The Relationship Between Tax Evasion and Gst Rate

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Abstract: Malaysia has just implemented a new tax system that is the Goods and Services Tax or GST, which took effect form 1st April 2015. One of the reasons why GST was implemented is to-ensure the country did not become too dependent on the revenue from direct taxes. More importantly, it was also intended to enhance compliance among direct taxes. Tax evasion reflects a negative impact on the country, similar to economic development. A year after Malaysia implemented the GST, tax audit conducted by GST Audit Department of Royal Malaysian Customs Department Wilayah Persekutuan Kuala Lumpur (RMCD WPKL) has found that the tax evasion detected amounted RM87, 887.45. Hence, the objective of this study is to identify the association between probability of detection and the GST rate. The sample data in this study contained from 42 resolve audits which were underpaid GST and overstated input tax from April 2015 to April 2016. The statistical results exposed that there is an association between probability of detection and GST rate. Thus, RMCD should take action towards combating tax evasion in GST especially in understanding the taxpayer's non compliance behavior.

Key words: Goods Services Tax · Tax Evasion

INTRODUCTION

Preamble: Globally, most countries depend heavily on taxes as a source of government income. It has also become an important economic tool for managing the economy in any country, mainly to developing countries such as Malaysia [1]. Pomerleau [2] stated, developed countries increase their revenue through cooperation between both income taxes; individual and company, goods and service tax (GST), taxes on property and social insurance taxes. Generally, proceeds from the tax collected is used to finance the government expenditure that consists of public services such as national security, healthcare, education and training and also maintenance of law and order [3].

For Malaysia, major sources of the country's income are from direct tax and indirect tax. However, effective from April 1ˢ, 2015, the government of Malaysia has implemented a new tax system which is GST as a way to substitute the existing tax system which is sales and services tax (SST). Ernst and Young [4] stated that GST have increased in many countries around the world and has become an essential source of government revenue since the beginning of the global economic recession in 2009. The GST's introduction in Malaysia was aimed to enhance the effectiveness and efficiency of the current tax system. Furthermore, it could increase revenue without directly subjected to income from PETRONAS and income tax. Besides that, the GST implementation also hopes to improve the degree of compliance among taxpayers.

However, based on Oladipupo and Izedonmi [5], the public is always given a negative view on the matters relating to taxation. They do not want to pay any type of tax voluntarily. Therefore, the taxpayer were planning to pay less tax, either legally or not [6]. Therefore, it will result in non-compliance with tax and indirectly, there have been tax irregularities or tax evasion.

Tax evasion is an extreme form of tax non-compliance [6]. According to Kassipillai [3], tax evasion is a part of revenue deficiency that is also known as tax gap. In reference to [7], tax evasion is part of the tax gap when a tax is lost, which is the result of taxpayers' deliberately and unlawfully failing to declare their income that they know are taxable or they claim expenses that are not

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allowed. Tax evasion gives a negative impact on the country, similar to economic development. This is caused by a slight amount of tax revenue due to tax non-compliance [8]. Besides this, tax evasion also gives the impression of a lack of public confidence to the tax system and tax administration of the country [6].

According to Wisegeek [9], there are three main causes of tax evasion and tax gap: failing to pay taxes owed, underreporting income and failure to file tax returns. In VAT, Ogundele [10] stated that tax evasion comprised of failure to register, unreported sales and purchases, falsification of books, records and other documents and misclassification of goods in a multiple rate system. Besides that, tax evasion consists of failure to show or submit books, records or other documents, exaggerate refund claims, misuse of taxpayers' invoice and failure to pay tax already withheld.

In Malaysia, the Royal Malaysian Customs Department (RMCD) has been entrusted by the Ministry of Finance to administer and manage all concerning GST. Therefore, RMCD is responsible for ensuring the implementation of the GST as a new tax system that can be achieved successfully to increase the country's revenue and also reduce the occurrence of tax evasion. Both of these objectives are the issues and challenges arising in the implementation of the RMCD's "Plan Strategic 2015 – 2019". According to the plan, RMCD had taken action to implement an effective tax audit based on the Risk Management System.

Therefore, the question arises as to what extent the Risk Management System can help the RMCD to improve the effectiveness of tax audits in combating tax evasion. Many of previous studies stated that to tackle tax evasion, tax authorization should identify the tax non-compliance based on their risks. Based on the [11], HM Revenue & Customs (HMRC) focuses on tackling taxpayer's non-compliance in dealing with tax evasion. According to Pomerleau [2], most of OECD's countries do an audit-based approach by addressing the taxpayer-driven failure risks. They focused on small and medium sized enterprise (SMEs) due to the risk of under-reporting their tax liabilities.

Research Objective: The main objective of this research is to examine the association between probability of detection and the GST rate.

Scope of Study: This study used data which was collected from the GST Audit Department of RMCD WPKL audit reports. These audit reports are the findings of tax audits conducted during September 2015 to April 2016 on the registrant of GST in RMCD WPKL. The variables that are examined is probability of detection and GST rate.

Relevance of Study: Tax evasion can have negative effects, especially to the government in developing the national economy. Therefore, this study is beneficial in order to help RMCD design the strategies to improve the control system in addressing the occurrence of non-compliance and tax evasion in the GST era.

Background of the Study

Good and Service Tax (GST) in Malaysia: The presentation of GST or VAT was initially reported in the 2005 Budget keeping in mind the end result to supplant the current one of the indirect tax system in Malaysia which is SST. This new tax reform is anticipated to be actualized in January 2007. However, the Government had reported on 22 February 2006 that the execution would be put off to a later date. Although the government has delayed the implementation of the GST, the government did not remain silent. In fact, they continue to study to ensure that the GST can be implemented well and can be adopted by the public in Malaysia based on the experience of other countries that have implemented GST. Later, the GST tabled for its first reading in 2009 for the proposed implementation in 2011. The bill was supposed to be presented for the second reading in 2010 but was withdrawn. And lastly, on 25 October 2013, the Prime Minister of Malaysia, Datuk Seri Najib Tun Razak announced the introduction of the GST in the Budget 2014 to replace the SST, which will take effect in April 2015.

The primary objective is to make the GST as a current system more efficient, effective, transparent, comprehensive and business-friendly. As a result, the abolition of SST would open the GST to replace the SST tax system to become more efficient regarding cost effectiveness [12]. Furthermore, GST is equipped with generating a more stable source of revenue for the country due to less vulnerable economic fluctuations [13]. VAT has become the main source of income for Papua New Guinea since the implementation of VAT in1999. In fact, the revenue has increased by 19%. Also in Gabon, the VAT also becomes a revenue generator because in the first year of implementation (April 1995 to March 1996), the VAT revenues were 45% higher than the income of tax which had been replaced. It also showed that the increase in taxpayers compliance in Gabon. Besides that, the GST can provide many advantages to all levels in Malaysia.

For example, it increases the standard living by improving the social infrastructure, reduces business costs by recovering input tax, increased the taxpayers' compliance by introducing the self-assessment system in GST, improved delivery system by using the fully computerized environment and also reduces tax evasion.

Thus what is GST? Keen and Smith [14] defined that VAT is a comprehensive tax on all sales of commodities, either to consumers or other businesses. With reference to Oladipupo and Izedonmi [5], GST is a consumption tax, where it is on the end user and it is a multi-state tax collection. Below are some the characteristics of the implementation on GST in Malaysia

Basic of Taxation
According to Section 9 of GST Act 2014
"GST shall be charged and levied on (a) any supply of goods or services made in Malaysia by a taxable person in the course or furtherance of any business; and (b) important of goods and services into Malaysia."

Rate of Tax: In Malaysia, according to Section 10 of the GST Act 2014, the government has set three types of GST rate on taxable supplies. There are:

Standard Rated Supplies: The standards rate of GST in Malaysia in 6%. The taxable persons will be charged 6% on taxable supplies and are eligible to claim input tax.

Zero Rated Supplies: The zero-rated supplies of GST in Malaysia are 0%. For this rate, the taxable persons are entitled to claim input tax credit in acquiring this supply.

Exempt Supplies: It refers to supplies of goods and services that are not subjected to GST. The taxable persons are not entitled to charge the GST to the consumer and also claim input tax credit.

To identify the goods and services subject to tax based on the tax rate above, the user can refer to the GST Order because the changes on the taxable supplies always occur according to the current situation

GST Rate and Probability of Detection: A model developed by Allingham and Sandmo [15] in deterrence theory found that tax rate has a positive relationship with tax evasion. Nevertheless, it relies on certain assumptions and risk aversion to avoid punishment. Yitzhaki [16] identified the attitudes of taxpayers to risks and showed that where the taxpayer has the absolute risk aversion decreases with income, then an increase in the tax rate

would cause a reducing in evasion.

The empirical study conducted by [17] identified that among the more interesting results were the discovery that business tax evasion levels are unlikely to be reduced to a lower tax rate. It is the same with the outcome from the research conducted by [14] where it was reported that there is no evidence to show that higher tax rate is related to greater tax evasion.

According to [14], the level of VAT rate gives a significant impact to evasion where a higher rate of VAT, in particular, will promote the informality transactions. In North-Central Nigeria, the factors that influenced taxpayers' non-compliance among SMEs are complex filing procedures and high tax rates [18].

In determining the tax evasion on imported vehicles in Malaysia, [19] found that tax rate is positively associated with the excise duty. Similar with [20] where the study indicated that marginal tax rate has a positive relationship with the taxpayers' non-compliance for SMSs in Malaysia. However, there is no sufficient evidence to support that the service tax rate associated with service tax evasion [21].

Besides GST rate, the probability of detection as well is one of the factors to determine tax evasion. This factor becomes one of the elements in the Allingham-Sandmo model in 1972. [19] stated that based on this model, the penalty rate and probability of detection are intertwined with each other in determining the tax evasion.

A study conducted by [22] found that when the probability of detection and fines is higher, it will decrease the firms to evade tax. But, the result of the higher tax rate means uncertainty for the firms to avoid tax. Furthermore, the factors of higher tax rates on income, higher probability of detection and higher penalty rates led the optimal level for the firm to evade tax [23].

In addition, the probability of detection depends on the level of production. If the level of the firm's output is smaller than a predetermined standard of production, then the company will not be arrested for tax evasion. Furthermore, if the companies' production exceeds the threshold limited, the companies will be monitored and punished if caught by the tax authority. Also, it has concluded that the increase in the probability of detection and a reduction in the tax rate lead to a greater decrease in the size of tax evasion.

[21] in their research has found that the probability of detection is positively related to service tax evasion. They found that the risk companies with nil return and reminder for not submitting the return were led to them made a service tax evasion. They found that the risk companies

with nil return and reminder for not submitting the return were led to them made a service tax evasion. Therefore, it showed that GST rates and the probability of detection have an influence in determining tax evasion and are inter-related with each other.

Conceptual Research Framework: Figure 1 shows the conceptual framework of this study. The framework use GST rate as a dependent variable and risk probability of detection as an independent variable. The framework was developed to determine the association between the risk probability of detection and GST rate.
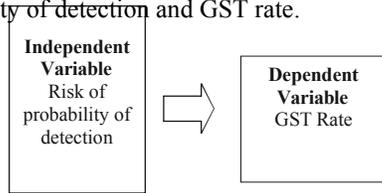

Fig. 1: Research Framework

MATERIALS AND METHODS

Measurement of Dependent Variable: GST Rate: In the GST era, there are three types of GST rate, which are Standard Rated Supplies, Zero Rated Supplies and Exempt Supplies. However for this study, the category only divided into two groups which is "1" for standard rate and "0" for mixed supplies [21].

Measurement of Independent Variable: Probability of Detection: The measurement of risk probability of detection was indicated as "1" for the risk registrant detected from the risk profiling and "0" for registrant with no risk sign [21].

RESULTS AND DISCUSSION

Frequency of GST Rate Category: The GST rate measured by a category created variable coded as "1" for registrant who supply the standard rated supply of 6 per cent while "0" is for registrant who supply the mixed supply which consists of standard rated, zero rated, exempt supply and also out of scope supply.

From the figure above, the majority of the registrant supply the standard rated of 6 per cent (55%) while for registrant who supply the mixed supply is 45%.

Frequency of Probability of Detection: The determinant of tax evasion is probability of detection. The registrants

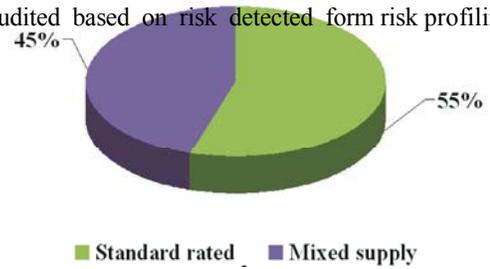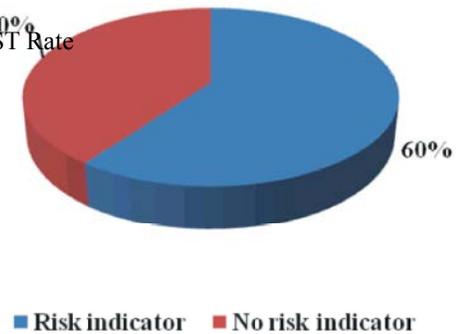were audited based on risk detected form risk profiling.

Fig. 2: GST Rate

Fig. 3: Probability of Detection

The probability of detection was measured by variable coded as "1" for the registrant detected from the risk profiling and "0" for registrant with no risk sign.

From Figure 3, it shows that the majority is the risk registrant with 60% while for non-risk registrant is only 40%.

Chi-Square Test: This test was performed to examine the association between probability of detection and GST rate. This test assesses the detected frequencies of cases that happen in each of the classes [20].

From the result, it indicated that there is a significant association between probability of detection and GST rate, ($\chi^2 = 2.888$, $p < 0.10$). Based on phi coefficient value in Table 1, -0.262 showed that there is a small effect association between probability of detection and GST rate. According to [4] criteria, it showed that 0.10 is small effect, 0.30 for medium effect and 0.50 is considered large effect.

Followed by the percentage of each classed for probability of detection and GST rate, the crosstabulation result is shown in Table 1. Based on that table, 29.4% of registration with no risk detected involved in mixed supply which is combination either standard rate, zero rate, exempt supply, relief or out of scope supply.

However, about 70.6% of registrants with no risk detected supply with standard rate which is 6 per cent.

Table 1: Summary Statistics of Chi-Square Test: Association Between GST rate and Probability of Detection

Probability of Detection	Rate		Pearson Chi-Square	Phi	*p*-value
	Mixed supply (%)	Standard rate (%)			
No risk (%)	29.4	70.6	2.888	-0.262	0.089*
Risk (%)	56.0	44.0			
Total (%)	45.2	54.8			

*significant at 0.1

For registrants with risk detected, there were 56% involved in mixed supply while 44% of them were supplying to their customers with the charged standard rate of 6 per cent. Furthermore, according to these results, 45.2% of the registrants were involved in mixed supply and 54.8% of the registrants only supply for standard rate.

CONCLUSION

Probability of detection and GST rate has influence in determination of tax evasion and is inter-related with each other. According to [13], the increase in the probability of detection and a reduction in the tax rate lead to a greater decrease in the size of tax evasion and vice versa. Therefore, Chi-square test of independence was conducted and showed that there is an association of relationship between probability of detection and GST rate. The Chi-square result expressed that there is a significant association between probability of detection and GST rate at significant level 0.1.

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