

TAX EVASION- BLACK ECONOMY OF INDIA

A STUDY ON THE FACTORS INFLUENCING TAX EVASION

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ABSTRACT: *Tax Evasion is an interesting fact but a sad reality concerning the economic distress of a country. The concept is pervasive globally with interesting research from male gender were the highest tax evader to Bank of America paying no taxes in 2009 though it made a profit of \$ 4.4 billion. This paper presents the significant factors leading to tax evasion. As revenue generation is a primary factor that leads to the economic development and growth of a country. Tax evasion might curb the growth of the county leading to huge amount of black money generation. This paper highlights the factors relating to tax compliance namely, tax burden, tax morale, tax system and how it correlates with tax evasion.*

Keywords: *Tax Evasion, Tax burden, Tax Morale, Tax system,*

1. INTRODUCTION

The Government data on income tax reveals that there is painfully less number of taxpayers in India. In other words, tax evaders are so huge that it can bring a major slow down in the economy of a country. The amount of taxpayers has been considerably reduced from 4.85% in the previous year to 3% in the current year. This brings a great concern that the domestic tax evasion is of a huge concern than chasing the black money through demonetisation. Even though the country is marching towards the completion of 20years in Economic liberalisation, it still did not show light on the massive income tax evasion. It is evident from the recent survey that the salaried class in India constitutes the main source of Income taxpayers, which was roughly around 15%. This statistics is larger than the professionals and corporates who generate higher income than the salaried class people in India. It is also revealed through statistics that the burden falls on the chosen individuals. This is a huge failure of the Government, as the government increased the tax rate every year making the burden to be borne by the few taxpayers. Due to the compliance procedures and documents, the Assessors are not able to track down the required procedures relating to the tax compliance, which has ultimately led to the black money and illegal transactions in the country.

The significance of the study

With the High valued currency notes ban in the country, many citizens hoped that their hardships would make for a long-term profit for the country. This experiments that were considered to be more vital than the surgical strike of Pakistan proved to be a failure, as it has no measure on the tax evasion. There should have been strict regulations on the tax evasions and serious reforms on the corporate secrecy and political disorders in order to bring growth and development to the country. There is always a gap between the tax collection and income as well as the consumption patterns of the economy of the country. This holds the significance of this paper in explaining the factors that lead to the tax evasion.

Statement of the problem

Revenue generation is a prime factor that leads to the growth and development of a country as well as a strong weapon to attract more inflows in the form of investments. Tax collection is a primary factor through which revenue can be

generated. Despite all the efforts and measures by the government, to generate the revenues, tax evasion has curbed the generation of revenues. This, in turn, has reduced the capital, economic and growth generation as well as increased the debt of the nation. Therefore, it is necessary to address and trace the factors that lead to the problem of tax evasion in order to curb the black money generation as well as to increase the growth and development of the economy.

Methodology of the study

The data was collected through questionnaires and it was designed to gain information pertaining to the perception of taxpayers and their perception on the tax system, tax burden. The questionnaire also assessed the ethical issues in order to understand the tax evasion concepts. The other part of the questionnaire attempted to highlight the morale of the respondents. The research questionnaires were distributed to the individual salaried taxpayers. The data obtained were analyzed through path analysis.

2. Tax evasion

Practically all countries depend on taxation as their main sources of revenue. However, the tax evasion issue has been around ever since the tax has been introduced. There are many definitions of tax evasion. Richardson (2008) defines that tax evasion as an intentional behavior to evade the payment of tax. Since there is much confusion on tax evasion and tax avoidance, Kim (2008) indicated that tax evasion is illegal while tax avoidance is due to gaps in the laws where the taxpayers can find ways to reduce the amount of tax payable. Many researchers agreed that tax evasion is an unethical and unlawful practice of avoiding tax (Zakaria et al., 2013 [1]; Harun et al., 2011[2]; Greene, 2009 [3]).

The issue of tax evasion is a complex multidimensional problem. The fight against tax evasion was of the main issues at the European Council in 2013, stated by Martin Schulz, the President of European Parliament, "If all taxes due were actually to be collected, the debts of all EU states could be redeemed within a decade". EU council 2013 justified that "In times of budgetary constraints, combating tax fraud and tax evasion is more than an issue of tax fairness which it becomes essential for the political and social acceptability of fiscal consolidation." This shows that tax evasion gives negative impact even to the developed countries like EU.

Oxfam [4] agreed that tax evasion gives negative impact to the developing countries. The estimates on tax revenue lost due to corporate income shifting amounted between US\$35billion and US\$160billion per year, meanwhile, additional revenue losses due to the tax evasion by wealthy individuals in developing countries were estimates from US\$15billion to US\$124 billion annually [4-5]. Baker [5] stated that the capital mispricing in international trade and the fake transactions adding up to a huge amount of loss in developing countries.

There are various reasons and ways for individuals or corporation to evade tax, especially in developing countries. Zakaria et al. (2013) [1], Schneider and Savasan (2007) [6] found that there is a positive relationship between the size of government and tax evasion. The researchers agreed that when the size of government increases, the ability to control over each sector in the economy is limited, the intensity of regulations will also increase and all these will increase the likelihood of tax evasion. Persson (2014) [7] found the informal sector in developing countries somehow is the contributors to the numbers of tax evasion. The study indicated that the developing countries typically have large informal sectors and small-scale firms like street vendors, village shops and etc. The incomes for these informal firms are hard and impossible to measure for tax purposes with the absence of formal record keeping. The earlier researches, Joshi and Aye (2002) [8] agreed that the informal sector forms a significant proportion of the economy in developing countries, thus it has attracted the interest of governments on the benefits of taxing the informal sector.

Bekeo [9] identified the method used to evade tax by different categories of taxpayers. The self-employed usually take the form of non-filing of returns and failure to keep records. The most attractive method used by small to medium companies is underreporting of income and overstatement of deductions. Bekeo [9] also found the method used by big companies is different from self-employed and the small to medium companies. Big companies tend to use the complicated methods to conceal and shift their tax based through their intra-company transactions.

In general, tax evasion is an unethical act, which gives negative impact to the countries, and the previous researchers also found that there are various methods used by taxpayers to evade tax. Next discussion will be the focus on the motivation, indicators or determinants that caused the taxpayers to evade tax.

Tax morale

The individuals of a country chose to pay tax or evade tax in order to maximise his satisfaction and comfort. Though, there are many factors attributing to the facts of tax evasion Attitudes and norms can influence the choice of tax compliance and tax evasion [10]. This depicts that there is a relationship between the tax compliance and the tax morale. This has also been supported by many authors (Fishbein, 1980 [11;12]. Torgler [13] strongly argues that there is justifiability of evasion as a substitution for tax morale. In the studies of Torgler & Markus [14], has identified five variables, which influences the tax morale. They are Tax

authority, Tax system, perception and experiences with deterrence factors and tax evasion, awareness of tax issues, trust in government, social capital and obedience. Their studies reveal that there is a significant correlation between tax compliance and tax morale. They also reveal that tax morale is considered to be the key factor in enhancing the tax compliance. However, there are some exception to this case where the tax payers do not even search for ways to evade taxes [15], Frey & Feld, 2002 [16], Elffers, 2000 [17] and there is some empirical research to support the arguments as to indicate that the taxpayers do comply to pay the taxes [18]. Tax morale is highly correlated with the term ethics as it concerns the behavior of the citizens as taxpayers and their association and responsibility towards Government and Country (Song & Yarbrough, 1978) [19]. Some of the research findings argued that the tax morale and societal institutions are highly significant in the determination and compliance of tax.

Tax system

Bird et al, (2006) [20] argues that tax sustainability is dependent on a fair system of taxation and government's responsiveness with its connection between the payments of supply of public priorities. The tax system is another key factor that becomes the cause of the shadow economy. A well-functioning law system can rule out the pitfalls in tax evasion of a country and contribute to the development of an economy. Raymond Fisman & Shang –Jin Wei [21] responds to the phenomenon arguments that higher the tax tariff in a country, higher will be the tax evasion. They also suggest that there is a behavioral response of higher tax rates with tax evasion. In their research, they also concluded that 1% increase in the tax rate would result in 3% increase in tax evasion, which would be a devastating factory for the growth and development of the country. Many researchers were also in the argument that a higher tax rate consequentially encourages tax evasion [22], Jon Bakija & Williams College, 2001 [23], Adebisi & Gbegi, 2013 [24]. Allingham and Sandmo [25], in their model, have stated that there is a substitution effect that tax system favors tax evasion.

Tax burden

Higher tax rates lead to increase in the burden of the taxpayers, which ultimately results in the evasion. Some of the empirical evidence suggests that level of the tax burden is positively correlated with evaded incomes (Clotfelter, 1983) [26]. A higher tax rate leads to the higher burden of the taxpayers and it encourages tax evasion [22]. Tax burden can be measured through the meeting of the policy requirements and goals relating to tax system (Atrostic & Nunns, 1991) [27]. Therefore, the tax burden is linked to the system and policies of the government, which induces them to pay tax. This burden may ultimately lead to tax evasion in order to increase the savings of an individual.

The above studies revealed there is a relationship between tax burden and tax evasion, tax morale and tax evasion, tax system and tax evasion, however, none of the studies has identified how all the elements viz., tax system, tax morale, tax burden leads to tax evasion. This study attempts to explore the factors that determine the interrelationship

between the tax system, tax morale, tax burden and tax evasion.

3. RESULTS AND DISCUSSION

The objective of the study is to understand the relationship between various factors relating to tax compliance of private and government employees. The factors relating to Tax compliance namely, Tax Burden, Tax Morale, Tax Evasion and Tax System, which were individually studied earlier, were now related in this section. The theoretical path analysis model explaining the relationship between these variables is given below. The arrows leading from Tax System factor to Tax Morale, Tax Burden and Tax Evasion measures the direct effect of Tax System of Tax Morale, Tax Buren and Tax Evasion. The arrows leading from Tax Morale and Tax Burden to Tax Evasion measures the direct effect of Tax Morale and Tax Burden on Tax Evasion factor. Also, the Tax Morale and Tax Burden factors are assumed to mediate between Tax System and Tax Evasion to measure the indirect effect of Tax System on Tax Evasion.

The factor scores of all the four factors were used in the model. The concepts of the factors and their relationship are explained below.

Tax System: The **Tax System** measures the attitude of the respondents towards the current Tax System. The scores found using the statements measure the extent of the positive attitude of the respondents regarding the Tax System. The higher the score, the more the positive attitude of the respondents towards Tax System.

Tax Morale: The **Tax Morale** measures the opinion of the respondents towards the extent of morale followed by the respondents in Tax Compliance. The scores found using the statements measure the extent of positive opinion of the respondents regarding the Tax Morale. The higher the score, the more the morale of the respondents in the tax matters.

Tax Burden: The **Tax Burden** measures to what extent the respondents who pay taxes consider paying taxes as more or less burdensome. The scores obtained for this factor reflect their opinion about Tax Burden. More the scores may be taken as a positive side of the respondents regarding tax burden.

Tax Evasion: The set of statements framed to assess the **Tax Evasion** mindset of the respondents, as to whether they are favourable towards Tax Evasion or not. The scores obtained will reveal the perception of the respondents towards Tax evasion. Higher the scores may be considered as the respondents substantiating Tax Evasion.

Based on these, the path model was developed using the objectives given below.

1. To examine how the opinion on Tax System affect the perception of the respondents towards Tax Morale, Tax Burden and Tax Evasion.
2. To examine how the opinion on Tax Burden and Tax Morale affect the Tax Evasion.
3. To establish a causal relationship of Tax Systems with Tax Burden and Tax Morale and also Tax Burden and Tax Morale with Tax Evasion
4. The effect of Tax System on Tax Evasion when mediated by Tax Morale and Tax Burden.

Once the overall goodness of fit the model is established, the following hypotheses will be tested.

Ho1. There is a direct positive relationship between Tax System and Tax Burden. (That is a positive opinion on Tax System leads to a positive opinion on Tax Burden.)

Ho2: There is a direct positive relationship between Tax System and Tax Morale. (That is a positive opinion on Tax System leads to a positive opinion on Tax Morale.)

Ho3: There is a direct negative relationship between Tax System and Tax Evasion. (That is a positive opinion on Tax System leads to less favorable attitude towards Tax Evasion.)

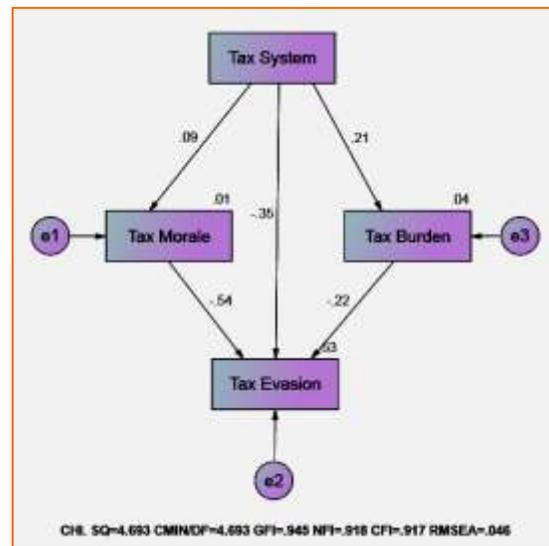
Ho4. There is a direct negative relationship between Tax Burden and Tax Evasion. (That is a positive opinion on Tax Burden leads to less favorable attitude towards Tax Evasion.)

Ho5: There is a direct negative relationship between Tax Morale and Tax Evasion. (That is a positive opinion on Tax Morale leads to less favourable attitude towards Tax Evasion.)

Ho6: There is a mediation effect played by Tax Morale and Tax Burden between Tax System and Tax Evasion. (The effect of Tax Morale and Tax Burden intervenes between the relationship of Tax System and Tax Evasion).

The results of Path Analysis are given in the following model explaining the relationship between the four tax factors.

The



above diagram shows the relationship between Tax System, Tax Morale, Tax Burden and Tax Evasion. The path coefficients are standardized regression coefficients. The regression estimates produced by AMOS for Unstandardized regression are given below. The regression coefficients were estimated by Maximum Likelihood method. AMOS ver.20 was used to estimate the path coefficients. The following model fit statistics were employed to test the goodness of fit of the model.

CMIN: CMIN given by AMOS is a chi-square statistic, which compares the tested statistics with the theoretical model. That is the non-significant chi-square value indicates the data fits the model well.

CMIN/DF: It is a relative chi-square measure, is an index of how much the fit of data to the model has been reduced by one or more paths. The index having a value of 3 or below 3

says the data best fits the model, whereas a value between 3 and 5 is good.

GFI: The Goodness of Fit Index tells you what proportion of the variance in the sample variance-covariance the model accounts for. This should be above 0.90 and below 1 for a good model fit. A value of 1 is considered as a saturated model.

NFI: Normed Fit Index, is simply the difference between the two models' (default and independence) chi-square values divided by the chi-square value of independence model. The NFI value above 0.90 is considered to be a good fit.

CFI: The Comparative Fit index uses a similar approach and is said to be a good index, which can be used for the even small sample. The value above 0.90 is considered to be a good fit.

RMSEA: The Root Mean Square Error of Approximation, estimates lack of fit compared to the saturated model. RMSEA value of 0.05 or less indicates good fit and between 0.05 and 0.08 is an adequate fit.

The model fit statistics estimated by AMOS are given below.

CMIN	= 4.693 (P<0.05)
DF	= 1
CMIN/DF	= 4.693
GFI	= 0.945
NFI	= 0.918
CFI	= 0.917
RMSEA	= 0.046

The results show that all the goodness of fit indices namely, GFI, NFI and CFI satisfy the criterion value of being above 0.90. The Chi-square value is significant (P<0.05) but CMIN/DF value is within the admissible limit of 5. The RMSEA value falls below 0.05. Since all the goodness of fit indices is within the admissible limits it is inferred that the model is good. The model shown above gives the standardized regression weights of the corresponding variables and also squared multiple correlations. The regression coefficients show that these coefficients are comparable since they are independent of units of measurement. The Tax System is found have a positive relationship with Tax Morale and Tax Burden since the respective regression coefficients are positive, whereas it is negatively related with Tax Evasion as the regression coefficient is negative. The direct effect of Tax System on Tax Evasion is more, but negative, compared to other variables. The direct effects of Tax Morale and Tax Burden on Tax Evasion are negative since the regression coefficients are negative. The direct effect of Tax Morale on Tax Evasion is higher (-0.54) compared to Tax Burden (-0.22) on Tax Evasion. The magnitude and direction of a relationship between all the four factors are studied in detail with the unstandardized regression weights produced by AMOS, which is given below.

The above estimates are unstandardized regression estimates. The values given above are the regression estimates of the corresponding independent variables. S.Es are the Standard Errors of respective regression coefficients. C.R (Critical ratio) is the ratio of regression estimate values to S.E. Probability (P) shows which regression coefficients significantly contribute to the dependent variables (** or *

indicates the respective regression weights are significant at less than 1% or 5% respectively. Ns indicate the regression weights are not significant).

Estimate of path coefficients.
Regression Weights for the path model

Variable To	Path	Variable from	Estimate	S.E.	C.R.	Prob. (P)	Sig
Tax Morale	<---	Tax System	.064	.036	1.763	.078	Ns
Tax Burden	<---	Tax System	.191	.045	4.201	<.0001	**
Tax Evasion	<---	Tax Morale	-1.180	.077	-15.381	<.0001	**
Tax Evasion	<---	Tax Burden	-.388	.062	-6.289	<.0001	**
Tax Evasion	<---	Tax System	-.548	.056	-9.740	<.0001	**

The table shows that the regression coefficient of Tax System on Tax Morale is positive has no significant effect on Tax Morale. Hence the hypothesis Ho1 that **'There is a direct positive relationship between Tax System and Tax Morale'** is not accepted. The regression coefficient of Tax System on Tax Burden is 0.191, which shows that there exists a direct positive relationship between these two and the probability level shows that the regression coefficient is significant at 1% level and hence the hypothesis Ho2 that **'There is a direct positive relationship between Tax System and Tax Burden'** is accepted.

The regression coefficient of Tax System on Tax Evasion is - 0.548, which shows that there exists a direct negative relationship between these two and the probability level shows that the regression coefficient is significant at 1% level and hence the hypothesis Ho3 that **'There is a direct negative relationship between Tax System and Tax Evasion is accepted.** The table further shows that the unstandardized regression weight of the variable Tax Burden is negative (-0.388) and has a significant effect on Tax Evasion. The regression result shows that the direct effect of Tax Burden on Tax Evasion is sustained and hence the hypothesis **H04** that **'There is a direct negative relationship between Tax Burden and Tax Evasion' is accepted.**

It is further seen that there is a direct negative relationship between Tax Morale (regression weight being -1.180) and has become significant at 1% level. Hence the hypotheses **H05** that **'There is a direct negative relationship between Tax Morale and Tax Evasion' holds and the hypothesis is accepted.**

Direct, Indirect and Total Effects – Unstandardised

Effects	Variables	Tax System	Tax Morale	Tax Burden
Direct	Tax Morale	.064	---	---
	Tax Burden	.191	---	---
	Tax Evasion	-.548	-1.180	-.388
Indirect	Tax Morale	---	---	---
	Tax Burden	---	---	---
	Tax Evasion	-.150	---	---
Total	Tax Morale	.064	---	---
	Tax Burden	.191	---	---
	Tax Evasion	-.698	-1.180	-.388

Direct Effects - Estimates

The coefficients associated with the single-headed arrows in a path diagram are sometimes called direct effects. In Unstandardised model. for example, Tax System has a direct positive effect on Tax Morale of 0.064. That is, due to the direct effect of Tax System, when Tax System goes up by 1, Tax Morale increases by 0.064. Similarly, the direct effect of Tax System on Tax Burden is 0.191. That is, the Tax System score goes up by 1 the Tax Burden Score also increases by 0.191. However, the direct effects of Tax System and Tax Morale on Tax Evasion are negative. That increase in Tax System and Tax Morale decreases the Tax Evasion score. The regression weight of Tax Burden on Tax Evasion is also negative which shows that increase in the Tax Burden score (Opinion being positive on Tax Burden) will decrease the Tax Evasion.

Indirect Effects - Estimates

The above table describes the indirect effect of the variable Tax System, on Tax Evasion. Tax System is found to have an indirect negative effect on Tax Evasion (-0.150). That is, an increase in the score of Tax System will result in a proportionate decrease in the Tax Evasion Score. However, before considering the mediating effect between the Tax System and Tax Evasion the separate regression was run for Tax Evasion with Tax Evasion as the dependent variable. The results are produced below.

Regression model

Variable To	Path	Variable from	Estimate	S.E.	C.R.	Prob. (P)	Sig
Tax Evasion	<---	Tax System	-.698	.068	-10.232	<0.001	**

The results show that when the direct effect of the Tax System has a significant negative effect on Tax Evasion (-0.698), which has reduced to -0.548 when the mediating variables Tax Morale and Tax Burden are introduced. However, the introduction of the mediating variables has not reduced the significant direct effect of Tax System. That is, even after introducing the mediating variables the direct effect of Tax System on Tax Evasion is significant at 1% level. Hence it is inferred that the hypothesis **Ho6 that 'There is a mediation effect played by Impact of WorkForce diversity between WorkForce factors and Management of WorkForce diversity' is not accepted.**

Total Effects - Estimates

The total effect is the combined direct and indirect effect of each column variable on each row variable. For example, the total effect of Tax System on Tax Evasion is -0.698, which is nothing but the direct effect of Tax System on Tax Evasion when there were no mediating variables. Since there were no other variables explaining the relationship among the four factors in this model, the direct unmediated effect has become the total effect.

Direct, Indirect and Total Effects – Standardised

Effects	Variables	Tax System	Tax Morale	Tax Burden
Direct	Tax Morale	.090	---	---
	Tax Burden	.210	---	---
	Tax Evasion	-.349	-.539	-.224
Indirect	Tax Morale	---	---	---
	Tax Burden	---	---	---
	Tax Evasion	-.095	---	---
Total	Tax Morale	.090	---	---
	Tax Burden	.210	---	---
	Tax Evasion	-.444	-.539	-.224

Similar to unstandardized regression weights, the relative contribution of the standardized direct, indirect and total effects of each of row variable on the column variable is given above. Since the standardized regression weights are free from units of measurements they are comparable. For example, it can be said that the direct effect of Tax System (-0.349) on Tax Evasion is relatively higher than Tax Morale (0.090) and Tax Burden (0.210) in absolute values. Similarly, the effect of the variable Tax Morale (-0.539) on Tax Evasion is higher than the effects of Tax System (-0.349) and Tax Burden (-0.224) on Tax Evasion. In the case of Total effect also, the effect of Tax Morale (-0.539) on Tax Evasion is higher than Tax System (-0.444) and Tax Burden (-0.224) on Tax Evasion.

4. CONCLUSION

Path Analysis was applied to find the effect of three factors namely, Tax System, Tax Morale and Tax Burden on Tax Evasion. The effect of Tax System on Tax Morale and Tax Burden was also studied. The mediation effects of Tax Morale and Tax Burden between the factors Tax System and Tax Evasion were also studied. The path model was developed and the goodness of fit statistics were employed for the validity of the model. The goodness of fit statistics were within the admissible limits it was inferred that the model is good.

Finally, the path coefficients were estimated and direct, indirect and total effects of exogenous and endogenous variables were found out. The unstandardized and standardized regression weights were calculated. The results showed that there is a no direct positive relationship between Tax System and Tax Morale. Tax System has a significant positive effect on Tax Burden. The effects of Tax System and Tax Burden on Tax evasion were negative and significant. Tax Morale is found to have a significant negative effect on Tax Evasion. After introducing the mediating variables the direct effect of Tax System on Tax Evasion was reduced to a certain extent but was not insignificant. Hence mediation effect of Tax Morale and Tax Burden between Tax System and Tax Evasion could not be fully ascertained.

Tax System was found to be more contributing towards Tax Evasion than its effect on Tax Morale or Tax Burden. However, Tax Morale is more contributing towards Tax Evasion compare to the direct effects of Tax System and Tax

Burden on Tax Evasion. The same results were found for total effects also. This study might be useful for the policymakers in order to generate the policies towards tax evasion as the factors pertaining to tax evasion has been evidenced in the structure.

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