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Regressivity of the corporate taxpayers' compliance costs

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Abstract

This study evaluates the regressivity of taxpayers' compliance costs with the corporate income tax reporting requirements. Compliance costs as a percentage of sales turnovers, ranged from 0.057% of the smallest company to 0.001% of the largest company. Larger companies were generally found to have greater compliance costs than their smaller counterparts, but as a percentage of sales, these costs were greater for smaller corporations. This study adds to the growing body of international literature concerning the distribution of compliance costs burden. Findings from these research activities should lead to the progression of more effective and efficient tax policies and practices.

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1. Introduction

Tax Compliance obligations may result in tax compliance costs incurred by taxpayers. Sandford (1995) defined tax compliance costs as costs incurred by taxpayers in complying with the requirements laid by the tax authorities. He segregated compliance costs of corporate taxpayers into main components, specifically: (1) internal costs; (2) external costs and (3) psychological costs. The internal costs component comprises of time costs of employing internal staff such as tax manager, accountant, account clerks and programmers to handle the company's tax affairs. The external costs component includes payments made to tax professionals from outside a company and any incidental costs incurred in relation to the tax work. These payments include the financial costs of professional

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fees paid to tax agents, accountants, legal advisers and any other external consultants in relation to the corporate income tax (CIT). Incidental tax compliance costs are other expenses incurred in the completion of tax activities such as the costs of postage, travelling and stationeries. Finally, the third component, Psychological costs are negative experiences of taxpayers in dealing with the requirements of tax rules and legislations.

The focus of this paper is on the regressivity of tax compliance costs incurred by taxpayers. Regressivity of tax compliance costs means that the costs were a relatively minor burden for large companies but extremely onerous for small companies. Larger companies were generally found to have greater total compliance costs than smaller counterparts. However, as a percentage of annual sales turnovers, compliance costs were greater for smaller as compared to larger companies. According to Ariff & Pope (2002), regressivity derives from economies of scale in operation, which favors larger companies, together with the presence of deadweight nondiscretionary component of compliance costs. They suggested that nondiscretionary component include the costs of setting up records, employing trained personnel and making returns to the tax authorities where every company would incur a certain minimum cost in this regard.

The lack of studies conducted in Malaysia, and in the emerging economies generally, warrants more attention towards conducting empirical studies that could provide insights to address some of the tax compliance costs regressivity issues.

2. Literature review

Regressivity of tax compliance costs violates the principle of equity for a good tax system. This principle states that a tax system should be fair among taxpayers and a good tax should be proportional to income so that the burden of supporting government is in accordance to benefits received from government (Smith, 1776). Political costs theory introduced by Watts and Zimmerman (1978) argues that politicians have the authority to use the politics of the distribution of wealth utilizing mechanisms such as taxes and insurance contributions. The theory proposed that the amount of political costs will depend on the size of company. Research concerning political costs and the relation of these costs with the size of company, confirmed the theory that larger companies suffer more political costs than smaller company (see for example Milne, 2002). Nevertheless, the larger companies have more effective rate of tax than smaller, thus, there is regressivity of political costs incurred by corporations.

Regressivity of tax compliance costs have been reported in detail for most countries in the advanced economies. Sandford, Godwin and Hardwick (1989) examined compliance costs of CIT in the UK through a survey of businesses. Regressivity of CIT compliance costs were established where tax compliance costs estimates as a percentage of taxable turnovers, ranged from 0.048% for the smallest corporation, to 0.01% for the largest corporation. In Australia, Pope, Fayle and Chen (1991) provided compliance costs estimates of Australian PLCs, utilizing the 1986/87 survey data and a subsequent study by Pope, Fayle and Chen (1994) utilized survey data of Australian companies for 1990/91. Evans, Ritchie, Tran-Nam and Walpole (1997) evaluated the compliance costs of all business-related federal taxes for the 1994/95 period. In spite of dissimilarity in compliance costs estimation in these Australian studies, regressivity of tax compliance costs were evidenced in all studies. In the US, there were seminal studies on large corporations by Slemrod and Blumenthal (1996) and Slemrod (1997). Slemrod and Venkatesh (2002) analyzed on large and mid-sized businesses, and Slemrod (2004) completed a broader study on all corporations and partnerships. As with all other existing literatures, the US studies found a regressive relationship between costs of compliance and company size.

Ariff, Loh and Talib (1995) study's furnished CIT tax compliance costs estimation of PLCs in Singapore for year of assessment 1994. A similar Singapore estimate, conducted a year later utilizing 1995 data by Ariff, Ismail and Loh (1997) found regressivity of tax compliance costs per SGD1,000 sales turnover by turnover group ranged from SGD0.083 (largest group) to SGD0.395 (smallest group) due to economies of scales. Comparable findings from a similar CIT tax compliance costs study in Hong Kong were also reported by Chan, Cheung, Ariff and Loh (1999). The study, which was administered for fiscal year 1995, observed the typical regressivity of tax compliance costs. In Canada, a report for the Technical Committee on Business Taxation by Erard (1997), examined the tax compliance costs of Canadian large companies for the 1995 tax year. The tax compliance costs of Canadian large companies increased with size although less than proportionately, portraying regressivity.

There is a limited amount of research on tax compliance costs estimations of corporations in the emerging economies. Bertolucci (2002) examined compliance costs of Brazilian listed companies for 1999 tax year.

Compliance costs of Indian companies in 2000/01 were investigated by Chattopadhyay & Das Gupta (2002). Klun (2004), administered compliance costs research in Slovenia. Blazic (2004) carried out a broad-based survey into compliance costs covering all Croatian taxes for 2001/02. Yesegat (2009) examined compliance costs incurred by the Ethiopian companies in relation to VAT for 2005/06 fiscal year. Most of these studies in the emerging economies concluded that the compliance costs are relatively low as compared to the countries in the advanced economies but the regressivity issues are supported. In Malaysia, the first study on tax compliance costs incurred by Malaysian taxpayers is by Loh, Ariff, Ismail, Shamsher and Ali (1997). They examined the costs of complying with income tax among PLCs. The second study by Hanefah, Ariff and Kasipillai (2001) estimated the costs of complying with income tax by small and medium enterprises (SMEs). The third study by Abdul-Jabbar (2009) evaluated compliance costs estimations for corporate SMEs under the SAS environment. Regressivity of tax compliance costs which were revealed in the existing studies was also evident in all the three Malaysian studies.

More recent studies have supported the findings concerning regressivity of CIT compliance costs and these studies provide comparisons of findings from different tax regimes. The World Bank Group (WBG) for example has carried out a number of studies for businesses in developing and transition countries, specifically in Africa, Asia, Latin America and the Middle East. This study has found extremely regressive patterns in the developing economies, with small businesses subjected to tax compliance costs of up to 15% or more of turnover (Coolidge, 2012). Lignier and Evans (2012) completed an international research project in evaluating tax compliance costs affecting the small business sector. The analysis of results by business size category confirms and documented the continuing strong regressivity of tax compliance costs.

The findings of existing studies on compliance costs estimates established the regressivity of CIT compliance costs incurred by corporate income taxpayers. These studies cited an inverse relationship between company compliance costs as a percentage of revenue and company size, suggesting that compliance costs decreased as company size increased. CIT compliance was disproportionately distributed among different size groups of taxpayers, where as a percentage of annual sales turnovers, compliance costs were greater for smaller as compared to larger companies.

Therefore, Hypothesis 1 (H_1) posits that company's compliance costs as a proportion of company's sales turnover tend to be regressive as they bear more heavily on smaller companies as compared to the larger ones.

H_1 : *The distribution of corporate income tax compliance costs is not fair as smaller companies bear a disproportionately heavier burden of compliance costs.*

3. Research method

The research method employed is based on the experience of previous researchers with few modifications to suit specific characteristics of Malaysian tax compliance requirements. The target population was large corporate taxpayers registered with the IRB and the sample was drawn from a published directory of Malaysian public listed corporations (PLCs). Sampling frame from the IRB's database of registered corporate taxpayers would provide a better sample but researcher was not able to obtain the information due to confidentiality reason. Companies in Eastern Malaysia were excluded from the main sample due to budgetary and time constraints. Sectors with less number of companies were also excluded due to low number of representations. In designing the research instrument, available questionnaires (for example Sandford et al., 1989) were mainly considered. Data collection for this study comprised of two sequential steps; a pre-testing and final survey implementation. Although the questionnaire items have mainly been validity-tested in previous studies, pre-testing was conducted in this study to ensure their suitability in the context of Malaysian PLCs. Final data collection for this study utilized a researcher-administered questionnaire survey method. This method was chosen as the reliability of tax compliance costs estimates are greatly dependent on the accuracy of the data acquired from survey respondents. A self-administered survey method can address these shortcomings, as according to Hanefah et al. (2001), a representative population using personal data collection, will yield a more reliable responses.

4. Analysis on regressivity of tax compliance costs

Based on the 98 usable survey data in this research, the highest response was from the companies with annual sales turnover level of between MYR100 and MYR500 million (36.7%); followed by the annual sales turnover level of less than MYR100 million (31.6%). The remaining respondents were in a turnover level of more than MYR500 million. For this type of study, annual sales turnover value was normally used as a general proxy for size (Chan et al., 1999) as the use of alternative measure of size such as profit/loss and tax payable would cause problems since loss-making companies would be excluded (Ariff et al., 1995). This paper examines the distribution of tax compliance costs in terms of business size. Compliance costs analysis by sales turnover were conducted for the overall mean compliance costs estimates and also for the three main cost components, specifically internal, incidental and external costs, as well as on the compensation amount expected by taxpayers.

The tax compliance costs distribution by size, expressed as a percentage of annual sales turnover was regressive (Table 1). The mean compliance costs, as percentage of annual sales turnover for companies with turnover level of less than MYR100 million, was 0.057%. For the next category level of sales turnover of between MYR100 to MYR500 million, the percentage fell to 0.016% and it further decreased to 0.001% for sales turnover of more than MYR500 million. The mean percentage showed that the tax compliance costs of PLCs fell remarkably in relation to the companies' annual sales turnover. For comparison, the mean compliance costs percentage in the lowest turnover level was almost four times higher from the middle category and as much as 57 times higher than the highest level of turnover. The overall mean compliance costs of Malaysian PLCs as a percentage of the average weighted turnover level was 0.01%.

Table 1. Mean Compliance Costs as a percentage of Sales Turnover

Turnover Level (Million) ^a		Compliance Costs	
		Mean (MYR)	Percentage of Turnover
Less than MYR100	(31)	28,802	0.057 ^b
MYR100 to MYR500	(36)	46,673	0.016 ^b
More than MYR500	(31)	65,978	0.001 ^c
Overall	(98)	47,126	0.010 ^d

^a Number of respondents is given in parentheses. ^b Denominator used is the midpoint of the turnover level.

The compliance costs distribution was further analyzed in terms of internal, incidental and external costs components and the compensation amount. As a percentage of annual sales turnovers, a similar regressive pattern towards smaller PLCs was also observed in these costs components and compensation amount. As shown in Table 2, the internal costs of PLCs in the lowest sales turnover level (Less than MYR100 million) was 2.1 times higher than the middle level (MYR100 - MYR500 million) and 10.5 times higher than the highest level (More than MYR5,000 million). The middle level was five times higher than the highest level. An ANOVA test found a significant mean difference between sales turnover levels of internal compliance costs ($f=3.275$, $p=0.042$). A further analysis using a Bonferroni post hoc test showed that differences existed between the sales turnover of the lowest and middle levels.

Table 2. Mean Internal Compliance Costs as a percentage of Sales Turnover

Turnover Level (Million) ^a		Compliance Costs	
		Mean (MYR)	Percentage of Turnover ^b
Less than MYR100	(23)	10,360	0.021
MYR100 to MYR500	(29)	29,782	0.010
More than MYR500	(22)	24,207	0.002
Overall	(74)	22,088	0.005

^a Number of respondents is given in parentheses. ^b Denominator used is the midpoint of the turnover level.

As for the regressivity of incidental compliance costs (Table 3), PLCs in the lowest sales turnover level was 11.7 times higher than the middle level and seven times higher than the highest level. The middle sales turnover level was however 0.6 times lower than the highest level. An ANOVA test found a significant mean difference between sales turnover levels of incidental compliance costs ($f=4.600$, $p=0.012$). A further analysis using a

Bonferroni post hoc test revealed that significant differences existed between the sales turnover of the middle and the highest levels.

Table 3. Mean Incidental Compliance Costs as a Percentage of Sales Turnover

Turnover Level (Million) ^a		Compliance Costs	
		Mean (MYR)	Percentage of Turnover ^b
Less than MYR100	(10)	1,750	0.0035
MYR100 to MYR500	(11)	814	0.0003
More than MYR500	(13)	5,031	0.0005
Overall	(34)	2,701	0.0006

^a Number of respondents is given in parentheses. ^b Denominator used is the midpoint of the turnover level.

A similar regressive trend was also observed for the mean external compliance costs (Table 4). The lowest range sales turnover level was 5.1 times higher than the middle range level and 8.1 times higher than the highest range level. The middle range sales turnover level was 1.6 times higher than the highest level. An ANOVA test found a significant mean difference between sales turnover levels of external compliance costs ($f=15.421$, $p=0.000$) at a 1% significance level. A further analysis using a Bonferroni post hoc test exhibited that differences existed between the sales turnover of the lowest and the highest sales turnover levels and between the middle and the highest sales turnover levels.

Table 4. Mean External Compliance Costs as a Percentage of Sales Turnover

Turnover Level (Million) ^a		Compliance Costs	
		Mean (MYR)	Percentage of Turnover ^b
Less than MYR100	(31)	20,552	0.041
MYR100 to MYR500	(33)	24,473	0.008
More than MYR500	(29)	49,907	0.005
Overall	(93)	31,097	0.007

^a Number of respondents is given in parentheses. ^b Denominator used is the midpoint of the turnover level.

A regressivity of compliance costs was also found for compensation amount expressed in terms of sales turnover levels (Table 5). Thus, it is appropriate to conclude that the regressivity of tax compliance costs estimates established in this study is robust and reliable.

Table 5. Compensation by Sales Turnover

Turnover Level (Million) ^a		Compliance Costs	
		Mean (MYR)	Percentage of Turnover ^b
Less than MYR100	(29)	48,241	0.100
MYR100 to MYR500	(34)	35,853	0.010
More than MYR500	(26)	75,538	0.001
Overall	(89)	51,483	0.010

^a Number of respondents is given in parentheses. ^b Denominator used is the midpoint of the turnover level.

5. Conclusions

Overall, the increase in compliance costs of PLCs were not proportional to the increase in size, either measured by internal, incidental, external and total compliance costs. It was hypothesised that the distribution of CIT compliance costs is not fair as smaller companies bear a disproportionately heavier burden of compliance costs. In this study, tax compliance costs estimates, as a percentage of taxable turnovers, ranged from 0.057% of the smallest PLCs to 0.001% of the largest PLCs. The high level of regressivity found in this study is also consistent with the findings of existing Malaysian and international studies. The relatively higher compliance costs burden incurred by smaller companies may likely impact the equity of the tax system as a whole. The findings of this study add to research evidence from countries in emerging economies, which according to Ariff and Pope (2002), have weaker tax policy and less transparent tax system than those in the advanced economies

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