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AN INVESTIGATION OF WAYS OF TAX NON-COMPLIANCE: THE CASE OF SMALL BUSINESS SECTOR IN PAKISTAN

Abstract

This study aims to identify different ways committed by taxpayers of Pakistan to avoid and evade tax. It is also aimed to determine the association between different ways pertaining to avoidance and evasion of tax. The data was collected through survey using five point Likert scale. Descriptive analyses, cumulative normal distribution, factor analysis, correlation technique and central limit theorem are applied to analyze the collected data. Data analysis reveals that different ways pertaining to avoidance and evasion of tax are correct at 100% probability level and significantly associated with each other.

Keywords: Taxation, Central Limit Theorem, Non-compliance, Small Business.

Introduction

Government sources are basically depending upon the amount of taxes paid by the taxpayers to tax authorities, if people will try to escape the amount of taxes through illegal or legal means then a large amount of tax is lost and government becomes unable to provide the required perquisites to general public due to shortage of funds (Reynolds, 1963), and people undergo through a process from escaping from tax, termed as tax non-compliance which normally categories into tax avoidance and evasion.

Conceptual distinction between avoidance and evasion of tax depends on taxpayers' actions. Tax evasion is widely considered as criminal action, violation of law or illegal activity. In tax evasion, taxpayers try to refrain from reporting their taxable income which they earned from legal source of earnings, and continuously engaged in illegal activity but always worries about the fear of detection of crime held by them. Faseun (2001) recognized the failure to file return to tax authority as a most common type of evasion of tax. In this type, taxpayers do not want to pay tax because they are already victim of different thoughts such

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as: government will not spend this amount for the benefit of general public; they are very poor and unable to meet their expenses; lack of sense of responsibility etc. Evader of tax may be sent to court for criminal offences and resultantly they are punished with time imprisonment, penalties, and fines for tax evasion.

Similarly, Sosanya (1981) observed that tax evasion has made a favorite crime for people and armed robbery has become like minority interest. Now, this crime is spreading so extensively at national level due to the existence of cash economy with vast proportion and taxpayer has no control over it. Instead, tax avoidance is considered as a legal activity held within legal framework of law. In tax avoidance, tax payers create ambiguity in treatment of tax in order to reduce the liability e.g. taxpayers convert their revenues as capital incomes because the tax rate levied on capital incomes is low from tax rate levied on revenues or labor incomes. Another distinction is that taxpayers do not feel the fear of detections held by them because they provide the complete statements of transactions ensuring the reduction in tax which they desired.

Tax avoidance is considered as a legal activity aimed to save tax but on the other hand tax evasion is rated as illegal, immoral, outright or violation of law in which different means are used in order to escape from tax. Farayola (1987) recognized tax-evasion as concealment of figures, misrepresentation, dishonest or fraudulent activity which is undertaken in order to reduce amount of tax or avoiding the payment of tax. It is also considered as criminal act or deliberate action of commission or omission. Acts regarding commission or omission includes: failure to answer queries; overstating expenses; documenting fictitious transactions; understating income; clamming relief; omission of items from returns; failure to submit returns; and failure to pay tax.

Tax avoidance occurs when taxpayers try to pay least amount of tax and settle their financial affairs in such manners that they do not interfere with legal rules and it also consisted of different strategies that are adopted for saving tax. Kiabel (2001) reported that this term can be shortly used to signify those devices or activities that taxpayers use in saving amount of tax as well as hiding actual income of taxpayers which they earned from legal means. A case law of David M. Ritchin and Ayrshire Pullman Motor Services vs. Inland Revenue Commissioner clearly captured the tax avoidance meaning when Lord Clyde held that:

"No man in this country is under the smallest obligation moral or otherwise so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow and quite rightly to take every advantage, which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is in like manner entitled to be astute to prevent so far as he honestly can the depletion of his means by the Revenue".

Here case law clarified that avoidance of tax is legal activity because taxpayers use same tax laws in order to limit their liabilities. Some examples of tax avoidance in Pakistan are: excess of expenses over income; seeking professional advice; illiteracy of tax calculation; one person is bearing the burden of whole family; absence of social responsibility; and do not maintain adequate records, etc. Slemrod and Yitzhaki (2002) also examined the tax avoidance behavior of

taxpayers. He argued that actions of tax avoidance cannot be changed the consumption basket – consumption of leisure – of individuals and this act create discrimination in real substitution responses. He also developed an operational definition of tax evasion which is very much different from simple definition that focused on intention of lawmakers and also told that tax avoidance is an action which consists of unintended-consequence of tax policy.

Moreover, tax officials estimate the effects of change in tax amount on actual revenues with an assumption of constant tax foundations. But the demand of tax payment reduces as the rate of tax increases; therefore, officials can easily estimate the effect of change in amount of tax on actual revenues so that demand effect can be classified as avoidance. This definition easily explores the distinction in tax avoidance in shape of demand and supply effect through relative price effects. But there is no need to bother about this distinction because perception of people differs from each other like it is very difficult for some people to distinct morally between tax avoidance and evasion. For example, a poor man tries to hide his income and violates the law. On the other hand, a rich man hires a tax lawyer and then tries to violate law. In both of the cases, morally both are trying to violate the law and their actions are different from each other but this borderline should kept in mind while reviewing theoretical literature whether the action of taxpayer is legal or illegal, although, a basic assumption is that taxpayers hide their incomes from tax collector and it's a violation of law because taxpayers tried to hide their taxable income from tax collector which they earned from different legal sources. Therefore, they are held responsible for punishment from tax authorities.

Pakistan is currently going through tax avoidance and evasion. Due to global crisis and increase in tax rate, however, most of the people do not pay tax by adapting or adopting illegal ways and some people do not report their actual taxable income to tax officials in order to avoid paying tax. Therefore, this step is undertaken with a view to examine that what are different ways that taxpayers use in order to avoid or evade paying tax to relevant tax authority.

1.1 Significance of the Study

This study is important as it provides an initial step in understanding the different ways used by taxpayers in tax avoidance and tax evasion. Further, the tax officials may take advantage of the findings of this study and can develop an efficient and effective tax system which could minimize the ways pertaining to tax avoidance and evasion.

This study is structured in such a way that introduction is followed by literature review, theoretical background, research methodology, finding/results, conclusions, and limitations of the study along with future prospects and policy implications.

Literature Review

Hove and Hove (2016) conducted study to explore the causes for tax avoidance and evasion in Zimbabwe. Data was collected through questionnaire from large corporation and SMSs from Bulawayo. This study concluded that large corporations are fewer victims of tax avoidance and evasion than SMSs. Main reasons are: lack of trust on authority, lack of trust on government, high tax rates,

and corruption. Study recommended that educate the people regarding payment of tax.

Mughal and Akram (2012) attempted to explore the causes for tax avoidance and evasion. Data was collected through questionnaire and central limit theorem was applied to check the accuracy of causes. This study identified ten main causes/reasons for tax avoidance and evasion which are: proliferation of taxes, poverty, poor relationship between authority and taxpayers, no public enlightenment campaign, inequitable & inefficient tax system, inadequate tax incentives, inadequate enforcement for default, illiteracy of tax calculation, high tax rates, and absence of tax morality. Study recommended: announcement of tax incentives, tax clearance certificates, establishment of audit unit, and tax census.

Kiable and Nwokah (2009) conducted study in order identify reasons for tax avoidance and evasion; different ways that taxpayers use in order to evade and avoid tax; and different social and economic impacts of tax avoidance and evasion. Study found that lack of adequate public-enlightenment, poverty and loopholes in tax laws were main causes of tax avoidance and evasion. Furthermore, taxpayers interference with tax agents through corruption and make concealment in profit in order to evade and avoid tax which result in inequality in the society, resentment among honest taxpayers, and inability of Govt. to provide needed services sufficiently. In addition, study recommended that revenue courts should be established to handle tax evasion and avoidance cases, high penalties should be imposed on tax payers, aggressive and deliberate public-enlightenment campaign by the Govt., and officials should be trained to fulfill their job.

Zhang (2007) attempted to assess the different reasons and remedies to tax avoidance in New Zealand. In this study, development in other jurisdictions, leading case laws, and New Zealand income tax act is reviewed in discussing legislative rules. Study recommended: purposive interpretation of law, reinforcement of anti-tax avoidance rules, improving anti-tax avoidance provision, advanced rulings system, and establishment of effective disclosure.

Hanousek and Palda (2003) empirically explore the determinants of tax evasion and attitudes of different variables with the tax compliance. Study found that gender and age of people has different impacts on tax compliance. Males are more tolerant to cheating behavior than females and young people do not justify the tax evasion than old. Furthermore, differences in the behaviors due to gender and age of people are considered as structural behavior in tax morale.

Erard and Ho (2001) attempted a behavioral study to identify the tax evasion determinants by using available tax databases to explore non-compliant taxpayers' characteristics, and tax compliance motivation factors.

Smith (1992) conducted a behavioral study to analyze the tax evasion determinants in presence of absolute grievance. Study found that presence of absolute grievance negatively affects tax morale which leads towards more tax evasion.

Falkinger (1988) attempted a behavioral study to identify the tax evasion determinants in presence of absolute grievance. Study found that presence of absolute grievance negatively affects tax morale which leads towards more tax evasion.

Toby (1983) examined the reasons of tax avoidance. He argued that tax avoidance means manipulate the transactions using different techniques. Like establish companies in those countries that provide tax free zones, transfer of losses of obvious companies in order to get benefits regarding tax e.g. set-off against profit, and establishing associated or subsidiary company in order to get tax advantage in favor of both. Furthermore, he observed the behavior of taxpayers that how they evade tax. He argued that taxpayers are engaged with different activities which are increasing the inflationary pressure in country, and erode moral values. Companies and individuals have lot of money. Individuals take high amount of profit to their homes and companies declare high amount of dividends to their investors. In results, amount of money is increasing in the economy without increase in quantity of goods or services that increase inflationary pressure in economy.

Lewis (1982) introduced a model in order to identify the different characteristics of taxpayers such as their perceptions of constitutional structure and fiscal policy, influence on their attitudes, demographic and group differences, educational factor, sex, age, ethnic background, and income. Some studies identified that educational background (Vogel (1974); Fallan (1999); Webley et al. (1991); and Almond and Verba (1963)), gender (Webley et al. (1991); and Friedland et al. (1978)), age (Webley et al. (1991); and Mueller (1963)), employment status (Vogel (1974); and Webley et al. (1991)); and treated as criminals by tax officials (Naidoo, 2005), are main determinants that influence tax evasion.

Yitzhaki (1974) proposed seminal theoretical model and attempted a behavioral study to analyze the tax evasion determinants. Study identified, level of risk aversion, amount of penalty imposed and probability of being audited as tax evasion behavioral determinants.

Theoretical Background

1.2 Allingham and Sandmo Model (1972)

This classical model elucidated, level of risk aversion, the amount of penalty imposed and probability of being audited as strong tax evasion behavioral determinants. This model provides the starting point to the later models. According to this model, Potential evader is liable to pay an amount in form of tax X at a specific rate t on his level of income Y. Here, only evader is known about the amount of tax X than evader will pay an amount X less than the amount paid by Y. In absence of tax rate t he will pay X on the base of certainty and save an income (Y-X) than the tax evasion and probability p to be audited be thus discovered. After the audit the amount of tax evaded will be discovered then tax evader will liable to pay some amount at penalty rate λ which will high from the tax rate t. Therefore, evader will try in order to maximize the expected utility function.

$$E[U] = (1 - p)U(Y - tX) + pU((Y - tX) - \lambda(Y - X))$$

This model is serving as base model. Firstly, the reputation factor λ is included in A-S model so that the effect of non-economic considerations can be examined. Furthermore, λ also included. λ refers to "the part of the psychic cost more directly linked to what authors identify as tax morale".

$$E = U(1 - p) + t(Y - X) + pU((1 - t)Y - t(Y - X)) + (Y - X) \quad (2)$$

Second argument is related to the grievance in absolute terms (ag). In this argument people think that the government expenditures are very high and they are wasting the funds of public and taxes are too high due to the corruption of civil servants. The third argument in this study is related to the grievance in relative terms (rg). In this argument behavior of those people is examined those accepting the labor of black economy and alleged-level of tax evasion by others. The remaining two variables are sense of solidarity and duty. In both cases, taxpayers abstain from avoidance and evasion of tax if they have strong sense of solidarity with others' well-being, sense of social/legal/moral duty regarding payment of tax. Furthermore, variables named as gender of people, and their expected income will also be taking into consideration in this model.

This model proposed different taxpayers' group to captures different behaviors regarding tax evasion. First group includes the behavior of those people who said that they will never plan to evade tax in future and they had never evaded. Second group includes the behavior of those people who refrain themselves from tax evasion but they can evade tax when economic benefits will be high from reputation factor or anticipated psychic costs. Last group includes the behavior of those people who take into account the amount of penalty and the probability of audit and this last group is very important to concentrate in order to explore the tax evasion behavior.

Research Methodology

In this study, population consisted of all those people whom incomes fall in the range of taxable income. Further, responses are collected from approximately 72 cities of Pakistan. A questionnaire is developed after reviewing literature of different studies by using five point Likert scale. Total twelve hundred questionnaires are distributed using non-probability sampling and response rate is 86.92%.

As for as concerned with analysis techniques, descriptive statistics along with inferential statistics are used in this study, which are consisted of arithmetic mean, standard deviation, frequency tables, percentages, and variance analysis. Furthermore, Central Limit Theorem is applied to check the accuracy of factors, factor analysis is applied to calculate loadings, and correlation is applied to check the association. All these techniques are applied by using SPSS, and reliability of questions is also checked through SPSS and Cronbach's Alpha of questions related to ways that are used to avoid or evade paying tax is 0.715.

2. RESULTS

Table 1 Analysis of Ways Tax Avoidance and Evasion

Sr.	Particulars	No. of Samples that Identified it	Mean (M)	X-M	(X-M) ²

		(X)			
1	Artificially Disposition of Assets	775	715.625	59.375	3525.39
2	Do Not Maintain Adequate Records	761	715.625	45.375	2058.89
3	Purchase Fixed Assets Exempted From Tax	668	715.625	-47.625	2268.14
4	Inflate & Setting of Expenses Against Increased Profits	723	715.625	7.375	54.39
5	Claim the Fictitious Deductions	633	715.625	-82.625	6826.89
6	Omission of Taxable Income	693	715.625	-22.625	511.89
7	Improper Characterization of Income/Expenses	733	715.625	17.375	301.89
8	Concealment of Profits	739	715.625	23.375	546.39
	Total	5725			16093.88

5.1 Statistics of Variance, Standard Deviation and Cumulative Normal Distribution

$$\text{Variance } (\sigma^2) = \frac{\sum (X-M)^2}{n - 1}$$

$$= \frac{16093.88}{7} = 2299.13$$

$$\text{Standard Deviation } (\sigma) = \sqrt{2299.13}$$

$$= 47.95$$

Application of Central Limit Theorem (Z):

$$Z = \frac{X - M}{\text{S.D}}$$

$$\text{S.D}$$

Where: X = 1042, M = 715.625, S.D = 47.95

$$Z = \frac{1042 - 715.625}{47.95} = 6.83$$

$$47.95$$

Apply Cumulative Normal Distribution:

$$\Pr (Z \geq 6.83) \rightarrow 1 - \Pr (Z \leq 6.83)$$

$$= 1 - (0.99998)$$

$$= 0.00002$$

In Table 1, and above explained computations, variance is 2291.13, SD 47.95 and while applying the central limit theorem, the relevant values are M=715.63, X=1042, SD=47.95, Z=6.83. By applying normal distribution calculator, the value of cumulative normal distribution is calculated which is equal to zero. It can be

concluded that there is 100% probability that all ways stated in this study leads towards tax evasion and avoidance.

Table 2 Ranking of Ways of Tax Avoidance and Evasion

Sr	Items	Factor Loads	Ranking	Mean (M)	Ranking	SD
1	Claim Fictitious Deductions	0.661	1	3.61	5	1.07
2	Improper Characterization of Income/Expenses	0.535	2	3.82	4	1.00
3	Do Not Maintain Adequate Records	0.468	3	3.88	2	0.90
4	Inflate & Setting of Expenses Against Increased Profits	0.389	4	3.87	3	1.00
5	Concealment of Profits	0.383	5	3.92	1	1.00

Table 2 shows ranking of top five ways based on factor loading and arithmetic mean. According to factor loading; claim fictitious deductions are at first; improper characterization of income/expenses is at second; do not maintain adequate records is at third; inflate & setting of expenses against increased profits is at fourth; and concealment of profits is at fifth.

According to arithmetic mean, concealment of profits is at first; do not maintain adequate records is at second; inflate & setting of expenses against increased profits is at third; improper characterization of income/expenses is at fourth; and claim fictitious deductions is at fifth.

Table 3 Correlation Analysis

	1	2	3	4	5	6	7	8
1	1							
2	0.320**	1						
3	0.155**	0.282**	1					
4	0.163**	0.215**	0.301**	1				
5	0.273**	0.284**	0.237**	0.229**	1			
6	0.178**	0.187**	0.145*	0.181**	0.494**	1		
7	0.260**	0.261**	0.228**	0.195**	0.351**	0.310**	1	
8	0.162**	0.186**	0.179**	0.171**	0.201**	0.223**	0.327**	1

** Correlation is significant at the 0.01 level (2-tailed).

Note: 1 = Artificially Dispose Assets; 2 = Do not Maintain Adequate Records; 3 = Purchase Fixed Assets Exempted from Tax; 4 = Inflate & Setting Off Expenses against Increased Profits; 5 = Claim Fictitious Deductions; 6 = Omission of

Taxable Income; 7 Improper Characterization of Income / Expenses; and 8 = Concealment of Profits.

In above table, there is positive significant association among ways of tax evasion and avoidance used in this study

Conclusions

First of all, results indicate that ranking of top five ways of tax avoidance and tax evasion is different. Ranking of top five ways on the basis of factor loading is stated as: 1. claim fictitious deductions, 2. improper characterization of income/expenses, 3. do not maintain adequate records, 4. inflate & setting of expenses against increased profits; and concealment of profits is at fifth. On the other hand, it is further verified from the computations of central limit theorem that ways stated in this study are correct at 100% level. Finally, significant and positive correlation was found among ways of tax evasion and avoidance.

This study emphasizes on the examination of different ways used by taxpayers lived in seventy-two cities of Pakistan for tax avoidance and evasion. Like any other study, this study also has few limitations. Firstly, this study is limited to seventy-two cities of Pakistan. Future researches may include more cities and/or rural areas of Pakistan. Such studies may endorse the findings of this study and/or might extend the findings. Secondly, time and financial matters were also the big constraints in data collection. Future studies may use longitudinal design to collect data. This may help revealing the changes in tax evasion and avoidance because of time laps. Lastly, these results cannot be generalized due to difference in behavior of taxpayers of different countries, and also difference between tax laws of different countries.

It is also suggested that: employees should be retained and continuously trained in order to complete the job according to the demands of job, they should also inspire to refrain from corruption and frauds, and encouraged through good salary package; and efforts should be taken by Federal Government and FBR for enforcement of punishments and penalties in true sense.

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