A PROPOSED MODEL OF NON-COMPLIANCE BEHAVIOUR ON EXCISE DUTY: PROBABILITY OF DETECTION AS MODERATING EFFECT

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Abstract

Tax non-compliance is a severe problem faced by tax authorities. Despite the escalating levels of tax non-compliance, only a few studies have been conducted in Malaysia which are mainly focused on direct taxes like income and corporate tax. Studies on indirect tax non-compliance behavior in Malaysia are still limited. Hence, in this study we have developed new model for predicting tax non-compliance based on the deterrence theory associated with the Fischer's model in indirect tax context. The potential factors that contribute to the losses of excise duty revenue as indirect tax are caused by smuggling offences involving cigarettes, liquor and imported vehicles and are examined in the model. The non-compliance behavior with regards to payment of excise duty is highlighted through a conceptual framework that integrates audit rate, tax knowledge and corruption as main effects of non-compliance. In addition a probability of detection variable as an indirect effect (moderating variable) on excise duty non-compliance is also examined in this study.

Keywords: Excise duty, non-compliance, probability of detection, smuggling.

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1. Introduction

Royal Malaysian Customs Department (RMCD) is a governmental agency responsible for indirect tax collection such as import duty, export duty, excise duty, goods and services tax and vehicles levy. Moreover, RMCD also indirectly involved in safeguarding the Malaysia's financial interest and legitimate businesses. However, this department estimates the loses of excise duty exceeded RM 300 million for cigarettes, liquor and imported vehicles annually (RMCD Annual Report, 2014). The major cause for this loses is smuggling activities. The tax non-compliance behaviour among taxpayers still persist even though there are several acts been gazetted such as Customs Act 1967, Goods and Services Tax Act 2014, and Excise Act 1976. Despite, the fines and penalty imposed on the tax defaulters, non-compliance is still a major problem.

However, the studies on tax non-compliance with regard to indirect taxes is still scarce. In the Customs context, smuggling activities is one of the important determinants causing non-compliance. Smuggling is defined as a conduct that involves violating the law by importing and exporting products illegally without paying customs taxes (Alano, 1984). Similarly, illegal importation of goods from one territory to another is illustrated as smuggling (Deflem & Henry-Turner, 2001). While, Merriman, Yurekli and De Beyer (2003) defined smuggling as

excise duties evasion on goods which aretraded across borders. The key purpose of smuggling is to evade the payment of tariffs and excise duties which results in monetary and non-monetary profits for smugglers (Buehn & Farzanegan, 2012).

Smuggling activities consists of three types which are 1) incorrectly declaring the amount, for instance declaring lower quantity and price, 2) incorrectly declaring the descriptions of goods (Cooper & Bhagwati, 1974) and 3) fake invoicing, complicated transactions attempts, using two invoices, the false invoices are used for declaration and the genuine invoices are used for record purposes (double invoicing), tariff code miss-classification, over stated and under stated valuation and shipments (Thanasegaran & Shanmugam, 2007). In the Malaysian context indirect taxes are avoided through

falsifying the declaration, smuggling or Customs fraud (Miskam, Noor, Omar & Aziz, 2013). Thus, probability of detection is one of the enforcement factors that is needed to explain taxpayers' non-compliance behaviour.In this study a research framework is developed that integrates the probability of detection as a moderating variable to explain compliance with excise duty payments by importers.

2. Literature Review

2.1. Deterrence Theory and Fischer's Model

The conventional Deterrence Theory emphasized on sanctions and detections as a primary determinants in combatting tax non-compliance issues. Under this theory, importers (taxpayers) concerned on maximizing their expected utility by declaring excise duty that balances the benefits of successful evasion compared to the consequences of detection. This theory only focuses on economic factors. Therefore, in order to establish a comprehensive model, Fischer's model introduced in this study which incorporates with economic, sociological and psychological variables. In addition, audit rate adopted as variable in both Deterrence Theory and Fischer's model while probability of detection introduced as moderating effect and tax knowledge and corruptions are added to Fischer's model.

2.2. Probability of Detection

Probability of detection is defined as a likelihood of the tax authority in discovering the taxpayers' non-compliance and finding the rectification (Jackson & Milliron, 2002). In the prior research there are inconsistencies findings between tax compliance and their determinants, specifically on deterrence factors (Dubin, Graetz, & Wilde, 1987; Dubin & Wilde, 1988). The tax compliance theories are unable to explain real level of compliance in many countries (Feld & Frey, 2002; Slemrod, 2009; Torgler, 2003b;Torgler, Demir, Macintyre, & Schaffner, 2008). The prior economic scholars proposed that some variables might have moderating relationship (Kirchler, 2007). This is parallel with the explanation by Baron and Kenny (1986) when they mentioned that inconsistencies or weak relationship in the criterion variable and predictor variables will be stated as moderators. Furthermore, according to Edwards and Lambert (2007)the moderator variable is introduced when there is influence in strengthening the relationship between the independent variables and dependent variable and its effect on behaviour.

Taxpayer's behaviour relies on calculation of expected utility maximization (Allingham & Sandmo, 1972). This relates to the economic theory of crime established by Becker (1968). The level of tax evasion relies negatively with size of the sanction if arrested and the probability of being arrested. If taxpayers perceived that they will be detected through audit in that particular year they will declare everything accurately. Hence, probability of detection has a significant

role in determining the reporting behaviour by taxpayers. For instance, Riahi-Belkaoui (2004) analyzed individual decision between tax planning and tax evasion. The empirical evidence in this study was based on data derived from 30 countries. The relationship between tax law regulations and tax compliance is positive and significant. He concluded the most effective way to deter tax evasion is by creating tax morale among taxpayers'.

While Martinez-Vazquez and Rider (2005) identified compliance and increased enforcement have positive effect. This is in line with other academic scholars findings, they also indicates compliance level determined by detection risk (Alm, 1991; Pforsich, Gill, & Sanders, 2010). The probability of detection have greater consequences to the most of individual compared to anticipated compliance (Alm, McClelland, & Schulze, 1992). Therefore, Fischer, Wartick and Mark (1992) proposed perceived detection risk influenced taxpayer compliance behaviour than actual detection risk. Modugu and Anyaduba (2014) examined the effect of probability of detection via audit and other qualitative nature to determine the compliance level of corporates in Nigeria. The findings indicated there was a positive relationship between probability of detection through audit and tax compliance.

2.3. Audit Rate

Tax audit in Custom's context involves the systematic inspections of business systems. This is done by examining the commercial records regarding the payment of excise duties, books and records. The audit rate was implemented to ensure accurate taxes are collected, detect customs fraud and to improve the awareness of customs laws and regulations (Excise Act, 1976). Taxpayers with non-compliance behavior will be detected through investigations and tax audit. Generally there are mixed findings in relation to the tax audit and tax non-compliance. For example, a study by Tagkalakis (2013) showed there is a significant positive correlation between tax audit and tax compliance. Similarly did the findings by Isa and Pope (2011) when they mentioned tax audit have significant deterrent effect on taxpayers' compliance under self-assessment system.

However, Beron, Witte and Tauchen (1990) found tax audit and tax compliance only applied a moderate positive effect. While, taxpayers' internal motivation will cause the negative relationship between tax rate and tax compliance. The higher the tax audit will motivate to lower the compliance behavior (Frey, 2003). In addition, Alm, Jackson McKee (1992a) indicates the tax audit effects are nonlinear and small, causing the deterrent impacts on taxpayers compliance to ultimately decline. A similar outcomes also found in tax compliance experimental studies done by Alm, Deskin and McKee (2004) and Alm and McKee (2006). Therefore, the hypothesis developed for the present study is:

H1a: There is a positive relationship between tax audit with excise duty non-compliance.

The empirical evidence of prior literatures showed probability of detection and tax audit have significant relationship in determining compliance behaviour. Hence probability of detection will strengthen the relationship between tax audit and excise duty non-compliance (Sekaran & Bougie, 2013). Therefore, the hypothesis for moderating effect of probability of detection and tax audit as below:

H2b: The positive relationship between audit rate and excise duty non-compliance will be weaker and negative relationship will be stronger when perceived probability of detection is high.

2.4. Tax Knowledge

Tax knowledge is defined as taxpayers' awareness on excise duty rules and regulations. Tax knowledge is an element needed to ensure the voluntary compliance of taxpayers in tax system (Saad, 2014). Tax knowledge on taxation is essential in shaping compliance behaviour and preparing the accurate tax returns (Mansor, Saad & Ibrahim, 2004; Palil, 2010). Similarly, Loo, McKerchar and Hansford (2008) and Loo, Mckerchar and Hansford (2009) claimed tax knowledge is an influential factor in determining taxpayers' compliance behaviour in the tax system. The higher the taxpayers' tax knowledge will motivate higher compliance level (Kasipillai & Abdul Jabbar, 2003; Kirchler, Niemirowski, & Wearing, 2006). Additionally, intentional or unintentional non-compliance behaviour among taxpayers is caused by the absence of tax knowledge (McKerchar, 1995). The above explanation from the previous studies showed the positive relationship between tax compliance and tax knowledge. These findings contradict the study by Harris (1989). He indicates there is no direct significant influence of taxpayers' compliance behaviour. While, Collins, Milliron and Toy (1992) found negative relationship between tax knowledge and tax compliance. Hence, this shows the mixed findings in most of the tax compliance studies in explaining the relationship between tax knowledge and taxpayers compliance behaviour. Thus, the proposed hypothesis is:

> H2a: There is a positive relationship between tax knowledge with excise duty non-compliance.

However, the probability of detection might influence the findings of the relationship between taxpayers' tax knowledge and their tax compliance. The probability of detection playing an essential role in declaring tax returns accurately with the tax knowledge acquired if the taxpayer perceived they will be audited for the specific year (Riahi-Belkaoui, 2004; Richardson, 2008). In line with this, probability of detection considered as a moderating effect based on the inconsistent relationship as discussed above between tax knowledge as an independent variable and excise duty non-compliance as dependent variables. Hence, probability of detection might change the direction of the association between two variables from positive to negative (Baron & Kenny, 1986; Lindley & Walker, 1993). Therefore, the hypothesis formed for current study is:

> H2b: The positive relationship between tax knowledge and excise duty non-compliance will be weaker and negative relationship will be stronger when perceived probability of detection is high.

2.5. Corruption

Additional payment to government officials for illegal corrupt transaction is known as corruption (Collins, Uhlenbruck, & Rodriguez, 2009). The corruptions phenomenon is an escalating problem in most of the developing countries (Alabede, 2012). The mixed findings are indicated by most of the academic scholars in tax non-compliance studies. Uslaner (2010) stated the corruption will deter taxpayer to pay taxes. Additionally, Torgler (2003) claimed overcoming the corruption issues will restrict taxpayers compliance behaviour. Similarly, Spicer and Lundstedt (1976) mentioned taxpayers feel deceived if they perceived their tax burdens not spent fairly. The successful control of corruption is positively related to tax compliance (Picur & Riahi-Belkaoui, 2006). Again, Uslaner (2010) revealed the greater compliance level could be achieved with less corruptions. Akdede (2011) found the negative relationship between corruption and tax evasion.

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In Customs perspective, Customs officers are involved in classification determining the value of imported goods and the total tax paid.(Flatters & MacLeod, 1995). Taxpayers true tax liabilities rely on the assessment made by the Customs Officials. The Customs Officers involvement in corruptions related to misclassification of imported goods, lower rating the restricted categories of goods and understating the volume of shipments (Flatters & MacLeod, 1995). Hence, the suggested hypothesis is:

H3a: There is a positive relationship between corruption with excise duty non-compliance.

However, the relationship between taxpayers' behaviour towards tax compliance and tax evasion may be moderated by the presence of probability of detection. According to Çule and Fulton (2009)who concluded the increases in corruptions and tax evasion in business environment if acceptable will lower the cost. This could be achieved if the taxpayers' are not detected through tax audit and investigations. Therefore, the below hypothesis is proposed:

H3b: The positive relationship between corruption and excise duty non-compliance will be weaker and negative relationship will be stronger when perceived probability of detection is high.

3. Research Conceptual Framework

This study is based on the deterrence theory associated with Fischer's model. Based on the prior literatures it was suggested that the tax audit, tax knowledge and corruption might affect the importers intention as taxpayers in determining non-compliance behaviour on excise duty. Hence the model as shown in figure 1, serves as a conceptual framework for this study.
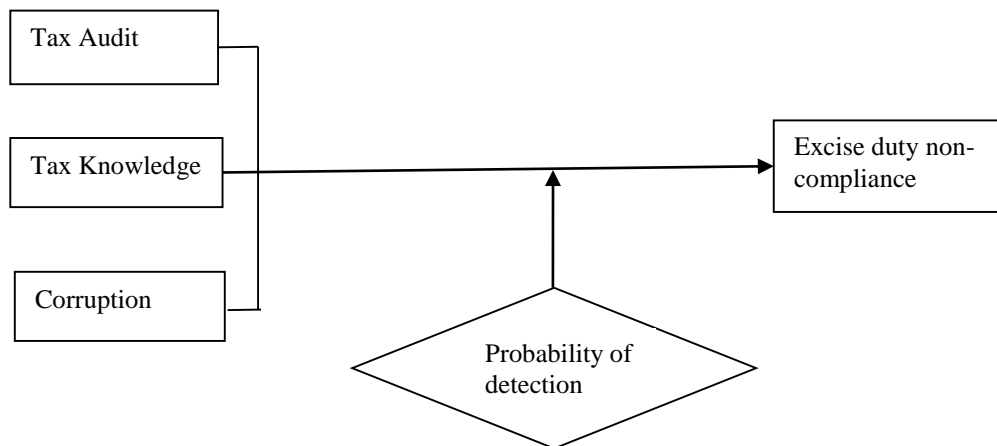

Figure 1. Research Proposed Model

4. Conclusion

The purpose of this study is to investigate the determinants of importers tax compliance behaviour. Thus, probability of detection is introduced as moderating effect and audit rate, tax knowledge and corruption as independent variables on excise duty non-compliance as dependent variable. The findings of this study will bridge the tax gap (difference between tax paid and tax owed) in excise duty non-compliance study. If the studies conducted in indirect taxes, mostly focused on sales tax, import tax and goods and services tax. However, excise duty non-compliance studies are still minimal and should be highlighted. Therefore, this study will pave the way to identify the important determinants in excise duty non-compliance in Malaysia. Hence, this study has potential in contributing to the body of knowledge in indirect tax

environment in Malaysia's context by associating with economical, sociological and psychological factors.

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