They suggest that perception of detection risk may be increased through publicity campaigns which should be more cost effective than trying to increase actual detection risk level.

Use of informers

Few countries have a legislative basis for payment of rewards to informers. It appears that the United States and Malaysia are the only countries which have

a statutory basis for paying rewards to informers for information with respect to tax evaders. In Malaysia, section 141 of Customs Act 1967 stipulates that rewards will be paid to any officer or other person for services rendered in connection with the detection of smuggling cases or offences under this Act. The informers also will be protected from discovery in which the name and address and the substance of the information received from an informer will be kept secret. (Section 124A and section 125 of Customs Act 1967)

According to Le Baube (1992) though much of the information has little or no value and discarded quickly, but enough is valid to make such a system worthwhile. Public knowledge of such a system can be an effective deterrent.

Taxpayer education and service

It has been said that half of the compliance process depends on the taxpayer's awareness of his responsibility and his knowledge of the compliance process. Past surveys also reveal that taxpayers require more information than provided by the tax forms or returns. Those who did not consult other sources of information showed significant misunderstanding and inaccuracies (Vogel, 1974)

The American Bar Association Commission (1988) identified three key areas to promote compliance: informing citizens generally about their rights and responsibilities, providing forms and publications that are structured to make it easy to comply and assisting individual taxpayers. The main objective of taxpayer education programs is to inform taxpayers about their duties and obligations to comply with the tax laws (Kidder and Mc Ewen, 1989; Bird, 1992). Nagin (1990) observed that taxpayer education and assistance provided by the tax agencies could reduce compliance cost to taxpayers.

James and Wallschutzky (1995) noted that many taxpayers might be willing to comply in full but are unable to do so because they are not aware of or do not

understand their full obligations and even if such taxpayers understood their obligations they may not know how to meet them or may be unable to do so for other reasons. According to James and Wallschutzky, additional expenditure devoted in assisting such taxpayers either by informing or educating them might yield greater additional revenue than if it were to spent on additional enforcement activities.

As tax non-compliance may result from confusion or ignorance of tax laws, the design of taxpayer education programs should include the use of mass media to educate taxpayers. (Klepper and Nagin, 1989b; Roth et.al, 1989). Klepper and Nagin (1989b) also suggest that the design of a taxpayer education program should provide clear direction of what is required by law, by expressing for example the legal and moral obligation for every citizen to comply with tax laws.

Amnesty program

A tax amnesty program is a positive measure to combat evasion in societies. Taxpayers are allowed to correct past errors by voluntarily disclosing them without suffering penalties or sanctions or by allowing the taxpayers to pay previously delinquent taxes with reduced civil and criminal penalties (Mikesell, 1986)

Even though there are many arguments and conflicts of ideas between proponents and opponents of tax amnesties, there has been little empirical study on the impact of these programs on voluntary compliance. Alm, Mc Kee and Beck (1990) examined the long-term effects of a tax amnesty on voluntary compliance. Surprisingly, the findings show that the average level of compliance falls after an amnesty. According to Alm, Mc Kee and Beck (1990), a combination of amnesty and enforcement programs will be more effective in generating compliance than a change in enforcement or a tax amnesty alone.

Positive approach

Several researchers have suggested the concept of positive approaches for encouraging taxpayer compliance. Smith and Kinsey (1985) emphasized that the tax administration should shift from detection strategies to prevention strategies if the long-term goal of increased voluntary compliance is to be accomplished. A study by Schwartz and Orleans (1967) found that a moral appeal was more effective than an appeal to sanctions. Rather than emphasizing penalties, the government should explore positive approaches to increasing taxpayer compliance such as emphasizing where the taxpayer can get help. (Hite, 1989)

Smith and Stalins (1990) define positive incentives to include material rewards, factors which reinforce or increase satisfaction, pride, rectitude, feeling of fairness and the like. They also suggest that verbal rewards and respectful treatment are more effective in changing attitudes and behaviours than materialistic rewards. Verbal rewards can comprise simple items of appreciation such as a letter thanking taxpayers for their effort or compliance. Respectful treatment can involve several dimensions which include taxpayer service, polite treatment, having one's views heard and timely responses to request for help.

Le Baube (1992) also suggests that to increase the effectiveness in administration, the tax administration should make apology when the computer system is in error and sympathetic understanding when the taxpayer is correcting his error. Sour (2002) also concluded that the positive incentives are better to increase compliance than deterrence factors.

Conclusion

This chapter describes the different views of researchers regarding the compliance behaviour of taxpayers. A variety of variables affecting tax compliance and a few suggestions to increase tax compliance have been included in this study.