

eJournal of Tax Research

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Indicators of tax morale: an exploratory study

Margaret McKerchar^{1*}, Kim Bloomquist², and Jeff Pope³

Abstract

Taxpayer compliance research has tended to focus on why people evade their taxes rather than on why the vast majority of people do willingly comply with their tax obligations. Whilst tax administrations globally seek to improve the efficiency of their revenue collections, there is growing recognition of the need to have a deeper understanding of why taxpayers comply voluntarily. A person's internal motivations to comply are commonly characterised as his/her 'tax morale', the 'key' to the puzzle of understanding taxpayer compliance behavior. Thus tax morale is often seen as a 'black box' or the error term for the difference between predicted and observed behavior, a puzzle within a puzzle. This paper initially explores the origins and likely determinants of tax morale, followed by a discussion of measurement difficulties. The key feature of this paper is our attempt to use real taxpayers whose actual compliance behavior is known (rather than self-reported) to identify factors that could be indicative of taxpayer morale from data reported in individual tax returns. Using data from the Internal Revenue Service's National Research Program from the audit of 1,101 cases with only sole proprietor income, we tested six indicators that theoretically have some correlation with tax morale. Our main findings are threefold. Firstly, IRS random audit studies suggest a possible tax morale component to taxpayer compliance based on the distribution of reporting compliance rates. Secondly, it is extremely difficult to separate this tax morale component from other factors that are at least equally significant in deterring underreporting. Thirdly, although much of the focus in the more recent tax morale literature has focused on religiosity as a causal factor, a more secular explanation may be simply one's personal integrity (or moral rules and norms) irrespective of religious beliefs if any.

JEL classification: K34 Tax Law

PsycINFO classification: 2260 (Research Methods and Experimental Design)

Keywords: compliance; taxation law

1. INTRODUCTION

Taxpayer compliance research has tended to focus on why people evade their taxes rather than on why the vast majority of people do willingly comply with their tax obligations (Slemrod, 1992). By and large this is not surprising given the threat that tax evasion poses to revenue collections and societal well-being. Yet as we observe

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* Corresponding author. Sincere thanks to Brian Erard who provided helpful feedback on earlier versions of this article and to participants at the 2012 Tax Research Network Conference, University of Roehampton. Nonetheless the usual caveats apply.

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tax administrations seeking to improve the efficiency of their revenue collections, there is growing recognition of the need to have a deeper understanding of why taxpayers do comply voluntarily (Kornhauser, 2007). Understanding taxpayer compliance is undoubtedly complex (Andreoni, Erard, & Feinstein, 1998; McKerchar, 2001), and remains an important challenge for both researchers and tax administrators.

People's willingness or internal motivations to comply is commonly characterized as their 'tax morale' (Kornhauser, 2007). Tax morale is depicted as the 'key' to the puzzle of understanding taxpayer compliance behavior (Kornhauser, 2007); the 'black box' or 'residuum' of all that is inexplicable when it comes to the influences of tax evasion (Feld & Frey, 2002). That is, tax morale is cast as the error term for the difference between predicted and observed behavior, a puzzle within a puzzle. Many have attempted to shed light on taxpayers' internal motivators to comply by various means including surveys and experiments, but hard evidence is difficult to find (Torgler & Murphy, 2004; Book, 2007). To unlock the puzzle seems almost impossible when so little is known about the key itself.

Against this background we set out to try and shed some light on tax morale, its indicators and impact on compliance. We relied on data from the Internal Revenue Service's (IRS) National Research Program (NRP) from the audit of 1,101 cases having only sole proprietor income and tested a range of indicators that we thought might have some correlation with tax morale.

The remainder of this paper is organized as follows: First we explore the compliance literature more fully to understand the origins and likely determinants of tax morale, and its measurement. Secondly, the methods and procedures of this study are described. An analysis of the results of our testing is presented in the third part of this paper, followed by discussion in the fourth and final part.

1.1 Origins and likely determinants of tax morale

The concept of tax morale is not new. Drawing on the work of Schmölders (1959) on taxpayers' attitudes towards their tax burden, Strümpel (1969) first introduced the term 'tax mentality' to describe a person's willingness to pay tax. Based on a cross-country survey, Strümpel found that tax mentality was affected by the way taxpayers were treated by tax authorities. Lewis (1979) further developed this work in his empirical assessment of tax mentality (i.e. either a positive or negative attitude towards tax evasion) using a survey method. Lewis found that tax mentality differed between countries, by exchange factors, by social orientation and by demographic characteristics. Lewis concluded that there was no simple "general factor" of tax mentality, but that the most reliable predictor of individual attitudes appeared to be how much tax the individual paid, with higher-paying individuals being less willing to pay. However a study by Cox (1984) using data from the IRS Taxpayer Compliance Measurement Program (TCMP) could not support the existence of a relationship between tax rates and compliance. This conclusion was reaffirmed recently by Phillips (2011) using the full 2001 IRS NRP dataset.⁴ He states (pg. 44) that tax rates have "little practical significance on compliance relative to the effects of information

⁴ The same dataset from which we draw our sample of 1,101 sole proprietor cases.

reporting.” Amongst these and other early studies by fiscal psychologists (for example see Schwartz & Orleans (1967); Vogel (1974)) there appeared to be a general consensus that, in theory, taxpayer attitude influenced behavior, but there was little, if any, consensus about the nature of this relationship.

In spite of these promising beginnings in the study of tax morale, it was to remain a fairly dormant area of research for many years as economics-of-crime models based on the seminal work of Allingham & Sandmo (1972; for a review see Kirchler, 2007) dominated the compliance literature. These models assume taxpayers to be rational beings and thus responsive to punishments or sanctions. In spite of the popularity of these models (particularly with economists), fiscal psychologists remained convinced that non-economic factors strongly influenced taxpayer compliance behavior (Slemrod, 1992). Empirical evidence in support of tax compliance motivated by non-economic factors is found in the recent study by Phillips (2011, pg, 45). In his analysis of 2001 NRP data, Phillips found that IRS auditors did not detect underreporting on 46 percent of tax returns with positive unmatchable income.⁵ This observation led the author to conclude “the economics-of-crime framework...has limited ability to explain why taxpayers with unmatchable income would not underreport. In net, it therefore appears that both a rational economics-of-crime framework as well as alternative behavioral explanations are necessary to explain the incidence of noncompliance.”

Subsequent fiscal psychology studies adopted a more conceptual approach to compliance behavior, instead emphasizing the multiplicity and complexity of tax behavior and the challenges in measuring and understanding it over time (for example see Jackson & Milliron (1986); Klepper & Nagin (1989a); Long & Swingen (1991)). Further, the reliability of empirical models based on self-reported behavior, game simulations and hypothetical case studies has been questioned (Hassledine & Bebbington, 1991; Hessing, Elffers, & Weigel, 1988). How taxpayers form attitudes and beliefs and how these then in turn impact on their decision-making processes remains a challenging area for researchers, though a vast body of literature does exist (for a review see Andreoni, Erard, & Feinstein, 1998; McKerchar, 2001). It is from this body that we focus now on the study of tax morale which has re-emerged in the last decade as an area of particular interest to researchers.

Torgler and Murphy (2004) describe tax morale as the intrinsic motivation to pay one's taxes. They acknowledged the difficulty in defining the concept in more concrete terms and conclude that it is generally understood to describe the moral principles or values individuals hold about paying their tax. Torgler (2007) argues that there are three key factors important for understanding tax morale. They are (1) moral rules and sentiments (for example, norms and guilt; may be strongly influenced by religious motivations); (2) fairness, and (3) the relationship between taxpayer and government (i.e. governance and trust).

⁵ Unmatchable income includes, among other sources, non-farm sole proprietor income. Of the 1,101 taxpayers in our selected sub-sample of NRP sole proprietor cases, IRS auditors did not detect underreporting in 133 cases (12 percent).

In considering the first of these factors, the extent to which religiosity impacts on moral principles (and in turn on tax compliance or tax evasion) is unclear given the limited studies to date in which it is considered and the mixed findings that have resulted (see for example Grasmick, Bursik, & Cochran, 1991; Stack & Kposowa, 2006; Torgler, 2006; and more generally Henrich et al, 2010). Further, Torgler (2007) tends to downplay the role of cultural differences which have been highlighted elsewhere in the literature (Ashby & Webley, 2010; Coleman & Freeman, 1997; Richardson, 2006). In terms of the second factor, fairness, it appears that taxpayers' perception of fairness of the tax system plays an important role in non-compliance behavior and more so in respect of tax evasion (Bordignon, 1993; Etzioni, 1986; Porcano & Price, 1992; Roberts & Hite, 1994; Smith, 1992; Tan, 1998). Turning to the third factor, there is support in the literature for the positive impact of trust in tax administration and government on motivating taxpayers to comply voluntarily (Feld & Frey, 2007; Frey, 2003; Torgler, 2003). The higher the level of trust held by taxpayers the higher is the predicted level of voluntary compliance (Kirchler, Hoelzl, & Wahl, 2008). Again the common theme is that whilst these three factors do appear likely to be important determinants of tax morale, the evidence is not yet compelling.

1.2 Measures of tax morale

As Torgler & Murphy (2004) note, empirical work on tax morale is almost non-existent. In their Australian research they use World Values Survey (WVS) data from 1981 and 1995 and one general question (p.308) to assess the level of tax morale:

Cheating on taxes if you have the chance is (answers to be given on a ten point scale 1="never justifiable" to 10 = "always justifiable".

They acknowledge that having only one question to measure tax morale could be a criticism of the appropriateness and sufficiency of their approach. (This is in addition to the weaknesses of self-reports.) The rationale provided for the approach is that it has been used in earlier studies (see Torgler, 2007). One important contribution of this study by Torgler and Murphy (2004) is that it does allow for a comparison over time of changes in attitudes to tax evasion. Whether or not it provides an adequate indicator of tax morale is doubtful, but the reality is there is little other empirical data available to researchers, and as we know from the literature, this is not an easy puzzle to conceptualise or solve.

In our research we attempt to address the problem in reverse. We start with real taxpayers whose actual compliance behavior is known (rather than self-reported). They are all self-employed taxpayers who we contend had the same opportunity to evade. We try to work backwards to identify factors (from data reported in their tax returns) that could be indicative of their morale, or why they were willing (or unwilling) to pay their taxes. It may not unlock the puzzle, but it may help tax administrators better understand taxpayers and predict compliance outcomes and more effectively identify and treat risks to revenue collections.

2. METHOD

Our goal in this study is to try to identify or otherwise construct indicators of tax morale from tax return data and, in turn, use these indicators to investigate the role of tax morale on observed reporting compliance for individual (sole proprietor) taxpayers.

The data used for this study is derived mainly from the IRS's NRP study of individual taxpayers for tax year (TY) 2001 (Bennett 2005). The sample contains 44,768 audit cases weighted to represent 125,790,958 taxpayers who filed timely tax returns for TY 2001. For the present study, a sub-sample of this data set was selected which consists of taxpayers whose only source of income (pre and post-audit) is derived from a Schedule C sole proprietorship.⁶ This subset of 1,673 cases represents 1,101,977 taxpayers. A further restriction was made to exclude filers with no taxable income as determined by the examiner. Eliminating these cases facilitates construction of our dependent variable, *compRate*, defined as the ratio of reported income to "true" income (i.e., income per exam). The final sample has 1,101 cases representing 559,555 individual filers.

A second data source is the Data Master-1 (DM-1) file maintained by the U.S. Social Security Administration (SSA). The DM-1 has demographic data (e.g., gender, age and citizenship) for persons (living and deceased) who have registered with the SSA. An IRS relational database, the Compliance Data Warehouse (CDW), maintains an updated copy of the DM-1 file, along with an extensive collection of current and historical tax return data. Lastly, data on income per capita by postal (zip code) zone was obtained from the U.S. Bureau of the Census' decennial census.

As discussed in the introduction, tax morale has been characterized as reflecting a composite of influences stemming from (a) moral rules and norms that delineate what is acceptable behavior for individuals as part of a social collective, (b) the perceived overall fairness of the tax system and (c) trust in governmental institutions. Previous studies have associated the first element of this triumvirate, morality and norms, with a measure of religiosity. For example, Torgler (2006) and Torgler, Schaffner and Macintyre (2010) use the fraction of individuals in a population that claim membership in one of the world's major religions as a measure of the degree of religiosity.

The existing literature is often vague concerning how claimed membership in a major religion influences tax reporting behavior. Perhaps exposure to religious teaching and its lessons about caring for the less fortunate inspires a greater willingness to comply when tax time comes around. Another explanation is suggested in the work by Henrich et al. (2010) who argue that involvement in supra-kinship institutions (e.g., a market economy or major world religion) implants in a population a set of norms governing transactions among unrelated individuals. They present evidence from a series of behavioral experiments that shows claimed membership in a major religion

⁶ It is well-known that reporting compliance varies widely depending on source of income (Johns and Slemrod 2010). Therefore, by selecting taxpayers having a single source of income we are better able to control for the opportunity to evade.

(i.e., Christianity or Islam) is positively associated with exchange fairness in some (but not all) situations.

Unfortunately, for this study we do not have an indicator of religious affiliation from U.S. tax return data. However, taxpayers may itemize deductions that often include contributions to both religious institutions and civic organizations that serve the needs of the broader community.⁷ We construct the variable *reportsContributions* to indicate a taxpayer's willingness to consider the needs of others in his/her financial affairs. This indicator is equal to 1 if a taxpayer reports making charitable contributions, zero otherwise. A positive relationship is hypothesized between the presence of charitable contributions and the ratio measure of tax reporting compliance.

Another possible indicator of personal commitment to local norms of behavior is citizenship in the country of residence. Using the DM-1 data we construct a dummy variable, *isUSCitizen*, equal to 1 if the taxpayer is a U.S. citizen, zero otherwise. Again, we hypothesize a positive relationship between citizenship and tax compliance.

Fairness of the tax system is the second factor contributing to an individual's level of tax morale. We propose two variables to capture this influence, albeit indirectly. These are: (1) the log of taxable income (*logTaxableIncome*) and (2) a dummy variable equal to 1 if taxable income in TY 2001 was greater than in TY 2000 (*txblIncTY01MoreThanTY00*).

We hypothesize that taxable income is positively related to one's perception of tax unfairness and thus negatively correlated with our measure of reporting compliance. Evidence for this relationship is found in telephone surveys conducted by Gallup, Inc. in which households were asked to give their view on the fairness of the federal income tax. Combining responses collected from 2005 through 2011, the Gallup surveys show that 55 percent of households in the highest income group (\$250,000 or more) responded "No, not fair" regarding their own tax burden versus 31 percent of households in the lowest income group. The positive correlation between income and tax unfairness holds for all household income categories (Table 1 bottom row).

Table 1
Views About Own Income Taxes – by Annual Household Income

	Less than \$30,000	\$30,000- \$49,999	\$50,000- \$99,999	\$100,000- \$249,999	\$250,000 or more
	%	%	%	%	%
Too high	45	49	51	54	67
About right	43	47	47	43	26
Too low	4	2	2	3	6
Yes, fair	60	63	60	59	44
No, not fair	31	34	38	40	55

See <http://www.gallup.com/poll/147152/americans-split-whether-taxes-high.aspx>. Site last accessed on February 8, 2012. Results shown based on 2005-2011 combined survey data.

⁷ We realize this indicator is less than ideal since some taxpayers, instead of itemizing, use the standard deduction. This amount varies depending on one's filing status (e.g., single, married filing jointly, head of household, etc.).

However, Table 1 also shows that households with income between \$30,000 and \$49,999 had a slightly more favourable view of tax fairness than did households with income less than \$30,000 (the “Yes, fair” response of 63 percent for the former group versus 60 percent for the latter). The statistical significance of this result is unknown. However, because these two income groups largely occupy the lowest tax bracket, it suggests that a year over year increase in household income could translate into a more favourable perception of tax system fairness at the margin. The variable *txblIncTY01MoreThanTY00* is used to link an increase in reported taxable income in TY 2001 versus 2000 to a marginal increase in the perception of the fairness of one’s tax burden.

Trust in governmental institutions is the third element of tax morale. Again, relying on information available on the Form 1040 – the tax form used by individuals to file their U.S. federal income taxes – we identified two potential indicators of trust in government. Our first indicator is the taxpayer’s response to the question about directing a small portion of their tax liability to a public fund used to underwrite the cost of Presidential elections. A positive response to this question does not result in an increase in taxes, but merely redirects \$3 of existing tax liability to this special fund. We propose that individuals who respond affirmatively to this question are revealing a heightened sense of trust (hope?) in the political institutions that make up the federal government. Consequently, we hypothesize a positive correlation between the variable *designatesToPresElecCampaignFund*, which equals 1 if the taxpayer elects to direct \$3 in taxes to this fund zero otherwise, and the dependent variable *compRate*.

Our other indicator of trust in government, again indirectly, is the presence on the tax return of a deduction for state income tax (*reportsStateIncomeTaxDeduction*). This variable is equal to 1 if the filer claims a deduction for state income tax, zero otherwise. Although some U.S. states do not have a state income tax, we nevertheless hypothesize a positive relationship between this variable and reporting compliance since a non-zero entry indicates payment of income taxes to at least one other governmental jurisdiction.

We also include a number of variables in order to control for taxpayers’ demographic and tax filing characteristics. Demographic control variables include: age, gender, marital status, presence of children and income per capita in the taxpayer’s place of residence. The variable *age* is the age of the primary filer. The primary filer is the name of the first taxpayer shown on the return if the filing status listed on the tax return is married filing jointly. Empirical research suggests age is positively correlated with tax compliance (Roth, Scholz, and Witte 1989, pp. 133-135). The dummy variable *hasKids* indicates if the filer claims one or more child exemptions. The influence of this variable on tax reporting compliance is uncertain. The variables *isFemale* and *married* are dummy variables set equal to 1 if the primary taxpayer is female or the taxpayer is married. In tax compliance laboratory experiments females consistently exhibit higher reporting compliance than males (Alm 1999) and we expect this variable to have a positive sign here as well. The empirical evidence is mixed for the role of married filing status on compliance. On the one hand, married taxpayers may be more responsible in their approach to filing taxes. However, married taxpayers also may experience more financial stress which could provide incentive to evade. Therefore, we are uncertain about the direction of influence for *married*. Since

not all U.S. states have a state income tax, we include a dummy variable (*stateIncomeTax*) to control for this influence.⁸ The final demographic variable is the log of per capita income for residents of the zip code where the taxpayer resides (*logIncPerCapita*). We included this variable as an indicator of relative well-being. Again, we are uncertain of the sign on this variable.

Several variables are included to control for filing characteristics of taxpayers. The variable *filesSchCEZ* is a dummy variable equal to 1 if the filer uses the simple version of the form required of sole proprietors. Since use of this form indicates a reduction in filing burden we expect a positive relationship between use of the C-EZ form and reporting compliance. The dummy variable *firstTimeFiler* is equal to 1 if an individual is filing for the first time. We conjecture that first-time filers will have higher noncompliance due to lack of familiarity with tax laws and hypothesize a negative sign for this variable. The variable *usesPaidPreparer* is a dummy variable equal to 1 if the filer uses a paid tax preparer. Although one might expect, all other things equal, that professionally prepared tax returns would exhibit higher compliance than returns prepared by taxpayers themselves, preparers also can use their knowledge to exploit “gray” areas in the tax code that non-experts might not be aware of. Therefore, we are uncertain about the sign of this variable. The dummy variable *claimsEIC* is equal to 1 if the filer claims the Earned Income Credit (EIC). We hypothesize a negative relationship between this variable and relative reporting compliance due to the increase in burden complexity required to claim this credit and, because the EIC is a refundable credit⁹, some taxpayers may be tempted to claim this credit even though they received no earned income during the year. The dummy variable *schSEPresent* takes on a value of 1 if the filer files a Schedule SE used to figure the self-employment tax. Again, since all of the filers in our sample are Schedule C filers, all are required to complete this form. If the Schedule SE is missing, it may indicate the presence of misreporting. We hypothesize a positive sign for this variable.

Our remaining three control variables for taxpayer filing characteristics also are dummy variables. The variable *noTxblIncTY00* takes on a value of 1 if the filer had no taxable income in TY 2000 (either because the individual did not file a tax return or filed a tax return and reported zero taxable income) and zero if the file did report some taxable income. The variable *reportsZeroBothYears* is equal to 1 if the filer reported zero taxable income in both 2000 and 2001 (the individual had to file a tax return in both years). If the filer reported some positive taxable income in one of the two years this variable is assigned a value of zero. We hypothesize a negative relationship between both variables and reporting compliance based on the belief that reports of zero income may indicate the presence of underreporting. Finally, the variable (*auditPrior2Years*) is equal to 1 if the taxpayer was subject to an operational (non-random) audit for either TY 1999 or 2000. Although empirical research on the influence of a prior tax audit on subsequent reporting behavior is inconclusive (Erard 1992) we hypothesize a positive correlation between *compRate* and *auditPrior2Years*.

⁸ The following US states do not have an income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. The state of New Hampshire taxes interest and dividends and Tennessee has a tax on certain forms of investment income.

⁹ A refundable credit means that taxpayers may receive this credit even though they owe no income tax.

Table 2 displays summary statistics for the variables used in this analysis. The variable *compRate_tc* is *compRate* top coded to a value of 1. Within the sample data there are 29 cases where taxable income reported by the taxpayer exceeded the examiner-determined amount of taxable income. These cases (representing 13,131 taxpayers) were assumed to have 100 percent reporting compliance.

Table 2
Study Variables Summary Statistics

Variable	Type*	Mean	Sum
compRate	R	0.484	533
compRate_tc	R	0.313	344
age	R	41.185	45,345
auditPrior2Years	D	0.026	29
claimsEIC	D	0.533	587
designatesToPresElecCampaignFund	D	0.170	187
filesSchCEZ	D	0.091	100
firstTimeFiler	D	0.046	51
hasKids	D	0.401	442
isFemale	D	0.241	265
isUSCitizen	D	0.482	531
logIncPerCapita	R	9.833	10,826
logTaxableIncome	R	9.234	10,167
married	D	0.305	336
noTxblIncInTY00	D	0.574	632
reportsContributions	D	0.102	112
reportsStateIncomeTaxDeduction	D	0.062	68
reportsZeroBothYears	D	0.278	306
schSEPresent	D	0.970	1,068
stateIncomeTax	D	0.748	824
txblIncTY01MoreThanTY00	D	0.276	304
usesPaidPreparer	D	0.741	816

Note: 1,101 total observations

*R=real, D=dummy

Figure 1 displays a histogram of the top-coded dependent variable *compRate_tc* (unweighted). The bi-modal shape of this distribution also is characteristic of the reporting behavior of subjects in tax compliance laboratory experiments (Alm, Bloomquist & McKee 2010). Figure 1 shows that about one-half (50.5 percent) of 1,101 sample cases report less than 10 percent of true tax liability and approximately 15 percent of cases have compliance rates of 90 percent or higher. Cases between the two extremes appear to be roughly uniform in distribution.

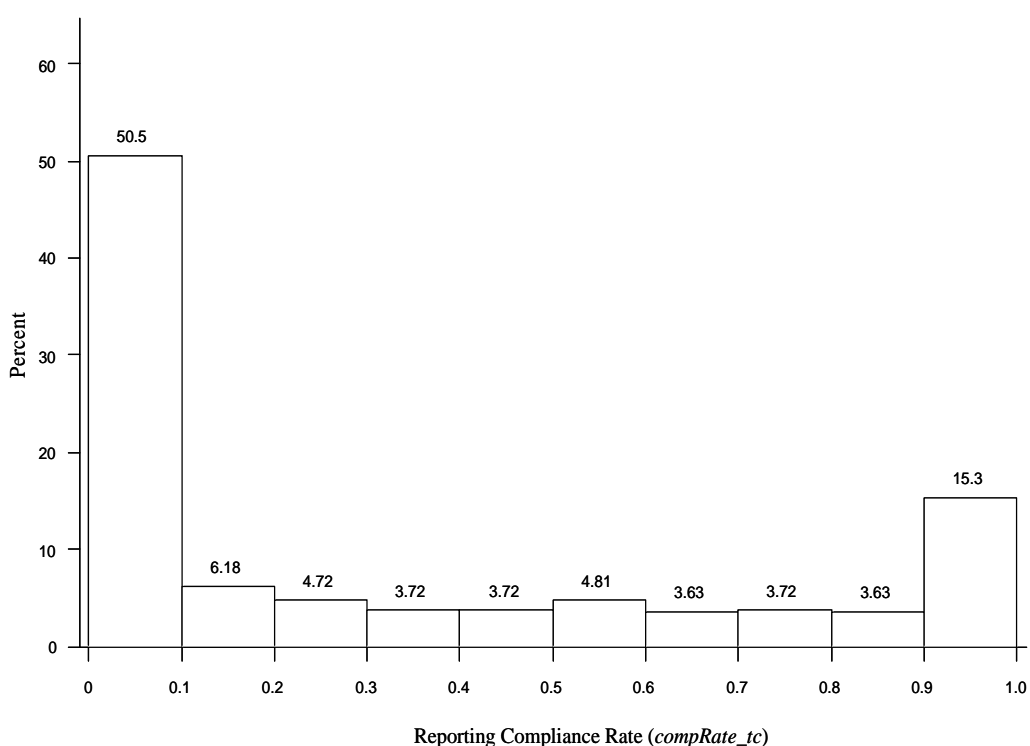


Figure 1. Histogram of Reporting Compliance Rate

3. ANALYSIS

We estimate the relationship between the dependent variable (*compRate*), our six proposed indicators of tax morale, and control variables using ordinary least squares (OLS) regression, ordered probit and tobit models with the results shown in Table 3. The OLS model uses the top-coded version of our reporting compliance rate measure (*compRate_tc*). Results reported for the ordered probit model recode *compRate* into the values 1, 2 or 3 depending on whether the value of *compRate* is equal to zero, between zero and 1, or a value of 1 or higher. The tobit model uses *compRate* as the dependent variable but censors values to an upper bound of 1. Recall there are 29 cases where the value of *compRate* exceeds unity.

Focusing first on the tax morale variables, *designatesToPresElecCampaignFund* has the wrong sign and is only statistically significant using tobit estimation. The negative sign on this variable could indicate that some filers¹⁰ designating \$3 to the Presidential election campaign fund do so as a way to signal their trust in governmental institutions when, in fact, they are underreporting their tax liability elsewhere on the return. The variable *isUSCitizen* has the predicted sign but is statistically insignificant in all models. Reported taxable income (*logTaxableIncome*) is statistically significant in the OLS and tobit models and has the predicted negative sign. This result supports the view that a perception of tax unfairness is associated with higher levels of income and has a negative impact on reporting compliance. The variable *txblIncTY01MoreThanTY00* also has the predicted sign and is statistically significant in all models. This finding supports the idea that taxpayers experiencing an improvement in their economic circumstances have a more favourable attitude concerning fairness of the tax system and are willing to comply more. The variable *reportsContributions* is statistically significant in all models but with the opposite sign. This could indicate that taxpayers view claiming charitable contributions as an opportunity to underreport tax liability more than an opportunity to contribute toward the welfare of the wider community. Finally, the variable *reportsStateIncomeTaxDeduction* has the predicted sign and is significant in OLS and tobit models.

Table 3 also shows the impact of the demographic and tax filing control variables on reporting compliance. Turning first to the demographic control variables, *age* has the predicted positive sign and is statistically significant (at the 5% level) across all models. The presence of children (*hasKids*) is strongly significant and is positively correlated with *compRate*. This could mean that the taxpayers are willing to report their tax liability more accurately if some of this can be offset using the exemption for child dependents. The variable *isFemale* has the predicted sign but is not statistically significant in any of the three models. Marital status (*married*) also is not statistically significant. However, income per capita in the filer's postal zone of residence (*logIncPerCapita*) is positive and statistically significant. This result might indicate that filers residing in wealthier areas tend to be more compliant because they either have less financial stress or these taxpayers have a more favourable attitude toward government (*ceteris paribus*). In other words, even though we find evidence that income is positively related to the notion that income taxes are unfair, residing in an

¹⁰ Recall that our sample, by design, is not representative of all US taxpayers.

area with other relatively well-to-do households may diminish this sentiment somewhat. Finally, the variable *stateIncomeTax* is not statistically significant in any of our models.

Among the variables controlling for filing characteristics of taxpayers, the variables *auditPrior2Years*, *firstTimeFiler*, *usesPaidPreparer*, and *reportsZeroBothYears* are not statistically significant. The variables *claimsEIC* and *noTxblIncInTY00* have the predicted negative sign and are significant in all models. Similarly, *schSEPresent* and *filesSchCEZ* also are significant and have the predicted positive sign.

Table 3
Estimation Results

Variable	Coefficient (standard error)				
	OLS	Ordered Probit	Model 1	Tobit	
			Model 2	Model 3	
age	0.00217*(0.00092)	0.00778*(0.00353)	0.00251*(0.00104)	0.00268*(0.00103)	0.00229*(0.00101)
auditPrior2Years	0.03119 (0.05958)	0.10824 (0.23159)	0.04548 (0.06718)		
claimsEIC	-0.34116**(0.02301)	-1.09316**(0.09238)	-0.36560**(0.02572)	-0.36404**(0.02563)	-0.36190**(0.02563)
designatesToPresElecCampaignFund	-0.04756 (0.02577)	-0.08304 (0.10019)	-0.05627*(0.02869)	-0.05790*(0.02854)	-0.05931*(0.02858)
filesSchCEZ	0.12506**(0.03464)	0.50696**(0.13260)	0.15771**(0.03941)	0.16260**(0.03908)	0.16691**(0.03896)
firstTimeFiler	-0.04676 (0.04647)	-0.11146 (0.18636)	-0.03890 (0.05201)		
hasKids	0.08351**(0.02463)	0.39342**(0.09608)	0.08942**(0.02748)	0.09456**(0.02724)	0.07688**(0.02440)
isFemale	0.01904 (0.02470)	0.03343 (0.09504)	0.02139 (0.02773)		
isUSCitizen	0.01922 (0.01993)	0.09501 (0.07653)	0.02158 (0.02228)	0.02564 (0.02184)	
logIncPerCapita	0.08172**(0.02617)	0.19773 (0.09956)	0.08689**(0.02930)	0.08749**(0.02921)	0.09172**(0.02918)
logTaxableIncome	-0.04761**(0.00800)	-0.04267 (0.03110)	-0.05708**(0.00900)	-0.05744**(0.00894)	-0.06019**(0.00884)
married	-0.02868 (0.02558)	-0.14589 (0.09760)	-0.02763 (0.02858)	-0.03536 (0.02726)	
noTxblIncInTY00	-0.09331*(0.03708)	-0.28026*(0.13576)	-0.10407*(0.04178)	-0.13163**(0.02283)	-0.13294**(0.02284)
reportsContributions	-0.10529**(0.03761)	-0.34508**(0.14701)	-0.12246**(0.04197)	-0.11952**(0.04191)	-0.12135**(0.04179)
reportsStateIncomeTaxDeduction	0.12409*(0.04841)	0.22139 (0.17933)	0.14298**(0.05458)	0.13961**(0.05394)	0.13695*(0.05394)
reportsZeroBothYears	0.04010 (0.04349)	0.30354 (0.16138)	0.04115 (0.04889)		
schSEPresent	0.30498**(0.05708)	1.61392**(0.30664)	0.32184**(0.06345)	0.32800**(0.06311)	0.32381**(0.00821)
stateIncomeTax	-0.00119 (0.02226)	-0.03646 (0.08599)	-0.00327 (0.02486)		
txblIncTY01MoreThanTY00	0.15104**(0.03083)	0.68508**(0.11639)	0.16770**(0.03456)	0.14976**(0.02464)	0.15228**(0.02465)
usesPaidPreparer	0.00403 (0.02211)	0.03828 (0.08533)	0.00505 (0.02475)		
constant	-0.29328 (0.27198)	-2.98570**(1.05987)	-0.25769 (0.30404)	-0.23820 (0.30274)	-0.22645 (0.30308)
Number of observations	1,101	1,101	1,101	1,101	1,101
Adj R-Sq	0.3226				
F Value	27.19**				
Log Likelihood		-885.45589	-508.21371	-509.42300	-511.18254
AIC		1815	1060	1051	1050

*p < .05. **p < .01.

Table 4 displays the average of the individual marginal effects of the variables in our final model (Tobit Model 3). The variables accounting for the largest influence on reporting compliance are *claimsEIC* and *schSEPresent*. Although the absence of a Schedule SE is a relatively rare event¹¹, when it does occur it suggests a significant understatement of tax. Similarly, for filers like those in our sample whose only source of income is from a sole proprietorship, tax underreporting is often found on returns that claim the EIC.

Among our proposed indicators of tax morale appearing in Model 3 the variables *txblIncTY01MoreThanTY00* and *reportsStateIncomeTaxDeduction* have the greatest influence on reporting compliance. *logTaxableIncome* contributes only modestly and the variables *reportsContributions* and *designatesToPresElecCampaignFund* have the wrong signs.

Table 4
Average of the Individual Marginal Effects (Tobit Model 3)

Predictor	Average Marginal Effect
age	0.00216
claimsEIC	-0.34086
designatesToPresElecCampaignFund	-0.05586
filesSchCEZ	0.15721
hasKids	0.07241
logTaxableIncome	-0.05669
logIncPerCapita	0.08639
noTxblIncInTY00	-0.12521
reportsContributions	-0.11430
reportsStateIncomeTaxDeduction	0.12899
txblIncTY01MoreThanTY00	0.14343
schSEPresent	0.30498

4. DISCUSSION

Relying mainly on data from individual tax returns this paper has tried to shed light on the question: “Does tax morale help to explain the unexpectedly high levels of tax compliance observed in IRS random audit studies and, if so, to what extent?” Our experience shows that answering this question is made difficult by the absence of direct measures of the constituent components of tax morale. Of our six proposed measures of tax morale only three appear to have a material influence on reporting compliance rates of individual filers whose only source of income is from a small business (sole proprietorship). However, even with these variables it is possible to

¹¹ For example 1,068 out of 1,101 filers (97 percent) in our sample filed a Schedule SE with their tax return (see Table 2).

interpret these findings in a different light. For example, *logTaxableIncome* may be correlated with increasing tax unfairness but higher income is also taxed at higher marginal tax rates that could induce more underreporting. The variable *reportsStateIncomeTaxDeduction* may be positively related to trust in government institutions, but reporting this deduction also lowers tax liability and may offset, in part, a sense of tax unfairness. Finally, *txblIncTY01MoreThanTY00* may be associated with a growing sense of fairness, but also may reflect reduced financial stress and a greater ability to pay tax.

There is little doubt that a positive attitude toward governmental institutions contributes to a greater willingness to pay one's taxes. However, it is extremely difficult to separate this influence from other factors that are at least equally significant in deterring underreporting. An obvious example is the presence of third-party information reporting that allows the tax authority to perform automated checks of income reported on tax returns (IRS 2007, Johns & Slemrod 2010; Phillips 2011).¹²

Although much of the tax morale literature has focused on religiosity as a causal factor, influences of a more secular origin may also play a role.¹³ For example, in a recent telephone survey conducted by the IRS Oversight Board¹⁴ 79 percent of respondents said that their "personal integrity" had a "great deal of influence" on whether they report and pay their taxes honestly and another ten percent say it is "somewhat of an influence" for a combined total of 89 percent. In comparison, 65 percent of survey respondents cited "third-party reporting to the IRS" as having either a great deal or somewhat of an influence on compliance. Other factors that promote tax compliance at least somewhat in the IRS Oversight Board (2012) survey include "fear of an audit" (59 percent of respondents) and "belief that your neighbors are reporting and paying honestly" (42 percent).

Although this study has many weaknesses it is mainly a reflection of the difficulty of finding good measures of tax morale and compliance given the lack of extensive demographic information on tax returns (Johns & Slemrod, 2010). Further, it is acknowledged that audit outcomes may not always be accurate or in accordance with the taxpayer's own assessment of compliance behavior. There is the possibility of systemic differences in the ability of auditors to detect misreporting (Hessing, Elffers, & Weigel, 1988; Johns & Slemrod, 2010). Nevertheless, this study is an advance in that it does clearly provide a well-established measure of noncompliance via actual random taxpayer audits. By selecting a unique sample of taxpayers whose only source of income is from a sole proprietorship, we have attempted to control for the opportunity to evade.

Additional improvements could be made by subsequently surveying individual taxpayers selected for random audit to provide supplemental demographic

¹² For example, IRS (2007) reports net underreporting on wage and salary income subject to extensive third-party information reporting and tax withholding is only one percent versus 57 percent for non-farm proprietor income not subject to third-party information reporting.

¹³ Whilst we found no strong support for the role of religiosity, the great difficulties of measuring religiosity and/or personal integrity should be re-iterated and emphasized. This suggests that qualitative research in this specific area may prove to be more fruitful than quantitative analysis.

¹⁴ See <http://www.treasury.gov/irsob/reports/2012/IRSOB~Taxpayer%20Attitude%20Survey%202012.pdf>.

characteristics that could provide better measures of ethical views toward tax compliance. To what extent this information would prove useful for tax administration we leave to future work. Given the difficulties in understanding tax morale and compliance behavior more generally, it could be that tax administrators have to look to more concrete strategies to maximize revenue collections such as reducing opportunities to evade (Kagan (1989); Klepper & Nagin, 1989; Pope & McKechar, 2012); and greater focus on the enforcer role of tax practitioners given their significant influence on taxpayers (Klepper, Mazur, & Nagin, 1991; Tan, 2011).

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Tax incentives to encourage migration of skilled labour: another tax expenditure or a failure of tax residence?

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Abstract

In a world of increasing labour mobility, is it good tax policy to use tax incentives to encourage migration to meet shortages of skilled labour? Countries as diverse as Australia, New Zealand, Singapore, Denmark and China, to name but a few,¹ think so. But is this the best response? This article seeks to answer these questions, first by analysing the taxation regimes of various countries which have encouraged migration of skilled labour by providing tax incentives and asking why they did so (Part I). It then examines empirical studies and related literature with a view to determining whether occupational or residence decisions really are responsive to the taxation of labour (Part II). There is a wealth of literature on tax incentives to promote foreign direct investment. But comparatively little analysis has critiqued tax incentive regimes designed to attract labour. This article aims to fill this gap and goes on to consider whether such regimes may best be viewed, not as tax expenditures, but as curing the failure whereby many countries adopt an over-embracing concept as to when an individual becomes a tax resident (Part III). It will be argued that, although the case for enacting a tax incentive regime as the best way to encourage migration of skilled labour is problematic and has not been made out, it would be unrealistic to expect countries to refrain from doing so. Accordingly, the article proceeds to set out the design elements such a regime should contain to ensure that the policy goals identified can best be satisfied (Part IV). Finally, the article explains the lessons learned from the analyses undertaken and answers the questions posed above (Part V).

1. A COMPARATIVE STUDY OF TAX INCENTIVE REGIMES AIMED TO ATTRACT MIGRATION OF SKILLED LABOUR

As indicated above, many countries have enacted taxation incentive regimes to attract migration of skilled labour. This article will examine five of these, namely, those in Australia, China, Denmark, New Zealand and Singapore. For comparative purposes, the experience of Israel will also be analysed – since its taxation incentive is directed at encouraging immigration generally. Most of these incentives provide an exemption to qualified persons for foreign source income and, where relevant, offshore capital gains. They are generally aimed at attracting foreign, non-resident skilled workers to relocate (and often to encourage expatriates to return) and virtually all are time limited

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¹ An OECD study found that as of 2010 15 OECD countries had introduced targeted income tax concessions to attract migration of highly-skilled workers: see *OECD Tax Policy Studies: Taxation and Employment (No 21)* (2011), p 124. Some of those countries, such as the United Kingdom and Switzerland, go further. They use tax incentives to encourage wealth migration.

(i.e. incentives expire after a stated period or when the relevant person becomes a permanent resident). Table 1 summarises the main features of these regimes.

TABLE 1

Country	Qualifying person	Form of incentive and type of income covered	Compliance obligations and qualification conditions	Time period
Australia ²	Temporary resident – a person who is a tax resident but who does not hold a permanent visa ³ or citizenship and does not have an Australian spouse	Exemption for foreign source income that is not part of the person's Australian employment income [Notes – a temporary resident is also exempt from capital gains tax unless the asset is 'taxable Australian property'. Special rules apply to tax capital gains on shares and rights acquired under employee share schemes.]	Normal compliance obligations apply, except that interest paid to foreign lenders is not subject to withholding tax	Exemption ceases when the person is no longer a temporary resident
China ⁴	A person who is not domiciled in China and who has resided in China for less than 5 years ⁵ [Note – even where a non-Chinese domiciliary (expatriate) stays in China for more than 5 years, it is relatively easy for that person to avoid becoming a resident taxpayer under the Individual Income Tax Law. To achieve this result, the person must stay outside China for more than 90 days cumulatively, or 30 days consecutively, within the relevant calendar year. ⁶]	Exemption for all non-Chinese source income and gains, except where it is paid or borne by a Chinese entity or individual	Normal compliance obligations apply	Exemption applies for 5 years [Note – see, however, Note contained in the first substantive column of this table which shows that, for an expatriate, non-resident tax status is relatively easy to achieve.]

² Income Tax Assessment Act 1997 (Cth), s 768-910. The rules came into effect on 1 July 2006. See generally, <http://www.ato.gov.au/individuals/content.aspx?doc=/content/76537.htm> (accessed 18 February 2013).

³ Under the Migration Act 1958 (Cth) a temporary visa allows a person to remain in Australia during a specified period or until a specified event happens or while the person has a specified status. A permanent visa allows a person to remain in Australia indefinitely.

⁴ Individual Income Tax Law of the People's Republic of China, art 1 and the Regulations Implementing the Individual Income Tax Law of the People's Republic of China, arts 2, 3 and 6. The law and regulations came into operation on 1 January 1994. They can be found at http://www.chinatax.gov.cn/n6669073/n6669088/index_3.html (accessed 18 February 2013).

⁵ For this category, the exemption described in the next column of this table is available only with the approval of China's State Administration of Taxation: see Regulations Implementing the Individual Income Tax Law of the People's Republic of China, art 6.

⁶ Regulations Implementing the Individual Income Tax Law of the People's Republic of China, arts 2 and 3.

Denmark ⁷	Overseas researchers (scientists) and high income earners ⁸ employed in other professions. The person must have been recruited abroad and not been liable to tax in Denmark in the prior 10 years. Danish citizens living abroad can apply for the incentive	Flat rate of income tax of 26% (no deductions from income allowed), instead of the normal progressive income tax with a top marginal rate (including labour market contributions) of around 56% (2012). The incentive only applies to earnings from the qualifying employment; all other income is taxed at normal rates	The foreign national must apply for a tax and social security number within 3 months of arriving in Denmark and at the same time make a formal application for the tax incentive	The incentive expires after 60 months ⁹
Israel ¹⁰	New immigrants and returning residents – the latter category refers to an individual who resided overseas for at least 10 years from the date he or she left Israel or was a foreign resident on 1 January 2007	Exemption for foreign source income, including income from professional work, salary and capital gains. New immigrants are also entitled to additional tax deductions (known as ‘tax credit points’)	New immigrants and returning residents should complete an application form. Offshore income need not be reported in the individual’s tax return ¹¹	The exemption applies for 10 years. New immigrants are exempted from tax on offshore pension income without time limit. Interest income earned by new immigrants on foreign currency deposits is exempt for 20 years, provided the funds deposited were owned prior to immigration and were deposited in an Israeli banking institution

⁷ Danish Withholding Tax Act, s 48E. The rules came into effect in 1991. See generally, Guide published by the Danish tax authority (SKAT), ‘Tax Scheme for Foreign Researchers and Key Employees’ www.skat.dk/SKAT.aspx?thisId=97319.205905 (accessed 18 February 2013).

⁸ The income threshold for the scheme to apply to non-researchers is around €10,000 per year (as of 2011). The threshold only applies to earnings from the relevant employment to which the incentive applies. In other words, other sources of income are not counted when considering this condition of eligibility.

⁹ Between 2008 and 2011, a qualified person could chose between the then standard incentive tax rate of 25% for 36 months or a higher rate of 33% for 60 months.

¹⁰ Income Tax Ordinance [New Version] 5721–1961, s 14. The exemption commenced in 2002 when Israel moved from a territorial to a worldwide tax system. The exemption was expanded in 2008 to provide enhanced incentives as well as to cover returning residents (in addition to the original category of new immigrants). The law can be found at [www.financeisrael.mof.gov.il/FinanceIsrael/Docs/En/legislation/FiscalIssues/5721-1961_Income_Tax_Ordinance_\[New_Version\].pdf](http://www.financeisrael.mof.gov.il/FinanceIsrael/Docs/En/legislation/FiscalIssues/5721-1961_Income_Tax_Ordinance_[New_Version].pdf) (accessed 18 February 2013). As indicated above, it is important to appreciate that Israel’s exemption regime is not directed at encouraging skilled labour migration as such; rather, it is meant to encourage immigration generally (see Table 2).

¹¹ Income Tax Ordinance [New Version] 5721–1961, s 134B.

New Zealand ¹²	Transitional resident – a person (who may or may not be a citizen) who was not a tax resident for the previous 10 years	Exemption for foreign source income (except employment income from overseas employment performed while living in New Zealand and business income relating to services performed offshore)	The exemption applies automatically to a qualified person. The normal compliance obligations apply	The exemption applies for 4 years from the first calendar day of the month the person qualifies as a tax resident in New Zealand
Singapore ¹³	Not ordinarily resident – a person (who may or may not be a citizen or permanent resident) who was not a tax resident for at least 3 years prior to becoming a tax resident in Singapore	Exemption for a portion (that corresponds with the number of days spent outside Singapore for business reasons in a year) of the person's Singapore source employment income [Notes – Singapore's jurisdiction to tax is based on source and, to a limited degree, remittance. However, except in a very limited manner, the remittance jurisdiction does not apply to resident individuals. ¹⁴ The source of employment income is determined by where the employment is exercised, and not simply by where the employment duties are performed. ¹⁵]	To qualify, a person must spend a minimum of 90 days outside Singapore for business purposes pursuant to his or her employment in the year of assessment and have a minimum employment income of S\$160,000. In addition, where the tax on the apportioned income is below 10% of the person's total Singapore employment income, the person must pay a tax rate of 10% on his or her total Singapore employment income. A one-time election, using a special form, must be submitted to the IRAS on an annual basis no later than 15 April in each Year of Assessment	The incentive ceases after 5 years

Given the popularity of these regimes, what prompted the surveyed countries to adopt them? Table 2 answers this question. As will become apparent two broad rationales are generally advanced when introducing tax incentives to promote migration of skilled workers – to remove taxation barriers for migration decisions and to attract and/or retain skilled workers.

¹² Income Tax Act 2007 (New Zealand), CW 27 and HR 8. The rules came into effect on 1 April 2006 and were enacted by the Taxation (Depreciation, Payment Due Dates Alignment, FBT and Miscellaneous Provisions) Act 2006. See generally, www.ird.govt.nz/yoursituation-nonres/move-nz/temp-tax-empt-foreign-inc.html (accessed 18 February 2013).

¹³ Income Tax Act (Cap 134, 2008 Rev Ed) ('ITA'), s 13N. The rules came into effect in the Year of Assessment 2003. See generally, IRAS Circular, 'Not Ordinarily Resident Scheme' (7 July 2008) (updated on 29 August 2008), at www.overseasingaporean.sg/userfiles/blog/files/NOR%20Circular_07_07_08%20.pdf (accessed 18 February 2013).

¹⁴ ITA, s 13(7A).

¹⁵ See Pok, Ng and Timms (Eds), *The Law and Practice of Singapore Income Tax* (Singapore: LexisNexis, 2011), chap 19.

TABLE 2

Australia ¹⁶	China	Denmark	Israel	New Zealand	Singapore
To attract internationally mobile skilled labour, and to ease the cost pressures for Australian business of employing skilled foreign workers ¹⁷ ¹⁸	To distinguish between ordinary residents and non-permanent or short-term residents. China's rules are similar in concept to those of Japan. ¹⁹ The tax policies underpinning China's rules emanated from the 1980s and were designed to complement China's numerous tax incentives to increase foreign direct investment. They were thus intended to attract skilled expatriates, experts and scholars to work in China and are not represented by China to be a labour migration incentive, even though they should have some incentive effect ²⁰	To strengthen the competitiveness of Danish companies and research institutions by facilitating research and product development. The incentive also addressed concerns about the high costs borne by Danish companies and research institutions of employing researchers and skilled professional staff ²¹	Essentially this is an immigration policy aimed specifically to increase the number of people who choose to return or to come and live in Israel. The reform is described by the Ministry of Finance as "one more benefit the Ministry of Immigrant Absorption initiated for Israel's 60th anniversary, all intended to ease the return of Israelis living abroad and the absorption of new immigrants." ²²	To help New Zealand businesses recruit highly skilled individuals from overseas, resulting in positive effects for the New Zealand economy. ²³ This incentive also addressed concerns that had been expressed relating to the additional costs borne by New Zealand businesses in recruiting overseas talent by virtue of New Zealand's wide jurisdiction to tax foreign income earned by all residents	To attract talent to relocate to Singapore ²⁴

¹⁶The temporary resident tax incentive was based on recommendation 22.18 of the *Review of Business Taxation* (known as the Ralph Review, 1999) that, inter alia, considered what reforms should be made to Australia's international tax regime: see www.rbt.treasury.gov.au/ (accessed 18 February 2013).

¹⁷ Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No 1) Bill 2006 (Cth).

¹⁸ Australian Government, Budget Paper No 1: Budget Strategy and Outlook 2005-06 (2005) 'Part 1: Fiscal Outlook and Budget Priorities', pp 1-15: see www.budget.gov.au/2005-06/bp1/html/bst1-05.htm (accessed 18 February 2013). Some highly paid expatriates, prior to relocation overseas, negotiate so-called 'equalisation' payments as part of their Australian remuneration package (so that they are no worse off in tax terms by becoming an Australian tax resident). This was considered an added cost to Australian business which may make it more expensive to recruit and retain skilled foreign workers.

¹⁹ See <http://www.nta.go.jp/tetsuzuki/shinkoku/shotoku/tebiki2011/pdf/43.pdf> (accessed 18 February 2013). Specifically, a non-permanent resident is one who meets the normal residence test but is not a Japanese national and has not maintained a residence in Japan for an aggregate of 5 years during a 10 year period. A non-permanent resident is taxed only on domestic source income and foreign-source income which is remitted to Japan.

²⁰ The author is grateful to Professor Cui Wei, China University of Political Science and Law for this comparison and to Dr Ren Linghui, Ernst & Young Tax Services Ltd (Hong Kong) for placing this 'incentive' in its historical perspective.

²¹ See www.eatlp.org/uploads/Members/Denmark02.pdf (accessed 18 February 2013), sourcing material from the SKAT homepage; see further, *OECD Tax Policy Study* (2011), n 1 above, p 132.

²² See <http://www.gov.il/FirstGov/TopNavEng/PageReturnHomeEng> (accessed 18 February 2013).

In addition to the publicly stated reasons explaining why each of these countries enacted tax incentive regimes to attract skilled labour, other rationales should not be discounted. These include tax competition (many other countries, including Japan,²⁵ the United Kingdom and several other European Union nations, have similar incentives to those examined) and equity considerations (reflecting the view that temporary residents should be taxed on a concessional basis since they do not obtain the same long term advantages from tax funded public spending as ordinary residents on matters such as social welfare and pension benefits).²⁶

To complete this introduction, the OECD Tax Policy Study Taxation and Employment (No 21)²⁷ has usefully summarised the arguments for introducing tax concessions to promote skilled labour migration. The following list provides an overview of why a country may wish to proceed along the tax incentive path:

- To reduce the effect of tax on the migration decisions of foreign high-skilled workers
- Increasing the attractiveness of high-tax jurisdictions as a residence and work location for high-skilled mobile workers
- Reducing the barriers to migration created by domestic tax rules, including the reach and complexity of rules for taxing foreign source income and gains
- Responding to the introduction of tax concessions in other countries
- Using the tax system to attract and retain mobile high-skilled workers (where more direct means to obtain these outcomes are not feasible) so as to:
 - capture knowledge-related spillovers
 - address skill shortages
 - derive a fiscal gain
 - complement other government policies.

²³ See <http://www.ird.govt.nz/technical-tax/legislation/2006/2006-3/2006-3-temp-exemption-from-tax/leg-2006-3-temp-exempt-tax-migrants.html> (accessed 18 February 2013). Concerns with the previous law, under which all residents were taxed on foreign source income and which was seen as a barrier to migration, were highlighted by the *Final Report of the Tax Review 2001* (see www.treasury.govt.nz/publications/reviews-consultation/taxreview2001, accessed 18 February 2013) as well as by the government discussion document, *Reducing Tax Barriers to International Recruitment to New Zealand*, released in November 2003 (see <http://taxpolicy.ird.govt.nz/sites/default/files/2003-dd-international-recruitment.pdf>, accessed 18 February 2013).

²⁴ See Pok, Ng and Timms (Eds), *The Law and Practice of Singapore Income Tax* (Singapore: LexisNexis, 2011), chap 19, p 1021.

²⁵ See n 19 above.

²⁶ See, e.g., Invest: Sweden, *Tax Relief for Foreign Employees* (Fact Sheet: Running a Business; January 2012): see www.investsweden.se/Global/Global/Downloads/Fact_Sheets/Tax-relief-for-key-foreign-employees.pdf (accessed 26 November 2012). This concern was also acknowledged in Denmark: see the comments by the Danish Minister for Taxation on Bill L 158 of 10 December 1991, cited in www.eatlp.org/uploads/Members/Denmark02.pdf (accessed 18 February 2013).

²⁷ Note 1 above, pp 131–135. At p 132 the Study notes that: “Tax Systems across the OECD have typically been designed with *immobile* permanent residents in mind.” (emphasis added).

2. ARE OCCUPATIONAL OR RESIDENCE DECISIONS REALLY RESPONSIVE TO THE TAXATION OF SKILLED LABOUR?

Published studies on this question relating to mobile highly skilled workers, who are the target of the analysis in this article, are fairly uniform in concluding that the empirical evidence available does not suggest that migration decisions are highly responsive to taxation.²⁸

However, the OECD Tax Policy Study which supports this conclusion cautions that:

“While the literature is to an extent mixed, it suggests that tax can affect migration decisions, especially for the high-skilled, but that this effect is likely to be relatively small. This is unsurprising given the number of other factors that affect the migration decision. However, as mobility continues to increase it is likely that the influence of tax on migration decisions will also increase. This poses a number of issues for tax policy.”²⁹ (emphasis added)

Other studies express similar reservations:

“More empirical research is needed to determine which [labor mobility] benchmark is most important. We do not yet know whether locational, leisure, occupational, or residence decisions are most responsive to the taxation of labor, but as labor mobility becomes more important in the global economy, the need for answers to these questions will become more pressing.”^{30 31}

In relation to domestic patterns of migration, tax elasticities may be more pronounced:³²

“Tax – along with potential for professional development and better career options – is a major influence on people’s decision to migrate. Looking specifically at tax as a motivator for migration, Richard Vedder from Ohio University has been looking at domestic migration patterns within the US. Vedder has found indications that Americans by and large choose to migrate into low tax states and that this tendency has been consistent over the last 20 years.³³ Kathleen Day has also found that regional fiscal policies including taxation to some degree influences inter provincial migration in Canada.”³⁴

Finally, given the longevity of the Danish tax incentive for foreign researchers and skilled workers, initiated more than two decades ago, it is not surprising that several

²⁸ Ibid, p 11.

²⁹ Ibid, p 129.

³⁰ Mason, ‘Tax Expenditures and Global Labor Mobility’ (2009) 84 NYU Law Review 1540, p 1622.

³¹ Tangentially, the *OECD Tax Policy Study* (2011), n 1 above, p 10 also concluded that: “Empirical evidence suggests that low-income earners, single parents, second earners and older workers are relatively responsive to changes in labour income taxation, particularly at the participation margin. In addition, taxable income elasticities suggest that higher-income individuals are more responsive to taxes than middle- and lower-income workers.”

³² Ulrich, ‘Taxing Talent’ Adam Smith Institute Policy Paper (2010), available at www.adamsmith.org/sites/default/files/resources/ASI_Immigration_AW.pdf (accessed 18 February 2013).

³³ Citing Vedder, The Heartland Institute (2005).

³⁴ Citing Day, ‘Interprovincial Migration and Local Public-Goods’, (1992) 25(1) Canadian Journal of Economics-*Revue Canadienne D’Economie* 123–144.

studies have analysed its efficacy. The main conclusions reached can be summarised as follows:

- The tax incentive has increased in popularity since it was introduced – from 229 people in 1992, to more than 2,800 in 2009. Although 2,800 may seem a small figure, it is not insignificant in a labour force of 3,000,000 people.³⁵
- From these statistics, it is arguable that the tax incentive has shown that highly skilled workers are responsive to lower taxes and that it is a viable way to attract qualified people to Denmark.
- However, it is important to appreciate that this conclusion focuses upon the short term – since it reflects figures based on attracting highly skilled workers, but ignores statistics on permanently retaining them. Indeed, only 50 qualified workers chose the longer, higher tax, five year option under the Danish scheme, which would more likely lead to long-term residency. [Note: as indicated in Table 2 and note 9 above, from 2008 to 2011 a qualified person could choose to be taxed at the standard incentive rate of 25% for 36 months or a higher rate of 33% for 60 months]. These statistics show that the incentive seemingly has not been effective in retaining highly qualified workers in Denmark.³⁶
- On the basis of a study using population wide Danish administrative tax data, the tax incentive doubled the number of highly paid foreigners in Denmark relative to slightly less paid ineligible foreigners. These statistics show a very large elasticity of migration with respect to after tax earnings. The study also showed evidence of sharp bunching of durations of stay at the pre-2012 three-year limit before the incentive expired (compare note 36 above and related text). This illustrates a significant but quantitatively small intensive duration response.³⁷

To summarise, the thrust of these studies, particularly the more recent ones, and the cautions expressed therein, reveal clear tensions relevant to enacting and evaluating tax incentives to attract the migration of highly skilled workers. Although most deny that labour migration is significantly influenced by tax considerations, it appears that the full ramifications of the increasing mobility of skilled labour and its responsiveness to tax incentives may not be fully appreciated. In today's more fluid economic and social environments, there is an arguable case that tax incentives targeted at attracting migration of mobile skilled workers is worthy of consideration and analysis.³⁸ Indeed, as indicated above, it is no coincidence that this path has been

³⁵ Note 32 above, citing Danish Treasury Department, 18-5-2009, SKAT.dk.

³⁶ Ibid, citing C.K. Jessen, (21-7-2010), www.business.dk.

³⁷ See Kleven, Landais, Saez and Schultz, 'Taxation and International Migration of Top Earners: Evidence from the Foreigner Tax Scheme in Denmark' (Draft, November 2011), p 1, available at http://ceg.berkeley.edu/visitors_31_4127414159.pdf (accessed 18 February 2013).

³⁸ A survey carried out by KPMG, *Tax, Demographics and Corporate Location* (March 2009) supports this conclusion. The survey involved 260 senior human resources managers from 11 countries and was intended to test the views of business on the desirability and practicability of greater labour mobility, as well as the role that governments should play in influencing the movement of labour. Respondents were virtually unanimous in the view that the greatest barrier to employing more foreign workers is restrictions on immigration. However, 79% of respondents also supported government action being taken to remove fiscal barriers for individual employees and their employers, particularly in relation to

taken by several countries (including those surveyed in this article), particularly those imposing higher than average effective tax rates on employment income and high and/or complex taxation on foreign source income.³⁹ The question remains, however, whether this is the best policy response and how can we evaluate it?

3. A CRITIQUE OF TAX INCENTIVES TO ATTRACT MIGRATION OF SKILLED LABOUR

If, as seems to be well accepted, (1) a highly skilled workforce adds real value to a country's economy, (2) countries' responses to labour shortages will change as labour becomes increasingly mobile, (3) tax incentives to promote migration of skilled labour are increasing and (4) as a practical reality, countries will not simply refrain from enacting those incentives, a crucial question must be considered, namely, what design features should be incorporated into the incentive so as to best promote its objective? Before answering this question, we must first set out an appropriate framework to critique and justify such incentives.

To provide background for this analysis, the OECD Tax Policy Studies: Taxation and Employment (No 21)⁴⁰ has summarised the arguments against introducing tax incentives to attract labour migration. They are as follows:

- Incentives may not be necessary due to an already highly attractive labour market
- Incentives may not work, e.g. because of limited labour mobility or tax concession design difficulties
- Even if they do work, there may be other more efficient policy measures available
- Incentives may not be justifiable on broader equity grounds, since they discriminate against resident workers with similar skills
- Scheme design can become complex due to the need to target the incentive by reference to a particular policy goal. This may lead to possible uncertainty and impose substantial compliance and administrative costs relative to the potential benefits sought.

In addition, the main argument advanced against Denmark's researcher tax incentive scheme bears repetition – namely, the available evidence supports the conclusion that whilst this incentive encourages highly skilled workers to locate in Denmark, it does not encourage them to permanently remain there.

Confining our analysis initially to a critique of 'tax incentives', there is a deep and rich literature on their use and efficacy to attract foreign direct investment (FDI).⁴¹

the cross-border portability and harmonisation of the tax treatment of pension schemes. 70% were even prepared to support harmonised personal income tax rates, to reduce what they considered to be arbitrage distorting labour markets, especially in the Asia-Pacific region.

³⁹See *OECD Tax Policy Study* (2011), n 1 above, pp 10, 12 and 44. See also, Kleven, Landais, Saez and Schultz, n 37 above, who conclude that tax incentives for highly paid workers could generate very harmful tax competition in European countries.

⁴⁰ *Ibid*, pp 135–137.

However, comparatively little attention has been paid to evaluating tax incentives designed to encourage migration of skilled labour.⁴² As indicated above, it is necessary to establish a framework to perform this task with a view to ultimately determining how the policy goals sought to be met by such tax incentives can best be attained. A classic framework involves an examination of their effectiveness, efficiency (cost), fairness and transparency. In addition, the utility of tax incentives needs to be understood in the context of the prevailing historical, social and economic circumstances of the country providing them.

(a) Tax Holidays

Table 1 above shows that all the surveyed countries except Denmark provide tax holidays (exemptions) to qualified taxpayers, albeit for foreign source income only. At face value, this seems troublesome since, at least in the FDI context, tax holidays have been widely criticised as being the least effective and efficient form of tax incentive.⁴³ In that context, tax holidays have been described as serving no specific purpose and for being unfocused.

In the context of our current study, the major pitfalls of tax exemptions are: they result in revenue loss that cannot be predicted in advance; the costs are not directly related to the benefits that are envisaged will accrue to the country granting the incentive; studies do not appear to have distinguished which segments of the skilled labour force are more responsive to tax incentives than others; and they are rarely effective in retaining skilled workers on a more permanent basis. In addition, a tax exemption discriminates against domestic workers having the same skills, thus highlighting the potential for negative unforeseen consequences. Adopting this analysis, a tax exemption appears hard to justify and should be evaluated with circumspection.

(b) Reduced Tax Rate

By and large, the criticisms directed at tax holidays also apply to the reduced tax rate provided by Denmark (the remaining country surveyed in Table 1) for relevant domestic employment income, although instinctively one may be tempted to conclude that from a tax policy perspective a tax reduction for a limited period of time is not as egregious as a tax holiday.

(c) General Comments

Notwithstanding the criticisms above, if a country's policy goal is to attract migration of highly skilled workers on a short-term basis *and* the incentive chosen is finely focused upon those segments of the skilled workforce that are more highly mobile and responsive to the level of taxation on their income, the empirical studies discussed in Part II above show that an incentive can be effective in promoting (although not

⁴¹The seminal work of Alex Easson, *Tax Incentives for Foreign Direct Investment* (The Hague: Kluwer Law International, 2003) and the OECD, *Checklist for Foreign Direct Investment Policies* (Paris: OECD, 2003) provide an excellent starting point for researching this area.

⁴²The framework for the following analysis first appeared in Cockfield (Ed), *Globalization and Its Tax Discontents* (Toronto: University of Toronto Press, 2010), chap 3, Halkyard and Ren, 'Evaluating China's Tax Incentives for Foreign Direct Investment: An Eassonian Analysis'. The analysis contained in this article is comparative in nature and deals solely with tax incentives to encourage migration of skilled labour; the earlier work dealt solely with the corporate tax incentive regimes in China.

⁴³Easson, n 41 above, pp 140–141.

necessarily retaining) this goal. Furthermore, subject to the comments below relating to evaluating the cost of enacting an incentive, the ancillary benefits flowing to a country from the influx of skilled labour should not be insignificant.

However, this argument begs the question of whether a tax incentive is the most effective, efficient (in terms of a cost-benefit analysis), fair and transparent means of pursuing the economic goal of a country to develop a skilled labour force? At this juncture two matters could be noted. First, just because the tax system can be used to treat a perceived problem does not mean that it should be so used. Second, as a general matter a market failure (the shortage of skilled labour) may be better handled by addressing that failure directly rather than indirectly through the tax system.

Furthermore, even if we confine our analysis to taxation options,⁴⁴ would enhanced deductions for employing skilled workers or tax credits for employers developing employee work skills be a preferable way to meet the policy goal? In terms of tax policy generally and tax incentive design specifically, and bearing in mind what activity is being incentivised and the issues of equity which arise if only limited areas of economic activity would benefit from the availability of enhanced deductions or tax credits, the answer is probably 'no'. Yet this is only one of many questions that could be put. And, as indicated in the previous paragraph, the analysis does not adequately address systemic concerns expressed in many countries (particularly developing countries) by skilled workers and their employers – for instance, would it not be preferable to tackle problems of skills shortage by improving overall education standards, economic wellbeing, environmental quality and quality of life for workers and their families?

The real difficulty with the analyses attempted above, and with a country's decision to grant tax incentives to attract migration of skilled labour in the first place, is that it simply has not been proven that they produce the best result. Indeed, there does not seem to have been a thorough debate or empirical study on this issue. Although it might be countered that tax incentives in this area create a modestly incentivised tax environment which is justifiable from a tax policy perspective, the fact remains that Part II above indicates that there is a paucity of hard evidence to show that the activities targeted for tax exemptions and reductions are those which are particularly, as distinct from generally, sensitive to taxation (in the sense that they focus upon attracting skilled labour which would not migrate without the chosen tax incentive).⁴⁵ Without such evidence, how can we confidently answer the question that the tax

⁴⁴See further, Jogarajan, 'Bring them Home – The Case for Tax Concessions for Returning Australians' (2006) 16(1) Revenue Law Journal 1, pp 17–18 who argues that the main alternative to tax concessions for skilled labour migration, namely a direct subsidy, grant or provision of services (such as housing), is not justifiable and is thus not a "substitutable tax expenditure". The author recognises however that such a conclusion should not preclude us from considering generally whether using direct methods of support and assistance (as distinct from a tax incentive), including migration regulation and a focused public spending program on education, may better meet a country's desire to address shortages of skilled labour.

⁴⁵The *OECD Tax Policy Study* (2011), n 1 above, p 10 puts it thus: "The variation in empirical estimates [relating to the responsiveness of workers to income tax changes] highlights the need for tax policy makers to be aware of the groups likely to be affected by a tax change, and their likely response to the change, in order to understand the overall impact of the reform on employment, tax revenue and the income distribution."

incentive chosen is the most effective option for a country to attract highly skilled labour of the type it wishes to increase?⁴⁶

Even if the answer to this question is assumed, or answered positively, we must proceed to examine whether the incentive chosen is the most efficient (least costly) and whether, and to what extent, considerations of equity and fairness between taxpayers⁴⁷ and the community interest and transparency indicate any contrary conclusion.

At the risk of repetition, it would be remiss not to acknowledge the difficulties and limitations faced in evaluating the tax incentive regimes set out in Table 1. In short, there are major problems in obtaining relevant data that could provide a statistical and empirical basis to support a typical tax incentive analysis. Specifically, as illustrated by Part II above, the surveys relating to the influence of taxation upon migration of skilled labour (effectiveness) in today's environment are not comprehensive and in many ways are incomplete and outdated. Moreover, the cost of the incentive (efficiency) seems difficult to estimate with any degree of confidence.⁴⁸ And, as shown by Israel's experience in Table 2, the social and economic conditions influencing the introduction of a tax incentive (reflecting the government's desire to encourage immigration and Israelis to return) may itself provide the justification for a country to proceed in this way, regardless perhaps of tax incentive policy considerations.

Criticism may sometimes be directed at countries for being complacent and not reacting quickly enough in terms of granting tax incentives to encourage skilled labour migration, particularly given the continuing level of tax competition worldwide. This article does not tackle this argument directly, but instead cautions that a country should be wary in changing its tax policy on incentives by introducing what many commentators would view as 'yet another tax expenditure'. Notwithstanding an environment of arguably increasing tax competition to attract skilled labour, many countries have not sought to shape their economic development by relying upon tax incentives. And, in this regard, it is by no means clear that the economies of these countries have suffered by not going down the tax incentive path.

⁴⁶Interestingly, the most comprehensive of the policy papers published, the *OECD Tax Policy Study* (2011), n 1 above, p 139, concludes that where countries enact a broad tax incentive which is not dependent upon the worker having a narrowly legislated skill set (such as the temporary tax exemption for qualified persons on foreign source income in Australia and New Zealand) it can be expected that the take-up (effectiveness) will be more substantial.

⁴⁷See Jogarajan, n 44 above, p 20, who argues that a tax concession exempting for a limited period foreign source income of skilled workers returning to their country of origin would not be perceived in the same light as reducing their tax liability on domestic source income (which the author considers would be unfair).

⁴⁸For instance, both Australia and New Zealand treat their respective temporary resident tax incentive provisions as "tax expenditures" for the purpose of their tax expenditure budgets. In Australia, the cost thereof was estimated at A\$45 million for each of the years 2011/12 and 2012/13, but the reliability of these figures was acknowledged as "low": see *Australia Tax Expenditure Statement 2011*, available at www.treasury.gov.au/PublicationsAndMedia/Publications/2012/Tax-Expenditures-Statement-2011/SES/Tax-Expenditures (accessed 18 February 2013). In New Zealand, the amount of the expenditure was "not quantified": see *New Zealand – Tax Expenditure Statement 2011*, available at www.treasury.govt.nz/budget/2011/taxexpenditure/b11-taxexpstmt.pdf (accessed 18 February 2013).

What does seem clear in this context is that, whether tax incentives are introduced or not in response to the increasing calls for them, the debate should not be focused upon doomsday stories from self-interested parties. Rather, to the extent that tax incentive analysis is engaged, this debate should not be divorced from benchmarking the policy goals sought to be achieved with considerations of effectiveness, efficiency, fairness, clarity and transparency – concepts which have been the subject of numerous policy and empirical studies, albeit in other fields. It is the desirability for a measured and principled approach to granting tax incentives which this article advocates.

(d) A Different Analysis Focusing Upon Tax Residence

What often seems lacking in tax incentives analysis is a detailed consideration of the role they play within the context of a country's income taxation system as a whole – and this leads us to another way to analyse 'tax incentives' to attract migration of highly skilled labour. Rather than evaluate them by reference to the classic benchmarks generally applied to tax incentives, a more satisfying justification for their existence is to consider such provisions as reflecting a key element of most tax systems (including most of those surveyed in Part I above) – whereby non-residents are taxed on a different basis (tax on domestic source income only) to residents (tax on a worldwide basis).

If one accepts that these provisions are often designed to remove taxation barriers for highly skilled workers to migrate by exempting foreign source income for a relatively short period of time (a conclusion supported by Table 2 above, with the possible exception of Denmark), then it might be argued that they only benefit workers who in a more perfect tax world should be treated as non-residents. In the absence of such provisions, an individual normally becomes subject to worldwide taxation in the host country simply by staying in that country for a fairly limited period of time. After satisfying what is typically a low threshold (which, depending on individual facts and circumstances, may be evidenced by physical presence of much less than 183 days in any year), that person becomes a tax resident, at a very minimum for that year, regardless of (1) the total time she actually remains in the country and (2) the extent to which she benefits from the tax-funded public spending available to the long-term or 'domiciled' resident. Accordingly, in the case of skilled mobile workers these provisions may best be viewed, not as tax expenditures, but as curing the failure whereby most countries adopt an over-embracing concept as to when an individual becomes a tax resident.

4. DESIGN ANALYSIS

To paraphrase Alex Easson, albeit in a different context, there is a disconnect between conventional thinking that casts doubt on the efficacy of tax incentives (which is reflected in Parts II and III of this article) and the reality in many countries where they are extensively adopted.⁴⁹ Accordingly, notwithstanding the criticisms, doubts and queries raised above, it is unrealistic to expect the wholesale abolition of the tax incentives similar to those detailed in Table 1. Indeed, some will argue that properly designed incentives can be simpler and more cost-effective than the alternative that might be advocated – a direct spending program involving grants to encourage such

⁴⁹ Easson, n 41 above, Preface and p 12; and, to underline this point in the present context, see n 1 above.

migration or increased public expenditure on education and quality of life for a country's residents.

In this Part, we will consider the design of the types of incentives surveyed in Table 1 above in order to see whether they match the goals sought to be achieved. It is also necessary to appreciate the role that good administration plays in their realisation, for lack of transparency and certainty ultimately comes at a cost.

- The policy goal sought to be achieved must clearly inform the type of tax incentive adopted.
 - If the main goal is to address perceived tax barriers to migration of skilled labour generally (e.g., a country having a worldwide tax system which is complex and / or has high rates of personal tax), then a tax exemption for foreign source non-employment related income and gains seems appropriate (all countries surveyed except Denmark took this approach). In this case the skill requirements targeted by the incentive may be (but often are not) fairly general and can be controlled through rules regulating immigration (as in Australia, New Zealand and Singapore). In this regard, the tax exemption is a critical design feature since, notwithstanding the traditional arguments directed against tax holidays, it provides the best justification for taxing migrating skilled workers differently from the longer-term resident during the period when it all too easy under modern tax systems for such a person to be treated as a resident taxpayer and thus typically taxed on a worldwide basis.
 - However, if the goal is to address market failure by seeking to fill skill shortages in certain identified industries, then a reduction of tax on labour income (as in Denmark and arguably China⁵⁰) may be considered. In this case, to the extent achievable, analyses should be undertaken showing that the tax incentive proposed will be effective, efficient and provide overall benefit to the host country (bearing in mind, however, the very difficult problems of undertaking such assessments, as illustrated by Part III). The skill requirements need to be very carefully targeted and restricted in their application to promote the type of skilled labour sought to be encouraged and focused upon the most mobile forms of skilled labour required.
- The incentive should be drafted in sufficient detail and clarity so that there is no doubt as to who will benefit, what that benefit will consist of, and how it is calculated (all countries surveyed seem to satisfy this requirement).
- Ideally, the exercise of discretion to determine whether a person qualifies for the incentive should be kept to a minimum (all countries surveyed seem to

⁵⁰China has a higher tax free threshold (which takes the form of a standard monthly deduction) for expatriates than for nationals: see n 4 above.

satisfy this requirement).⁵¹ Any lack of transparency would doubtless affect the efficacy of the incentive.

- The incentive should be of a limited duration (all countries surveyed except China) and expire after a period when there is no doubt that the beneficiary is both legally and substantively a tax ‘resident’ of the host country. A time limitation also reduces the cost of the incentive and allays equity concerns.
- Although a case can be made for minimum income threshold before the incentive applies (as is the case in Denmark),⁵² selectivity should not depend upon levels of income and marginal tax rates but rather upon the types of skills sought.
- It does not seem necessary to restrict the incentive to non-citizens (as is the case in Australia), provided the intended beneficiary has not been a tax resident for a minimum number of (say) five years. This would particularly be the case where a country wished to retain skilled workers and wanted to avoid providing a ‘free’ incentive for those citizens who would return in the normal course, after a short-term stay abroad (as is the case in Denmark, New Zealand and Singapore).
- Finally, the incentive should be periodically reviewed to see whether its continued existence is justifiable (changes to the relevant incentive have, since their inception, been made in Australia, Denmark and Australia, as well as Israel). By way of contrast, China’s tax incentives in this area are long outdated since many expatriates now coming and staying are not necessarily those that the Chinese government initially wanted to attract (foreign experts and highly skilled workers). Those benefitting from the incentive now include many short-term residents staying in China for non-skilled work.⁵³

5. CONCLUSIONS

This article has analysed the tax incentive regimes adopted by various countries to attract migration of skilled labour. In each case the incentive chosen sought to address perceived tax barriers to such migration or cure market failure indicated by skilled labour shortages in specific industries (Part I). However, applying a classic tax incentive analysis to the regimes enacted in those countries, the question whether this response is the most appropriate appears highly contentious. Specifically, we have seen that limited data is available to show whether the incentives adopted are effective

⁵¹It is apparent that, at least at face value, the terms of many of the incentives surveyed in Table 1 are sufficiently clear and detailed and do not rely upon the exercise of discretion before they can be availed of. Generally speaking, those incentives appear to be appropriately selective to match the policy goals set for them in Table 2. All these matters produce a healthy result from a tax policy perspective, since certainty, transparency and accountability in administering tax incentives is necessary to maintain the integrity of the taxation system. This is important, since it does not appear to be in anyone’s interest to instigate another round of tax competition or, to use Alex Easson’s analogy, escalate a “race to the bottom”.

⁵²Compare Jogarajan, n 44 above, p 22.

⁵³See n 20 and related text. It is understood that suggestions have been made to remove this ‘tax incentive’ from China’s Individual Income Tax Law and to treat expatriates on the same basis as Chinese nationals, but China’s State Administration of Taxation has not decided whether to propose this to the Standing Committee of the National People’s Congress.

(Part II) and, in terms of cost, efficient; and they are clearly inequitable since they are not available to domestic workers who possess the same skills as those who do benefit. It is clear that the difficulties in applying such an analysis abound and cannot be lightly dismissed (Part III).

Nonetheless, tax incentives directed at promoting the migration of skilled labour show no signs of abating and, as unfortunate as some may consider this to be, this trend may be pragmatically justified by an increasingly competitive global market for skilled workers and the appreciation that there is much still to learn about the impact of taxation upon the elasticities of labour migration (Part II). Notwithstanding the criticisms directed at tax incentives in this area, it would be foolish to think they will disappear.

In the event, our focus turned to design issues (Part IV) so as to best ensure that the incentive adopted by a particular country is the most effective, efficient and equitable tax response to combat the skills shortages identified. All the countries surveyed remind us that design must be dictated by the goals sought to be achieved; that the political and social circumstances of a country may trump all other factors (Israel); that economic factors, including skills shortages resulting from market failure and the barriers that a domestic tax system poses to the migration of skilled labour, informs not only the existence of the incentive but also the form it takes (contrast the experience of Denmark with that of Australia, New Zealand and Singapore); and that each incentive should be reviewed periodically to revalidate its continued operation (which has not been the case in China).

Rather than evaluate tax concessions to attract the migration of skilled labour by reference to the benchmarks classically applied to tax incentives, Part III also shows that a more satisfying justification for their existence is to consider such provisions as reflecting the need to cure the failure whereby many countries adopt an over-embracing concept as to when an individual becomes a tax resident. Such an approach best validates the stance taken by all the countries surveyed (except Denmark) whereby foreign source non-employment income and gains of the skilled worker is generally exempted for a limited period of time, upon the expiry of which the relevant person under virtually every tax system would become a resident of the country providing the 'incentive'.

As we have seen, special measures designed to encourage migration of skilled labour are contained in tax expenditure budgets of various countries (including Australia and New Zealand)⁵⁴. They are usually called "concessions". But perhaps they are not concessions at all. Rather, they are the norm and the real problem is not one of concessionary treatment but of over-taxation in countries that have not enacted such rules. In other words, they are only concessions because they deviate from the rules applied to 'normal' residents and, as explained in Part III (d), skilled workers to whom they apply may become tax residents in a host country virtually immediately upon arrival. The definition of a tax "resident" was developed a century ago before the days of labour mobility. It is thus arguable that the baseline rule for tax residence is the problem and that special rules for temporary residents might be the correct rule, not a concessional rule, for temporary residents. If we assume that the logic of taxing on a residence basis remains compelling, we should then ask whether the definition of

⁵⁴ See n 48 above.

resident developed in a very different era makes sense today or whether it is more logical to refine the definition for today's world.

Finally, the theme of this article illustrates the broader problem that global taxation of personal services income is far from perfect. In addition to widely held concerns regarding the threshold and criteria for tax residence of an individual, the difficulty in distinguishing between dependent and independent services and why these are taxed differently, and why under double tax treaty agreements (DTAs) employees are treated differently from directors and sportsmen and artistes are treated differently still, clearly show the necessity for reform both domestically and under DTAs. Given that service provision is increasingly important in our world economy, it seems a shame to end with the observation that in many ways taxation of personal services income is confusing – but it is a mess⁵⁵ and, notwithstanding the difficulty, it is important to clean it up.

⁵⁵The author gratefully acknowledges the analogy provided by Brian Arnold, 'The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess' (2011) *Bulletin for International Taxation* 59.

Looking at Pakistani Presumptive Income Tax through principles of a good tax?

Najeeb Memon*

Abstract

This paper concerns the use of an appropriate Presumptive Income Tax (PIT) regime for informal economies. Regular income tax due to high bookkeeping costs stimulates activities in the informal economy. Consequently, many developing countries rely on PIT regimes. However, the adequacy of the current PIT regimes to tackle informal economies has received little attention from researchers particularly in terms of the principles of a good tax system. This paper analyses the PIT regime of Pakistan, one of the largest informal economies in Asia, for its adequacy in this regard. The findings reveal that being a turnover based PIT design, Pakistani PIT is technically complex and impose high compliance costs on small business. The Pakistani PIT also does not adhere well with the efficiency and equity principles because it does not secure neutral tax treatment for all types of business sectors. The findings of inadequacy of the Pakistani PIT are also reflected in the stagnant tax base, lower tax to GDP ratio and the persistently large informal economy in Pakistan.

1. INTRODUCTION

The large informal economy is major obstacle in the implementation of income tax in developing countries.¹ Therefore, income tax is incapable of securing its objectives including revenue collection.² Since the informal sector mainly arises from the high compliance costs of normal income tax³ (that is, a tax charged on taxable income which is worked out after deduction of allowances and perquisites etc) and weak tax administration,⁴ consequently, many developing countries, some on the recommendations of the donor agencies⁵ have switched over to a presumptive form of

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¹ James Alm, Jorge Martinez-Vazquez and Friedrich Schneider, 'Sizing the Problem of Hard to Tax' (2003) Andrew Young School of Policy Studies, Georgia State University, May 2003, 19 <<http://aysps.gsu.edu/publications/2003/hardtotox.pdf>> at 15 May 2008.

² Friedrich Schneider and Bettina Hametner, 'The Shadow Economy in Columbia: Size and Effects on Economic Growth' Working Paper No. 0703 Department of Economics, Johannes Kepler University of Linz, Austria, January 2007, 5.

³ See Schneider and Hametner, above n 2, 4.

⁴ Alm et al above n 1, 19; Robin Burgess and Stern Nicholas, 'Taxation and Development' (1993) 31 *Journal of Economic Literature*, 776.

⁵ Engelschalk Michael, 'Small Business Taxation in Transition Countries' World Bank, Washington DC, at 2.

income tax. Presumptive Income Tax (PIT) regimes are now integral components of tax systems of many Eastern European, Asian, African and Latin American countries.⁶

This tax policy shift is due to PIT's merits of simplicity⁷ and efficiency which helps tax compliance by taxpayers.⁸ For its simplicity a PIT is easy to enforce, hence, is also a solution to the weak tax administration of these countries.⁹ However, whether the PIT regimes used in the developing countries have all these virtues is yet an unexplored area. Despite widespread use of PITs in many developing countries such as indicator based PIT in transitional European countries and asset based PIT in Latin American countries to tackle the informal sector, little research has been undertaken to assess existing PIT regimes for tackling the informal economy.

This paper analyses the PIT regime of Pakistan, one of the large informal economies in Asia, for its adequacy to control an informal economy. After reviewing the causes of the informal economy in general and in the context of Pakistan, the design of Pakistani regime and its features are evaluated against the principles of a good tax system as ranked in context of informal economies.¹⁰ Taxation of income from assets (e.g. dividends, interest, and rental income) is beyond the scope of this paper, because, this paper mainly focuses on business and professional incomes, which constitutes the major share of informal activity.

The findings reveal that being a turnover based PIT design, the Pakistani PIT is technically complex and imposes high compliance costs on small business. The Pakistani PIT also does not adhere well with efficiency and equity principles because it does not secure neutral tax treatment for all types of the business sectors. The findings of inadequacy of the Pakistani PIT are also reflected in the stagnant taxpayer base, lower tax to GDP ratio and the persistently large informal economy in Pakistan.

The remaining paper has 7 sections. Section 2 provides an overview of the informal economy. Section 3 highlights the nature of the Pakistani informal sector. In Section 4, the methodology for the use of principles of a good tax system is set out. The provisions of the Pakistani PIT are summarized in Section 5. Section 6 assesses the adequacy of the Pakistani PIT to tackle the informal economy in light of the principles of a good tax system. Finally, Section 7 concludes the paper.

⁶ TJ Steenekamp, 'A Tax on Gross Fixed Assets as Minimum Corporate Tax for South Africa' (2000):68(3) South African Journal of Economics, 183.

⁷ Vito Tanzi and Milka Casanegra de Jantscher, 'Presumptive Income Taxation: Administrative, Efficiency & Equity Aspects' Working Paper No. 87/54, IMF, 17 August 1987, 8 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=884840> at 12 October 2008.

⁸ Efraim Sadka and Vito Tanzi, Tax on Gross Assets of Enterprises, as a Form of Presumptive Taxation Working Paper No. 92/16, IMF, February 1992, 6 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=884616> at 24 June 2009.

⁹ Sonia Gandhi, 'Presumptive Direct Taxes,' The World Bank 2002, 7 <www.worldbank.org/publicsector/pe/Tax/presumptivedirecttaxes.html> accessed on 13 September 2007.

¹⁰ Memon Najeeb, (2010) 'Prioritizing Principles of a Good Tax System for Small Businesses in Informal Economies' 25:1 Australian Tax Forum, Australian Institute of Taxation, 67.

2. INFORMAL ECONOMY

Despite considerable research on the informal economy, the subject is still controversial particularly regarding its definition and estimation procedures.¹¹ Generally, the informal economy is defined as “those economic activities and the income derived from them that circumvent or otherwise elude government regulation, taxation or observation”.¹² The informal economy is also used as a proxy for Hard-to-Tax Taxpayers (HTT).¹³

Small businesses form the core cluster of the informal economy.¹⁴ Small businesses usually are grouped with medium enterprises and both are referred in the literature as Small and Medium Enterprises (SME). The SME sector includes farmers, traders, small scale manufacturers and small scale businesses engaged in the service sector such as lawyers, doctors, repair workshops and restaurants.¹⁵ The statistics confirm that SMEs constitute 80-90% of the workforce and over 50% of the GDP in the informal economies.¹⁶

2.1 Causes and Size of Informal Economy

Informal economies are created and sustained by three most important factors in the developing countries. First is the high tax compliance cost. The high compliance costs for small business is due to complex laws and procedures such as keeping accounts for the determination of income.¹⁷ Second is weak and corrupt tax administration.¹⁸ Third is the high tax burden due to high tax rates.¹⁹ Memon has shown that these factors have led to the growth of the informal economy.²⁰

The extent of the size of the informal economy is generally estimated by comparing the total number of businesses with the registered ones in the country or by comparing the registered businesses with the total population. For example, in Rwanda out of

¹¹Schneider Friedrich and Klingmair Robert, ‘Shadow Economies around the World’, 2004 Working Paper No. 0403 Department of Economics, Johannes Kepler University of Linz, Austria, 3.

¹²Feige Edgar, ‘The Underground economies, Tax evasion and information distortion’, (1989) Cambridge University Press; this definition is also referred in Dell’Anno Roberto, ‘Estimating the Shadow Economy in Italy: A Structural Equation Approach’ (2003) Discussion Paper, Department of Economics and Statistics, University of Salerno.

¹³See Alm et al, above n 1, 4.

¹⁴Designing Tax System for Micro and Small Businesses: Guide for Practitioners (2007) International Finance Commission (IFC), World Bank, Washington DC, 3.

¹⁵Gunther Taube & Helway Tadesse, ‘Presumptive Taxation in Sub-Saharan Africa: Experience and Prospects’ (1996) Working Paper, International Monetary Fund, 3.

¹⁶Stern Richard and Loeprick Jan, ‘Small Business Taxation: Is this the Key to Formalization? Evidence from Africa and Possible Solutions’, (2007) FIAS Tax Team, World Bank Group, 3.

¹⁷Shabsigh Giath, ‘The Underground Economy: Estimation, and Economic and Policy Implications: The Case for Pakistan’ (1995) Working Paper International Monetary Fund; also see Sandford C T and Hasseldine J, ‘The Compliance Costs of Business Taxes in New Zealand’ (1992) Institute of Policy Studies Victoria University of Wellington, Wellington.

¹⁸See Alm et al, above n 1, 19.

¹⁹Cebula Richard J., ‘An Empirical Analysis of the Impact of Government Tax and Auditing Policies on the Size of the Underground Economy: The Case of United States, 1993-94’ (1997) 56:2 American Journal of Economics and Sociology, pp.173-185.

²⁰Memon Najeeb, ‘Is Income Tax Responsible for Large Informal Economies?’ (2010) 14:1 The Asia Pacific Journal of Taxation, pp. 107-126.

70,000 micro and small enterprises only 1000 are registered with the tax authority. In Philippines, registered VAT taxpayers constitute 0.32% of the total population.²¹

More accurately, using scientific techniques, such as the Electricity Demand Method the average size of the informal economy in Africa, Asia, South America, OECD and Eastern European countries is computed at 41%, 26%, 41%, 18% and 38% respectively.²² The size is further enlarged by the recent worldwide growth in the service industry.²³ The statistics of the size of informal economies show that a large part of the total economy goes un-taxed in the form of the informal sector.²⁴ More aptly, the statistics reflect the massive 'tax base gap'²⁵.

2.2 Implications of Informal Economies and a Remedy

An informal sector has many adverse implications. The informal economy is hard to tax. It also develops among the wider population, a perception of unfairness²⁶ which promotes non-compliance and thus jeopardizes revenue collection.²⁷ Poor revenue collection is reflected in a low direct tax to GDP ratio in developing countries as compared to developed countries. For instance, the ratio is 7% in the sub-Saharan region but 22% in industrial countries.²⁸ Beyond that, the advantage of not paying tax in the informal sector causes allocation of more resources to this less productive sector²⁹ which ultimately could cause an economic recession.³⁰

PIT regimes are recommended for their simplicity to facilitate taxpayers' compliance and enforcement by tax administration because it is 'just not possible' to tax the actual small businesses in informal economies³¹ as the determination of actual income involves high costs such as that of bookkeeping. More aptly, the main rationale behind the use of the PIT is to promote compliance of small taxpayers by simplifying income tax procedures³² and consequently reducing compliance costs. The PIT is also easier to implement by weak tax administrations which are unable to determine the actual income of the large number of small businesses in developing countries.³³

²¹ See IFC, above n 14, 5.

²² Schneider Friedrich, 'The Increase of Size of the Shadow Economy of 18 OECD Countries: Some Preliminary Explanations' (2000) Paper presented at the Annual Public Choice Meeting, March 10-12, 2000, Charleston, S.C.

²³ See Alm et al, above n 1, 1.

²⁴ See Taube and Tedesse, above n 15, 3.

²⁵ See Stern and Loeprick, above n 16, 3.

²⁶ Gloppen Siri and Rakner Lise, 'Accountability Through Tax Reform', 2002 Institute of Development Studies (IDS) Bulletin Vol.33, 2002.

²⁷ See Alm et al, above n 1, 20.

²⁸ Auriol Emmanuelle and Warlters Michael, 'Taxation Base in Developing Countries' (2005) 89 Journal of Public Economics 626.

²⁹ See Alm et al, above n 1, 27.

³⁰ See Alm et al, above n 1, 38.

³¹ See Tanzi and Casanegra, above n 7, 15; also see Makedonskiy S.N, 'Taxation Mechanisms Based on Simplified and Indirect Evaluation of Tax Liabilities' (2005) Russian-European Centre for Economic Policy (RECEP), 4. Memon also reaches the same conclusion after analyzing the causes of informal economies (see Memon, above n 18).

³² Parthasarathi Shome, 'Tax Administration and Small Taxpayer', Policy Discussion Paper No. PDP/04/02, International Monetary Fund, May 2004, 7 <<http://www.imf.org/external/pubs/ft/pdp/2004/pdp02.pdf>> at 12 December 2007.

³³ Memon Najeeb 'Analysis of Presumptive Income Tax for Small Business in Large Informal Economies: A case of Pakistan' (2010) PhD Thesis, The University of New South Wales, Australia.

However, despite the above theoretical merits of PIT, there is no conclusive evidence that a PIT can largely tackle informal sectors in developing countries. In Ukraine for example, contradictory findings are recorded for changes in the informal economy in the period after the imposition of a PIT.³⁴ In Eastern European countries, the lack of stability, transparency and focus and unjustified generosity of the PIT regimes is blamed for their failure.³⁵

3. INFORMAL ECONOMY IN PAKISTAN AND THE USE OF PIT

Pakistan is one of the emerging economies of the world. In recent years, the major contribution to its economy has come from the services sector.³⁶ However, most businesses in the service sector are small in size and these operate in the informal sector. This is reflected in the large share of the informal economy in the country's GDP. The size of the informal sector in Pakistan is estimated at 39.5%.³⁷

The services sector or more simply, the informal sector in Pakistan, is dominated by small business. More specifically the service sector contributes 53.3 % to GDP through 2.65 million enterprises³⁸ which are SMEs.³⁹ According to the Economic Census of Establishment Pakistan, these entities constitute 80% of the total enterprises in Pakistan (i.e. 3.2 million).⁴⁰ The capital investment on average in the SME sector is less than 1 million rupees (A\$15,385).⁴¹ For this reason it is stated that Pakistan's economy is an economy of SMEs.⁴²

The specific reasons why small business in Pakistan operates in the informal sector are the same as in other parts of world as discussed in the preceding section of this paper. Broadly, taxation is identified as the main constraint in the SME growth.⁴³ Sixty seven percent of the enterprises surveyed have stated that the tax regulations as most problematic.⁴⁴ Pakistan ranks at 140th on the ease of paying taxes.⁴⁵

³⁴Thieben Ulrich, 'The Impact of Fiscal Policy and Deregulation on Shadow Economies in Transition Countries: The Case of Ukraine' (2001) 114: Public Choice, 308.

³⁵See Engelschalk, above n 5, 1-7.

³⁶'Trade in Services: An Answer Book for Small and Medium Sized Exporters' ITC/P216.E/TSS/BAS/07-VIII Trade Secrets Series, International Trade Centre UNCTAD/WTO/Small & Medium Enterprise Development Authority (SMEDA) Pakistan, 2007, 143 <<http://www.smeda.org/downloads/TradeinServices-Pakistan.pdf>> at 8 July 2009.

³⁷Friedrich Schneider, Shadow Economies and Corruption All over the World: New Estimates for 145 Countries (2007), Economics 2007-9, 17 (The Open Access, Open Assessment E-Journal) <[www.economics-ejournal.org/economics/journal articles](http://www.economics-ejournal.org/economics/journal%20articles)> at 16 November, 2008.

³⁸Pakistan, 'Economic Survey of Pakistan 2006-07' Government of Pakistan, 60 <<http://www.accountancy.com.pk/docs/economic-survey-of-pakistan-2006-07.pdf>> at 12 March 2008.

³⁹Economic Census of Establishment of Pakistan (2005) Federal Bureau of Statistics of Pakistan.

⁴⁰Economic Survey, above n 38.

⁴¹Shahab Khawaja 'Unleashing the Potential of SME Sector with a Focus on Productivity Improvements' presented at Pakistan development Forum – 2006, 2 <www.smeda.org> at 7 April 2009.

⁴²'Developing SME Policy in Pakistan' SME Issues Paper –For Deliberation by SME Task Force' Policy Planning and Development Department, SMEDA, 2006, 1 <www.smeda.gov.pk> at 4 April 2009.

⁴³Khawaja, above n 41, 5.

⁴⁴SME Task Force Report, above n 42, 7.

⁴⁵Usman Khan, 'Assessment of the Provincial Legal and Policy Framework Related to Private Sector Development' Final Report of the Economic Advisor, Commerce and Investment Department, Government of Punjab, 2007, 6.

Tax related costs are relatively more serious for small business because of its regressive effects.⁴⁶ More aptly, compliance costs are similar for taxpayers who have a turnover of 1 or PKR50 million (A\$65,000) in a year. In most cases for income tax, small business has to keep books whose cost is higher than their tax liability. For example, the cost of maintaining accounts is approximately PKR 27,000 (A\$350) in Pakistan⁴⁷ where the average income of small business is PKR 100,000 (A\$1,400). Fundamentally, the maintenance of books of account and hiring a professional for tax compliance purposes is not possible for small businesses due to cost constraints.⁴⁸ Further, sole proprietors of small businesses are also often deficient in accounting skills⁴⁹ which makes tax compliance hard for them.

The assessment of income includes discretion for the tax administration and which may ultimately provide an opportunity to harass taxpayers. Besides that, the task of the determination of income for a large number of small businesses is beyond the capacity of the tax administration in Pakistan.

Like any other informal economy and for reasons mentioned above, small business prefer to operate in the informal sector, therefore, growth in the tax base, which is the manifestation of taxpayers' compliance, is stagnant.⁵⁰ The poor income tax to GDP ratio (that is percentage of GDP collected as income tax) in Pakistan which hover around 3.5% of GDP as compared to the average ratio 7% or 22% in developing and developed countries respectively as discussed in section 2.2 of this paper, clearly indicates that a large component of national income escapes taxation. Consequently, the lack of revenue hampers development projects which when coupled with the misallocation of resources to the informal economy, causes Pakistan to persistently remain a developing rather than becoming a developed state.

In the recent past, the Government of Pakistan has identified the SME and services sector as top priority.⁵¹ Small Medium Enterprise Development Authority (SMEDA) in Pakistan, therefore, suggests fiscal facilitation (ie. assisting the taxpayers through easy procedures and education) and 'simplification in the regulatory environment'.⁵² The Asian Development Bank (ADB), in its report, suggested the adoption of a Self Assessment Scheme (SAS) would reduce the interface required between the tax officials and the payers.⁵³ It was even suggested to use a 'fixed tax' based on assets in

⁴⁶ See Chris Evans, Katherine Ritchie, Binh Tran-Nam and Michael Walpole, 'Taxation Compliance Costs: Some Recent Empirical Work and International Comparisons' (1998) 14:2 Australian Tax Forum, 93-122.

⁴⁷ For part time salaries of accounting graduates see [http://www.bayrozgar.com/Accounts-Tax-CS-Audit/Accountant-\(Part-Time\)-13534.html](http://www.bayrozgar.com/Accounts-Tax-CS-Audit/Accountant-(Part-Time)-13534.html) at January 25, 2011. The cost of bookkeeping through online services is also available on various websites.

⁴⁸ Khawaja, above n 41, 9; SME Task Force Report, above n 42, 7.

⁴⁹ Khawaja, above n 41, 12.

⁵⁰ SME Task Force Report, above n 42, 6.

⁵¹ 'SME Led Economic Growth – Creating Jobs and Reducing Poverty: SME Policy 2007' SMEDA, Ministry of Industries, Productions and Special Initiatives, Government of Pakistan, 2007, 8 <http://www.smeda.org/downloads/SME_Policy_2007.pdf> at 10 October 2009.

⁵² SME Policy, above n 42, 15.

⁵³ Faisal Bari, Ali Cheema and Ehasan ul Haq, 'Barriers to SME Growth: An Analysis of Constraints' Working Paper No.3 Asian Development Bank, October 2005, 65 <http://www.adb.org/Documents/PRM/Working_Papers/wp-03.pdf> at 12 March 2009).

order to help small businesses in the retail, restaurant and hotel sector.⁵⁴ In light of these recommendations, a PIT regime was introduced in Pakistan.

4. PRINCIPLES OF A GOOD TAX SYSTEM

Earlier literature on the principles of a good tax system in general and in the context of informal economies in particular suggests focusing upon simplicity, equity and efficiency⁵⁵ when evaluating a tax system.⁵⁶ Further, Memon suggests that the requirements of developed and developing countries differ hence ranking of these principles to cater for requirements of large informal economies should be taken in account while assessing a tax system.⁵⁷ More simply, Memon suggests that simplicity should be preferred over efficiency and the later over equity in developing countries due to the specific characteristics of these countries.

4.1 How to Determine Simplicity in a Tax System

As discussed in section 2.2, simplicity in the tax system plays a crucial role in improving small businesses' compliance and consequently in controlling the informal sector. Although simplicity has many facets like certainty, consistency and clarity⁵⁸ for assessing any tax regime, simplicity could be examined from two perspectives.⁵⁹ First is the technical complexity, which reflects clarity, certainty, consistency, stability and flexibility in the language and content of a tax code. Second is the operational complexity, which covers both the administrative and compliance costs. More aptly, technical complexity reflects the causes of the increased cumbersomeness in the tax code. The operational complexity, on the other hand, is the manifestation of technical complexity plus 'the burden of documentary requirements'⁶⁰ in form of financial costs to prepare those documents. This break up of tax complexity clarifies, 'the intricate connection between complexity and compliance and administrative costs'⁶¹. The above interpretation also explains how a simple rule (from a technical perspective) can be expensive to comply with, if it imposes a huge burden of documentary evidence.⁶²

As measuring simplicity quantitatively is a very hard task, a qualitative analysis of the Pakistani PIT is made in this paper. Consequently, in its first stage, Pakistani PIT is analysed qualitatively for all the facets of technical complexity. However, the analysis of the facets of technical complexity is made from the legal perspective (similar to the

⁵⁴ Khawaja, above n 41, 9.

⁵⁵ Alley C. and Bentley D., 'A Remodelling of Adam Smith's Tax Design Principles', (2005) Law Papers, Faculty of law Bond University, 580.

⁵⁶ Memon, above n 10, 67.

⁵⁷ See Memon, above n 10.

⁵⁸ Graeme S. Cooper, 'Themes and Issues in Tax Simplification' (1993) 10, Australian Tax Forum, 424.

⁵⁹ 'A Tax System Re-designed: More Certain, Equitable and Durable' Review of Business Taxation Report by John Ralph, Rick Allert and Bob Joss, July 1999, 106 <<http://www.rbt.treasury.gov.au/publications/paper4/index.htm>> at 12 May 2009.

⁶⁰ It is referred by Cooper as the number of tasks demanded from the taxpayer to perform (see Cooper, above n 58, 447).

⁶¹ This connection is identified as a complex link in Simon James 'Tax Simplification is a not a Simple Issue: The Reasons for Difficulty and Possible Strategy' (2007) Discussion Paper No. 07/18 ISSN 1472-2939 School of Business & Economics, University of Exeter, 2007, 7.

⁶² Margaret McKerchar, Kristen Meyer and Stewart Karlinsky, 'Making Progress in Tax Simplification: A comparison of the United States, Australia, New Zealand and the United Kingdom' Working Paper No. 49, Research Series, Faculty of Law, University of New South Wales, 2008, 370.

methodology used by Taylor)⁶³, rather than from the linguistic perspective. In the referred study Taylor had evaluated a possible impact of reducing complexity in the tax code on minimizing the tax compliance costs. Taylor examined the legal complexity of Australian income tax law in terms of redundancy, superfluosity, grouping according to rational scheme, frequency of changes and ambiguity in interpretation of provisions of the law. In the next stage, the Pakistani PIT is qualitatively analysed for operational complexity with reference to the administrative and compliance costs. This qualitative analysis is based on the size of the tax return, the computation details, bookkeeping requirements, documentary requirements, audits and costs related to appellate procedures.

4.2 How to Determine Efficiency in a Tax System

The efficiency of a tax system is mainly assessed from its substitution effect (known as dead weight loss) and its neutrality in tax impact. Despite the clarity of the concept of deadweight loss⁶⁴, it is widely acknowledged that it is hard to measure quantitatively the impact of any taxation in terms of the deadweight loss or even in terms of 'the quantum of the substitution effect'.⁶⁵ The Meade report mentions this limitation in the following terms:

*'It is not possible to take into account all the indirect effects of given tax arrangements on economic efficiency'*⁶⁶

A qualitative evaluation is also difficult in terms of the substitution and deadweight loss, because, the behaviour of all the actors of economy is quite un-predictable. On the other hand, it is equally hard to make quantitative estimates of the level of the neutrality in a tax system particularly in view of its many facets such as neutrality in tax treatment of various sectors, of various classes of income and of risk exposures.

In view of the above limitations for assessing efficiency, it is suggested that a qualitative analysis be made on the basis of the extent a tax measure is 'neutral' in its treatment of income.⁶⁷ Nevertheless, while applying this approach, all the facets of economic neutrality need to be judged. This approach would be consistent with the Strong Foundation document, which states:

*'...tax design in a complex environment is as much art as it is science: judgement is often as important as fact and analysis.'*⁶⁸

In addition to the neutrality of a tax regime, efficiency can also be assessed from the burden of taxation⁶⁹ (that is, the tax liability) which varies depending upon the

⁶³ Christopher John Taylor, 'Beyond 4100: A Report on Measures to Combat Rising Compliance Costs Through Reducing Tax Law Complexity' (Report, Taxation Institute of Australia, 2006).

⁶⁴ Keith Bain 'The Principles of Taxation- Part I' Notes on Public Finance, University of East London, Department of Economics, 2000, 4 at <<http://homepages.uel.ac.uk/K.Bain/tax1.pdf>> at 6 January 2009.

⁶⁵ Bain, above n 64, 2.

⁶⁶ The Structure and Reform of Direct Taxation, Report of a Committee chaired by J.E. Meade, The Institute of Fiscal Studies, 1978 (London: George Allen & Unwin), 11.

⁶⁷ Haig, Robert Murray., 'The Concept of Income – Economic and Legal Aspects' in Musgrave R.A. and Shoup C.S. (ed.) Readings in the Economics of Taxation (1959), 54-76; Haig's chapter was originally published in 1921.

⁶⁸ Ralph J, Allert R and Joss B., 'A Strong Foundation: Establishing Objectives, Principles and Processes' Discussion Paper I, Review of Business Taxation, Commonwealth of Australia, November 1998, 67 <www.rbt.treasury.gov.au> at 14 April 2009.

applicable tax rates.⁷⁰ This approach is identical to that adopted by Memon for analysis of various PIT designs.⁷¹

4.3 How to Determine Equity in Tax System

The term equity is used for even-handed treatment of taxpayers in tax system. Equity has conventionally been understood to have two facets. The first facet is known as horizontal equity, which states that taxpayers under identical economic circumstances should be taxed identically.⁷² The second facet is called vertical equity, which postulates that those taxpayers, who have better economic circumstances (i.e. higher ability to pay), should contribute more than others to the treasury.⁷³

Horizontal equity is essential for perceptions of fairness and encouraging compliance by small business.⁷⁴ On the other hand, vertical equity is essential for distribution of wealth.⁷⁵ However, achieving vertical equity is difficult, therefore, it may be given less preference in informal economies compared to horizontal equity.⁷⁶

For taking decisions regarding the horizontal equity in a tax system, it should be conceded at the beginning that 'measuring equity is not easy'.⁷⁷ A qualitative evaluation is not possible due to the multiplicity of the variables involved and innumerable categories and levels of income in an economy. Since neutrality of a tax measure is a bedrock for both efficiency and equity principles⁷⁸, the analysis regarding the efficiency principle will be relevant to horizontal equity. In addition, some aspects of neutrality having a direct impact on horizontal equity can be examined such as treating equals equally. Vertical Equity, on the other hand, can be assessed by the extent of progressivity in a tax system.

5. OVERVIEW OF PAKISTANI PIT REGIME

In this section, all the relevant provisions of the Income Tax Ordinance of Pakistan 2001 (hereinafter called ITO 2001) of Pakistan are described.

5.1 Pakistani PIT for Informal Sector

The ITO 2001 contains a number of PIT provisions, which tax the professional and business income of both small entrepreneur and large corporate entrepreneurs. More

⁶⁹ Michael Dirkis, 'Is it Australia's? Residency and Source Analysed', Research Study No 44, Australian Tax Research Foundation (2005) 50.

⁷⁰ Report of the Royal Commission on Taxation, chaired by Kenneth LeM. Carter (1966) Vol.2, 118.

⁷¹ Memon, above n 33, 143.

⁷² Ralph, above n 68, 63; also see 'Reform of Australian Tax System' Draft White Paper Australian Government Publishing Service Canberra, 1985, 14.

⁷³ Ralph, above n 68, 63; Draft White Paper above n 72, 14.

⁷⁴ Draft White Paper, above n 72, 14.

⁷⁵ Memon above n 11, 89; also see Felice Russo, 'Vertical Equity and Welfare: Which Effective Redistribution? An Application of Italian Data' (2004) Societa Italiana di Economia Pubblica, Universita Di Pavia.

⁷⁶ Memon, above n 10, 92.

⁷⁷ Taxation Review Committee, chaired by K.W. Asprey, Full Report (1975), 13; Meade Report, above n 67, 13 states that 'Unfortunately, in considering the tax side of the budget equation neither 'horizontal equity' nor 'vertical redistribution' are in fact straightforward simple objectives, and in judging any particular tax structure, it is necessary to consider in more detail, how these ideas should be interpreted'.

⁷⁸ Ralph, above n 68, 75.

generally both corporate and non-corporate businesses are eligible for the Pakistani PIT. Small business is mostly required to comply with more than one of these provisions depending upon the nature and scope of their activities. A summary of these provisions is given below.

5.1.1 Withholding based PIT for Local Business Activity (Sections 153, 156A, 234, 234A and 205 read with Section 169)

The receipts of small business from the supply of goods⁷⁹, execution of contracts⁸⁰, provision of services⁸¹, sale of compressed natural gas (CNG) and petroleum products and brokerage and commission are liable to withholding tax (WHT) under s 153, 234A, 156A and s 205 respectively. The tax so deducted is the final discharge of a tax liability under legal PIT (ie. a PIT regime created through legislative action where proxy of income is used for charging income tax and there is no discretion with the tax administration) enacted through the deeming provisions (those are provisions which treat something such as turnover as income by legal fiction) which are contained in the section 169(1). The WHT rate on petroleum products, CNG and brokerage is 10%, 4% and 10% under Div. VIA, VIB to Part III and Div. II to Part IV to Schedule I respectively. For activities covered under section 153, WHT rates under the Div. III Part III to Schedule I are as follows:

- For sale of rice, cotton seed or edible oils, 1.5% of the receipts
- For sale of any other goods, 3.5% of the receipts
- For transport services, 2% of the receipts
- For any other services, 6% of the receipts
- For contracts, 6% of the receipts.

Any taxpayer with these activities is only required to file a single page statement along with the ‘certificate of WHT deduction’ or ‘tax payment receipt’ under ss 115(4). This regime does not envisage the maintenance of accounts or the requirement for an audit. However, it is noted that linking PIT with WHT has complicated the compliance requirements for taxpayers for the following reasons. First, since corporations, registered firms and Associations of Persons (AOPs) are the statutory WHT agents, only those transactions of small business are subject to withholding tax which are executed by them with the WHT agents. Thus, small business usually transact with each other (i.e. as part of the informal sector) to avoid withholding tax and consequently being taxed under the PIT regime. More aptly, the PIT regime could be effective only in catching a non compliant business, when they are transacting with the WHT agents and those who do not transact with WHT agents generally escape taxation.

When small business do not transact with the WHT agents (who predominantly operate in the formal sector), then they are not subject to the WHT and consequently

⁷⁹ Section 153 (9) provides that in this section “sale of goods” includes a sale of goods for cash or on credit, whether under written contract or not.

⁸⁰ However, it is not explained in the tax code that how a contract of services and supplies could be distinguished from “execution of contracts” as services and supplies could also be made through a contract and have different applicable tax rates. Thus, the term “execution of contract” has led to ambiguities giving rise to a constant source of litigation.

⁸¹ Section 153 (9) provides that in this section, – “services” includes the services of accountants, architects, dentists, doctors, engineers, interior decorators and lawyers, otherwise than as an employee.

fall within the ambit of the normal income tax. Under the regular regime, small business is required to file their tax return under s 114 and is assessed pursuant to the Universal Self Assessment Scheme (USAS) under s 121. A return filed under s 114 must be audited and small businesses have to prove the veracity of the declared version by keeping accounts. Consequently the taxpayer is exposed to all the complexities of ITO 2001 and the compliance costs increase enormously. Such high compliance costs discourage voluntary compliance.

Second, when only some of the taxpayer's transactions are subject to WHT and fall within the PIT, then his/her remaining transactions are taxable under the normal income tax regime. In this scenario the operating expenses would be apportioned to each of the parts for the determination of the profits to be taxed. The allocation method is prescribed in s 67 read with Rule 15 of Income Tax Rules 2002.

The method of allocation of the costs requires accounting information to be provided. Consequently, a taxpayer has to keep accounts for both of the activities. Moreover a taxpayer with "hybrid" activities has to file both the tax return and statement and is also potentially liable to a tax audit.

5.1.2 Withholding Based PIT for International Business Activity (Sections 148 and 154 read with Section 169)

When a person makes commercial imports and exports, its receipts are going to be subjected to the WHT under s 148 and 154 respectively. The Customs Department and banks are the WHT agents for this most documented sector. The tax so deducted is the final discharge of tax liability under the legal presumption, which is enacted through the deeming provision contained in ss 148(7), 154(4) and 169(1). The WHT rates for exports and imports are 1% and 2% under Div. IV of Part III and Part II to the Schedule I respectively.

For income deemed from any of these activities, a taxpayer is only required to file a single page statement along with the 'certificate of WHT deduction' or 'tax payment receipt' under ss 115(4). This regime does not envisage the maintenance of accounts and requirement for an audit.

It is noted that when only part of a transaction falls under any of the preceding WHT based PIT provisions then the taxpayer suffers from hybrid tax treatment. This means for the remaining transaction he/she has to file the regular return and operating expenses have to be apportioned between two streams of income. Consequently the compliance costs increase enormously for the same reasons as mentioned for the hybrid activities in the preceding section.

5.1.3 Tax on retailers (Section 113B)

Retailers, which are organized as sole proprietor or AOP, can use the option of paying tax at 0.75% of the turnover (as prescribed in Div. IA of Part I to Schedule I of the Ordinance) under s 113A. Similar retailers having turnover of more than 5.0 million rupees are liable to tax at 1% of the turnover under the s 113B. Both payments are the final discharge of their tax liability. The retailers are required only to file a single page statement under ss 115(4).

5.1.4 Widespread WHT Regime

Besides the above withholding taxes, which fall within ambit of the PIT regime, small business is also liable to WHT in respect of the following activities under various sections of the Income Tax Ordinance, 2001:

- 231A Cash Withdrawal from
- 236 Telephone Use
- 235 Electricity Use
- 234 Registration of Motor Vehicles
- 231B Purchase of Motor Vehicles

6. ANALYSIS OF THE PAKISTANI PIT

The Pakistani PIT is analysed against the principles of simplicity, equity and efficiency as follows. Despite describing the Pakistani PIT in section 5, for better comprehension, a reader is advised to have the ITO 2001⁸² available alongside due to numerous referencing to bare legislation in this analysis. Nevertheless, most important PIT provisions are annexed to this paper for quick reference. At the end of this section, the results of the analysis are compared to the well known performance benchmarks of a tax system such as taxpayer base and revenue collection.

6.1 The Pakistani PIT and Simplicity

In the first stage, consistent with section 4, simplicity in the Pakistani PIT is analysed qualitatively for the facets of clarity, certainty, consistency, stability and flexibility. This legal analysis, which pertains to the technical complexity of the regime, is conducted in the pattern adopted by Taylor.⁸³ In the next stage, the operational complexity of the Pakistani regime is analysed qualitatively for compliance costs such as bookkeeping, documentary requirements and details of computation. At this stage, the enforcement costs are also analysed qualitatively.

6.1.1 Technical Complexity

The clarity, certainty, consistency, stability and flexibility of the Pakistani PIT is assessed in this part of the paper through the total number of provisions, the number of redundant provisions, superfluous words and sentences and frequency of changes in the regime.⁸⁴

6.1.1.1 Number of Provisions

Consistent with section 5, the Pakistani PIT system has a very large number of substantive provisions. Although the Pakistani PIT system contains three regimes, it is primarily based on the direct and reverse WHT. There is a wide range of economic activities, which are subjected to withholding tax and for each of them, the ITO 2001 contains a separate fully fledged regime within the Ordinance. However, in total, there

⁸²The link to the Income Tax Ordinance 2001 of Pakistan is
<<http://www.fbr.gov.pk/newdt/ITOrdinance/ITOrdinance2009/ITaxOrdinance2001ut28-10-2009.pdf>>.

⁸³Taylor, above n 63.

⁸⁴This analysis is based on the approach adopted by Taylor, above n 63.

are ten different activities which are subjected to WHT based final tax regimes. All the remaining withheld taxes are allowed as a credit against a taxpayer's assessed income tax liability.

A small business is influenced by most WHT provisions, because it usually has parts of different activities which are subject to WHT. Sometimes the same activity is subjected to tax twice. For example, when imported goods are supplied by the business, then they are subjected to WHT both at the import and supply stage. Consequently, the law contains provisions for exemption from application of the WHT at one of the stages. For example, s 153(5)(a) deals with exemption from WHT when tax is already deducted at the time of import under s 148. The ITO 2001 includes a series of provisions to prevent taxpayers from being subject to double withholding.

Additionally, in the ITO 2001, there are number provisions which contain exemptions and reductions in rates or liabilities in respect of the PIT regime. These are inserted to offer fiscal concessions to some industrial sectors, perhaps for promoting economic growth. There are 30 such provisions in the Second Schedule to the ITO 2001.

Further, there are some supporting provisions which are explanatory in nature and these also add to the volume of PIT legislation. These include explanations and definitions for the terms used in different PIT regimes such as definitions for terms of 'services' and 'supplies' used in PIT under s 153. Also, for retailers and rent earners, there are separate PIT regimes in the tax code, which also have explanatory provisions.

In all, the Pakistani PIT system has three types of PIT regimes, which operate through numerous provisions of the ITO 2001. In addition, the Pakistani PIT in terms of the number of provisions (which are not logically grouped – see 6.1.1.3), is technically complex and consequently this may make compliance difficult.

6.1.1.2 Rules Rendered Unnecessary Due to Subsequent Developments

The author could only locate one provision in the Pakistani PIT which has become completely redundant due to subsequent amendments in the regime. After the repeal of subsection 6B of s 153 (which had brought supplies by association of persons and individuals under the final tax regime), there is no need to retain the exemption from application of this provision by clause 46B of Part IV of the Second Schedule. Its presence only adds to the technical complexity. In view of this single redundancy, it can be concluded that the Pakistani PIT does well in this regard.

*6.1.1.3 Grouping According to a Rational Scheme*⁸⁵

It is recognised that the basic choices in tax design involve grouping according to a rational scheme. An appropriate grouping of the provisions, for instance in accordance with the nature of the income and type of statutory obligation, helps lead to quick compliance. It also reduces the uncertainty and the time consumed in cross referencing the legislation.

⁸⁵Vann called it grouping by mechanical function: see Richard J. Vann, 'Improving Tax Law Improvement: An International Perspective' (1995) 12 Australian Tax Forum 193, 193.

This feature is completely ignored in the Pakistani PIT regime. For example, the final tax treatment of dividends is grouped with Chapter II, which is primarily concerned with the charge of tax. This is done despite the fact that its withholding section is rightly grouped in Division III to Part V of Chapter X (this chapter is titled as “Procedure”). Similarly, the treatment of the withheld tax in this regard as a final tax is given in Section 8 of Chapter II (this Chapter is titled as “Charge of Tax”), whereas the same treatment for all other withheld taxes is covered in the Section 169 of Chapter X of the ordinance.

In the same vein, it is noted that WHT collections in respect of brokerage and commission, transport businesses, and CNG stations, which should have been placed in Chapter X, are grouped in Chapter XII under the title of “Transitional Advance Tax Provisions”, despite the fact that these have been a permanent feature in the Pakistani Tax Code for more than the last 15 years. Even if it was necessary to keep them separate, the chapter should have been put next to Chapter X or could have been made a separate part of Chapter X for the purpose of quick referencing.

Lastly, the final tax regime for shipping is inserted by clause 21 in Part II of Second Schedule, instead of by an insertion in Chapter X or Chapter IX (the latter is titled as “Minimum Tax”). This is an example of the worst form of grouping, because Part II of the Second Schedule contains provisions envisaging a reduction in rates for certain classes of taxpayers and the presence of charging provision for shipping business in that Part appears ectopic (that is, out of place or abnormal position).

6.1.1.4 Superfluous Provisions, Words and Sentences

ITO 2001 should not have any superfluous provisions and more ideally, the law should not have any superfluous words or sentences in the provisions. This attribute is important to ensure the policy intention of the ITO 2001 is unambiguous. It is also important for reducing the time consumed in complying with the law. This aspect seems to have been ignored in drafting the Pakistani PIT legislation, as seen in the following examples:

(i) Despite the presence of Section 169(1), which eloquently lists withheld taxes that are a final discharge of tax liability, the following separate provisions are inserted in the respective withholding tax sections. These are simply a duplication of legislative intention and policy.

Profit on debt	s.150(3)
Income of supplies, rendering of services and execution contracts	s.153(6)
Brokerage and commission	s.233 (3)
Income from sale of commercial imports	s.148(7)
Income from exports	s.154(4)
Income from sale of petroleum products	s.156A(2)
Income from sale of CNG products	s.234A(3)
Income from transport	s.234 (5)

(ii) Sections 148(2) and s 153(4) which deal with issuance of an exemption from the application of WHT are redundant because s 159(3) empowers the Federal Board of

Reserve⁸⁶ to issue an exemption to any taxpayer in respect of all or any WHT. More simply, when the blanket power is given to the Board through one provision, there is no need for this separate provision. Such duplication should be avoided to ensure the legislation is concise thus reducing the time needed to comply with it. Thus, s 148(2) should be omitted.

(iii) The scope of ‘contract’ in s 153(1) is limited as follows:

“(1) Every prescribed person making a payment in full or part including a payment by way of advance to a resident person or permanent establishment in Pakistan of a non-resident person -

(a) for the sale of goods;

(b) for the rendering of or providing of services;

(c) on the execution of a contract, other than a contract for the [sale] of goods or the rendering of [or providing of] services,

shall, at the time of making the payment, deduct tax from the gross amount payable at the rate specified in Division III of Part III of the First Schedule”

Examination of the scope of contract, as laid out above, shows that the section contains some superfluous words. The use of the words “other than a contract for the sale of goods or the rendering of [or providing of] services” does not bring any clarity to the concept of the ‘contract’ in general and the constituents of the term ‘contract’ in particular. It may be because every contract involves some kind of services and/or sale of goods. More simply, it is hard to determine when a supply of goods and rendering of services is an execution of the contract; or when a supply of goods and rendering of services is not an execution of a contract. These terms such as ‘execution of contract’ are artificial and have no commercial distinction on many occasions and therefore adds to ambiguity and uncertainty.

These ambiguities have led to tax litigation and conflicting judgements by the courts. In the case of *Assessee v Department*⁸⁷, receipts of a cricketer from a contract with the Pakistan Cricket Board were taxed under the normal income tax regime as service receipts by the assessing officer. In that case, Mr. Jawaid Masood Tahir Bhatti, Judicial Member of the Income Tax Appellate Tribunal of Pakistan (ITAT), held that these are contract receipts.

On the other hand, the recent decision of the Sindh High Court in the case of *M/S Premier Mercantile Services v CIT Karachi*⁸⁸ says that anything not covered under ‘supplies’ and ‘sale of goods’ as per the definition in the ITO 2001 are contract receipts. The relevant clauses of s.153(9), which set out scope of contracts by excluding ‘services’ and ‘sale of goods’ are reproduced below:

⁸⁶ Federal Board of Revenue: the income tax authority under Income Tax Ordinance 2001 (Pakistan) s 207.

⁸⁷ ITA No. 1850/KB to 1852/KB of 2002 (2004 PTD 2749) decided on 24th May, 2004. The matter was decided in the favour of the cricketer that such receipts are contractual in nature and fall within the ambit of PIT regime.

⁸⁸ See *Premier Mercantile Services v CIT Karachi* 2007 PTD 2521.

“services” includes the services of accountants, architects, dentists, doctor, engineers, interior decorators and lawyers, otherwise than as an employee.

“sale of goods” includes a sale of goods for cash or on credit, whether under written contract or not.

In this case stevedoring services of the taxpayer were taxed by the revenue department under the normal income tax regime as services, which fall outside the ambit of the PIT. The court by agreeing with the taxpayer held that service receipts which are not covered within the definition of ‘services’ as envisaged in subsection (9), shall fall within the ambit of “contract”, if these are performed under the contract.

The court failed to give a logical reason as to why it included service contracts of this type, and not other services contracts, within the scope of ‘contracts’. A plain reading of s 153 does not even impliedly suggest that all services would be split between those falling in clause ‘b’ and those falling under clause ‘c’ on the basis of the definition given in s153 particularly when that definition is ‘inclusive’ in nature.

(iv) Clause 42 of Part IV of the Second Schedule, which exempts operators of chemical and oil terminals from the application of the PIT, is also superfluous, because all companies which provide services are excluded from the ambit of the PIT by s 153(6). Since all the operators of the terminals in Pakistan currently are organized as companies, and sea terminal businesses fall within the ambit of the service industry, they already enjoy the exemption by s153(6). Thus, clause 42 is redundant.

6.1.1.5 Frequency of Changes in the Regime

Despite the fact that the Pakistani PIT in the ITO 2001 is the replica of the earlier PIT regime contained in the repealed Income Tax Ordinance, 1979 it still has undergone several amendments. Almost every Finance Bill brings repeated changes in every activity covered under the PIT, which manifoldly increases its underlying uncertainty. This all makes the tax code quite unstable and unclear. Some examples on this tendency follow:

(i) The deduction of tax on profit on debt under s 151 for a non corporate taxpayer was not a final discharge until an insertion of subsection (3) in s 151 through the Finance Bill 2006. This changed the tax liability for a non-corporate taxpayer.

(ii) The insertion of clause (bb) to s 153(5) through the Finance Bill 2007 provides an exemption to ginners (who separate seeds from cotton in order to produce cotton lint) from application s 153(1). There are two observations in this regard. First, it should be grouped with other exemptions provided in Part IV of the Second Schedule. Second, this insertion appears superfluous, because, after making the payment the ginner can obtain an exemption certificate from the Commissioner under s 159(1). Alternatively, the ginner can deposit the tax on behalf of the payer and provide him/her a copy of a tax payment receipt. The latter arrangement seems convenient to both the parties and thus is prudent in business terms. Thus, the addition of clause (bb) adds to the complexity of the legislation.

(iii) In respect of s 153, until 2002 only professional services were liable to withholding of tax. Later, all types of services were subjected to WHT through the Finance Bill 2002. Subsequently, the tax so withheld was treated as a final discharge of tax liability by an amendment in the Finance Bill 2006.

(iv) A concession for providers of services to exporters of textile products is inserted as subsection (1A) of s 153. The tax rate for them now becomes equivalent to that applicable to exports generally. Besides the fairness and the neutrality issues in this amendment, the reduction in tax rates should have been grouped with a reduction in the rates for other taxpayers in Part II of the Second Schedule.

(v) By inserting the second proviso to s 153(6), through Finance Bill 2007, advertising receipts by print media and the sale of goods and execution of contracts by listed companies are taken out of the ambit of the PIT. In the context of principles of a good tax system, although the exclusion of listed companies is explicable, it is difficult to understand the rationale of exempting a type of business (that is, print media) from the PIT regime.⁸⁹ Moreover, this exemption should have been inserted in the Second Schedule where other exemptions are grouped.

(vi) Suppliers of own manufactured goods (only companies) were exempted retrospectively from the ambit of the PIT through the insertion of subsection (6A) of s 153 by Finance Bill 2005; which was further amended in 2008 to suspend the retrospective application of the exemption.

(vii) The insertion of clause 47D in Part IV of Second Schedule allowing the PIT regime to apply to cotton ginners coincided with the omission of clause 40 of the Finance Bill 2005, which contained the option of the PIT for all manufacturers. This option was initially withdrawn retrospectively in order to curb tax avoidance through transfer pricing in the pharmaceutical industry, who used to file returns under the PIT option. But later for unclear reasons, clause 41A was inserted by the Finance Bill 2005, which again offered the option for all activities to use the PIT pertaining to periods before 2005. This clause was later also omitted by Finance Bill 2008. Frequent legislative amendments have the potential to create additional uncertainty and compliance costs for taxpayers.

(viii) The insertion of subsection (6B) of s 153 appears to be due to an error because individuals and AOPs were already falling within the ambit of the PIT. This insertion was then later correctly identified as a redundant provision and removed by the Finance Act 2008. This type of arguably hasty insertion and subsequent removal only adds complexity to the law.

(ix) Subsection (8A) of s. 153 of the Finance Bill 2006, which increased the rate of withholding tax rate for the payees when they failed to provide their tax identification number, was also withdrawn immediately after its insertion through Finance Bill 2007.

In all, the Pakistani PIT has been subject to significant and repeated changes even after the promulgation of the new Ordinance in July 2001. For instance, in Part IV of the Second Schedule, which contains the exemption from the application of PIT related WHT and the applicability of the PIT regime, 68 amendments have been made since 2001; which includes 22 new insertions, 35 removals and 11 substitutions. Moreover, even the definition of the prescribed person in s 153 has been amended six

⁸⁹ Generally, exempting a high profit yielding activity from the ambit of PIT is considered as a concession because then such a business declare lower incomes in a collusive arrangement with the accounting professionals and tax administration.

times. Finally, in the simplest regime of retailers, more than seven amendments have been made since its introduction in 2004. In view of the above, it seems that what was opined by Ahmad and Stern in 1991 still holds true:

“The Pakistani tax system has developed as a series of ad hoc measures dictated largely by short term pressures and the immediate convenience and relative ease with which extra revenue can be generated.”⁹⁰

6.1.1.6 Ambiguity of the Interpretative or Explanatory Provisions

Some interpretative and explanatory provisions which suffer from ambiguities are outlined in this part of the paper.

(i) The collection of tax under s 151 on interest payments to individuals is not treated as income under the definition clause 29 of s 2 despite ITO 2001 treating tax withheld on it as the final discharge of tax liability under s 169.

(ii) Although the definition of services and sale of goods is provided in s 153(9), (reproduced earlier in this section), the definitions have created more uncertainty and ambiguity. The definition of the ‘contract’ is not provided in s 153(9), perhaps because of an inability of the legislature to define it after excluding services and supplies from its scope. A contract without services and supplies would be nothing but a hollow assignment. This is discussed further in the efficiency section of this analysis.

(iii) Since manufacturers are excluded from the ambit of PIT under s 153, a manufacturer is defined in subsection 9 of s 153:

“manufacturer” for the purpose of this Section means, a person who is engaged in production or manufacturing of goods, which includes-

(a) any process in which an article singly or in combination with other articles, material, components, is either converted into another distinct article or produce is so changed, transferred, or reshaped that it becomes capable of being put to use differently or distinctly; or

(b) a process of assembling, mixing, cutting or preparation of goods in any other manner.

This definition does not seem clear and may add to the ambiguity. For example, under this definition, particularly due to the words ‘or preparation of goods in any other manner’, even a service provider of any type such as a wood cutter or sizing in the textile industry can claim to be a manufacturer if that treatment provides it some tax benefit.

(v) The insertion of the presumptive regime in the Second Schedule for shipping business is ambiguous regarding the return filing and assessment requirements. All other incomes falling within the ambit of the final tax regimes are deemed to have been assessed under s 120 and consequently such businesses with incomes falling within the ambit of the final tax regime are absolved from filing a return under

⁹⁰ Ehtisham Ahmad and Nicholas Stern, *The Theory and Practice of Tax Reform in Developing Countries* (1991), 2.

subsection (3) of s 169. The ectopic insertion of this final tax regime for shipping activities or its incorrect grouping has resulted in the omission regarding its assessment and filing requirements in subsection (3) of s 169.

6.1.1.7 Provisions Where the Literal Meaning is Never or Rarely Enforced

The pertinent example here is clause (d) of subsection 153(5) which is related to payment for securitization of receivables by a Special Purpose Vehicle to the Originator. In the real business world, these situations are quite rare. Similarly, the literal meaning of ‘manufacturer’ cannot be applied to the definition given under s 153 because it has an inclusive feature and therefore has widespread connotation. The same is also true for the definitions of contract, sale of goods, and services given under s 153. More aptly, it is hard to strictly include all business activities and sectors within the the literal meanings of these terms. The use of such words therefore only adds to the technical complexity.

6.1.2 Operational Complexity

As follows, the operational complexity of the Pakistani PIT regime is analysed qualitatively in terms of the compliance burden such as bookkeeping and other documentary requirements. More specifically, it is examined in the context of the average liability of small business (that is, the ratio of compliance costs to tax liability).

As discussed in section 5, small taxpayers in Pakistan mostly have to maintain books of accounts⁹¹, because the probability that all the transactions undertaken will fall within the ambit of the PIT regime is very low.⁹² The only exception when a taxpayer is not required to keep accounts is when 80 percent or more of his/her receipts are subjected to WHT.⁹³

As discussed in section 3, in small businesses, compliance costs associated with the maintenance of accounts are regressive. It is noted that the cost to maintain accounts can amount to a large percentage of the income earned by a taxpayer. Compliance costs can even be higher than the tax liability itself. For instance, a taxpayer having income at PKR 192,000⁹⁴ (which is maximum income of individuals constituting 65% population) shall bear a tax liability of PKR 7,680 under the normal income tax regime, which is equivalent to approximately one fourth of the compliance costs related to bookkeeping.

Further, the WHT on various activities, which are not covered under PIT, require small businesses (even those who fall under PIT) to interface with the tax administrator in order to get a refund of tax withheld on those activities. In the absence

⁹¹ Internal costs on the recording data and acquiring knowledge to comply with tax obligations are virtually all the compliance costs (see Cynthia Coleman and Chris Evans, ‘Tax Compliance Issues for Small Business in Australia’ (2003) in *Taxing Small Business: Developing Good Tax Policies* Neil Warren (ed.), Australian Tax Research Foundation Conference Series 23, 163).

⁹² It may be, because, only a few business activities are covered under PIT. Moreover, transactions within the formal sector are only subject to WHT which is a prerequisite to be eligible for PIT. Thus, activities, which are subject to WHT, fall outside the ambit of PIT.

⁹³ CBR Circular NO: 12 of 1991, Federal Board of Revenue of Government of Pakistan.

⁹⁴ PKR192,000 is the maximum income of 65 percent population in Pakistan (see *Nature and Extent of Corruption in Pakistan* Transparency International Pakistan, March 2002, 20).

of an electronic refund mechanism, many small businesses do not even apply for the refund due to fear of being harassed by the tax administration. The gap in the total number of SMEs (that is, 3.2 million) in Pakistan and total number of registered taxpayers (that is, 1.2 million) supports this contention. Byrne describes such withheld taxes in Latin American countries as de facto final assessment regimes.⁹⁵ This loss of refund is an additional tax compliance cost.

It is noted that in the Pakistani PIT, there is no satisfactory simplified regime for small entrepreneurs in Pakistan. As compared to other PIT designs available such as indicator based PIT or an asset based PIT⁹⁶, even when all the taxpayers' receipts are subject to WHT, the PIT based on the WHT is not simple, because taxpayers have to keep records for both the turnover and taxes withheld throughout the year. On the other hand, retailers who fall under the simplified non-WHT based turnover tax regime have to keep a record of turnover only. Moreover, the tax liability is uncertain in the retailer's regime, because the adjustment for taxes withheld under various provisions of the WHT regime against the liability under the retailers regime is not clear in the law. This means that the retailer bears additional tax burden for other WHTs, which are not the final discharge of the tax liability.

Lastly, the high level of technical complexity in the Pakistani PIT, as discussed in the preceding section, tends to increase the uncertainty and ambiguity, which consequently increases compliance costs. In all, the Pakistani PIT is complex from an operational perspective.

Regarding the enforcement aspect of operational complexity the Pakistani PIT, being a turnover based PIT, is not easy to monitor in cash based economies and therefore is not a good tax design. Additionally, the Pakistani PIT is hard to enforce and comply with, because, most taxpayers either fall within the normal income tax regime or have to face a hybrid treatment and consequently have to keep books of account. Only a small number of taxpayers fall within the ambit of the PIT, when their total receipts are subject to WHT.

Finally, using a PIT regime based on WHT Pakistan with weak administration is simply "going from bad to worse". The monitoring of WHT is harder than implementing the normal income tax due to the intricacies in handling the voluminous information required. Moreover under this regime, WHT agents assume the role of tax administrators and in an environment where they are not being effectively monitored. It makes the role of a WHT agent problematic and the fair implementation of the regime doubtful. Therefore, the Pakistani PIT is not easy to enforce. Because of its ineffective implementation, this regime could even be suspected of becoming counterproductive in terms of the equity and efficiency principles.

6.2 Pakistani PIT and Efficiency

Consistent with section 5, neutrality is a bedrock of the efficiency principle. Therefore, the Pakistani PIT is analysed initially against all facets of neutrality. Later,

⁹⁵ Peter D. Byrne, 'The Business Asset Tax in Latin America – No Credit Where It Is Due' (1994) *Tax Notes International* 529, 533.

⁹⁶ Memon, Najeeb, 'Presumptive Income Tax Designs for Improving Small Business Compliance' (2009) 15:4 *New Zealand Journal of Taxation Law and Policy*, pp.275-297.

the deadweight loss caused by the Pakistani PIT, which is linked to its tax design, is assessed.

6.2.1 Neutrality

The Pakistani PIT is analysed against six aspects of neutrality as follows.

6.2.1.1 Neutrality in Tax Rates, Expenditures and Concessions

Tax rates, which determine the tax burden in any tax system in general and the PIT regime in particular, should be chosen on some logical basis. The rates in the PIT for small business should be fixed in proportion to the average income of relevant sectors or any other rational basis.⁹⁷ More simply, different profit margins demand different tax rates for each business activity in order to bring neutrality in tax treatment. Thus, a turnover based Pakistani PIT should have classifications and rates on the same basis or a similar logical basis. But regrettably, this aspect is completely ignored in the Pakistani PIT.

For instance, the PIT rates on turnovers prescribed under s 153 are without any rationale. All services are being taxed at the same rates irrespective of the industrial sector. Similarly, all supplies are taxed at identical rates which disregard their nature. Further, all contracts are treated as on par without paying any heed to the nature and value of the contract. The profit margins among all these activities are usually different from sector to sector; and also for the level of turnover. Thus, subjecting them to a uniform tax rate violates neutrality in terms of equal tax burden for equal incomes.

Moreover, within WHT based PIT regimes, some activities are taxed at high rates and others at very low rates. Exports are taxed at 1% and imports at 2%, but fabric imports are taxed at 1%. Transport services are taxed at 2% and other services at 6%.⁹⁸ The difference in tax rates is without any sufficient economic rationale (for example, one of an average income). Even the difference in tax rates does not correspond to differences in the profit margin from these activities. Robina and Rider show that contractors pay 20 percent of federal tax receipts in Pakistan, even though they account for only 2.3 percent of its GDP.⁹⁹ This discriminatory treatment of different activities in terms of different tax rates, without paying any heed to the actual or average income of those activities, causes allocation of resources to low taxed sectors at the expense of high taxed ones and consequently economic distortion.

It is worthy to refer to decision of the Indian Supreme Court in case of *Kunnathat Thathunni Moopil Nair etc. v State of Kerala and another*¹⁰⁰ which lays down broad guidelines for taxation in this regard. The facts of the case were that a petition was filed challenging the constitutionality of Travancore-Cochin Land Tax Act 15 of 1955.

⁹⁷Robina Ather Ahmed and Mark Rider, 'Pakistan's Tax Gap: Estimates by Tax Calculation and Methodology' Working Paper No. 08-11, Andrew Young School of Policy Studies, December 2008, 36.

⁹⁸The textile related services for exports are taxed at 0.5% under section 153(1A). The tax rate on imported fabric is reduced from 2% to 1% by clause 9 to the Part II of Second Schedule.

⁹⁹See Ahmed and Rider above n 97, 27.

¹⁰⁰*Kunnathat Thathunni Moopil Nair etc v State of Kerala and another* AIR 1961 SC 552; 3 SCR 67.

Section 4 thereof provided that there shall be charged and levied basic tax at uniform rate in respect of all lands in the state of Kerala of whatever description and held under whatever tenure.

The Indian Supreme Court held that:

“Similarly, different kinds of property may be subjected to different rates of taxation, but so long as there is a rational basis for the classification. Art. 14 will not be in the way of such a classification, resulting in unequal burdens on different classes of properties. But, if the same class of property similarly situated, is subjected to an incidence of taxation, which results in inequality, the law may be struck down as creating an inequality amongst holders of the same kind of property.” (Kunnathat Thathunni Moopil Nair etc. v State of Kerala and another at page 90)

The classification and rates in the Pakistani PIT is also without any rationale and therefore appear confiscatory because they result in unequal tax burdens on different classes of businesses. This shows that the lack of classification and rates (which results in a loss of neutrality) in the PIT legislation, being confiscatory in nature, not only has adverse economic consequences, but arguably also destroys the legitimacy of such legislation. Taxing the turnover without further distinguishing the economic activity is not a neutral classification.

Further, originally the Pakistani PIT had some sub-categories for the different types of exports depending on the extent of value added by the exporter and some sub-categories in terms of the difference in values of the contract and these were subjected to different tax rates. This shows that there is a scope of improving the classification and developing sub-classifications in order to make tax incidence neutral and equitable. It is pertinent to note the suggestion made by the Supreme Court of Pakistan, in the case of *Ellahi Cotton Mills Ltd v CIT*, on the point of confiscatory nature of the PIT legislation:

“We have no doubt that if the representatives of the business community take up the question of reasonableness of the above rates of tax provided under Section 80C, 80CC and 80D with the government, the same would be given the due consideration, particularly keeping in view that there is good equation between the business community and the government in power. No government of any worth would like to destroy the industries and the business of the country by imposing taxes at the rates which may be confiscatory or expropriatory.” (Ellahi Cotton Mills Ltd v CIT [1997PTD1555] at Paragraph 26 of the order)

Lastly, the Pakistani PIT provides concessions in different forms through the Second Schedule of ITO 2001. Besides exempting from tax total income of some classes of income, a number of concessions are inserted in the form of lower tax rates, rebates in tax liability and exemptions from the application of the PIT regime. The total number of the concessions, with respect to taxes collected at source, is 30. Most of the concessions appear completely without any economic rationale and are detrimental to neutrality of the regime.

6.2.1.2 Neutrality in all Classes of Income

The Pakistani PIT regime is not neutral for all classes of income. The tax rate for the interest income falling within the ambit of WHT based PIT under s 151 is 10 percent.

Similarly, the tax rate for rental income at the lowest bracket is 5 percent. In both these PIT regimes, gross receipts are relatively closer to the actual income, because only a few deductions are admissible against the receipts. Consequently, the tax burden on taxpayers falling within the ambit of these PIT regimes is low.

As compared to that, gross receipts of business or professional activities are subjected to tax rates ranging between 1-10% (such as those falling within the ambit of sections 148, 153, 156 and 233) which impose a higher effective tax liability, because the income from these activities constitutes a relatively small part of their overall receipts. In other words, there are several expenses deductible from business and professional turnovers before arriving at net profit figure. More simply, interest receipts due to less admissible expenses are almost equal to net profits from investment; whereas net profits from investment in a business venture reflect only a small component of its total receipts.

For example, Mr. A receives interest income of PKR65,000 from his interest bearing securities. This income is taxable under the PIT at 10% and consequently bears tax at PKR 6500. The effective tax rate for this income is also 10%, because no deductions are admissible against the receipts of PKR65,000 which are earned on the securities financed by his investment of Rs. 650,000 made up of savings. On the other hand, Mr. B receives receipts of PKR 650,000 on account of supplies he makes to his customers. These receipts also fall within the ambit of PIT at a tax rate of 3.5% and consequently bear tax of PKR 22,750. If this is assumed that net profit margin of this trading activity is 10%, then, the tax of Rs. 22, 750 on his income (which @ 10% of net profit margin stands at PKR 65,000) means he bears an effective tax rate of 35%. More simply, if the supplier earns net profits equivalent to the profits on bank deposits then it bears a much higher tax burden. This indicates that investment in trading bears higher effective tax rate as compared to investment in bank deposits.

6.2.1.3 Neutrality in Tax Burden for all Types of Legal Persons

The Pakistani PIT is not neutral in terms of its treatment for different types of legal persons which may encourage business to organize in a form which acts as tax shelters. Following are some examples in this regard.

(i) The interest income of corporate entities under s 151 is excluded from the ambit of the PIT. On the other hand, the interest income of AOP, individuals and partnerships is taxable under the PIT. This all creates an avenue for tax planning and results in higher economic costs.

(ii) Services income under s 153 in respect of corporations is taken out from the ambit of PIT by the first proviso to subsection (6). This exclusion from PIT provides an opportunity to evade taxes under the normal income tax regime by having a collusive arrangement with the tax authorities because now very low or nil tax liability can be assessed under the normal tax regime.¹⁰¹ This discrimination opens a door for tax planning and ultimately influences the way the business may be organized.

(iii) The income from a supply of goods by a corporate manufacturer is taken out of the ambit of PIT by subsection (6A) of s 153. This provision creates a distinction in

¹⁰¹ See above n 89.

the treatment between the corporate and the non-corporate sectors. This would have exactly identical consequences as discussed in respect of the services sector in the preceding paragraph.

(iv) The income of listed corporations from the sale of goods and execution of contracts is outside the ambit of PIT by clause (ii) of the second proviso to subsection (6) of s 153. It perhaps is done to encourage listings in the stock exchange but it may cause wider negative economic ramifications. For instance, all the private companies or partnerships may not be ready in terms of other financial indicators to change their form and obtain listing and consequently the tax system would be discriminating against them. This intervention through tax policy, to influence the choice of form of business organization, appears unprecedented at least in Pakistan.

(v) The income from commercial imports by large import houses, irrespective of the form of business organization, is taken out of PIT by clause (d) to subsection (7) of s 148. Those corporations, which are conducting trading houses, are exempt from both PIT regimes under sections 148 and 153, if they meet certain conditions. This favourable treatment to large importers may become detrimental for small entrepreneurs which may make them uncompetitive and may ultimately wipe them out from the market.

6.2.1.4 Neutrality in Availability of Tax Avoidance Opportunities

The Pakistan PIT creates evasion opportunities, which substantially distorts economic decision making. These opportunities arise both when all or even a part of a taxpayer's receipts fall within the ambit of the PIT regime. These opportunities are primarily due to ambiguous definitions and the scope of the terms 'services', 'supplies' and 'contracts',¹⁰² in the law. A few examples in this regard are outlined as follows:

(i) Taxpayers can split the contract to label part of their receipts as being from supplies rather than the contract so as to bear less tax. For example, Mr. Z has contracts for the supply and installation of solar energy equipment. If it is assumed that the cost comprises PKR 1,500,000 for the equipment and PKR 500,000 for the installations, this makes a total of PKR 2,000,000. In case Mr. Z makes one deal for the sale and installation then he bears tax at 6% and the total liability stands at PKR 120,000. Alternatively, if he separately treats the sale as a supply and the installation as a service charge then the supply of the equipment bears tax at 3.5% and the installation service bears tax at 6%. Consequently, the total tax liability by splitting the contract would stand at PKR 52,500 (for supplies) plus PKR 30,000 (for services), a total of PKR 82,500. This shows that the tax liability can be significantly reduced by structuring a transaction. Moreover, the larger the value of transactions, the more attractive is it to undertake tax planning.

(ii) Sometimes a taxpayer may make choices by playing on the ambiguities in the statutory definitions of the different activities. For example, services are not distinguished between businesses of providing services such as airlines and couriers. It is noted that when taxpayers earn greater profits, then they prefer to be assessed under the PIT; and when they earn low profits, they want to be assessed under the normal income tax regime, by claiming that they are just a business and do not fall within the

¹⁰²The definitions of these terms in law are already reproduced in the preceding section of simplicity.

definition of services under s 153. The tax administration, in order to collect more revenue or sometimes for dishonest motives, also uses the same loopholes. For instance, manufacturing activities such as dyeing have been taxed by the revenue administration under the PIT as service receipts. More simply, there are claims and counterclaims regarding the nature of the same receipts.

Additionally, the exclusion of services from contracts in the subsection defining the scope of PIT under s 153, as reproduced earlier in section 6.1.1.4, also has created another series of litigation.. For instance, in the same earlier mentioned case of *Premier Mercantile Services v CIT Karachi*, the Sindh High Court despite the exclusion of the word 'professional' from the definition of services, the Court upheld that the taxpayer fell under the ambit of PIT as a contract and that its services were not those which were covered within the definition provided in subsection (9).

On the other hand, the services of the cricketer, as mentioned earlier in the case of *Assesse v Department*¹⁰³, were also held by the Income Appellate Tax Tribunal (ITAT) of Pakistan to fall outside the ambit of the services both under ITO 2001 and the now repealed ordinance. The Tribunal held that these kind of services are a contract and not services by giving a reasoning based on the Contract Act, 1872, which was completely different than the reasoning followed in the earlier decisions:

“It is elaborated that the term services is applied where the person is dictated in respect of ‘what to do’ and ‘how to do’, whereas under the strict definition of the contract a person is only explained for ‘what to do’. He is not explained that how he has to do his work. Otherwise, under the Contract Act, there are only three ingredients of the contract i.e. offer, acceptance and consideration. In the present case, there is a contract but under the contract, there is no limitation upon the appellant ‘how to do’.” (page 4)

Conversely, in the case of *CIT v Khursheed Ahmad*¹⁰⁴, the taxpayer filed a return under the normal income tax regime for its income from janitorial services and the tax department taxed it as a contract under the PIT. The Lahore High Court decided the matter in favour of the taxpayer as follows:

*“A plain reading of the provision Section 80C will not leave any doubt that rendering of services have been provided exemption even if the same are in execution of a contract. The various principles of interpretation of fiscal statute like application of law in its natural meaning and favour to the taxpayer in case of doubt, provides guideline and following the same it we hold that the department’s presumption is without any support or argument”.*¹⁰⁵

The above conflicting claims and judicial pronouncements are evident of the embedded complexity in the regime, which provides a breeding ground of tax arbitrage opportunities and corruption.¹⁰⁶

¹⁰³ ITA No. 1850/KB to 1850/KB of 2002 (2004 PTD 2749).

¹⁰⁴ CIT v Khurshid Ahmed 2008 PTD 1243, Paragraph-8 of the order.

¹⁰⁵ This case pertains to the repealed ordinance which had an almost identical PIT regime.

¹⁰⁶ In addition, the argument of the court is bad in law as it ignored the fact that the definition is inclusive' which broadens the scope of the services falling in its ambit. A similar finding was given while describing the scope of 'income' in the Constitution (where income has an inclusive definition) by the

The sale and buy back transaction executed between businesses and leasing companies to raise finance was taxed by the tax department under the PIT as a sale. The Lahore High Court decided the matter against the department in the case of *CIT v JD Sugar Mills Ltd.*¹⁰⁷ In this case the taxpayer JD Sugar Mills Ltd sold and bought back part of its plant with a leasing company. Subsequently, the legislature inserted the remedial provisions as clause c to s 153(5), to exempt such transactions from the ambit of PIT. But that adds to the complexity of the tax code. It is pertinent to mention here that in this case, the court observed that WHT agents deduct tax on behalf of the tax agency even if the payment does not fall in the ambit of any of the items (services, supplies and contracts), perhaps because of the fear of incurring penalties for non-compliance of the WHT regime under the law.¹⁰⁸

The above mentioned cases are just a few examples, but the actual number of cases all over Pakistan on these or similar issues could, in my view, be numerous and only an empirical study of the statistics of the legal division of Federal Board of Revenue could provide an accurate figure.

(iii) Furthermore, when a taxpayer's activities fall partly under the normal income tax and partly under the PIT regime, there is an opportunity for tax avoidance by claiming more of the expenses within the normal income tax and less within the PIT because in the PIT, which is final discharge of tax liability, these expenses do not help in reducing the tax liability. This opportunity arises due to the ambiguous Rule 13 for allocation of expenses. Consequentially, voluminous litigation is pending in the courts, which increases tax planning costs and also adversely impacts the economy.

(iv) The Pakistani PIT also encourages tax evasion and avoidance through collusive arrangements. For instance, big manufacturing units create sister concerns to obtain all services from them at inflated costs (as the sister concerns fall within the PIT) and reduce their overall tax liability. Similarly, professionals can take advantage of the PIT for services income by substituting regular employment with a service contract. More simply, they prefer a service agreement, which falls under the PIT under s 153 read with s 169. The tax burden for the same receipts under the PIT is much less as compared to tax payable under the salary regime.¹⁰⁹ Employers might also prefer this collusive arrangement with professionals to reduce the employer's costs. This causes a loss of revenue, whose quantum is yet to be ascertained. Some companies even use service contract arrangements as a channel to siphon profits outside the company, by hiring friends and relatives under these contractual arrangements. Such friends are then paid high sums as service fees to claim huge deductions against profits of the company. Depending upon the type of company, the company tax rate ranges between 30-40%. Moreover, due to the lack of imputable income, a taxpayer may camouflage

SC of Pakistan in the famous case of Ellahi Cotton Mills Ltd v Federation of Pakistan. The SC held that 'the fact that the word 'includes' has been employed and not the word 'means' indicates that the definition given in Article 260 for the above term is not exhaustive'.

¹⁰⁷ See *CIT v J.D Sugar Mills Ltd* 2009 PTD 481.

¹⁰⁸ See *CIT v J.D Sugar Mills Ltd* 2009 PTD 481.

¹⁰⁹ The services are taxed at rate of 6%, whereas the tax rate for the highest slab bracket is 25% of salary income is 20% under Para 1A of Div. I of Part I to Schedule I.

profits from other activities as arising from an activity falling within the ambit of the PIT.¹¹⁰

6.2.1.5 Neutrality in the Tax Burden Regarding the Choice of Capital Structure

PIT is inherently against the debt financing of the company because it takes away the tax shelter which debt financing provides under the normal income tax. But, consistent with SME studies in Pakistan, most small businesses are funded by equity; hence this disadvantage makes little difference for them. Nevertheless, in strict terms of the criteria of neutrality, the PIT takes away the advantage of the debt financing which is considered as a cheap source of finance. Businesses which are mostly financed by debt may face more fluctuations in their income in case they fall under the PIT. More simply, increased fluctuation in Earnings after Interest and Tax (EAIT) in a risky business would be aggravated when debt comprises most of its capital. This discourages debt financing in the risky business (see Table 1 below).

Table 1: Increased Fluctuation of Take Home Income under PIT¹¹¹

Normal Income Tax Regime			
	2007 PKR	2008 PKR	2009 PKR
Turnover	5,000,000	4,500,000	2,000,000
Expenditure	(4,000,000)	(4,000,000)	(3,000,000)
EBT	1,000,000	500,000	(1,000,000)
Tax at rate as per Div I, Part I of the First Schedule	(210,000)	(50,000)	(000)
Earning After Tax	790,000	450,000	(1,000,000)
Change from Previous Year	100% (Base Year)	57%	-13%
Presumptive Income Tax Regime			
	2007 PKR	2008 PKR	2009 PKR
Turnover	5,000,000	4,500,000	2,000,000
Expenditure	(4,000,000)	(4,000,000)	(3,000,000)
EBT	1,000,000	500,000	(1,000,000)
Tax on Contracts at Rate of 6%	(300,000)	(270,000)	(120,000)
EAT	700,000	230,000	(220,000)
Change From Previous Year	100% (Base Year)	33%	-31%

¹¹⁰ It is recommended to reintroduce the concept of imputable income in the PIT as it was present in Section 80C(5A) of the repealed ordinance which provided that where an assessee derives income from any source which is subject to tax in accordance with the provisions of this section, and the tax liability is less than the tax payable on such income had it not been chargeable to tax under this section, the difference in tax shall be payable in accordance with Section 54 along with the return of income provisions of sub-Section (4) notwithstanding (for details see the repealed Income Tax Ordinance 1979 of Pakistan).

¹¹¹ The author's own calculations.

6.2.1.6 Neutrality in Assigning the Role of Withholding Tax Agent

When the tax agency assigns a business the role of being a WHT agent, then, it increases its compliance costs. It involves shifting the role of tax collection to business and such a role incurs time and monetary costs. On the other hand, when some businesses are specifically exempted from performing that role, then, it means they have been favoured in terms of the compliance costs. For example, AOP is required under the law to act as a WHT agent under s 153 whereas other legal persons such as individuals are exempted from this role. AOP, therefore, is comparatively at a disadvantageous position in terms of compliance burden.

6.2.2 Overall Tax Burden

The Pakistan PIT is detrimental to work and entrepreneurship for several reasons. First, it is noted that differential tax treatment for each class of income discourages a taxpayer to take multiple ventures, because doing so increases the volume and cost of compliance. Second, the fixed tax rates on turnover without relation to the intricacies of this proxy base, generates higher tax liability with the increasing turnover irrespective of the level of actual profits. Since the turnover is a direct reflection of increased effort as a result, this regime becomes a disincentive to carry out more effort. Moreover, the tax rates are too high in some sectors e.g. supplies and contracts and consequently business risk is multiplied in those sectors. More aptly, a PIT with a low tax rate is helpful in tackling the informal economy, because it decreases economic gains from operating in the informal sector by reducing the technical compliance burden.¹¹² Thus, the Pakistani PIT is not appropriate in this regard. However, despite the higher burden, the marginal tax rate in the Pakistani PIT is zero, when the income is beyond the level where tax liability corresponds with the prescribed tax rates of PIT, which is an incentive for high performing taxpayers and businesses.

6.3 Pakistani PIT and Equity

Since neutrality is a bedrock of both efficiency and horizontal equity, the findings of analysis made in section 6.2 for the efficiency principle are equally relevant to horizontal equity. Nevertheless, in this section, those aspects of neutrality, which have a direct impact on horizontal equity, are analysed. Vertical equity, on the other hand, is assessed by the level of progressivity in the PIT regime.

6.3.1 Neutrality in Tax Treatment of Employed and Self-Employed Taxpayers

The Pakistani PIT for self-employed persons violates the equity principle. The main concern is that those who are falling within the PIT are not allowed any basic exemption. Thus, a taxpayer under the PIT regime which has turnover of just PKR 1 million (A\$ 9,000) has to pay tax at rate of 5% (that is, PKR 50,000 (A\$550)). Alternatively, under the normal income tax, this taxpayer, if it is assumed that the net profit margin is 10%, would declare income of PKR 100,000 (A\$1,100) and will pay no tax as this level of income as it falls below the taxable limit. The tax paid under the PIT by this taxpayer is more than

¹¹² Memon, above, n 20.

double the tax liability of a taxpayer, who declares net income of PKR 0.5 million (A\$5,500) under the normal income tax; or is equivalent to the liability of a retailer who opts for a fixed tax and has turnover of PKR 50 millions (A\$ 600,000). It shows that small businesses, which fall within the ambit of the PIT, bear a relatively higher tax burden.

Comparisons of tax liabilities of self-employed persons between the PIT and normal income tax for various activities; and of the tax liability between employed and self employed persons is given below in Tables 2, 3 and 4. This comparison clearly demonstrates the discriminatory treatment in the Pakistani tax system. In Table 2, the self employed medical doctor bears a different tax when compared to an employed medical doctor. Even a medical self-employed doctor, who falls under the normal income tax regime, pays a different amount than the one who falls under PIT. Further, self-employed professionals of different sectors also bear different tax burdens and that differential treatment is not supported by any logic.

Table 2: Comparative Tax Liability of Employed and a Self-Employed Professionals¹¹³

Doctor Employed		Doctor Self –Employed under the Normal Income Tax Regime		Doctor Self –Employed under PIT Regime	
Salary	300,000	Under the normal income tax regime a taxpayer deducts expenses which are un-verifiable and usually constitutes 70-80% of the receipts.		Receipts	300,000
Tax at 0.75%	2,250			PIT tax at 6%	18,000
Under Para 1(A) Div. I to Part I of Ist Schedule				Net Profit	60,000
				Tax at 0%	NIL
		Under Para 1 Div. I to Part I of the First Schedule			

In Table 3, the self employed lawyer bears tax liability different than the one borne by the self employed transporter despite the same volume of receipts.

Table 3: Comparative Tax Liability of various Self Employed Persons Falling Within the Ambit of PIT u/s 153¹¹⁴

Self- Employed Lawyer		Self –Employed Transporters	
Receipts	300,000	Receipts	300,000
PIT tax at 6%	18,000	PIT tax at 2%	6,000

¹¹³ The author's own calculations.

¹¹⁴ The author's own calculations.

In Table 4 below, it highlights that despite the same volume of turnover, a trader of rice bears a different tax liability as compared to a trader of yarn.

Table 4: Comparative Tax Liability of Suppliers of Different Commodities Falling Within the Ambit of PIT u/s 153¹¹⁵

Self- Employed trader of rice		Self –Employed Trader of yarn	
Receipts	300,000	Receipts	300,000
PIT tax at 1.5%	4,500	PIT tax at 3.5%	10,500

6.3.2 Neutrality among Taxpayers with Different Levels of Turnover

Identical tax rates in the PIT for various activities do not reflect identical tax treatment because they are applied on turnover rather than on actual income. Businesses even in the same sector with different turnovers may or may not have identical profit margins due to a difference in their break-even points (that is, level of sales where total costs equal total revenue and no profit is made) in accordance with the concepts of costing; and due to different business strategies of their owners (for example, selling more at low margins or selling less at high margins). The Pakistani PIT, therefore, does not tax equals equally.

The Pakistani PIT may therefore favour taxpayers with high turnover, who have crossed the breakeven point much earlier than those with low turnover. For example, a taxpayer with turnover of PKR 25,000 (A\$230) is subjected to a tax rate similar to that of taxpayer from an identical sector, which has turnover of PKR 5 million (A\$5,500) despite the fact that they both may not have similar profit margins. The taxpayer with a very low turnover may not yet have even achieved the breakeven point, but still has to bear a tax burden. This regime favours taxpayers with a high turnover. Similarly, this regime is also detrimental to those businesses which follow a strategy of selling more at low margins compared to those selling less at high margins.

Therefore, in a turnover based PIT, some equality can be achieved only by grouping taxpayers in accordance with their operational gearing and different business strategies in order to charge tax close to the tax on their actual income.

6.3.3 Vertical Equity

As I suggest, the progressive tax rates are not suggested due to the inherent conflict between vertical equity and efficiency principles.¹¹⁶ For vertical equity, the only recommendation is that the taxpayer, who earns more, should proportionally pay more to the tax administration. This is on the basis that in my view, proportional vertical equity generates a sensible balance between two tax objectives; the ability to pay and the incentive to work. Consequently, in the Pakistani PIT, a similar rate for all levels of turnover is quite appropriate for vertical equity.

¹¹⁵ The author's own calculations.

¹¹⁶ See Memon, above n 10.

6.4 Looking at Performance Benchmarks

The Pakistani PIT fails to do well when measured against the benchmarks of tax performance as considered in this paper. This is evident from the stagnant base, (see Table 5) and the revenue collection from the small business jurisdiction (see Table 6) and the low tax to GDP ratio (see Table 7). Table 1 shows an insignificant increase in number of returns filed and tax paid by the non-salaried class. There is no considerable increase in taxpayer registration. The increase in registration in retailers is because for them, the PIT regime essentially acts similar to a concession – as reflected in the insignificant revenue collection (see Table 5) – as it has a hard to enforce turnover based design and a tax rate of half a percent.

Table 6 reflects the poor revenue collection in tax jurisdictions (zones) dealing with small businesses of two large cities in Pakistan. This may explain why the Pakistani nation, with a population of 160 million, has just 2.28 million registered taxpayers. Table 7 shows that the tax to GDP ratio in Pakistan is falling.

Table 5: Income Tax Returns/Statements During 2005 to 2008¹¹⁷

PKR in millions

Taxpayers	2005		2008	
	No. of Returns Received	Tax Paid (PKR)	No. of Returns Received	Tax Paid (PKR)
Non-Salaried Individuals	510,189	1,540.00	616,395	1,461.50
Statements				
Importers	9,826	2.55	15,425	0.9
Exporters	8,967	13.92	10,212	1
Contractors/ Suppliers	33,993	6.62	32,266	6.2
Other(including Retailers)	36,378	114.43	1,171,656	165.8

Table 6: The Collection from Non-Corporate Jurisdictions of Karachi, Lahore¹¹⁸

PKR in millions

	2001-02	2005-06
CIT, `A' Zone, Karachi	851	1,138
CIT, `B' Zone, Karachi	559	437
CIT, `C' Zone, Karachi	1,670	NA
CIT, `E' Zone, Karachi	741	885
CIT, `A' Zone, Lahore	966	2,988
CIT, `B' Zone, Lahore	2,035	-
CIT, `C' Zone, Lahore	6,506	10,207

¹¹⁷ CBR Quarterly reviews for Jan-March 2008, Fiscal Research and Statistics, Directorate Research & Statistics accessed through <http://www.fbr.gov.pk/DRS/Default.asp> on 17/11/2008 at 12:15PM.

¹¹⁸ See above n 118.

Table 7: GDP and Tax to GDP ratio of Pakistan for last ten years¹¹⁹

PKR in millions

YEARS	GDP (calculated under Market Prices)	Total Taxes		DIRECT TAXES	
		Collection (Net)	Tax to GDP ratio (%)	Collection (Net)	Tax/GDP Ratio (%)
1998-99	2,677,656	370,436	12.61	110,207	3.75
2002-03	4,875,648	528,857	10.85	151,898	3.12
2007-08	8,723,215	1,060,576	10.12	387,819	3.70
2010-11	18,116,453	1,558,015	8.6	602,451	3.33

Source:

Federal Board of Revenue Year Book 2010-11 Source: Statistical data (Historical) Fiscal Research and Statistics, Directorate Research & Statistics accessed through <http://www.fbr.gov.pk/DRS/Default.asp> on 25/1/2013.

More aptly, the 'estimates show that the informal sector over the years is grown in Pakistan from 36.8% in 1999-2000 to 39.5% in 2004-05'¹²⁰, which reflects at least partly the failure of the regime to encourage the transition from informal to formal sector.

In all, the poor performance of the PIT may be reflection of the findings of the above analysis such as the existing complexity in the procedures and the lack of perception of fairness arising from poorly designed tax rates which fails to provide neutrality in its tax treatment.

7. CONCLUSION

Many developing countries rely on the PIT regimes to collect taxes from large informal economies. This reliance is result of their inability to enforce normal income tax because of high compliance costs and weak tax administration. The merit of the simplicity in an ideal PIT such as being less costly to comply and easy to enforce makes it theoretically superior to a normal income tax in large informal economies. However, despite the widespread use of the PIT, there is little research on its ability to tackle large informal economies.

This paper analyses the PIT regime of Pakistan, one of large informal economies in Asia for its adequacy to control informal economy. After reviewing the causes of the informal economy in general and in context of Pakistan, the design of the Pakistani regime and its features are evaluated against principles of a good tax system as ranked in the context of informal economies.

¹¹⁹ See above n 118.

¹²⁰ See Schneider, above n 38.

The findings reveal that being a turnover based PIT design, the Pakistani PIT is technically complex and imposes high compliance costs on small business. The Pakistani PIT also does not adhere well to the efficiency and equity principles because it does not secure neutral tax treatment for all types of business sectors. The findings of inadequacy of the Pakistani PIT are also evident in a stagnant taxpayers base, lower tax to GDP ratio and a persistently large informal economy in Pakistan.

The above findings suggests that current turnover PIT designs may be replaced with a better alternative such as an asset based PIT design or a PIT design based on economic indicators. In the event that the replacement of the PIT is not currently possible, complexities identified in the section of simplicity are suggested to be removed through a legislative review; and for efficiency, a detailed classification of industrial sectors with separate tax rates for each class could be provided to ensure neutrality in tax treatment.

Like any other study, the findings of this paper also suffer from some limitations such as these are not supported with sufficient empirical analysis particularly with respect to PKR value of compliance and enforcement costs resulting from the legal complexities identified in this paper, quantum of tax revenue which is lost due to existing tax arbitrage opportunities in the tax code and actual volume of shifting of tax incidence in the turnover based PIT design.

Lastly, there is scope of further research with respect to Pakistani PIT regime. As stated earlier, some more empirical evidence may be gathered to endorse the findings of the qualitative analysis made in this paper. For replacing the existing turnover based PIT design with a better alternative, an experimental study at a small scale is suggested to evaluate pros and cons of all other PIT designs which are in practice in several transitional European and other developing countries such as an asset based PIT design or an indicator based PIT design. However, the willingness of the government in this regard is a prerequisite.

APPENDIX: MAIN PIT PROVISIONS OF THE INCOME TAX ORDINANCE, 2001

Section 67 Apportionment of Deductions.- (1) Subject to this Ordinance, where an expenditure relates to –

- (a) the derivation of more than one head of income; or
- (ab) derivation of income comprising of taxable income and any class of income to which sub-Sections (4) and (5) of Section 4 apply, or;
- (b) the derivation of income chargeable to tax under a head of income and to some other purpose,

the expenditure shall be apportioned on any reasonable basis taking account of the relative nature and size of the activities to which the amount relates.

- (2) The Board may make rules under Section 237 for the purposes of apportioning deductions.

Rule 13 of Income Tax Rules 2002:- (1) This rule applies for the purposes of Section 67, which provides for apportionment of expenditure incurred for more than one purposes.

- (2) Any expenditure that is incurred for a particular class or classes of income shall be allocated to that class or classes, as the case may be.
- (3) (a) Any common expenditure including financial expenses, excluding relatable or attributable to the non-business advances or loans and amount at (2); relatable to business including presumptive and exempt income, shall be allocated to each class of income according to the following formula, namely:-

$$A \times B/C$$

where –

- A is the amount of the expenditure incurred;
- B is the total amount gross receipts (without deduction of expenditures) for the tax year for the class of income; and
- C is the total amount gross receipts (without deduction of expenses) and net gains for the tax year of all classes of income;

- (b) where, however, there is net gain, brokerage, commission and other income is to be taken and turnover of such transactions is taken at these figures, such income is to be compared with gross profit from business for adopting figures for component “B” and “C” of the formula at (a) above.

Section 151 Profit on Debt: (1) Where

- (a) a person pays yield on an account, deposit or a certificate under the National Savings Scheme or Post Office Savings account;
- (b) a banking company or financial institution pays any profit on a debt, being an account or deposit maintained with the company or institution;

- (c) the Federal Government, a Provincial Government or a Local Government pays to any person profit on any security other than that referred to in clause (a) issued by such Government or authority; or
- (d) a banking company, a financial institution, a company referred to in sub-clauses (i) and (ii) of clause (b) of sub-Section (2) of Section 80, or a finance society pays any profit on any bond, certificate, debenture, security or instrument of any kind (other than a loan agreement between a borrower and a banking company or a development finance institution) to any person other than financial institution the payer of the profit shall deduct tax at the rate specified in Division I of Part III of the First Schedule from the gross amount of the yield or profit paid,....., at the time the profit is paid to the recipient.

148. Imports.- (1) The Collector of Customs shall collect advance tax from every importer of goods on the value of the goods at the rate specified in Part II of the First Schedule.

(2) Nothing contained in sub-section (1) shall apply to any goods or class of goods or persons or class of persons importing such goods or class of goods as may be specified by the Board.]

(5) Advance tax shall be collected in the same manner and at the same time as the customs-duty payable in respect of the import or, if the goods are exempt from customs-duty, at the time customs-duty would be payable if the goods were dutiable.

(6) The provisions of the Customs Act, 1969 (IV of 1969), in so far as relevant, shall apply to the collection of tax under this section.

[(7) The tax collected under this section shall be a final tax 5[except as provided under sub-section (8)] on the income of the importer arising from the imports subject to sub-section (1) and this sub-section shall not apply in the case of import-

- (a) raw material, plant, machinery, equipment and parts by an industrial undertaking for its own use;
- (b) fertilizer by manufacturer of fertilizer; and
- (c) [motor vehicles] in CBU condition by manufacturer of [motor vehicles].]
- (d) large import houses, who,-
 - (i) have paid-up capital of exceeding Rs.[250] million;
 - (ii) have imports exceeding Rs.500 million during the tax year;
 - (iii) own total assets exceeding Rs.[350] million at the close of the tax year;
 - (iv) is single object company;
 - (v) maintain computerized records of imports and sale of goods;
 - (vi) maintain a system for issuance of 100% cash receipts on sales;
 - (vii) present accounts for tax audit every year;
 - (viii) is registered with Sales Tax Department; and
 - (ix) make sales of industrial raw material of manufacturer registered for sales tax purposes.]

(8) The tax collected from a person under this section on the import of edible oil [and packing material] for a tax year shall be [minimum] tax.]

(9) In this section –

“Collector of Customs” means the person appointed as Collector of Customs under section 3 of the Customs Act, 1969 (IV of 1969), and includes a Deputy Collector of Customs, an

Additional Collector of Customs, or an officer of customs appointed as such under the aforesaid section;

“value of goods” means the value of the goods as determined under the Customs Act, 1969 (IV of 1969), as if the goods were subject to *ad valorem* duty increased by the customs-duty, federal excise duty and sales tax, if any, payable in respect of the import of the goods.]

Explanation.- For the purpose of this section the expression “edible”, “edible oils” includes crude oil, imported as raw material for manufacture of ghee or cooking oil.]

153. Payments for goods and services. — (1) Every prescribed person making a payment in full or part including a payment by way of advance to a resident person or permanent establishment in Pakistan of a non-resident person—

- (a) for the sale of goods;
- (b) for the rendering of [or providing of services;
- (c) on the execution of a contract, other than a contract for the [sale] of goods or the rendering of or providing of services,

shall, at the time of making the payment, deduct tax from the gross amount payable at the rate specified in Division III of Part III of the First Schedule.

(1A) Every exporter or an export house making a payment in full or part including a payment by way of advance to a resident person or permanent establishment in Pakistan of a non-resident person for the rendering of or providing of services of stitching, dyeing, printing, embroidery, washing, sizing and weaving, shall at the time of making the payment, deduct tax from the gross amount payable at the rate specified in Division IV of Part III of the First Schedule.

(2) The gross amount payable for a sale of goods shall include the sales tax, if any, payable in respect of the sale.

(4) The Commissioner may, on application made by the recipient of a payment referred to in sub-section (1) and after making such enquiry as the Commissioner thinks fit, allow, by order in writing, any person to make the payment without deduction of tax.

(5) Sub-section (1) shall not apply to –

- (a) a sale of goods where –
 - (i) the sale is made by the importer of the goods;
 - (ii) the importer has paid tax under section 148 in respect of the goods; and
 - (iii) the goods are sold in the same condition they were in when imported;
- (b) a refund of any security deposit;
- (ba) a payment made by the Federal Government, a Provincial Government or a [Local Government] to a contractor for construction materials supplied to the contractor by the said Government or the authority;]
- (bb) a cotton ginner who deposits in the Government Treasury, an amount equal to the amount of tax deductible on the payment being made to him, and evidence to this effect is provided to the —prescribed person;]
- (c) the purchase of an asset under a lease and buy back agreement by a modaraba, leasing company, banking company or financial institution; or
- (d) any payment for securitization of receivables by a Special Purpose Vehicle to the Originator.

(6) The tax deducted under this section shall be a final tax on the income of a resident person arising from transactions referred to in sub-section (1) or (1A):

Provided that sub-section (6) shall not apply to companies in respect of transactions referred to in clause (b) of sub-section (1) [Provided further that this sub-section shall not apply to payments received on account of—

- (i) advertisement services, by owners of newspapers and magazines;
- (ii) sale of goods and execution of contracts by a public company listed on a registered stock exchange in Pakistan; and
- (iii) the rendering of or providing of services referred to in sub-clause (b) of sub-section (1):

Provided that tax deducted under sub-clause (b) of subsection (1) of section 153 shall be minimum tax.]

(6A) The provisions of sub-section (6) in so far as they relate to payments on account of supply of goods from which tax is deductible under this section shall not apply in respect of [a company] being a manufacturer of such goods.

(8) Where any tax is deducted by a person making a payment to a Special Purpose Vehicle, on behalf of the Originator, the tax is credited to the Originator.

(9) In this section, “prescribed person” means –

- (a) the Federal Government;
- (b) a company;
- (c) an association of persons [constituted by, or under,] law;
- (cc) a non-profit organization;
- (d) a foreign contractor or consultant;
- (e) a consortium or joint venture;
- (f) an exporter or an export house for the purpose of sub-section (1A) ;
- (g) an association of persons, having turnover of fifty million rupees or above in tax year 2007 [or in any subsequent tax year];
- (h) an individual, having turnover of fifty million rupees or above in the tax year 2009 or in any subsequent year.]

(11) “services” includes the services of accountants, architects, dentists, doctors, engineers, interior decorators and lawyers, otherwise than as an employee.

“sale of goods” includes a sale of goods for cash or on credit, whether under written contract or not.

“manufacturer” for the purpose of this section means, a person who who is engaged in production or manufacturing of goods, which includes-

- (a) any process in which an article singly or in combination with other articles, material, components, is either converted into another distinct article or produce is so changed, transferred, or reshaped that it becomes capable of being put to use differently or distinctly;
or
- (b) a process of assembling, mixing, cutting or preparation of goods in any other manner.]

154. Exports. — (1) Every authorized dealer in foreign exchange shall, at the time of realization of foreign exchange proceeds on account of the export of goods by an exporter, deduct tax from the proceeds at the rate specified in Division IV of Part III of the First Schedule.

(2) Every authorized dealer in foreign exchange shall, at the time of realization of foreign exchange proceeds on account of the commission due to an indenting commission agent, deduct tax from the proceeds at the rate specified in Division IV of Part III of the First Schedule.

(3) Every banking company shall, at the time of realization of the proceeds on account of a sale of goods to an exporter under an inland back-to back letter of credit or any other arrangement as prescribed by the [Board], deduct tax from the amount of the proceeds at the rate specified in Division IV of Part III of the First Schedule.

(3A) The Export Processing Zone Authority established under the Export Processing Zone Authority Ordinance, 1980 (VI of 1980), shall at the time of export of goods by an industrial undertaking located in the areas declared by the Federal Government to be a Zone within the meaning of the aforesaid Ordinance, collect tax at the rate specified in Division IV of Part III of the First Schedule.]

(3B) Every direct exporter and an export house registered under the Duty and Tax Remission for Exports Rules, 2001 provided in Sub-Chapter 7 of Chapter XII of the Customs Rules, 2001 shall, at the time of making payment for a firm contract to an indirect exporter defined under the said rules, deduct tax at the rates specified in Division IV of Part III of the First Schedule.]

(3C) The Collector of Customs at the time of clearing of goods exported shall collect tax from the gross value of such goods at the rate specified in Division IV of Part III of the First Schedule.]

(4) The tax deducted under [this section] shall be a final tax on the income arising from the [transactions referred to in this section].

113A. Tax on Income of certain persons. — (1) Subject to this Ordinance, where a retailer being an individual or an association of persons has turnover upto rupees five million for any tax year, such person may opt for payment of tax as a final tax at the rates specified in Division IA of Part I of the First Schedule.

(2) For the purposes of this section, —

(a) “retailer” means a person selling goods to general public for the purpose of consumption;

(b) turnover shall have the same meaning as assigned to it in sub-section (3) of section 113.

(3) The tax paid under this section shall be a final tax on the income arising from the turnover as specified in sub-section 1[(1)]. [The retailer shall not be entitled to claim any adjustment of withholding tax collected or deducted under any head during the year.

233. Brokerage and commission. — (1) Where any payment on account of brokerage or commission is made by the Federal Government, a Provincial Government, a [Local Government], a company or an association of persons constituted by, or under any law (hereinafter called the “principal”) to a person (hereinafter called the “agent”), the principal shall deduct advance tax at the rate specified in [Division II of] Part IV of the First Schedule from such payment.

(2) If the agent retains Commission or brokerage from any amount remitted by him to the principal, he shall be deemed to have been paid the commission or brokerage by the principal and the principal shall collect advance tax from the agent.

(3) Where any tax is collected from a person under sub-section (1), the tax so collected shall be the final tax on the income of such persons.

Clause (21) of Part III to the Second Schedule: In the case of any resident person engaged in the business of shipping, a presumptive income tax shall be charged in the following manner, namely:-

- (a) ships and all floating crafts including tugs, dredgers, survey vessels and other specialized craft purchased or bare-boat chartered and flying Pakistan flag shall pay tonnage tax of an amount equivalent to one US \$ per gross registered tonnage per annum; and
- (b) ships, vessels and all floating crafts including tugs, dredgers, survey vessels and other specialized craft not registered in Pakistan and hired under any charter other than bare-boat charter shall pay tonnage tax of an amount equivalent to fifteen US cents per tonne of gross registered tonnage per chartered voyage provided that such tax shall not exceed one US \$ per tonne of gross registered tonnage per annum:

Provided that the reduction under this clause shall not be available after the 30th June, 2020.

Explanation.- For the purpose of this clause the expression “equivalent amount” means the rupee equivalent of a US dollar according to the exchange rate prevalent on the first day of December in the case of a company and the first day of September in other cases in the relevant assessment year.”]

Tax Disputes System Design

Sheena Mookhey*

1. INTRODUCTION

Seminal dispute resolution theorists Ury, Brett and Goldberg said that: '[D]isputes are inevitable when people with different interests deal with each other regularly.'¹ Echoing this, the current Australian Commissioner of Taxation (the Commissioner), has recently said: '[I]n relation to the application of tax law to complex facts, some level of disputation is inevitable.'²

This paper considers the effectiveness of tax dispute resolution processes from a dispute systems design theoretical perspective. Specifically, this paper is divided into three parts. By way of background and in order to provide a context within which to analyse and evaluate, the first part summarises the goals and theoretical framework for dispute systems design, including the fundamental principles for 'best practice' in dispute systems design. The second part outlines the range of current processes available for resolving tax disputes between the Australian Taxation Office (the ATO)³ as one party, and a taxpayer as the other party. The third part performs an evaluation of those processes against the fundamental dispute systems design principles, and concludes that the ATO dispute resolution model possesses much of the best practice principles, although there are some deficiencies.

Given that tax disputes is a subject that has not been examined extensively by dispute resolution scholars, particularly not recently, the aim of this paper is to contribute to, and update, the existing knowledge. The relevance of this subject to dispute resolution in commerce is inherent in that tax impacts all commercial participants and segments, small to large.

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¹ WL Ury, JM Brett and SB Goldberg, *Getting Disputes Resolved*, Program on Negotiation at Harvard Law School (1993), xii.

² Commissioner of Taxation, *In search of solutions* (Speech to the Administrative Appeals Tribunal and the ACT Bar Association, Canberra, 26 August 2009).

³ Note that the ATO makes decisions in the name of the Commissioner.

2. DISPUTE SYSTEMS DESIGN THEORETICAL FRAMEWORK

Dispute systems design involves the design and implementation of a dispute resolution system, which is most commonly conceptualised as a series of procedures for dealing with the stream of disputes connected to an organisation or institution, rather than for an individual dispute or an individual procedure.⁴

A number of goals for dispute systems design are apparent from the literature. As Wolski⁵ summarises, the central goal is to reduce the costs associated with dispute resolution, where costs are measured by reference to four broad criteria: transaction costs (i.e. money, time and emotional energy expended in disputing), satisfaction with procedures and outcomes, long-term effect of the procedures on the parties' relationship and recurrence of disputes. Dispute systems design also aims to prevent disputes by improving the parties' capability to negotiate differences at a 'pre-dispute' level, that is, before differences escalate into disputes.

Three inter-related theoretical propositions are said to underpin dispute systems design.⁶ The first proposition is that dispute resolution procedures can be characterised according to whether they are primarily interests-based, rights-based or power-based in approach. Interests-based approaches focus on the underlying interests or needs of the parties with the aim of producing solutions that satisfy as many of those interests as possible. Rights-based approaches involve a determination of which party is correct according to some independent and objective standard. Power-based approaches are characterised by the use of power, that is, the ability to coerce a party to do something he or she would not otherwise do.⁷ Coming back to the underpinning theoretical propositions, the second proposition is that interest-based procedures have the potential to be more cost-effective than rights-based procedures, which in turn may be more cost-effective than power-based procedures. Accordingly, the third proposition is that the costs of disputing may be reduced by creating systems that are 'interests-oriented', that is systems which emphasise interests-based procedures, however recognise that rights-based and power-based procedures are necessary and desirable components.⁸

A number of principles have been put forward for 'best practice' in effective dispute systems design. This paper focuses on the six fundamental dispute system design principles put forward by the seminal theorists Ury, Brett and Goldberg in *Getting Disputes Resolved*.⁹

3. URY, BRETT AND GOLDBERG MODEL

The following section specifies the six fundamental principles of the Ury, Brett and Goldberg model and the elements of each principle in turn.

⁴ Generally, see Ury, Brett and Goldberg, n1 above, 21.

⁵ B Wolski, "The Model Dispute Resolution Procedure for Australian Workplace Agreements: A Dispute Systems Design Perspective", (1998), vol.10, no.1 *Bond Law Review* 1, 13.

⁶ *Ibid.*

⁷ Generally, see R Fisher, W Ury and B Patton, *Getting to Yes: Negotiating Agreement Without Giving In*, Penguin Books (1999, 3rd ed.), 4; Ury, Brett and Goldberg, n1 above, 7.

⁸ Ury, Brett and Goldberg, n1 above, 21.

⁹ Ury, Brett and Goldberg, n1 above.

Principle 1 - Create ways for reconciling the interests of those in dispute

By this, Ury, Brett and Goldberg mean:

- Establish clear negotiation procedures that are easy to follow and bring about negotiation as early as possible;
- Design multiple steps in the negotiation procedure, so that the progression to a ‘full-fledged’ dispute is slowed;
- Motivate use of the system by creating multiple points of entry, providing negotiators with necessary authority to implement a resolution and preventing retaliation against disputants;
- Ensure that there are people that disputants can turn to for help in respect of the negotiation procedures, including a mediator, and make certain that these people are adequately trained in the appropriate skills.¹⁰

Principle 2 - Build in “loop-backs” that encourage disputants to return to negotiation

By this, Ury, Brett and Goldberg mean:

- Where interests-based procedures do not resolve the dispute and it becomes a rights-based or power-based dispute, design loop-back procedures that allow the disputants time-out to re-assess their position before it becomes too entrenched;
- Examples in a rights-based dispute are information procedures in respect of outcomes of previously resolved cases, advisory arbitration or mini-trials;
- Examples in a power-based dispute are cooling-off periods or third-party intervention.¹¹

Principle 3 - Provide low-cost rights and power “back-ups”

By this, Ury, Brett and Goldberg mean:

- If interest-based negotiation breaks down, establish alternative procedures for providing a final resolution based on rights or power that are also low-cost;
- Examples in a rights-based dispute are conventional arbitration, final-offer arbitration and the hybrid mediation-arbitration procedure.
- Examples in a power-based dispute are voting, limited strikes and establishing rules of prudence in respect of utilisation of power.¹²

¹⁰ WL Ury, JM Brett and SB Goldberg, “Designing an Effective Dispute Resolution System”, (1988), October, *Negotiation Journal* 413, 415-421.

¹¹ Ury, Brett and Goldberg, n9 above, 421-423.

Principle 4 - Prevent unnecessary conflict through notification, consultation and feedback

By this, Ury, Brett and Goldberg mean:

- A party taking action likely to affect others should notify and consult them beforehand, so that points of difference can be identified and dealt with early and to prevent disputes;
- Allow for analysis and feedback after disputes to overcome systemic problems and to prevent disputes. This may occur at the organisational-level or through establishing a forum for discussion with parties, or by ombudsman or other external monitoring agencies.¹³

Principle 5 - Arrange procedures in a low-to-high costs sequence

By this, Ury, Brett and Goldberg mean:

- Provide clear alternatives to high-cost litigation early on in a dispute. This involves arranging the procedures outlined in the initial four principles in a low-high cost sequence;
- For example, interest-based negotiation would be followed by interests-based mediation and mediation by loop-back procedures and then low-costs back-ups.¹⁴

Principle 6 - Provide the necessary motivation, skills and resources to allow the system to work

By this, Ury, Brett and Goldberg mean:

- Specific motivation (such as mandatory processes) and training programs and technical assistance must be put in place and adequately sustained to maintain a properly working dispute resolution system.¹⁵

4. TAX DISPUTES

As may be expected, there are many intricacies in tax law and a plethora of rules governing its application and administration, what may be disputed, how, when and by whom. This paper does not set out to cover these issues, and it is not essential to do so in order to analyse tax dispute resolution processes - a simple acceptance that tax disputes occur is sufficient as a starting point. Nonetheless, a brief outline of the elemental concepts follows, which may be useful background for readers not conversant with tax.

¹² Ury, Brett and Goldberg, n9 above, 423-426.

¹³ Ury, Brett and Goldberg, n9 above, 426-427.

¹⁴ Ury, Brett and Goldberg, n9 above, 427-428.

¹⁵ Ury, Brett and Goldberg, n9 above, 428-429.

The ATO is a Federal Government statutory agency that operates under the *Public Service Act 1999* and the *Financial Management and Accountability Act 1997* and acts as the Federal Government's principal revenue collection agency. The Commissioner is the individual office responsible for the general administration of a wide range of tax laws (e.g. income tax, goods and services tax, fringe benefits tax) and is, effectively, the 'head' of the ATO.¹⁶

Taxpayers are entities (e.g. individuals, trusts, corporations) that have obligations, liabilities and entitlements under the tax laws administered by the ATO.

Tax disputes may arise at any stage after the ATO has provided a view to a taxpayer in respect of a tax liability or entitlement and related issues, and the taxpayer takes a contrary view. Given the self-assessment regime, tax disputes principally arise from the ATO's review and audit activities.¹⁷ Tax disputes typically come within four categories:

- a. Complaints;
- b. Objections to private binding rulings given to taxpayers on tax-related issues by the ATO;
- c. Disputes as to facts or the application of tax law by a taxpayer as matters are being assessed by the ATO; and
- d. Objections to assessments of liability to tax.¹⁸

Categories (b) and (d) generally refer to statutory rights, while categories (a) and (c) relate to administrative due process.¹⁹

5. ATO DISPUTE RESOLUTION MODEL

The current processes available for tax dispute resolution in Australia is comprehensive and essentially consists of four layers: the ATO (internal), the Commonwealth Ombudsman (external, administrative), the Administrative Appeals Tribunal (the AAT) (external, administrative) and the courts (external, judicial). Alternative Dispute Resolution (ADR) and the Taxpayers' Charter²⁰ are supplemental features. The processes are illustrated in the following figure:

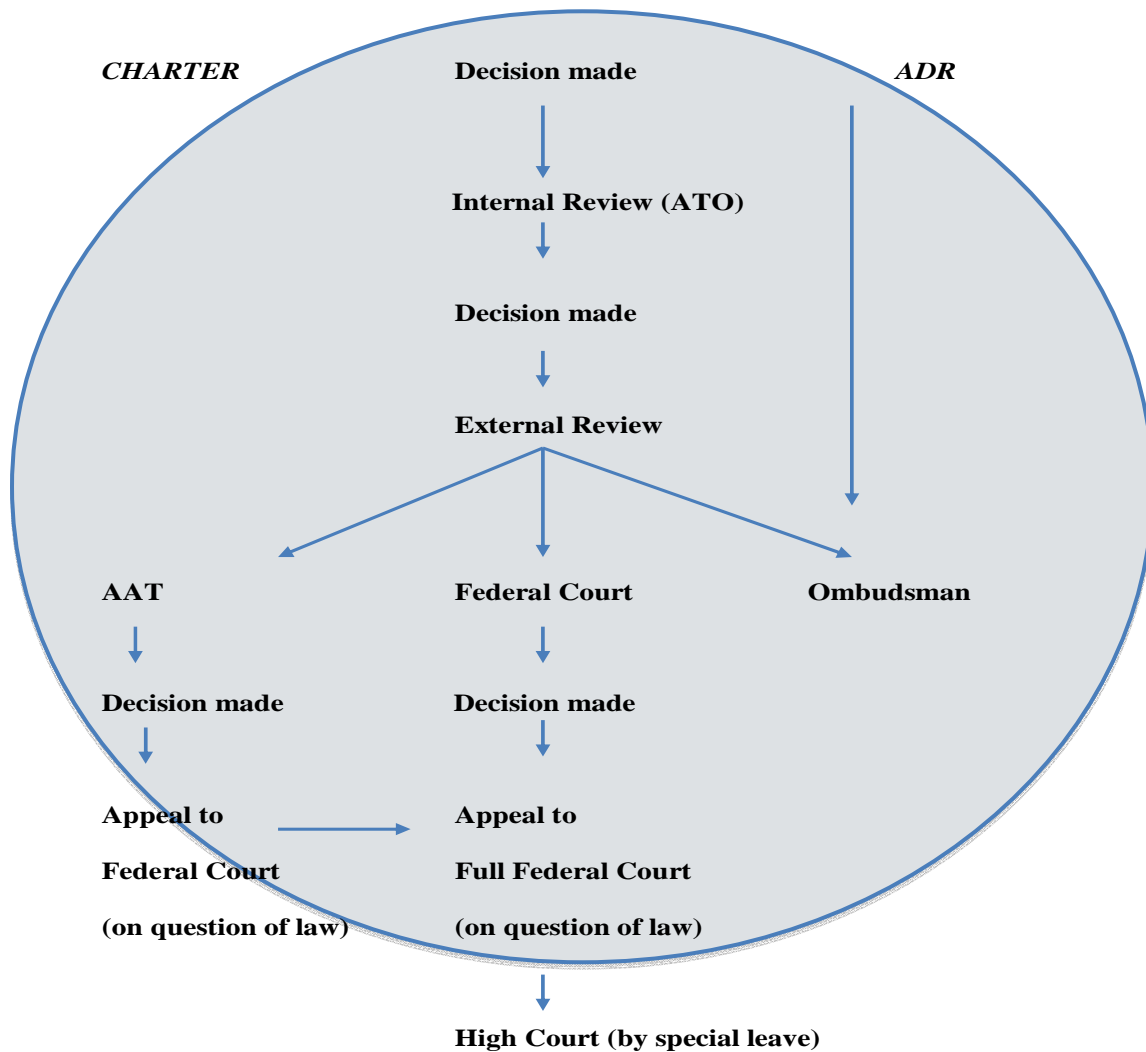
¹⁶ Commissioner of Taxation, Annual Report 2010-2011, 2011.

¹⁷ Australian Taxation Office, *Your case matters 2012: Tax and superannuation litigation trends*, Edition 2, 2012, 4.

¹⁸ Commissioner, n2 above.

¹⁹ Ibid.

²⁰ Australian Taxation Office, *Taxpayers' charter: What you need to know*, as at June 2010.



The following section provides an overview of each of the processes. Again, this overview is at a high-level, given the intricacies.

Internal review and Taxpayers’ Charter

The Taxpayers’ Charter is a document that outlines the rights and obligations and the service and other standards taxpayers can expect from the ATO. It should be noted that the Taxpayers’ Charter creates no new rights, but it contains many rights which are legally enforceable either through existing legislation or through common law principles, which would be applied or upheld by the courts.²¹

Taxpayers can expect the ATO to:

- treat them fairly and reasonably, and as being honest in their tax affairs unless they act otherwise;

²¹ Ibid.

- respect their privacy, keep the information it holds about them confidential and give them access to information it holds about them, in accordance with the law;
- offer professional service and assistance to help them to understand and meet their tax obligations, and make it easier for them to comply;
- give them advice and information they can rely upon and be accountable for what it does;
- accept that they can be represented by a person of their choice and get advice about their tax affairs;
- explain to them decisions it makes about their tax affairs;
- respect their right to a review and to make a complaint.²²

As set out in the Taxpayers' Charter, the ATO will generally provide a written or oral explanation for its decisions and taxpayers may also seek a free, written statement of reasons for certain types of decisions²³ under the *Administrative Decisions (Judicial Review) Act 1977 and Freedom of Information Act 1982*. The ATO also provides contact details for the original ATO decision-maker and informs the taxpayer about their obligations, rights and the specific review processes available in relation to the decisions made.

At a taxpayer's request, the ATO will also review any of its decisions and actions taken in relation to that taxpayer and attempt to resolve any points of difference quickly and informally. Reviews are conducted by an independent ATO officer that did not make the original decision.²⁴

There are some additional ATO internal review offerings specifically available for the 'top end of town' – namely, independent review of position papers for large market audit cases and specific issues resolution programs for professional tax advisors.²⁵

A taxpayer may also lodge a complaint with the ATO via various mediums (online, Freefax, written, dedicated ATO complaints telephone line).²⁶ The ATO's complaints handling process conforms with the *Australian Complaints Handling Standard*, the Commonwealth Department of Finance and Administration's *Client Service Charter Principles* and the Commonwealth Ombudsman's *Guide to Complaints Handling*.²⁷ Broadly, it entails attempting to have complaints directly resolved with the original ATO decision-maker or their manager. Where the complaint cannot be resolved at this point, the ATO offers an internal complaints service, independent of the business areas, known as the Problem Resolution Service.

²² Ibid.

²³ Prescribed.

²⁴ Taxpayer' Charter, n20 above; Australian Taxation Office, *Guide to correcting mistakes and disputing decisions*, as at 3 July 2012.

²⁵ This is known through the author through work experience.

²⁶ Ibid.

²⁷ Commonwealth Assistant Treasurer, *The Inspector-General of Taxation in the Taxation System Consultation Paper*, 2002, 27.

Finally, a taxpayer dissatisfied with assessments or certain types of other decisions²⁸ made by the ATO may also challenge the decision in accordance with the formal objection procedures in Part IVC of the *Taxation Administration Act 1953*. Again, the objection is reviewed by an independent ATO officer.

Ombudsman

The role and powers of the Commonwealth Ombudsman (the Ombudsman) are set out in the *Ombudsman Act 1976*. The Ombudsman's office includes a specialist team concerned with the ATO²⁹ and can also use the title Taxation Ombudsman.³⁰

Broadly, the Ombudsman may investigate a complaint made to it by a taxpayer in relation to a range of administrative actions taken by the ATO and the ATO's complaints handling process applied in respect of a taxpayer's complaint. Generally, the Ombudsman will not investigate complaints where it determines that the taxpayer has not given the ATO the opportunity to attempt to rectify the perceived problem in the first instance.³¹

The Ombudsman considers the ATO processes, rather than the details of the taxpayer's particular circumstances, and makes recommendations to the ATO regarding rectification or other actions. The Ombudsman can be used to ask questions on a taxpayer's behalf through its information gathering powers.³²

AAT and judicial route

The Assistant Treasurer recently remarked: 'the ATO has sole responsibility for interpreting tax laws at first instance (for the purposes of administering those laws), while the Courts are the final arbiters.'³³

A taxpayer dissatisfied with decisions relating to assessments or penalties, or objection decisions, may seek judicial determination of the matter in the Federal Court of Australia (Federal Court) or the AAT in accordance with the formal review and appeal procedures in Part IVC of the *Taxation Administration Act 1953* (Part IVC proceedings), and bears the burden of proof in doing so. A taxpayer can also apply to have decisions of the ATO reviewed by the Federal Court under the *Administrative Decisions (Judicial Review) Act 1977* on certain grounds.³⁴

Broadly, the AAT performs a merit review of administrative decisions and is able to affirm, vary or set aside and substitute the decision under review, whereas the Federal Court determines the dispute according to the law and the existing rights of the parties. The Federal Court only has limited power to intervene where there has been an exercise of discretionary power by the Commissioner, and can confirm or vary the decision.

²⁸ Prescribed.

²⁹ As one of the Commonwealth Government agencies it is empowered to investigate.

³⁰ Consultation Paper, n27 above, 31.

³¹ Ibid.

³² ATO guide, n24 above.

³³ Commonwealth Assistant Treasurer, *Address to Tax Forum* (Speech, Canberra, 5 October 2011).

³⁴ Prescribed.

A taxpayer or the ATO can appeal to the Federal Court from a decision of the AAT on a question of law in a Part IVC proceeding, or the AAT itself may refer questions of law in a Part IVC proceeding before it to the Federal Court, under of the *Administrative Appeals Tribunal Act 1975*. A further appeal to the Full Federal Court may be made against a decision of the Federal Court, and then ultimately to the High Court of Australia (by special leave).

Apart from the above, a taxpayer or the ATO may seek an injunction, declaration or other kind of relief under the *Judiciary Act 1903* (and State and Territory equivalent acts), although this is rarely used in tax disputes.

ADR

ADR is an umbrella term for processes, other than judicial determination, in which an impartial person assists those in dispute to resolve the issues between them.³⁵ Some (including the Commissioner³⁶) also use the term ADR to include approaches that enable parties to prevent or manage their own disputes without outside assistance.

The ATO, like other Federal Government agencies, is obliged to act as a model litigant under the Attorney-General's *Legal Service Directions*.³⁷ The model litigant obligation requires the ATO to endeavour, where possible to avoid, prevent and limit the scope of legal proceedings including by giving consideration in all cases to ADR before initiating legal proceedings and by participating in ADR where appropriate. The requirement to consider ADR is a continuing obligation from the time the litigation is contemplated and throughout the course of litigation.³⁸

To the extent that the ATO is a party to civil proceedings in the Federal Court, it is also required to file a genuine steps statement in relation to actions taken, or not taken, to resolve the dispute prior to commencing proceedings under the newly effective *Civil Dispute Resolution Act 2011*.³⁹ Furthermore, both the Federal Court and the AAT may also direct the ATO to participate in certain ADR proceedings.⁴⁰ The AAT in particular has a routine practice of referring all matters before it to a conference.

To comply with the abovementioned requirements, in PS LA 2007/23⁴¹ the Commissioner has instructed ATO staff with a role of management of tax disputes that they must consider whether it would be appropriate to participate in some form of ADR. PS LA 2007/23 covers the following issues at a very high-level:

³⁵ National Alternative Dispute Resolution Advisory Council, *Dispute Resolution Terms*, 2003.

³⁶ Commissioner of Taxation, *Practice Statement Law Administration PS LA 2007/23*, 2007, para 21.

³⁷ Commonwealth Attorney-General's Department, *Legal Services Directions 2005*, 2005, Appendix B.

³⁸ *Ibid.*

³⁹ Sections 6 and 7; Part 4.

⁴⁰ Section 34A *Administrative Appeals Tribunal Act 1975*; Section 53A *Federal Court of Australia Act 1976*.

⁴¹ PS LA 2007/23 n22 above, para 8. Note that Practice Statements are ATO internal documents that provide the Commissioner's instruction to ATO staff on what policies and guidelines they must followed in respect of tax law administration matters, and are publicly available pursuant to freedom of information law.

- hallmarks of when the ATO's participation in ADR is appropriate;
- types of ADR, choice of ADR practitioners and costs of ADR;
- confidentiality and admissibility of communications made during ADR;
- guidelines for ATO attendance and drafting of documents in the course of ADR.

The basis for the ATO's settlement of tax disputes is set out in the Code of Settlement Practice.⁴² In this, the Commissioner takes the view that the settlement of tax disputes in appropriate circumstances is consistent with the good management of the tax system and the best use of the ATO resources. However, the ATO cannot negotiate liability on a commercial basis, and must settle on a 'principle' basis (i.e. what is the tax liability). Accordingly, the Code of Settlement Practice includes a comprehensive list of circumstances where it would be generally inappropriate for the ATO to settle (for example, where the outcome of the settlement would be contrary to an articulated ATO policy reflected in the law).⁴³

There are no further guidelines on the ATO's conduct obligations with respect to ADR, nor a model or standard template for conduct.⁴⁴ The ATO has indicated in other forums⁴⁵ its preference for a differentiated approach based on the nature of the tax dispute.

6. EVALUATION AGAINST CRITERIA

Moving onto the crux of this paper, how does the ATO disputes resolution model measure up against the Ury, Brett and Goldberg model? Here it is emphasised that the focus is the effectiveness of the design of the current ATO model according to the Ury, Brett and Goldberg model, rather than the ATO's effectiveness in resolving disputes in practice or related matters, or the history and evolution of the ATO model. ATO dispute prevention processes are also not canvassed.

Effectiveness against principle 1 - Create ways for reconciling the interests of those in dispute

The ATO dispute resolution model meets the broad requirements of this principle.

The first point to make is that there are clear procedures established for dispute resolution and the information the ATO provides around the procedures is substantial and easy to understand, catering to the diverse profiles of taxpayers (what is complex is the underlying tax law and bases for dispute). A good example of this is the *Guide to correcting mistakes and disputing decisions*,⁴⁶ although the 'ATO approach to dispute resolution' webpage has plenty of other guides and other publications concerning dispute resolution processes and related issues. As mentioned above, the

⁴² Australian Taxation Office, *Code of settlement practice*, as at 23 December 2011.

⁴³ Code of settlement practice, n42 above, para 25-26.

⁴⁴ Note that there is, however, a model settlement template.

⁴⁵ For e.g. Commissioner n2 above.

⁴⁶ ATO guide, n24 above.

ATO informs the taxpayer of their rights and specific review processes available in relation to decisions made. There is also a structured framework for ATO's conduct, namely, the Taxpayer's Charter, PS LA 2007/23, Code of Settlement Practice and PS LA 2009/9.⁴⁷

As Bentley also points out,⁴⁸ the formal hierarchical process of the ATO model provides specifically for a multi-step process, however, on the other hand, the ATO model does not provide for multiple entry points to the process at the first level. Although, there is the ability to enter at different levels, there are not many informal stages in the ATO model and entry at a subsequent level escalates the progression of the dispute, rather than slowing progression.

The ATO model encourages direct negotiation with the ATO itself (i.e. without outside assistance) in the first instance, however its internal review and complaints handling processes allow taxpayers to turn to an independent ATO officer, other than the original decision-maker. Although, there has been some concerns raised regarding the independence of the internal review aspect in that the reviewing officer may be located in the same business area as the original decision-maker.⁴⁹ The ATO has recognised this issue as a risk, however ultimately dismissed the concerns and disagreed with the Inspector-General of Taxation's recommendations to establish a separate internal appeals function.⁵⁰ It is suggested that such a separate appeals function would be in accordance with the Ury, Brett and Goldberg's commentary around motivation to use a dispute system. However, given that the ATO has disagreed with the Inspector-General of Taxation's recommendations, this is, essentially, a 'moot point'.

As mentioned above, the ATO also allows taxpayers to seek external assistance and be represented by professional advisors.

There is also a framework for ADR in tax disputes, as outlined above. However, whether the ATO will participate in ADR, and what form of ADR, is the decision of the ATO and there is no obligation set out in PS LA 2007/23 for the ATO to provide an explanation to a taxpayer for a decision not to participate in ADR. The consensus also appears to be that ADR has generally been employed sparingly, and during litigation rather than during the earlier dispute stages.⁵¹ As such, it will not always be the case that the taxpayer can turn to an ADR practitioner, as is the requirement of the Ury, Brett and Goldberg model.

⁴⁷ Commissioner of Taxation, *Practice Statement Law Administration PS LA 2009/9*, 2009. This deals with the ATO's conduct of litigation.

⁴⁸ D Bentley, "Problem Resolution: Does the ATO Approach Really Work", (1996), vol.6, no.1 *Revenue Law Journal* 17, 39.

⁴⁹ Inspector-General of Taxation, *Review into the Australian Taxation Office's use of early and Alternative Dispute Resolution: A report to the Assistant Treasurer*, 2012, 100.

⁵⁰ IGT, n49 above, 107-108.

⁵¹ IGT, n49 above, 9.

Effectiveness against principle 2 - Build in “loop-back” procedures that encourage disputants to return to negotiation

The ATO dispute resolution model provides for loop-backs to negotiation in that the ADR options are (theoretically) available at each level and third-party intervention in form of the an independent ATO review officer or Ombudsman is also available, depending on the type of dispute. Particularly where there is no further recourse to the courts (in most tax disputes involving process), the emphasis on a negotiated outcome is implicit in the ATO model (this is reflected in the Taxpayers’ Charter in particular).⁵²

It is worthy of note that the Inspector-General of Taxation has recommended that the ATO replicate AAT conferencing protocols, whereby the ATO directly conferences with the taxpayer prior to commencement of formal proceedings, as a mandatory procedure.⁵³ The ATO has agreed ‘in principle’ with this recommendation for large and complex cases, although it is not clear how it will be adopted and to what extent, in terms of the ATO procedures.⁵⁴ If adopted, this would serve as a further loop-back procedure.

Positively, the ATO model also allows for loop-forward processes. That is, there is the ability to move straight from the informal to more formal procedures without having to go through all the mechanisms.⁵⁵

Similarly, there is a degree of flexibility in that taxpayer can choose which procedures to use (as the taxpayers have the burden of proof in tax disputes). Although, the ATO model does not allow for multiple-parallel options, other than complaining to the Ombudsman in tandem with pursuing other recourses. This too is limited, as the Ombudsman may only intervene in certain types of tax disputes or aspects of tax disputes, and the Ombudsman requires internal review to have occurred beforehand.

However, a significant impediment to negotiation is the abovementioned settlement restrictions the ATO must adhere to. The above discussion regarding the ATO’s participation in ADR is also relevant here.

Effectiveness against principle 3 and 5 - Provide low-cost rights and power alternative procedures and arrange procedures in a low-to-high costs sequence

It makes logical sense to deal with principles 3 and 5 together.

A problem with the ATO dispute resolution model is that the procedures are apparently sequential, but the upfront costs would not differ greatly whether the negotiations were with the original ATO decision-maker or reviewing officer, or conducted for the taxpayer by the Ombudsman, in an ADR setting or court setting –

⁵² Bentley, n48 above, 40.

⁵³ The IGT wording is “to consider, and if appropriate, engage in”.

⁵⁴ IGT, n49 above, 39-42.

⁵⁵ Ibid.

from the taxpayer's perspective, it would be necessary to have their position worked out and require substantial input/costs to do this from the outset.⁵⁶

Also, given the ATO's abovementioned settlement restrictions and that the taxpayer bears the burden of proof, depending on the type of tax dispute and the profile of the taxpayer, taxpayers will often move straight to the apparently higher-cost, rights-based procedures due to the belief that it would be necessary to do this in any case to reach a definitive outcome.

Again, depending on the type of dispute and profile of the taxpayer, taxpayers would most likely also engage a professional advisor from the outset given the complexity of the tax law. Professional advisor fees, if incurred, would represent the bulk of explicit costs to taxpayers.⁵⁷

It is also noteworthy that it is well-recognised in the literature on tax compliance costs that the implicit costs (i.e. opportunity costs of time) and psychological costs (stress, frustration and anxiety) are also high at all levels.⁵⁸

So, in short, the cost difference between the levels then essentially comes down to the type of dispute, the profile of the taxpayer, whether a professional advisor is engaged and, if recourse to the courts is available, the differences in application/filing costs between the AAT or Federal Court. For a small taxpayer, there may be a noticeable increase in costs at each level particularly if they do not engage a professional advisor and pursue informal procedures or recourse to the AAT. However, rather than increasing the pressure for a negotiated outcome at an early stage, this may rather form a deterrent for small taxpayers pursuing tax disputes at all and therefore a barrier to social justice.⁵⁹ For large taxpayers, whatever the minimal difference in costs to them between the levels is unlikely to increase the pressure for a negotiated outcome and deciding which recourse to pursue is most likely to be a strategic-based and commercial decision rather than costs-based.

Effectiveness against principle 4 - Prevent unnecessary conflict through notification, consultation and feedback

Notification is built into the ATO dispute resolution model. As the Taxpayers' Charter reflects, various conduct obligations require the ATO to clearly stipulate its decisions and what actions it is taking in relation to a taxpayer's affairs, and provide an explanation of its reasons, including the primary sources and factual information on which these are based. As mentioned above, the ATO informs the taxpayer of their compliance obligations in relation to decisions made, and must adhere to certain timeframes around notification.

⁵⁶ Bentley, n48 above, 40.

⁵⁷ B Tran-Nam and M Walpole, "Independent Tax Dispute Resolution and Social Justice in Australia", (2012), vol. 35, no.2 *UNSW Law Journal* 470, 488.

⁵⁸ Tran-Nam, n58 above, 487, 489-490.

⁵⁹ Tran-Nam, n58 above, 487-489, 491-492, 492-498.

Although not a feature of the ATO model per se, other ATO initiatives such as the Compliance Program (where the ATO details its ‘target areas’ and planned compliance activities for the forthcoming year) and Decision Impact Statements (where the ATO sets out its views and implications for taxpayers, in a broader sense, following discrete litigation outcomes) serve as a form of notification. The ATO’s wider shift in focus to a ‘risk differentiation framework’ for classifying taxpayers and invitation for taxpayers to make voluntary disclosures in the course of ATO compliance activities⁶⁰ also allow identification of issues and points of difference in the pre-dispute stage.

Consultation is implicit in the ATO model as most ATO interaction with taxpayers and/or their professional advisers in the lead-up to the making of a decision involves exchanges of information, views and often, informal discussion/meetings.⁶¹ Consultation also occurs at a systemic level through consultative forums established by the ATO such as the National Tax Liaison Group, which recently established a Dispute Resolution sub-committee.

However, to point out some flaws, when dealing with internal reviews and complaints, there is usually no further consultation between the original ATO decision-maker and the taxpayer, but the original ATO decision-maker may stay involved with the taxpayer on an ongoing basis (rather than a new ATO officer being appointed to the taxpayer), which can contribute to conflict escalation rather than to the resolution of differences between the ATO and the taxpayer.⁶²

An impediment to proper consultation (particularly for small taxpayers) may lie in the complexity of the tax law and the language used and that most tax disputes involve a range of issues of fact and law, including alternative positions. The negative perceptions and behavioural attitudes of taxpayers and their advisors (who are generally trained in adversarial and rights-based justice and present a ‘third-party’ problem) towards the ATO⁶³ is also problematic. It is suggested that in order to achieve this facet of the Ury, Brett and Goldberg model, these points need to be addressed via other strategies such as improved communication to ensure taxpayers understand the nature of the ATO’s concerns and understanding of the facts and generally adopting and promoting a policy of open and informal information sharing with taxpayers.

Feedback certainly occurs at a systemic level though things like the abovementioned consultative forum and the ATO’s own internal monitoring system.⁶⁴ There is also evidence of systemic analysis in ATO publications such as *Your Case Matters*⁶⁵ and the ATO annual report (which includes a separate section on litigation and disputes).

⁶⁰ ATO guide, n24 above.

⁶¹ Bentley, n48 above, 38.

⁶² Ibid.

⁶³ M Burton, “Responsive Regulation and the Uncertainty of Tax Law: Time to Reconsider the Commissioner’s Model of Cooperative Compliance?”, (2007), vol.5, no.1 *eJournal of Tax Research* 71, 92 and 98.

⁶⁴ It is apparent that the ATO maintains an internal monitoring system of sorts through various minutes and publications, however the details and output of the monitoring system are not publically available.

⁶⁵ *Your Case Matters*, n17 above.

The Ombudsman through its annual reporting mechanism (which includes a separate section on the ATO) and Inspector-General of Taxation reviews⁶⁶ are also examples of systemic feedback and analysis.

However, what is significantly missing from the ATO model is a formal procedure for obtaining feedback from taxpayers as parties to tax disputes.⁶⁷ ‘Micro-level’ feedback of this kind would provide information on substantive issues (i.e. ‘what is happening inside the room’) and therefore allow better evaluation of the effectiveness of the ATO model and reform, in accordance with the accepted dispute resolution research protocol.⁶⁸

Effectiveness against principle 6 - Provide the necessary motivation, skills and resources to allow the system to work

Mandatory processes are not feature of the ATO dispute resolution model, although the ATO is bound by the abovementioned model litigant obligations and genuine steps statement requirements. The ATO is also intending to update the Taxpayers’ Charter to state that: ‘the ATO will consider avenues for dispute resolution, including ADR, in appropriate circumstances.’⁶⁹

The ATO’s cultural commitment to, and focus on, dispute resolution is certainly evident from a variety of recent speeches,⁷⁰ publications⁷¹ and initiatives - most notably, the abovementioned National Tax Liaison Group Dispute Resolution sub-committee, as well as the ATO’s commitment to put in place a ‘Dispute Management Plan’ in accordance with recent National Alternative Dispute Resolution Advisory Council recommendations to all Federal Government agencies.⁷²

However, there has been a lot of criticism levelled at the day-to-day ATO officers’ capability to engage in meaningful and effective dispute resolution.⁷³ Positively, in response to this, the ATO has recently committed to enhancing the skills of personnel via specific dispute resolution training initiatives.⁷⁴

⁶⁶ The Inspector-General of Taxation is an independent statutory office responsible for identifying systemic tax administration issues and reports to the Commonwealth Treasury with recommendations for improvement. The Inspector-General is not concerned with individual taxpayers or matters. Relevantly, the Inspector-General just completed a review into the ATO’s use of early and alternative dispute resolution; see IGT, n49 above.

⁶⁷ Bentley, n48 above, 38.

⁶⁸ National Alternative Dispute Resolution Advisory Council, *ADR Research: A resource paper*, 2004, 34-35.

⁶⁹ IGT, n49 above, 42.

⁷⁰ E.g. Commissioner, n2 above.

⁷¹ E.g. ATO dispute resolution webpage.

⁷² National Tax Liaison Group Dispute Resolution Sub-Committee, *Minutes May 2012 Meeting*, 2012; National Alternative Dispute Resolution Advisory Council, *Managing Disputes in Federal Government Agencies: Essential Elements of a Dispute Management Plan*, 2010.

⁷³ IGT n49 above, 45-47.

⁷⁴ *Ibid*; see also Minutes, n70 above.

7. CONCLUSION

Overall, the ATO dispute resolution model supports its assertions that it's eager to seek to resolve disputes with taxpayers. Certainly, it is apparent that the ATO is no straggler in disputes resolution systems design with its model possessing much of the best-practice principles advocated by the Ury, Brett and Goldberg model such as clear, multi-step procedures and emphasis on negotiation, notification and consultation. Further improvement to the ATO model should come with the specific dispute resolution training initiatives for ATO personnel.

Nonetheless, there are some deficiencies in the ATO model that require reform. In particular, reforming the ATO model so that there is an increase in transaction costs at each level and affordable access to first-level external review is highly desirable, so as to increase the pressure for a negotiated outcome at an early stage. Receiving feedback from taxpayers as parties to tax disputes is also desirable. Exploration of viable, practical options for such reform is a future area for research.

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The use of discretions in taxation: the case of VAT in Bangladesh

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Abstract

Discretion is an inevitable part of bureaucratic action and tax discretion is positioned between the tax authority's immediate concern for maximizing revenue and the wider concern for good governance. Striking a balance between the conflicting concerns is more challenging in developing countries than in others. The paper explores the extent of tax discretions in the context of Value Added Tax (VAT) in Bangladesh. Based primarily on documentary analysis, the paper adopts a social science perspective to argue that the discretionary powers in the Bangladesh VAT regime infringe taxpayers' rights to certainty, transparency and fairness and hence they require an effective control mechanism for confining, structuring and checking these discretions. The paper also argues that besides striking a balance between the revenue authority's discretion and the rule of law, the administrative discretionary behaviour of the revenue authority needs to be streamlined by the social control that entails a paradigm of good governance as well as by specific written guidelines.

Keywords: Bangladesh, tax discretion, corruption, value-added tax, social control, good governance

1. INTRODUCTION

Among different executive branches of the state, it is taxation where the use of discretionary power by the tax authority spawns strong feelings as well as grievances among taxpayers. Though it is admitted in literature 'that tax discretions should be treated as an integral part of the legal system and judged to the same – if not higher – standards of legitimacy as other forms of administrative law' (Cogan 2011:4), many tax administrations seem to have been entangled in the paradox of discretion, or, in the problem of deciding the boundaries or the breadth of discretion to be allowed (Freedman and Vella 2011).

Grappling with this paradox is particularly challenging in developing countries like Bangladesh where the immediate concern for maximizing tax revenue to fund the ever increasing demand to finance the government's expenditure sometimes outweighs the far reaching concern for good governance in general and rule of law in particular. The situation becomes further compounded with the perennial presence of corruption in different parts of the public sector in developing countries in general and in tax administration in particular; tax administration in developing and transitional countries is believed to be more vulnerable to corruption than many other public service departments (Le 2007). The corruption scenario takes on another dimension with the presence of excessive discretions.

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Bangladesh is one of the first two South Asian countries that adopted VAT in 1991 by replacing the age old 'excise'¹ duty on the domestically produced goods and services and sales tax at the importation stage with the express aim to 'to expand the tax base, simplify the tax collection procedure and curb the tax evasion' (Government of Bangladesh 1991a).

Allegedly characterized by the presence of undue and excessive discretionary powers vested in the tax administration by the primary and secondary legislation, Bangladesh's VAT has caused a great deal of grievances amongst taxpayers since its inception. Among the tax issues that have attracted wide media coverage are key stakeholders' complaints, specifically business people about excessive tax discretions which surely figure more prominently than others.

Given the wide ramifications of excessive and uncontrolled discretions in Bangladesh's VAT regime and that no academic study of this phenomenon has so far been done, the aim of the present paper is to investigate, in the context of VAT in Bangladesh, the level of discretion accorded the executive branch of government including the tax administration. Essentially explorative in nature, the study attempts to consider discretionary powers from the social science perspective in terms of decision goals and decision process (Hawkins 1992) as impacting the principles of good governance such as transparency, accountability and certainty. Rather than considering the relationship of discretion with the conceptions of justice or rule of law, which is the domain of jurisprudence, an attempt has been made in the paper to explore social problems that uncontrolled or excessive discretions can create in the tax jurisdiction of a developing country.

Based primarily on documentary analysis and secondary sources of data, the remainder of the paper has been organized as follows. The first section will provide a brief contextual background that will consequently touch upon the conceptual framework of discretion in general and tax discretion in particular with reference to the literature. The second section will attempt a careful study of the state of discretionary powers in the VAT domain to fit the primarily legislative elements into the wider framework of simplicity and transparency. The third section provides an analysis of those discretions in the light of available literature, and the final section provides some concluding remarks.

2. BACKGROUND: CONTEXT AND CONCEPT

2.1 VAT in Bangladesh

Prior to the introduction of VAT, Bangladesh had an enduring legacy of excise taxes characterized by some disadvantageous features such as cascading and presumptive taxation. In addition to the overarching goal of improving the country's poor tax to GDP ratio to a satisfactory level, VAT was introduced. With a very poor tax-GDP ratio² and a tax structure overwhelmingly dependent on indirect taxes, Bangladesh

¹ As opposed to a selective tax, as it is known internationally, the excise duty in Bangladesh was a kind of sales tax.

² The tax-GDP ratio in Bangladesh is 8.96% (NBR 2011) which is one of the lowest in the world and lower than the average 14.9% of the low income countries (Keen, M. and A. Simone (2004). Tax Policy in Developing Countries: Some Lessons from the 1990s and some Challenges Ahead. Helping

obtains the lion's share of its tax-revenue from VAT. VAT including supplementary duty³ presently accounts for 56.85% of the total tax revenue and 5.09% of GDP (NBR 2011).

As in many other tax administrations in different countries, in Bangladesh, the presence of excessive discretionary powers in the tax laws has been a butt of criticism as well as grievances from the business quarter. The grievances manifested especially during the series of consultative meetings that the National Board of Revenue (NBR), the apex body for tax policy and implementation, held with different stakeholders prior to the annual budget. For example, in a recent meeting with the NBR, the Federation of Bangladesh Chambers of Commerce and Industry (FBCCI), the country's peak representative organisation representing the interest of the private sector in trade and industry, proposed the reduction of discretionary powers of VAT officials in a bid to ensure hassle-free business (Financial Express 2012). FBCCI particularly expressed its concern over VAT officials' excessive power to search and seize conveyances carrying VAT-able goods.

Not only business bodies, the general taxpayers and civil society members have also expressed their concern over the tax office's discretionary power (Financial Express 2010). As a result of the growing concern over this issue, the Finance Ministers of different governments in Bangladesh have pledged to reduce tax officials' discretionary powers in their budget speeches. For example, in the FY 2005-06 budget speech, the Finance Minister mentioned the reduction of discretionary powers of tax officials along with measures to ensure transparency and dynamism in tax administration as a major reform measure (Government of Bangladesh 2005). The same commitment to further reducing administrative and liability discretion of tax authorities appeared in the budget speeches in the following period. In the most recent budget speech (FY2012-2013), the Finance Minister mentioned limiting the discretionary powers of tax officials as one of the fundamental principles of revenue collection (Government of Bangladesh 2012).

2.2 Discretion and tax discretion

The use of discretions as a central and inevitable part of the legal system as well as a feature of decision-making process has been a contested issue. There are a host of arguments for and against the use of discretion both in judicial and administrative laws. While Hawkins (1992) regarded discretion as a "central and inevitable part of the legal order", Davis (1969, cited in Hawkins 1992) regarded discretion as the major source of injustice. Advantages and disadvantages of the use of discretion with reference to both legal jurisprudence and bureaucracy have been quite widely discussed in the literature on discretion. While some consider the relationship between rules and discretion as opposing entities (e.g. Davis) some others (e.g. Dworkin) refuted the supposed dichotomy between rules and discretion; Dworkin's metaphor for discretion as 'the hole in the doughnut' - discretion like the hole in the doughnut, does not exist except as an area left open by a surrounding area of restriction' - (1977b:31 cited in Sainsbury 1992) implies that discretion is in fact bounded by rules. Here

Countries Develop: The Role of Fiscal Policy. S. G. e. al. Washington, D.C., International Monetary Fund.

³ Supplementary duty is an excise-like selective tax imposed by VAT Act. VAT alone accounts for 39.45% of tax revenue.

emerges the argument that ‘the use of rules involves discretion, while the use of discretions involves rules’ (Hawkins 1992:12). Though in the Weberian bureaucracy there is no room for discretion in decision-making, later scholars have recognized that discretion is an inevitable part of bureaucratic action (Feldman 1992).

Discretion has been defined by scholars in numerous ways. All definitions, more or less, posit discretion as the power or right to make official decisions using reason and judgment to choose from among acceptable alternatives. Despite considerable agreement on defining discretion as well as its inevitability prompted by ‘vagaries of language, the diversity of circumstances and the indeterminacy of purposes’ (Galligan, cited in Hawkins 1992:11), what is actually a contested area, is the boundary of discretion- both in judicial and administrative laws. Admitting the need for some discretion for officials, Davis advocated the use of precise rules to confine discretion when it is too broad. As protection against arbitrariness he argued for discretion to be checked and scrutinized by another. As in other areas of law, there needs to be a balance between legitimate needs for the exercise of discretion by the revenue administration and the equally legitimate interests and rights of taxpayers (Cogan 2011:4).

The literature on discretion reveals different levels of the use of discretion:

- Discretion in the interpretation of rules and their application;
- Discretion as the space between legal rules in which legal actors may exercise choice (Hawkins 1992);
- Discretion explicitly granted by rules for decision-making by an authority; and
- Discretion embedded in rules (Harlow and Rawlings, 1984, cited in Sainsbury 1992).

Galligan (1986) argued that the use of discretionary powers is increasing in the modern state. He attributed the following reasons to the increased use of discretionary powers:

- In order to have comprehensive control in areas of welfare, the economy and the environment, diffusion of a wide range of powers among a variety of officials is necessary;
- Many regulatory undertakings have to be handled by specialist authorities who may not perform them through a rigid rational framework.

On the other hand, in most of the good governance and anticorruption discourses, administrative discretionary power has been seen as an element that curtails transparency and hence contributes to corruption. For example, ‘undue’ administrative discretion and lack of transparency have been seen as contributing to corruption by the Commonwealth Secretariat (2000) and hence, the elimination of the use of discretionary authority in tax administration has been advanced as policy reform agenda. In the same vein, the corruption formula devised by the American economist Robert Klitgaard (1988) shows discretion as a major factor of corruption:

$$\text{Corruption} = \text{Monopoly} + \text{Discretion} - \text{Accountability}$$

This formula clearly highlights the general perception that the higher the rate of discretion in decision-making coupled with higher monopoly and lower rate of accountability, the broader the corruption potential.

Tax discretion thus can be seen from this point of view also. It is argued that tax administrations in developing and transitional countries are more vulnerable to corruption (Le 2007)⁴ than many other branches of the state machinery. Researchers have attributed the generally more tangible presence of corruption in tax administrations, particularly in those of developing countries, to their complex tax and trade regimes including multiple discretionary exemptions, confusing and non-transparent procedures for tax compliance and excessive discretionary power of tax inspectors (Le 2007; Zuleta, Leyton et al. 2007). In this context, it has remained a matter of debate to what extent the tax administration should be given discretion and how the paradox of discretion will be balanced.

Admitting the inevitability of administrative discretion as what he calls a necessary evil, Dillman (2002) argued that though discretion appears to be antithetical to a rule-based democracy, it is essential for making democratic practices responsive and effective. This paradox of discretion, he suggests, can be resolved through striking a balance between discretionary powers and their exercise within certain constraints that include political, organizational and cultural realities coupled with professional and ethical standards. Tax discretions, as noted earlier, are no exception. Given that effective and efficient operation of revenue authorities requires a certain amount of discretion, it is equally important that discretions used for efficient collection of taxes do not negate or undermine the taxpayers' rights and interests. Hence, the critical question that faces scholars as well as politicians is: how to strike a balance between revenue authority discretions and the principles of good governance in general and the rule of law in particular?

Against this background, the following section will investigate the level of discretionary powers in VAT, which, as far as revenue is concerned, is the most important area of the tax regime in Bangladesh. In the course of analyzing the findings, the answer to the question, posed above, in the context of Bangladesh will emerge.

2.3 Discretionary powers in Bangladesh VAT

Committed to the principle of the rule of law as well as equality before law, Bangladesh operates under the doctrine of separation of powers with separate legislative, executive and judicial powers vested respectively in the Parliament, the Executive Government and the Judiciary. The Parliament has the fundamental power to impose tax as, according to Article 83 of the Bangladesh Constitution, 'No tax shall be levied or collected except by or under the authority of an Act of Parliament'. And within the framework of the constitutional provision, it is through express legislation of Parliament that a great deal of authority has been delegated to executive Government including the tax authority.

⁴ Though Le (2007) argued that surveys in developing and transitional countries indicate that revenue administration agencies are typically the most corrupt public institutions, in the case of Bangladesh, Transparency International Bangladesh survey has so far not ranked the revenue administration as one of the first few most corrupt departments.

Discretionary powers have been granted by the Value Added Tax Act, 1991 (henceforth the VAT Act) (Government of Bangladesh 1991b) to three sets of actors as follows:

- The Government⁵ represented by the Internal Resources Division under the Ministry of Finance;
- NBR, the apex body for the formulation and implementation of tax policy;
- VAT officials at different hierarchical levels.

The functions of these three sets of actors overlap with each other. While the VAT officers act as the agents of the Government and the NBR, the functions of the Government and the NBR differ only in the procedure of discharging their responsibilities. The first two actors are in fact two facades of the same body⁶ reinforcing the argument that in developing countries, tax administration is tax policy (Casanegra de Jantscher 1990).

In terms of the contents of discretions, there are essentially three types of discretions granted to the above mentioned actors:

- Discretions to produce secondary legislation and to sub-delegate powers to VAT officers, granted to both the Government and NBR. This type of discretion includes the power to grant tax concessions;
- Specific administrative and liability discretions granted to the Government and the NBR;
- Specific administrative and liability discretions granted to VAT officers.

The delegation and exercise of discretionary powers in Bangladesh's VAT thus can be looked at from two levels: the organization and the individual.

⁵ Though the word 'government' has been used throughout the VAT legislations, it has not been defined. But practices suggest that the word 'government' refers to the executive branch of the government and specifically to the division of the Ministry that is responsible for tax policy formation and its implementation.

⁶ According to the Rules of Business, the functions of the government are carried by a ministry or a division. On the other hand, National Board of Revenue, the apex authority for collection of all tax revenue in the country, is an attached department of Internal Resources Division under the Ministry of Finance. While a division is a self-contained administrative unit responsible for the conduct of business of the Government in a distinct and specified sphere, an attached Department means the department which has direct relation with a Ministry/Division [Government of Bangladesh (1996). Rules of Business. C. Division. Dhaka, Cabinet Division.]. The difference between NBR and the government is quite indistinct as the secretary of the Internal Resources Division (IRD) is the ex-officio chairman of the Board which comprises four members from the indirect tax wing and four members from direct tax wing. In addition to its main responsibility of formulating and implementing tax policy, NBR performs all the functions and exercise the powers vested in the government by various tax laws. The structure and the functions of NBR clearly vindicates the proposition that in developing countries, tax administration is tax policy (Moore, M. (2007). *How Does Taxation Affect the Quality of Governance?* IDS Working Paper 280. Brighton, Institute of Development Studies).

2.3.1 Organisation Level

Delegation of legislative power to the government and the revenue authority is quite common in many countries. Research shows that within the framework of the rule of law, the parliament makes policy decisions and assigns policy guidelines to the executive (Dourado 2011; Walpole and Evans 2011). In the case of Bangladesh, legislative competences as well as specific discretionary powers has been delegated to the Government and the revenue authority.

Government's discretionary powers

Among the discretionary powers that the Government enjoys under the VAT Act in Bangladesh, the following are prominent:

- Power to exempt any goods and service from VAT and/or supplementary duty; (s 147)
- Power to write-off any Government dues when it can be ascertained that the dues cannot be realized; (s 71ka)
- Power to determine the goods on which VAT will be assessed on the basis of the maximum retail price as printed on the packet of the goods [s 5(3)].

NBR, the revenue authority

The most important delegation of powers bestowed on the tax authority is authorizing the NBR to produce secondary legislation. Section 72 of the VAT Act confers to the NBR the power to make rules 'for carrying out the purposes of this Act'. Within the limits of not breaching the generality of the legal provision laid down in the primary legislation, the NBR has the power to make rules on a wide range of areas that include determination, assessment, and collection of VAT. In exercising this power, the NBR produced the Value Added Tax Rules, 1991 (Government of Bangladesh 1991c) and a number of other special rules, Statutory Regulatory Orders (SROs) and general orders (see Hossain 2010). In addition to the overwhelming power to make rules, the NBR has been granted a number of specific powers in the VAT Act. Prominent among them are as follows:

- Power to exempt any goods or services for any special purpose [s 14(2)];
- Power to determine the threshold for VAT registration [s15];
- Power to determine the rate and amount of value addition in respect of goods and services at the retail stage [s5(2)];
- Power to impose VAT on services based on the specific rate of value [S 5(4)];
- Power to impose a tariff on any goods for assessment of VAT [s 5(7)];
- Select goods or services for withholding and advance payment of VAT [s 6(4)];
- Use of banderol or stamp for any goods [s 6(4)];
- Determine the turnover threshold and bring any goods or services under the VAT regime, irrespective of their turnover (s 8).

The above examples show that the scope of delegation of powers to the Government and the revenue authority is much wider than that in many other countries.

⁷ All references to sections in this paper are to the sections in the VAT Act.

2.3.2 Individual Level

VAT officials have been granted enormous discretionary powers both under the VAT Act and the VAT Rules. The most prominent discretion that the Bangladesh VAT officers enjoy is their power to adjudicate offences committed under VAT law. Drawn heavily from the excise regime, this power is popularly known as a quasi-judicial power of VAT officers. Adjudication power is conferred on all VAT officers except an assistant revenue officer on the basis of the limit of the value of goods and services related to the offence. As adjudicating officers, they have the discretion to impose a penalty, in case of evasion, of up to two and a half times the amount of payable tax. Among other discretions that different levels of VAT officers in Bangladesh exercise, the following are noteworthy:

- A commissioner has the power to grant an exemption of VAT to any goods that fall within the given criteria of a cottage industry;⁸
- A commissioner has the power to issue an order for supervised clearance for any goods if he has reasons to believe (emphasis added) that it is required [s 26kha(1)] and determine the amount of payable tax for a tax period on the basis of a single verification [s26kha (4)];
- A commissioner of VAT has the power to fix, suo moto, for any reason he considers fit the base value of any goods on which VAT will be calculated (Rule 3, VAT Rules);
- A VAT divisional officer has the power to grant a VAT registration on being fully satisfied and also to give forced registration to a taxable business on being satisfied (s15);
- An officer not below the rank of an assistant commissioner has the power to order a sale verification if he thinks that it is needed to determine the input-output coefficient or the sale price has been suppressed [s 35(3)];
- Under Rule 3 of the VAT Rules, a VAT divisional officer has the power to revise a declared price if it appears that the declared price is-
 - inconsistent with the provision of the Act
 - significantly lower than the price of similar goods
 - significantly low due to some relationship between the buyer and the seller; and
 - amount of value addition is significantly low.

The judgment of ‘inconsistency’, ‘significantly low’ or ‘low’ is, however left to the VAT officer’s discretion for no parameters for the exercise of this judgement have been prescribed in the VAT Act.

Besides the above examples, a reading of the complete list of discretionary powers in the VAT Act and the VAT Rules and orders made under it, unequivocally shows that they are pervasive. The discretions are either explicit or implicit. The reference to the requirements of “necessary”, “essential”, “exceptional”, “reasonable” or “satisfactory” found in those discretions nevertheless empower the officers with significant freedom to manoeuvre (Harlow and Rawlings, 1984, cited in Sainsbury 1992) in making their administrative decisions in the realm of VAT.

⁸ According to an SRO (No. 168-Law/2003/376-VAT dated June 12, 2003), a VAT commissioner has the power to grant exemption from paying VAT to certain businesses defined as cottage industry.

3. EXERCISE OF DISCRETIONS: SOME INSTANCES AND THEIR (POSSIBLE) CONSEQUENCES

Having laid out the wide scope of discretions conferred on the executive branch by the VAT Act and Rules, we can now turn to examine a selection of the use of discretions by different actors.

3.1 Government's extra statutory power to grant tax concession

The Government in the exercise of the powers conferred under section 14 of the VAT Act to exempt any goods or services from VAT has issued as many as 36 Statutory Regulatory Orders (SROs)⁹ which deal with different general and specific exemptions, listing the goods, services or persons entitled to exemptions at different stages of business transaction. These exemption SROs supplement the list of VAT-exempt goods and services appended to the primary law as the First Schedule. This means, in order to find out the taxability of a good or service in the Bangladesh VAT regime, one will have to go through not only the First Schedule of the VAT Act but also all the exemptions set out in the SROs.

3.2 Assessment of VAT on the basis of printed retail price

By exercising the power conferred in section 5(3) of the VAT Act to assess VAT on goods on the basis of their retail price at the production level, the Government initially included seventeen items which has now been reduced to two, namely cigarette and disinfectants. The provision in section 5(3) of the VAT Act allows a cascading method of calculation of VAT. For example, if the MRP is Taka 100, then VAT payable at the manufacturing level is TaKa 15 (Taka 13.04 as would have been derived from a backward calculation). So the MRP equals the manufacture's share of Taka 85 plus VAT Taka 15, which means Taka 15 has been realized as VAT on a selling price of Taka 85 therefore the VAT rate increases to 17.65% instead of the statutory rate of 15%. Though in this instance, the problem is not so much with the exercise of discretionary powers as with the legal provision itself, the Government's decision to resort to this method of calculation was challenged in the Supreme Court by a multinational footwear manufacturer in 1998.¹⁰

3.3 NBR's power to assess VAT on the basis of tariff value and truncated base

The "strong"¹¹ discretionary power that NBR derives from the law, enables it to fix a tariff value for the assessment of VAT for any goods, or, a truncated base for any services. In line with the best international practice, there are two statutory rates of VAT in Bangladesh: 15% for all goods and services for home consumption and 0% for all goods and services to be exported and deemed-exported from the country. But by dint of its discretionary powers, NBR issued an SRO entitled "Determination of

⁹ Total number of SROs, issued as gazette notifications either by the government or by the Board in exercise of their discretionary powers, is more than 600. Many of them, though, have been cancelled or repealed or substituted by others over the period of last twenty years.

¹⁰ It has been known through personal communication with a VAT official that the case is still pending with the High Court Division of the Supreme Court.

¹¹ According to Dworkin, there are two types of discretion: strong and weak. While strong discretion implies creating one's own standards for judgment, weak discretion involves interpreting a given standard in order to apply it (cited in Galligan Galligan, D. J. (1986). *Discretionary Powers: A Legal Study of Official Discretion*. Oxford Clarendon Press).

VAT on the basis of actual rate of value addition Rules, 2010". Arising from that statutory regulatory order, as many as nine other effective rates, namely 1.5%, 2.25%, 3%, 4%, 4.5%, 5%, 5.0025%, 5.5% and 6% have emerged due to different tax bases enumerated in the VAT Rules. For example, the rate of VAT for construction services is 4.5% as the VAT assessment is done on the basis of 30% of the total receipt, i.e. $30 \times 15\% = 4.5\%$. Similarly, NBR's power to fix a notional value for the assessment of VAT yielded glaring examples of presumptive taxation in Bangladesh VAT. The presumptive elements which are particularly responsible for Bangladesh VAT being called a 'so-called VAT' or 'excise/turnover tax' are not only discriminatory but also have an adverse effect on the coherence of the modern tax (Saleheen 2012).

3.4 Commissioner's power to assess on presumption

Section 26kha incorporated in the VAT Act in 2006 empowers a Commissioner of VAT to use his/her discretionary power to determine the minimum amount of sale, amount of value addition, base value for tax payable or amount of payable tax for the supplier of taxable goods or taxable service in question. The presumption described in this provision entails that the assessment of VAT liability that will be based on relevant information of a similar taxable good or service rather than on the taxpayer's actual sale. No explanation in black and white other than 'for public interest' has ever been provided to the taxpayers in defense of presumptive taxation. Nor does the legislation spell out under what circumstances this kind of presumptive taxation should be preferred over taxation according to the actual assessment of the tax base.

3.5 VAT officer's power to re-determine value of goods

The VAT Rule 3 empowers the authority to re-determine the value of the relevant goods for imposition of VAT on any of the following grounds: (i) the declared base value is inconsistent with the provisions of section 5 of the Act, (ii) the declared base value is less than the base value of similar goods or goods of same nature and quality in the same jurisdiction or any other jurisdiction; and (iii) the extent of value addition as shown in Form 'Musak-1' is significantly low.

Though some limits have been set in the exercise of this power, the discretion is quite 'strong'. Particularly, determining 'the extent of value addition being significantly low' depends on the discretion of the VAT officer as there is no specified standard amount or rate of value addition for a particular product. The issue of value declaration and its approval seems to be the most troubling as well as controversial area in VAT at least for a number of reasons. Firstly, in a sharp departure from the standard principle of valuation in VAT, VAT officers have power to resort to notional valuation rather than transaction price. Secondly, the process of value declaration and its revision by VAT officers is a long drawn out process which could end up in re-determining the value with retrospective effect along with a substantial fine and penalty. In the second case, one very crucial principle of tax law design - the principle of non-retroactivity - is undermined.

3.6 Power to interpret the law

It has already been noted earlier in the paper that one important aspect in the exercise of discretionary powers is the interpretation of rules and their application. Unlike the discretion conferred on Her Majesty's Revenue and Customs in the United Kingdom to interpret the law, the primary legislation of VAT, i.e. the VAT Act does not give the Government or the Board any power to interpret law. In contrast, the VAT Rules made by the NBR under the authority derived from the VAT Act has granted both itself and the Commissioners powers to issue orders, notification, explanation or circular on ensuing matters of their jurisdiction. This power has yielded a good number of explanatory orders, circulars and letters some of which have been alleged to be contradictory to one another (Financial Express 2009).

4. ANALYSIS

To begin with the nature of discretions, it can be said that the discretion granted to the Government and the NBR is ultimate as they are not subject to review other than by their own volition. On the other hand, the discretions used by the officers are provisional as they are subject to review and possible reversal by another official (Hawkins, 1992). In another dimension, most of the discretions are "strong" as the parameters for applying them, either by the organization or by individuals, are not clearly defined or standardized or published.

Though all these discretions are legitimate in so far as they are drawn from both primary and secondary legislation, there has been strong criticism from many stakeholders for the inclusion of excessive discretionary powers in tax laws in general and VAT law in particular. Despite repeated ministerial pledges to reduce tax discretions and the resultant actions to curtail discretionary powers of tax officials, the extent of discretionary powers is still wide enough to create uneasiness among the taxpayers as far as transparency in applying tax rules and their certainty are concerned. As undue and excessive discretionary powers with their concomitant unpredictability, inconsistency and unfairness are seen as potential threats to the wider framework of good governance, tax discretions in VAT in Bangladesh have been decried by different segments of stakeholders since the inception of VAT in Bangladesh in 1991. In response to this kind of criticism, as noted earlier, Finance Ministers have been seen to make a promise to reduce tax officers' administrative discretion almost in each of their past budget speeches (see for example, Government of Bangladesh 2005; Government of Bangladesh 2008).

It is generally argued in the literature that discretion itself is not as unacceptable as the lack of a control mechanism for the exercise of that discretion (Freedman and Vella 2012). In the case of Bangladesh VAT, there is an ostensible lack of a control mechanism for the exercise of administrative discretion, which tends to infuse a great deal of arbitrariness in the application of laws and rules. For example, as noted earlier, a VAT officer has the power to increase the value of a product if it appears to him/her that amount of value addition in the product under consideration is significantly low. But there is no written standard of value of this addition in respect of the goods.

By contrast, tax administrations in many developed countries, for example, the Australian Tax Office (ATO 2004), have written guidelines to guide officers in the exercise of the statutory discretion contained in their tax laws. But, the potential for arbitrariness that negates the spirit of the rule of law (Dicey, 1885, cited in Freedman

and Vella, 2011) is amply evident in the VAT Act and Rules in Bangladesh. Looking at the pervasiveness of the discretionary powers especially on the Government's blanket power to exempt any goods or services from VAT and NBR's power to produce rules, the balance between discretionary powers and the rule of law appears to be tilted towards the former. This bias towards the use of discretionary powers by the Government to some extent explains the fact that the Members of the Parliament (MPs) do not have a significant role in the formulation of the country's annual budget, especially the formulation of tax measures (Sirajuzzaman 2012). This pattern corroborates the fact that despite Parliament being the formal supreme law-making institution, the Government, with its unbridled discretionary powers monopolizes the legislative process from initiation to approval (Rahman 2007).

In addition to adversely contributing to the imbalance between the revenue authority discretions and the rule of law, the use of discretions causes certain other social impacts.

First, the relationship between discretion and corruption is well established. Though there are no empirical studies, the general perception is that a great deal of corruption in the Bangladesh tax administration emerges from the misuse and abuse of discretionary powers. This applies both to organizational and individual discretions.

Second, undue and excessive use of discretionary powers infringes taxpayers' rights. Especially, some of the explicit officials' discretions such as determination of value for the assessment of VAT and determination of tax liability on the basis of presumptive methods clearly violate the core principle of VAT self assessment. The taxpayers' grumbling over the discretionary powers given to tax officials who are widely accused of abusing such powers not only to harass the former but also to benefit themselves frequently makes newspaper reports in Bangladesh (The Daily Star 2011).

Third, the extensive powers of the Government and the Board to produce secondary legislation have complicated the whole legal and administrative framework of VAT in Bangladesh. Though Schneider suggests (cited in Hawkins 1992) the more complex the rule the greater the discretion available to individual decision-makers in its interpretation and application, the reverse proposition i.e. discretionary powers can make the rule complex seems to be equally true. In the case of Bangladesh's VAT, the volume of secondary legislation in the form of SROs, Rules, General Orders, and Notifications is vast. Many taxpayers and VAT practitioners allege that to find a valid legal provision on a certain matter is tantamount to wandering in a maze (Financial Express 2010) comprising a plethora of rules, orders and notifications of which some are still valid, some rescinded and some substituted by others.

Last but not the least, the use of discretionary powers in tax law has prompted much litigation. Litigation filed by aggrieved taxpayers has been identified as a serious bottleneck in the collection of tax revenue in Bangladesh. According to the statement placed before the Parliament in 2010, litigation impeding the collection of different taxes has blocked the revenue flow amounting to Taka 1200 billion¹² (GOB 2010a).

¹² This figure is about 20% of the tax revenue collected in FY 2009-10.

Of this amount, VAT at domestic stage alone accounts for Taka 428 billion (GOB 2010b). It is usually believed by the insiders in VAT administration as well as many stakeholders that many of these cases owe their origin to the excessive discretionary powers of the VAT officials (Financial Express 2010).

4.1 Trends towards strengthening the rule of law in taxation matters

Despite the predominance of discretionary powers in the decision making process in Bangladesh's VAT, there are a couple of encouraging trends. First, Bangladesh's VAT law grants the taxpayers – existing or potential – the right to appeal against any decision of any VAT officer. The first step of the appeal process is limited to departmental ambit: appeal to Commissioner (Appeal) in case of a decision given by an officer below the rank of a Commissioner, and appeal to VAT Tribunal in case of an appeal against the decision of a Commissioner. After exhausting the departmental appeal procedures, the aggrieved can go to a court of law.

The second emerging trend is that the tax authority has realized the imperative for gradually reducing excessive discretions in VAT law as well as their negative impacts. As a result, since the late 90s there has been a trend to gradually reduce administrative discretion conferred on VAT officers. In most budget speeches, curtailing discretionary powers of tax officers has been mentioned in the same breath with ensuring simplicity and transparency and curbing corruption. As a combined effect of stakeholders' criticism and the tax authority's realization of the importance of reducing administrative discretionary powers, some powers such as power to enter business premises, seize a conveyance carrying VAT-able goods and imposing penalties in departmental adjudication have been curtailed with some measures to regulate their exercise. Although with the passage of time since the introduction of VAT in 1991, a number of discretionary powers of the field officers have been reduced and brought under some control mechanism, those vested in the Government and the NBR have remained as wide as before. A reading of the draft of new VAT law posted in the NBR website, however, reveals that there has been a conscious attempt to drastically reduce organizational and individual discretion.

5. CONCLUSION

The foregoing discussion shows that the gamut of administrative discretion in Bangladesh's VAT is not only broad but the discretions themselves are also "strong". The impact of the array of administrative discretion ranges from infringing taxpayers' rights such as self-assessment under the law being replaced by presumptive methods of taxation from discriminating between different segments of taxpayers to providing tax officials with opportunities for indulging in potential corrupt practices. Specifically, the present extent of discretionary powers at both organizational and individual levels in Bangladesh's VAT stands as a stumbling block to a transparent and accountable tax system. This scenario can be described as what Davis regarded as a substantial amount of unnecessary discretion threatening the proper application of policy (cited in Hawkins 1992). It is inevitable for any administrative law system to run with some discretion, even within the framework of the rule of law. Tax law is no exception. While the provision to exercise discretion is often essential for achieving the desired outcome of an administrative decision, 'the more discretion built into the system the more chance there is for disagreement as to how it is exercised, and the

more opportunity there is for favouritism and corruption to occur' (ICAC 1995:104). Corruption and unethical behaviour, poor administrative practice, and inconsistent decision making are some of the consequences of unbridled discretion. This aspect needs to be paid special attention to in tax jurisdictions like Bangladesh which are more vulnerable to corruption than others. Moreover, besides the tangible negative consequences of undue discretions, improper exercise of discretion affects all stakeholders as it weakens the integrity of the system, and involves the loss of public trust and faith. This is another dimension to take into consideration for the sake of fostering fair taxation culture in jurisdictions where healthy tax culture is only in a formative stage.

The uniqueness of situation, as some scholars like Handler argue, warrants discretion as its flexibility can be turned to the advantage of social justice (cited in Hawkins 1992) but cannot be a defence for the pervasiveness of discretion in taxation. On the other hand, applying discretions to a set of similar situations can give birth to inconsistent decisions causing discrimination among the taxpayers. Given the excessive and pervasive presence of discretionary powers at different levels of administration currently existing in Bangladesh's VAT law, replication of some international best practice will be worth considering.

Enormous power of the Government and NBR to produce secondary legislation, without any reference to the Parliament, in the form of SROs and other orders, affecting tax liability of taxpayers in particular and other stakeholders' economic decisions in general, has to be regulated in order to ensure certainty and predictability of the system.

In order to prevent discretions from degenerating into arbitrariness as has often been alleged in the Bangladesh revenue context, 'confining, structuring and checking of discretionary power' (Davis, cited in Hawkins 1992:17) is essential at all levels. The confining, structuring and checking of discretionary powers requires a couple of commitments. First, the discretionary behaviour in the decision-making process as a social rather than individual process can be streamlined by some social control (Feldman 1991). This social control obviously entails a paradigm of good governance in the state of affairs as a whole. Given that Bangladesh ranks poorly in the global good governance index (Mahmud, Ahmed et al. 2008), and its taxation system is alleged to lack good governance qualities (Prothom Alo 2012), it is imperative that the tax policy and implementation be infused with good governance principles such as participation, transparency and accountability. Second, as for individual discretionary powers, there must be some written guidelines, especially for applying liability discretion. A guideline may contain principles such as: (i) decisions are based on material that can be logically demonstrated; (ii) reasons are given for decisions; (iii) power is used for the proper purpose; and (iv) a certain action is done with integrity, competence, tolerance and in the public interest (Ombudsman 2006). This guideline, is practiced in many developed countries' tax jurisdictions in exercising discretionary powers and will ease the situation to a great extent and improve administrative practice. Better still, they could be used as tools for making the concerned officers accountable for their action. Moreover, the control mechanism is not only essential but also a prerequisite for gaining and retaining the trust of the taxpayers in the tax system in order for it to be effective and efficient.

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