

TAX LITERACY RATE AMONG TAXPAYERS: EVIDENCE FROM MALAYSIA

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Abstract

The extent of taxpayer knowledge can have a major impact on the degree of compliance with taxation rules and regulation. Low knowledge creates uncertainty about requirements of the tax regulation and can lead to high degree of involuntary non-compliance. This study highlighted the importance of taxation knowledge by measuring Malaysian's tax payers' tax literacy rate taking into consideration the following criteria: 1) Individual ability to fill the tax return form independently, 2) Taxpayer's interest in learning about tax, and 3) Incident of errors in filling the tax return forms. Questionnaires were used in this study to ascertain the tax literacy rate. The results indicate that among the respondents, professionals group has the highest percentage of tax literacy and the farmers have the lowest percentage. Majority of the businessmen paid for services for filling tax return forms and high rank officers are the highest among the group for not employing others for filling the tax forms. Businessmen have the highest incidence of error in filling tax return form and most of teachers reported no error in filling such forms. Most businessmen showed interests and were willing to spend time to learn about taxation. They perceived taxation knowledge as an important tool for themselves and also for their family. Overall results indicate that more than 60% of respondents are tax literate. However, a significant number of them are actually 'functionally tax illiterate'. Most of them thought that they knew a lot about taxation as they had read them in the tax literature sent to them by the IRB. However, the evidence was contrary to this conjecture. The information on the extent of taxpayers' knowledge is potentially useful to the tax authorities to assist them in developing effective compliance enhancement policies

Keywords: *tax literacy rate, tax return*

INTRODUCTION

The extent of taxpayer knowledge can have a major impact on the degree of compliance with taxation rules and regulation. But more importantly, uncertainty about the requirements of the tax regulation can lead to a high degree of involuntary non-compliance without any intention to evade tax. While there has been few prior studies on this area in developed countries, this study examines the issue in Malaysian environment on tax payer living around the Klang Valley of Malaysia. The findings from this exploratory study should help policy maker in designing a more effective tax system in the country

Taxation is a universal knowledge needed by each citizen with potential tax liability. The “universality” of taxation knowledge however is very limited. The different tax systems practices in different countries of the world make knowledge very localized and the more rapid the development in the literature of taxation overtime, the more quickly the previous knowledge becomes obsolete. Because of the above constraints, ordinary citizen may find it to be quite difficult to keep up to date with the tax laws and procedure. Therefore, only the really keen parties who are directly involved in the tax administration or tax related profession would make an attempt to know about these new developments in taxation all the time.

Information on the extent of taxpayers knowledge is potentially useful to the tax authorities in the development of effective compliance enhancement policies. For example, if knowledge of a particular area of the tax regulation is low, compliance is also likely to be on the relevant items (Spicer and Lundstedt, 1976). This follow up research can determine the extent of the problem and appropriate action ranging

from clarification or interpretation of the regulation to complete re-writing of the relevant section can be undertaken. In addition if investigations reveal that particular subsets of taxpayers have low levels of knowledge, in general or in relation to particular aspects of the tax regulations, compliance- enforcement campaigns may be targeted more effectively.

Illiteracy can be loosely defined as “a lack of the ability to read, write and understand a fact”. United Nations Education, Scientific and Cultural Organizations (UNESCO) defined ‘literate person’ as one who can both read with understanding and write a short simple statement on his everyday life. On the other hand World Book Encyclopedia (1984) classified literacy into two categories – the first class and the second class. The first class definition is identical to the one provided by the UNESCO. The second class of literacy is the “functional literacy”. These are “persons with the reading, writing and understanding ability required to hold a job or perform other necessary tasks. However, a “functionally illiterate” person is therefore described as one who cannot meet the literacy demand of his society. This definition is very pertinent and relevant in today’s competitive job market (Eriksen and Fallan, 1996). In countries where literacy rates are almost zero, there are staggering numbers of functional illiteracy. In Malaysia it is expected that by the year 2020, an average worker will need more than a high school education to compete effectively in the job market.

This study defines tax literacy as ‘having the sufficient ability to read, write and understand taxation matters’. Those people who cannot understand complete the tax returns forms will be considered as tax illiterate person. On the other hand for an individual who claimed he has the ability to

perform these tasks but is deficient in tax knowledge, will be categorized as a functionally tax illiterate person (Des, 1989). For example in the world where the tax rules and regulations change and being constantly revised, a tax literate individual who did not upgrade himself with such new information in the end can be functionally tax illiterate.

It is not possible to expect most if not all citizens in a country to know about taxation and be up to date with its development. However, it is expected that the citizen must have at least the minimum level of tax knowledge required. However there is another important issue that need to be considered. Is what constitutes a basic knowledge in taxation sufficient for every citizen without having to update themselves every year? Isn't providing this basic knowledge of taxation without assuring an effective updating mechanism actually render citizen into "functional illiteracy"?

Unfortunately there are 'dearth' of literature on tax illiteracy even in the developed countries. However significant number of studies have conducted on the matter of tax compliance. For example, James *et al.* (1995) used experimental methods to explore the economic and non-economic factors that seem likely to affect tax compliance. Several factors were suggested as determinants of taxpayer compliance decisions. They ranged from economics-of-crime approach to those that emerge from other social sciences; detection and punishment, public good provision and social norms. Alm *et al.* (1992) used data from laboratory experiments, to determine the degree of taxpayer compliance in the absence of detailed and reliable information individual compliance choices. The results showed taxpayer reporting increases with greater audit and penalty rates, a lower tax

rate and when they receive something for their taxes. Reckers *et al.* (1994) examine the influence of ethical beliefs on tax compliance decisions. Specifically with regards to whether an individual's ethical beliefs about tax compliance mediate withholding effects and tax rate effects in tax evasion decisions. The results indicate that tax ethics are highly significant in tax evasion decisions and may be a 'missing variable' in decision-making process. To ascertain the extent of taxpayer literacy regarding Malaysia tax regulation, a survey has been carried out with selected sample taxpayer.

RESEARCH DESIGN AND METHOD

In order to determine the people tax literacy rate, a survey was carried out in early 2003. After identifying the sample target, a set of questionnaire that is already been prepared was then distributed among the respondents in the Klang Valley of Malaysia. In some of the cases, questionnaires were filled on their behalf during the face-to-face interview particularly for the farmers, low ranking officers and businessmen. Of the 160 questionnaires distributed, a total of 143 were completed and returned after three weeks.

This sample was categorized according to the age, type of employment and race of respondents. The type of employment is categorized into six groups: professionals, high rank officers, low rank officers, teachers, businessmen and farmers (see Table 1 below).

The respondents' background in relation to their tax affairs were also considered (see Table 2). Interestingly about 67% of the respondents have had experiences in filling tax returns form, which mean they are familiar with tax return items inquired. Also identified, the majority of these respondents actually pay their tax through

salary deduction indicating their passive easier way.
attitude toward taxation or just taking the

Table 1: Background of respondents in the tax illiteracy survey

a. Age group		
	Respondents	%
Age		
18-30 years old	25	17.5%
31-39 years old	33	23.1%
40-49 years old	42	29.4%
50-59 years old	28	19.6%
Over 60 years	<u>15</u>	<u>10.5%</u>
	143	100%
b. Employment categories		
Professionals	32	22.4%
High Ranks officers	31	21.7%
Low Ranks officers	21	14.7%
Teachers	14	9.8%
Businessmen	35	24.5%
Farmers	<u>10</u>	<u>7.0%</u>
	143	100%
c Race		
Malaysian	78	54.5%
Chinese	43	30.1%
Indian	<u>22</u>	<u>15.4%</u>
	143	100%

Table 2: Respondents' Taxpaying Background

a. Experience in filing tax returns form		
	Respondents	%
Have experience it before	96	67.1%
Never	<u>47</u>	<u>32.9%</u>
	143	100%
b. Experience in paying taxes		
Have experience it before	121	84.6%
Never	<u>22</u>	<u>15.4%</u>
	143	100%
c. Estimated tax payable		
Less than RM 2,500	102	71.3%
RM2, 500 - RM4, 999	21	14.7%
RM5, 000 - RM9, 999	7	4.9%
Over RM10, 000	<u>13</u>	<u>9.1%</u>
	143	100%
d. Mode of payment		
Lump sum	45	31.5%
Installments	<u>98</u>	<u>68.5%</u>
	143	100%

RESULTS

In this study we measure individual tax literacy rate from three different angles. The first measurement is based on individual “ability to fill the tax return form independently.” This is a practical definition, which assumes that to be able to fill the tax return form, one need to know a minimal knowledge of taxation. Logically, one is not required to know more than is necessary to help them handle their own affairs. The definition is also practical as far as the tax administrators’ is concerned. The objective of promoting tax literacy among the taxpayers is to reduce or lighten the burden of tax administration and hence increases efficiency and effectiveness in the tax collection effort in the economy. The respondents

were asked if they had obtained any form of help in filling their tax returns form. In this case we had made a strong assumption that any individual that seek help only implies that he cannot understand and fill the form independently and thus he is tax illiterate.

Result shows that professionals group had the highest literacy rate at 92% and the farmers group has the lowest at 27%. Thus in overall it shows that about 66% of the respondents are tax literate and the rest of them (34%) are illiterate (see Table 3).

From those who seek help, we further asked them if they had obtained the services free of charger or paying for those services (see Table 4 below).

Table 3: Basic tax literacy level based on 'ability to fill tax returns form' measure (in percentage)

Respondent Categories	Literate	Illiterate
Professionals	92.1	7.9
High Ranks officers	89.8	10.2
Low Ranks officers	44.7	55.3
Businessmen	41.6	58.4
Teachers	62.3	37.7
Farmers	27.6	72.4
Average	66.35	33.65

Table 4: Services for filling tax returns form (in percentage)

Taxpayers Categories	Free Service	Paid Service
Professionals	69.2	30.8
High Ranks officers	87.9	12.1
Low Ranks officers	12.1	87.9
Businessmen	11.8	88.2
Teachers	70.9	29.1
Farmers	52.5	47.5
Average	64.9	35.1

Result shows that on average only 35% of the respondents paid for the service in filling the tax returns form. The rest (65%) obtained free help in filling their tax returns form. The amount of 88% of the businessmen paid for the services followed closely by the low ranks officers. Most of the high ranks officers (88%) obtained free help in filling their tax returns form, presumably by seeking help from their secretaries, clerk or accountant. From the results above, there are several observations that could be made. Businessmen are among the groups that are illiterate in taxation, as 88% of them could not fill their own tax returns form. This is true when about 88% of them paid for the service. The reasons could be due to the fact that tax knowledge required by a businessman is a lot more complicated and comprehensive that it is not possible for them to master all that. They are more conscious about their tax affairs in reflection to their business and thus, they are willing to resort for professional help and pay for the service to make sure they fill their tax returns form correctly. Businessmen are also known to be busy all the time and since they can afford to pay for the service, they just did not attempt to fill the form by themselves.

Professionals are the most literate group in the survey (92%) followed closely by the high ranks officers (90%). This actually reflects the attitude of professionals group towards the tax knowledge. They might keep up to date with tax development as a matter of interest and maybe they need this knowledge to be able to manage their organization effectively. The same could be said to the high ranks officers. The teachers group probably have more opportunity to be up to date with tax development as they are more exposed to the 'knowledge'.

The other interesting fact to note is that the teachers group is among those who did not pay for the service to fill in their tax returns form. Some good reasons to explain this is due to the fact that they maybe could not afford it or are just not concerned with tax matters. Ironically, the same cannot be said on the low ranks officers. Although their income levels are at par with teachers, majority of them resort to paid service in filling their tax returns form.

The second, we can also measure tax literacy rate indirectly by observing the taxpayer interest in taxation. The interest in checking tax return assessment implies the familiarity or potential awareness of tax matters by these taxpayers. Respondents in the survey were asked whether they do check the tax assessment finalized by the Inland Revenue Board before they paid they tax due. 'Checking' here refers to running through the arithmetic in the tax calculation. Incidentally, the Inland Revenue Board do enclosed a brief literature on the method and rules in determining income tax payable of taxpayers. Result shows that most of the professionals group (84%) checked their tax return and most of the farmers (75%) did not (see Table 5). It can be concluded here that the higher the social background in terms of income and education, the more likely that taxpayer would put up an interest in checking their tax return therefore the higher the literacy rate.

Finally we can also determine the literacy rate by looking into the incident of error in filling tax returns form. The result shows that in general the percentage of error is reasonably low among all the group. The highest rate of error came from the businessmen group (21%) (see Table 6 below). This finding could be explained in relation to the level of sophistication that

prevails in the tax returns form for the business income.

Table 5: Taxpayers' interest in checking their Tax Assessment - Form (in percentage)

Taxpayer	Checked	Do not Check
Professionals	84	16
High Ranks officers	74	26
Low Ranks officers	42	58
Businessmen	75	25
Teachers	77	23
Farmers	25	75
Average	66	34

Table 6: Incident of error in filling tax returns form (in percentage)

Taxpayer Categories	No Error	Error
Professionals	93	7
High Ranks officers	95	5
Low Ranks officers	95	5
Businessmen	79	21
Teachers	98	2
Farmers	92	8
Average	92	8

Calculation of capital allowances, loss brought forward, capital gains and other complicated items made this group more prone to making mistakes in their assessment processes. This further highlighted the concept of 'functional illiteracy' in taxation. This also possibly explains why businessmen seek the professional help in filling up their tax returns form.

Overall the professional groups were the most confident in saying that they understand and appreciate the basic rule and regulation in taxation. This findings is consistent with the previous finding about capability of high ranking officers filling their own tax returns. In terms of taxation knowledge, professional, businessman and the high rank officers were close matching. It is quite surprising also to see the high

literacy level of the low rank officers. Most of these 'claimed knowledge taxpayers' felt that they were quite well versed on the regulations about taxable receipts, allowable expenses, personal and other relief and tax credit. All these almost cover the basic knowledge requires in determining taxable income. The inclusion of businessman in high scoring group seems to be inconsistent with earlier result where most of the businessmen are thought to be tax illiterate. However, result shows that these groups felt that they are not very well verse in the rules and regulation relating to resident status, tax bracket, tax rebate and capital allowances (see Table 7 below). Worst of all, most of these groups do not appreciate the concept of statutory income.

Table 7: Taxpayers appreciation of Income Tax rules and regulations (in percentage)

Concept/Regulations	Professional	High Rank Officers	low Rank Officers	Businessman	Teachers	Farmers
Resident Status	73	65	92	72	45	12
Taxable Receipts	85	78	95	83	79	74
Allowable Expenses	84	82	72	84	58	94
Capital Allowances	61	64	65	72	62	91
Statutory Income	37	27	18	6	19	26
Personal and other relief	89	83	79	77	57	71
Tax incentive	37	52	62	57	23	58
Tax Rebate	83	78	73	63	24	25
Tax Credit	62	73	69	89	91	31

To gain appreciation of the actual tax illiteracy phenomenon in Malaysia, the survey had further probe the taxpayer's knowledge of Malaysian taxation. A series of questions related to tax knowledge were asked. The result is shown in Table 8. Assuming that taxpayers want to calculate their own tax liability, they are required to know some basic rules and regulation on taxation. A series of questions attempt to provide some basic measure of taxpayer's capacity and capability in performing their own assessment.

A few implications could be made from these observations. First, the professional, businessman and high ranks officers groups might felt that they have minimum tax knowledge required to access or calculate their own taxable income. If their knowledge about tax rates and brackets could be up graded, they are able to conduct their own tax assessment. As to the businessman and those with income source other than employment, the tax knowledge required would be higher. The concept of capital allowances, loss carry forward statutory income, tax incentive and dividend ranking is important for them. The survey results show that the businessmen are par-

ticularly weak in this area and tax education is needed in this area.

It is quite surprising to observe the low level of tax literacy among teachers. Presumably, they regard their knowledge in taxation were so basic relative to other knowledge, such as the minimum knowledge required to teach the subject. Surprisingly, even the farmer's level of tax knowledge is high, except for technical concepts like resident status, statutory income, tax bracket and tax rebate.

In order to ascertain taxpayer knowledge in taxation and match them with their perceived knowledge, a form of "tax quiz" were slipped indirectly in the questionnaires. This is to test taxpayers actual understanding of some of the basic tax knowledge. The findings are shown in the Table 8 and Table 9. Respondents were asked whether a particular receipt will be taxable under income tax act in Malaysia.

Table 8 shows that except for salaries and wages, monthly allowances and EPF (Employee Provident Funds) withdrawal, most taxpayers had a good understanding of the taxability of each of the receipt items. For example most taxpayer perceived that company houses, companies cars

and compensation for loss of office are not taxable.

Table 8: Taxpayers actual understanding of the taxable receipt rules and regulation (%)

Concept/Regulations	Professional	High Rank Officers	Low Rank Officers	Businessman	Teachers	Farmers
Salaries and wages	95	87	95	94	96	86
Monthly allowances	81	82	94	73	78	68
Housing allowances	76	57	83	56	54	43
Entertainment allowances	48	54	67	67	42	58
Company Houses	62	43	52	42	27	46
Company Cars	68	48	31	63	48	51
Travelling	67	67	48	61	63	79
Compensation for loss of office	82	61	36	26	33	18
Gratuity	61	74	47	85	73	82

Table 9: Taxpayers actual understanding of the allowable expenses for tax purposes (%)

Concept/Regulations	Professional	High Rank Officers	Low Rank Officers	Businessman	Teachers	Farmers
Travelling expenses	64	58	75	71	76	41
Utility	62	57	69	68	72	45
Entertainment Expenses	53	73	67	63	62	72
Membership fees to professional bodies	71	48	68	48	82	27
Interest expenses on housing loans	63	76	64	45	66	78
Expenses to manage rented properties	42	61	53	38	67	34

One important observation that could be made from result in Table 8, is the possible practices of tax evasion among present taxpayers. By accident, as a result of tax literacy and misinformation about tax rules and regulation, it is expected that most of these groups particularly the businessman and the high rank officers do not declare the benefits-in-kinds they received. This could be intended or out of ignorance. This issues need to be addressed properly to make our tax system more productive and equitable.

Table 9 shows the results of the “tax quiz” on allowable expenses for tax purposes. Respondents were asked on the tax status of personal expenses. As the items asked were more technical in nature than the receipt items the results were quite expected. Except for clothing expenses which were clearly non-allowable to the businessman, teacher, low rank officers and farmers, most respondents were not sure of the *allowability* of these personal and expenses items. For example about 40% of the high rank officers, professionals and business-

man's believe that clothing expenses, interests expenses and personal housing was allowable expenses for tax purposes. Surprisingly not many taxpayers thought that membership fees to professional; bodies is an allowable expenses for tax purposes.

Overall, the professional groups were the most on this incomes taxability knowledge. The findings here are consistent with result in Table 7. In general, the findings showed that taxpayer's perceived judgment about their tax literacy level were overstated. This could be quite disturbing in the future. They might not realize that their tax knowledge is so shallow and need some reinforcement. What is more serious is that these taxpayers ignorance of tax knowledge would wrongly fill in their forms. They might under-declare their income with the presumption that certain receipts or benefits are tax-free and therefore need not be disclosed in the tax return. This in effect is an unintentional "tax evasion exercise".

DISCUSSION AND CONCLUSION

The findings show that between 30-35% of the Malaysian taxpayers are tax illiterate. Though more than 60% of these taxpayers felt that they are tax literate, the study showed that most are "functionally tax illiterate". Most of the tax payers may think that they knew a lot about taxation as they had read them in the tax literature send to them by the IRB (Inland Revenue Board) and they have a lot of experience filling tax returns forms. It was found that most taxpayer had lower level of tax knowledge. To a certain extent, this does hinder them from filling their tax return, though it not guarantee the accuracy of task. They might have been making errors and mistakes in filling in their tax return forms and this could go on undetected as the returns checking capacity of the IRB is not sufficient.

Not knowing the right way to calculate taxable income and tax payable would also create misunderstanding on the part of taxpayers. Taxpayers will not appreciate the way the assessment officers conduct the assessment. This could create continuous conflict between the two parties. In the long run, making all tax payer tax literate would proof profitable investment to the nation as whole. Not only will it make the taxpayers more concerned of the tax matters; taxpayers could also share the burden of assessment with IRB under the self-assessment system. This will reduce the administrative costs of the IRB and improve efficiency of the tax administration in the country.

Having established the importance of making our tax payer more tax literate, we must established the concern and willingness of taxpayer to get themselves literate in the tax knowledge. With the presumption that most taxpayers felt tax knowledge is important and they are willing to learn and updated their knowledge on the latest tax rules and regulations, it is now up to the policy makers to design policies that will help to mitigate tax illiteracy problem.

LIMITATIONS

There are several limitations of the study that need to be considered in evaluating the findings. First, the survey is done on respondents living in Klang Valley of Malaysia. To the extent that this group is unique, the findings may not be generalizable to the general population of taxpayers in Malaysia. Second, the usual limitations associated with self-reported questionnaire apply (i.e., response and non-response bias). The potential for response bias was mitigated by the anonymity of the respondents, promised confidentiality of responses, and direct return of the completed questionnaires to the authors. Finally, the variables

(employment categories) investigated in the study are not meant to be complete or exhaustive; there maybe other variables that influence tax literacy rate which were not included.

The limitations highlighted above suggest possible directions for future research. For example, future research could be extended to more regional areas such as East and West Malaysian and having bigger sample of population. Future studies could also examine ways to reduce the response and non-response bias such as disguising the objective of the study or shortening the reply period. Finally, future studies could include other variables such as age factor, work experience and so on in assessing tax literacy rate in Malaysia.

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