Tax Knowledge, Tax Complexity and Tax Compliance: Taxpayers’ View

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Abstract

This study examines taxpayers’ views on their level of tax knowledge and perceived complexity of the income tax system. Further, the study attempts to delve in the underlying reasons for non-compliance. Data was gathered through telephone interviews with thirty participants, and analysed using thematic analysis. Results suggest that taxpayers have inadequate technical knowledge and perceive tax system as complex. Tax knowledge and tax complexity are viewed as contributing factors towards non-compliance behaviour among taxpayers.

1. Introduction

The self-assessment system (SAS) has been widely practiced around the globe. Under this system, one issue that has been highlighted is the non-compliance behaviour. This unresolved issue could be probably due to the feature of SAS itself; that is the shift of responsibilities to compute tax payable from the tax authorities to taxpayers. In order to discharge these responsibilities, taxpayers are expected to be well-versed with the existing tax laws and provisions. This is especially crucial as they are answerable to the tax authorities in the case of a tax audit. Another prominent attribute of SAS is voluntary compliance, as the tax returns submitted by taxpayers are deemed to be their notice of assessment. In other words, penalty mechanisms will be applied if taxpayers do not submit a correct tax return within the stipulated period. One possible way of ensuring tax compliance, as suggested by previous studies is to enhance taxpayers’ tax knowledge (Loo, 2006; Loo et al., 2008; 2009). Similarly, a less complex tax system would also encourage tax compliance (Cox & Eger, 2006; Richardson, 2006). Notwithstanding the importance of tax knowledge and low level of tax simplification on compliance behaviour, not much has been written on this issue in New Zealand setting, except for few studies on readability of tax laws (Saw & Sawyer, 2010; Pau et al., 2007; Richardson & Sawyer, 1998; Tan & Tower, 1992). Thus, this paper will address this gap.

Using qualitative approach, this study intends to (1) reveal taxpayers’ perceptions on their knowledge and complexity of the income tax system in New Zealand, and (2) learn whether or not such perceptions affect their compliance behaviour. The results of this study can help the New Zealand policy makers understand the important segment of tax knowledge and complexity of the income tax system so that appropriate improvements can be made to ensure high compliance in future. In addition, this paper will contribute to the tax literature in two ways: (1) the
information obtained will add to the limited literature available in the region, and (2) the information on tax knowledge and tax complexity may provide the basis to develop tax knowledge and tax complexity measures. The remainder of this paper is organized as follows: the following section contains a brief overview of the New Zealand income tax system. This is followed by a review of literature on tax knowledge, tax complexity and compliance behaviour. Section 4 highlights the analysis and findings of the study, while Section 5 concludes the paper.

2. New Zealand income tax system

The New Zealand income tax legislation was first enacted in 1891 through the Land and Income Tax Assessment Act 1891. The applicable tax rates at that time were set at sixpence for a pound on taxable income up to £1,000, after an initial £300 exemption, and one shilling for a pound for the remaining balance (Committee of Tax Experts, 1998). These two-steps tax scale was adopted until 1911, when the number of steps was subsequently increased to nine in 1911 (Vosslamber, 2009). This change was only effective until 1913 when a graduated income tax was introduced in 1914. In 1941, the tax system returned to the step system of taxation with 39 steps (Vosslamber, 2009). Since then, the number of steps has changed a number of times (for details, see Stephens, 1993; Vosslamber, 2009) to settle to two steps in 1990 with a top rate of 33 percent, the lowest in the Organization for Economic Cooperation and Development (OECD) at that time (Stephens, 1993). Lowering the income tax rate (from 66 percent to 33 percent) reduced the share of personal income tax from 64 percent of total tax revenue in 1984 to 49 percent in 1990. To balance with that, fringe benefits tax (FBT), goods and services tax (GST) and resident withholding tax on interest and dividend income were introduced in 1985, 1986 and 1989, respectively (Brash, 1996). In addition, over time, exemptions for low income earners were also abolished, leaving the New Zealand tax system with no tax-free threshold. In 1998, a self-assessment system, which requires voluntary compliance, was fully implemented. This chronology from 1891 till 1998 indicates that numerous reforms have been made by the New Zealand tax authority to improve the tax system and deal with an increasingly complex environment. The more recent changes were undertaken in the year 2010. The focus of such changes was to achieve a fairer and more sustainable tax system. In order to accomplish this objective, lower personal income tax rates have been introduced, with a minimum of 10.5 percent to the maximum of 33 percent (the previous minimum and maximum tax rates were 12.5 and 38 percent, respectively). In order to fund the tax revenue reduction as a result of lowering the income tax rates, the rate for GST was increased from 12.5 percent to 15 percent. This tax reform was considered the most thorough and beneficial overhaul of the income tax systems in 25 years (Government of New Zealand, 2010).

3. Literature review

This section describes the selected past year studies on tax knowledge, tax complexity and compliance behavior.

3.1. Tax knowledge

Tax knowledge is an essential element in a voluntary compliance tax system (Kasippilai, 2000), particularly in determining an accurate tax liability (Palil, 2005; Saad et al., 2003). More recent studies undertaken in Malaysia (Loo, 2006; Loo et al., 2008; 2009) also suggested tax knowledge to be the most influential factor to determine taxpayers’ compliance behavior under the self-assessment system. This is empirically established by several other studies (for example, Kasipillai & Jabbar, 2003; Kirchler et al., 2006), which documented that possessing tax knowledge would lead to higher compliance rates. On similar note, the absence of tax knowledge may lead to non-compliance behavior among taxpayers, either intentionally or unintentionally. This is postulated by McKerchar (1995) who studied small business taxpayers in Australia. She suggested that small business taxpayers are not even aware of their tax knowledge shortfall and this may lead to unintentional non-compliance behavior. Such evidence was also documented among individual taxpayers in Malaysia who unintentionally committed mistakes in their tax return forms (Loo, et al., 2008). In this study, a mixed method design was used by conducting mail survey, quasi-experiment and case study concurrently between November 2005 and July 2005.
The abovementioned studies, which indicate a positive relationship between tax knowledge and compliance behavior, however, were not consistent with an earlier study by Harris (1989), who claimed that tax knowledge has no direct significant effect on taxpayers’ compliance behavior. One possible explanation for such inconsistent results is the difference in tax jurisdictions. The studies mentioned above were either conducted in Malaysia or Australia, while this study was conducted in the US. Another potential reason may be that the different measures were used in the studies.

3.2. Tax complexity

Tax complexity arises due to the increased sophistication in the tax law (Richardson & Sawyer, 2001). Tax complexity can take many forms such as computational complexity, forms complexity (American Institute of Certified Public Accountants, 1992), compliance complexity, rule complexity (Carnes & Cuccia, 1996), procedural complexity (Cox & Eger, 2006) and the low level of readability (Pau et al., 2007; Richardson & Sawyer, 1998; Saw & Sawyer, 2010). A review of tax complexity in a comparative study of seven countries by Strader & Fogliasso (1989) suggests that Japan, the UK, France, Italy and the US, all have highly complex tax system. Only Sweden and Netherlands are considered to have a moderately complex tax system. In New Zealand itself, various tax reforms have been made since the mid 1980s to overcome the complexity of the tax system (for details, see Hasseldine & Bebbinton, 1991). However, Tan and Tower (1992) claimed that the efforts made by the tax authority at that time to simplify the tax law failed. In their study, the authors applied the Flesch Reading Ease Index to measure the readability level of New Zealand tax legislation, Tax Information Bulletins (TIBs) and Tax Return Guides. The Flesch Reading Ease Index measures the difficulty ranging from zero (most difficult) to 100 (least difficult). Their findings indicated that there was no progress with simplification at that time, except for the Tax Return Guides. Further, Tan and Tower (1992) recommended that shorter sentences and active style of writing will help improve the readability of tax legislation and consequently reduce the complexity of the tax law.

A more recent study by Pau et al. (2007), however, provided contrary evidence on tax simplification in New Zealand. The researchers tested the effectiveness of the newly written Income Tax Act 2004, TIBS and binding rulings using readability measures, namely the Flesch Reading Ease Index, Flesch-Kincaid Grade Level Index, average sentence length and percentage of passive sentences. They found significant improvements in respect of tax simplicity through these measures. Sawyer (2007) agreed that there have been some improvements in tax simplification but continual change to the legislation has to a certain extent delayed the rewrite program (and also delayed the benefits). As an extension to the previous studies, Saw and Sawyer (2010) examined the readability of a sample of the selected sections of the Income Tax Act 2007, TIBs and binding rulings using similar measures as in Pau et al. (2007). Overall, the results suggested further significant success to the review project, undertaken by the New Zealand government in its tax simplicity goals in the context of improved readability. Following this rewrite project, the results of this study also indicated that the percentage of people with an education level of Years 11-13 to understand the Income Tax Act 2007 has significantly increased.

In Malaysia, Mustafa (1996), who studied taxpayers’ perceptions towards the self-assessment system which was to be introduced (at that time), suggested the presence of tax complexity in Malaysia, particularly in terms of record-keeping, too much detail in the tax law and ambiguity. The findings were partly consistent with the six potential causes of complexity labeled as: ambiguity, calculations, changes, details, forms and record-keeping, identified by Long and Swingen (1987). Such complexity was also present in Australia where it forces taxpayers to engage tax agents to deal with their tax matters (McKerchar, 2001; 2003). McKerchar (2003) further identified the most common problem faced by taxpayers is to understand the instructions in the Taxpack 2000. This is followed by the problems of understanding the rules, the tax return forms and other relevant written information provided by the tax authority.

Richardson (2006), in his research on 45 countries, found that complexity is the most important determinant of non-compliance, apart from education, income source, fairness and tax morale. His findings were consistent with Cox and Eger (2006) who focused on the State Road Funds in the US State of Kentucky. The authors found that procedural tax complexity contributes to an increase in tax non-compliance. In Australia, McKerchar (2005), who
carried out a survey among tax agents, noted that tax agents were not happy with the increasing complexity of the tax law. She further claimed that the tax agents desired a much simpler tax law, with less regulatory material and ad-hoc change. Similar findings were documented by Kirchler et al. (2006). He found that taxpayers were more likely to comply when the tax law was perceived as less complex.

3.3. Tax compliance

According to James and Alley (2002, p. 32), tax compliance refers to the willingness of individuals to act in accordance within both the ‘spirit’ and the ‘letter’ of the tax law and administration without the application of enforcement activity. Prior to that, Roth et al. (1989) defined tax compliance as filing all required tax returns at the proper time and that returns accurately report tax liability in accordance with the tax law applicable at the time the return is filed. The findings from a cross cultural study between Hong Kong and Australia indicated that Australian taxpayers were generally more compliant than the Hong Kong taxpayers (Richardson, 2005). Bobek et al. (2007), on the other hand, used a hypothetical tax scenario in their experimental study to investigate the taxpayers’ noncompliance behaviour in the US, Australia and Singapore. Results indicated that Singaporean taxpayers had the lowest noncompliance rate at almost 26 percent, while Australian taxpayers had the highest at 45 percent. The findings further suggested that complete compliance was highest in Singapore (54 percent) and lowest in Australia (30 percent). The US was in the middle in terms of both the compliance and noncompliance rates. Belkaoui (2004), in his study on thirty countries, measured the level of tax compliance using the index that varies from 0 to 6, where higher scores indicated higher compliance. In this study, New Zealand was ranked the second most compliant after Singapore. This was followed by Australia, the United Kingdom (UK) and Hong Kong. Malaysia was ranked eighth, after the US, while Italy was considered to be the least compliant. A review of the above-mentioned studies provides useful information to the researcher on the level of compliance behaviour across countries. However, studies on compliance behaviour would be less meaningful without investigating the potential factors leading to such behaviour. Jackson and Milliron (1986), in their earlier review of 43 tax compliance studies undertaken from 1974 to 1985, identified fourteen key variables of compliance behaviour, which include: age; gender; education; income level; income source; occupation; peer influence; ethics; fairness; complexity; tax authority contact; sanctions; probability of detection; and tax rates.

4. Analysis and results

A total of 2,267 potential participants were invited to take part in this study. However, only 30 participants were finally interviewed via telephone. The participants comprise of 18 males and 12 females, from eight different regions in New Zealand. The largest group of participants reside in the Auckland region (10 participants), followed by the Canterbury and Wellington regions, with seven and five participants, respectively. The interviews involved eleven salary earners, twelve retirees, five entrepreneurs, one student and one welfare beneficiary. Prior to interviews, a set of general questions relating tax knowledge, tax complexity and compliance behaviour were prepared. The interviews were recorded and transcribed. A step-by-step thematic analysis was then performed on the transcribed data. Results indicated that some participants had a general idea of the income tax system but not much on the details of the system. They admitted that their knowledge was restricted to a broad knowledge of the income tax such as, the objectives of income tax, types of income tax, and tax rates. The following are examples of the comments received:

“It [the income tax system] is a progressive system which essentially assists with redistributing wealth at a certain stage.”

(Participant 1, male, self-employed)

“Pretty limited, really. I know that there are obviously the goods and services tax that the company has to pay for and the employer has to deal with the PAYE [Pay As You Earn] and there are things, like fuel tax.”
“Tax knowledge, obviously with my background, I’ve got better than average, but I certainly wouldn’t claim to
be a tax expert; I [am] certainly not at the details level, but much on a broader policy [level].”

(Participant 13, male, retired Deputy Governor)

The majority of the participants explicitly claimed the importance of technical knowledge of the income tax
system. This does make sense due to the need to apply tax knowledge when meeting their income tax obligations.
When the lacking of technical knowledge of taxation is not so much an issue for salary and wage earners (since they
do not have to file tax returns), such a deficiency is certainly of concern for the self-employed people or those with
other incomes who are required to file tax return forms. This is evidenced from the study where only two
participants (both were retirees), claimed to be independently prepare their own tax return forms, while the
remaining participants (with obligations to file the tax return forms) sought help from accountants. A selection of
participants’ comments is outlined below:

“[My tax knowledge is] very limited. I’ve tried to do it [tax return], but it’s confusing.”

(Participant 5, female, retired)

“I have a very good accountant, so I expect my accountant to make sure I’m informed. I’ve been self-employed
[person] for a lot of years, so I think I have as much as I need to know.”

(Participant 20, female, office manager)

From the interviews, very few participants mentioned their knowledge of the legal aspects of the income tax
system. This could be due to the fact that they had little of it and/or they did not find it to be an important aspect of
income tax to discuss. From the findings, we can infer that the most important type of knowledge to taxpayers is
technical knowledge. This can be drawn from their responds while being interviewed where majority of
interviewees were discussing about this type of knowledge. This is followed by the general knowledge and the least
important is the legal knowledge. Notwithstanding the importance of the technical knowledge, most of the
interviewees admitted to have limited knowledge on this aspect that eventually forced them to seek tax
professionals’ assistance. Similar scenario was reported in Malaysia where the demand for tax agents increased due
to the lack of technical knowledge among taxpayers (Saad et al., 2003). On another note, McKerchar (1995) and
Loo et al. (2008) cautioned the possibility that this tax knowledge shortfall could lead to unintentional
noncompliance behavior among taxpayers, as what happened in Australia and Malaysia.

With regard to the complexity of the income tax system, the majority of participants claimed that the system is
generally too complex for taxpayers to understand. This opinion was shared not only by the self-employed people
but also by the salary and wage earners, retirees and even students. The following is a sample of views from
participants:

“It is [complex] for somebody like me. I do try to understand, like I read about it and I just get lost. [It’s ] not for
me. Some people’s brains are very financial and I think my brain is not.”

(Participant 15, female, factory worker)

“It is complex. I think it could be made more simpler for everybody, so everybody truly understand because
sometimes they make forms and it’s too much. That needs to be taken out.”

(Participant 3, female, full-time student)

These findings seemed to be inconsistent with Saw and Sawyer (2010) who claimed that the rewrite project has
improved readability of tax legislations, even among people with an education level of Years 11-13. One possible
explanation could be the difference in the definition of complexity in the studies. In Saw and Sawyer (2010), they measured complexity in terms of the difficulty to read and understand (using certain indexes) the tax legislations including Income Tax Act, TIBs etc. Meanwhile, in the present study, the researcher sought taxpayers’ views on their actual experience in dealing with the income tax system.

During the final section of the interviews, participants were probed on the reasons for tax non-compliance. The first reason is the taxpayers’ attitude of being greedy and no feelings of civic duty to share their incomes with other members if the society. Secondly, is the taxpayers’ belief that they could avoid paying tax without being caught by Inland Revenue. Such perceived behavioral control among taxpayers motivated them to constantly not comply with their tax obligations. Some attributed that control to the assistance provided by the accountants, while others blamed the loopholes in the tax system itself that provided room for manipulation. Thirdly, is the complexity of the income tax system which compelled taxpayers to not comply, either intentionally or unintentionally. Finally, is the fairness perception of the income tax system. Participants clearly mentioned that their negative perceptions of the income tax system, particularly on the tax rate structures and government spending, had motivated them to avoid and evade paying tax.

5. Conclusion

This study investigates taxpayers’ view on their level of tax knowledge, perceived complexity of the income tax systems and the underlying reasons of non-compliance behavior. From the interviews, taxpayers appeared to have inadequate knowledge on the technical aspects of the income tax system. This issue was even critical among the self-employed participants who are expected to deal with onerous tax matters, such as PAYE, GST, Kiwisaver etc. In dealing with these tax affairs, they may have to incur more compliance costs. The income tax system was also perceived as inherently complex. The huge amount of paperwork to be completed in complying with their tax obligations further escalated the problem. This is not surprising as the New Zealand income tax system has been criticized for being overly complex. With regard to compliance behavior, participants generally believed that attitude, perceived behavioural control, complexity and fairness perceptions have partly contributed to taxpayers’ non-compliance. The information obtained from this study would be beneficial to both tax literature and practice. In terms of tax literature, this information will serve as guidelines for researchers to develop tax knowledge and tax complexity measures. Also, the information on possible determinants of non-compliance could be used for future research. From the policy makers’ perspectives, this information will assist tax authority to develop their tax education and simplification program.

References


