ASPECTS OF THE HIDDEN ECONOMY AND TAX NON-COMPLIANCE IN MALAYSIA

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A THESIS SUBMITTED FOR THE DEGREE OF DOCTOR OF PHILOSOPHY OF THE UNIVERSITY OF NEW ENGLAND, ARMIDALE, N.S.W. 2351, AUSTRALIA

April 1997
DECLARATION

I certify that the substance of this thesis has not been submitted for any degree and is not currently being submitted for another degree or qualification.

I certify that any help received in preparing this thesis, and all sources used, have been acknowledged in this thesis.

JEYAPALAN KASIPILLAI
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This thesis is dedicated to my father, Thambar Kasipillai, who passed away in April 1994.
ABSTRACT

In recent years, tax administrators and policy makers have become increasingly aware that tax evasion and non-compliance with income tax laws is becoming a serious problem. Methods of measuring tax evasion and estimating non-compliance have been applied in developed countries such as the USA, Australia and the United Kingdom but to date no such studies are available in Malaysia. This study reports on the findings of two primary surveys and results derived from an econometric model developed to estimate the size of the hidden economy (hidden economy is used as a proxy for tax evasion) in Malaysia. The survey on ‘Taxpayers Understanding and Knowledge Index’ suggested that there is some ignorance of basic income tax laws and this may lead to unintentional non-compliance. The survey on ‘Insights of the Hidden Economy in Malaysia’ provided some qualitative insights into the workings of the hidden economy in Malaysia. The ranking of sectors, in descending order of importance for hidden income generation, was used as a proxy to evaluate the extent of tax evasion.

The econometric model provides some quantitative measures of tax evasion and has yielded plausible estimates of the size of the hidden economy: these range from a high of 8.7 per cent of GNP in 1980 to a low of 3.7 per cent in 1993. By using calculated average tax rates, the tax evaded for each of the years from 1971 to 1994 was also computed, with estimated tax losses between a low of RM192 million (in 1971) and a peak of RM1,350 million (in 1984).
An understanding of the causes of tax evasion and non-compliance, of where and how it occurs, and of its quantitative significance are important to the design of a coherent and efficient enforcement policy. This study is the first major attempt to obtain this kind of information for Malaysia.
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<td>ASEAN</td>
<td>Association of South East Asian Nations</td>
</tr>
<tr>
<td>ATM</td>
<td>Automated Teller Machine</td>
</tr>
<tr>
<td>ATO</td>
<td>Australian Tax Office</td>
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<td>ATR</td>
<td>Average Tax Rate</td>
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<td>BNM</td>
<td>Bank Negara Malaysia</td>
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<td>CPI</td>
<td>Consumer Price Index</td>
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<tr>
<td>DW</td>
<td>Durbin-Watson Statistic</td>
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<tr>
<td>DGIR</td>
<td>Director Gener: I of Inland Revenue (Malaysia)</td>
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<tr>
<td>EFTPOS</td>
<td>Electronic Funds Transfer at Point of Sale</td>
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<td>GATT</td>
<td>General Agreement for Trade and Tariffs</td>
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<td>GCR</td>
<td>General Currency Ratio</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GNP</td>
<td>Gross National Product</td>
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<td>HIDEO</td>
<td>Hidden Economy</td>
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<tr>
<td>INCVEL</td>
<td>Income Velocity for Legal Money</td>
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<td>IRB</td>
<td>Inland Revenue Board</td>
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<td>Inland Revenue Department</td>
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<td>Inland Revenue Service</td>
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<td>ITA</td>
<td>Income Tax Act 1967 (Malaysia)</td>
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<td>M1</td>
<td>Narrow money</td>
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<td>MNCs</td>
<td>Multinational Companies</td>
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<td>NIPFP</td>
<td>National Institute of Public Finance and Policy</td>
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<td>OAS</td>
<td>Official Assessment System</td>
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<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
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<tr>
<td>OLS</td>
<td>Ordinary Least Square</td>
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<td>PATA</td>
<td>Pacific Asia Tax Administrators</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<td>PAYE</td>
<td>Pay-As-You-earn</td>
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<td>PBA</td>
<td>Project Based Audit</td>
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