

## **The Compliance Costs of the Personal Income Taxation in Malaysia**

Noor Sharoja Sapiei\* and Mazni Abdullah\*\*

### **Abstract:**

*The paper examines the taxation compliance costs of the individual taxpayers in Malaysia. Two research questions are investigated in this study: (i) the compliance costs incurred by individual taxpayers and (ii) the preparer of tax returns. The survey was conducted between May 2, 2007 and July 31, 2007 where a total of 500 questionnaires were distributed to individual taxpayers in the region of Klang Valley in Malaysia. A total of 144 useable responses were received and used for the final data analysis. The findings from the survey provide pertinent and useful insights about the compliance costs of Malaysian individual taxpayers and the usage of tax agent for filing of tax returns. The results of the study indicate that the highest time spend was on record keeping. With regards to monetary costs, the highest cost spend was on the cost of hiring tax advisors. However, a large percentage of taxpayers still prepared their own tax returns. In all, the study found that the compliance costs of individual taxpayers in Malaysia were relatively low in term of the total monetary value.*

**Field of research: Taxation, Compliance Costs, Individual Taxpayers**

### **1. Introduction**

Sandford (1995) defined compliance costs as “The costs incurred by the taxpayers in meeting the requirements imposed on them by the law and the revenue authorities, over and above the actual payment of tax and over and above any distortion costs inherent in the nature of the tax.” Therefore, in order to comply with tax regulations, taxpayers need to incur not only the amount of tax payable but also other costs such as the costs of acquiring sufficient knowledge to meet their legal requirements; compiling the necessary receipts, completing tax returns or payments to the preparer of tax returns, incidental costs of postage, telephone and travel, dealing with tax auditors, and resolving disputes with tax authorities.

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\*Noor Sharoja Sapiei, Faculty of Business and Accountancy, University of Malaya,  
Email: [noorsharoja@um.edu.my](mailto:noorsharoja@um.edu.my) Phone: +603 79673903

\*\*Mazni binti Abdullah, Faculty of Business and Accountancy, University of Malaya  
Email: [mazni@um.edu.my](mailto:mazni@um.edu.my) Phone: +603 79673915

## **Sapiei & Abdullah**

In Malaysia, the introduction of Self Assessment System (SAS) for individuals in 2004 may have also impact the amount of compliance costs incurred. Introduction of SAS merely means that responsibility to calculate income tax now lies with the taxpayers. Although it seemed as a simple move, yet it has tremendous effect on the taxpayers as they are forced to learn how to better manage their tax affairs. Otherwise, taxpayers could hire the tax agent to settle their tax affairs.

The Inland Revenue Board (IRB) would be involved more in tax audit and tax investigation. In other words, taxpayers should be prepared to be visited by the IRB officer. According to Kasipillai (2007), with the introduction of SAS, it is anticipated that a large proportion of taxpayers, particularly the business community, would not complete their own returns, but get a tax agent or tax advisor to complete them on their behalf which will result in a higher compliance costs. Therefore, with the introduction of SAS, and increased audit activity compliance costs would have increased even further.

Research into taxation compliance costs have been the subject of growing interest and policy revamp in most developed countries. However, in developing countries research on compliance costs is limited and not well established. Furthermore, thus far very few published evidence on the taxation compliance costs in Malaysia is found. This paper aim to fill the gap and the paper focuses on compliance costs of individual taxpayers in Malaysia and the usage of tax agent for filing of tax returns.

### **Objectives and significance of the research**

In view of lack of research on compliance costs that are incurred by individual taxpayers in Malaysia, this study aims to examine the types of compliance costs incurred and the corresponding amount in terms of time spend and monetary cost incurred and the usage of tax agent.

Specifically, the objectives of the study are as follows:

- (i) the compliance costs incurred by individual taxpayers; and
- (ii) the usage of tax agent for filing of tax returns.

The findings of this study will provide information on the extent of cost incurred by individual taxpayers in complying with tax regulations. The information on compliance costs of individual taxpayer compliance costs would provide invaluable insights and inputs especially to the tax authorities in the formulation of tax policy.

**2. Literature Review**

Researched findings on individual tax compliance costs of developed countries are generally well established (see Table 1). In the US, literature on individual taxation compliance costs begin with the work of Wicks (1966) which concluded that compliance activities claim an average of 32 percent of state and 11.5 percent of federal tax revenues. Those with the highest compliance costs were the self-employed and individuals engaged in professional, managerial and sales occupation.

**Table 1: Individual Tax Compliance Costs Findings**

<b>Country</b>	<b>Author(s) [Year, Compliance Costs (%)]</b>
USA	Slemrod & Sorum [1984, 5-7] ; Hite & Sawyer [1994, 5.8]; & Slemrod [2005, 11.1]
UK	Sandford [1973, 1.9], Sandford et al [1989, 2.8], Sandford [1994, 2.21]
Australia	Pope & Fayle [1990,9.2], Pope [1994,9.2] & Evans et al [1997, 4.0]
Canada	Vailancourt [1989, 2.53]
Germany	Fischer [1989, 0.75]
Israel	Friedkes & Gavish [1989, 1.32]
Netherlands	Allers [1994, 1.4]
New Zealand	McCulloch [1992, 8.1]
Norway	Nicolaissen [1989, 2.7]
Sweden	Malmer [1994, 0.88]
Spain	Delgado & Diaz [1992, 3.3]
India	Chattopadhyay & Das Gupta [2002, 49]

\*The compliance costs is as percentages of tax revenue

In 1982, Slemrod and Sorum conducted a survey of Minnesota households and estimated compliance costs as 5 to 7 percent of income tax revenue. The survey is repeated by Blumenthal and Slemrod (1992) and concluded that the average time spend on compliance activities has increase from 21.7 hours to 27.4 hours. Both surveys indicated that on average, self-employed taxpayers spent nearly three times as much of their own time on tax compliance as other taxpayers and were twice as likely to use professional assistance to prepare their taxes.

## Sapiei & Abdullah

The most recent study by Slemrod (2005) estimated that total compliance costs for individuals amounted to \$85 billion in 2004 representing 11.1% of personal income-tax revenues. The most recent study by Moody (2005) also found that the compliance costs of individual's taxpayers were regressive, hitting lower-income individuals harder than higher-income individuals.

A series of studies by Sandford (1973), Sandford et al (1989) and Sanford (1994) in the UK found similar results as what is concluded in the US where compliance costs seemed to be borne more heavily by the self employed and the average compliance costs of low-income respondents, as a percentage of income, were greater than those of high-income people. The studies also found that compliance costs for the individual income tax to be 1.9 percent of revenues in 1973, 2.8 per cent in 1989 and 2.21 per cent in 1994. Studies on personal income tax in Australia found that the percentage of compliance costs becoming smaller through time. Pope et al. (1990) estimated compliance costs at 10.8 per cent, Pope (1995) at 9.2 per cent and 4.3 per cent of tax revenue by Evans et al. in 1997. For Canada, the studies found that the compliance cost as a percentage of tax revenue to be 2.53% and tax compliance costs were higher for the self employed.

The estimated compliance costs of individual taxpayers are found lower in studies done in several other developed countries. For example, Delgado and Diaz (1995) analyzed personal income-tax compliance costs in Spain using face-to-face interviews and found that compliance costs represented 3.3 per cent of tax revenues. The results from a study in Sweden indicated even lower compliance costs. Malmer (1994) examined the compliance costs of personal income taxes. He determined that compliance costs represented 1.0 per cent of tax revenues. Allers (1994; 1995) examined the compliance costs of personal income taxes and the wealth tax in the Netherlands using face-to-face interviews and drop-off questionnaires. Allers concluded that compliance costs for personal income taxes represented 1.4 per cent of personal income tax revenues.

Comparing compliance costs estimates is difficult due to differing tax systems and methodological differences (Hite and Sawyer, 1997). Anyway few attempts were made by researchers to arrive at comparable estimates. For example, Pope's (1994) compliance cost estimates of the Australian individual taxpayers of 9.2 per cent of tax revenue is comparable with 3.6 per cent for the U.K. (1983-84) hence concluded that compliance costs were higher in Australia than in the UK.

Research into compliance costs in developing countries is limited and not well established. Ott and Bajo (2000) in their paper presented the reasons or obstacles which include lack of experts; many experts overloaded by more pressing issues; no taxpayer associations and no civil initiatives. According to Klun (2004), possible reasons include a lack of interest by scholars; no co-operation from tax authorities; surveys in developing countries are not common and constant changes in tax systems.

## **Sapiei & Abdullah**

Despite these obstacles, there are few outstanding researches done in this area. In 2001 personal income tax was conducted in Slovenia and in 2004, a broad-based research into compliance costs was undertaken in Croatia. These studies found that the compliance costs are relatively low, primarily because most taxpayers consider filing their tax declaration to be a simple procedure and consultancy costs are low (Blazic, 2004).

Given the extensive nature of compliance costs studies undertaken in developed countries, and it is slowly becoming become prominent in developing countries, it is crucial that research into taxpayers compliance costs in Malaysia be pursued.

### **3. Methodology and Research Design**

Data was collected using postal questionnaire survey. Despite the approach's limitations such as non-response, postal questionnaire permits data to be collected from a representative sample across many industries and geographical regions (Hussey and Hussey, 1997). Five hundreds questionnaires were distributed to individual taxpayers in the region of Klang Valley in Malaysia. A total of 144 useable questionnaires were obtained and used for the final analysis representing a response rate of almost 29 per cent.

### **4. Discussion of Findings**

This section analyses the responses which represent a summary of the data to the survey questionnaires. Throughout this section the text should be read in relation to the relevant tables and figures. A short descriptive paragraph accompanies each table and figure.

#### ***4.1 Analysis of Respondents***

Table 2 shows the frequencies related to the characteristics of the sample taxpayers. Slightly higher percentages (58%) of respondents were male while 42 per cent were female of the total 144 respondents. The individuals participated in the survey were at their taxable working age as 91 per cent with age between 25 and 55 years old. The age ranging from 25 to 40 may represent the prime working age of working individuals where 61 per cent of respondents fall within this bracket. While the 41 to 55 years of age group may represent the upper management or business owner with a higher degree of income stability with 30 percent of respondents falls within this bracket. Therefore, it makes this study looking into the main contributor towards the tax authority's revenues

## Sapiei & Abdullah

In relation to our analysis with the respondent's age, level of income shows the same pattern. Almost 51 per cent earn between RM2,500 and RM5,000 while 28% earn more than RM5,000. However the educational attainment was generally average among respondent with just 33 per cent possessing a graduate degree and 10 per cent with master, PHD and other professional certificates. A large majority of respondents (72%) was employed with 27 per cent as a government servant. A little over one-quarter (28%) was self employed.

**TABLE 2: Profile of Respondents**

<b>Demographic Information</b>	<b>Total</b>	<b>Percent*</b>
<b>Gender:</b>		
Male	84	58%
Female	60	42%
<b>Age:</b>		
Below 25	1	1%
25 - 32	43	30%
33- 40	45	31%
41-48	23	16%
49 – 55	21	14%
Above 55	11	8%
<b>Race:</b>		
Malay	43	30%
Chinese	88	61%
Indian	11	8%
Others	2	1%
<b>Marital Status:</b>		
Single	42	29%
Married	102	71%
<b>Salary:</b>		
< RM2,500	30	21%
2,500 – 5,000	73	51%
5,001 – 7,500	22	15%
7,501 – 10,000	15	10%
> 10,000	4	3%
<b>Academic Qualification:</b>		
STPM & lower	57	40%
Diploma	24	17%
Bachelor	48	33%
Master/PHD/Prof	15	10%
<b>Occupation:</b>		
Self Employed	41	28%
Government servant	39	27%
Public sector	64	45%

\*Percentage is based on the total number of respondents, 144.

## Sapiei & Abdullah

Majority of respondents (61%) were Chinese, while only 30 percent of the respondents were Malays and Indian respondents with a small percentage of 8 percent. The remaining 1 percent was taxpayers from other races and they identify themselves as Kadazan and Caucasian. The number of married respondents represents 71 per cent, which might be representing a more stable group of individuals with the income that falls under taxable bracket and are more concerned about fulfilling the tax requirement.

### 4.2 Types of Cost

From the responses, the type of compliance costs can be divided into two categories. The first category is not a direct cost but it is based on the time spend for each type of cost. The second category is on the specific cost incurred where we could directly know the monetary amount. The list of compliance costs that taxpayer has to incur in order to comply with the tax a regulation is presented in table 3:

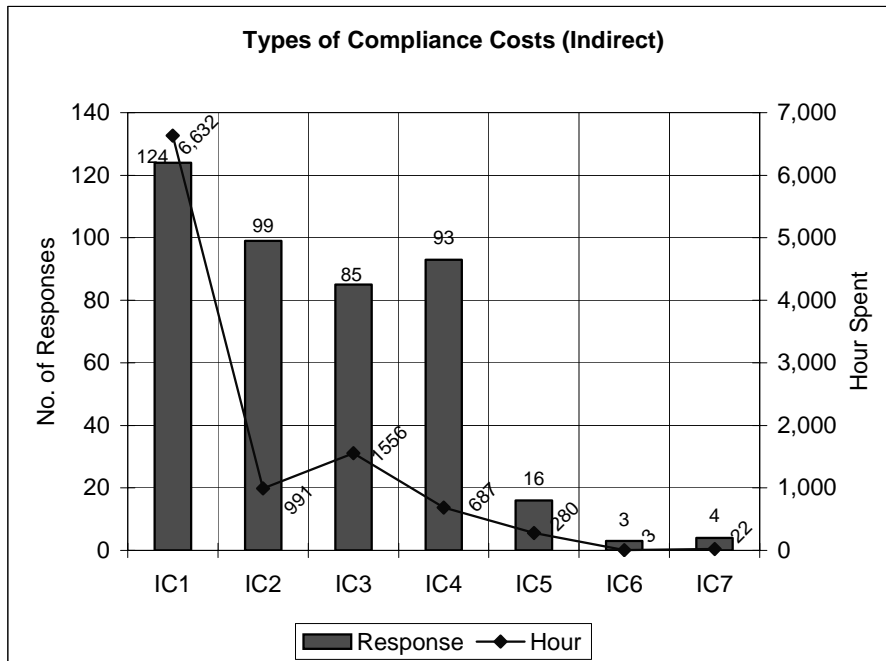
**Table 3: Types of Compliance Costs**

Indirect	IC1	Record keeping for income tax purposes
	IC2	Understanding of personal tax return systems and all the law and regulation
	IC3	Tax planning and researching the income tax literature
	IC4	Completing your tax return, submitting your tax return and pay the taxes
	IC5	Time spent on activities associated with tax objection, inquiries and appeal
	IC6	Time spent on activities associated with tax audit
	IC7	Attending seminar
Direct	DC1	Purchase of book or any tax related material
	DC2	Traveling/ Postage
	DC3	Stationery/Photocopying
	DC4	Purchase of tax software
	DC5	Hire Tax advisor
	DC6	Telephone and internet cost
	DC7	Attending seminar

**4.3 Time Spend on Each Type of Indirect Cost**

Record keeping for income tax purposes unsurprisingly is the highest time spends of 6,632 hours in the year of assessment 2007. The explanation to the result might be because with the introduction of SAS, taxpayers become aware that they need to keep record in order for them to claim all the deductions available. The least time spend is on activities associated with tax audit. In all, the total time spend are RM10,171 and the mean time spend for individual taxpayer is 70.6 hours. The full result is shown in figure 1 below.

**Figure 1: Indirect Compliance Costs**



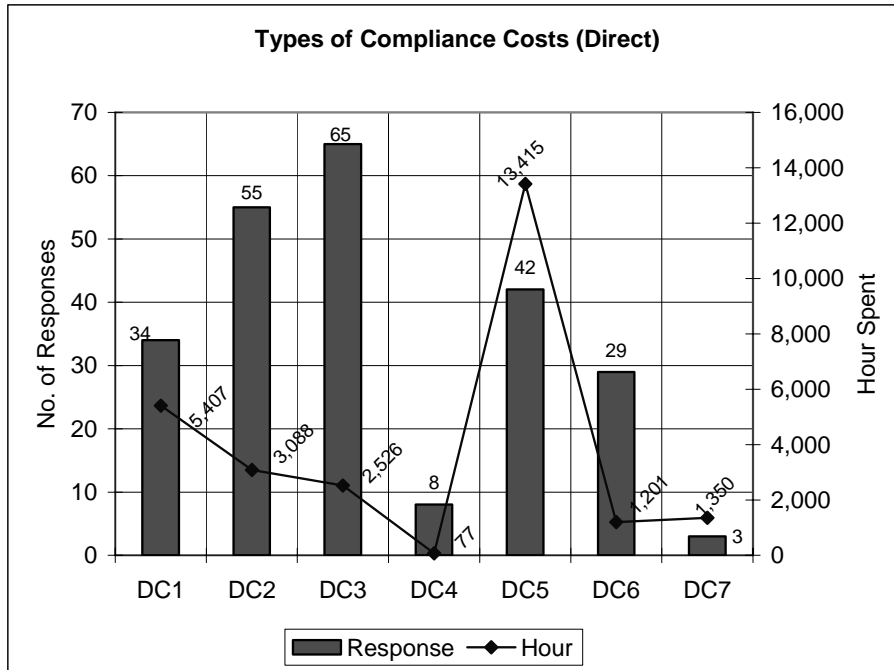
**4.4 Direct Monetary Costs**

The highest cost spends for direct cost is on the cost of hiring tax advisor. Although only 42 respondents noted that they use tax agent as compared to 65 respondents for stationary and photocopying costs, it is very much understandable as the cost per unit of hiring a tax agent is quite high compared to cost of stationery, photocopying and any other related materials (Figure 2). In all, the material costs amounted to RM27,064 and the mean monetary compliance costs amounted to RM187.9 for each individual taxpayer.



## Sapiei & Abdullah

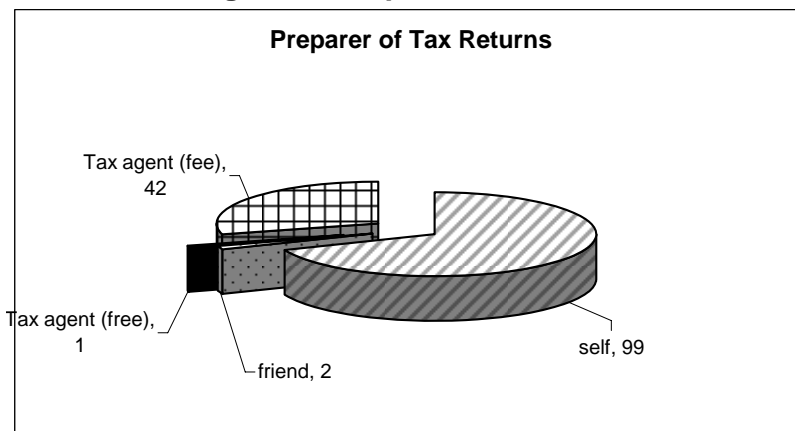
**Figure 2: Direct Compliance Costs**



### 4.5 Preparer of Tax Returns

The researchers have also discovered that most of the respondents either use an unpaid professional tax agent or do the assessment themselves. In relation to the result on direct costs 42 respondents hire a professional tax agent for a fee. The reason might be due to the fact that only 28% of the respondents were self employed. Most of the respondent did their own tax filing, only one respondent hire a professional tax agent for free and two respondents asked their friend.

**Figure 2: Preparer of Tax Returns**



## 5. Conclusion

Compliance costs of taxation are also known as a hidden cost of taxation or the excess burden of taxation. The awareness or initiatives to reduce the cost must come from the taxpayers themselves because IRB would be more concern on improving their process systems and compliance of taxpayers. However, in Malaysia little is known on taxation compliance costs and no research has been conducted on individual tax compliance costs.

This study is a modest attempt to identify the types of costs incurred and the corresponding amount and the preparer of tax returns. The findings of this study are similar with previous compliance costs studies in developing countries where the individual taxpayers' compliance costs were relatively low. The monetary compliance costs are approximately 0.27 per cent of the personal income tax revenue. The results also provide evidence that unlike the practice in most developed countries, the majority of taxpayers in Malaysia do not used tax agent. Based on these findings, further research can be carried out to investigate further such as the determinants of compliance costs.

The results of the study, however, are limited in several ways. First, the study is associated with the usual limitations of cross-sectional survey research, namely data collected at a single point of time. Second, this study covers only a small number of taxpayers. Hence, the findings of the study might limit their generalisability. Future research can be conducted to explore further on the problem that are faced by taxpayers in complying with tax legislation, practical action to reduce compliance costs and also to include psychological costs of individual taxpayers compliance costs.

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## Sapiei & Abdullah

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