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tax administrations seeking to improve the efficiency of their revenue collections, there is growing recognition of the need

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-

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

(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

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

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 credit[9], 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

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.

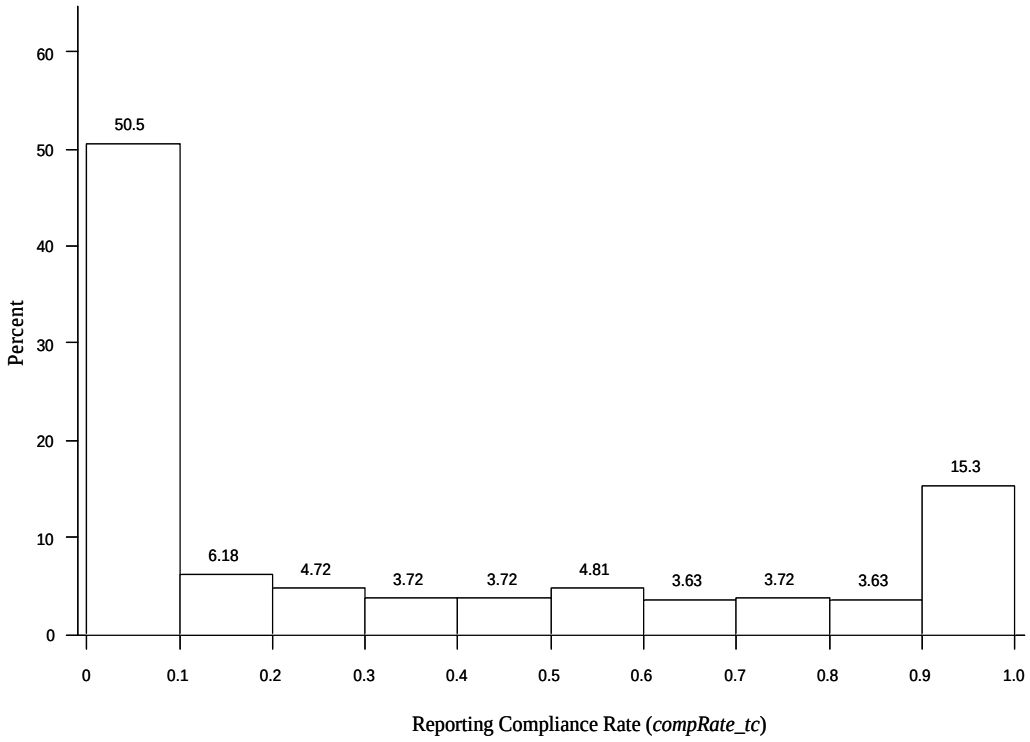

Figure 1. Histogram of Reporting Compliance Rate

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 filers[10] 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 vi

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 event[11], when it does occur it suggests a significant

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 & McKerchar, 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.

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 y			

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]

[16] The 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).

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

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[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'Economique 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
>
> and e

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 A

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 taxpayers[47] 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 mi70.92 8wrob

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

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 mess[55] and, notwithstanding the difficulty, it is important to clean it up.

[55]The 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.

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

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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

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 simplicity[7] 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 un-explored 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

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

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 enterprises[38] 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]

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

[35] See 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.

[37]Friedrich 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> at 16 November, 2008.

[38]Pakistan, '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.

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

[40] Economic Survey, above n 38.

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

[43] Khawaja, above n 41, 5.

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

[45] Usman Khan, 'Assessment of the Provincial Legal and Policy Framework Related to Private Sector Development' Final Report of the Economic Advisor, Commerce and In-6(an)-11(0(n-6(an)1n(c)11(e)11(a)-2(nd I)20(uc)

Tax related costs are relatively more serious for small business because of its

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

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, superfluousness, 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 loss[64], 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

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:

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 2001[82] 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

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 ac

Reserve[86] 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:

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[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

> *"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 busine

(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 b sue h]2g(s)-2(h)1a ma

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 accounts[91], 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]

3

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

Similarly, the tax rate for rental income at the lowest bracket is 5 percent. In both

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 unu-5(i1)11(77l)-5(i(r)-2(T0g

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]

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[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

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.

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

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 j EMC /P <</MCID (f)-2(oh)a-3(os-5(e)-2d

Table 7: GDP and Tax to GDP ratio of Pakistan for last ten years[119]

PKR in millions

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

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Many developing countries rely on the PIT regimes to collect tax(eg)13(o3(y9t)8(s at649(al)-3

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 wh11(s)-se(f)9onco;ia-4-3(as)sie: -4(4 ( )Tj 0.196 Tw -)53ID 6 >>s tC0 Td 3as0 Td

(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. e s - 3 (y) 1 s t 3

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

(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.

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 co Tw -12.9tiectw [(m)17(e)-2lu5(i)6b5(e)11(ov)11(e)-2(r)9(j)-15(uct)-be entduisg tae tear,

(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

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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

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 Wolski[5] 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*

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 no 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.

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

By this, Ury, Brett and Goldberg mean:

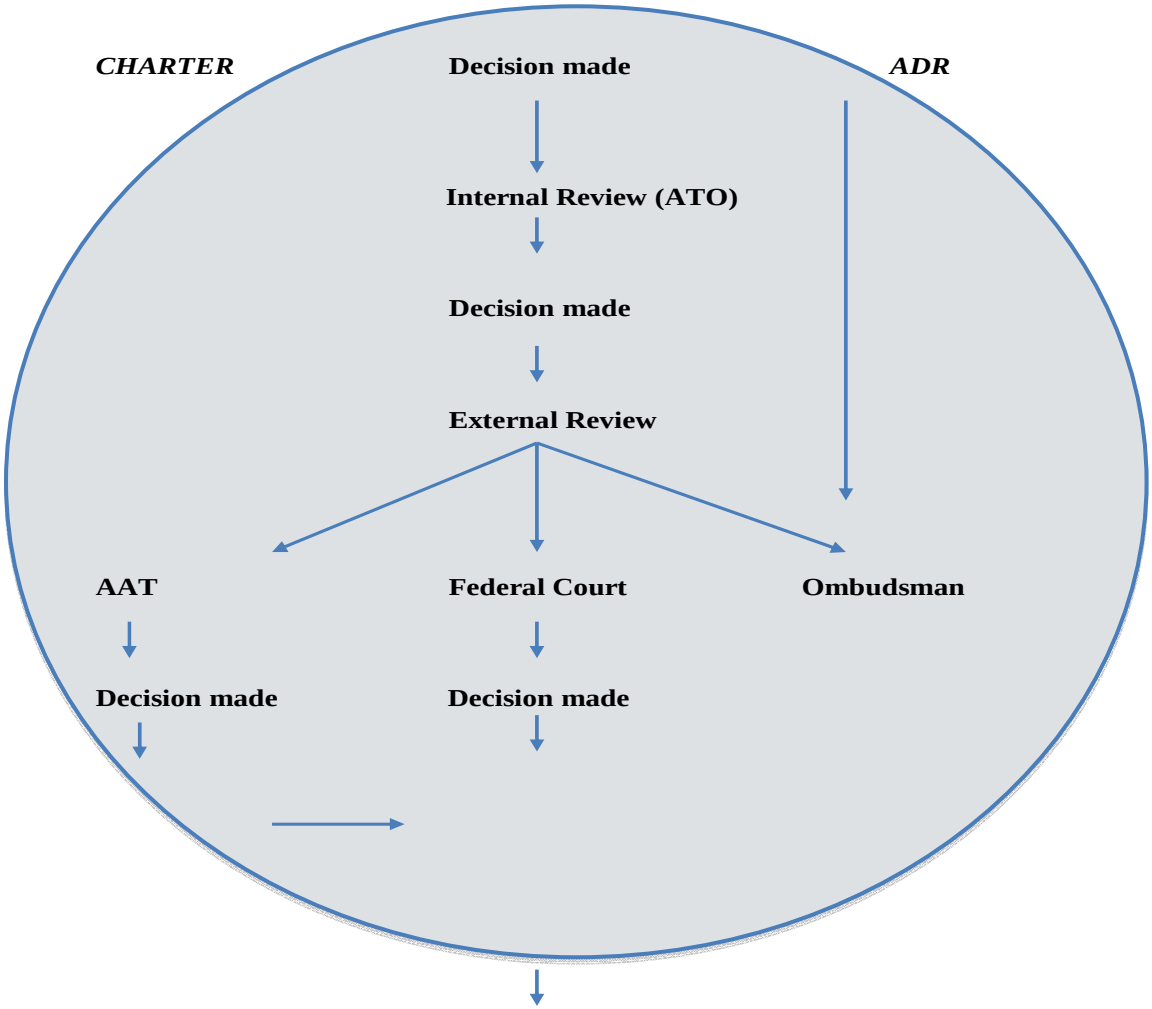
> A party taking action likely to affect others should notify and consult them beforehand, so that points of difference can be identified and dealt with early and to prevent disputes;
>
> Allow for analysis and feedback after disputes to overcome systemic problems and to prevent disputes. This may occur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

Principle 5 - Arrangeand hciduTs 57 T TD.00012Tc.0008 Tw(ei an ow -to-hih nco)7.48(t)3(y shequncie

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


CHARTER
Decision made
ADR
Internal Review (ATO)
Decision made
External Review
AAT
Federal Court
Ombudsman
Decision made
Decision made

Finally, a taxpayer dissatisfied with assessments or certain types of other decisions[28] 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

hallmarks of when the ATO's par

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

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 activities[60] 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 ATO[63] 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 9525 -1.1475 T

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The Ombudsman through its annual reporting mechanism (which includes a separate section on the ATO) and Inspector-General of Taxation reviews[66] 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] publications[71] 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 iden fov fo fo-1.1.1(npay1.1 or m)2 T3 .8(-1.J9rs..51(-) fo)2 .855

7. CONCLUSION

Overall, the ATO dispute resolution model supports its assertions that it's eager to seek to resol6(ode03 (v)-2Sy)eTncAIwith taxpayto7(v)rs. Csseainlytotha, thATOatitno6( )]TjTD.003

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

Ahmed Munirus Saleheen*

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 dev9tsning countries than in ot

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.

obtains the lion's share of its tax-revenue from VAT. VAT including supplementary duty[3] 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

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 Government[5] represented by the Internal Resources Division under the Ministry of Finance;

NBR, the apex body for the formulation and implementation of tax policy;

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

2.3.2 Individual Level

VAT officials have been granted enormous discretionary powers both under the VAT

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 internationa

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.

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. Bu seic6504the r in t4

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 per

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

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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