

COMPLIANCE COSTS OF SMALL AND MEDIUM ENTERPRISES*

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Several new findings on compliance costs of small and medium enterprises ("SMEs") are reported in this article for the first time from an emerging economy, Malaysia. Prior studies were done using large exchange-listed firms. This article reports findings from postal as well as personally-administered survey questionnaires relating to compliance costs for the tax year 1999 as reported in responses collected in early 2000. The compliance costs of SMEs are substantially higher compared with the costs measured for exchange-listed and, therefore, larger firms. The average tax is merely one-eleventh of the average tax paid by a typical listed firm, yet the average compliance cost of a listed firm is only three times that of a typical SME. Thus, compliance costs are four times more burdensome for SMEs. These findings are particularly significant for tax administration and legislators because of the large burden even with self-assessment planned to be implemented in stages, commencing with self-reports by companies in 2001. Self-assessment is likely to increase, especially at the start of self-assessment year, the already high compliance costs of SMEs.

* The authors wish to thank the grants committee at the Universiti Utara Malaysia ("UUM") for the financial support to conduct compliance cost studies in Malaysia. Several research students assisted in the fieldwork and in follow-up activities to compile the research database at the UUM. Ariff likes to express his thanks to the UUM for funding research visits as the Visiting Bumi Commerce Bank Chair. The authors are also grateful to an anonymous referee for useful comments on an earlier version of this article. They take full responsibility for any errors.

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1. INTRODUCTION

Tax compliance cost studies have become popular in several developed countries, where taxpayer opposition and opposition lobbies are well organised against new taxes or for that matter any form of tax increase. Not so in developing countries. The few studies, to be cited later, that reported on compliance costs in emerging/developing economies did indicate that the public listed companies surveyed had much lower compliance costs than is the case for similar companies in matured economies with middling economic growth rates. The higher compliance costs in such countries may be traced to the greater complexity of taxation as well as the greater administrative surveillance of taxpayers, that is, more efficient tax collection. However, a missing link in this line of research in developing countries is the estimate of such costs for the SMEs. Without this measure, it is not possible to provide information for the emerging/developing economies on the full range of cost experiences across the full spectrum of firms, both big and small. This study is a first modest attempt to measure compliance costs of SMEs in an emerging economy, Malaysia.

Widespread dissemination of compliance cost studies done in the 1980s and in the early 1990s in matured economies has led to governments in such countries reporting likely compliance cost impacts before new tax laws are considered. This is the so-called impact statement preceding tax bills in Parliaments. Such awareness has the cumulative effect of slowing a government's urge to impose new taxes. Some of the significant studies of compliance costs that have contributed to this debate were undertaken by Slemrod and Sorum,¹ Sandford,² and Fayle,³ Blumenthal and Slemrod,⁴ Ariff

¹ JB Slemrod and N Sorum, "The Compliance Costs of the US Individual Income Tax System" (1984) 37(4) *National Tax Journal* 461.

² C Sandford, "What it Costs to Pay Tax: Policy Issues" [1989] *Accountancy* 113.

³ J Pope and R Fayle, "The Compliance Costs of Personal Income Taxation in Australia, 1986/87 - Empirical Results" (1990) 9 *Australian Tax Forum* 85.

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et al⁵ and Cheung et al.⁶ Several of these studies covered small and medium sized companies in Australia, the US and the UK while the last two covered only public listed companies in two Asian city states.

The only compliance cost study in Malaysia covered the public listed companies as at 1995. The results of that study by Loh et al⁷ suggest that average compliance costs of listed firms are high and that the costs are regressive in the sense that costs increase with decreasing firm size. This study is an extension of these earlier studies but covering the SMEs. For policy formulation purposes, one needs to research with care both the SMEs and the large listed firms. Studying the compliance costs of the SMEs, it is hoped, will provide new information on the regressive nature of tax compliance costs. As a matter of policy, costs to SMEs should not be permitted to become so high as to discourage SMEs from engaging in risk-taking entrepreneurial activities, which are essential at the early stage of development of an emerging economy. Thus, any findings from this study are likely to have a major impact on policy formulation not just in tax law changes but also on the whole idea of how to utilise SMEs as a pro-growth economic structure in development.

Since most firms are not listed in formal exchanges, it is, therefore, an important step in research to obtain estimates and confirm the usual hypothesis about compliance costs incurred by SMEs. The total number of firms listed in the stock market as at 1 May 1999 was merely about 470 (Main Board) and 210 (Second Board). The official reference book for SMEs contains 10,400 names, which make SMEs 15 times larger in numbers. However, the

⁴ M Blumenthal and J Slemrod, "The Compliance Costs of the US Individual Income Tax System: A Second Look After Tax Reform" (1992) 45(2) *National Tax Journal* 185.

⁵ M Ariff, Z Ismail and A Loh, "Compliance Costs of Corporate Income Taxation in Singapore" (1997) 24 (9-10) *Journal of Business Finance and Accounting* 1253.

⁶ D Cheung, S Chan and M Ariff, "Compliance Costs of Corporate Taxation in Hong Kong" (1999) 25(4) *International Tax Journal* 42.

⁷ A Loh, M Ariff, Z Ismail, M Shamsir and M Ali, "Compliance Costs of Corporate Taxation in Malaysia, 1995" (1997) 14(3) *Pacific Accounting Review* 134.

total number of listings of SMEs in the Yellow Pages of the telephone directory and the Ministry of Trade and Industry's ("MITI") directory alone is many times the number listed on the exchange or in the reference list. Hence, the experience of SMEs in this regard merits a separate study.

The rest of the article is organised into six sections. Part 2 provides a brief introduction to the small and medium firms in Malaysia's economy. Part 3 provides a description of the concepts to be applied in this study. The methodology based on a widely used survey procedure is described in Part 4. Part 5 summarises the main findings. The article ends with a short conclusion in Part 6.

2. WHY STUDY SMEs?

SMEs form the backbone of business community with an estimated 45,000 of these enterprises playing a significant role in this emerging economy, which has moved to the middle-income developing countries category in the 1990s. Their share of revenue is very small though, accounting for about 15 percent of the total revenue of the manufacturing sector, for example.⁸ They are regarded as the driving force of the economy.⁹ Three-quarters of the total of 2,039 manufacturing firms are classified as SMEs, indicating the dominance of SMEs in this sector. Furthermore, manufacturing SMEs contribute to around 20 percent of the total output of the manufacturing sector, underscoring the dominance by the larger firms of this sector. But the larger manufacturing firms depend on the crucial services of these SMEs as their suppliers. The official reference list of SMEs contains a total of 10,400 firms in 1999.

⁸ SMEs are generally labour intensive and they lack information technology and knowledge of automation. SMEs, therefore, have not become competitive enough to increase their share of the output even though they form three-fifths of the number of manufacturing firms. With larger firms, particularly foreign manufacturing firms using them as contractors, the rate of technological knowledge is increasing steadily.

⁹ KC Chan, "Are SMIs Really at Risk?" *The Star*, Star Publications Ltd, Kuala Lumpur, 7 February 1999 (Datuk Chan is Deputy Energy, Communications and Multimedia Minister)

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A study of SMEs can provide information to tax planners on how compliance costs may be maintained at low levels if compliance costs are regularly estimated for this group of firms. The economy's efficiency is closely tied to the continued resilience of this sector since manufacturing sector contributes 35 percent of Malaysia's gross domestic product. Management of companies would like to know their average compliance cost and how that compares with larger enterprises to which they are suppliers. They may even be able to manage the controllable part of their compliance costs, if they knew what these costs were from a careful study.

2.1 Definition of SMEs

According to the MITI, small and medium industries ("SMIs") are defined as "companies with employees not exceeding 150 with an annual sales turnover not exceeding Malaysian Ringgit (RM) 250 million".¹⁰ This new and liberal definition has been adopted by MITI since 1998. Therefore, companies satisfying both criteria (relating to employees and sales) would qualify to apply for the financing facilities, a government incentive, provided to promote SMIs. In this article, the acronyms SMIs and SMEs are used interchangeably. The primary aim of the new definition, it has been claimed, is to encourage expansion of existing industries and simultaneously create a new breed of SMEs that would add value to the manufacturing chain. Promotion of such companies will encourage smaller ones to be more efficient and become resilient.

The government also targets the SMEs for special supports. As SMEs play an important role in providing support services to larger industries, particularly in the manufacturing sector, the government provides various financing facilities to encourage their active participation to promote economic growth. The financial facilities provided via the following funds are:

¹⁰ Ministry of International Trade and Industry, *Directory of Small and Medium Industries* (Malaysia, 1999).

- Industrial Technical Assistance Fund,
- Rehabilitation Fund for Small and Medium Industries,
- Technology Acquisition Fund, and
- Commercialisation of Research and Development Fund.

In 1998, the government allocated (Ringgit Malaysia) RM2.5 billion equivalent to about US\$660 million to the SME fund to encourage new investment in selected sectors, namely manufacturing, agriculture-based and special services industries. It has been claimed, by the government, that this assistance will lower cost, and will directly encourage exports, and facilitate the growth of new industries, including start-ups in high technology sectors.

3. CORPORATE INCOME TAXATION AND COMPLIANCE COSTS

This Part covers the concepts and definitions relating to compliance costs of companies. Prior studies¹¹ have defined compliance costs as those relating to the costs of conforming to the mandatory requirements of a tax regime involving the preparation and submission of timely tax returns in accordance with the relevant tax laws in force in a country. Compliance costs, therefore, are costs associated with the number of hours spent in preparing tax returns, administrative expenses, and any money spent on the procurement of the services of tax professionals.¹² These costs can be categorised into *internal* and *external* costs.

¹¹ Slemrod and Sorum, above n 1; Sandford, above n 2; and Blumenthal and Slemrod, above n 4.

¹² According to C Evans, K Ritche, B Tran-Nam and M Walpole, *Taxation Compliance Costs - Some Recent Empirical Work and International Comparisons*, Third International Conference on Tax Administration, 16-17 April 1998, "pure" compliance costs are costs directly incurred by taxpayers in meeting the requirements of the tax law. These include taxpayers' own labour, unpaid helper and internal staff costs, costs of external advisers, and incidental or overhead costs such as specific travel, stationery, postage and computer use incurred by taxpayers. Social welfare costs as well as administrative costs borne by taxation authorities are, however, excluded.

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3.1 Internal Costs

Internal costs relate to the time spent by company staff on maintaining and preparing information for professional advisers, completing tax forms and dealing with revenue authorities on matters pertaining to inquiries, objections and appeals.

3.2 External Costs

External costs arise from payments made to acquire the services of lawyers, accountants and investment advisers from outside a company. Complying with the tax laws and regulations, including filing annual tax returns with the Inland Revenue Board ("IRB"), may require these services. Compared to internal costs, external costs are more easily recognisable and quantifiable. Internal costs are more difficult to quantify since it involves fairly subjective apportionment of overhead and other costs. Time spent by the internal staff in preparing the annual tax returns is very subjective and therefore is difficult to quantify, yet it has to be estimated. Nevertheless, methods have been devised by other research including that undertaken by Ariff et al in 1997 in this economy¹³ in computing internal costs of companies, and this study employs the same method to compute the compliance costs of SMEs.

Sandford et al¹⁴ further classified compliance costs into computational and planning costs.

3.3 Computation Costs

Computation costs arise from compiling and maintaining relevant information on a periodic basis in advance of time to be ready to prepare mandatory information required by the revenue authorities at the time of report submission. Computation costs are an unavoidable

¹³ Ariff et al, above n 5.

¹⁴ C Sandford, MR Goodwin and PJW Hardwick, *Administrative and Compliance Costs of Taxation* (1989).

item for companies, and such costs are also non-discretionary in nature.

3.4 Planning Costs

This is a discretionary item that is related to the tax minimising efforts of a company to manage its tax-related matters. Planning costs are avoidable since planning involves efforts to mitigate and legally avoid taxes. They are only covered if management in its discretion chooses to minimise tax.

3.5 Self-Assessment System and Initial Compliance Costs

The implementation of a self-assessment system ("SAS") commencing in 2001 is predicated as a fair and honest reporting of tax liability. It requires taxpayers to maintain appropriate records and to exercise reasonable care in the reporting and submission of returns affecting their tax liability. The new measures necessitate taxpayers to incur *initial costs* in addition to their regular compliance costs. Thus, compliance costs could also be subdivided into *initial irregular costs* and regular costs, which have not, to the knowledge of the authors, been identified in prior studies.

3.6 Initial Costs

Initial costs may have two elements: costs relating to the implementation of new tax laws and costs linked with the learning process. When a significant change is made to an existing assessment system, as in this case, new compliance costs would be incurred. Not only is the current year basis of assessment being replaced with the preceding year as from 1 January 2001, SAS would be implemented in stages in ensuing years. When major changes are made to the assessment system as in this case, it is prudent for taxpayers to get things right the first time, or at least be as accurate as is humanly possible. Preparing for the new tax system may necessitate a sizeable amount of initial irregular costs. On the other hand, the initial costs of complying with the tax provisions will lead to lower costs in the

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future as the taxpayer gets used to understanding the issues pertaining to the new amendments. These are costs associated with the learning curve.

3.7 Regular Costs

Regular or on-going compliance costs are costs incurred by taxpayers, who are used to the tax systems. Taxpayers who comply with the requirements of the law incur such costs periodically.

3.8 Review of Literature

Most of the early studies relating to compliance costs concentrated on individual taxpayers.¹⁵ Following these studies, researchers in Australia, Singapore, UK and the US examined compliance costs of public corporations and companies. Pope et al investigated in 1991 the compliance costs of public companies in Australia and estimated the overall mean compliance costs per public company to be A\$62,604 (RM143,989).¹⁶ Ariff et al undertook in 1995 a similar study in Singapore and their mean compliance cost estimate was over S\$78,396 (RM172,471) for a company.¹⁷ A second Singapore study by Ariff, Ismail and Loh in 1997 estimated the average compliance costs to be S\$54,615 (RM120,153) following a number of tax reporting reforms.¹⁸ A study in Malaysia of public listed companies estimated the average compliance costs per company to be RM68,836.¹⁹

¹⁵ See J Martin, "Costs of Tax Administration: Nature of Public Costs" (1994) 1 *Bulletin of the National Tax Association* 104; J Wicks, "Taxpayers' Compliance Costs From Personal Income Taxation" (1966) 8 *Iowa Business Digest* 16; and Slemrod and Sorum, above n 1.

¹⁶ J Pope, R Fayle and DL Chen, *The Compliance Costs of Public Companies' Income Taxation in Australia 1986/87* (1991).

¹⁷ M Ariff, A Loh and AA Talib, "Compliance Costs of Corporate Taxation in Singapore 1994" (1995) 8(2) *Accounting Research Journal* 75.

¹⁸ Ariff et al, above n 5.

¹⁹ Loh et al, above n 7.

In a comprehensive UK study by the University of Bath on compliance costs, Sandford²⁰ noted that compliance costs for small traders started to rise in the mid-1980s. This was due mainly to heavier penalties imposed by revenue authorities on small businesses for not complying with tax regulations. As a result, many small businesses were forced to hire accountants to file their tax returns. Obtaining professional help meant extra financial burdens for the taxpayers. This obviously led to an increase in their compliance costs.

Similar studies had been carried out in the US by Slemrod and Blumenthal in 1996.²¹ The findings of their survey of 1,329 large corporations revealed that corporate compliance costs amounted to US\$2 billion for 1995 (that is an average of US\$1.505 million per corporation). As a fraction of the revenue raised, corporate compliance costs were found to be lower than for individual income taxpayers. The findings of this study also revealed that the cost-to-revenue ratio was higher for state corporate tax systems than for the federal tax system, reflecting the non-uniformity of the state tax systems. Furthermore, most of the respondents were of the opinion that the *Tax Reform Act 1986* made the US tax system more complex, resulting in higher compliance costs. Likewise, for UK companies, Sandford²² estimated in 1989 the average compliance costs to be £10,980 (RM69,174) for companies with turnover of more than or equal to £10 million (RM6.3 million). This study covered a national sample and therefore encompassed SMEs as well. Among several studies that investigated compliance costs in the corporate sector, costs of complying with corporate taxation were highest for Australian companies.

²⁰ C Sanford, "Accountant and the Cost of Compliance" [1990] *Accountancy* 104.

²¹ JB Slemrod and M Blumenthal, "The Income Tax Compliance Costs of Big Business" (1996) 24(4) *Public Finance Quarterly* 376.

²² Sandford, above n 2.

4. RESEARCH MET HODOLOGY

The following section covers the data collection and preparation of survey questionnaires.

4.1 Questionnaire Design

The questionnaire was divided into four sections. Section 1 (General Information) elicited data on the characteristics and nature of the business as well as the number of people employed by the company. Section 2 (External Costs) contained questions relating to the costs of employing external advisers to handle taxation matters. Information about the breakdown of the estimated fees for tax return preparation work, advisory and planning costs was elicited from respondents. Section 3 (Internal Costs) provided data on time spent on tax affairs by managers, accounting staff and computer officials and the amount as well as proportion of wages paid to each group. This enabled costs attributed to different groups to be aggregated as the appropriate unit costs. Finally, Section 4 (Other Matters) was designed to elicit respondent's opinion on ways to improve rapport between the personnel at the IRB and companies. This section also sought to ascertain whether the IRB's views had been sought on specific issues. It also examined the extent to which companies were prepared for the SAS and the impact of the new system on compliance costs.²³

4.2 Survey Questionnaire

The survey instrument solicited information regarding general characteristics of the company, external and internal costs, and aspects of the tax system covering opinions, constraints and suggestions for the improvement of the tax system.

²³ Under the Official Assessment System ("OAS"), all return forms were checked for arithmetical accuracy, computation of tax payable and full disclosure of taxable income. Such a system was perceived to be an ineffective and inefficient approach to ensure compliance with tax law. The OAS approach was also perceived to be inconsistent with IRB's policy of encouraging voluntary tax compliance.

4.3 Data Collection

The researchers conducted personal interviews, as SMEs normally do not readily respond to mailed questionnaires. Mailed questionnaires were also sent to prepare the respondents for the survey, and to establish the bona fides of the persons meeting the respondents. The survey population was taken from the directory of SME companies obtained from the MITI. A total of 300 companies were randomly drawn from a population frame. The population frame consisted of about 10,400 firms in the reference list, but only 300 SMEs located in the northern region were selected for this study. In view of the highly technical nature of the study, it was decided to use a smaller but representative population using personal interviews that would yield a higher response rate as well as more reliable responses. A total of 67 SMEs responded favourably to our request to participate in this study providing a response rate of 22.3 percent.

Reliability analysis was carried out and various sections were found to be reliable and valid after certain questions were eliminated. Based on Cronbach's Alpha, the overall reliability coefficient score obtained for the questionnaire was 0.80. Generally, the above reliability coefficient indicates that there is a high level of consistency in the responses. Reliability coefficients of 0.65 and above are considered more than acceptable for most behavioral science applications.²⁴ As for validity, the views of tax professionals were sought in designing the questionnaires. Discussions were also held with fellow academics pertaining to the design of the instrument and the method adopted in this study.

4.4 Pilot Study

A pilot study was carried out five months earlier among 12 SMEs located in the Northern region of West Malaysia to test the reliability and validity of the instrument. Personal interviews were conducted with finance managers and accountants of companies. Every step

²⁴ JC Nunnally, *Psychometric Theory* (2nd ed, 1978).

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was taken to ensure that the final survey instrument was clearly understood by the respondents.

4.5 Data Analysis

A total of 73 SMEs responded to our request to participate in this study. Six returned questionnaires could not be utilised as the information provided was unreliable, leaving 67 acceptable responses thereby providing a response rate of 22.3 percent. The response rate was low, as SMEs normally dislike divulging information, especially anything relating to detailed tax matters. The returns were classified into three groups (1, 2 and 3), based on the sales turnovers of the SMEs, to facilitate comparison of compliance costs across size groups. Group 1 comprised companies with turnover of less than RM5 million. Group 2 encompassed companies whose turnover ranged between RM5 million and RM50 million. Group 3 comprised companies with sales turnover exceeding RM50 million. Descriptive statistics such as the mean values obtained for the cost items were used to test for significant differences in compliance costs among various groups of companies. The procedure followed by Ariff et al in 1995 was adopted.²⁵ By regressing compliance costs on turnover values, past compliance cost studies on public listed companies have indicated that the absolute amount of compliance costs is higher for larger firms²⁶ though compliance costs per unit of revenue decline as firm size increases due to the economy of scale effect.

5. RESEARCH FINDINGS

The general characteristics of the companies are summarised in Table 1. Turnover of the SMEs ranged from RM600,000 to RM466 million (US\$157,895 to US\$70 million) with 21 companies having sales turnover of less than RM5 million; 38 between RM5 million and RM50 million; and the rest having more than RM50 million.²⁷

²⁵ Ariff et al, above n 17.

²⁶ Pope et al, above n 16; and Ariff et al, above n 5.

²⁷ See Table 1, Item (a).

Most of the companies were from the manufacturing sector (37) followed by commerce or trading (8) and construction and property development (7). The remainder of the companies were from the financial, insurance and service sectors as well as computer firms.²⁸

Table 1 - Profile of Respondents in Mail Questionnaire Survey in Malaysia (1998)

Characteristics of Companies	Companies
(a) Turnover in RM million	
Group 1: <i>Less than 5</i>	21
Group 2: <i>Between 5 and 50</i>	38
Group 3: <i>More than 50</i>	8
(b) Main Business Activity	
Construction and Property Development	7
Commerce/Trading	8
Computer/Software/IT	1
Financial, Insurance, Real Estate and Business Service	4
Manufacturing	37
Transport, Communication and Storage	1
Others	9
(c) Estimated Tax Liability	
Less than RM100,000	17
RM100,000 - RM499,999	15
RM500,000 - RM1 million	5
More than RM1 million	9

²⁸ See Table 1, Item (b).

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The statistics on the actual taxes paid are given under Item (c) of Table 1. The tax liability of each company varied from less than RM100,000 to more than RM1 million.²⁹ The others did not reveal their estimated tax liability. The average tax paid by a company included in the study is RM571,149 (US\$150,300) with a range of RM3,472 to RM3.3 million. The average tax per company paid by each listed company determined in an earlier study³⁰ that covered listed firms was RM6.5 million (US\$1.7 million) at the then average exchange rate. The average tax of an SME in this study is therefore one-eleventh of the average tax paid by a listed firm. This is our estimate of the order of the SMEs tax liability under the current laws.

**Table 2 - Dollar Compliance Costs per RM1,000
Sales Turnover (RM)**

Groups	1998 Year of Assessment
1	629,715
2	771,072
3	70,830
Average	21,964

Another significant new statistic is the estimate of compliance cost. The average compliance cost of SMEs is RM21,964 (US\$5,780 using the 1999 exchange rate) per firm. The average for the listed firms reported in the cited study was RM68,836 (US\$27,100). The relative compliance cost of SMEs is therefore one-third of the much larger costs of an exchange-listed company. This seems to indicate the severe regressive nature of compliance costs for SMEs. The internal compliance cost constitutes 75 percent of the total cost while the external cost stood at 25 percent. For listed firms,³¹ the external cost was reported to be 72 percent of the total. This suggests that the components of compliance cost (internal and external costs) are not similar in SMEs and listed companies. The SMEs do not spend more

²⁹ Only 46 companies out of 67 gave estimates of tax liability for year of assessment.

³⁰ Loh et al, above n 7.

³¹ Ibid Table 5.

on external advice as in the case of listed companies but rather rely heavily on their own staff to comply with the tax laws. In addition to the above costs, ten companies stated that they had to incur additional costs in complying with company income tax requirements for the 1998 financial year. These additional costs were incurred to handle back duty inquiries, stamping of documents, appeals against Scheduler Tax Deductions for employees and others.

Table 3 - Regression of Compliance Costs on Sales Turnover of Companies

Intercepts	Slope Coefficient	R-Squared	F-Ratio
2.053E-04 20.422	6.978 -0.0032	.005	0.001

The slope parameter with a value of 6.978 is not statistically significant. In this study, the respondents were all SMEs. Since they form a more homogenous group than the listed firms, the above analyses of the data suggest that the compliance costs do not significantly vary among the size groups within the SMEs, though the cost differences are large.

5.1 Computational and Planning Costs

Table 4 below shows the breakdown of compliance cost into the computation and planning components.

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Table 4 - Breakdown of Compliance Costs by Size (% Of Compliance Costs)

Size Group	Computation Costs (RM)	Planning Costs (RM)	Total costs (RM)
1	498,734 (79%)	130,981 (21%)	629,715
2	302,258 (39%)	468,814 (61%)	771,072
3	67,304 (95%)	3,526 (5%)	70,830
Average	12,960 (59%)	9,004 (41%)	21,964

The average computational cost was RM12,960, which amounted to 59 percent of the average total compliance costs. This ratio of 59 estimated for the SMEs differs from the 50 percent incurred by Singaporean public listed companies³² and the 45 percent incurred by Australian companies.³³ Malaysian listed companies, on the other hand, incurred 61 percent computation costs.³⁴ The average planning costs per company in this study were RM12,960 (US\$3,410), which represent 59 percent of the average total compliance costs. This proportion is not strictly comparable to the 50 percent or the 45 percent incurred in the other two countries. The difference could be due to the complexity of the tax system, perhaps accounted for by the scope for tax planning, the stage of development of the economy and the size of the company.

Computation cost for SMEs is 1.5 times the average planning cost reflecting the fact that a typical company used more resources to keep routine cost data associated with tax audits, withholding tax, payments to staff as well as data provided to advisers to complete returns. Costs were also incurred in relation to tax objections, inquiries and appeals. Computation costs of Group 3 companies

³² Ariff et al, above n 5.

³³ Pope et al, above n 16.

³⁴ Loh et al, above n 7.

amounted to 95 percent of the average total compliance costs. This should be contrasted to the computation costs of Group 1 companies which amounted to 79 percent of the overall average and 39 percent for Group 2 companies.

The differences in computation costs between Group 1 and Group 3 companies and between Group 2 and 3 companies were not statistically significant, whereas the differences between Group 1 and Group 2 companies were only marginally significant (at a low acceptance level of $p = 0.08$). The smaller companies, on average, spent less than one-third of their compliance costs on tax planning activities compared to 61 percent in the case of Group 2 companies, and 5 percent for Group 3 companies. This probably reflects the complex nature of the business activities of larger companies with more diversified investment opportunities and financing patterns, which may require special tax considerations, for example, development tax offsets and capital allowances.

These results also indicate that there are no significant differences in planning costs among the three groups of SME companies. This means that companies in the three categories spend almost an equal amount on tax planning irrespective of their size.

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5.2 Internal and External Costs

**Table 5 - Breakdown of Compliance Costs by Sources of Costs
(% Of Compliance Costs)**

Group	Internal Costs (RM)	External Costs (RM)	Total Costs (RM)
1	428,845(77.2%)	126,570 (22.8%)	555,415
2	578,013 (75.5%)	187,837 (24.5%)	765,850
3	31,200 (47.4%)	34,650 (52.6%)	65,850
Average	15,493 (75%)	5,210 (25%)	20,703³⁵

Only 25 percent of the total compliance costs incurred by all companies was paid to external advisors. It is useful to compare this result with the findings reported for listed firms, which indicate that payments to external advisors represented about 72 percent of the total compliance costs incurred by listed companies. A majority of the SMEs therefore prepared tax returns and related documentation internally compared to listed companies, 91 percent of which sought the assistance of external professional advisers to handle their tax matters. The main reason for 25 percent of the SME respondents relying on the external advice was to handle the non-routine income tax affairs while a small percentage of the respondents said that they undertook tax planning, and other related tax matters. The other reasons for using the external adviser included the desire to undertake income tax planning (10.4%), the need to handle routine matters or lodge income tax returns (29.9%) and other related matters (1.5%).

This finding suggests that smaller companies are less likely to employ external advisers to prepare their tax returns and that these advisers probably handled other routine matters pertaining to

³⁵ The overall average of RM20,703 in the last column is different from the average compliance cost because of differences in the sample size.

corporate tax. SMEs spent 75 percent of the expenses on internal resources to comply with tax laws rather than on external advisors.

The breakdown of computation costs into internal and external components across companies in the various groups is found in Table 6.

Table 6 - Breakdown of Computation Costs into Internal and External Costs (% Of Computation Costs)

Group	Internal Costs (RM)	External Costs (RM)	Total Costs (RM)
1	409,664 (82%)	89,070 (18%)	498,734
2	168,836 (56%)	133,422 (44%)	302,258
3	28,704 (43%)	38,600 (57%)	67,304
Average	9,063 (70%)	3,897 (30%)	12,960

Thirty percent of the total computation costs of all companies pertain to payments to external agents, thus the internal costs were 70 percent. The proportion of external costs of Group 1 companies was 18 percent, 44 percent for Group 2 companies, and 57 percent for Group 3 companies. This finding is consistent with the responses made by the smaller companies in the sample.

The breakdown of costs from tax planning activities incurred from internal and external resources by the three groups in question is provided in Table 7.

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Table 7 - Breakdown of Planning to Internal and External Costs (% Of Planning Costs)

Group	Internal Costs (RM)	External Costs (RM)	Total Costs (RM)
1	125,742 (96%)	5,239 (4%)	130,981
2	422,110 (92%)	36,704 (8%)	458,814
3	3,209 (91%)	317 (9%)	3,526
Average	8,464 (94%)	540 (6%)	9,004

Only 6 percent of planning expenditure was due to fees paid to external advisers for their services in formulating tax plans. The external cost component for the largest companies was also only 9 percent compared to 4 percent for a smaller company.

5.3 Additional Analysis

The authors also calculated compliance costs as percentages of tax revenues paid to the IRB as declared by the sampled firms.

Table 8 - Percentage of Compliance Costs to Tax Revenue

Group	Estimated Tax Revenue (RM)	Compliance Costs (RM)	Percentage Costs to Tax
1	1,775,843	629,715	31.3
2	16,262,172	771,072	4.70
3	8,013,639	70,830	0.82
Average	566,304	20,964	3.70

Sanford³⁶ showed that UK companies, on average, incurred compliance costs of 2.2 percent of the total tax revenue. Pope et al³⁷

³⁶ Sanford, above n 2.

³⁷ Pope et al, above n 16.

estimated the compliances costs of Australian public companies with respect to income taxation in 1986/87 to be anywhere between 11.4 and 23.7 percent of the tax revenue collected from public companies. The result for Singapore was an average of 4.0 percent for all companies for the 1995 year of assessment.³⁸ The numbers for the SMEs in Malaysia are the lowest. The average of 3.70 per cent (that is, 31.3%, 4.70% and 0.82%, respectively, for Groups 1, 2 and 3) appear to be comparable to the Singapore results, again with the proviso that the size differences are not controlled. The percentage compliance burden for SMEs in Malaysia is lower than the percentage in Australia but higher than the percentage in the UK. The Australian comparison highlights the complexities of the tax system in that economy while that of the UK shows the reforms made in the late 1990s to lessen the compliance costs in that economy. An alternative plausible explanation is that the companies in the Sanford³⁹ and in the Pope et al⁴⁰ samples were smaller, and if the consistent findings that smaller firms have higher costs (the regressive principle) holds, one might expect higher percentage of compliance costs to tax revenue than reported on an unadjusted basis. This indicates that the Malaysian SMEs have relatively low absolute compliance cost compared to Australia and Singapore but higher compared to UK. Compared to 1.1 percent compliance costs as a percentage of taxes paid by the listed Malaysian firms, the 3.70 percent compliance costs to the SMEs is rather burdensome.

The findings also indicate that larger SMEs use accounting firms and legal advisers as their main sources of external advice. Accounting firms were sought mainly to undertake accounting, secretarial and tax return preparation work. The main reasons for seeking external advice were to handle routine income tax affairs and to undertake income tax planning. External assistance was also sought by these companies because the depth of technical knowledge, particularly in specialised areas, was not readily available within the firm and also because it was more cost-effective.

³⁸ Ariff et al, above n 5.

³⁹ Sandford, above n 2.

⁴⁰ Pope et al, above n 16.

5.4 Qualitative Responses

The open-ended responses to qualitative questions contained interesting comments. These comments reveal considerable convergence of views among respondents with respect to their impression of the IRB and its staff. Some frequently mentioned responses were:

- (i) "IRB staff are not very helpful";
- (ii) "IRB personnel maintained strict confidentiality on taxpayers' records";
- (iii) "Difficult to access IRB staff over the telephone";
- (iv) "Tax return forms are not processed quickly".

A general concern is the absence of IRB tax rulings on specific issues. The respondents would like to see the IRB becoming transparent suggesting, for instance, that tax rulings should be made readily available when such information is sought by taxpayers. Some respondents pointed to the inadequacy of training of IRB staff adding that their attitude towards time management and their speed in responding to queries by SMEs required urgent attention.

6. CONCLUSION

An important area of tax research during the last two decades has been the issue of costs to taxpayers in complying with taxation obligations. As for Malaysia, the issue of compliance costs is more significant for a number of reasons. First, there is increased consciousness of the vital role of SMEs to the general economy. Several governments such as those in Australia, Malaysia and Thailand see small and medium companies as the vehicle for greater economic growth as well as the means to create more employment opportunities. The US economy has found that the fast growth in employment between 1993 to 1999 was actually generated by the SMEs applying new technologies.

Secondly, tax systems appear to become increasingly more complex either due to major amendments being made to existing laws or new assessment systems being introduced as is the case in this emerging economy. This study is particularly significant for taxpayers, as the self-assessment system will be implemented in 2001, commencing with companies. Compliance costs are expected to significantly increase because of this, particularly during the initial stages of the new assessment era, when companies are getting things right the first time or as correct as humanly possible. The implementation of SAS in Malaysia will result in transfer of costs from administration (IRB) to compliance (taxpayers). Thirdly, there is an increasing outcry by the public for more tax authority accountability. Although there will be a shift in costs from the revenue authorities to taxpayers once SAS is introduced, government accountability dictates that there should be an overall reduction in economic costs.

Interesting findings have been obtained in this first study of small businesses. The average tax paid by the SMEs is one-eleventh of the taxes paid by a typical listed firm. Yet the compliance cost of a listed firm is only three times that of the compliance costs of a typical SME. This suggests that the compliance cost is four times more regressive for an average SME. Considering the average tax paid by the SME, compliance cost is approximately four percent of the tax liability. That is, compliance costs amount to four cents in a dollar of tax paid. For the exchange-listed Malaysian firms, the compliance cost is 1.1 percent of the taxes paid. Again this confirms the four-fold regressiveness of tax compliance costs of small businesses in Malaysia.

Finally, an important aim of this study was to report relevant research data to assist in the formulation of realistic proposals for tax reforms that would result in an overall reduction in compliance costs for both small and large firms. The proposals may hinge on measures that could be introduced by the government that will lower costs of SMEs in adhering to the requirements of the tax provisions. Tax simplification should be an essential element in the tax reform

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agenda. A rigorous tax education program too must be extended to private business enterprises while the authorities need to educate the tax personnel on the need for better response rate and timeliness as well as tax rulings.