

EXCISE DUTY COMPLIANCE BEHAVIOR IN MALAYSIA

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Abstract: *Taxation became a main of revenue in most of the developed and developing countries. However, tax non-compliance remains a serious issue around the globe. The negative impact of tax non-compliance on the economy and the evolving nature of indirect tax in Malaysia have induced this study. Although this phenomenon always present, but less attention is given compared to direct taxes such as income and corporate taxes. Malaysian government was emphasizing on strengthening its financial capacities via indirect taxes. As a result, the establishment of raising indirect taxes revenue is needed to ensure a sustainable country's development. However, the level of compliance among importers still not satisfied. Thus, the objective of this study is to examine the determinants of importers excise duty compliance. Using the deterrence theory as the basis of this study's framework, data were collected from 500 useable excise duty offenders scattered throughout Malaysia. Results from regression analysis (partial least square) shown that penalty rate, the probability of detection and tax knowledge revealed a positive and significant relationship with excise duty compliance. Implications and recommendations for policy makers are discussed.*

Keywords: *Penalty Rates, Probability of Detection, Peer Influence, Tax Knowledge, Excise Duty Compliance*

Introduction

Most of the developing countries rely on trade-related taxes for their economic growth and generating wealth (Mashiri & Sebele-Mpofu, 2015). In prior literatures, less attention was given to the impact of smuggling and illegal trade activities on indirect tax revenue (Mashiri & Sebele-Mpofu, 2015). As a result, World Trade Organization [WTO] initiated an opening market through successful negotiations on trade barriers reduction, customs duties or tariff reduction, quotas and import restrictions. In the same vein, World Customs Organization [WCO] standardized Customs policies to ensure the harmonized system application around the globe. However, the trade facilities not only used for legal means but also by criminals. Tax non-compliance and shadow economy involving indirect taxes are two major issues encountered by most of the tax administrator and policy makers. Tax non-compliance consisting of tax avoidance and tax evasion consumed high portion of national revenue in developed as well as developing countries (Mashiri & Sebele-Mpofu, 2015).The empirical evidence pertaining tax non-

compliance is still scarce as it represents the crucial phenomenon in developed and developing countries (Ross & McGee, 2012). This is caused by lacking on precise data estimating tax evasion and avoidance. Further, Tsakumis, Curatola and Porcano (2007) stated the identification of tax non-compliance determinants is crucial which caused most of the tax researchers lacking in providing high-quality data. Even though, tax non-compliance studies have been established since many years ago, only a few can be linked to indirect taxes. This indicates the wide gap to the indirect tax non-compliance studies compared with direct taxes. An understanding of excise duty non-compliance as an indirect tax could provide an empirical evidence to Royal Malaysian Customs Department (RMCD) with appropriate strategies to improve tax non-compliance. Tax non-compliance on excise duty comprising of cigarettes, liquor and imported vehicles are quite rampant compared to other commodities such as tiles, tyre and electric appliances. Despite the various transformation programs introduced by RMCD to improve excise duty collection, prior statistical evidence indicates the increase of tax non-compliance among importers as taxpayers. For instance, the additional excise duty detected from illegal trade and smuggling offences cases are quite high. In the year 2012, RM358.56 million (4,810 cases), RM374.63 million (5,070 cases) in 2013 and RM360.29 (4,254 cases) in 2014 (RMCD Annual Report, 2012-2014). Due to the increase of tax non-compliance, tax revenue collected is less than the expected actual tax. The important determinants lead for smuggling and illicit trade include low chances of being caught and prosecuted, weak legal and regulatory frameworks as well as weak enforcement (Thornton, 2013).

In this regards, there is a need to identify and critically examine significant determinants that contribute to the voluntary compliance. Therefore, the enforcement strategies incorporated with socio-psychology measures needed to curb excise duty non-compliance. Deterrence model emphasized on monetary aspect where taxpayers will make a rationale choice by considering the expected gain compared to losses determined the decision to evade tax. It has been asserted that enforcement measures such as penalty rate and the probability of detection implied. Braithwaite (2011) indicates not only law enforcement is a solution to build up compliance capacity but also other factors should be considered. Thus, this study is conducted to investigate the relationship between penalty rate, probability of detection, peer influence, and tax knowledge with excise duty compliance by importers in Malaysia.

Literature Review

Tax non-compliance consists of tax avoidance and tax evasion. Tax evasion is defined as intentional behaviour of taxpayers violating tax law to escape from tax payment (Gabor, 2012). Whereby, tax avoidance involves taxpayers used loopholes in tax system to reduce paying taxes. Excise duty is one of importance components in indirect taxes. The excise duty imposed to import into Malaysia and locally manufactured goods as stated in Section 6 of Excise Act 1976. The commodities bound in Excise duty act includes liquor, tobacco, cigars, cigarettes, four wheel drive, multi-purpose vehicles and playing cards. Non-compliance in Customs context involves various methods such as; 1] True values of goods are under declared; 2] Tariff category misclassified; 3] excise duty correctly assessed but are released without tax payment; 4] Goods are not pass through Customs clearance in importing and exporting countries [smuggling]; 5] Falsifying country of origin documents (Uzzaman & Yusuf, 2011). The economic approach of tax non-compliance behaviour pioneered by Becker (1968). Deterrence Theory assumed that taxpayers' decision to pay tax determined by monetary gain after weighing the positive and negative behaviour of non-compliance which are based on probability of detection and penalty

severity. Taxpayers' would commit crime or unlawful conducts if the gain were greater than what would be gained by lawful activities. Individual would commit in non-compliance if the consequences of being caught and punished [law enforcement] were less than the reward of non-compliance. Two models, i.e., financial self-interest model and expanded model that consist of non-economic variables, have been developed to explain tax compliance (Fischer, Wartick, & Mark 1992). Originally developed by Becker (1968), and later applied to explain the behavior of taxpayers (Allingham & Sandmo, 1972), the financial self-interest model postulates that people will comply with paying tax due to economic reasons. The probability of being caught, the amount that will be imposed if get caught, and the punishment received when caught are economic factors that determine whether people will pay tax or not. The financial self-interest model assumes that individuals will try to maximize the benefits of evasion and minimize the cost of being detected before performing the behavior. If the benefits are larger than the cost, they will execute the behavior. The financial self-interest model has been used widely in studies on tax evasion and tax compliance

In Malaysian Customs perspective penalties under Excise Act [1976] stated in section 71-79 imposed for making incorrect statements, falsifying documents, giving false information, evasion of excise duties, illegal manufacturing of dutiable goods, selling liquor without license, obstructing excise officers and rescued goods. Penalty is regarded as an enforcement measures in tax system to discourage taxpayers involve in tax non-compliance (Devos, 2013; Filippin, Fiorio, & Viviano, 2013; Madi et al., 2010). The rationale of penalty and sanctions will be efficient if the taxpayers perceive the opportunity being caught and prosecuted successfully is high (Devos, 2013). Devos (2013) reported that a positive association of penalties and tax compliance. Varma and Doob (1998) further stated judges should impose higher penalties to deter committing an offence than benefit derive from successful non-compliance. Penalties as deterrent effect still be questionable for most of the tax authorities.. Based on the studies conducted in Australia, New Zealand, United Kingdom and United States revealed that penalties has limited impact upon tax non-compliance (Devos, 2013).

Probability of detection is ambiguity situation faced by the taxpayers whether to involve in tax non-compliance or not. Taxpayers' compliance improved for ambiguity-averse but reduces for ambiguity lovers (Snow & Warren, 2005). The empirical evidence revealed probability of being audited and detected might not be an effective measure in combatting tax non-compliance which relies taxpayers' preferences for ambiguity (Snow & Warren, 2005). However, Jayawardane (2016) stated the weak probability of detection influenced taxpayers' attitude in tax compliance decision in Colombo, Sri Lanka. The weak probability of detection increases tax non-compliance. To detect potential audit issues, Lee and Curatola (2015) conducted an experiment to investigate firms tax reporting and financial reporting when increase the detection risk. They found that corporate tax professionals were more likely to recommend uncertain tax positions for the strong reporting firm. In the low detection risk environment, corporate tax professional recorded higher tax reserve when their firms had a weak uncertain tax position and vice versa.

Peer influence is defined as influence of other people consider as important to individual such as family, friends, and colleagues and more likely to share the tax compliance choices with them (Bobek, Hageman, & Kelliher, 2011). Most of the prior literatures identified peer influence have significant influence in determining compliance decision (Blanthorne & Kaplan, 2008; Bobek, Roberts, & Sweeney, 2007). Further, Wenzel (2004a) suggested peer influence has 'substantial impact' on tax compliance behaviour. Therefore, peer influence playing an important role in determining taxpayers' actual behaviour apart from other measures impose by tax authority to

deter non-compliance (Prinz, Muehlbacher & Kirchler, 2014). In Malaysia, Ho and Wong (2008) stated evading taxes are acceptable and tolerable for the taxpayers if their peers are perceive so.

Tax knowledge is essential in shaping compliance behaviour. Tax knowledge in Customs context involves tax specific knowledge required for importation procedures includes tariff classification, valuation, origin rules and ‘Customs facilitations’. Also covered the process of goods clearance involving other agencies such as port operators, port authority, Customs, health department and agricultural department. Tax knowledge is taxpayers understanding on tax law and regulations to deter tax non-compliance (Kasipillai, Aripin, & Amran, 2003). Improvement on taxpayers’ knowledge will enable them to understand tax system and tax laws in respective countries. The adequate tax knowledge on tax system enable taxpayers’ to perform their responsibilities to declare their goods importation, tariff code, tax rate, goods entry process, and classification accurately which leads to higher compliance level among importers as taxpayers’. Loo, Mckerchar and Hansford (2009) found that tax knowledge was an influential factor in determining taxpayers’ compliance behaviour In the same vein, Mohamad, Nor, Bakar and Nanta (2013) and Pui Yee, Moorthy and Choo Keng Soon (2017) stated tax knowledge is needed to improve taxpayers’ discipline in tax compliance which signify tax knowledge have positive relationship with tax compliance. Saad (2014) emphasized on the importance of tax knowledge in deterring tax non-compliance behaviour. The results indicates taxpayers has inadequate knowledge on technical parts leads them to perceived the tax system is complex and will motivate to non-compliance behavior.

Based on the prior studies results the conceptual framework for the current study as illustrated in Figure 1. The conceptual framework is based on deterrence theory which consists of penalty rate, probability of detection, peer influence and tax knowledge as independent variables and excise duty compliance as dependent variable.

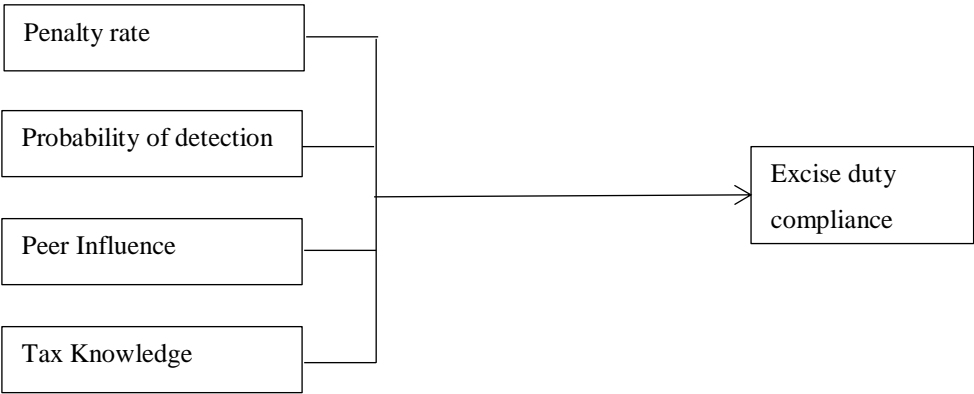


Figure 1: Conceptual framework

Based above discussion, the following hypotheses are as follows:

- H1: There is a positive relationship between penalty rate with excise duty compliance
- H2: There is a positive relationship between probability of detection with excise duty compliance
- H3: There is a positive relationship between peer influences with excise duty compliance
- H4: There is a positive relationship between tax knowledge with excise duty compliance

Methods

This study was cross sectional in nature. The population of these offenders totaled 1,275 comprising of three commodities cigarettes, liquor and imported vehicles (RMCD Annual Report 2014). A total of 600 structured questionnaires were distributed and 521 questionnaires (83%) were returned as completed. After data screening considering outliers, 500 samples remained as useable for further analysis. The structured questionnaires were adapted from previous studies in the field of taxation There are 9 items was used to measure excise duty compliance adapted from Kirchler and Wahl (2010). Penalty rate was measured by 5 items adapted from Devos (2005). Probability of detection was measured using 6 items adapted from Wenzel (2004b). Peer influence and tax knowledge was measured using 5 items and 7 items respectively adapted from Bobek et al.(2007) and Sakurai and Braithwaite (2001). Questionnaires were answered on a 7-point Likert scale ranging from 1=strongly disagree to 7=strongly agree. Targeted respondents were managers responsible and significantly involved in customs declarations. This study used a disproportionate stratified random sampling technique to select the sample. According to Kumar, Talib and Ramayah. (2013), the disproportionate sampling technique is selected when there is more variability within the stratum. The population in this study was homogeneous and divided into subgroups based on commodities known as strata. A simple random sampling was used to draw the sample from each stratum (Kumar et al., 2013). For the purpose of this study, there were three strata of offenders divided by commodities, i.e., cigarettes, liquor, and imported vehicles. From each commodity group, samples were drawn using simple random sampling, which was carried out by using SPSS version 22.

Findings

Reliability, Validity and hypothesis Test

To analyze the model, this study employed PLS-SEM 3.2.7 software (Ringle, Wende, & Becker, 2015). The two-stage analytical procedures by Anderson and Gerbing (1988) followed known as measurement model (validity and reliability) and the structural model (testing the hypothesized relationship).The measurement model measures the relationship between the latent variable and it's indicators (Hair, Hult, Ringle & Sarstedt, 2016). There are two types of model examined to assess the measurement model consisting of convergent validity followed by discriminant validity. Convergent validity of measurement ascertained by examining loadings, average variance extracted [AVE] and also composite reliability [CR]. The loadings were all higher than 0.60, the composite reliability were all higher than 0.70 and AVE values were also higher than 0.50 as suggested by Hair et al., (2016) as shown in Table 1.

Table 1: Convergent Validity

| Constructs | Items | Loadings | Cronbach | CR | AVE |
|------------------------|-------|----------|----------|-------|-------|
| Excise Duty compliance | EDN1 | 0.824 | 0.851 | 0.893 | 0.626 |
| | EDN5 | 0.740 | | | |
| | EDN7 | 0.854 | | | |

| | | | | | |
|--------------------------|------|-------|-------|-------|-------|
| | EDN8 | 0.795 | | | |
| | EDN9 | 0.739 | | | |
| Penalty Rate | PR1 | 0.604 | 0.848 | 0.810 | 0.524 |
| | PR2 | 0.668 | | | |
| | PR3 | 0.652 | | | |
| | PR5 | 0.926 | | | |
| Probability of Detection | POD4 | 0.917 | 0.808 | 0.912 | 0.839 |
| | POD5 | 0.915 | | | |
| Peer Influence | PI1 | 0.893 | 0.800 | 0.883 | 0.716 |
| | PI2 | 0.881 | | | |
| | PI4 | 0.758 | | | |
| Tax Knowledge | TK1 | 0.875 | 0.925 | 0.940 | 0.694 |
| | TK2 | 0.828 | | | |
| | TK3 | 0.820 | | | |
| | TK4 | 0.660 | | | |
| | TK5 | 0.897 | | | |
| | TK6 | 0.886 | | | |
| | TK7 | 0.842 | | | |
| Tax Agent | TA2 | 0.721 | 0.825 | 0.871 | 0.531 |
| | TA3 | 0.769 | | | |
| | TA4 | 0.693 | | | |
| | TA5 | 0.793 | | | |
| | TA6 | 0.736 | | | |
| | TA7 | 0.654 | | | |

The outer model's construct validity is established by discriminant validity. Discriminant validity is a compulsory test for testing hypotheses. Discriminant validity differentiates between the own respective construct and not related to other constructs (Hair et al., 2016). Fornell-Larcker criterion measure applied to assess discriminant validity. Each construct's AVE's square root larger than its squared correlations with other construct in the model. The square root of the AVE represented by the bolded values on the diagonals were greater than the corresponding row and column values (see Table 2).

Table 2: Discriminant Validity

| | EDN | PI | POD | PR | TA | TK |
|-----|--------------|--------------|--------------|--------------|--------------|--------------|
| EDN | 0.791 | | | | | |
| PI | 0.678 | 0.846 | | | | |
| POD | 0.605 | 0.530 | 0.916 | | | |
| PR | 0.337 | 0.309 | 0.374 | 0.724 | | |
| TA | 0.477 | 0.483 | 0.350 | 0.177 | 0.729 | |
| TK | 0.652 | 0.671 | 0.534 | 0.378 | 0.463 | 0.833 |

The model's predictive capabilities and constructs relationship assessed in the structural model as suggested by Hair et al.(2016). Structural model involves evaluating R^2 , path coefficients [beta values] and corresponding t values through bootstrapping procedure with resampling technique of 1000. Further, predictive relevance [Q^2] and effect size [f^2] also should be reported in the basic model (Hair et al., 2016). This study's model showed that R^2 value for excise duty non-compliance for direct effect is 0.591 suggesting that 59.1% of the variance in excise duty compliance explained by penalty rate, probability of detection, peer influence and tax knowledge.

Table 3: Structural Model Analysis

| Hypotheses | Path Coefficient [β Value] | t-value | Decision |
|------------|--------------------------------------|---------|---------------|
| H1 | 0.317 | 5.816 | Supported |
| H2 | 0.258 | 5.505 | Supported |
| H3 | 0.034 | 0.836 | Not Supported |
| H4 | 0.233 | 4.409 | Supported |

The existence of effect determined by p-value. Therefore, effect sizes and confidence intervals were included as suggested in reporting this study's result. Table 3 indicates that the structural model analysis for direct analysis. From the analysis it was found that penalty rate (t=5.816, p<0.01), probability of detection (t=5.505, p<0.01) and tax knowledge (t=4.409, p<0.01) positively related to excise duty compliance which supported H1, H2 and H4. Meanwhile, the findings not supported peer influence (t=0.836, p>0.05).

Discussion

This study aims to investigate excise duty compliance and its determinants. Penalty rate was supported to be positively related to excise duty compliance for direct relationship. Hence, this hypothesis was supported it is suggested that the greater the penalty, the greater will be excise duty compliance. The result is consistent with Cowell (2004) and Eide (2000) who showed a significant and positive relationship between penalty and tax non-compliance. It can be concluded that in the RMCD context, penalty is regarded as a deterrent to high-risk evaders. Specifically, persistent offenders tend to be affected by penalty. The finding of this study

suggests that the effectiveness of penalty imposed by the RMCD relies on the moral perception of offenders. Offenders who view penalties as being a serious deterrent will cause them to not engage in offences. This indicates not only enforcement strategy will build up desired compliance. In this vein, RMCD should educate taxpayers rather than imposing severe penalties.

Probability of detection was supported to be positively related to excise duty compliance. This result is congruent with Kalangi (2014) and Modugu and Anyaduba (2014) found a positive relationship between probability of detection and tax compliance. This may be because probability of detection was defined as one of the enforcement strategies imposed by tax authorities to deter tax compliance behaviour. In the traditional view, taxpayers makes a rational calculation by weighing the gains from successful non-compliance with the expected lost from probability of detection. When the probability of being caught rises through audit caused the increases of compliance cost by severity fines and other consequences. Therefore, taxpayers are keener to involve in non-compliance activities to gain monetary loses. Thus, probability of detection does emerge as an important factor in excise duty compliance. The enforcement effect on tax non-compliance indicates the stringent enforcement effect will decrease non-compliance (Hanno & Violette, 1996)

This study discovered that tax knowledge and excise duty compliance was related. This observation is similar to the result of Mei Tan and Chin-Fatt (2000). The RMCD importation declaration requires many complex and technical procedures such as tariff classification, valuation, origin rules, and facilitation provided by other agencies especially at border such as port authorities, port operators, agriculture department, chemistry department, road transport department, and tax agents. This study revealed that sufficient importation knowledge was used to minimise non-compliance on excise duties. Hence, adequate importation knowledge induced ethical behaviour among importers. It is suggested that importers should attend the courses, workshops and seminars conducted by RMCD to improve tax knowledge.

Peer influence variable found that the hypothesis was not supported. This finding contradicts with those found peer influence to be important determinant (Bobek et al., 2007; Borrego et al., 2013; Kahle & White, 2004). In excise duty compliance, peer influence involves importers and tax agents. These two groups affect importers' tax compliance. Business partners (other importers) and tax agents are the people with whom the importers connect on a regular basis. This study is in line with the findings by Hessing, Elffers, and Weigel (1988) identified no relationship between taxpayers compliance versus non-compliance decisions with perceived subjective norm (peer influence) of tax agents. This finding is also consistent with the result of Hite and McGill (1992), they revealed tax agent is not the main consideration to cause the potential impact on taxpayers decision. In this study importers are not influenced by others in declaring excise duty accurately, according to the tax law. One of the reasonable interpretation for this result could be the importer's aggressive return might incur high fees and more time. Clearly, it is revealed importers are motivated to hire tax agent with more conservative returns in declaring tax liabilities.

The use of self-reported survey like other compliance studies may not represent the actual behaviour of respondents (Van Dijke & Verboon, 2010). This limitation occurs especially when information is sought on tax sensitive and embarrassing issues.

Conclusions

Tax non-compliance remains a complex challenge for tax authorities, policy makers and researchers. Even though many strategies have been developed and carried out, tax non-compliance has not been fully solved. Optimum compliance could be achieved by addressing different aspects of non-compliance. This study provides empirical evidence by integrating economic, social and psychological determinants of non-compliance. It offers additional insight into the relationship between importers, tax agent, and numerous tax compliance determinants. The findings offer an understanding for the RMCD to develop and design new strategies to achieve optimum voluntary compliance of importers.

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