

# *The effects of the self–assessment system on the tax compliance costs of small and medium enterprises in Malaysia*

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## **Abstract**

*This paper briefly discusses the importance of Small and Medium Enterprises (SMEs) in Malaysia. The concepts of tax compliance costs and prior compliance costs studies, both internationally and in Malaysia, are succinctly reviewed. The methodology used in the current estimates, based on the traditional postal survey questionnaire technique, is presented. The main part of the paper presents current (2006 survey year) estimates of the compliance costs of taxation of Malaysian SMEs and compares these estimates with earlier (1999) estimates. The findings clearly suggest that SME compliance costs over the period have fallen, contrary to the general presumption. The introduction of the Self–Assessment System (SAS) in 2001 and the subsequent simplification measures taken by the Inland Revenue Board are probably major explanatory factors. However, the major Asian financial crisis during the pre–SAS study may also have encouraged SMEs to significantly overstate their compliance costs at that time. The usual regressive pattern of compliance costs is confirmed, and estimates, in terms of business size and other characteristics, internal/external costs, and computational/planning costs are analysed. This research approach follows that of earlier studies in Australia (by Pope et al), Malaysia, Singapore and Hong Kong (by Ariff et al).*

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## 1. Introduction

The Malaysian government introduced the income tax self-assessment system (SAS) in stages: first to companies from the year of assessment 2001; and, subsequently, to personal and other taxpayers in 2004. The decision to implement SAS was first announced in the 2000 Malaysia Budget, which was tabled before the Parliament in 1999. The intention of SAS was mainly to benefit the Inland Revenue Board of Malaysia (IRB). Kasipillai noted that the specific aims of the IRB were to improve tax collection, to reduce the cost of collecting taxes, and to increase voluntary compliance.<sup>1</sup> Arguably, SAS involves a substantial shift of responsibility onto the taxpayers in terms of their compliance obligations and burdens. Additionally, further requirements were introduced, such as additional record-keeping, advanced tax estimates, and monthly advanced tax payments. Nonetheless, a number of tax simplification measures, mainly to the business community, had been made throughout the introduction of SAS to assist taxpayers. These included simplifications to the business basis period and a re-categorisation of capital expenditure for the purpose of capital allowances. Moreover, a number of public rulings have also been issued by the IRB in order to facilitate interpretations of tax law.

The introduction of the SAS, the regular amendment of the various tax laws, and perhaps the increasing complexities of the tax system may have had an adverse impact on Small and Medium Enterprises (SMEs). The compliance burden and associated costs under the SAS regime were expected to increase significantly, mainly during the early years of SAS. The possible increase is often presumed, but only a few specific references are available.<sup>2</sup>

The international literature largely confirms the disproportional effect of tax compliance costs upon SMEs,<sup>3</sup> the difficulties of SMEs in managing regulatory

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- 1 Kasipillai, JA *comprehensive guide to Malaysian taxation: current year assessment* (McGraw Hill, Kuala Lumpur, 2005) at 26-27.
  - 2 See Hanefah M, Ariff M. and Kasipillai J "Compliance costs of small and medium enterprises" 2001 4(1) *Journal of Australian Taxation* at 73-97; Ariff M and Pope J *Taxation & compliance costs in Asia Pacific economies* (University Utara Malaysia Press, Sintok, 2002) and Mathieu L, Waddams C and Antwi F "The distribution of UK personal income tax compliance costs" 2007 iFirst(1) *Applied Economics* at 1-18, accessed 2 June 2008, available at <http://www.informaworld.com/10.1080/00036840701604370>. However, only the Mathieu et al study empirically measured and compared the compliance costs in the context of self-assessment, but is confined to personal taxpayers.
  - 3 See for example Sandford C and Hasseldine J *The compliance costs of business taxes in New Zealand* (The Institute of Policy Studies, Wellington, 1992), Pope J Fayle R and Chen D *The compliance costs of companies' income tax in Australia* (Australian Tax Research Foundation, Sydney, Research Study No 23, 1994) and Evans C, Ritchie K, Tran-Nam B and Walpole M A *Report into the taxpayer costs of compliance* (Australian Government Publishing Service, Canberra, 1997). Evans et al's study is also known as the ATAX study.

requirements,<sup>4</sup> and the difficulties of maintaining records for business and tax purposes.<sup>5</sup> The lack of proper records is likely to result in the SMEs failing to meet tax laws.<sup>6</sup> The effect of SAS upon the compliance costs of SMEs is investigated in this paper, and contributes to a broader policy discussion.

This paper is organised as follows. The following section defines and briefly presents the importance of SMEs in Malaysia. Section three succinctly discusses the concepts of compliance costs and reviews prior tax compliance costs studies, both internationally and in Malaysia. The fourth section then considers the methodology used in the current estimates. The findings are presented in the fifth section, and Section six discusses these by comparing them with an earlier pre-SAS study in a Malaysian tax policy context. The final section makes some brief concluding comments.

## 2. Definition and the importance of small and medium enterprises in Malaysia

Small and Medium Enterprises in Malaysia have played an important role in the economic growth of the nation. In 2005, there were almost 520,000 SMEs, comprising around 99 per cent of all enterprises in Malaysia, and contributing almost 48 per cent of the total value added of business establishments, and around 65 per cent of total employment.<sup>7</sup> Up until September 2005, no standard definition of SMEs has been employed in Malaysia.<sup>8</sup> Various measures have been used, including the number of full time employees, annual sales turnover, amount of assets or shareholder's funds, paid-up capital, and combinations of these methods.

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4 Fernandez P and Oats L 1998, "The small business under a goods and services tax regime", in C Evans and A Greenbaum (eds), *Tax administration: facing the challenges of the future* (Prospect Media Pty Ltd, Sydney, 1998) at 162 and Kasipillai J and Liew R "The small and medium enterprise under a GST regime" (2004), November, *Accountants Today*.

5 Hanefah M and Al-Mureshi A "Accounting in small and medium enterprises" (1991) January, *Akauntan Nasional* and Small Business Deregulation Task Force. *Time for business: report of the Small Business Deregulation Task Force* (Commonwealth of Australia, Canberra, 1996) at 2.

6 Abdul-Jabbar H *The implementation of Schedules Monthly Tax Deduction: The case of small and medium industries in Kedah Darul Aman* (Masters Thesis, University Utara Malaysia, 1996) and CPA Australia, *Small business survey program: compliance burden* (CPA Australia, Melbourne, 2003).

7 National SME Development Council. *Small and medium enterprise (SME) Annual Report 2005* (Bank Negara Malaysia, Kuala Lumpur, 2006) at 19-23.

8 The definition was originally established by the National SME Development Council on 1 December 2004 (Bank Negara Malaysia, *Conclusion of the Second National SME Development Council Meeting*, Press Release, 2 December 2004) and was subsequently endorsed by them on 9 June 2005. However, the definition was released for Malaysian adoption only on 13 September 2005 (National SME Development Council, *Definition for small and medium enterprises in Malaysia*, Bank Negara Malaysia, Kuala Lumpur, 2005, available at [http://www.smeinfo.com.my/pdf/sme\\_definitions\\_ENGLISH.pdf](http://www.smeinfo.com.my/pdf/sme_definitions_ENGLISH.pdf)). It is important to note that the definition has been used earlier to classify SMEs in the SME Annual Report 2005 (National SME Development Council 2006), above n 7.

The Small and Medium Industries Development Corporation (SMIDEC), a primary government agency responsible for the development of SMEs in Malaysia, has defined SMEs as businesses with an annual sales turnover not exceeding RM25 million, and with full-time employees not exceeding 150. In June 2004, the government formed the National SME Development Council (NSDC) in order to promote the development of SMEs with a more coordinated approach. In September 2005, the NSDC released a new common definition for SMEs in Malaysia. The definition of SMEs is based on two criteria, either number of employees or annual sales turnover.<sup>9</sup> The SMEs are further categorised primarily into four sectors: manufacturing, manufacturing-related services, services (including information and communications technology) and primary agriculture. A summary for the NSDC definition of SME in terms of those sectors is shown in Table 1. The NSDC also further distinguishes between micro, small and medium-sized enterprises. The current study adapts this definition.<sup>10</sup>

**Table 1: National small and medium enterprise definition**

Sectors	Employees	Annual Turnover
- Manufacturing		
- Manufacturing-related services	≤ 150	≤ RM25 million
- Services		
- Primary Agriculture	≤ 50	≤ RM 5 million

Source: National SME Development Council (2005, pp 3-5)

### 3. Earlier studies of compliance costs

Compliance costs of taxation are costs incurred by taxpayers, in addition to their tax liability, in conforming to government tax requirements.<sup>11</sup> Compliance costs of taxation include three major components, namely money costs, time costs and psychological costs to the taxpayers.<sup>12</sup> Money costs refer to an amount spent on tax professionals (i.e. tax agents, accountants, investment advisers, legal practitioners) and expenses relating to taxation guides, books and other incidental costs (ie communication,

9 National SME Development Council (2005), above n 8.

10 Ibid. The upper limit for the lowest turnover level used to define SMEs into micro, small and medium enterprises is somewhat different between the manufacturing/manufacturing-related (less than RM250,000) and the services/primary agriculture (less than RM200,000) sectors. The current study standardised the amount to RM250,000 so as to facilitate responses from all sectors.

11 Sandford C, Godwin M and Hardwick P *Administrative and compliance costs of taxation* (Fiscal Publication, Bath: UK, 1989) at 10. They 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.

12 Ibid at 11-12.

stationery, travel).<sup>13</sup> On the other hand, time costs are incurred in maintaining records for tax purposes, completing tax forms or time spent in dealing with both tax professionals and the tax authority. Psychological costs include the stress and anxiety of handling tax affairs. Prior studies generally acknowledged the possibility of psychological costs, but ignored them in practice because of estimation difficulties. Similarly, the current study does not estimate psychological costs.

The development of earlier research on tax compliance costs has been discussed in three phases by Sandford, covering the period between the 1930s and early 1980s.<sup>14</sup> Thereafter, following a number of pioneering UK compliance costs studies by Sandford,<sup>15</sup> a considerable number of studies have been undertaken globally.<sup>16</sup> Despite, the emergence of international interest in tax compliance costs studies, Evans<sup>17</sup> pointed out that the first study in the Asia Pacific region was only published in Australia in 1990,<sup>18</sup> followed by a series of four compliance costs studies on major Australian taxes.<sup>19</sup> Since then, a number of studies have been conducted largely in Australia,<sup>20</sup> and also in other Asia Pacific countries such as New Zealand,<sup>21</sup> Singapore,

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- 13 Tax-related incidental costs are often reported as “other costs” (Sandford 1989, above n 11; Sandford and Hasseldine 1992, above n 3 and Pope, Fayle and Chen 1994, above n 3). It is also referred to as “internal non-personnel costs”, especially in the US (Slemrod J and Blumenthal M “The income tax compliance cost of big business” 1996 24(4) *Public Finance Quarterly*, at 411-438 and Slemrod J and Venkatesh V *The income tax compliance cost of large and mid-size businesses*, Social Sciences Research Network-Working Paper no 914, 2002).
- 14 Sandford, Godwin and Hardwick (1989), above n 11 at 27-34.
- 15 Ibid.
- 16 The development of tax compliance costs in the modern era is not considered further; interested readers should refer to Sandford C (ed.) *Tax compliance costs measurement and policy* (Fiscal Publications, Bath: UK, 1995); Evans C, Pope J and Hasseldine J (eds.) *Taxation compliance costs: A festschrift for Cedric Sandford* (Prospect Media Pty Ltd, Sydney, 2001); Evans C “Studying the studies: an overview of recent research into taxation operating costs” 2003 1(1) *eJournal of Tax Research*, at 64-92 and Pope J “Tax compliance costs”, in Lamb M, Lymer A, Freedman J and James S (eds), *Taxation: an interdisciplinary approach to research* (Oxford University Press, Oxford, UK, 2005) at 203-216.
- 17 Evans (2003), above n 16 at 66.
- 18 Pope J, Fayle R and Duncanson M *The compliance costs personal income taxation in Australia, 1986/87* (Australian Tax Research Foundation, Sydney, Report No 9, 1990).
- 19 Pope J and Fayle R “The compliance costs of public companies” income taxation in Australia 1986/87: empirical results”, 1991 8(4) *Australian Tax Forum*, at 485-538; Pope J, Fayle R and Chen DL *The compliance costs of employment related taxation in Australia*, (Australian Tax Research Foundation, Sydney, 1993a); Pope J, Fayle R and Chen DL *The compliance costs of wholesale sales tax in Australia*, (Australian Tax Research Foundation, Sydney, Report No 19, 1993b) and Pope, Fayle and Chen (1994), above n 3.
- 20 Especially by Evans et al., (1997), above n 3; Rametse N and Pope J “Start-up tax compliance costs of the GST: empirical evidence from Western Australian small businesses” 2002 17(4) *Australian Tax Forum* at 407-422 and Tran-Nam B and Glover J “Estimating the transitional costs of the GST in Australia: a case study approach” 2002 17(4) *Australian Tax Forum* at 499-536.
- 21 Sandford and Hasseldine (1992), above n 3.

Malaysia, Hong Kong<sup>22</sup> and India.<sup>23</sup> Conclusively, all prior studies have supported the presence of a fixed costs effect on smaller firms and ensuing regressivity. The same pattern applies for a single type of tax and overall business taxes.

In Malaysia there have been two published compliance costs studies conducted prior to the introduction of the self-assessment system. The first study, conducted by Loh et al. estimated the income tax compliance costs of public listed companies in Malaysia.<sup>24</sup> The second study, conducted by Hanefah, Ariff and Kasipillai focused on SMEs, but was confined to companies in the northern peninsular of Malaysia.<sup>25</sup> Both Malaysian studies confirmed the regressive nature of tax compliance costs among smaller companies. A summary of the results of both studies is presented in Table 2.

**Table 2: Mean compliance costs in Malaysia prior to the self-assessment system**

	Large Company <sup>a</sup>	SME Company <sup>b</sup>
Internal Costs	RM19,176 (28)	RM15,493 (75)
External Costs	RM49,660 (72)	RM 5,210 (25)
Additional Costs <sup>c</sup>	–	–
Overall Costs	RM68,836 (100)	RM20,703 (100) <sup>d</sup>

The costs percentage is given in parenthesis

Source: a 1995 Loh et al. (1997) figures and b 1999 Hanefah, Ariff and Kasipillai (2001) figures.

c Both studies did not report their additional or other costs separately. Refer footnote 13.

d This total was not equal to overall reported mean compliance costs of RM21,964 due to differences in the response number. Refer footnote 35 of Hanefah, Ariff and Kasipillai (2001) for details.

As shown in Table 2, the average compliance costs of SMEs in absolute values are almost one-third of the large companies.<sup>26</sup> Hanefah, Ariff and Kasipillai emphasised that the composition of both internal and external costs, as measured by costs percentage, of SMEs were completely different from large companies.<sup>27</sup> The current study updates compliance costs estimates for SMEs under the SAS regime.

22 For a comprehensive discussion refer Ariff and Pope (2002), above n 2.

23 Chattopadhyay S and Das-Gupta A *The income tax compliance cost of Indian corporations* (National Institute of Public Finance and Policy, New Delhi, 2002a); Chattopadhyay S and Das-Gupta A *The personal income tax in India: compliance costs and compliance behaviour of taxpayers* (National Institute of Public Finance and Policy, New Delhi, 2002b).

24 Loh A, Ariff M, Ismail Z, Shamsheer M and Ali M "Compliance costs of corporate income taxation in Malaysia, 1995" 1997 14(3) *Pacific Accounting Review*.

25 Hanefah, Ariff and Kasipillai (2001), above n 2.

26 The inflation rate, as measured by the Consumer Price Index change, over the period 1995 to 1999 was between 2.6 and 3.5 per cent per annum, except for 5.2 per cent in 1998 (Economy Reports 1999-2000, 2000-2001, 2001-2002, 2002-2003 and 2003-2004 issued by the Treasury of Malaysia).

27 Hanefah, Ariff and Kasipillai (2001), above n 2.

## 4. Research method

### Sample, timing and the questionnaire design

The survey questionnaire was mailed to a sample of 1,300 SME companies in peninsular Malaysia. The current study used the SME directory available via the SME information portal managed by the Secretariat to the National SME Development Council (NSDC).<sup>28</sup> The sample was drawn proportionally from each category of the business sector. The population and sampling frame of the current study is presented in Table 3.

**Table 3: Population and the sample size by stratified proportionate sampling**

Sector	Number of Companies	Percentage of Population	Sample Size
Manufacturing	5,239	54	702
Services	2,158	22	286
Manufacturing-related services	848	9	117
Construction	734	8	104
Others	690	7	91
Overall	9,669	100	1,300

The survey was carried out with the support of SMIDEC and relates to the tax year 2006. The data collection period spans between July 2007 and September 2007. Recognising the deadline for the submission of a company's tax return varies according to the financial year end, or specifically, within six months after the financial year end<sup>29</sup>, the survey period chosen is considered the most appropriate. Prior to the actual survey, two phases of a pilot study were conducted, to ensure the questionnaire was well understood. The first involved a personal interview with three tax professionals and five tax academics in the northern region and four universities respectively.

28 The portal was recently launched in the early 2006 and is publicly accessible via <http://www.smeinfo.com.my>. The directory was considered as the most suitable list of population as it is based on the new national definition of SMEs. As at 15 June 2007, there were 14,388 SMEs registered with the NSDC. The gross population of the current study was derived at 9,912 companies after excluding SMEs in the Eastern Malaysia, namely in Sabah, Sarawak and Federal Territory of Labuan (1,211) and non-corporate SMEs (3,265). However, recognising a low number of representations in the primary agriculture (215) and mining (28) sectors, the net population was further reduced to 9,669.

29 For example, a company that ends their financial year end on the 31 December 2006 is required to furnish their tax return by 30 June 2007.

Secondly, a pilot study was conducted by way of personal interviews among a small sample of SMEs in the northern region of Malaysia.<sup>30</sup>

The final survey questionnaire was prepared in English and another translated version was made available in the Malay language. It is common in Malaysia to make available both versions, mostly in a single print out.<sup>31</sup> However, the current study employed two separate versions of the questionnaire. The dual version was considered necessary to substantially reduce the length of the questionnaire and, most importantly, to obtain a reasonable response rate. The printing of background colour differentiated the English (printed in orange) and the Malay (printed in blue) versions of the questionnaire. The respondents were given the option of responding to either version. A single-page questionnaire, in this instance A3 sized paper folded into A4 size, was among the main design layouts recommended by Dillman to increase the response rate.<sup>32</sup>

### Survey response rate

The survey obtained a gross response of 16 per cent (after allowing for out-of-frame replies).<sup>33</sup> The large majority of SMEs (81 per cent) responded to the English version. It is important to note that the current study considered as many as twelve of Sandford's recommendations to improve the response rate and quality.<sup>34</sup> Though the response rate was considered low, it is comparable to a number of Asia Pacific

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- 30 The structured interview questions were sent in advance to 18 SMEs with the help of the SME Bank of Malaysia. A week after a follow-up call was made to confirm their involvement in the study. However, only 11 SMEs agreed to participate in the study. The remaining seven SMEs were unable to participate due to either their head office being located elsewhere, not having commenced their operations, or refusing to take part. The final interview was able to be conducted with nine SMEs only due to the busy schedule of the other two SMEs. Following pilot interviews, a few modifications were made to the questionnaire.
- 31 Generally, for business-related surveys, the main language is English, which is visible in a normal font. The Malay language is included in an italic font.
- 32 Dillman D *Mail and telephone surveys: The total design method* (John Wiley and Sons, New York, 1978). The single page design was successfully implemented in nearly all of Pope et al, studies (1990), above n 18; (1993a and 1993b) above n 19 and (1994) above n 3 and recently by Rametse N *Start-up compliance costs of the Goods and Services Tax (GST) for small businesses in Australia* (PhD Thesis, Curtin University of Technology, 2006).
- 33 The out of frame replies were mostly due to change of business addresses and included eight responses that were discarded mainly due to incompleteness and non-SMEs response. The net sample frame and the useable responses were 1,116 and 175 respectively, hence giving a useable response rate of 16 per cent.
- 34 Sandford (1995), above n 16 at 378-379 highlighted as many as 17 considerations in this specific area of tax compliance costs to improved 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. It is important to note that those considerations are well-suited to the major elements of the Total Design Method of Dillman (1978), above n 32.

tax studies, including studies in Malaysia.<sup>35</sup> Even business surveys, either targeting SMEs or large firms, often yield a response rate of between 10 per cent and 20 per cent in Malaysia<sup>36</sup> and in other South East Asian countries.<sup>37</sup> A Malaysian SME survey conducted by SMIDEC had an average response rate of 18 per cent.<sup>38</sup>

Having acknowledged the typically low response rate, it is crucial to examine whether non-responding SMEs would have responded differently. The issue of non-response bias was measured by two approaches: first by employing wave analysis;<sup>39</sup> and second, by comparing the responses to a key question (on the perceived level of

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- 35 For example, 14 and 17 per cent (Loo EC 2006 “Determinants of individual taxpayers’ compliance behaviour: experience of the transition from the pre to post self assessment in Malaysia”, in M Walpole and M Mc Kerchar (eds), *Further Global Challenges in Tax Administration*, Fiscal Publications, Birmingham, 2006) and 22 per cent (Hanefah, Ariff and Kasipillai 2001, above n 2), both in Malaysia; 15.1 per cent in Hong Kong (Chan S, Cheung D Ariff M and Loh A “Compliance costs of corporate taxation in Hong Kong” 1999 25(4) *International Tax Journal*; 26 per cent in Singapore (Ariff M, Ismail Z and Loh A “Compliance costs of corporate income taxation in Singapore” 1997 24(9 and 10) *Journal of Business Finance and Accounting*; and 16.9 per cent in Australia (Pope and Fayle 1991, above n 19). A response rate of 1.15 per cent in the Indian Corporation study (Chattopadhyay and Das-Gupta 2002a, above n 23) is perhaps the lowest response reported in the tax compliance costs literature. A small number of North American studies also reported response rates of about 10 per cent (in Vaillancourt F *The administrative and compliance costs of the personal income tax and payroll tax system in Canada, 1986*, Canadian Tax Foundation, Ontario, 1989) and (in Slemrod and Venkatesh 2002, above n 13).
- 36 Hazman, S “The level of participation and influence of HR managers in the strategic management process in Malaysian corporations” 1998 33(2) *Malaysian Management Review* at 47-60; Kanapathy K and Jabnoun N “Are ISO 9000 and TQM programmes paying off for Malaysian manufacturing companies” 1998 33(2) *Malaysian Management Review* at 40-46; Ahmad R and Abu-Bakar Z 2000, “Information systems skills requirements in Malaysia” 2000 13(2) *Malaysian Journal of Computer Science* at 64-69; Othman R, Abdul-Ghani R and Arshad R. “Great expectation: CEO’s perception of the performance gap of the HRM function in the Malaysian manufacturing sector” 2001 30(1) *Personnel Review* at 61-80; Jaafar M and Abdul-Aziz A-R “Resource-based view and critical success factors: A study on small and medium sized contracting enterprises (SMCEs) in Malaysia” 2005 *The International Journal of Construction Management* at 61-77; Hooi LW “Implementing e-HRM: The readiness of small and medium sized manufacturing companies in Malaysia” 2006 12(4) *Asia Pacific Business Review* at 465-485.
- 37 Jobber D and Mirza H “Incentives and response rates to cross-national business surveys: A logit model analysis” 1991 22(4) *Journal of International Business Studies* at 711-721; Sefnedi, Mohamad O and Ibrahim DN “Which marketing competency explains export performance?” *The 7th Asian Academy of Management Conference*, eds. A Nasurudin, DN Ibrahim, I Osman, MS Haron, CH Quah, R Ali, R Thurasamy, Y Zainuddin and ZA Ahmad, Penang, Malaysia, 2007) at 706-715.
- 38 E-mail communication with the SMIDEC on 15 January 2008.
- 39 For this purpose, the responses were divided into three waves: those who responded before the first reminder was sent, those who responded after the first reminder but before a second reminder sent, and those who responded after the second reminder.

compliance costs) in the both full questionnaire survey and a single postcard survey.<sup>40</sup> Both suggested fairly similar estimates by respondents and non-respondents alike.

## 5. Estimates of tax compliance costs of small and medium enterprises in Malaysia

### Profile of the responding small and medium enterprises

A summary of the profile of responding SMEs, by general business and specific size proxies, is reported in Table 4 and 5 respectively. As shown in Table 4, the most frequently stated sector was service (44 per cent), followed by manufacturing (21 per cent) and manufacturing-related (18 per cent). In terms of proportion, responses received from all sectors were not similar to their true proportion in the population. The responses received from the services, manufacturing-related and construction sectors were almost twice as high, but the manufacturing sector was twice as low. As the manufacturing sector is often targeted as a research subject in Malaysia, the lack of response from this sector is perhaps not surprising. It is also possible that the SMEs are perhaps confused when differentiating the manufacturing-related and services sectors.<sup>41</sup>

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40 As first developed and used by Allers (*Administrative and compliance costs of taxation and public transfers in the Netherlands*, Woltersgroep Gronigen, 1994). Most compliance cost studies now adopt this approach (for example Evans et al. 1997, above n 3; Rametse and Pope, 2002, above n 20).

41 Refer Table 4, note c.

**Table 4: Business characteristics of responding small and medium enterprises**

	Number of Respondents <sup>a</sup>	Percentage <sup>b</sup>
Business Sector		
Manufacturing	37	21.1
Manufacturing-related Services	32	18.3
Services	77	44.0
Construction	27	15.4
Other <sup>c</sup>	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
Paid-up Capital		
RM500,000 or less	105	60.3
RM500,001 to RM2,500,000	58	33.3
RM2,500,001 or more	11	6.3
Estimated Tax liability		
No tax	42	24.4
RM1 to RM99,999	102	59.3
RM100,000 to RM249,999	12	7.0
RM250,000 to RM499,999	9	5.2
RM500,000 to RM999,999	5	2.9
RM1,000,000 or more	2	1.2
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 hundred 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. It is most likely that some respondents, who are not sure of their sector, may indicate "other sector".

Regarding length, the large majority of responding SMEs are assumed to have tax-related experience since they have been in business for more than five years (78 per cent), or at least for two years (17 per cent). As for their paid-up capital, more than 93 per cent had paid up capital of up to RM2.5 million. The remaining seven per cent is within the definition of SMEs, but would not qualify as SME companies for tax purposes, since their paid-up capital exceeded RM2.5 million. In addition to those 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).

As for employment size, almost half of the respondents are in the category of between five and 19 employees, as shown in Table 5. In terms of turnover, 75 per cent of the SMEs were in the first three levels of turnover, with relatively more respondents in the turnover level between RM250,000 and RM1 million (27 per cent) and between RM1 million and RM5 million respectively (26 per cent). Following the NSDC definition of SMEs, just over half are small companies, followed by nearly one-third being micro companies.

**Table 5: Business size of responding small and medium enterprises**

	Number of Respondents	Percentage <sup>a</sup>
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 <sup>b</sup>		
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
NSDC Definition		
Micro	54	30.9
Small	98	56.0
Medium	23	13.1
Overall	175	100.0

a Total percentage of not equal to hundred for some sections is due to rounding.

b The categories are based on a criteria used for defining SMEs into micro, small and medium enterprises and modified to facilitate respondents. Refer footnote 10.

## Compliance cost estimates

The compliance cost estimates require the presence of all three cost components, ie internal time spent and appropriate wages rate by staff category, additional non-staff costs, and external tax fees. The internal time costs are the sum of time costs of four different categories of staff within the business, namely manager/accountant, accounting staff, administrative staff, and other staff. The amount is computed by multiplying annual time spent on tax activities to their respective hourly wage rate.<sup>42</sup> The additional non-staff costs are mainly related to costs of printing, stationary, postage, communication, and to a small extent travelling costs.<sup>43</sup> Broadly in Malaysia, additional costs are incurred both within companies and by external professionals.<sup>44</sup> As for external tax fees, it is common in Malaysia to have tax fees charged separately from financial audit or other fees. Thus it is a straightforward monetary cost charged by external professionals solely on tax activities.

All responses, in particular for all three cost component questions, were scrutinised for validity and a number of telephone follow-up calls were made (to those who stated their telephone numbers) to address the issue of possible incorrect or illogical responses, and to address the missing items too.<sup>45</sup> The mean compliance costs of Malaysian SME companies in 2006,<sup>46</sup> by cost component, are summarised in Table 6.

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42 The hourly wage rates were computed by dividing monthly wage rates reported by the respondents to their respective monthly working hours. The *Malaysian Employment Act 1955* (s 60I) stipulated 26 days to be used in determining an hourly wage rate. A normal working hour is eight hours per day or 208 hours per month. Accordingly, respective wage rates were divided by 208 hours to obtain an hourly rate.

43 The term “additional costs” was used in this study rather than “other costs” as it is easier for Malaysian respondents to understand. Refer also footnote 13.

44 It is common for tax professionals to reimburse those costs from their tax clients. The amount is included in the tax invoice, but shown separately from tax fees. The approach is similar to financial audit practices in Malaysia.

45 These included a total of 41 responses that did not indicate their answer to estimating time spent and relevant wages in the requested form (ie monthly basis); 21 of them were corrected via telephone follow-up calls and the remaining 20 cases (without a contact number) via assumptions similar to that telephone follow up. Another 40 cases had missing values, at least for one of its compliance cost components, mainly for internal time spent and wages (28 cases). Nonetheless, the overall missing percentage in the current study was less than five per cent. A few questionnaires with extreme outliers and missing values were replaced by imposing a realistic maximum value and mean value respectively. The reference value for wages and tax fees was obtained from the Federation of Malaysian Manufacturer Survey 2006 and from a separate survey of tax professionals respectively. No appropriate reference values are available for internal time spent by staff categories and for non-staff additional costs. Accordingly, the researchers’ best judgment was used in handling extreme outliers for those variables. Traditionally, mean substitution is the most widely used method (see Hair J, Anderson R, Tatham R and Black W *Multivariate data analysis*, 5th edn. Prentice-Hall International, New Jersey, 1998). Little’s MCAR test indicates the missing pattern as missing completely at random (MCAR), thus enabling any substitution method to be used without resulting in bias.

46 The survey was conducted in 2007 and relates to the financial year and/or tax year 2006.

**Table 6: Estimated mean compliance costs of Malaysian small and medium enterprises by component – 2006**

	Mean Costs (RM)	Costs Breakdown (Percentage)
Internal Costs	4,863	52
External Costs	3,786	41
Additional Costs	646	7
Overall	9,295	100

Number of respondent equals to 175.

The average cost is almost RM9,300 per company, as shown in Table 6. Around half the average compliance costs is associated with the internal time spent and around two-fifths is a direct monetary cost paid to external advisors. Other costs (ie non-staff) to comply with the tax laws accounted for seven per cent. In terms of cost nature, the computational and planning costs were recorded at 74 and 26 per cent respectively. The compliance costs of Malaysian SMEs by size, as shown in Table 7, follow the usual regressive pattern.

**Table 7: Mean compliance costs of Malaysian small and medium enterprises by turnover and as a percentage of turnover**

Turnover Level <sup>ab</sup>	Number of Respondents	Compliance Costs	
		Mean (RM)	Percentage of Turnover
Less than RM250,000	37	8,162	6.53
RM250,000 to RM999,999	48	7,086	1.13
RM1,000,000 to RM4,999,999	46	9,673	0.32
RM5,000,000 to RM9,999,999 <sup>c</sup>	17	9,715	0.13
RM10,000,000 to RM24,999,999 <sup>c</sup>	14	15,965	0.09
RM25,000,000 or more <sup>c</sup>	13	11,605	0.04
Overall	175	9,295	–

a Refer Table 5, note b.

b The denominator used is the midpoint of the turnover category, except for the largest, where RM30 million was used, because the actual mean size of the turnover is not available.

c Recognising a low number of cases for this turnover category, computation was carried out for the combined category of RM5 million and more. The mean compliance costs and its percentage to turnover were RM12,262 and 0.06 per cent respectively.

Table 7 indicates that tax compliance costs for SMEs for businesses with less than RM250,000 annual turnover were 6.5 per cent, followed by about one per cent for those in the turnover level of RM250,000 to RM1 million, and 0.32 per cent for those in the RM1 million to RM5 million turnover category. Compliance costs for SMEs having a turnover of at least RM25 million were only 0.04 per cent. Thus, compliance costs (in absolute value) increase as the turnover level increases. However, the relative costs as a percentage of turnover decrease significantly.

The small and medium enterprise compliance costs were analysed by alternative measures of size, namely number of staff employed, and size, as per the NSDC combined definition. Findings are presented in Table 8. In terms of staff employed, compliance costs (in absolute value) tend to increase as the relative size of staff becomes larger. Compliance costs analysed as per the NSDC criteria (measured in terms of micro, small and medium companies) also increase as size increases.

**Table 8: Mean compliance costs by staff level, NSDC size and other business characteristics**

	Mean Compliance Costs (RM) <sup>a</sup>
Number of Staff Employed	
4 or less	7,466
5 to 19	8,981
20 to 50	10,609
51 to 150	10,937
NSDC Size	
Micro	7,741
Small	9,777
Medium	10,888
Business Sector	
Manufacturing	10,428
Manufacturing-related Services	9,701
Services	8,219
Construction	10,473
Business Length	
Up to 5 years <sup>b</sup>	7,980
More than 5 years	9,659
Overall	9,295

a N equals to 175, Refer Table 4 and 5 for details pertaining to the number of respondents.

b Responses were pooled as the category of less than two years has eight responses only.

Additionally, compliance costs were analysed by business sector and length of time in business. As shown in Table 8, compliance costs for the manufacturing and construction sectors were found to be relatively higher than the manufacturing-related services, service and other sectors. Small and Medium Enterprises that have been in business for up to five years appear to have relatively lower compliance costs compared to those who have existed for more than five years.

## 6. Comparison with earlier Malaysian estimates

Probably the most important finding is that the average compliance costs of RM9,295 in the current study is almost 58 per cent lower than the average compliance cost of RM21,964 in the pre-SAS study.<sup>47, 48</sup> Surprisingly the cost is lower in the context of the SAS environment, contrary to the presumed expectation. Nonetheless, this finding is not entirely surprising as a similar trend was evident in Australia. Broadly, the ATAX study indicates that compliance costs either at individual, business or overall levels were found to be relatively lower as compared to a series of Pope et al's studies.<sup>49</sup> The fact that Pope et al's studies were conducted prior to SAS, and that the ATAX study was carried out during the SAS, is often overlooked and not highlighted in the literature.<sup>50</sup> As a result, and citing several other key compliance costs studies internationally, Mathieu, Waddams and Antwi emphasised the possibility of high total tax compliance costs in countries where SAS is well established, low where SAS is not implemented, and of intermediary costs for countries where SAS has recently been introduced.<sup>51</sup> At this point it is worth mentioning that Ariff and Pope stressed in advance the likelihood of costs declining in the longer run, provided that SAS was implemented effectively.<sup>52</sup> Table 9 presents the comparative findings of the pre-SAS and post-SAS studies on Malaysian SMEs.

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47 Hanefah, Ariff and Kasipillai (2001), above n 2. The variables used in this study are similar to those used in Hanefah et al, which was based on the approach adopted by Pope, Fayle and Chen (1994), above n 3. However, one noteworthy aspect was regarding additional costs. The Hanefah et al study did not report their additional costs separately.

48 The comparison was made at nominal value. If inflationary effects were to be considered, the yearly inflation rate, over the period of 1999 to 2006 was around 2 per cent, except for 3.0 and 3.6 per cent respectively in 2005 and 2006 (Economy Reports 2003-2004, 2004-2005, 2005-2006, 2006-2007 and 2007-2008 issued by the Treasury of Malaysia).

49 Evans et al (1997) above n 3. The comparison was made on the basis of tax revenue and gross domestic product (GDP). Methodological differences should be noted when comparing these studies.

50 Perhaps Mathieu, Waddams and Antwi (2007) were the first to highlight this fact. Above n 2 at 2.

51 Ibid at 2-3.

52 Ariff and Pope (2002), above n 2 at 277.

**Table 9: Comparative compliance costs of Malaysian small and medium enterprises**

	Pre-SAS <sup>a</sup>	Post-SAS <sup>b</sup>
Tax year	1999	2006
Scope	Corporate Income Tax	Corporate Income Tax
Coverage	Northern region of Peninsular Malaysia	Peninsular Malaysia
Tax Compliance Cost <sup>c</sup>		
- Average per Firm	RM21,964	RM9,295
Component of Costs <sup>c</sup>		
- Computational	RM12,960 (59)	RM7,217 d (74)
- Planning	RM 9,004 (41)	RM2,474 d (26)
Sources of Costs <sup>c</sup>		
- Internal	RM15,493 <sup>e</sup> (75)	RM5,509 (59) <sup>f</sup>
- External	RM 5,210 <sup>e</sup> (25)	RM3,786 (41)

a 1999 figures from Hanefah, Ariff and Kasipillai (2001).

b Data from the current study.

c All values are in current year prices – refer footnote 48. The percentage is given in parentheses.

d This total was not equal to RM9,295 due to differences in the response number.

e Refer Table 2, note d.

f Inclusive of additional costs component.

To some extent, these cost decreases may be because it has been more than six years since the implementation of SAS in Malaysia. The previous study related to the tax year 1999 and the data was collected in 2000. It is important to highlight that there were two major tax changes announced in 1999,<sup>53</sup> namely the introduction of SAS and the application of a current year basis to replace the existing preceding year basis. The timing of the previous study itself may have stimulated the respondents to exaggerate their compliance costs. Nonetheless, the increase in the proportion of external work, from 25 per cent,<sup>54</sup> to almost 41 per cent in the current study, provides evidence that tax professionals, as expected, now play a significant role in the SAS regime. Additionally, the increasing nature of routine income tax work under the SAS (from 59 to 74 per cent), as measured by computational percentage, adds consistency to the current estimate.

Another possible explanation may relate to the economic climate when the previous study was conducted. The major Asian financial crisis during Hanefah, Ariff and Kasipillai's study may have encouraged SMEs to highly overstate their compliance costs. The timing of the current study is perhaps suitable given that no major income

53 Ministry of Finance Malaysia. "The 2000 budget speech", 29 October 1999.

54 In Hanefah, Ariff and Kasipillai (2001), above n 2.

tax changes took place during the study period. Moreover, the possibilities of high initial costs or start-up effects were removed as the SAS has been in place for more than six years.

It is also probable that this significant decline is due to the success of numerous simplification measures taken by the IRB. The most important of these are the substantial reduction of capital expenditure categories for capital allowance purposes, the simplification of the business basis period, the introduction of dual tax rates for SMEs, and permitting 100 per cent capital allowance for small value assets during the relevant purchased year.<sup>55</sup> In Singapore, Ariff, Ismail and Loh found a significant decrease of 30 per cent in the tax compliance costs was evident for just one year after (1994 to 1995).<sup>56</sup> The researchers strongly believed that the decrease was largely attributable to the simplification measures taken by the Inland Revenue Authority of Singapore (IRAS). Therefore, it is most likely that the numerous efforts taken by the IRB have resulted in significant benefits for the business community.

Despite the low compliance costs finding in the current study, the regressive nature of compliance costs remains perhaps even greater in the current estimates, as shown in Table 10. However, perhaps the introduction of the dual tax rates to SME companies is a compensation in this regard, and this should be extended to non-corporate SMEs as well. Arguably, further specific simplification measures for the SME sector could also be introduced.

**Table 10: Compliance costs as a percentage of turnover**

Pre-SAS <sup>a</sup>		Post-SAS <sup>b</sup>	
Turnover RM Million	Compliance costs as a percentage of turnover <sup>c</sup>	Turnover RM Million	Compliance costs as a percentage of turnover
		Less than 0.25	6.53
Less than 5	1.20	0.25 – 1	1.13
		1 – 5	0.32
		5 – 10	0.13
5 – 50	0.07	10 – 25	0.09
		25 or more	0.04
More than 50	0.02		

a 1999 figures from Hanefah, Ariff and Kasipillai (2001).

b Data from the current study (2006 figures).

c Computed using a similar approach to the current study as the information is not available in Hanefah, Ariff and Kasipillai's study. The denominator used is the midpoint of the turnover category, except for a category of more than RM50 million, where RM55 million was used.

55 The changes took effect for the years of assessment 2000, 2002, 2003 and 2006 respectively.

56 Ariff, Ismail and Loh (1997), above n 35 at 1258.

It is important to note that the current study was restricted to companies only. It would be interesting to examine the extent of cost change over the period for non-corporate SMEs, such as self-employed and/or partnership businesses and large companies. The compliance costs for non-corporate SMEs are expected to be higher than corporate SMEs as a percentage of turnover. It is expected that their internal time cost would be relatively higher, possibly due to the relative lack of proper record keeping in such business entities. The record keeping in the corporate SMEs is probably better than the non-corporate SMEs, as the former are subject to an annual financial audit.

## **7. Concluding remarks**

This paper has shown that the income tax compliance costs of SMEs has decreased significantly under the SAS, probably of around 50 to 60 per cent. Though this trend is partly surprising, the decline is fairly reasonable taking into consideration the timing of the pre-SAS study. The previous study was carried out during the period when some major income tax changes had just been initiated, and more importantly, during the period when a major financial crisis affected the Asian region. On the other hand, the present study was carried out during a period of relative stability in the tax system. Despite this, as expected, the high proportion of external costs, 41 per cent compared with pre-SAS estimates of 25 per cent, shows that the role of tax professionals is substantially greater under the SAS regime. In terms of cost nature, the computational component under the SAS had increased as well to 74 per cent, compared to 59 per cent in the pre-SAS regime. However, the regressive nature of compliance costs upon small businesses remains an important area in tax policy considerations. The IRB's success in simplifying income tax law should be emphasised. It is expected that the IRB will continue its efforts in introducing further tax simplification measures. Currently, the IRB does not have a specific policy on compliance costs of SMEs. Further studies on compliance costs are possibly needed to convince the IRB in this regard. Thus further research into other business taxpayers, with considerable attention towards tax compliance costs, is strongly recommended.