

Analysis of presumptive income tax for small business in informal economies: a case of Pakistan

Author:

Memon, Najeeb Ahmad

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**ANALYSIS OF PRESUMPTIVE INCOME TAX FOR SMALL
BUSINESS IN INFORMAL ECONOMIES: A CASE OF PAKISTAN**

Najeeb Ahmad Memon

Student No. 3204080

*A thesis submitted to the Australian School of Business of The University of New South
Wales in fulfilment of the requirements for the degree of Doctor of Philosophy*

August 2010

This thesis is dedicated to my daughters Simrah and Hira

Abstract

This thesis analyses the use of Presumptive Income Tax (PIT) in developing countries with large informal economies dominated by small business. It asks the question:

“Are the current PIT designs used to tax small business in large informal economies appropriate?”

To answer the question, this thesis makes a qualitative analysis of the causes of large informal economies in developing countries. Then, common PIT designs are evaluated qualitatively against the principles of a good tax system. Finally, legal analysis of Pakistani PIT legislation is undertaken with particular reference to the principles of a good tax system.

This thesis makes a number of important contributions to the existing body of knowledge. First this thesis identifies the bookkeeping and other procedural requirements for tax compliance as the major reason why small businesses operate informally.

Second, this thesis identifies a single PIT (that is, an asset based PIT) amongst a range of PIT designs, which logically is the most appropriate design to meet the needs of small business and tax administration in large informal economies. This identification is achieved by comparative analysis of PIT designs against the causes of informality.

Third, earlier literature has not made comparative analysis of existing PIT designs against the principles of a good tax system for assessing their adequacy to tackle large informal economies. This thesis performs this task and finds that an asset based PIT is the most appropriate among all PIT designs in this regard.

Fourth, prior to the analysis of PIT designs against the principles of a good tax system this thesis makes a contribution in the existing literature in terms of redefining and prioritizing these principles in context of large informal economies. This thesis suggests ranking simplicity, efficiency and equity in that order.

Lastly this thesis provides the first ever comprehensive analysis of the Pakistani PIT to assess its ability to tax the informal sector and the level of its adherence to the principles of a good tax system. This thesis finds that the Pakistani PIT does not satisfy the principles of simplicity, efficiency and equity because of its inappropriate design, poor legal drafting and its intricate relationship with the normal income tax. The thesis recommends an asset based PIT along with details regarding its base, valuation techniques etc to tax the Pakistani informal economy.

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2. Memon Najeeb (2009) 'Presumptive Income Tax Designs for Improving Small Business Compliance' *New Zealand Journal of Taxation Law and Policy* 15:4 pp.275-297..... mainly drawn from Chapter 3.
3. Memon Najeeb (2010) 'How to Tax Small Business in Informal Economy: Comparative Analysis of Presumptive Income Tax Designs' *Bulletin for International Taxation* 64:25 International Bureau of Fiscal Documentation (IBFD) pp.290-302. Recently, a Chinese Journal *Taxation Translation Journal* has obtained permission from IBFD to translate and re-publish this article in Chinese language mainly drawn from Chapter 4.
4. Memon Najeeb (2010) 'Prioritizing Principles of a Good Tax System for Small Businesses in Informal Economies' *Australian Tax Forum* 25:1 pp.57-94..... mainly drawn from Chapters 5 and 6.
5. Memon Najeeb (2010), 'Looking for a Better Tax Design to Reduce Regulatory Burden of Small Business in Developing Countries' *Tax Notes International* 58:5 Tax Analysts pp.399-408..... mainly from Chapter 7.

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2. Memon Najeeb, 'Looking for a Better Tax Design to Reduce Regulatory Burden of Small Business in Pakistan' *International Council for Small Business* (ICSB) World Conference 2010 Cincinnati, Ohio, USA..... drawn from Chapter 7 and 10.
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Table of Contents

Acronyms	xiv
List of Figures	xvi
List of Tables	xvii
List of Annexures	xviii

PART - I

Chapter 1 Introduction to the Thesis.....	1
1. The Context of the Thesis.....	2
2. Research Gap Bridged by the Thesis	5
3. Justification of the Thesis	6
4. Aim, Approach, Contribution and Scope of the Thesis	9
5. Structure of the Thesis.....	11
Chapter 2 Large Informal Economies: Causes and Consequences.....	14
1. Introduction.....	14
2. Definition and Scope of the Informal Economy	15
2.1 Definition of Informal Economy	15
2.2 Informal Economy is Synonymous with the Small Business Sector	16
3. Size of Informal Sector: The Extent of Non-Compliance	19
4. Causes of Informal Economy in Developing Countries.....	20
4.1 High Taxation Costs	20
4.1.1. Administrative Compliance Costs	22
4.1.2 Technical Compliance Costs	27
4.1.4 Peculiarity of Small Business	28
4.2 Economic Gains: Operating Informal is a Competitive Advantage	29
4.3 Tax Morale	32
4.4 Weak Tax Administration.....	34
4.5 Illiteracy.	39
5. Implications of Informal Economy	40
5.1 Loss of Revenue	41
5.2 Depleting Tax Morale.....	42
5.3 Economic Slowdown.....	43

5.3.1 Dwarfism in the Small Business Sector.....	43
5.3.2 Disadvantaged Large Business.....	45
6. Conclusion	46
Chapter 3 Presumptive Income Tax: Concept, Designs and Features.....	48
1. Introduction.....	48
2. Grounds of Presumption in Tax.....	49
3. Presumption in Income Tax.....	53
3.1 Income: Its Concept and Determination	53
3.2 Presumption in Income Tax	55
3.3 The Methods of Constructing PIT Designs	60
3.3.1 Description of Methods of Constructing PIT Designs in the Literature.	61
3.3.2 Approach Adopted in this Thesis for Describing Methods of Construction	63
3.3.2.1 PIT Designs Using another Economic Base as Proxy for Income ...	63
3.3.2.2 PIT Designs Using Production Indicators for Income Tax Liability	65
3.3.2.3 Miscellaneous PIT Designs	69
3.4 Introducing PIT Regimes in Tax Codes	72
3.4.1 The Legal Presumptive Income Tax.....	72
3.4.2 The Administrative Presumptive Income Tax	73
3.5 Qualifications in Respect of Designs and Legislative Forms	75
3.6 Features to Customize PIT Regimes	76
3.6.1 Exclusivity.....	76
3.6.2 Rebuttable or Irrebuttable	76
3.6.3 Mechanical or Discretionary	77
3.6.4 Entry and Exit Thresholds for Determining Eligibility	78
3.6.5 Time Frame	79
3.6.6 Minimum or Maximum Liability	79
3.6.7 Selection for Audit.....	79
3.6.8 Taxing Average Income: Quantum of Tax Burden	80
3.6.9 Optional or Compulsory	80
3.6.10 Open for Auction	81
4. Classification of PIT Regimes in Practice	81
4.1 Standard PIT Regimes	82

4.1.1 Fixed Percentage of a Performance Indicator	82
4.1.2 Fixed Tax	83
4.1.3 Standard Deduction Method.....	83
4.2 Estimated PIT Regimes	84
4.3 Minimum Tax PIT Regimes	84
4.4 Other PIT Regimes	85
5. Conclusion	85

Chapter 4 The Use of PIT for Small Business in Large Informal Economies87

1. Introduction.....	87
2. Inability of the Normal Income Tax to Tackle Informal Economies	89
3. PIT to Tax Small Business in Informal Economies	91
3.1 High Administrative Compliance Costs and Enforcement Costs	95
3.1.1 Reducing Administrative Compliance Costs	96
3.1.2 Reducing Enforcement Costs: Helping Weak and Corrupt Tax Administration.....	98
3.2 Tax Rates (Technical Compliance Costs).....	102
3.3 Reducing Economic Gains for Encouraging Transition to Formal Economy	104
3.3.1 Encouraging Transition to Formal Sector	104
3.3.2 Graduating to the Normal Income Tax	106
3.4 Tax Morale and Perception of Fairness	107
4. Conclusion	112

PART - II

Chapter 5 Principles of a Good Tax System in Context of Large Informal Economies 115

1. Introduction.....	115
2. Desirable Principles of Taxation	116
3. Simplicity	120
3.1 Definition	121
3.2 Assessing Simplicity.....	127
3.2.1 Debate on Alternative Approaches	127
3.2.2 A Simple Approach to Simplicity	130
3.3 Approach Adopted in the Thesis	131

4. Efficiency.....	134
4.1 Role of Taxation in Economic Growth	134
4.2 Aim of the Efficiency Principle	136
4.3 How to Limit Economic Harm of Taxation? The Neutrality Criteria	138
4.4 Assessing Efficiency	142
4.5 Approach Adopted in the Thesis	143
5. Equity	143
5.1 Choices for Vertical Equity (Distribution of Income).....	144
5.2 Horizontal Equity for Promoting Voluntary Compliance	147
5.3 Approach Adopted in the Thesis	148
6. Conclusion	150
 Chapter 6 Prioritizing Principles of a Good Tax System for Large Informal Economies	152
1. Introduction.....	152
2. Need for Ranking the Principles of a Good Tax System	153
3. Identifying the Complementary Principles.....	154
4. Identifying the Competing Principles	155
4.1 Simplicity and Equity	155
4.2 Simplicity and Efficiency	156
4.3 Efficiency and Vertical Equity.....	157
5. Resolution of the Conflicts	157
5.1 Simplicity versus Equity (Horizontal) and Efficiency	157
5.2 Efficiency versus Vertical Equity	163
6. Approach Adopted in this Thesis for Large Informal Economies	167
7. Conclusion	169
 Chapter 7 Comparative Analysis of PIT Designs and Features against Principles of a Good Tax System.....	171
1. Introduction.....	171
2. Simplicity.....	173
2.1 Factors Influencing Complexity.....	173
2.2 Analysis of Common PIT Designs	175
2.2.1 Analysis of Technical Complexity	176

2.2.1.1 <i>PIT Designs Using another Economic Base as a Proxy for Income</i>	176
2.2.1.2 <i>PIT Designs Using Production Indicators for Income Tax Liability</i>	178
2.2.2 Analysis of Operational Complexity	179
2.2.2.1 <i>PIT Designs Using another Economic Base as a Proxy for Income</i>	180
2.2.2.2 <i>PIT Designs Using Production Indicators for Income Tax Liability</i>	183
2.3 Findings	184
3. Efficiency	185
3.1 Neutrality	185
3.1.1 PIT Designs Using another Economic Base as a Proxy for Income.....	185
3.1.2 PIT Designs Using Production Indicators for Income Tax Liability	190
3.2 Deadweight Loss	191
3.3 Tax Burden.....	191
3.4 Findings	192
4. Equity	193
4.1 Horizontal Equity	193
4.2 Vertical Equity	194
4.3 Findings	195
5. Analysis of the Features	195
5.1 Exclusivity and Minimum Features.....	196
5.2 Rebuttable and Irrebutable Features.....	196
5.3 Mechanical and Discretionary Features.....	197
5.4 All other Features	198
6. Conclusion	199

PART - III

Chapter 8 PIT in the Perspective of Pakistani Informal Economy	201
1. Introduction.....	201
2. Informal Economy: Service Sector in Pakistan	202
2.1 Small Business is Synonymous to Service Sector in Pakistan.....	203
2.2 Importance of Small Business in the Economic Growth.....	204
2.3 Problems Confronting Small Business	205
2.3.1 Peculiarities of Small Business	206
2.3.2 Lack of Finance	206
2.3.3 Language Gap and Illiteracy	206

2.3.4 Taxation and Other Regulatory Burdens	207
2.4 Implications.....	209
2.5 Realisation at Last	210
3. Informal Economy and Evasion in Pakistan.....	211
4. Background of PIT in Pakistan	216
5. Conclusion	222
Chapter 9 Overview of Pakistani PIT Legislation	223
1. Introduction.....	223
2. Basis of Income Tax Charge.....	224
3. Mechanism for Determination of Tax Liability	225
3.1 Normal Tax Regime	225
3.2 Presumptive Tax Regime.....	226
3.3 Dual Tax Regime	229
4. Types of Income Subject to Presumptive Tax Regime	232
4.1 Income from Investment.....	232
4.1.1 Profit on Debt (Section 151)	232
4.1.2 Dividends (Section 150)	234
4.1.3 Tax on Rental Income (Section 15)	234
4.1.4 Income from Wining Prizes (Section 156)	235
4.2 Income from Business and Professional Activities.....	235
4.2.1 Income from Supply of Goods, Rendering of Services and Execution of Contracts (Section 153)	235
4.2.2 Income from Brokerage or Commission (Section 233).....	237
4.2.3 Income from Commercial Imports (Section 148)	237
4.2.4 Income from Export and Export Related Activities (Section 154)	237
4.2.5 Income from Sale of CNG and Petroleum Products (Sections 156 and 234A)	238
4.2.6 Tax on Retailers (Sections 113A and 113B).....	238
4.2.7 Income of Transporters (Section 234)	239
4.2.8 Tax on Shipping Activities	239
5. Widespread WHT Regime.....	240
6. Concessions in PIT Regime for Different Economic Sectors	241
6.1 For Income Covered Under Section 150	241

6.2 For Income Covered Under Section 153	242
6.3 For Income Covered Under Section 154	243
6.4 For Income Covered Under Section 148	244
6.5 For Income Covered Under Section 233	244
7. Conclusion	245
Chapter 10 Analysis of Pakistani PIT System.....	249
1. Introduction.....	249
2. Pakistani PIT and Principles of a Good Tax System	250
2.1 Pakistani PIT and Simplicity.....	250
2.1.1 Technical Complexity	251
2.1.1.1 Number of Provisions.....	251
2.1.1.2 Rules Rendered Unnecessary Due to Subsequent Developments ...	252
2.1.1.3 Grouping According to a Rational Scheme.....	253
2.1.1.4 Superfluous Provisions, Words and Sentences	254
2.1.1.5 Frequency of Changes in the Regime	258
2.1.1.6 Ambiguity of the Interpretative or Explanatory Provisions	262
2.1.1.7 Provisions Where the Literal Meaning is Never or Rarely Enforced	266
2.1.2 Operational Complexity	266
2.2 Pakistani PIT and Efficiency.....	269
2.2.1 Neutrality.....	269
2.2.1.1 Neutrality in Tax Rates, Expenditures and Concessions	271
2.2.1.2 Neutrality in all Classes of Income	275
2.2.1.3 Neutrality in Tax Burden for all Types of Legal Persons	277
2.2.1.4 Neutrality in Availability of Tax Avoidance Opportunities.....	278
2.2.1.5 Neutrality in the Tax Burden Regarding the Choice of Capital Structure	284
2.2.1.6 Neutrality in Assigning the Role of Withholding Tax Agent	284
2.2.2 Overall Tax Burden	284
2.3 Pakistani PIT and Equity	285
2.3.1 Neutrality in Tax Treatment of Employed and Self-Employed Taxpayers	286
2.3.2 Neutrality among Taxpayers with Different Levels of Turnover	287

2.3.3 Progressiveness of Tax Rates	288
2.4 Analysis of Findings against the Prioritized Principles.....	288
3. Pakistani PIT and the Recommended Design and Features	289
3.1 Pakistani PIT and the Design Recommendations for Simplicity	289
3.2 Pakistani PIT and the Design Recommendations for Efficiency	291
3.3 Pakistani PIT and the Design Recommendations for Equity.....	293
3.4 Pakistani PIT and Recommended Features	294
3.5 Findings	295
4. Pakistani PIT and Well Known Performance Indicators.....	296
4.1 Revenue Collection	296
4.2 New Registrations or Expansion of the Taxpayer Base	298
4.3 Changes in Size of Informal Sector.....	299
5. Conclusion	299
Chapter 11 Recommendations Regarding Asset Based PIT for Pakistan	306
1. Introduction	305
2. Construction of an Appropriate Asset Based PIT	307
2.1 Choice of PIT Features	307
2.2 Determination of Tax Base	307
2.2.1 Gross Assets or Net Assets	308
2.2.2 Current or Long Term Assets and Tangible or Intangible Assets	309
2.2.3 Qualifications: the Assets of Professionals	311
2.2.4 Valuation of Assets.....	312
2.3 Fixed or Assessable Tax	315
2.4 Tax Burden.....	315
2.5 Basic Exemption	316
2.6 Unified Basis.....	317
3. Additional Suggestions for Administering PIT in Pakistani Jurisdiction	317
Chapter 12 Conclusion of the Thesis.....	322
BIBLIOGRAPHY.....	326

Acronyms

ADB	Asian Development Bank
AICPA	American Institute of Certified Public Accountants
AMT	Alternative Minimum Tax
AOP	Association of Persons
ATO	Australian Tax Office
CIT	Commissioner of Income Tax
CNG	Compressed Natural Gas
EAIT	Earnings after Interest and Tax
EBIT	Earnings before Interest and Tax
FBR	Federal Board of Revenue
FC	Fixed Cost
FIAS	Financial Investment Advisory Service
GDP	Gross Domestic Product
GNP	Gross National Product
GST	General Sales Tax
HTT	Hard to Tax Taxpayers
IFC	International Finance Commission
IJI	Islami Jhamoori Ittehad
ITO	Income Tax Ordinance
MNC	Multinational Corporation
MT	Minimum Tax
OECD	Organization of Economic Cooperation and Development
PIT	Presumptive Income Tax
PKR	Pakistani Rupee

PT	Presumptive Tax
RMTRC	Resource Mobilization and Tax Reform Commission
ROI	Return on Investment
SME	Small Medium Enterprise
SMEDA	Small Medium Enterprise Development Authority
SP	Sale Price
SSAS	Simplified Self Assessment Scheme
TARP	Tax Administration Reform Project
USAS	Universal Self Assessment Scheme
VAT	Value Added Tax
VC	Variable Cost
WHT	Withholding Tax

List of Figures

Figure 1	Aid to Thesis Structure13
Figure 2	Type of Tax Treatment for Resident Small Business 230

List of Tables

Table 1	GDP and Tax to GDP Ratio of Pakistan211
Table 2	Tax Levels: Tax Revenues as a Percent of GDP212
Table 3	Tax Effort Indices - Low Income Countries.....212

List of Annexures

Chapter 9

Annexure I	Rates of Tax for Individuals and Associations of Persons	246
Annexure II	Tax Rates for Income from House Property.....	247
Annexure III	Tax on Motor Vehicles	248

Chapter 10

Annexure I	Illustration of Increased Fluctuation of Take Home Income under PIT as Compared to that under Normal Income Tax Regime	300
Annexure II	Comparison of Tax Liabilities of Different Classes of Income Generated by Identical Volume of Activity	301
Annexure III	Three Tables of Tax Collection Figures.....	302
Annexure IV	Illustration of Allocation of Expenses in Single Product Operation Cases	303
Annexure V	Three Tables Comparing Tax Liability between Self Employed and Others	304
Annexure VI	Income Tax Returns/Statements During 2005 to 2008.....	305

CHAPTER 1 INTRODUCTION TO THE THESIS

Scope of this Chapter: As the title suggests, this chapter introduces the thesis of the author. This chapter mentions the context of problem which the thesis intends to resolve. Later, this chapter puts forth the justification, aim, approach, scope and contribution of the thesis. The chapter concludes by laying down the structure of the thesis.

This thesis is concerned with the problem of levying income tax in developing countries with large informal economies dominated by small business. Small businesses often do not comply with the income tax because of high compliance costs emanating from its complex nature. This promotes the informal economy. Weak and corrupt tax administration also contributes to non-compliance. As a result, income tax is not successfully implemented¹ and consequently fails to achieve most of its objectives such as revenue collection. In many developing countries, therefore, Presumptive Income Tax (PIT), which is a tax on proxy of income rather than actual income, is used as a substitute for the normal income tax. Because of low compliance costs and the reduced role of tax administration, which arise from its simplicity, PIT facilitates compliance by small business and encourages formal activities. However, the literature shows that the results of PIT are inconsistent, perhaps due to inadequate follow up and research in this area.² Despite the simplicity related theoretical merits of PIT, the uncertainty about its success demands investigation of its design. The primary objective of this study is to compare most common PIT designs against the needs and characteristics of small businesses and the principles of a good tax system.

The thesis demonstrates that the most common PIT designs in practice fail to take into account the needs and characteristics of small business and are inconsistent with the principles of a good tax system. The author's thesis is that small businesses can be more

¹ Vito Tanzi, *Public Finance in Developing Countries* (1991) (Edward Elgar, England), 205.

² For details see S.N. Makedonskiy, 'Taxation Mechanisms Based on Simplified and Indirect Evaluation of Tax Liabilities' Russian-European Centre for Economic Policy (RECEP) 2005, 9-35 <http://www.recep.ru/files/documents/Taxation_Makedonskiy_eng.pdf> at 8 June 2008; Michael Engelschalk, 'Small Business Taxation in Transition Countries' Report No. 35109, World Bank, Washington, D.C., 1 June 1995, 25 <http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2006/02/08/000090341_20060208095329/Original/351090Business0taxation0SME0paper1ME2.doc> at 08 May 2008; Richard Bird and Sally Wallace 'Is It Really So Hard to Tax the Hard to Tax? The Context and Role of Presumptive Taxes' in James Alto, Jorge Martinez-Vazquez, and Sally Wallace (eds.) *Taxing the Hard to Tax: Lessons from Theory and Practice* (2004), 152.

effectively taxed under a better PIT design, which is not only consistent with the principles of a good tax system, but will also tackle the informal economy.

1. The Context of the Thesis

Taxation is not only about collecting money from persons. It also has implications for the political, social and humanitarian facets of life. For instance, tax policy also reflects political factors including concerns of fairness.³ Tax policy, besides revenue collection, encompasses many other objectives. Tax design should meet some standards (the most widely used being simplicity, equity and efficiency), in order to prevent the collection of money having a negative impact on the economic and social aspects of life.

Comparative analysis suggests that income tax, being a direct form of taxation, is more equitable⁴ and efficient when compared to other taxes. Such analysis is supported by several studies.⁵ The income tax has also been quite satisfactory in terms of revenue sufficiency. Income tax provides a major part of revenue in developed countries⁶, and constitutes a substantial part of revenue in developing countries. In short, income tax is established as an appropriate tax measure.

However, normal income tax (that is, a tax charged on taxable income which is worked out after deduction of allowances and perquisites etc) is not rated highly in terms of 'simplicity'. This is because accounting records need to be maintained in order to

³ Richard M. Bird and Eric M. Zolt, 'Introduction to Tax Policy Design and Development', World Bank, 28 May 2003, 9 <<http://www.fiscalreform.net/library/pdfs/BirdZoltTaxPolicyPaper.pdf>> at 24 July 2008.

⁴ However, since incidence of every tax is ambiguous, hence, the effect of income taxation on redistribution would remain dubious (for details see Joseph E. Stiglitz, *Economics of Public Sector* (Second edition, 1988), 411-436). Also see Per Krusell, Vincenzo Quadrini and Jose-Victor Rios-Rull, 'Are Consumption Taxes Really Better than Income Taxes?' (1996) 37 *Journal of Monetary Economics* 475-503. Further, questions about incidence of all taxes as a group or each tax in the whole life span of a taxpayer are also scarcely researched (Bird and Zolt, above n 3, 19-23).

⁵ See Bird and Zolt, above n 3, 22, 23; Harvey S. Rosen, *Public Finance* (Fourth edition, 1998), 297.

⁶ James Alm and Sally Wallace 'Can Developing Countries Impose an Individual Income Tax?' Working Paper, Andrew Young School of Policy Studies, Georgia State University, 2004, 6 <http://aysps.gsu.edu/publications/2004/alm/indiv_incometax.pdf> at 16 December 2008. Sally Wallace, 'Imputed & Presumptive Taxes: International Experiences and Lessons for Russia' (2002) Working Paper No. 02-03 Andrew Young School of Policy Studies Georgia State University March 2002.

accurately determine the tax base - namely income.⁷ More broadly, Gandhi argues that financial transparency is a prerequisite for effective income taxation.⁸ The lack of this prerequisite seriously undermines income tax performance in developing countries. More simply, bookkeeping and related elements such as complex income tax return forms require some social and economic pre-requisites such as high literacy levels and developed accounting profession for their observance, which are scarce in developing countries. Consequently, income tax does not perform well in developing countries as is evident from their low direct tax to GDP ratio.⁹

Gordon argues that the major prerequisites for an effective income tax include (1) Predominant monetary/documented economy (2) High literacy rate (3) Honest and reliable accounting (4) Honest and reasonably efficient tax administration.¹⁰ The scarcity of these prerequisites in developing countries is primarily an outcome of lack of adequate infrastructure, less skilled human resources, dearth of capital and the dominance of agriculture in developing countries.¹¹

More specifically, Wallace observes that the lack of accounting information in respect of income of small businesses is the main hurdle in income tax implementation and compliance in the informal economies of developing countries.¹² Most business entrepreneurs in developing countries are small, uneducated and make use of cash transactions. The consequent absence of adequate record keeping is therefore a 'severe handicap' for levying income tax in the small business sector.¹³ It is noted that the economic transition from agriculture to industry in developing countries has not occurred to same degree as in developed nations and thus, accounting practices are not

⁷ Richard M. Bird, 'Administrative Dimensions of Tax Reform' (2004) *Asia-Pacific Tax Bulletin* 134, 139.

⁸ Sonia Gandhi, 'Presumptive Direct Taxes' the World Bank, 2002, 1 <www.worldbank.org/publicsector/pe/Tax/presumptivedirecttaxes.html> at 13 September 2007.

⁹ Somchai Sujjapongse, 'Tax Policy and Reform in Asian Countries: Thailand's Perspective' (2005) 16 *Journal of Asian Economics* 1018, 1023.

¹⁰ For details see Richard K. Gordon Jr., 'Income Tax Compliance and Sanctions in Developing Countries' in Richard M. Bird and Oliver Oldman (eds.) *Taxation in Developing Countries* (Fourth edition, 1990), 455.

¹¹ Bird, above n 7, 139.

¹² Wallace, above n 6b, 1.

¹³ Gunther Taube and Helway Tadesse, 'Presumptive Taxation in Sub-Saharan Africa: Experience and Prospects' Working Paper No. 96/5, International Monetary Fund January, 1996, 4.

sufficiently developed to assess income accurately.¹⁴ Practically, it is hard to implement income tax in developing countries on actual earned income in the absence of information on small business income.¹⁵ A sub-Saharan African study also confirms this.¹⁶

Consequently, there is widespread non-compliance on the part of taxpayers and ineffectiveness in tax administration.¹⁷ As a natural corollary, there are large informal sectors in most developing countries and governments are deprived of lawful revenue needed both for its operation and development of infrastructure.¹⁸

In view of the above, in some jurisdictions, especially in French colonies, the normal income tax based on global income has been substituted by schedular taxes.¹⁹ Although schedular taxes might be useful for some income like dividends, interest and salary, they might not address the issue of taxing business or professional income.²⁰ Studies suggest that reforms in the normal income tax have also been ineffective in this regard.²¹ Ultimately, PIT, a modified form of income tax, is entrusted to secure tax

¹⁴ Gandhi, above n 8, 4. Although income tax laws are written in the ideal level, in reality most taxpayers do not possess administrative resources to maintain accurate books and comprehend complex tax codes. PIT, therefore, is in widespread use in developing countries.

¹⁵ Dageny Faulk, Jorge Martinez Vazquez and Sally Wallace, 'Taxing Potential Income: A second look at Presumptive Taxes' Annual Conference on Public Finance Issues, Andrew Young School of Policy Studies, Georgia State University, 31 May 2006, 1 at http://aysps.gsu.edu/isp/files/ISP_CONFERENCES_ALTERNATIVE_METHODS_OF_TAXING_FAULK_MARTINEZ_WALLACE_PAPER.pdf > at 12 June 2009.

¹⁶ Taube and Tedesse, above n 13, 12.

¹⁷ Margaret McKerchar and Christopher Evans, 'Sustaining Growth in Developing Economies through Improved Taxpayer Compliance' (2009) 7:2 *eJournal of Tax Research*, 171-201.

¹⁸ Friedrich Schneider and Bettina Hametner, 'The Shadow Economy in Columbia: Size and Effects on Economic Growth' (2007b), Working Paper No. 0703, Department of Economics, Johannes Kepler University of Linz, Austria, January 2007, 4. Moreover, all prerequisites for implementation of income tax can be secured by massive expenditure policy. However, that option demands huge revenues for government, which it is not capable of collecting due to unsuccessful implementation of income tax. How to set this order right is the question that every government in developing countries finds hard to solve.

¹⁹ Alm and Wallace, above n 6a, 6, 10. The normal income tax determines tax liability on the basis of actual (rather than a presumed income) global income from all classes of income whereas the schedular tax charges income on each class of income separately. For details see Chapter 3.

²⁰ Although separately, a schedular system still requires business and professional income to be determined (see Alm and Wallace, above n 6, 6, 12, 22). As discussed the determination of income is the major cause of difficulty in taxing small business income.

²¹ For details see Chapter 4.

objectives by meeting the needs of small businesses in the informal sector of developing countries.

2. Research Gap Bridged by the Thesis

Many developing countries have been using PIT to tax small businesses in order to tackle their large informal sectors. It is believed that low compliance costs emanating from the simplicity of PIT reduces the informal economy by encouraging voluntary compliance by small businesses.²² The taxpayer's attitude towards compliance changes due to the fact that a simple PIT does not impose a high compliance burden in terms of maintenance of accounts and does not give much discretion to the tax administration.²³ PIT also relieves weak administration of the gigantic task of determining the actual income of a large number of small income earners.²⁴ A tax policy designed to facilitate compliance of small business in the informal sector is behind the use of PIT regimes. However, as Muten observes, PIT should be used only for the transition period until the country gets to a development level, where a normal income tax could be implemented successfully.²⁵

Popular presumptive taxes designed in a couple of developing countries to tackle small business in informal economies are based either on 'turnover' or 'gross income'. Other commonly used regimes in this regard are indicator based standard and estimated regimes.²⁶ However, despite its use for more than the last two decades, the results of PIT as discussed in the following paragraph are unclear in terms of tackling informal sector and achieving tax objectives and the principles of a good tax system.

²² Wallace, above n 6b, 1.

²³ Bird and Zolt, above n 3, 51.

²⁴ Manuel Marquez, Alberto Barreix and Luiz Villela, '*Recommendations and Best Practices on Taxation of SMEs in Latin America*' Guide on Technical Cooperation in the Area of Fiscal Policy, Tax Administration and Customs Administration No.ATN/FG-9357-RG, Inter-American Development Bank, 24-26 October 2005, 10 <<http://www.itdweb.org/smeconference/documents/1%20idb%20paper.pdf>> at 2 November 2007.

²⁵ Leif Muten, 'Income Tax Reform' in Vito Tanzi (ed.) '*Fiscal Policies in Economies in Transition*' (1992). It may take a couple of years to develop an appropriate tax policy, tax administration and its operational environment. It, therefore, is wise to use some transitional tax regime like one having presumptive basis. More simply, PIT can only be used as a transitional measure until prerequisites for the normal income taxation are secured.

²⁶ Makedonskiy, above n 2a, 9.

The uncertainty about PIT's performance in tackling the informal economy in developing countries could be due to scarcity of research in this area. In Ukraine, contradictory findings are recorded for improvements in the informal economy in the period after the imposition of PIT, when computed under different models.²⁷ Nevertheless, under all models, the informal sector in Ukraine showed some reduction in size after the introduction of PIT. In Albania, when combined with improvements in tax enforcement, PIT resulted in an increase in the number of registered taxpayers by 28% in one year.²⁸ On the other hand, a study of transitional countries blames the lack of stability, transparency and focus, and an unjustified generosity of PIT regimes as reasons for their failure.²⁹ Another study reveals that PIT regimes failed due to imprecise goals, lack of follow through and time limitation of eligibility.³⁰ Further, it is noted that the revenue contribution by PIT regimes in many countries is meagre.³¹

This lack of confidence in the performance of PIT, despite the theoretical merits of this most simplified regime, could be due to incorrect choices in its design and features, which are inadequate to meet the needs of small business. More aptly, there are a number of PIT variants and it is not yet established which of them is suitable for taxing small businesses in the informal economy of a developing country. This all provides the reason for this investigation.

3. Justification of the Thesis

The justification of this study is:

- (i) The comparative lack of interest in PIT by fiscal experts, despite its widespread use in taxation systems of developing countries.³²

²⁷ Ulrich Thieben, 'The Impact of Fiscal Policy and Deregulation on Shadow Economies in Transition Countries: The Case of Ukraine' (2003) 114 *Public Choice* 295, 308.

²⁸ Engelschalk, above n 2b, 25.

²⁹ Engelschalk above n 2b, 1-7.

³⁰ Bird and Sally, above n 2c, 152.

³¹ See Engelschalk, above n 2b, 27.

³² Vito Tanzi and Milka Casanegra de Jantscher, 'Presumptive Income Taxation: Administrative, Efficiency & Equity Aspects' Working Paper No. 87/54, IMF, 17 August 1987, 5,6<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=884840> at 12 October 2008 take note of rare mention of PIT in public finance books and categorically mention that finance scholars have shied away from PIT by considering it as a primitive and backward; Charles E. McLure, Jack Mutti, Victor

- (ii) Most taxpayers in developing countries pay income tax under some form of PIT (e.g. administrative PIT or fixed tax) rather than the normal income tax.³³ But regrettably, PIT is neither explored well nor is its legislation or designs compared for their adequacy with respect to requirements of a specific problem and the principles of a good tax system.³⁴
- (iii) PIT regimes, which are currently in practice, have divergent designs and their success in securing the goals such as taxing the informal economy is unclear.³⁵ Most of the analytical studies in PIT are done in the form of case studies with limited focus.³⁶ These usually are in the form of single articles covering only one area of the subject. Earlier studies in PIT either examine its general merits or describe its designs, but there are hardly any studies which link them to suggest the merits of each PIT design in the context of a specific problem. More specifically, there are hardly any studies which evaluate PIT designs against the principles of a good tax system in the context of informal economy.

For instance, a sub-Saharan African study suggests that traditional PIT regimes have some weaknesses and therefore average income based PIT for imports (that is, a tax on presumed average income from value of commercial imports) or other Withholding Tax (WHT) based PIT are recommended for raising revenue. This study examines some kinds of PIT regimes, but does not analyse other designs, particularly those which are used to tax small business in the informal sector.³⁷ On

Thuronyi and George Zodrow, *The Taxation of Income from Capital and Business in Columbia* (1990), 92 had made similar observation; Christian R. Jaramillo, 'On the use of Presumptive Income Taxes to Alleviate the burden of Tax Compliance' (2003) *Accounting & Tax periodicals*, National Tax Association – Tax Institute of America 105, 105 also endorses that PIT has received little attention in public finance; Christian, R. Jaramillo H., 'Presumptive Income Taxation and Costly Tax Compliance' Working Paper, Department of Economics, University of Michigan, 19 March 2004, 23 <<http://www.fiscalreform.net/library/pdfs/presumptive%20income%20tax--jaramillo.pdf>> at 12 February 2009 calls for formal analysis of effects of PIT; Faulk et al, above n 15, 1 gave similar reasons for the lack of study in this area.

³³ Tanzi and Casanegra, above n 32a, 3.

³⁴ Id.

³⁵ Wallace, above n 6b, 2.

³⁶ Jaramillo, above n 32c, 105.

³⁷ Taube and Tedesse, above n 13.

the other hand, a study by Thuronyi only describes PIT designs but does not evaluate their relative importance to specific tax policy issues.³⁸

- (iv) More specifically, though the ineffectiveness of the normal income tax increases reliance on PIT by developing countries to tax the informal sector, studies (as mentioned earlier) do not confirm the success of PIT. It is possible that the uncertain outcome of the PIT to achieve this aim could be due to inappropriate design choices. It is a well known saying that one size does not fit all. Thus, each problem requires its own specific design. A PIT design, which is suitable to address the needs of small business, should be used to tackle the informal sector. The lack of knowledge about such a design provides justification for this study.

In addition to appropriateness of PIT design, a number of features can be incorporated in a PIT regime to address a particular tax problem. It seems that features in PIT regimes have not been tailored to meet the needs of a particular jurisdiction, such as taxing small business in the informal sector of developing countries³⁹, and that might be the reason for its unclear outcome. More aptly, it is widely accepted that PIT regimes are not well managed in many countries and there is a strong case for administratively improving its design⁴⁰ in order to encourage voluntary compliance by small business and help its effective enforcement. This study intends to help in this regard.

- (iv) In order to implement a PIT design suitable for informal sector, an appropriate degree of administrative skill is needed to tailor its design, features, rates and quantum of tax liability to the specific requirements of each jurisdiction. For instance, what is simple for one developing country may not be simple for another depending upon the literacy level and economic development etc. The lack of administrative skill results in poor PIT designs, which are unfair and inefficient.⁴¹ Therefore, the administration should be provided with appropriate guidelines to

³⁸ Victor Thuronyi, 'Presumptive Taxation' in Victor Thuronyi (ed.) *Tax Law Design & Drafting* (Volume 1, 1996).

³⁹ Makedonskiy, above n 2a, 4, 35.

⁴⁰ Seth Terkper, 'Managing Small and Medium-Size Taxpayers in Developing Economies' (2003) *Tax Notes International* 211, 211.

⁴¹ Gandhi, above n 8, 6.

calibrate a suitable PIT design and features for taxing small business in the informal economy for its specific jurisdiction. The analysis of PIT designs and features in the context of the needs of small business in this study aims to provide a conceptual framework, which could help the tax administration calibrate its PIT regime to the specific requirements of their jurisdiction.

4. Aim, Approach, Contribution and Scope of the Thesis

The sole aim of this study is to determine the most appropriate PIT regime (its design and features) for taxing small business in the informal economy of developing countries. The significance of this thesis is that it is the most wide ranging single study of PIT for one policy objective, namely taxing small business in order to tackle the informal economy in developing countries.

To achieve this aim, this thesis analyses common PIT designs and features against two parameters. First, PIT designs are analysed against the causes of the informal economy in order to ascertain whether a particular PIT design addresses each of those causes. Second, PIT designs and features are examined against the principles of a good tax system to find out which design is the most appropriate for taxing small business in the informal sector.

Later, PIT legislation of one developing country, namely Pakistan, is tested against the principles of a good tax system in order to ascertain how far that legislation matches the recommended appropriate PIT design. The results of the analysis of Pakistani PIT are then matched against the major objectives e.g. revenue collection and widening of taxpayer base. Lastly, the conclusions are drawn to make recommendations for redesigning PIT for Pakistan.

Broadly, this thesis makes a number of important contributions to the existing body of knowledge. First, this thesis identifies a single PIT, amongst a range of PIT designs, which logically is the most appropriate to meet needs of small business as well as tax administrators in the context of informal economies in developing countries. In addition, this thesis defines and prioritizes the principles of a good tax system in the context of the informal economy of developing countries. Lastly, this thesis provides

the first ever comprehensive analysis of Pakistani PIT in terms of its ability to tax the informal sector and level of adherence to the principles of a good tax system.

The choice of Pakistan for a case study in this thesis is based on the author's long and deep experience with tax administration of that country on one hand, and the heavy use of presumptive measures in Pakistan's income tax code on other hand. As compared to other countries, the author has better access to the case law and government tax rulings in Pakistan, which is helpful due to the time and length constraints of the thesis. Further, despite the use of PIT for the last two decades to tax the informal economy, the tax to GDP ratio in Pakistan remained around 9.0 percent and the number of taxpayers in Pakistan constitutes 1.2 percent of its population. Such poor outcomes encouraged the author to undertake a detailed evaluation of Pakistan's PIT.

The choices as to the scope of the thesis also had to be made due to the time and length limitations and to keep the thesis manageable. This thesis is confined to the role of PIT in taxing small business in the informal sector of developing countries and omits its role of controlling evasion in the formal sector in general or in the corporate sector in particular. Therefore, the use of Minimum Tax (MT) in developing countries and its success in curbing evasion is beyond the scope of this thesis. This thesis also excludes large informal businesses, which operate informally due to their deliberate non-compliant behaviour. The use of PIT for controlling evasion by such sectors, which emanates from non-compliant taxpayer behaviour and constitutes the tip of the OECD's compliance behaviour pyramid⁴², is identified as a potential research area for the future.

Further, the analysis of PIT designs against the principles of a good tax system requires examination of the designs in the context of a country's overall tax legislation of which they form a part. But that demands insight into the legislation of many countries which is beyond the resources of this thesis. Thus, designs are not evaluated in this thesis in their legislative context, but in their abstract ideal forms.

The scope of this thesis is limited to legal presumption, because, administrative presumptions mostly involve some kind of computation of income, which makes the

⁴² For details about the compliance behaviour pyramid see OECD, '*Compliance Risk Management: Managing and Improving Tax Compliance*' Guidance Note, Forum on Tax Administration OECD, October 2004, 39, 41 <<http://www.oecd.org/dataoecd/44/19/33818656.pdf>> at 18 December 2009.

compliance complex and requires prerequisites for its implementation. The administrative PIT, therefore, is usually practiced in developed countries and has little relevance to the problem of small business in developing countries.

Regarding the informal sector, this thesis will focus only on legal income which is concealed from the tax authorities. All illegal income (in which goods and services are themselves illicit such as drug trafficking), being a minor portion of the GDP in most countries, and raising issues other than taxation, are beyond the scope of this thesis. This approach is also consistent with the approach adopted in developing countries for tackling the informal economy.⁴³

The use of presumption in other types of taxes is beyond the scope of this thesis, partly because presumptive taxation is used mostly in income taxation.⁴⁴ Further, a larger number of taxpayers in developing countries are subjected to presumptive income tax than any other presumptive tax. Besides that, presumptive taxes constitute a larger proportion of income tax collection than any other tax in most developing countries.

This thesis also avoids providing a definition of small business. The definition of a small business depends upon the level of economic development, per capita income and proportionate size in each country. Therefore, the definition of small business should be different in each country.

Lastly, to control the informal economy a multipronged approach involving multiple organizations across the government is required.⁴⁵ But, this thesis focuses solely on the role of the tax agency. Therefore, this thesis will not take up issues such as illiteracy and poor return of benefits, which are also important causes of non-compliance in the developing countries.

5. Structure of the Thesis

As shown in Figure 1 of this chapter, the thesis consists of three parts. Part I describes the problem of the small business dominated informal sector in developing countries

⁴³ See Colin C. Williams, 'Tackling the Informal Economy: Towards a Co-ordinated Public Policy Approach' (2005) 20:2 *Public Policy & Administration* 38, 39.

⁴⁴ Victor Thuronyi, above n 38, 5.

⁴⁵ Williams, above n 43, 38-53.

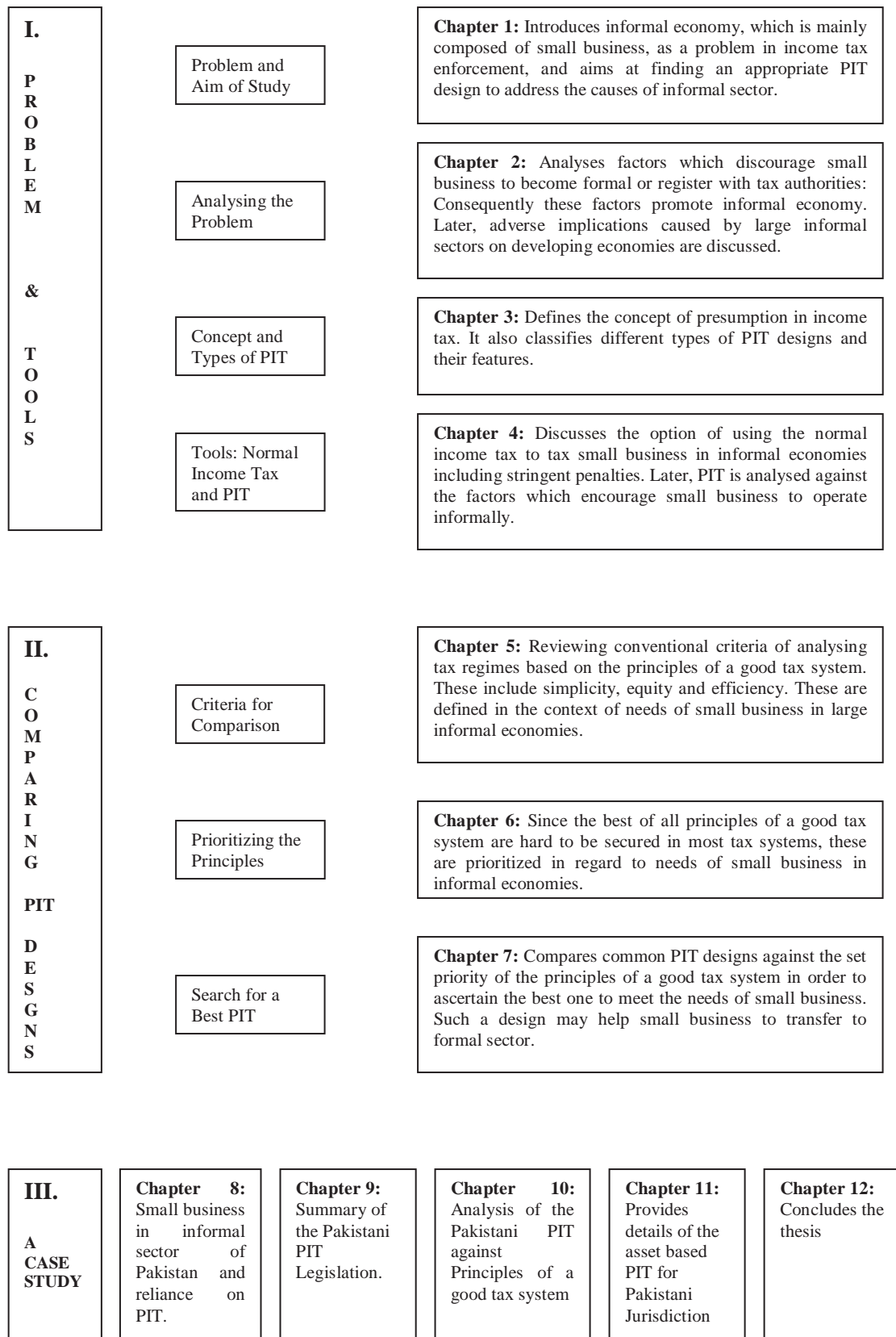
and the relative usefulness of income tax and PIT as tax instruments to tackle the problem. Part I, besides this chapter, contains three more chapters. Chapter 2 reviews literature about the causes and implications of the informal economy in developing countries. Chapter 3 describes the concept, designs and features of PIT. Chapter 4 analyses various reforms in income tax for taxing the informal sector. This chapter also weighs the relative importance of each common PIT design to address the causes of the informal economy in the context of the needs of small business in developing countries.

Part II addresses diverse PIT designs for their ability to address the informal sector, by evaluating them against the conventional criteria of a good tax system. Part II consists of three chapters. Chapter 5 defines the principles of a good tax system in the specific context of large informal economies. Chapter 6 prioritizes the principles of a good tax system for small business in the context of informal economies of developing countries. Chapter 7 makes a comparative analysis of various PIT design and features in terms of the principles and recommends the most appropriate design for large informal economies.

Part III undertakes a case study of the PIT regime of one developing country, namely Pakistan, to ascertain the validity of findings of the analysis made in Part II. Part III consists of five chapters. Chapter 8 reviews literature about informal sector in Pakistan and describes reasons for the introduction of PIT. Chapter 9 summarizes the provisions of Pakistani PIT for small business in informal sector. Chapter 10 analyses the Pakistani PIT legislation against the principles of a good tax system. Later in this chapter, the performance of the existing Pakistani PIT is evaluated against the well known performance indicators in taxation such as revenue collection and expansion of the taxpayer base. Chapter 11 provides recommendations for an asset based PIT design for Pakistan and suggesting supportive measures which could enhance performance of this PIT design in specific context of Pakistan. Chapter 12 concludes the thesis.

Figure - 1

AID TO THE THESIS STRUCTURE



CHAPTER 2 LARGE INFORMAL ECONOMIES: CAUSES AND CONSEQUENCES

Scope of this Chapter: This chapter explores the reasons as to why small businesses in developing countries prefer to operate informally. The analysis of the reasons provides a broad policy guideline for searching for an appropriate tax instrument to tackle large informal economies. The aim of the thesis to find an appropriate PIT design for taxing the informal sector could also be accomplished through a better understanding of the causes of informal economy. The analysis in this chapter suggests reducing both the compliance costs and the role of tax administration by doing away with bookkeeping requirements. More aptly, PIT is recommended to supplant the normal income tax.

1. Introduction

The informal economy, which is dominated by small business⁴⁶, is a major hurdle to economic growth in developing countries. It causes loss of revenue, inequities and economic distortions. Income tax is recommended as the preferred revenue instrument for the informal economy. Other taxes are considered as regressive and consequently a catalyst for the informal economy.⁴⁷ However, statistics show that income tax fails to secure most of its objectives⁴⁸ in developing countries, because the majority of small businesses do not comply with their taxation obligations and instead operate in the informal sector. They hide all or part of their business transactions from the income tax authorities⁴⁹ because the risk of being caught is low due to weak tax administration.⁵⁰

The hiding of income from tax authorities is loosely synonymous with informal activity. In this regard, it is even alleged that income tax itself, because of its high compliance costs, is responsible for the sustenance and growth of the informal sector.⁵¹ Thus, tax

⁴⁶ James Alm, Jorge Martinez-Vazquez, and Friedrich, Schneider, 'Sizing the Problem of the Hard to Tax' (2003) Andrew Young school of Policy Studies, Georgia State University, May 2003, 6 <<http://aysps.gsu.edu/publications/2003/hardtntax.pdf>> at 15 May 2008

⁴⁷ Alm et al, above n 46, 4.

⁴⁸ Schneider and Hametner, above n 18, 5.

⁴⁹ World Bank, 'Designing Tax System for Micro and Small Businesses: Guide for Practitioners' International Finance Commission (IFC), World Bank Group, Washington DC, December 2007, 3.

⁵⁰ World Bank IFC Report, above n 49, vi.

⁵¹ Simon Johnson, Daniel Kaufmann and Pablo Zoido-Lobaton, 'Regulatory Discretion and the Informal Economy' (1998) 88 (2) *The American Economic Review* 349-390.

policy makers in developing countries should construct an income tax design, which ensures voluntary compliance from its operators. For this purpose it is essential to understand the undercurrents of the informal economy in developing countries. More simply, the causes, which encourage small business to operate informally, should be explored in order to construct an income tax design which can counteract those causes.

The analysis in this chapter finds that high compliance costs in general and costs of bookkeeping in particular, high tax rates, and weak administration are the major causes of the informal economy. Low tax morale, corruption in tax administration and economic advantages of operating in the informal sector are the consequential effects of the overall high compliance burden. These findings lead to a recommendation to reduce the compliance burden and lessen the role of tax administration by doing away with the bookkeeping requirements for small business. More specifically, PIT should supplant the normal income tax in large informal economies of developing countries.

The remainder of this chapter is divided in to five sections. Section 2 defines the informal economy. Section 3 reviews the size of informal sector in developing countries to highlight the extent of the problem. Section 4 discusses the causes of informal economy in developing countries in order to draw a broad policy guideline for constructing an appropriate income tax design for small business. Section 5 highlights the implications of the large informal sector on the economy. Finally, Section 6 concludes the chapter.

2. Definition and Scope of the Informal Economy

2.1 Definition of Informal Economy

Though a lot has been written about informal economy, its definition and estimation procedures are still controversial.⁵² The informal economy is commonly defined as market based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of GDP.⁵³ The informal economy has also been defined as those economic activities and the income derived from them that circumvent

⁵² Friedrich Schneider and Robert Klingmair, '*Shadow Economies around the World*' Working Paper No. 0403 Department of Economics, Johannes Kepler University of Linz Austria, April 2004, 3.

⁵³ Edgard L. Feige, '*The Underground Economies, Tax Evasion and Information Distortion*' (1989) 15.

or otherwise elude government regulation, taxation or observation.⁵⁴ The latter definition seems appropriate for income tax policy analysis, because it refers to both the income of such activities and concealing those activities from the tax administration.

However, this thesis expands the definition by including all market based legal production, supply and sale of goods and services, which are deliberately or inadvertently concealed from the public authorities with the effect of avoiding tax, social security contributions, legal labour market standards and other administrative procedures.⁵⁵ Inadvertent non-compliance is included in the definition, because, of the fact that many small entrepreneurs either do not have access to the information or are not literate enough to decipher complex tax codes.⁵⁶ They might prefer to operate in the formal sector if they were helped in relation to these matters. Illegal market activities are excluded from the scope of this thesis due to their small volume in most developing countries and because they involve issues other than taxation.

2.2 Informal Economy is Synonymous with the Small Business Sector

It is noted that informal economy estimates are used as a proxy for hard-to-tax taxpayers (HTT).⁵⁷ Small businesses are the core cluster of the informal economy and inter alia the HTT sector.⁵⁸ Some estimates show that most of small business activity falls within the ambit of informal economy.⁵⁹ Statistics also confirm that small businesses

⁵⁴ Vito Tanzi, 'Uses and Abuses of Estimated of the Underground Economy' (1999) 109 (456) *The Economic Journal* 338, 338; Roberto Dell'Anno, 'Estimating the Shadow Economy in Italy: A Structural Equation Approach' Working Paper No. 2003-07, Department of Economics and Statistics, University of Salerno, May 2003, 4 <[ftp://ftp.econ.au.dk/afn/wp/03/wp03_07.pdf](http://ftp.econ.au.dk/afn/wp/03/wp03_07.pdf)> at 8 October, 2008.

⁵⁵ This is consistent to the definition provided by OECD (for details see OECD, 'Measuring the Non-Observed Economy: A Hand Book' (2002) OECD Paris, 2002, 37-38 <<http://www.oecd.org/dataoecd/9/20/1963116.pdf>> 28 September 2008).

⁵⁶ Australia, 'Improving Tax Compliance in the Cash Economy' Cash Economy Task Force Report, Australian Tax Office, April 1998, iii <<http://www.ato.gov.au/content/downloads/SB39073.pdf>> at 9 August 2008.

⁵⁷ See Alm et al, above n 46, 6, 19; Taube and Tedesse, above n 13, 3 also mention that many HTT are members of the informal economy.

⁵⁸ See World Bank IFC Report, above n 49, 3; also see Alm et al, above n 46, 4.

⁵⁹ See table 17 in Anna Ivanova, Michael Keen and Alexander, 'The Russian Flat Tax Reform' Working Paper No. WP/05/16, January 2005, IMF, Washington DC.

constitute 80-90% of the workforce and over 50% of GDP in frontier economies.⁶⁰ Bahl and Bird also consider that the small business sector overlaps the informal sector.⁶¹ In the same vein, Shome blames the rapid growth in the small business sector as being responsible for simultaneous growth in the informal economy.⁶² Perhaps because of these relationships the term ‘small and medium entities’, is often used interchangeably for the term ‘informal economy’.⁶³

Although small business constitutes a major component of informal sector, large (both non-corporate and corporate) businesses are also engaged in variable levels of informal activities.⁶⁴ In large businesses, informal activity refers to income that is not recorded in the books from which the tax return is prepared.⁶⁵ This thesis mainly focuses on small business, because that is the major component of the informal sector in developing countries.

For policy purposes, small business is usually grouped with medium enterprises and both are referred in the literature as Small & Medium Enterprises (SMEs). SMEs include farmers, traders, small scale manufacturers and craftsmen. Small scale professional and businesses in the service sector like lawyers, doctors, repair workshops, restaurants, bakeries and hotels etc also operate in the informal sector.⁶⁶ They are often family operated and have very low profit margins.⁶⁷

The classification of these businesses into the ‘micro’, ‘small’ and ‘medium’ businesses varies from country to country and for different purposes. For example, for the purpose

⁶⁰ Richard Stern and Jan Loeprick, ‘*Small Business Taxation: Is this the Key to Formalization: Evidence from Africa and Possible Solutions*’, FIAS Tax Team, World Bank, 4 September 2007, 3 <<http://www.businessenvironment.org/dyn/be/docs/159/Coolidge.pdf>> at 5 April 2008.

⁶¹ Roy W. Bahl and Richard M. Bird, ‘Tax Policy in Developing Countries: Looking Back – and Forward’ (2008) 61 *National Tax Journal* 279, 290.

⁶² Parthasarathi Shome, ‘*Tax Administration and Small Taxpayer*’, Policy Discussion Paper No. PDP/04/02, International Monetary Fund, May 2004, 4 <<http://www.imf.org/external/pubs/ft/pdp/2004/pdp02.pdf>> at 12 December 2007; Marquez et al above n 24, 16 argues that Latin American countries lack business databases because small businesses in these countries mostly operate informally.

⁶³ See Alm et al, above n 46, 4.

⁶⁴ See Alm et al, above n 46, 5.

⁶⁵ See Australia ATO Report, above n 56, 17.

⁶⁶ Taube and Tedesse, above n 13, 3.

⁶⁷ Jaramillo, above n 32d, 4.

of access to finance, the definition of small business could be different from the definition used for the purpose of tax concessions. Similarly, a business which is called micro in a developed country may be called medium or large in a developing country because of proportionally lower capital levels in the developing countries. The term small business has to be seen in the context of the jurisdiction. For instance, a small business in a large city could be larger than a large business of a small village. For example, the Australian Taxation Office refers businesses with turnover of less than \$2 million per annum as micro business⁶⁸, whereas in a developing country like Pakistan, the average turnover of small businesses is between \$1,000 and \$4,000 only⁶⁹. Thus, for tax purposes, definition of small business needs to vary from country to country.⁷⁰

Moreover, a wide range of criteria is used for the purpose of the classification.⁷¹ In income tax, the choice of criteria is hard, because taxpayers may manipulate the criteria in order to avail themselves of the tax concessions envisaged for small business.⁷² Though business turnover is the most common criterion for offering eligibility for tax concessions, it is not rare to use the amount of tax paid, the number of employees, the capital base or even the industry type as the criterion.⁷³ In terms of entity type, corporate businesses are usually taken out of the definition of small businesses⁷⁴, because these are incorporated and are fulfilling many documentation obligations under the corporate law and consequently are expected to comply with tax requirements as well. For the same reasons, corporate business may not completely hide in the informal sector.

⁶⁸ Australia, 'Scoping Study of Small Business Tax Compliance Costs', A report to the Treasurer by Chairman Board of Taxation, Commonwealth of Australia, December 2007, 27 <http://www.taxboard.gov.au/content/scoping/scoping.asp> at 4 August 2008. This report takes this information from 'Commissioner of Taxation Annual Report 2006-07', 106 http://www.ato.gov.au/content/downloads/n0995_AR_2006_07_w.pdf at 23 June, 2010.

⁶⁹ For details see Chapter 8 of the thesis.

⁷⁰ OECD, 'Taxation and Small Business' Part II, OECD, April 1994, 23 http://www.oecd.org/document/46/0,3343,en_2649_34533_38007150_1_1_1_1,00.html at 10 September 2009.

⁷¹ A best criterion, which is in use to identify informal firm, is of International Labour Office, 1972. According to this criterion, an informal firm has less number of employees, pay fewer wages and has high evasion levels (Scale dualism, Wage dualism and Evasion dualism).

⁷² See World Bank IFC Report, above n 49, 40.

⁷³ See World Bank IFC Report, above n 49, 40; also see Marquez et al, above n 24, 5.

⁷⁴ See World Bank IFC Report, above n 49, 41.

3. Size of Informal Sector: The Extent of Non-Compliance

The extent of informality is roughly estimated by comparing the total number of businesses with the registered ones in a country or by comparing the registered ones with the total population of the country. For example, in Rwanda, out of 70,000 micro and small enterprises, only 1,000 are registered with the tax authority. In Philippines, registered Value Added Tax (VAT) taxpayers constitute only 0.32% of the total population.⁷⁵ These are crude indicators of the extent of non-reporting of transactions to the tax authorities.

The precise estimation of the size of the informal economy, however, is not only difficult, but is also riddled with controversies. Moreover, the accurate estimation of the informal economy is considered as a scientific exercise⁷⁶ and is not relevant to the thesis, which mainly focuses on how to tax small businesses in the informal sector rather than aiming to resolve its estimation controversies.⁷⁷ The methods of estimation are, therefore, not elaborated here. Nevertheless, some estimates of the size of the informal economy, computed under such mechanisms provide a sense of the extent of the problem. The average size of the informal economy in Africa, Asia, South America, OECD and transitional countries is 41%, 26%, 41%, 18% and 38% respectively.⁷⁸ The size has been further enlarged by the recent world wide growth in the service industry;⁷⁹ which is becoming the single most important sector in developing economies.⁸⁰ Internet trading is an emerging contributor in the growth of informal sector.⁸¹ The statistics of India, Brazil and China confirm this finding.⁸² The statistics on size show that a large

⁷⁵ World Bank IFC Report, above n 49, 5.

⁷⁶ See Schneider and Klingmair, above n 52, 3.

⁷⁷ However, the size of the shadow economies could be measured under various techniques such as Electricity Demand Method and the Model Approach.

⁷⁸ See Alm et al, above n 46, 9-10. For transitional countries, see Friedrich Schneider, 'The Increase of Size of the Shadow Economy of 18 OECD Countries: Some Preliminary Explanations' (2000) a paper presented at the Annual Public Choice Meeting, March 10-12, 2000, Charleston, S.C, 18 <<http://www.econ.jku.at/papers/2000/wp0008.pdf>> at 12 October 2007.

⁷⁹ This increase in the size has raised this issue to the top of the public policy agenda in developed countries as well (see Williams, above n 43, 39).

⁸⁰ See Alm et al, above n 46, 11.

⁸¹ United Kingdom, 'Comparing How Some Tax Authorities tackle the Hidden Economy' A report by the Comptroller and Auditor General; ordered by House of Commons, National Audit Office UK, 3 April 2008, 7 <www.nao.org.uk/idoc.ashx?docId=3890f6c0-c342-412f...1> at 24 February 2009.

⁸² Shome, above n 62a, 4.

component of the total economy is un-taxed because of the informal sector.⁸³ More simply these statistics reflect the huge size of the ‘tax base gap’⁸⁴ and the gravity of the problem in developing countries.

4. Causes of Informal Economy in Developing Countries

Income tax is considered to be a better instrument to collect revenue in informal economies⁸⁵ but paradoxically, among other factors, its inappropriate policy and legislative design have been promoting the informal economy in developing countries. Four of the most important stimulants of the informal economy or the reasons encouraging small business to operate informally are mainly linked to poor income tax design. These stimulants are discussed below in order to draw a broad policy guideline for constructing an appropriate income tax design for the informal sector.

4.1 High Taxation Costs

High tax compliance costs are considered as a strong disincentive to comply with tax requirements, and consequently are a major stimulant of the informal economy.⁸⁶ Some empirical studies show the influence of taxation costs on informal economy,⁸⁷ and many qualitative studies also endorse this view. For example, in Bulgaria, small businesses consider the tax burden as a big hurdle in their expansion.⁸⁸ In Pakistan, 67% of small businesses consider tax regulation to be the most problematic in doing business compared to other regulations.⁸⁹ In Ukraine, high tax rates and multiplicity of taxes are

⁸³ Taube and Tedesse, above n 13, 3.

⁸⁴ See Stern and Loeprick, above n 60, 3.

⁸⁵ Daniel Brou and Kirk A. Collins, ‘Winning at Hide and Seek: The Tax Mix and the Informal Economy’ (2001) 49:6 *Canadian Tax Journal* 1539, 1555.

⁸⁶ Schneider and Hametner, above n 18, 4; Stern and Loeprick, above n 60, 7 consider taxation as a key driver of informality.

⁸⁷ See Friedrich Schneider, ‘Can the Shadow Economy be Reduced through Major Tax Reforms: An Empirical Investigation of Austria’ (1994b) 49 *Supplement to Public Finance Finances Publiques* pp.137-152; Johnson et al above n 51, 390.

⁸⁸ Ahmet Salik Ikiz, ‘Shadow Economy in Bulgaria: Small and Medium Enterprises and Taxation’ Fiscal Reform and Economic Governance USAID 2002, 9 <<http://www.csd.bg/fileSrc.php?id=10420>> on 20 May 2009.

⁸⁹ Pakistan, ‘Developing SME Policy in Pakistan’ *SME Issues Paper–For Deliberation by SME Task Force* Small and Medium Enterprise Development Authority, 2006, 7 < www.smeda.gov.pk > at 4 April 2009.

considered as a major problem for entrepreneurship.⁹⁰ In New Zealand, 41% of total compliance costs are related to tax matters.⁹¹

The above studies are consistent with the finding of Jaramillo that small businesses can not afford the cost of keeping organized records of their economic activity⁹², which are required only for tax compliance. In many countries, the only interface small entrepreneurs are likely to have with the government is through interaction with the tax authorities⁹³ and any complexity and high costs in that activity are considered as the major barriers to doing business in the formal sector.⁹⁴ As stated by Yitzhaki, those who register may be forced in to bankruptcy due to there being a disproportionately high tax burden in relation to their income and production inputs.⁹⁵ Others survive perhaps only by operating in the informal sector.

Among taxes, income tax is the most problematic because many small businesses usually fall outside the ambit of indirect taxes. For example, in Pakistan, it is estimated that 84% of enterprises have annual sales below PKR 0.5m⁹⁶ (equivalent to A\$8,000), which is within the exemption threshold of Goods and Services Tax (GST).

In monetary terms, the increase in net 'take home' returns of a business after non-compliance, which is directly proportionate to the tax burden, provides a sufficient reason for a rational entrepreneur to stay informal. Therefore, tax and social security

⁹⁰ World Bank, *'The State of Small Business in Ukraine'* IFC, World Bank Group, 1996, 33 <[http://www.ifc.org/ifcext/eca.nsf/AttachmentsByTitle/Ukr_SME_survey1996_eng/\\$FILE/Ukraine_SME_survey_1996_Eng.pdf](http://www.ifc.org/ifcext/eca.nsf/AttachmentsByTitle/Ukr_SME_survey1996_eng/$FILE/Ukraine_SME_survey_1996_Eng.pdf)> at 4 October 2009.

⁹¹ KPMG, *'Business/New Zealand, Compliance Cost Survey'* Business NZ, KPMG, September 2006, 24, 35 <<http://www.kpmg.co.nz/download/103338/113071/2007%20Compliance%20Cost%20Survey%20-%20summary%20report.pdf>> at 12 June 2009.

⁹² See Jaramillo, above 32d, 4.

⁹³ Richard E. Stern and Paul A. Barbour, *'Designing a small business tax system that enhances growth; lessons from Africa'* Draft Discussion Paper, FIAS, World Bank, December 2005, 4 <<http://www.itdweb.org/smeconference/documents/3%20africa%20fias.pdf>> at 19 February 2009.

⁹⁴ *'Paying Taxes: The Global Picture'*, World Bank/PricewaterhouseCoopers, 2006, 5, 16 <http://www.doingbusiness.org/documents/DB_Paying_Taxes.pdf> on 4 October 2009: Taxation is identified as a main barrier for small business in Pakistan (see Chapter 8 of this thesis).

⁹⁵ Shlomo Yitzhaki, *'Cost Benefits Analysis of Presumptive Taxation, Alternate Methods of Taxing Individuals'* Andrew Young school of Policy Studies, Georgia State University, 1 June 2006, 3; Jaramillo, above n 32c, 108.

⁹⁶ 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 7 April 2009.

burdens are considered to be responsible for the persistence and growth of informal economies.⁹⁷

For further analysis, taxation costs are divided into the administrative and technical compliance costs.⁹⁸ Small business due its peculiar nature bears a proportionality larger burden of administrative costs, which is also emphasized below under a separate heading.

4.1.1. Administrative Compliance Costs

Administrative compliance costs are defined as costs borne by taxpayers over and above the tax liability and costs arising from tax related economic distortions.⁹⁹ These costs mainly are those arising from complying with administrative rules and include reporting compliance, procedural compliance and regulatory compliance.¹⁰⁰ The non-monetary elements of the administrative costs (like psychological costs) are difficult to estimate and are therefore not emphasized in this thesis.

In other words, compliance with laws normally causes supplementary costs¹⁰¹, which are linked to the complexity and intensity of regulation in the law. Though the burden on small business is composed of the technical and administrative compliance costs, the major share of this burden is administrative compliance costs.¹⁰² Theiben's economic model indicated that this burden plays a larger role than the statutory tax liability in a

⁹⁷ See Tanzi, above n 54a, 345; See Marquez et al, above n 24, 5; Annette Mummert and Friedrich Schneider, 'The German Shadow Economy: Parted in a United Germany?' (2001) 58/3, *Finanzarchi*, 262; Giles David E.A. and Tedds Linsey M., '*Taxes and the Canadian Underground Economy*' (2002), Canadian Tax Paper No.106, Canadian Tax Foundation Toronto/ Ontario; Friedrich Schneider, 'Shadow Economies around the World: What do We Really Know' (2005) 21:3 *European Journal of Political Economy* 598, 601.

⁹⁸ OECD, '*Compliance Measurement – Practice Note*' (2001), Tax Guidance Series: General Administrative Principles - GAP004 Compliance Measurement, Centre for Tax Policy and Administration, OECD, 10 May 2001, 3 <<http://www.oecd.org/dataoecd/36/1/1908448.pdf>> at 08 June 2009.

⁹⁹ See OECD Practice Note, above n 98, 3. Cedric Sandford '*The Rise and Rise of tax Compliance Costs*' 1995 <<http://www.tax.org.uk/showarticle.pl?id=1567>> at 4 October 2009 refers the administrative costs as the costs incurred by tax authorities in administering the tax system. This thesis follows the OECD's understanding of this term because it has focused on taxpayer's compliance related issues and could be more useful in examining the reasons of non-compliance in an informal economy.

¹⁰⁰ See OECD Practice Note, above n 98, 3.

¹⁰¹ See Schneider and Hametner, above n 18, 5.

¹⁰² Francesca Lagerberg, 'Putting Research into Practice' in Andy Lymer and David Salter (ed.) *Contemporary Issues in Taxation* (2003) 12.

firms' decision to operate informally.¹⁰³ The intricate tax system, which increases costs to meet statutory and procedural obligations, is considered as 'one of the main reasons'¹⁰⁴ for non-compliance and the preference for the business to stay in the informal sector. Shome also argues that the high administrative compliance cost discourage businesses to become formal and thus sustains the informal sector.¹⁰⁵

The findings of some studies that compliance costs have an insignificant effect in enforcing income tax¹⁰⁶ are not relevant to developing countries, because the effect of compliance costs depends upon the specific institutions of a country.¹⁰⁷ In fact, in developing countries, which mostly have arbitrary tax administrations, complexity of the tax system increases the compliance costs and the informal economy.¹⁰⁸

Some other studies, based on theoretical models, show that compliance costs have low impact on compliance level by arguing that compliance behaviour of a taxpayer is driven by the economic benefit instead of the complexity. Thus, if a complex provision yields an economic benefit, the taxpayer would comply with it. In contrast, a simple provision which does not yield an economic benefit would not be complied with.¹⁰⁹ However, such studies have little relevance for small business, which have neither knowledge nor resources to capitalize on complex tax saving provisions in the tax code.

Lastly, it is even noted that substantial tax reductions do not reduce the informal sector significantly, if the tax rules and regulations are not simplified.¹¹⁰ For example, an

¹⁰³ Thieben, above n 27, 309.

¹⁰⁴ See Schneider and Hametner, above n 18, 4.

¹⁰⁵ See Shome, above n 62a, 6.

¹⁰⁶ The estimates of informal activity in Austria show that decreasing complexity reduces informal activity (see Schneider F. and Neck R., 'Shadow Economy under Changing Tax Systems and Structures' (1993) 50 *Finanzarchiv*, pp.344-368).

¹⁰⁷ Thieben above n 27, 299-300 showed in Ukraine, which had uncertain rules and arbitrary behaviour, that simplification increases the compliance.

¹⁰⁸ See Theiben, above n 26, 299-300.

¹⁰⁹ Andrew D. Cuccia and Gregory A. Carnes, 'A Closer Look at the Relation between Tax Complexity and Tax Equity Perceptions' (2001) 22 *Journal of Public Psychology* 113, 133.

¹¹⁰ Schneider, above n 87, 137-152.

empirical study suggests that despite tax reforms in African countries, the tax system is still complex and therefore has failed to widen the taxpayer base.¹¹¹

A number of qualitative studies have been conducted to identify the constituents of administrative compliance costs in developed countries. For example, a Canadian study identified the amount of paper work, complexity of the tax system, frequent changes in tax legislation and multiple audits as main contributors to costs.¹¹² The CPA survey of small business in Australia found that 41% of small businesses felt that the paperwork burden to comply with tax had increased to the point where they questioned staying in business.¹¹³ Jaramillo even argues that many firms are effectively driven out of business by the tax requirements.¹¹⁴ It can be inferred very safely that, if small businesses of Australia with turnover of A\$2.0 million consider compliance costs cumbersome, then these costs for small business (which as discussed earlier are much smaller in terms of capital and turnover) in the developing country might be devastating.

The analysis of administrative compliance costs in the developing countries is scant. A study in Malaysia shows bookkeeping, both in terms of time and money spent, as the major compliance cost in personal income taxation.¹¹⁵ In India, a recent study identifies audits, bookkeeping and return filling as the highest of all compliance costs.¹¹⁶ Another study in India in respect of personal income tax revealed that 'record keeping and advisors fees form the bulk of costs for non-salaried individuals'.¹¹⁷ In terms of the

¹¹¹ Odd-Helge Fjeldstad and Lise Rakner, 'Taxation and Tax Reforms in Developing Countries: Illustrations from Sub-Saharan Africa' Chr. Michelsen Institute Report No. R 2003:6, May 2003, 7 <<http://www.cmi.no/publications/file/?1551=taxation-and-tax-reforms-in-developing-countries>> at 4 October 2009.

¹¹² Doug Bruce, 'Canada's Revenue Agency Five Years After' (Report, Canadian Federation of Independent Business, 2005), 9 <http://www.cfib.ca/quebec/en/pdf/crareport_190405.pdf> at 24 April 2008.

¹¹³ CPA Australia, 'Small Business Survey Program: Compliance Burden' April 2003, 6 <http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FECB8CD9D8B/cpa/hs.xsl/726_3049_ENA_HTML.htm> at 28 September 2008.

¹¹⁴ Jaramillo, above n 32c, 108.

¹¹⁵ Noor Sharoja Sapiei and Mazni Abdullah, 'The Compliance Costs of Personal Income Taxation in Malaysia' (2008) 4:5 International Review of Business Research Papers, 228.

¹¹⁶ Arindam Das-Gupta, 'The Income tax Compliance Costs of Corporations in India' (2000-2001)', Goa Institute of Management, Goa September 2003, 11 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=466041> at 12 July 2009.

¹¹⁷ Arindam Das-Gupta, 'The Compliance Cost of the Personal Income Tax in India, 2000-01: Preliminary Estimates' National Institute of Public Finance and Policy, New Delhi, October 2003, 10 <<http://ssrn.com/abstract=466021>> at 13 March 2009.

total income, compliance costs are equivalent to 6.8% of gross income of a taxpayer. However, this high cost does not include the psychological costs borne by taxpayers due to harassment by tax officials during audit proceedings.¹¹⁸ Further, this study found that, 'Even if time compliance costs are totally omitted, average monetary compliance costs as a percentage of tax are large relative to total compliance costs of the income tax found internationally'.¹¹⁹ More specifically record keeping, in terms of 'time compliance' in India, costs rupees 27,000 per annum for non-salaried taxpayers.¹²⁰ Further, the compliance costs are double the tax liability itself and these costs for non-salaried persons are 7-10 times higher than those of salaried persons.¹²¹ The author of this thesis, being a tax officer of Pakistan for more than a decade, notes that the many non-salaried entrepreneurs in Pakistan have a tax liability less than PKR 5,000 per annum (that is, 1/5th of the costs for maintenance of books). In all, the genuine difficulty in keeping even simple records by small business in developing economies is well recognized.¹²²

The above studies reflect the dismal picture of administrative tax compliance costs in developing countries and may explain why 'only 5% of the tax base complies with tax obligations'.¹²³ It is also noted that many small businesses keep accounts only for tax compliance and that constitutes the majority of total unwanted compliance costs.

More importantly, the impact of tax compliance costs varies from country to country depending upon the extent of small business activity. For example, the cost of maintaining accounts is approx. PKR 27,000 (A\$350) in Pakistan¹²⁴ where the average income of small business is PKR 100,000 (A\$1,400). The cost in Australia is equivalent to approximately A\$500¹²⁵, yet the average income of small business is approximately

¹¹⁸ Das-Gupta, above n 117, 16.

¹¹⁹ See Das-Gupta, above n 117, 16.

¹²⁰ See Das-Gupta, above n 117, 16.

¹²¹ See Das-Gupta, above n 117, 15.

¹²² Terkper, above n 40, 212.

¹²³ See Stern and Loeprick, above n 60, 2.

¹²⁴ For part time salaries of accounting graduates see [http://www.bayrozgar.com/Accounts-Tax-CS-Audit/Accountant-\(Part-Time\)-13534.html](http://www.bayrozgar.com/Accounts-Tax-CS-Audit/Accountant-(Part-Time)-13534.html) at January 25, 2011. The cost of bookkeeping through online services is also available on various websites.

¹²⁵ Chris Evans, Katherine Ritchie, Binh Tran-Nam and Mike Walpole, 'A Report into the Taxpayer Costs of Compliance' (Report, Australian Government Publishing Service Canberra, 1997), , 79.

A\$25,000 and the exemption threshold is A\$6,000. Therefore, the cost of bookkeeping in Australia, when compared to Pakistan, has a proportionately smaller influence on the decision of a small business as to whether to operate in the informal or formal sector.

Similarly, in the year 2000 when GST was introduced in Australia, start up costs based on new technology was approximately A\$3,000 (It excludes time costs) constituting 2% of average small business turnover (that is, say A\$100,000/=).¹²⁶ A similar cost in developing countries like Pakistan is around 25-100% of the turnover for small businesses (the average turnover is approximately PKR 0.5m (equivalent to A\$7,000)). Likewise, the free record keeping software offered in Australia is relatively very expensive for small business in developing countries, because that requires a computer system and an operator (the total start up costs are already mentioned above).¹²⁷ More aptly, the cost of a computer (i.e. approximately A\$1,000) is proportionately very high for a small business in Pakistan where average annual turnover is approximately A\$7,000; when compared to a micro business in Australia with turnover of A\$2.0 million. Even this cost is reported as a significant burden for small business in Australia, which generally has a turnover of A\$2.0-10.0 million¹²⁸, a volume of activity which only large businesses can have in a developing country such as Pakistan. More simply, the impact of compliance costs depends on the level of turnover and income which varies from country to country. Therefore, logically small businesses in developing countries, due to their low turnover, should be subjected to a relatively lower administrative compliance burden.

To put it differently, a taxpayer in a developing country, (for example, in Pakistan)¹²⁹ falling in the lowest taxpaying bracket (that is, taxable income of PKR 100,000 to 110,000 (equivalent to A\$1,400) is liable to pay tax at a rate of 0.5%. The resulting tax liability stands at approximately PKR550 (A\$8). Even up to taxable income of PKR 300,000 (equivalent to A\$4,000) the tax payable stands at PKR 15,000 (equivalent to A\$

¹²⁶ Jeff Pope and Nthathi Ramtse, 'Small Business and the Goods Services Tax; Compliance Cost: Estimates and Lessons from Tax Reform' (2002) 5 (3) *Journal of Australian Taxation* 382, 386.

¹²⁷ United Kingdom National Audit Office Report, above n 81, 33.

¹²⁸ Australia Board of Taxation Report, above n 68, 27, 57.

¹²⁹ Under Rule 29 and 30 of *Income Tax Rules 2002 of Pakistan*, every taxpayer having income from business and profession is required to keep books of accounts. Taxpayers above income of PKR 200,000 (equivalent to A\$2857) are required to keep cash book and ledger and other records.

200), which is less than the cost of keeping accounts. The cost of tax agents to file a tax return is in addition to the bookkeeping cost.¹³⁰

In view of the above, this thesis draws the attention of tax policy makers towards a drastic redesigning of income tax and doing away with the statutory requirement for bookkeeping and frequent audits in small business to reduce compliance costs and to effectively implement income tax. More aptly, Stern and Loeprick suggest that tax systems for small business should require compliance commensurate with their capacity.¹³¹

4.1.2 Technical Compliance Costs

Technical compliance costs are mainly those which arise from payment of taxes computed in accordance with the provisions of law.¹³² Studies claim that the tax rates influence the growth of the informal economy. For example, if the marginal personal income tax rate increases by one percentage point the shadow economy rises by 1.4 percentage points.¹³³ In an empirical study of Scandinavian countries, the average tax rates, the average total tax rates and the marginal tax rates have been found to be causally linked to an increase in the size of the informal economy.¹³⁴ Also, in underground-economy models, tax rates and the progressivity of tax rates are shown to have a positive effect on the probability of participating in the informal economy.¹³⁵

It is noted that even the introduction of simplified regimes in some countries could not reduce the informal sector, when those regimes had high tax rates.¹³⁶ However, developing countries, despite relatively low tax rates tend to have larger informal

¹³⁰ Even Australia with high literacy rates, 95 percent small businesses file returns through tax agents because of the perception that lodgement of returns require specialist knowledge (Australia Board of Taxation Report, above n 68, 95).

¹³¹ Stern and Loeprick, above n 60, 12.

¹³² See OECD Practice Note, above n 98, 3.

¹³³ Richard J. Cebula, 'An Empirical Analysis of the Impact of Government Tax and Auditing Policies on the Size of the Underground Economy: The Case of United States, 1993-94' (1997) 56 (2) *American Journal of Economics and Sociology*, 173-185.

¹³⁴ Friedrich Schneider, 'Estimating the size of the Danish Shadow Economy: Using the Currency Demand Approach' (1986) 88 (4) *Scandinavian Journal of Economics*, 643-688.

¹³⁵ Greg Trandel and Arthur Snow, 'Progressive Income Taxation and the Underground Economy' (1999) 62 *Economic Letters* 217, 218.

¹³⁶ See Stern and Loeprick, above n 60, 8.

sectors.¹³⁷ This paradox could be explained by the higher impact of the administrative compliance costs on small business in developing countries. Therefore, this thesis suggests both the reduction of the administrative compliance costs by simplifying income tax and a reduction of tax rates, because action in either of these areas alone might not tackle the informal sector.

4.1.4 Peculiarity of Small Business

Many qualitative and quantitative studies show that small firms also face ‘inverse economies of scale’ in relation to compliance costs. It takes an equal amount of time to register and pay income tax on profits of \$1 million as it does for profits of \$10,000.¹³⁸ In other words, compliance costs are regressive and put a disproportional burden on small businesses.¹³⁹ A study for Slovenia found that compliance costs are 0.08% and 3.73% of gross turnover for large and small businesses respectively.¹⁴⁰ A similar study in India found that compliance costs are between 0.01% and 1.28% of gross turnover for firms with turnovers over 5 billion rupees and with turnovers below 20 million rupees respectively.¹⁴¹ In Malaysia, compliance costs are four times higher for SMEs.¹⁴² Hence, there is more temptation, in terms of ‘take home’ returns, for small businesses to operate within the informal sector. This is consistent to what was said earlier, that the overall tax compliance costs faced by small businesses is higher than large businesses,

¹³⁷ Emmanuelle Auriol and Michael Walters, ‘Taxation Base in Developing Countries’ (2005) 89 *Journal of Public Economics* 625, 626.

¹³⁸ See Stern and Barbour, above n 93, 3.

¹³⁹ See Chris Evans, Katherine Ritchie, Binh Tran-Nam and Michael Walpole, ‘Taxation Compliance Costs: Some Recent Empirical Work and International Comparisons’ (1998) 14:2 *Australian Tax Forum*, 93-122; World Bank IFC Report, above n 49, 1; World Bank, ‘Tax Compliance Burden for Small Businesses: A Survey of Tax Practitioners in South Africa’ (2007) FIAS, World Bank Group, August 2007, 83-87 <<http://www.itdweb.org/smeconference/documents/2%20south%20africa%20fias.pdf>> at 5 October 2009; Chris Evans, ‘Studying the Studies: An Overview of Recent Research into Taxation Operating Costs’ (2003) 1(1) *eJournal of Tax Research* 64; Muhammad Arif and Jeff Pope, *Taxation and Compliance Costs in Asian Pacific Economies* (2002), 96.

¹⁴⁰ Maja Klun and Helena Blazi’C, ‘Tax Compliance Costs for Companies in Slovenia and Croatia’ (2005) 61 (3) *Finanz Archiv*, 418.

¹⁴¹ Saumen Chattopadhyay and Arindam Das Gupta, ‘The Income Tax Compliance Costs for Indian Corporations’ National Institute of Public Finance and Policy, New Delhi, December 2002, 18 <http://planningcommission.gov.in/reports/sereport/ser/stdy_cpirtcost.pdf> at 15 March 2008.

¹⁴² Mustafa Hanefah, Mohamed Ariff and Jeyapalan Kasipillai, ‘Compliance Costs of Small and Medium Enterprises’ (2002) 4 (1) *Journal of Australian Taxation* 73, 96.

which sometimes even hampers economic growth¹⁴³ in developing countries. It strongly endorses the case for simplifying the tax regime for small business.

In addition, the compliance attitude of small business is different from the corporate sector, because small business does not have access to expensive tax advisory services to reduce the tax liability of transactions.¹⁴⁴ On the contrary, small business tends to follow the principle of ‘all or none’ in terms of their disclosure of transactions. Consequently, they might prefer to conceal either all or none of the transactions from the tax authorities. Because of this characteristic, a tax regime with low compliance costs is recommended for small businesses, which can tilt their decision in favour of declaring all their transactions by operating in the formal economy.

4.2 Economic Gains: Operating Informal is a Competitive Advantage

Tax influences a persons’ cost-benefit analysis. For example, a business entrepreneur compares the costs and benefits of operating in the informal sector. The main economic gains in the informal sector arise from avoidance of income tax payments and savings of related compliance costs. Because of those gains, a small business can sell their products at a lower price and still have higher take home returns than a formal business. They also avoid wasting time and stress by not interacting with government agencies.¹⁴⁵ As a result, operating informally provides a competitive advantage and has an economic incentive.

In addition, those informal businesses have greater access to shadow labour, which is completely tax free (as no tax is withheld from them). Estimates of shadow labour are available for developed countries¹⁴⁶, but no such studies have been conducted in developing countries. This availability of cheap labour also provides a competitive edge. Employees also make some gains from the arrangement. Both employees and employers, as rational persons, develop tight relationships and social networks, which

¹⁴³ See Stern and Barbour, above n 93, 2.

¹⁴⁴ World Bank IFC Report, above n 49, vii.

¹⁴⁵ See World Bank IFC Report, above n 49, 20.

¹⁴⁶ For statistics see Schneider and Klingmair, above n 52, 14.

promote informal activities.¹⁴⁷ This relationship may be called a ‘symbiotic’ relationship, which is mutually beneficial to both colluding parties.

Further, the element of high un-employment rates in the formal sector in developing countries is pushing some employees to the informal sector against their will. Studies show a positive relationship between the unemployment rate and informal activities.¹⁴⁸ The decrease in the demand of labour in the formal sector during financial crises has tended to increase shadow labour.¹⁴⁹ The worldwide recession in the 1970s recorded the same trend¹⁵⁰ and a worldwide surge in the informal activities in the 2008-09 financial crisis could also be expected.

It is likely that shadow labour is not attracted to the formal sector, because shadow labour does not need business finance or a market share. They might be lured to the formal sector by reducing their tax burden and providing other benefits like social security in formal employment. Low salary tax rates may also take away the cheap labour advantage from informal employers and consequently they may shift to formal sector. Both these factors are absent in the tax system of developing countries, which may be the reason for their large informal sectors.

The withholding tax (WHT) regime is a common feature in many developing countries, where the payer has to deduct tax on the different transactions and deposit it in the treasury. When inputs are obtained from the informal sector, these are not subjected to WHT and therefore can be obtained at a cheaper rate. Informal businesses save a lot of tax money as their receipts are also not subjected to withholding tax. More simply, their receipts are higher by the tax amount as compared to that of formal businesses. The

¹⁴⁷ Schneider and Hametner, above n 18, 4. Peter S. Spiro, ‘Evidence of Post GST Increase in the Underground Economy’ (1993) 41(2/2) *Canadian Tax Journal* 247-258; Tanzi, above n 54a, 343; Canada, ‘*The underground Economy: Measurement and Consequences*’ Library of Parliament Canada, PRB 04-40E, 2 November 2004, 13 <<http://dsp-psd.pwgsc.gc.ca/Collection-R/LoPBdP/PRB-e/PRB0440-e.pdf>> at 5 October 2009.

¹⁴⁸ Friedrich Schneider and Benno Torgler, ‘*The Impact of Tax Morale and Institutional Quality on the Shadow Economy*’ Working Paper No. 0702 Department of Economics Johannes Kepler University of Linz, Austria, January 2007, 12.

¹⁴⁹ Peter De Gijsel, (1984), *Ökonomische Theorie des Schwarzarbeitsangebots und der Mehrfachbeschäftigung*. in: Gretschnann, Klaus; Heinze, Rolf G.; Mettelsiefen, Bernd (Hrsg.), *Schattenwirtschaft. Wirtschafts- und sozialwissenschaftliche Aspekte, internationale Erfahrungen*. Göttingen (Vandenhoeck und Rubrecht) pp.76–96 as quoted in Schneider and Hametner, above n 18, 6.

¹⁵⁰ Schneider and Hametner, above n 18, 6.

informal business, being unregistered, usually avoids acting as WHT agents for government and consequently does not incur compliance costs of the WHT regime. These are another of a series of financial gains arising from taking an informal position. Value Added Tax (VAT) regimes also have similar characteristics. The products are sold by the informal sector at a cheaper price (the difference of amount of VAT charge), which provides another competitive advantage. The WHT regime, like VAT, does have some taxing function in the informal sector¹⁵¹, but the informal sector can avoid it by operating purely in informal social networks and tight relationships. Social networks and personal relationships in human capital and high profits from irregular activities discourage people from shifting to the formal sector.¹⁵² Some qualitative studies endorse this view.¹⁵³

In the cost-benefit analysis of tax burden, taxpayers do take into account the benefits they receive from the government in return for the taxes paid. Poor performance by the government in terms of returning benefits to citizens results in a poor tax compliance culture and irresponsible citizenship. In countries where governments provide civic amenities and have a better rule of law, there are small informal economies and there is sufficient revenue mobilization. On the other hand, countries with a poor rule of law and high degree of discretion in tax administration have large informal sectors. Studies in the OECD and Latin American countries endorse this view.¹⁵⁴

In view of the above, low tax rates and simplified procedures are suggested in tax design for small business in order to reduce the competitive advantage of the informal sector. It is also suggested to shun the extensive use of the WHT regime and reduce tax rates of salaried income.

¹⁵¹ Richard M. Bird, 'Tax Challenges Facing Developing Countries' IIB Paper No. 9 Working Paper Series, Institute of International Business, Joseph L. Rotman School of Management, University of Toronto, March 2008, 13.

¹⁵² See Schneider and Klingmair, above n 52, 17.

¹⁵³ Above Spiro, above n 147, 253.

¹⁵⁴ Johnson et al, above n 51, 390.

4.3 Tax Morale

Some theoretical models for the underground economy show that tax morale has been the intrinsic motivation to pay taxes.¹⁵⁵ Tax morale evolves from the perception of individuals about the social, political and economic system. It is noted that when the government is not helpful in safeguarding the interests of taxpayers the compliance level decreases.¹⁵⁶ For instance, as mentioned earlier, when small businesses are required to maintain accounts at a cost double the tax liability, it is naïve to expect voluntary compliance. Additionally, large fixed costs of establishing a firm¹⁵⁷ and stringent government regulations, such as wage controls,¹⁵⁸ contribute to low morale. The resulting low tax morale ultimately promotes the informal sector. Schneider and Torgler by their economic model confirm that a decrease of tax morale by 1 unit would lead to an increase in the informal economy by approximately 20 percent points.¹⁵⁹ An experimental study utilising surveys also found that tax morale has positive influence on compliances.¹⁶⁰

More aptly, high tax compliance emanates from the high degree of tax morale. Tax morale is a conviction to contribute to society by paying taxes.¹⁶¹ Therefore, Schneider and Torgler calls operating in the informal sector as an ‘attitude’ of a citizen towards tax obligations.¹⁶² They believe that the ‘attitude’ problem casts wider implications in the form of large informal economies as compared to the ‘behavioural’ issue (which is a driving force in tax evasion). Though they did not define the terms ‘attitude’ and ‘behaviour’, behaviour is related to individual actions and ‘attitude’ is linked to individual feelings and opinions. More simply, an attitude is a more deep rooted and

¹⁵⁵ See Schneider and Torgler, above n 148, 12.

¹⁵⁶ See Schneider and Torgler, above n 148, 4.

¹⁵⁷ Simeon Djankov, Rafael Porta, Florencio De Silanes and Andrie Shleifer, ‘*The Regulation of Entry*’ Working Paper No. 2661 The World Bank and Harvard Institute of Economic Research, August 2000, 8, 26 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=242738> at 5 October 2009.

¹⁵⁸ See Schneider Klingmair, above n 50, 18.

¹⁵⁹ Schneider and Torgler, above n 148, 7.

¹⁶⁰ Ronald G. Cummings, Jorge Martinez-Vazquez, Michael McKee and Benno Torgler, ‘Tax Morale Affects Tax Compliance: Evidence From Surveys and an Artefactual Field Experiment’ (2009) 70 *Journal of Economic Behaviour and Organization* 447, 457.

¹⁶¹ See Schneider and Torgler, above n 148, 6.

¹⁶² See Schneider and Torgler, above n 148, 6.

persistent problem when compared to a behaviour.¹⁶³ A study of developing and transitional countries confirms that tax morale plays an important role in determining the size of the informal sector.¹⁶⁴

It is noted that a perception of the fairness of the tax system helps in building tax morale. For instance, high compliance costs for low income earners deplete tax morale, because they believe that the burden is disproportionate to their income. Similarly, when taxes are perceived as unfair and few tangible benefits are received in return for taxes paid, then taxes cannot be collected voluntarily as a moral duty.¹⁶⁵

Broadly, the obligation of paying taxes ‘can not be assumed as a social norm’¹⁶⁶ in countries where there are excessive tax burdens, high levels of corruption, weak institutional structures, lack of transparency and the rule of law. High levels of corruption and discretion in the government multiply compliance costs and develop the perception that the law breakers survive.¹⁶⁷ The informal economy grows and sustains in countries with these attributes. More aptly ‘if citizens feel cheated, if they believe that corruption is widespread, their tax burden is not spent well and they are not well protected by the rules of law, the incentive for them to get involved in the informal sector grows’.¹⁶⁸ Empirical studies confirm that countries with high corruption have a large informal economy.¹⁶⁹

¹⁶³ Elizabeth Walter and Kate Woodford, *Cambridge Advanced Learning Dictionary*, (Second edition, 2005). For more details regarding distinction between attitude and behaviour to taxation see Alan Lewis, *The Psychology of Taxation* (1982, Palgrave Macmillan England), 272.

¹⁶⁴ See Schneider and Torgler, above n 148, 26-27.

¹⁶⁵ See Fjeldstad and Rakner, above n 111, 27-28.

¹⁶⁶ See Schneider and Torgler, above n 148, 10.

¹⁶⁷ See Schneider and Torgler, above n 148, 8.

¹⁶⁸ See Schneider and Torgler, above n 148, 27.

¹⁶⁹ Eric Friedman, Simon Johnson and Daniel Kaufmann, ‘Dodging the Grabbing Hand: The Determinants of Unofficial Activities in 69 countries’ (2000) 76 *Journal of Public Economics* 459, 460, 481; Andreas Buehn and Friedrich Schneider, ‘*Corruption and the Shadow Economy: A Structure Equation Model Approach*’ Discussion Paper No. 4182 Institute for the Study of Labour, Department of Economics, Johannes Kepler University of Linz, May 2009, 27 <<http://ftp.iza.org/dp4182.pdf>> at 5 October 2009; Johnson et al, above n 51 also considers taxation as a key promoter of informal economy.

However, it is noted that the tax morale does change in response to changes in governments' performance or changes in tax rates and tax burdens.¹⁷⁰ More simply, as argued by Bird, the tax base (i.e. the total national income which is subjected to tax), which reflects the aggregate compliance level in a country, can be increased or decreased through the manner in which the taxes are collected.¹⁷¹ Thus, to improve tax compliance, governments have to improve the delivery of their services including the operation of the tax system.¹⁷² For small business, this should be in form of reducing compliance costs and tax rates.

Finally, the ultimate outcome of a persistent perception of unfairness is that people may have no bad feelings towards shadow economic activities; and people may find it easy to justify their unofficial supply of or demand for goods and services because the friends and family members do the same.¹⁷³ Then, it becomes an accepted norm in the community that not paying tax on cash receipts is acceptable.¹⁷⁴ It becomes a vicious cycle with more and more people joining in to establish their own justice.¹⁷⁵ Some analytical studies have identified it as a lack of a taxpaying culture.¹⁷⁶

Conclusively, tax morale plays a significant role in encouraging compliance in the informal sector. Further, a simple tax regime without discretion with the tax authorities can help repair the tax morale in countries, which still have to go a long way in developing their institutions.

4.4 Weak Tax Administration

Tax administration comprises three interrelated activities. First, the identification of tax liabilities under existing tax legislation. Second, the assessment of taxes to determine if

¹⁷⁰ Klaus Gretschmann, Schattenwirtschaft, Staatstätigkeit und Finanzwissenschaft – Einige theoretische Überlegungen; in Gijssels, P. (Ed.): Schattenwirtschaft und alternative Ökonomie: Eine Herausforderung für die politische Ökonomie?; Regensburg: Transfer Verlag (1984) pp. 76–96 as quoted in Schneider and Hametner, above n 18, 6.

¹⁷¹ See Bird, above n 151, 6.

¹⁷² See Fjeldstad and Rakner, above n 111, 28.

¹⁷³ See Schneider, above n 78b, 8.

¹⁷⁴ See Australia ATO Report, above n 56, 3.

¹⁷⁵ Friedrich Schneider and D. Enste, *The Shadow Economy: Theoretical Approaches, Empirical Studies, and Political Implications* (2002) Cambridge University Press, 123.

¹⁷⁶ See Fjeldstad and Rakner above n 109, 27.

the taxes actually paid is smaller or larger than the tax liabilities. Third, the collection, prosecution and penalty activities that impose sanctions on tax evaders and ensure that taxes and penalties due from taxpayers are actually collected.¹⁷⁷ Broadly, one of the jobs of tax administration is to bring every eligible taxpayer onto the tax roll in order to collect the due tax and that should be the corner stone of tax systems in developing countries. This shows that besides tax compliance costs, tax administration also plays a crucial role in securing tax compliance.

But in order to make tax administration effective, Newbery opines that it is necessary that relevant information about actors in the economy should be made available in a cost effective manner.¹⁷⁸ In developing countries, such necessary information is not available with their tax administrations.

There are many reasons as to why weak administration may not have the relevant information in developing countries. Theoretical models confirm that its performance is hampered due to lack of sufficiently skilled staff, financial resources and poor infrastructure.¹⁷⁹ The large number of individual taxpayers due to high populations in developing countries, most of which fall in the low income stratum, dilutes administration efforts. For example, in Pakistan, a total of 650 assessing officers¹⁸⁰ in the revenue authority can not effectively assess income, even if 5% of the total 1.7 million registered taxpayers are selected for audit. Additionally, these officers are also assigned the job of tracing the unregistered small businesses. Any suggestion for the increase in the size of the tax machinery may also not be cost-effective as ‘most of the small businesses in the developing countries have low income’¹⁸¹. On the other hand, in transitional countries, the tremendous growth in small businesses is caused by their shift to the market economy, which is beyond the capacity of tax administrations in those

¹⁷⁷ Arindam Das-Gupta and D. Mookherjee, ‘*Incentive and Institutional Reform in Tax Enforcement: An Analysis of Developing Country Experience*’ (1998), 4.

¹⁷⁸ David Newbery, ‘Taxation and Development’ in David Newberry and Nicholas Stern (eds.) *The Theory of Taxation for Developing Countries* (1987, Oxford University Press), 202.

¹⁷⁹ Burgess Robin and Nicholas Stern, ‘Taxation and Development’ (1993) 31 *Journal of Economic Literature* 762, 805-811.

¹⁸⁰ Pakistan, ‘*Reform of Tax Administration in Pakistan: Report of the Task Force on Reform of Tax Administration*’, the task force on the Tax Administration Reform Project (TARP) headed by Syed Shahid Husain, 14 April 2001, 7 <<http://www.fbr.gov.pk/reforms/ReformReport.asp>> at 10 August 2009.

¹⁸¹ Pakistan TARP Report, above n 180, 8.

countries to monitor, and therefore reduces their effectiveness in implementing income tax.¹⁸² In view of that, even creation of Small Business Units (SMU) similar to Large Taxpayer Units (LTU), which has been suggested to facilitate small businesses¹⁸³, may not be cost effective. Studies also reflect that the tax administration reforms play a limited role in widening the tax net¹⁸⁴, perhaps due to inadequate resources as compared to the size of the task.

Besides the lack of information, it is observed that the complex tax code is made more complex by the decisions of the unskilled administration.¹⁸⁵ This may be because, the unskilled administration is required to measure income accurately in the cash based economy, but is itself not prepared to implement such procedures which would allow this to occur.¹⁸⁶ This results in further weakening of tax administration. As a result, weak administration can not ensure tax compliance and leads to growth of the informal economy.

As mentioned earlier, the broadening of tax administration machinery is economically not feasible (or cost effective) because of the large number of low income taxpayers¹⁸⁷ and presence of complex tax code. Moreover, income tax is selected as an instrument for revenue, because its implementation is based on the spirit of voluntary compliance.¹⁸⁸ Taxing a large number of operators of the informal economy under the normal income tax, particularly when they are reluctant to comply voluntarily, results in high administration costs. This is another economic loss.¹⁸⁹ Moreover, Bird argues that

¹⁸² Engelschalk, above n 2b, 2. It also mentions that 82% of firms in Eastern Europe are small business.

¹⁸³ Richard M. Bird and Sally Wallace, 'Is It Really So Hard to Tax the Hard to Tax? The context and Role of Presumptive Taxes' ITP Working Paper No.0307, Joseph L. Rotman School of Management University of Toronto, December 2003, 29<<http://www.rotman.utoronto.ca/iib/ITP0307.pdf>> at 12 May 2007; also see Shome, above n 62a, 1.

¹⁸⁴ See Fjeldstad and Rakner, above n 111, 24.

¹⁸⁵ Balestrino A. and Galmarini U., 'On the Redistributive Properties of Presumptive Taxation' (2005) CESifo Working Paper No. 1381, 3 <http://www.cesifo-group.de/pls/guestci/download/CESifo%20Working%20Papers%202005/CESifo%20Working%20Papers%20January%202005/cesifo1_wp1381.pdf> at 10 September, 2008.

¹⁸⁶ Taube and Tedesse, above n 13, 11.

¹⁸⁷ Taube and Tedesse, above n 13, 12.

¹⁸⁸ Lawrence W. Kenny and Stanley L. Winer, 'Tax Systems in the World: An Empirical Investigation into the Importance of Tax Bases, Administration Costs, Scale and Political Regime' (2006) 13, *International Tax and Public Finance* 181, 187.

¹⁸⁹ Alm et al, above n 46, 29.

the costs of administering and complying with taxes are real economic costs, which should not be increased.¹⁹⁰ Hence, ‘government should not expand its enforcement actions to the point where an additional dollar of enforcement costs yields an additional dollar of revenue’¹⁹¹, because economic models show that the former involves a real resource cost, while the latter is simply a transfer from the private to the public sector.¹⁹² In view of above, the introduction of the simplest possible regime for small business could be a suitable alternative.

Further, it is commonly held that tax policy is tax administration¹⁹³, because good tax administration may achieve the difficult tax policy objectives. It is also argued that ‘a badly designed, but a well administered SME tax is preferable to a well designed but poorly run regime’.¹⁹⁴ But these views have recently been proven as incorrect in most African countries, where improved tax administration could not compensate for bad tax design, and despite tax reforms, no success was achieved in widening the taxpayer base.¹⁹⁵ As a result a simplified regime, where the role of the administration is minimized to the extent that its impact on the success of the regime becomes negligible, is a viable option. More simply, in the words of Thirsk, a change in tax policy should match the administrative capacity of developing countries.¹⁹⁶ In all, it is suggested that tax administration may be strengthened in a cost effective manner and may be assigned a task proportionate to its capacity.

Further, regarding tax reforms in transitional countries, Muten observed that ‘Rome was not built in one day, nor is a full fledged modern tax system to be set up within a year or two’¹⁹⁷. Therefore, it is wise to use some transitional tax regimes to help both the

¹⁹⁰ Bird, above n 151, 11.

¹⁹¹ James Alm, ‘What is an Optimal Tax System’ (1996) 49 (1) *National Tax Journal* 117, 124.

¹⁹² Joel Slemrod and Shlomo Yitzhaki, ‘*The Optimal Size of tax Collection Agency*’ Working Paper No.1759, National Bureau of Economic Research, October 1985, 1-2, 6 <<http://www.nber.org/papers/w1759.pdf>> at 6 October 2009.

¹⁹³ Casanegra De Jantscher Milka, ‘Administering the VAT’ in Malcolm Gillis, Carl S. Shoup and Gerardo P. Sicat (eds.) *Value Added Taxation in Developing Countries* (1990), 179.

¹⁹⁴ See Stern and Loeprick, above n 60, 10.

¹⁹⁵ See See Fjeldstad and Rakner, above n 111, 26.

¹⁹⁶ Wayne Thirsk, ‘*Lessons of Tax Reform: An Overview*’ Working Paper No. 576, World Bank, January 1991, 48<http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/1991/01/01/000009265_3960930154046/Rendered/PDF/multi_page.pdf> at 5 October 2009.

¹⁹⁷ Muten, above n 25.

administration and taxpayers in enforcement and compliance respectively, because it may take years before developing countries have a fully operative tax administration capable of running a fully fledged modern tax system at a satisfactory level.¹⁹⁸

Assuming that taxpayers act rationally, then a higher probability of detection and severity of punishment by the authorities may control the informal economy.¹⁹⁹ Some economists also hold a similar view that non-compliance is negatively correlated with the probability of detection and severity of punishment.²⁰⁰ Some scholars take the very extremist view that 'the greater the heights of punitiveness to which an agency can escalate, the greater its capacity to obtain 'voluntary' compliance from taxpayers.'²⁰¹ But such views may be suitable only in developed countries, where institutions do not contribute towards non-compliance.²⁰² Beyond that, Bird argues that the weak administration in developing countries is ineffective and is partly responsible for the 'culture' of non-compliance, which promotes the informal economy.²⁰³ In developing countries, higher penalties also need honest and efficient and resourceful administration, which is lacking there. More simply, levying sanctions involves huge costs²⁰⁴ which are beyond capacity of resource stricken tax administrations.

More broadly, the economic structure, administrative capacity, and political institutions limit the range of tax policy options.²⁰⁵ The degree of economic development of a country influences the choice of methods for estimating income and their application.²⁰⁶ The high tax rates and penalties to control the informal economy may be suitable for

¹⁹⁸ See Bird, above n 7, 150.

¹⁹⁹ This argument is based on the understanding that a rational man takes decisions on the basis of financial considerations.

²⁰⁰ A well known study in economics suggests that extent of tax evasion is negatively proportional to the probability of detection and the degree of punishment (see Michael G. Allingham and Agnar Sandmo, 'Income Tax Evasion: A Theoretical Analysis' (1972) *Journal of Public Economics* 323, 330).

²⁰¹ Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992), 37.

²⁰² Even in UK, instead of pure deterrence approach, some alternative measures are recommended. For details see Colin C. Williams, 'Tackling the Underground Economy in Deprived Populations: A critical Evaluation of the Deterrence Approach' (2004) 9 (3) *Public Administration and Management: An interactive Journal*, 224-239.

²⁰³ Bird, above n 7, 136.

²⁰⁴ United Kingdom National Audit Office Report, above n 81, 8.

²⁰⁵ Bird, above n 151, 6.

²⁰⁶ Tanzi and Casanegra, above n 32a, 8.

developed countries²⁰⁷, but they are counterproductive in developing countries as they further increase compliance costs. Bird, Alm et al. and several other studies based on empirical analysis and economic models²⁰⁸ also disagree with the economist's view of stringent enforcement as a driving force for achieving voluntary compliance. The view adopted in these studies is endorsed by the fact that developed countries have high levels of compliance despite low levels of deterrence. Fjeldstad states that it has proven difficult to apply the tax law with full force in the informal sector.²⁰⁹ Essentially, a tax auditor cannot be appointed to chase every taxpayer particularly in developing countries, as it is not cost effective. Therefore, measures of improving tax morale have more value than stringent enforcement.²¹⁰

In sum, although weak administration is responsible for the growth of the informal sector, strengthening the administration and stringent penalties may not be an immediate solution. It is, therefore, recommended that the role of the administration should be reduced proportionate to its capacity.

4.5 Illiteracy

All developing countries have 'poorly educated small business entrepreneurs'²¹¹ and have large informal sectors.²¹² This underscores the importance of the literacy level in a country towards complying with government regulations. The task of preparing even simple records on receipts, sales and costs under the normal income tax is generally beyond the capacity of small entrepreneurs.²¹³ The absence of adequate record keeping, a manifestation of an illiterate business environment, is recognized as a 'severe

²⁰⁷ In Australia, swift and severe sanctions are recommended when the need arises to enforce compliance (See Australia ATO Report, above n 56, iv).

²⁰⁸ James Alm, McClelland H. Gary and Schulze D. William, 'Why Do People Pay Taxes' (1992) 48 *Journal of Public Economics* 21, 22; Bruno S. Frey and Lars P. Feld, 'Deterrence & Morale in Taxation: An Empirical Analysis' CESifo Working Paper No. 760, August 2002, 12, 23 <<http://www.ifo.de/pls/guestci/download/CESifo%20Working%20Papers%202002/CESifo%20Working%20Papers%20August%202002/760.pdf>> at 23 March 2008.

²⁰⁹ Fjeldstad and Rakner, above n 111, 24.

²¹⁰ It may be noted that tax compliance is complex matter and is under influence of multiple factors (for details see Margaret McKerchar, 'The Impact of Complexity upon Un-intentional Non-Compliance for Australian Personal Income Taxation', (PhD Thesis, University of New South Wales, 2002,), Chapter 3.

²¹¹ See Stern and Barbour, above n 93, 3.

²¹² Bird, above n 7, 149.

²¹³ Taube and Tedesse, above n 13, 4.

handicap' for all modern taxes like income tax.²¹⁴ Modern business accounting is not yet in place in most of the developing countries because businesses still have crude operational mechanisms.²¹⁵

The growth of the informal sector is caused by the transition from an agrarian to an industrial economy without a proportionate development of business sophistication and financial transparency.²¹⁶ The managerial incapacity (which is more common in less literate than highly literate entrepreneurs) and absence of easy access to credit (causing business to resort to informal alternatives) are also contributing factors to the growth of the informal economy.²¹⁷ Broadly, revenue losses from the informal economy get smaller with an increase in development, which explains why the informal economy is a more serious problem in developing countries.²¹⁸ In view of that, a simple income tax design could encourage compliance.

5. Implications of Informal Economy

The informal economy adversely affects income tax implementation and economic growth in developing countries. Ineffective implementation of income tax diminishes the collection of revenues and financing of public infrastructure and consequently hampers economic growth.²¹⁹ The informal economy also undermines the growth potential of the economy by detracting resources from the more productive formal sector.²²⁰ Only in very rare circumstances a country is likely to meet its tax objectives and economic growth targets in the presence of a large informal economy.

²¹⁴ Taube and Tedesse, above n 13, 4.

²¹⁵ Bird, above n 7, 139.

²¹⁶ Tanzi and Casanegra, above n 32a, 3.

²¹⁷ Marquez et al, above n 24, 6.

²¹⁸ Alm et al, above n 46, 23.

²¹⁹ Schneider and Hametner, above n 18, 8.

²²⁰ Alm et al above n 46, 28.

5.1 Loss of Revenue

The informal economy deprives the state of lawful revenue.²²¹ The loss of revenue is because of non-compliance with the tax code by operators in the informal economy and the inability of the tax administration to implement income tax.²²² The revenue loss in developing countries is colossal due to the large share of the informal sector in their economies. The revenue loss is estimated at 40% of total potential revenues in developing countries²²³, which undermines the overall ‘tax effort’ of these countries.²²⁴ A low direct tax-GDP ratio in developing countries, as compared to developed ones, confirms the estimate. For instance, the direct tax-GDP ratio is 7% and 22% in sub-Saharan and industrial countries respectively.²²⁵ Another study of sub-Saharan Africa produces similar findings²²⁶.

Because of poor revenue collection, developing countries are likely to suffer from a scarcity of funds needed for development in sectors such as education which are a prerequisite for the formal economy. This even may start a vicious cycle causing further growth in the informal sector.

The small business sector has high revenue potential, which could be further increased substantially by the right tax policies, particularly in the service sector and innovative businesses.²²⁷ A study of Asian and Latin American administrations shows that small businesses generally constitute approximately one third of the total tax potential.²²⁸ This potential is well demonstrated by Vietnam, where creation and registration of more than 100,000 businesses in 2003-05 resulted in a significant improvement in revenue

²²¹ The impact of shadow economy in terms of revenue losses can be estimated by applying the average tax rate on the dollar value of unreported income in the economy.

²²² Jaramillo, above n 32c, 105-108.

²²³ Alm et al, above n 46, 23.

²²⁴ Alm et al, above n 46, 20-21. ‘Tax effort’ is defined in this article as total tax revenues divided by GNP for the same year.

²²⁵ Auriol and Walters, above n 137, 626.

²²⁶ Taube and Tedesse, above n 13, 7; for further similar literature see Thomas Jim, *Informal Economic Activity* (1992, Harvester Wheatsheaf London).

²²⁷ World Bank IFC Report, above n 49, 24.

²²⁸ United Nations, ‘*Improving Resource Mobilization in Developing and Transition Countries*’ 2002 UNDESA.

collection.²²⁹ It is argued that the key source of economic growth from within is the SME sector because of its revenue potential.²³⁰ It demands that the revenue potential of small business should be harnessed to meet budgetary requirements and economic growth in developing countries.

5.2 Depleting Tax Morale

The tax morale of the compliant taxpayers in the formal sector is negatively influenced by non-compliance of those who are liable to pay tax but do not pay by operating in the informal sector. Compliant taxpayers develop a perception of unfairness about the tax system, which encourage them also to operate informally.²³¹ This perception of unfairness also ‘deprives tax systems and enforcement authorities of their legitimacy’²³². Consistently with the discussion about the causes of the informal economy, this all ultimately takes the shape of a ‘non-paying tax culture’.

The lack of tax culture and poor revenue collection undermines the distribution of income and expenditure policies and widens the disparity between the rich and poor.²³³ A compliant taxpayer becomes poorer and a non-compliant taxpayer becomes richer day after day. Alm et al confirm that when inequality is widespread and eligible taxpayers are divided into two distinct sections, implementation of income tax becomes difficult and ‘the ability of the government to redistribute income gets constrained’²³⁴. Some tax policy makers look for alternative tax choices to make up for the revenue loss.²³⁵ For example, in Latin America indirect taxes account for more than 70% of total fiscal revenue.²³⁶ But, as argued earlier, indirect taxes promote the informal sector which unleashes economic downturn.

²²⁹ ‘Vietnam Development Report’ 2006.

²³⁰ Stern and Loeprick, above n 60, 3.

²³¹ Gloppen and Rakner, ‘Accountability Trough Tax Reform’, (2002) *IDS Bulletin* Vol.33, 2002.

²³² Marquez et al, above n 24, 5.

²³³ Vertical equity is jeopardized in the informal economy, when large income earners partly or fully succeed in hiding their income. Horizontal equity is compromised, when shadow labour earning income equivalent to that of official labour escapes taxation.

²³⁴ Alm et al, above n 46, 42.

²³⁵ Alm et al, above n 46, 25.

²³⁶ Marquez et al, above n 24, 7.

5.3 Economic Slowdown

Large informal sectors fetter economic growth by reducing growth potential in the small business of informal sectors by misallocating resources to the informal sector; and by diminishing revenue for infrastructure development.²³⁷ The studies, which show that shadow economy has some stimulating effect on the official economy,²³⁸ are discounted by the observation that there are relatively many more latent potentials and productivities of small businesses such as innovation, which can not be fully utilized in the informal economy.²³⁹ The net effect of an informal economy is to impede growth.²⁴⁰ A study in economics shows that if the informal economy increases by one percentage point the official growth in a developing country declines by 4.5-5.7 percent.²⁴¹ More specifically, the informal economy reduces economic growth, where the statutory tax burden is larger than the optimal tax burden (that is, as envisaged under the concept of marginal utility).²⁴²

5.3.1 Dwarfism in the Small Business Sector

The informal economy, which is dominated by small businesses, has some disadvantages, which retard the growth potential of small businesses²⁴³ and they suffer from dwarfism (smaller than a size that business otherwise could have grown to). In this regard, three main disadvantages are mentioned. First, non-compliance is not a costless option for small businesses.²⁴⁴ They bear a substantial indirect tax burden in form of bribes. They also cannot claim the credit for VAT paid on inputs²⁴⁵, which constitutes

²³⁷ Alm et al, above n 46, 27-47.

²³⁸ An informal economy also has some efficiency gains as well because the unregulated sector generates more dynamic entrepreneurship, more competition. It is why the corrupt governments and high tax evasion has the positive effects on the economic growth. In the end, however, negative implications prevail and the efficiency gains prove only short lived (see Alm et al, above n 46, 29).

²³⁹ Schneider and Hametner, above n 18, 23.

²⁴⁰ Alm et al, above n 46, 27.

²⁴¹ Schneider and Klingmair, above n 52, 30.

²⁴² Norman A. Loyaza, 'The Economics of the Informal Sector: A Simple Model and Some Empirical Evidence from Latin America' (1996) 45 Carnegie-Rochester Conference Series on Public Policy, 142 <<http://www.sciencedirect.com/science/article/B6V8D-3Y2FVG3-88/2/b4ab5da5f896b4fd13e41e5e6dba715e>> at 5 October 2009.

²⁴³ World Bank IFC Report, above n 49, vi.

²⁴⁴ World Bank IFC Report, above n 49, 1.

²⁴⁵ World Bank IFC Report, above n 49, 19.

75% of non-filers compliance costs²⁴⁶. Studies show that non-VAT registered businesses in South Africa suffer the highest marginal effective tax rates.²⁴⁷ Similarly, in countries that have an extensive WHT regime, informal business can not claim credit of withheld tax, which increases their compliance costs. Though taxpayers can avoid VAT on their inputs and WHT on their sales by remaining within their tight relationships in the informal economy, they bear cost of ‘lost business’ or investment opportunities. The cost of lost business is 25% of non-filers compliance costs.²⁴⁸

Second, consistent with the earlier discussion, economic gains of operating informally attract resources to the informal sector (which does not use them efficiently as explained in next paragraph).²⁴⁹ This misallocation could be because the effect of taxes on economic behaviour is different in developing countries as compared to developed ones. For instance, in developing countries, taxes have more influence on decisions regarding operating in the formal vs. the informal economy and domestic saving and portfolio investment rather than work vs. leisure.²⁵⁰ Therefore, the high Marginal Effective Tax Rate (METR) has a negative effect on investment and formalization decisions.²⁵¹ This results in a reduction in the efficiency of the economy.

Third, despite the large allocation of resources to the informal sector, these are not used sufficiently because small business individually can not expand due to limited access to credit.²⁵² Similarly, small business individually cannot take a large market share, because they cannot advertise due to fear of being un-earthed. This results in losses in economies of scale and the use of inefficient modes of payment.²⁵³ Similarly, small business may not mitigate business risk by obtaining insurance cover as it increases the

²⁴⁶ Arindam Das-Gupta, ‘Tax Compliance Costs and Non-Filing Behaviour’, Working Paper No.5, National Institute of Public Finance and Policy India, January 2004, 30 <http://www.nipfp.org.in/working_paper/wp04_nipfp_005.pdf> at 15 September 2008.

²⁴⁷ World Bank, ‘A Sector Study of Effective Tax Burden – South Africa’, FIAS, World Bank, April 2006, 75 [http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/Zambiataxconference_BackgroundpapersSouthAfrica/\\$FILE/SOUTH+AFRICA-METR+Study_+April+2006final.pdf](http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/Zambiataxconference_BackgroundpapersSouthAfrica/$FILE/SOUTH+AFRICA-METR+Study_+April+2006final.pdf) at 12 July 2008.

²⁴⁸ Das-Gupta, above n 246, 30.

²⁴⁹ Alm et al, above n 46, 28.

²⁵⁰ Bird and Zolt, above n 3, 23.

²⁵¹ Stern and Loeprick, above n 60, 7.

²⁵² World Bank IFC Report, above n 49, 21.

²⁵³ Alm et al, above n 46, 27.

risk of being caught. The informal sector is also exposed to high risk in terms of weak property rights such as title ownership.²⁵⁴ Broadly, such a frightened small businesses can not act as 'engines' for economic growth, unless they operate in the formal sector.²⁵⁵ They should be taken out of this frightening environment for the sake of their own well being and also for the larger objective of national economic growth.

5.3.2 Disadvantaged Large Business

The informal economy jeopardizes the performance of the formal sector. Consistent with the earlier discussion, informal business is an unfair competitor of formal business.²⁵⁶ More simply, the informal economy reduces the competitiveness of the compliant formal businesses²⁵⁷ and makes it difficult for them to survive and grow. This is particularly true for medium sized businesses because they bear a disproportionately high tax burden, as they can neither hide in the informal sector nor can obtain costly tax planning to reduce their tax bill.²⁵⁸ Further, to meet revenue targets they are one of the cows for milking in the barn by tax authorities, which increases their taxation costs and reduces their competitiveness.²⁵⁹ Consequently, formal businesses as a sector have less market share, which retard their growth. For instance, small retailers operating in the informal economy negatively impact on the development of large supermarkets.²⁶⁰ This results in losses in economies of scale and slows down the national economy.²⁶¹ An empirical study concludes that the size of informal sector remains negatively correlated

²⁵⁴ Auriol and Walters, above n 137, 640.

²⁵⁵ Shome, above n 62a, 6.

²⁵⁶ Marquez et al, above n 24, 6.

²⁵⁷ World Bank IFC Report, above n 49, 1.

²⁵⁸ Taube and Tedesse, above n 13, 15.

²⁵⁹ Bird and Sally, above n 179, 7.

²⁶⁰ World Bank, '*Pakistan : Improving the Performance of the Housing, Tourism and Retail Sectors*' Working Paper No. 37527, FIAS, World Bank, August 2005, 29 < http://www-wds.worldbank.org/servlet/main?menuPK=64187510&pagePK=64193027&piPK=64187937&theSitePK=523679&entityID=000090341_20061003154218> at 14 April 2009.

²⁶¹ It is pertinent to mention here that high compliance costs have adverse economic effects of deadweight losses, disincentive for investment and distorted production decisions (see Das Gupta, above n 115, 6).

with economic growth, and consequently is an independent determinant of economic growth.²⁶²

6. Conclusion

A large informal sector is the main feature of developing economies. Informal activities are promoted by high compliance costs, high tax rates, poor tax morale, the economic gains of operating informally and ineffective tax administration. The high compliance burden primarily is due to the costs of bookkeeping, which is proportionally higher for small businesses in the developing countries. Further, analysis of the causes of the informal economy suggests that these have a higher impact on the decision of small business to operate informally than they have on a large business. This may explain why the informal economy is primarily composed of small businesses. Because of large informal economies, developing countries enter into a vicious cycle of low revenue collection, poor tax morale and sluggish economic growth. This needs to be stopped if developing countries wish to achieve economic growth.

The analysis of the causes of the informal economy strongly suggests policy guidelines for income tax design for small business, which is the core constituent of the informal economy. The salient features of the policy guideline are:

- (i) Administrative compliance costs should be reduced for small business by simplifying the tax regime. More aptly, small businesses should be absolved from the maintenance of accounts, which is the major contributor to compliance costs. Therefore the Presumptive Income Tax (PIT) could be suggested in this regard as an alternative to normal income tax and matched to the compliance capacity of small business. Technical compliance costs should also be kept low by rationalizing tax rates for small businesses. The tax rates for salaried income should also be reduced to discourage labour supply to informal sector.
- (ii) The informal economy should be tackled by redefining the role of tax administration. The limited capacity of tax administration compared to the number of individual taxpayers suggests that its role should be reduced. A simplified income tax

²⁶² James Alm, Jorge Martinez-Vazquez and Sally Wallace, 'Introduction to the Volume' in James Alm, Jorge Martinez-Vazquez and Sally Wallace (eds.) *Taxing the Hard to tax: Lesson From Theory and Practice* (First Edition, 2004) 40. This book relies on the study of Loayza, above n 238, 153.

regime, which does not insist on taxing the income accurately on the basis of accounts, can reduce the role of tax administration. More aptly, PIT should supplant normal income tax in this regard.

(iii) The widespread WHT should be done away with for two reasons. First, this would reduce the compliance costs for the business, which become too high when the business assumes the role of tax collector and is required to fulfil additional statutory obligations. Second, it would equalize the operational costs and selling price between the formal and informal sectors and consequently reduce the competitive advantage of the informal sector.

In sum, the above mentioned policy guidelines suggest the use of PIT to tax small businesses in the informal economies of developing countries. This suggestion makes it imperative to explore the concept and designs of PIT in the next chapter. Once the concept and designs are reviewed, PIT's efficacy to address the causes of informal sector can be examined in the subsequent chapter.

CHAPTER 3 PRESUMPTIVE INCOME TAX: CONCEPT, DESIGNS AND FEATURES

Scope of this chapter: Chapter 2 provided the policy guideline to use PIT for addressing causes of the informal economy in developing countries. As a natural corollary, Chapter 3 thoroughly reviews the concept of PIT, its designs and features. This chapter also debates the methods of constructing PIT as well as its current practice in developing and developed countries. This chapter, therefore, lays down the platform for analysing the efficacy of PIT and searching its suitable design to tax the informal economy in subsequent chapters.

1. Introduction

Presumptive Income Tax (PIT) is one of the oldest forms of tax. However, with the introduction of modern business accounting, tax on ‘actual’ income dominates the tax structure of most countries. This may explain why PIT has received little attention in the literature.²⁶³

In developing and transitional countries, PIT still supplements the normal income tax because these countries do not meet the pre-requisites of successfully administering the normal income tax, which include literacy, a documented economy and an efficient tax administration. Moreover, a large population of taxpayers in these countries are small businesses which cannot afford the compliance costs of income tax. PIT is therefore used in these countries to control non-compliance of small business. Developed countries also find some PIT rules useful for taxing small business and in curbing transfer pricing.²⁶⁴

The policy guidelines based on the analysis of the causes of the informal economy in Section 6 of Chapter 2 suggests the use of PIT. This requires a review of the concept of PIT and the range of its designs and features. It is also imperative to review the different PIT regimes, which are currently in practice in different countries across the world to tax small business, particularly in the informal sector. Such a review of the range of available PIT designs and features will enable tax policy makers to construct an appropriate PIT regime to address the specific issue of a jurisdiction such as taxing

²⁶³ Public Finance scholars have shied away from this concept because they consider it as primitive and backward tax (see Tanzi and Casanegra above n, 32a, 1).

²⁶⁴ Taube and Tedesse, above n 13, 16 contains examples of France and Israel.

the small business sector. This chapter therefore explores in detail the presumptive form of income taxation.

After an overview of the grounds of presumption in tax, this chapter describes the range of PIT systems used by different countries along with their designs and features. As compared to earlier literature on the subject, this chapter brings uniformity, clarity and comprehensiveness to the range of PIT regimes and aims to assist policy makers to choose the best PIT design for a specific tax objective.

The review of PIT designs and features shows that PIT is a very flexible tax measure which can be tailored to meet the requirements of a particular tax policy objective in general and the taxing of small business in the informal sector in particular. On other hand, the multiplicity of PIT regimes in different developing countries reflects the lack of coordination and collaboration among those countries all of which are facing the identical problem of tapping the revenue potential of small business in their informal economies. This suggests that these countries should learn from each others experiences and develop an appropriate design for their common tax objectives.

The remainder of this chapter is divided into four sections. Section 2 describes basic grounds of presumption in any tax. Section 3, after describing presumption in income tax, analyse methods of construction of PIT designs. This section also outlines legal and administrative forms of introducing PIT. A summary of possible features in a PIT design is also given in this section. Section 4 classifies PIT regimes on the basis of current practice across the world. Section 5 concludes this chapter.

2. Grounds of Presumption in Tax

A State mostly charges taxes to meet its expenditures and to redistribute income. Historically, states charged various kinds of taxes. Ideally for the reason of fairness, states have intended to tax those individuals who have higher well being (both psychological and physiological) or have higher functional capabilities (capacity to pay)²⁶⁵ but due to the subjective nature of such concepts and for administrative prudence, some objective and measurable (quantifiable) economic bases (surrogate

²⁶⁵ For further details about the concept of well being, capacity to pay and ability to pay see Kevin Holmes, *The Concept of Income: A Multi-Disciplinary Analysis* (2000, IBFD Publications BV), 5-13.

bases) are used by legislatures to tax individuals.²⁶⁶ This is the first compromise in the process of levying tax. Consequently, a common feature in all the taxes is that every tax is charged as a proportion of some ‘economic base’.

Taxes used reflect the state’s choice of an economic base. The use of every economic base produces different economic and social consequences. Before the 20th century the value of land, house property, other kinds of asset and even the total assets of a person were used as the economic bases for different taxes. The taxes, so collected, were called Land Tax, Property Tax, Asset Tax or Wealth Tax.²⁶⁷

Since a tax is charged as a proportion of some economic base, the accurate measurement of the relevant economic base is recognized as mandatory for the determination of correct tax liability. However, in certain situations such as the cost effectiveness of its implementation, even these quantifiable economic bases are difficult to be measured with precision. For instance, in the case of small business, the cost of determination of income is higher than the tax liability as discussed in Section 4.1.1 of Chapter 2. In such situations, a further compromise is made to replace the actual economic base by other supplanted indicators, which are more easily observable but may not be as fair and efficient as the actual base. Moreover, these surrogate bases are used by amending the relevant laws and have no conceptual endorsement from other disciplines such as accounting. This replacement of the actual base with the proxy base in tax is called presumption in tax and such tax is called Presumptive Tax (PT).

Presumption in tax can be constructed by the following two methods.

(1) When it is hard to measure the relevant economic base accurately, which makes precise determination of tax liability a difficult task, presumption in tax allows the use of a proxy indicator to determine the value or quantum of the original economic base of any tax. The economic indicators which are used as a proxy for the actual base are ‘easy-to-obtain indicators’²⁶⁸ and therefore are preferred over the actual bases.²⁶⁹

²⁶⁶ Ibid.

²⁶⁷ Some of these taxes are still part of the tax systems in many countries.

²⁶⁸ Wallace, above n 6b, 1.

²⁶⁹ The easy to enforce characteristic of PT provides the administrative rationale for such taxes (see Jaramillo, above n 32d, 1, 22).

For instance, in the house property tax, the number of rooms or/and area or/and location is used to roughly estimate value rather than actually determining the market value of each property of every person.²⁷⁰ Though the values of properties of the same size and in the same location may be different, this difference is ignored because of administrative and other practical reasons. (For example, the accurate determination of the market value of each property would not be a cost effective task). More simply, the value of the property is presumed on the basis of some related economic indicators for the purpose of reducing administrative and compliance costs. Another example is Pakistan, where in 1960s, the production capacity of manufacturing plants is used to substitute actual production for levying excise duty. Tanzi called this ‘Capacity Taxation’.²⁷¹

(2) When it is difficult to measure the economic base, then sometimes tax liability is determined directly without any reference whatsoever to the economic base. For instance, in the property tax, each person having a house is obliged to pay some amount as a fixed property tax irrespective of the value of the house.²⁷² In this ‘atypical’ form of PT tax liability is computed with complete disregard to the value of the economic base.²⁷³

The above discussion shows that tax liability may be presumed in complete disregard to the economic base (for example, in the case of fixed tax), or determined by substituting some other economic indicator as a proxy for the actual base (for example, rooms in the

²⁷⁰ In Pakistan, Property Tax is levied by provincial governments on the basis of annual rental value of property determined in accordance with location and size etc (see *Punjab Urban Immovable Property Tax Act 1963* (Pakistan) s 5 and s5A); and Wealth Tax is charged by Federal Government in Pakistan on immovable property on the basis of location and area till its abolition in 2000 (see *Wealth Tax Act 1963* (Pakistan) Part B to Schedule-I). In contrast to both these taxes in Pakistan, which are using proxies to determine the value of the properties, Council Tax in England is determined on the basis of the value a property can fetch on a particular date (see *Council Tax Act 2006* (New Valuation Lists for England) Chapter 7).

²⁷¹ Tanzi, above n 1, 204.

²⁷² Commercial Taxes Department of Government of Tamil Nadu, which is administering the Registration Act, 1908 (Central Act 16/1908) and the Indian Stamp Act 1899 (Central Act 2/1899) with few amendments is charging Fixed Stamp Duty irrespective of actual value of transacted property. The valuation of property is fixed on the basis of the street where property is located without paying any heed to size of a plot (for details see <www.tnreginet.net/test1/gvaluemainpage2007.asp> and <www.hindu.com/pp/2006/11/25/stories/2006112500120700.htm>).

²⁷³ Poll Tax to fund local government in the United Kingdom, instituted in 1989 by the government of Margaret Thatcher. It replaced the rates (tax) on council properties which were based on the market value of immovable properties (for details visit <<http://www.economicexpert.com/a/Poll:tax.htm>>).

house for the value of the house). In the former case, it is the tax liability itself which is presumed, whereas in the latter case, the proxy base substitutes for the actual tax base to compute the presumed tax liability. More simply, presumptive tax could be levied with or without the presumption of the economic base.

Consequently, a tax is called a presumptive tax if the base used in the implementation of the tax (the presumptive base) is not identical to the economic base (the actual base) originally intended by the tax law.²⁷⁴ More broadly, presumptive taxation covers a number of procedures whereby the desired base for taxation is not itself measured but is inferred from some simple indicators which are easier to measure than the base.²⁷⁵

Although, in a presumptive tax, tax liability determined may not be the correct liability (as it would be if were computed on the actually assessed economic base) it is expected to be very close to that amount. This concept is in line with the literal meaning of the word ‘presume’ –that is: “to believe some thing to be true because it is very likely although you are not certain”²⁷⁶. The meaning of ‘presumption’ justifies the inclusion of those taxes within the ambit of PT where tax liability is determined in complete disregard to the economic base (which is labelled as ‘atypical presumptive taxation’ earlier in this chapter). Hence, the only condition for a tax to be called presumptive tax is that its liability should be close to the actual tax liability.

In short, presumptive tax is a tax used when the tax cannot be charged accurately on the actual economic base. The lack of information required to determine the economic base accurately is the main reason for presumption in taxation. Therefore, presumptive taxation is not a perfect method of taxation and is a further compromise to the normal tax (that is, tax collected on the accurately determined economic base). Presumptive taxes generally substitute for taxes whose economic bases are hard to measure and

²⁷⁴ Yitzhaki, above n 95, 1.

²⁷⁵ Ehtisham Ahmad and Nicholas Stern, *The Theory and Practice of Tax Reform in Developing Countries* (1991), 276.

²⁷⁶ Elizabeth Walter and Kate Woodford, *Cambridge Advanced Learning Dictionary*, (Second edition, 2005).

whose determination requires complex accounting information (for example, the income tax).²⁷⁷

3. Presumption in Income Tax

The income tax uses ‘income’ as the economic base. As compared to the economic bases of other taxes, the concept of ‘income’ is complex. Therefore, it is imperative to examine the concept of ‘income’ before expanding upon presumption in income tax.

3.1 Income: Its Concept and Determination

The concept of income is controversial. Nevertheless, over many years, the concept of income has shifted from a theoretical and subjective interpretation (a measurement of well being [both psychological and physiological] and total individual utility) to a practical, objective and administrative interpretation.²⁷⁸ Consequently, it is recognized that, to be taxable, income must be expressible in terms of money, which includes the measurement of increases in net wealth and consumption.²⁷⁹ More simply, to obtain an administratively feasible and objective measure of income, the concept of ‘money income’²⁸⁰ is widely adopted. Moreover, an increase in net wealth plus consumption, as enunciated by Schanz-Haig-Simons income model, is generally accepted as the ‘foundation concept of income’.²⁸¹ The foundation concept of income envisages income from all sources to infuse fairness into the tax treatment.

²⁷⁷ However, property tax and vehicle tax etc, which do not normally involve complex information, is also being charged through presumptions in many countries. For instance, in Pakistan house property are being taxed on the basis of area (see *Punjab Urban Immovable Property Tax Act 1963* (Pakistan) s 5 and s5A) and vehicles on the basis of engine power (see *Wealth Tax Act 1963* (Pakistan) Part B to Schedule-I), despite the fact that the value of these assets can be determined more accurately by alternative methods. The oldest PT regime i.e. England’s Window Tax, which was introduced in 1696, the number of windows of a taxpayers home served as an indicator for determining property tax liability (see Lapidoth Arye, *The Use of Estimation of the Assessment of Taxable Business* (1977, IBFD Amsterdam). The earlier mentioned article is also referred to by Tanzi and Casanegra above n 32a to explain presumptive tax (that is, the use of a proxy indicator as a substitute to actual economic base of tax). Although some scholars can hold a different view, the value of a house property determined on the basis of its location, area and number of windows is mostly close to the actual value that could be fetched in free market.

²⁷⁸ Holmes, above n 265, 35.

²⁷⁹ Ibid.

²⁸⁰ Holmes, above n 265, 47.

²⁸¹ Holmes, above n 265, 83.

Economists and accountants have further narrowed down this concept of income, particularly under the principle of realisation and the distinction between capital and income.²⁸² However, the accounting concept of income is considered as the most practical concept due to difficulties involved in the valuation of assets. Thus, more reliance is placed on the revenue and expenditure (income) statement than on the balance sheet. Though accounting income does not yet incorporate imputed income and change in the value of human capital, it has started to take into account the changes in the value of assets.²⁸³ The accounting concept of income is in the process of evolution and may be expected to soon match the foundation concept of income, which is an ideal concept for tax policy purposes.

On other hand, the legal concept of income is subservient to the relevant law of jurisdiction. Income tax legislation mostly adopts accounting income as taxable income, particularly in respect of business and professional events, albeit with certain modifications. Though Holmes rightly calls the legal concept of income the narrowest view of income²⁸⁴, it is the most relevant concept which influences decision makers in almost every jurisdiction.

Nonetheless, this thesis adopts the accounting concept of income as the economic base for income tax because it is the starting point for the determination of taxable income under the tax laws of most jurisdictions. Moreover, resolution of the conflicts within different disciplines concerning the concept of income is beyond the scope of this thesis.

Finally, the income of a person could be from one or more than one source(s) or class(es). For example, a person can earn income from personal exertion, property, business etc. Consequently, two approaches are used to subject income to tax. The first is schedular income taxation, wherein each source or class of income is separately measured and subjected to a separate tax rate. The second is global income taxation, wherein total income from all the sources/classes is determined and is subjected to a

²⁸² Holmes, above n 265, 85-149.

²⁸³ For details see Berry Elliot and Jamie Elliot, *Financial Accounting and Reporting* (Thirteenth edition, 2009).

²⁸⁴ Holmes, above n 265, 241.

single tax rate.²⁸⁵ However, both the global and schedular approaches are similar in terms of the volume and variety of information needed for the correct determination of total income tax liability.

Currently, the global income taxation approach is prevalent in most countries except some recent trends toward schedular taxation.²⁸⁶ Under this approach, income from all sources is first required to be determined separately before being totalled and subjected to a single tax rate.

3.2 Presumption in Income Tax

In certain situations, for the purpose of charging income tax under tax law, the determination of income really becomes a challenging task. For example, when a small business cannot bear the cost of maintaining accounts, or when a big business uses accounting devices to conceal income and avoid or evade tax, then the hard task of determination of total income can be simplified by the use of a proxy base. This reduces the costs of compliance for taxpayers and the costs of enforcement for tax administrators. Conceptually, a proxy base is used as a substitute for income in the same manner as income is used as a substitute for well being or the ability to pay.²⁸⁷

A proxy base is usually chosen either from the very fundamental concept of income (that is, by choosing assets or the expenditure, which reflect(s) the capacity to pay), or from some other production or business indicators which reflect operational performance. The income tax charged on the basis of proxy or business indicators is called PIT.

The use of a proxy or indicators for income envisages taxing the ability to earn (that is known as potential income) rather than the actual income. Potential income taxation provides strong theoretical justification to presumptive income taxes. It may be argued

²⁸⁵ The shift in the policy from taxing schedular to global income was mainly due to equity concerns (see Tanzi and Casanegra, above n, 31a, 2).

²⁸⁶ Howell H. Zee, 'Personal Income Tax Reform: Concept, Issues and Comparative Country Developments' Working Paper No. WP/05/87, International Monetary Fund, Washington DC, May 2005; also see Encyclopaedia Britannica <<http://www.britannica.com/EBchecked/topic/284849/income-tax/71943/The-meaning-of-income>> at 22 December 2009.

²⁸⁷ Tanzi, above n 1, 194.

that presumptive income taxes are not an approximation to actual earned incomes but a methodology to measure potential income.

The use of a proxy base (except that based on assets or expenditure) may not be fair and efficient, and sometimes may lead to arbitrariness. This may be because the use of a proxy indicator may charge income tax on persons who have no income under any concept of income. It should also be noted that PIT is created by legal fiction and any item which is deemed as income through such amendment in the tax law, might not be income under the concept of 'income' under any discipline. For example, income tax charged on the basis of area of a shop (which is not an income) could be unfair because such a taxpayer may have no income or even have a loss under its fundamental concept.

A number of judicial decisions discussed in subsequent paragraphs have validated the use of presumption in income tax, have dismissed all the objections against the use of presumption income tax and have widened the scope of income. There were four main objections to the use of presumption in income in this regard. First, only profits and gains constitute income, so proxies cannot be used as synonyms to income. Second, PIT violates the fundamental right of protection of assets when it taxes a person who has no income but still has to pay tax under this presumption and consequently such a tax is confiscatory. Third, PIT is an inequitable tax, because it is only offered to a few classes of taxpayers and within that class not all taxpayers are taxed equitably. Fourth, taxing things like turnover even change the characteristic of tax from its direct to indirect form and that may be constitutionally invalid (depending upon the jurisdiction).

Courts in some jurisdictions have decided these matters in favour of the legislature. The reference to all such judicial interpretations is beyond the scope of this thesis. Nevertheless, the decisions of Indian superior courts, one of the largest informal economies in world, are referred below.

Regarding the first objection, the Indian Supreme Court in the case of *Assistant Commissioner of Land Tax Madras and Others v Buckingham and Carnatic Co. Ltd*²⁸⁸ expounded that how entries in the legislative list (including income) in the constitution should be interpreted. In this case, a tax levied on urban land under the Madras Urban

²⁸⁸ *Assistant Commissioner of Land Tax Madras and others v Buckingham and Carnatic Co. Ltd* (1970) 75 ITR 603.

Land Tax Act 1996 on the basis of the average market value of land, was challenged.

The court held that: ---

“The legislative entries must be given a large and liberal interpretation, the reason being that the allocation of the subjects to the lists is not by way of scientific or logical definition but by mere simplest enumeration of broad categories”

Indeed, the following argument of the Indian Supreme Court in another decision, *Navnit Lal C. Javeri v K. K. Sen, Appellate Assistant Commissioner of Income Tax, Bombay*, considered whether s 2(6A) (e) and s 12(1B) of Indian Income Tax Act 1922 regarding scope of income was ultra vires, clarifies the point:-

“But in considering the question as to whether a particular item in the hands of a citizen can be regarded as his income or not, it would be inappropriate to apply the tests traditionally prescribed by the income tax as such”.²⁸⁹

Further, after taking into considerations about the dynamic business world, taxpayers' behaviour and difficulties in determining the actual tax base, the Indian Supreme Court, in case of *A. Sanyasi Rao and Another v Government of Andhra Pradesh and Others*²⁹⁰, considered whether s 44AC and s 206C of the Indian Income Tax Act 1961 regarding collection of tax as a percentage of turnover in respect of prescribed items was ultra vires and upheld the use of presumption in taxation in the following words.

“Considered in the light of the practical difficulties envisaged by the revenue to locate the persons and to collect the tax due in certain trades, if the legislature in its wisdom thought that it will facilitate the collection of the tax due from such specified traders on a ‘presumptive basis’, there is nothing in the said legislative measure to offend article 14 of the Constitution in the light of the legal principles stated above. We are unable to hold that section 44AC²⁹¹ [of Indian Income Tax

²⁸⁹ *Navnit Lal C. Javeri v K. K. Sen, Appellate Assistant Commissioner of Income Tax Bombay* AIR 1965 SC 1375.

²⁹⁰ *A. Sanyasi Rao and another v Government of Andhra Pradesh and others* (1989) 178 ITR 31.

²⁹¹ Under this section, it was provided that 40% purchase price of any goods in the nature of alcoholic liquor for human consumption (other than Indian made foreign liquor) shall be deemed to be the profits and gains of the buyer from the business or trading in such goods chargeable to the under the head ‘profits and gains of the business.

Act 1961] read with section 206 is wholly hit by Article 14 of the Constitution of India”.

The second objection that PIT is confiscatory was also answered by the Indian Supreme Court in case of *Federation of Hotel & Restaurant v Union of India & Others*²⁹². In this case the constitutional validity of the Expenditure Tax Act 1987 was challenged. The tax was levied at a rate of 10 percent ad valorem on chargeable expenditure incorporated for the class of hotels wherein room charges of any unit of residential accommodation were rupees 400/- per day per individual. The court issued following guideline to the legislature:

“But with all the latitude certain irreducible desiderata of equality shall govern classification for differential treatment in taxation law as well. The classification must be rational and based on some qualities and characteristics, which are to be found in all the persons grouped together and absent in the others left out of the class, but this alone is not sufficient. Differentia must have a rational nexus with the objective sought to be achieved by the law.”

The above guiding principle shows that when the proxy has a rational nexus with an economic base of a tax then the presumption in taxation may not be confiscatory.

However, the court in case of *Sonia Bhatia v State of U.P.*²⁹³ then added that:

“The policy of tax, in its effectuation, might, of course bring in some hardship in some individual cases. But that is inevitable, so long as the law represents a process of abstraction from the generality of cases and reflects the highest common factor. Every clause, it is said, has its martyrs”.

Then, in the same case, presumption was justified in the name of national interest.

*“.....if in the process a few individuals suffer severe hardship that can not be helped, for individual interests must yield to the larger interests of the community or country as indeed every noble cause claims its martyr”.*²⁹⁴

²⁹² *Federation of Hotels & Restaurants v Union of India and others* AIR 1990 SC 1664.

²⁹³ *Sonia Bhatia v State of U.P* (1981) 3 SCR 239, 258; AIR 1981 SC 1274, 1284.

Nevertheless, the High Courts of Punjab and Haryana, in considering the use of extraordinary measures of taxation to plug large scale evasion, put a limitation that “the remedy should be proportionate to the evil that was sought to be remedied”.²⁹⁵

The third objection, that PIT is an inequitable tax, was considered by the Indian Supreme Court in the case of *Kunnathat Thathunni Moopil Nair etc. v State of Kerala and another*²⁹⁶ which lays down broad guidelines for taxation in this regard. The facts of the case were that 22 petitions under Article 32 of the Indian Constitution were directly filed with the court challenging the constitutionality of Travancore-Cochin Land Tax Act 15 of 1955 as amended by Act 10 of 1957. Section 4 thereof provided that subject to the provisions of this Act, there shall be charged and levied in respect of all lands in the state of whatever description and held under whatever tenure of uniform rate of tax to be called the basic tax.

The court held as follows:

“If the taxation generally speaking imposes a similar burden on every one with reference to that particular kind and extent of property, on the same basis of taxation, the law shall not be open to attack on the ground of inequality, even though the result of the taxation may be that the total burden on different persons may be unequal. Hence, if the legislature has classified persons or properties into different categories, which are subjected to different rates of taxation which reference to income or property, such a classification would not be open to the attack of inequality on the ground that the total burden resulting from such a classification is unequal.”

Regarding the fourth objection, Supreme Court of Pakistan, another country with a large informal economy, in the case of *Ellahi Cotton Mills v Federation of Pakistan*²⁹⁷ distinguished a decision of the Privy Council²⁹⁸ and said that the issue of the type of

²⁹⁴ *Sonia Bhatia v State of U.P* (1981) 3 SCR 239, 258; AIR 1981 SC 1274, 1284.

²⁹⁵ See *Sat Pal & Co. v Excise and Taxation Commissioner and others* (1990) 185 ITR 375.

²⁹⁶ *Kunnathat Thathunni Moopil Nair etc v State of Kerala and another* AIR 1961 SC 552; 3 SCR 67.

²⁹⁷ *Ellahi Cotton Mills Ltd. v Federation of Pakistan* (1997) PTD 15555; 76 TAX 5.

²⁹⁸ *King v Caledonis Collieries Ltd.* AIR 1028 P.C. 282. The question before the Privy Council to decide in this case was that whether the *Mineowners Tax Act* 1923 of province of Alberta, which imposed upon mine owners, as defined therein a percentage tax upon the gross revenue of their coal mines, was ultra vires being as an attempt to impose indirect taxation. The appeal was allowed in favour of

taxation can arise in jurisdictional disputes (that is, tax is a federal or a provincial subject) but not otherwise. This judgement was given in respect of appeals, which had been filed against the judgements of various benches of Lahore High Court issued to dispose of writ petitions. Those writ petitions challenged the PIT provisions of the Income Tax Ordinance 1979 of Pakistan (such as ss 80D, 80C, 80CC) as unconstitutional. The Supreme Court held that:

“Observations were made that there is a marked distinction between a tax on gross revenue and a tax on income, which for taxation purpose means gains and profits and that there may be considerable gross revenues but no income taxable by an income tax in the accepted sense. The above observations are to be viewed with reference to the above context in which they were made, namely the legislative power inter se between the Dominion and the provinces”.

Lastly, the scope of presumption is much wider in income tax than in other taxes. The multifarious nature of income (the base for income tax) envisages that a proxy base for each class of income can be separately used for designing a PIT or just one proxy base for all classes of income can be used. Furthermore, the role of complex accounting in the computation of income has widened the scope of the presumption in income tax because the presumption of income can be made at any step of its computation. For instance, the quantum of deduction is admitted on the presumptive basis for the computation of income.

3.3 The Methods of Constructing PIT Designs

The wide scope of presumption in income tax provides a range of PIT designs to choose from. The variety of PIT designs arises from the peculiar nature of its base, that is, income. As stated above, presumptions about income can be constructed in numerous ways. That is, total income or only a part or class of income can be supplanted by the presumptive base or alternatively some tax deductions (deduction base)²⁹⁹ can be allowed on a presumptive basis.

the appellant on the ground that in their opinion the tax in question was not a direct tax and, therefore, is not within the competence of the province to impose.

²⁹⁹ Joel Slemrod and Shlomo Yitzhaki, ‘Analysing the Standard Deduction as Presumptive Tax’ (1994) 1 (1) *International Tax & Public Finance* 25, 27.

Further, like presumption in any other tax, liability in the income tax can also be presumed by substituting the total income (or class of income) with another economic base, or presumed directly by ignoring the income completely. In the latter case, either a ‘production indicator’ is used to ascertain liability or even sometimes that too is ignored.

The choice of PIT design depends upon the policy objectives of a country.³⁰⁰ The choice of a PIT design should also ensure that this uncommon form of income tax meets the tests laid down in the court decisions mentioned above except when the circumstances of a country suggest otherwise. The one which merits repeating here is: ----

‘The classification [if envisaged in the regime] must be rational and based on some qualities and characteristics, which are to be found in all the persons grouped together and absent in the others left out of the class, but this alone is not sufficient. Differentia must have a rational nexus with the objective’ (See *Federation of Hotel & Restaurant v. Union of India & Others* (AIR 1990 SC 1664).

Though the court in the passage quoted focuses on the classification of taxpayers in a PIT regime, this logic should be extended to the choice of method of construction of PIT design.

Currently, a variety of PIT designs are developed and put into practice in many developing countries to tax small business. But there is no consensus among the policy makers about summarizing the methods used for constructing PIT designs. It is, therefore, crucial to develop a uniform approach for describing the PIT designs before exploring other unexplored facets of PIT. However, before proceeding to develop a uniform approach, it is essential to review the approaches adopted in the literature.

3.3.1 Description of Methods of Constructing PIT Designs in the Literature

Earlier literature contains inconsistencies, incoherence and lack of comprehensiveness in summarizing methods of PIT designing. For example, Thuronyi divides the methods used for PIT as follows:

³⁰⁰ Thuronyi, above n 38, 6.

- i. Reconstruction of income
- ii. Percentage of gross receipts (Minimum Tax)
- iii. Percentage of assets (Minimum Tax)
- iv. Industry specific methods (fixed amount for professions, contractual method, standard assessment guide)
- v. Outward signs of life style³⁰¹

This pattern of grouping designs is not consistent with any rational basis and suffers from a lot of overlap. For instance, the standard assessment guide (that is a fixed liability based on some indicators) is similar to a ‘fixed tax’ for the professions. Similarly, some of the turnover-based PITs can be found in the industry specific methods. Even the use of ‘outward signs of lifestyle’ and ‘contractual income’ is similar to the reconstruction of income approach. Broadly, for grouping PIT designs on the basis of methods of construction, it is more appropriate to look for similarity in the method of construction of designs rather than the similarity in names of designs. The similarity in the method of construction is suggested because that reflects the nexus of a proxy used to substitute income whereas names may be misleading in that context. Some examples in this regard follow as under.

Makedonskiy summarizes the methods for PIT designs as follows:

- i. Types and methods
- ii. Kinds (simplified taxes, forfeit system, imputed taxes, patents, minimum taxes, presumptive withholding tax and presumptive tax on imports)
- iii. Indirect tax liability³⁰²

This grouping is also not supported by any rational or administrative basis. For instance, the designs which are included in the group of ‘types and methods’ are not separate designs but are, in fact, the features of PIT which can be added or omitted from any particular PIT design. Furthermore, there is no explanation of why patents, despite being simple, are not included in the group of the simplified taxes. The forfeit system is also a design based on the indirect liability, but is incorrectly placed in the group called ‘kinds’.

³⁰¹ For details see Thuronyi, above n 38, 6-27.

³⁰² For details see Makedonskiy, above n 2a, 7-34.

Tanzi and Casanegra³⁰³ classify the methods for the PIT as follows:

- i. The estimation on basis of the indicators
- ii. Asset tax
- iii. Gross receipts
- iv. External indicators

Though these authors adopt a principled approach for grouping the methods, which is based on the type of the proxy base used for the presumption, they do not sufficiently emphasise some important methods of constructing PIT designs. Despite the fact that the designs based on these methods are covered in some other groups, because of their independence, each of them should be grouped separately. For example, a fixed tax such as patent (that is, a fixed tax on the basis of production indicators) falls in ‘estimation on the basis of the indicators’ which is enumerated above as (i) by Tanzi and Casanegra, but should be grouped separately due to its independent fixed character as compared to other estimated PITs in the group.

3.3.2 Approach Adopted in this Thesis for Describing Methods of Construction

The inconsistencies in existing descriptions of methods suggest the need for developing a more uniform, clear and comprehensive summary of the designs. This thesis therefore describes the methods of constructing PIT designs in relation to the peculiar nature of the economic base of income tax i.e. income, as discussed in the beginning of Section 3.3.

3.3.2.1 PIT Designs Using another Economic Base as Proxy for Income

In this group of PIT designs, some economic base other than income is used to as a substitute for income to presume the liability. This group of PIT contains the following designs.

- (i) ‘Turnover Tax’ wherein total turnover (proxy base) is presumed as income (actual base) of a person and then a prescribed tax rate is applied to determine

³⁰³ For details see Tanzi and Casanegra, above n, 32a, 7.

the tax liability.³⁰⁴ This design is commonly used for business and professional activities.³⁰⁵ Sometimes only a part of the business activity is subjected to this method of PIT. Instances of part presumption include the subjecting of ‘contractual income’ or ‘service income’ or ‘income from commercial imports’ to this type of PIT regime.³⁰⁶ A similar PIT is in place in the Senegal Islands where unregistered taxpayers have to pay tax at rate of 2% on the value of imported goods.³⁰⁷ In the part presumptions also, turnover is used as the proxy base for PIT. The remaining income from all other activities is subjected to the normal income tax regime.

- (ii) Sometimes turnover from only a single source/class of income e.g. interest or dividend (other than business income) is subjected to PIT.³⁰⁸ In the Netherlands, profits on debt and dividend receipts are deemed as income, without admitting any deductions, and are subjected to a prescribed tax rate.³⁰⁹
- (iii) In another PIT design, some part of turnover (e.g. 12% of turnover, a proxy base) is deemed as net profit (i.e. income, an actual base), and then is subjected to the normal income tax rate.³¹⁰ For example, average annual profitability rates for different businesses in Ethiopia.
- (iv) Total assets or net assets are used as the proxy for income in some PIT designs and are then subjected to a prescribed tax rate. For example, Asset Tax is used in practice in most of Latin American countries³¹¹ like Columbia, Mexico, Argentina, Nicaragua, Ecuador and Bolivia etc. The asset tax is also oldest form of PIT in the history of direct taxation. In 1760, the Principality of Milan

³⁰⁴ *Income Tax Ordinance 2001* (Pakistan) s 113B provides an optional PIT for the retailers: Art. 377 of Kazakh Tax Code also treat turnover/ gross income as income and subject it to prescribed tax rate (see other examples in Engelschalk, above n 2b, 11).

³⁰⁵ Thuronyi, above n 38, 10-11.

³⁰⁶ *Income Tax Ordinance 2001* (Pakistan) s 153 and s 169.

³⁰⁷ Taube and Tedesse, above n 13, 21.

³⁰⁸ See Tanzi and Casanegra, above n, 32a, 9; also see *Income Tax Ordinance 2001* (Pakistan) s 7, 8, 152 where dividend income is treated under PIT.

³⁰⁹ For details visit web page ‘*International Comparison of Australia’s Taxes*’ at <http://comparativetaxation.treasury.gov.au/content/report/html/08_Chapter_6-01.asp>.

³¹⁰ *Income Tax Proclamation-No 286/2002* (Ethiopia) Article 68(1) and (2).

³¹¹ T.J. Steenekamp, ‘A Tax on Gross Fixed Assets as Minimum Corporate Tax for South Africa’ (2000) 68(3) *South African Journal of Economics*, 177, 183.

introduced the taxing of lands on the basis of the Cadastre Listing for land values. This tax was charged on gross physical assets and taxpayers were required to declare estimated values.³¹²

- (v) For self-employed persons, the academic qualifications are used as the proxy economic base as a substitute for income. This basically gives human capital assets a treatment similar to other economic assets. These assets are later subjected to tax for determining the tax liability. The Occupational Assessment Tax, which is a local tax imposed by the Pennsylvania government, is a typical example.³¹³ In Ghana, doctors, lawyers and other occupational groups are subjected to a fixed tax e.g. doctors have to pay €500 per year.³¹⁴

3.3.2.2 PIT Designs Using Production Indicators for Income Tax Liability

In this group of PIT designs, income is not substituted by an economic proxy base but is presumed by relying on one or more than one production inputs that generate economic benefits to the taxpayer. This group of PIT contains the following designs.

- (i) The income tax liability in some PIT regimes is directly presumed without substituting the income by a proxy base. In this PIT, only one or two economic indicators are used to ascertain the income tax liability. The tax so charged is called Patent or Licence Fee. It is a fixed charge on the businesses irrespective of their operational performance in the year.³¹⁵ For example, in Bulgaria a number of commercial activities are subjected to this type of PIT called Patent.³¹⁶ Patents are prescribed for dining establishments (like restaurants, fast food etc), retail trade, manufacturing from metals, cosmetic services, different repairing services

³¹² Efraim Sadka and Vito Tanzi, *Tax on Gross Assets of Enterprises, as a Form of Presumptive Taxation* Working Paper No. 92/16, IMF, February 1992, 2-3 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=884616> at 24 June 2009.

³¹³ For details see 'What are local taxes in Pennsylvania' at <<http://cax.aers.psu.edu/taxreform/localtax.htm#occupation%20tax>> at 24th May 2008.

³¹⁴ Taube and Tedesse, above n 13, 13.

³¹⁵ Although sometimes PIT law is called as 'Law for Small Business Tax' or by some other title, the economic base used in them is a proxy of income (see example of Albania in Engelschalk, above n 2b, 16).

³¹⁶ *Law on Taxes on the Income of Natural Persons* 2007 (Bulgaria) Article 39 to Chapter 7 (i.e. Final Annual Patent Tax) of Part III.

etc.³¹⁷ These activities are grouped on the basis of the average profits and the related productions inputs. The production inputs, e.g. the location and area of the premises, are prescribed separately for each activity.³¹⁸ Under the Bulgarian tax code, a person is responsible to file a return and the administration has no role in the determination of tax liability.

Another example is the License Tax in Armenia. Although it is charged along with VAT, the income tax liability is determined on the basis of the production inputs for a number of activities.³¹⁹ Licenses are prescribed for activities like retails stores, stalls, caterers, transport services, auto repair shops, industrial fishing, entertainment services etc.³²⁰ The production inputs used for each activity are distinct but commonly these include the area, location, number of workers, working days, amount of equipment etc.³²¹ Under the Armenian tax code, some taxpayers are entrusted to file the return in this regard and for other prescribed taxpayers the administration determines the tax liability.³²²

Fixed taxes in the form of patents and licenses are commonly used in the transitional economies of Europe to tax small businesses.³²³ The use of these designs in Africa is also quite common. For example, in Ethiopia, lump sum taxes are computed on the basis of the average profitability.³²⁴ Ghana, Mozambique, Nigeria and Sierra Leone also have a similar form of PIT in their tax systems.³²⁵

³¹⁷ *Law on Taxes on the Income of Natural Persons* 2007 (Bulgaria) Article 40 to Chapter 7 (i.e. Final Annual Patent Tax) of Part III and s I of Appendix to Chapter 7.

³¹⁸ *Law on Taxes on the Income of Natural Persons* 2007 (Bulgaria) Article 40 to Chapter 7 (i.e. Final Annual Patent Tax) of Part III and s I of Appendix to Chapter 7.

³¹⁹ *Law of Republic of Armenia on Presumptive Tax* 1998 (Armenia) Article 2 to Chapter 1.

³²⁰ *Law of Republic of Armenia on Presumptive Tax* 1998 (Armenia) Articles 26 to 93.

³²¹ Id.

³²² *Law of Republic of Armenia on Presumptive Tax* 1998 (Armenia) Article 9 to Chapter 1.

³²³ For example, *Income Tax Law* (Serbia) Article 40 has provision about lump sum tax when taxpayer has no books of accounts (see Engelschalk, above n 2b, 12).

³²⁴ Yirgalem Selamawit and Parameswaran Ramawami, 'Presumptive Taxation in Ethiopia- Prospects and Challenges' (2006) Faculty of Business & Economics, Addis Ababa University <www.ethiopiareview.com> at 8 August 2007.

³²⁵ Taube and Tedesse, above n 13, 12; initially it was considered as a final discharge of tax liability, but now it is treated as mere advance payment.

- (ii) PIT regimes are also frequently designed through a method of assessment of income. In this design, no proxy economic base is used. But income is estimated on the basis of an average return for a set of multiple production inputs. The number of chairs in a restaurant or number of rooms in a hotel or even a number of spindles in a textile unit is used to work out income. These production inputs or units, which generate economic benefits, are relied upon when a taxpayer does not keep financial accounts for the determination of income.

In all, an average income is imputed from a set of multiple production factors. More simply, instead of financial accounting techniques, management accounting techniques are used for the approximate determination of income. Subsequently, on the basis of that assessment of average returns, the income tax liability is charged as a fixed tax.³²⁶ This kind of PIT requires detailed sectoral profitability studies so as to ascertain average profits and tax liabilities.³²⁷ This PIT design is also called an imputed tax.³²⁸

In contrast to the patent or license tax which uses one or two production inputs, this PIT uses a set of multiple indicators. For example, the most famous imputed tax which prevailed in Israel for a long time was the Tahshiv.³²⁹ The Hebrew term Tahshiv (Pl. Tahshivim) literally means calculator³³⁰, but in its relevant usage it could be translated as the Estimated Assessment Guide.³³¹ Tahshiv was introduced in 1954 and was finally abolished in 1975. However, unofficially it is still in practice in the garb of a reasonable income declaration guide for the taxpayers.

³²⁶ Taube and Tedesse, above n 13, 15.

³²⁷ Tanzi and Casanegra, above n, 32a, 13.

³²⁸ Makedonskiy, above n 2a, 5.

³²⁹ Makedonskiy, above n 2a, 18 incorrectly included Unified tax of Ukraine in this type of PIT (that is, 'Estimated PIT').

³³⁰ Wilkenfield H.C., *Taxes and People in Israel* (1973), 144.

³³¹ Yitzhaki, above n 95, 5; and Makedonskiy, above n 2a, 17 inappropriately called 'Tahshiv' as standard assessment method: a term that is more specific for fixed legal form of presumptions. Factually, Tahshiv is closer to the estimated form of presumptions, because multiple indicators are used to estimate the income (see Tanzi and Casanegra, above n, 32a, 13; Taube and Tedesse, above n 13, 15).

The Tahshiv is a sophisticated method of ‘tagging’.³³² Assessment guidelines are prepared after detailed scrutiny of the quantitative and qualitative indicators about a representative sample of trade.³³³ More than 80 Tahshiv were originally developed.³³⁴ The tax authorities defined categories with reference to the expected revenue of the trade. Additionally, other easy to observe indicators like location, opening hours, types of suppliers and customers or some specific other criteria were also used. The categories, so defined, were further subdivided by another set of production inputs for the determination of the tax liability. In case a taxpayer opted to pay the tax worked out under Tahshiv then it was the final discharge of his/her tax liability. Alternatively a taxpayer can opt for the normal regime. Because of this optional feature, Tahshiv becomes ‘maximum tax’ as discussed later in paragraph 3.6.6.

The example of restaurants using Tahshiv is set out below to illustrate the method of using multiple production inputs.

*“A distinction is made between exclusive, special, European, fish, Middle-eastern, vegetarian, Chinese, fast food and the restaurants for blue collar workers. The first section describes how to classify a restaurant among those groups on the basis of the opening hours, peak time, and duration of customers’ stay, type of customers’ clothing, quality of service, menu and type of furniture. Later within each classification group gross revenue per waiter is estimated within a range according to the sub-classification of cities and neighbourhoods. In order to calculate profit, the cost on food purchased is estimated to be 25-30 percent of the revenue.”*³³⁵

Since the profit is calculated by allowing a deduction for materials on the presumptive basis, this design is also called a ‘standard deduction’ as discussed later in section 3.3.2.3.

³³² It means classifying the population of the potential taxpayers into the easy to observe categories and collecting taxes according to the classification (see *Law of Republic of Armenia on Presumptive Tax* 1998 (Armenia) Articles 74-76 to Chapter 13).

³³³ Though some writers have called them as Standard PIT because standard assessment guides are used in them (see Yitzhaki, above n 95, 8), it is suggested that the term Standard PIT should be restricted for the use in respect of the fixed tax with a legal form. This suggestion is for the sake of avoidance of duplication in the nomenclature.

³³⁴ Tanzi and Casanegra, above n, 32a, 13.

³³⁵ Yitzhaki, above n 95, 6.

A similar regime in France is called Forfait. It is a contractual assessment, which could be done on collective or individual basis.³³⁶ The taxpayers' returns are evaluated against the available criteria, based on the average industrial profit margins, by the tax authorities. As a result, the tax authorities either accept a return or request the taxpayer to correct the declaration. In the case of an agreement by the taxpayers to the correction, the tax liabilities are presumed for a period of three years (the preceding, current and subsequent years). Otherwise, the taxpayer has the right to rebut the assessment.³³⁷

3.3.2.3 Miscellaneous PIT Designs

PIT designs not fitting into the above methods of construction are included in this group.

- (i) Occasionally in PIT designs, the income tax liability is determined without any reference to income and any production input. Further, no effort is made in these regimes to find the closest income and the liability thereof. For example, in Armenia, the tax of 125.0 thousand drams monthly for the foreign exchange dealer's activity is charged as a substitute for income tax. This tax is worked out without the use of a proxy or a production input and is the same for every dealer irrespective of the level of income.³³⁸
- (ii) 'Half PIT' designs are common in the tax codes. These designs envisage the use of presumptions for determining the quantum of admissible deductions.³³⁹ For example in Pakistan, for rental income, a repair expense is allowed as a 'standard deduction' at statutory rate of 20% of receipts irrespective of the actual expense.³⁴⁰ Similarly, as a substitute for actual deductions, the 'Optional Standard Deduction' is offered to individuals in the United States of America (USA).³⁴¹

³³⁶ Makedonskiy, above n 2a, 15-16.

³³⁷ Thuronyi, above n 38, 22.

³³⁸ *Law of Republic of Armenia on Presumptive Tax* 1998 (Armenia) Articles 74-76 to Chapter 13.

³³⁹ Kenan Bulutoglu, Presumptive Income Taxation, in P. Shome (ed.) *Tax Policy Handbook*, (1995), 260.

³⁴⁰ *Income Tax Ordinance* 2001 (Pakistan) s 17(1) (a). Recently this provision is omitted by *Finance Act* 2006.

³⁴¹ Slemrod and Yitzhaki, above n 299, 27.

In Mexico, a simplified tax treatment based on cash flow was introduced which allows from receipts an automatic deduction of 15% for freight transport, 10% for tourism and 60% for the urban transportation.³⁴²

The extent of personal use in any business expense like telephone, motor vehicle, entertainment etc is also determined on the presumptive basis by the tax administrators in most countries. For instance, while framing the assessment of a business entity with no proper accounts, tax administrators disallow a percentage of telephone and travel expenses etc. as being used for personal, rather than business, purpose.³⁴³ In respect of salaried income also, the 'value of benefit' of accommodation and/or motor vehicle provided by the employer is ascertained in a similar manner and that is usually made a part of the tax code and, thus, is statutory in nature.³⁴⁴

Sometimes these designs are disputed as not being presumptive in nature on the basis that under such a regime, tax is charged on actual income after allowing certain deductions.³⁴⁵ However, a deeper analysis of these designs reveals that these are similar to a turnover based PIT, except that, instead of using the presumption for receipts, a presumption is made about the volume of deductions.

- (iii) In another PIT design, an anomalous presumption for income is constructed to discourage some commercial transactions or to tax the concealed income. For example, any loan obtained without using a banking channel is deemed by legal fiction as income of the recipient of the loan.³⁴⁶ Sometimes any unexplained asset or expenditure of the person is deemed as his/her income by a deeming provision in the tax code.³⁴⁷ The deemed income in these PIT designs is also

³⁴² Makedonskiy, above n 2a, 11.

³⁴³ *Income Tax Ordinance* 2001 (Pakistan) s 121.

³⁴⁴ *Income Tax Rules* 2002 (Pakistan) Part I to Chapter I.

³⁴⁵ Makedonskiy, above n 2a, 24.

³⁴⁶ *Income Tax Ordinance* 1979 (Pakistan) s 12(12) (hereinafter called the repealed Ordinance). Sometimes unexplained possession of asset is deemed as income (see *Income Tax Ordinance* 2001 (Pakistan) s 111).

³⁴⁷ *Income Tax Act* 1961 (India) s 68.

called ‘notional’ income because it is not real and is created by a legal fiction.³⁴⁸

- (iv) A PIT can act as a substitute for using multiple taxes.³⁴⁹ A notable example is of the Russian ‘Uniform Tax’, which singularly replaces four taxes including income tax, sales tax, property tax and social security tax.³⁵⁰ Similarly, the ‘single tax for natural persons’ in Ukraine replaces the income tax, VAT, labour remuneration charges and social security contributions.³⁵¹
- (v) In some African countries income tax is charged as ‘Hut Tax’ or as ‘Poll Tax’ at a flat rate which is payable by adult males. Arowolo called it ‘Quasi Income Tax’.³⁵² This tax is fully integrated with the income tax in Nigeria but in other countries, such as Kenya and Uganda, it still exists as a separate tax.
- (vi) In international business activities, ‘half harmonization’ is used to curb tax competition and in relation to transfer pricing issues. The concept of formulary apportionment (i.e. apportioning group profits to its member companies) has been used by some countries such as Pakistan for determining the profits of branches of Multinational Corporation (MNC), although the most common users are the States within the USA.³⁵³ Recently, the formulary apportionment of the group profits under the rules of a home country has been suggested as a solution for tax competition in the European Union.³⁵⁴ In that scenario, the apportioned group profit is presumed as actual income in the source country.

³⁴⁸ Generally, whenever a proxy base is treated as income, then it is called ‘notional income’ because it is not an actual income and is deemed so by a legal fiction.

³⁴⁹ Engelschalk, above n 2b, 20.

³⁵⁰ Uniform Tax (Federal Law No. 148 FZ) in Russia replaced most taxes (see Wallace, above n 6b, 7).

³⁵¹ A taxpayer is required to purchase the patent once in a year. It is an optional PIT regime (see Makedonskiy, above n 2a, 21).

³⁵² Edward A. Arowolo, ‘The Taxation of Low Incomes in African Countries’ in Richard Bird and Oliver Oldman (eds.) *Readings on Taxation in Developing Countries* (Third Edition, 1975), 241; Although there could be some disagreements, the author agrees with this referred study that a Poll tax is a surrogate of an income tax because when an adult has to pay tax irrespective of his/her wealth it reflects that a Poll Tax is based on his/her ability to earn and pay.

³⁵³ Hans Jarle Kind, Karen Helene Midelfart and Guttorm Schjelderup, ‘Corporate Tax Systems, Multinational Enterprises and Economic Integration’ (2005) 65 *Journal of International Economics* 507, 508.

³⁵⁴ James J. Tobin, ‘Formulary Approach to Cross-Border taxation to be tested in Europe: No Transfe.....’ (2004) 33 (11) *ABI/INFORM Global Tax Management International Journal* 662, 662.

3.4 Introducing PIT Regimes in Tax Codes

It is observed that countries usually use the following two legislative methods to introduce PIT regimes: the legal method and the administrative method.

3.4.1 The Legal Presumptive Income Tax

The first source of presumption in income tax is purely by legislative action and PIT, so enacted, is called a 'legal PIT'. It is usually enacted by inserting provisions in the tax code which deem, through a legal fiction, that a tax collectable or payable under that provision, disregarding the actual income from the given activities, is the final discharge of income tax liability. For example, in Bulgaria tax charged as the patent is deemed as the final annual tax on income for the prescribed activities. Article 39 of the Bulgarian tax code provides:

'39(1) A natural person, including sole proprietor, who carries out activities specified in the Supplement (patent activities) shall be liable for a final annual tax (patent) tax on the income originating from these activities'.³⁵⁵

However, the language in the legal code may vary from country to country. Sometimes a PIT regime is introduced, by not making an insertion in the income tax code, but by enacting a separate law. The economic base used for the tax in that enactment is actually a proxy of income. In Armenia, the Law of the Republic of Armenia on Presumptive Tax contains a PIT design in the following words:

'Article 2 Presumptive Tax 1: In a context of this law presumptive tax is compulsory and non-refundable payment which will replace VAT and or Profit Tax, paid to the state budget to the amount and term established by the current law'.³⁵⁶

It is noted that the design under legal PIT is usually based on the use of a proxy base or the use of a few production inputs.

³⁵⁵ See *Law on Taxes on the Income of Natural Persons* 2007 (Bulgaria) Article 39(1).

³⁵⁶ See *Law of Republic of Armenia on Presumptive Tax* 1998 (Armenia) Article 2.

3.4.2 The Administrative Presumptive Income Tax

The second source of presumption in income tax is the administrative decree PIT which when implemented, is called an administrative PIT. It is introduced by inserting specific assessment provisions in the tax law which empower the tax administration to use multiple production inputs for the determination of income. Sometimes even the normal assessment provisions of the income tax law are amended to enact this PIT regime.

An administrative PIT is identical to an assessment based on the best judgment of the tax authorities ³⁵⁷ when taxpayers have not maintained adequate records. Broadly, a tax liability under this type of PIT is determined by the tax administration for each taxpayer. It involves the construction of income on the basis of some production inputs called 'indirect methods'. It is noted that there is a more extensive use of the indicators in an administrative PIT as compared to a legal PIT.

Besides production inputs, other indirect methods commonly used in an administrative PIT include the net worth method, the bank deposit method, and the expenditures method. In the expenditures method, personal expenses (i.e. external indicators) of the taxpayer are worked back to determine the income.³⁵⁸ Some scholars collectively refer to these indicators as quantitative indicators.³⁵⁹

The classical examples of an administrative PIT are the Tahshiv and the Forfait. Administrative PIT is also used to tax agricultural income in some African countries (for example, Angola, Chad, Malawi, Madagascar, Tanzania, Swaziland and Uganda).³⁶⁰

An administrative PIT, because of the active participation of the tax administration, is also called an 'estimated assessment'.³⁶¹ Estimated Assessments are 'sophisticated

³⁵⁷ One of such methods is mentioned by Thuronyi, above n 38, 8.

³⁵⁸ Bulutoglu, above n 329, 261; also see Makedonskiy, above n 2a, 29.

³⁵⁹ Konstantin V. Pashev, 'Presumptive Taxation: Lessons from Bulgaria' (2003) 18 (4) *Post-Communist Economies* 399, 404. Further, PIT designs using a proxy base like asset or turnover are called PIT based on the Value Indicators.

³⁶⁰ Taube and Tedesse, above n 13, 16.

³⁶¹ Makedonskiy, above n 2a, 18.

assessments',³⁶² as compared to legal PITs because a large number of production inputs are geared towards the estimation of income. The tax liabilities, so worked out, are also called imputed taxes. However, the use of multiple indicators increases the complexity and the interface between the taxpayer and the tax administrator which provides an 'invitation for corruption',³⁶³.

Sometimes, an administrative PIT is also called an 'atypical' PIT because factually, it involves the estimation of income by an assessing officer. Further no deeming provision in this PIT is used to supplant the income tax liability. The administrative PIT, therefore, is a rough method of determination of income through the assessment provisions of the tax code. This assessment method is followed for determination of income under the normal regime when a taxpayer does not maintain records. More aptly, an administrative PIT is akin to what is called in the accounting 'construction of the income statement from incomplete accounts'.

Broadly, all the accounting methods used for the computation of income are basically tools for the determination of income. The proximity of income so computed with actual income, depends upon the type of method used. For example, even historical accounting, which is the most preferred method, does not provide absolutely accurate information of income because it involves a presumption in a number of accounts such as depreciation of assets and determination of quantum of doubtful debts. In other words, when it comes to the assessment of income, then it is artificial to distinguish between methods used normally to assess income and methods used only in specific circumstances.³⁶⁴

It, therefore, may be argued that the determination of income always requires some degree of presumption. However, any further discussion on this aspect would lead back to the controversies surrounding the concept of income, which is beyond the scope of this thesis.

In sum, an administrative PIT is used in specific assessments when taxpayers do not keep sufficient accounting records (or when taxpayers themselves are incapable of

³⁶² Taube and Tedesse, above n 13, 16.

³⁶³ Makedonskiy, above n 2a, 18.

³⁶⁴ Tanzi and Casanegra, above n, 32a, 8.

determining their own income),³⁶⁵ and thus it involves a larger role for the tax administration in order construct income through multiple indicators.

3.5 Qualifications in Respect of Designs and Legislative Forms

It is imperative to make three qualifications about PIT designs and their legislative forms. First, it is not always possible to distinguish PIT regimes into legal and administrative forms with precision. There is no definite delineation between legal and administrative PIT regimes in practice. Some PIT regimes have a mix of legal and administrative attributes. For instance, the determination of presumptive tax liability in Armenia is laid down in the law itself for some taxpayers and they self assess the production inputs and file a return accordingly. But for other taxpayers, the determination of tax liability is left to the tax authorities to make by examining the production indicators and assess the liability thereof. In this regard, Article 9 of the Law of the Republic of Armenia on Presumptive Tax is reproduced below.

‘Article 9 Determination of the amount of the Presumptive Tax: 1. Determination (calculation) of Presumptive Tax amount shall be carried out by taxpayers with exception of cases provided by item 2 of the current article. 2. In cases stipulated by the Tax Legislation and other statutory acts regulating tax relation, Presumptive Tax amount shall be determined by Tax Body of the Republic of Armenia (hereinafter-tax body) in compliance with this law.’³⁶⁶

Second, different nomenclature is used for identical PIT designs and the legislative forms in different countries. For example, the patent in Bulgaria and license in Armenia have the same designs but have different names.

Third, there is a novel PIT regime in Pakistan wherein a person is entrusted to file its income tax under indirect methods or on a lump sum basis. This regime is called Simplified Self Assessment Scheme (SSAS).³⁶⁷ Although it is referred in the literature as Non-Presumptive SAS, characteristically it is a form of PIT. It has been introduced in some developing countries for small business by amendment in the assessment provisions. For cost effectiveness reasons, this regime was introduced for small

³⁶⁵ Tanzi and Casanegra, above n, 32a, 4.

³⁶⁶ See *Law of Republic of Armenia on Presumptive Tax 1998* (Armenia) Article 9.

³⁶⁷ *Income Tax Ordinance 2001* (Pakistan) s 120.

businesses where perhaps neither the taxpayer nor the tax administrator is capable of determining actual income due to absence of financial accounts. Being based on indirect methods income declared in SAS returns is not different from income under any PIT regime in general and the administrative PIT regime in particular.

3.6 Features to Customize PIT Regimes

PIT regimes vary not only in their design and legislative form, but also in their features regarding taxpayer eligibility, statutory compliance, treatment by the administrative and appellate authorities etc. These features are incorporated in PIT designs either through insertions in the relevant legislation or by administrative rulings. Irrespective of the method used for the incorporation, it is recommended that features of a PIT design be customized to the requirements of policy objectives. This customization may be secured by incorporating a combination of features, which are consistent with the policy objectives.³⁶⁸

Studies referred in Section 3 of Chapter 1 reflect a minimal analysis of this important facet of PIT design. Neither the whole range of the features nor the importance of each feature in achieving the tax policy objectives was ascertained and analysed. This chapter, therefore, presents the following ten fundamental features which are currently available for countries to choose from. However, this list of features is not necessarily final because there always remains scope of more additions due to the dynamic nature of business and tax.

3.6.1 Exclusivity

This feature envisages that the liability charged under the PIT regime is the final tax notwithstanding that the liability under the normal regime may be higher. Thus, the exclusivity feature is different from the Minimum Tax (MT) feature. In a PIT with a MT feature, its liability is required to be compared with that of the normal tax and whichever is higher is payable. On other hand, in a PIT with exclusivity feature, the PIT liability is the final liability irrespective of its quantum in comparison to that under the normal tax. Moreover, it is noted that these features – namely exclusiveness and MT, are mutually exclusive. The turnover tax and patent usually have the exclusivity feature.

³⁶⁸ Some of the features are mutually exclusive.

3.6.2 Rebuttable or Irrebuttable

This feature depicts the right of taxpayers to contest their liability computed under the PIT before appellate authorities. When a payment of tax is treated as a final discharge of tax liability, then it is called ‘irrebuttable PIT’. For instance, the PIT in Armenia is irrebuttable as there is no provision in the law assigning a right of appeal to taxpayers.³⁶⁹ A legal PIT regime is usually ‘irrebuttable’ which makes it unfair and unacceptable to many taxpayers.³⁷⁰ Makedonskiy claims there has been an increase in constitutional petitions in countries practicing irrebuttable PIT³⁷¹, which is testimony of its lower acceptance among taxpayers. Though his claim is not supported by any statistics, it is logically acceptable particularly when tax rates in PIT are high.

Occasionally for reasons of saving some taxpayers from the hardship of the fixed tax, tax relief is provided in a PIT regime. The tax authorities, after probing the financial affairs of the taxpayer, may offer that relief. For example, under Bulgarian presumptive tax, the annual patent can be reduced by 50% in cases where a loss is determined by the tax authorities.³⁷² This provision may reduce some of the arbitrariness caused by legal PIT on the equity and efficiency fronts.

The administrative PIT is usually ‘rebuttable’ under the judicial principle of the right of appeal against the actions of the Executive. For instance, the Forfait in France is rebuttable. However, the rebuttability feature increases the complexity of PIT.

3.6.3 Mechanical or Discretionary

Under a mechanical PIT regime, liabilities are determined in accordance with a set of rules prescribed by the law. Under a discretionary PIT regime, varying degrees of freedom are given to tax officials to determine tax liabilities. For example, patents in Bulgaria are mechanical and the taxpayers are required to only follow the statutory guidelines for determination of their tax liability.³⁷³ The Forfait in France is not

³⁶⁹ See *Law of the Republic of Armenia on Presumptive Tax* 1998 (Armenia).

³⁷⁰ Liability under s169 of *Income Tax Ordinance* 2001 (Pakistan) is not contestable under the law before any appellate forum.

³⁷¹ Makedonskiy, above n 2a, 7; Wallace, above n 6b, 2 also makes similar claim.

³⁷² See *Law on Taxes on the Income of Natural Persons of Bulgaria* 2007 (Bulgaria) Article 41.

³⁷³ See *Law on Taxes on the Income of Natural Persons of Bulgaria* 2007 (Bulgaria) Article 39(1).

mechanical because it is executed through detailed negotiation between the taxpayer and the tax collector. A legal PIT is usually mechanical and irrebuttable, while an administrative PIT is generally discretionary and rebuttable.³⁷⁴ It is therefore noted that in the countries with a weak and potentially corrupt administration, the discretionary PIT regime might be less successful.³⁷⁵

3.6.4 Entry and Exit Thresholds for Determining Eligibility

The eligibility criteria for a taxpayer to use a PIT regime, both in terms of ‘entry’ and ‘exit’, are important. The eligibility criteria may include one or more than one economic indicator such as level of gross income or turnover, number of employees, type of taxpayer, location, size and sector.³⁷⁶ For example, the Armenian PIT excludes manufacturers, drug stores, petroleum products sale, taxpayers with particular turnover, and the area of the premises from its ambit.³⁷⁷ The choice of criteria depends upon the policy objective of the country.³⁷⁸ For example, when the policy objective is to reduce the compliance burden of small business, then the criterion to be used is turnover, floor area, number of employees etc which reflects the volume of activity rather than the type of a taxpayer. Sometimes both the criteria are combined as in above mentioned example of Armenia.

PIT regimes for small business usually have two thresholds for an eligibility indicator. One is at the bottom and another at the top, and only taxpayers falling between the two thresholds are eligible to avail themselves of the PIT regime. It is noted that setting the ‘entry’ threshold too low would unfairly tax very low income groups and setting the ‘exit’ threshold too high may cause erosion of the tax base by benefitting large taxpayers.

³⁷⁴ But in one instance, the discretionary presumption was designed as irrebuttable (that is, presumption based on life styles in France). Later, it was also made rebuttable to meet the public demand (see Thuronyi, above n 38, 25).

³⁷⁵ Thuronyi, above n 38, 5.

³⁷⁶ Engelschalk, above n 2b, 12.

³⁷⁷ See *Law of Republic of Armenia on Presumptive Tax* 1998 (Armenia) Article 22.

³⁷⁸ Engelschalk, above n 2b, 11.

3.6.5 Time Frame

The time frame for a PIT regime, particularly where the tax liability is much less than that in the normal regime, should be defined and a taxpayer should not be allowed to make the use of the regime indefinitely. It is noted that the prolonged availability of a PIT regime creates a new class of taxpayers who tend to remain small forever and avoid transitioning to the formal sector.

On the other hand, placing the exact time frame for compulsory transition to the normal tax may not be logical, especially except when it is linked to the economic development of country because each taxpayer might not grow enough during that period to bear the compliance costs of normal tax. Consequently, such small business may try defeating the regime by restarting the activity under a new name. Therefore, a PIT regime, instead of adopting an exact time frame, should contain some graduating mechanisms to encourage transition to the normal tax such as incentives involving easy access to finance and insurance etc.

3.6.6 Minimum or Maximum Liability

An Alternative Minimum Tax (AMT) is mostly charged on assets or turnover. The liability under AMT is compared with that under the normal tax and the taxpayer is required to pay the higher of the two.³⁷⁹

On the other hand, under a maximum tax the taxpayer can pay the lower of the amounts computed under the normal and PIT regimes, provided that the amount of liability calculated via the normal method is supported by the accounting books. A maximum tax, therefore, rewards those who make an effort to keep records. Both the minimum and maximum PIT regimes can co-exist with the normal regime and ensure that the taxpayers must pay some tax under all circumstances.

3.6.7 Selection for Audit

Normally, some percentage of the returns filed under the normal tax is subjected to audit on the basis of selection criteria. However, there is no consistent practice for the

³⁷⁹ AMT increases the tax compliance burden because two liabilities are to be computed and keeping books is obligatory.

audit of the returns filed under a legal PIT. The returns filed under a legal PIT are usually immune from audit. Occasionally, the returns filed under a legal PIT are randomly audited to ensure that the proxy base is declared truthfully.³⁸⁰ On the other hand, an administrative PIT is the result of detailed negotiation between the taxpayer and tax authority, and hence is not subjected to audit.

3.6.8 Taxing Average Income: Quantum of Tax Burden

The tax burden imposed by any tax regime is not a peculiar design feature. However, a PIT regime, which does not tax actual income, can better secure the achievement of policy objectives if its tax burden is appropriately determined. In the current PIT regimes particularly those in the European transitional countries a nominal tax is charged to avoid overtaxing taxpayers.³⁸¹

However, some PIT regimes have incorporated this feature by taxing small businesses on their average income. Taxing on average income may be better than the normal tax because it has a marginal tax rate of zero and consequently may not put a higher tax burden upon the ‘better performers’. A tax on average income basically taxes the ability to pay (for example, an assets tax) and therefore promotes work and consequently economic growth.³⁸² Thus, the presence of a large informal sector provides an opportunity to harness the benefits of taxing average income through a PIT having a feature of taxing on average income. This is also close to the ideal concept of income (capacity to pay) as discussed in Section 3.1.

3.6.9 Optional or Compulsory

A PIT regime may have an optional feature. Consequently, taxpayers have a choice to either pay the liability under the PIT or the normal regime. For example, in Pakistan manufacturers had the choice to pay either under the PIT or normal regime.³⁸³ The Tahshiv is another example. When such an option is not provided, it is compulsory to follow the PIT regime. The demerit of the optional regime is that taxpayers keep

³⁸⁰ Engelschalk, above n 2b, 5.

³⁸¹ Engelschalk, above n 2b, 5-7.

³⁸² Sadka and Tanzi above n 307, 3; Faulk et al above n 15, 2, 3.

³⁸³ See *Income Tax Ordinance* 2001 (Pakistan) Clause 40 to Part IV of Second Schedule. This clause is now omitted.

hopping between the PIT and the normal regime to find an effective tax shelter. For instance, when a taxpayer has high income then he or she may prefer to pay fixed tax under PIT. Conversely, when a taxpayer has low income or a loss he or she may prefer to pay tax under the normal regime.

3.6.10 Open for Auction

The PIT regime can have a feature under which a taxpayer who incorrectly declares the tax liability may have his or her assets liable to purchase through open auction. In the 16th Century in the state of Milan, the asset tax had this feature.³⁸⁴ The list of pieces of land at the declared value used to be publicized and every piece of land was open to auction. Anyone who bid higher than the declared value was authorized to purchase at that value.³⁸⁵ Perhaps this feature has never been used ever since. But its value in controlling evasion is amazing. Even under a turnover-based PIT or the normal regime, business assets should be made liable to sale through auction at a price higher than the declared value (which may be determined under the cash flow method or net asset value method).

4. Classification of PIT Regimes in Practice

In contrast to Section 3.3.2 (which describes PIT regimes on basis of methods of construction), in this section PIT regimes are grouped on the basis of nomenclature in the following classes.³⁸⁶ The classes reflect differences in their legislative forms, designs and features. PIT regimes are classified differently by some researchers but those classifications are ignored in this study for two reasons. First, those classifications either duplicate or omit some PIT regimes. Second, a debate over classification has no relevance to the thesis.³⁸⁷

³⁸⁴ Sadka and Tanzi, above n 312, 2. An auction feature had also been in the use in tax systems of other countries such as in Thailand. In Thailand, however, the auction had been for the purpose of recovery of arrears rather than as a feature in its tax design to act as a deterrent for getting correct voluntary declarations of income (or ability to pay) from taxpayers.

³⁸⁵ Sadka and Tanzi, above n 307, 4.

³⁸⁶ Taube and Tedesse, above n 13, 12-21; Gandhi, above n 8, 3.

³⁸⁷ For other classifications see Wallace, above n 6b, 10; Yitzhaki above n 93, 3.

4.1 Standard PIT Regimes

Subject to earlier qualifications mentioned in Section 3.5, standard PIT regimes commonly are legal in form and determine the tax liability in a mechanical manner with little discretion in the hands of the tax administrator. Standard PITs are further sub-classified in the following three sub-classes.

4.1.1 Fixed Percentage of a Performance Indicator

This subclass includes PIT regimes having designs of ‘turnover tax’ and ‘gross income tax’. In these regimes, the actual tax base is replaced by a proxy base. For instance, in the ‘turnover tax’ and in the ‘gross income tax’, turnover and gross income substitute for income respectively.³⁸⁸ Both the turnover and gross income are then subjected to the prescribed tax rate. These standard regimes are also called turnover/gross income-based Presumptive Systems.³⁸⁹ These are the ‘typical’ PIT regimes because another economic base (which reflects the operational performance) is used as the proxy for income.

These regimes usually have a legal form. The substitution of the actual with a proxy base is legislated either through inserting a deeming provision in the tax code or by enacting a separate law. However, these regimes vary from one country to another in terms of the design, features and legal forms. For example, different tax rates for the legal and natural person are applied in some jurisdictions.³⁹⁰ In Kazakhstan, natural persons are subjected to the tax rate of 4-11% and legal entities are subjected to 5-13%.³⁹¹

As mentioned in Section 3.3.2, another fixed percentage type of ‘Standard’ PIT is a presumed turnover tax on some component of business activity or on the one source or class of income. For instance, the turnover of business activity related to ‘exports’ or ‘commercial imports’ is treated as income and then subjected to the prescribed tax rate. Similarly, an investment income like interest and dividends is also subject to this kind of PIT.

³⁸⁸ Gross income is inadvertently used for the gross turnover in some countries. For instance, in Ukraine gross turnover is called gross income.

³⁸⁹ Engelschalk, above n 2b, 7.

³⁹⁰ Engelschalk, above n 2b, 12

³⁹¹ Engelschalk above n 2b, 12.

4.1.2 Fixed Tax

In this sub-class of the Standard PIT mechanisms, usually one or two production inputs are used in determining the tax liability. These regimes are prescribed for a wide range of trades and professions. These regimes usually have legal form. Occasionally, in this subclass the normal tax liability is supplanted by presumed tax liability through legal fiction without referring to the tax base or even the production inputs.

Mostly these regimes are introduced by enacting a separate tax law where a different economic base (which may be a proxy of income) is used and the tax law is titled accordingly. As mentioned in Section 3.3.2, these regimes are named differently from country to country (for example, Lump Sum Tax, License Fee and Patents).

Although these vary in nomenclature, almost all such PITs determine liability through one or two production inputs for each class of trade and profession. A list of tax liabilities is prepared for a large number of taxpayers accordingly.³⁹² At the time of registration, tax rate that is applicable to a registering taxpayer is decided either by the tax administration (which has a discretion about the category) from the given prescribed lists, or by that taxpayer upon self assessment. Once decided, that taxpayer is expected to pay the tax at that rate.

4.1.3 Standard Deduction Method

This subclass comprises the ‘Half PIT’ design where the taxpayer has the option to take automatic deductions either from cash flow or turnover. Thus, this regime is a proxy of admissible deductions. Since the presumptions of deductions offer an upper limit for deductions, it is sometimes called a ‘floor’ or ‘ceiling’³⁹³. More simply, proxy deductions are allowed on the estimated basis instead of the actual deductions. The eligibility criteria for the taxpayers vary from country to country. As mentioned in Section 3.3.2, these PIT regimes are in practice in USA, Mexico and France.

In Mexico, receipts of the small entrepreneur of different sectors are subjected to automatic deductions at 15% for freight transport, 10% for tourism transport and 60%

³⁹² See *Law on Taxes on the Income of Natural Persons 2007* (Bulgaria) Appendix.

³⁹³ Yitzhaki above n 87, 4.

for urban transport to arrive at the taxable base.³⁹⁴ Similarly, in France, the taxable base is determined after allowing from receipts a deduction of 70% in the commerce sector, 50% in the service sector and 35% in other sectors.³⁹⁵

4.2 Estimated PIT Regimes

This class of PIT regimes authorizes the use of a range of indirect or quantitative methods for the determination of income and therefore are called ‘indicator based assessment’. These regimes can be used both at an individual and collective level after negotiations with taxpayers. Since these regimes involve extensive participation by the tax administration, they are called estimated PIT. For the same reasons, these regimes are also called Administrative/General Presumptions. The examples, as mentioned earlier in Section 3.3.2, include the Tahshiv, the Forfait and similar regimes in many African countries such as Angola, Chad, and Malawi etc.³⁹⁶

4.3 Minimum Tax PIT Regimes

This class of PIT regime requires the payment of at least minimum tax (MT) liability even if tax liability on the actual income is nil or lower than that MT liability. The MT is usually levied through deeming some proxy base as income of the taxpayer and then subjecting it to a prescribed tax rate. Moreover, the MT can be levied without having a presumptive character, that is, through a separate enactment.³⁹⁷ The common examples of a MT are an Asset Tax and a Turnover Tax wherein either assets or turnover are deemed as income respectively; or they are charged through separate enactments. The AMT regime may be used both for individuals and corporations.³⁹⁸

In Latin American countries and in India, MT is charged on the assets base of the taxpayer. The difficulty of measuring the asset base perhaps has caused the recent shift of using turnover as the basis for MT in some jurisdictions.³⁹⁹ The turnover, whose

³⁹⁴ Makedonskiy above n 2a, 11.

³⁹⁵ See Makedonskiy above n 2a, 12.

³⁹⁶ Taube and Tedesse, above n 13, 16.

³⁹⁷ Janet Stotsky, ‘Minimum Taxes’ in P. Shome (ed.) *Tax Policy Handbook*, (1995), 264.

³⁹⁸ The determination of tax rate here has always been a matter of considerable debate (see Sadka, above n 299, 12).

³⁹⁹ Gandhi, above n 8, 3.

information is easy to obtain in a documented economy, might be a better proxy base to tax the formal and corporate sector.⁴⁰⁰ For example, in Pakistan, the MT is charged as a percentage of turnover. In Africa, the MT is charged as a percentage of gross turnover in Chad, Ghana, Guinea, Nigeria etc; as a lump sum tax plus a percentage of gross receipts in Madagascar; and as greater of lump sum tax or a percentage of gross receipts in Congo, Gabon, Comoros, and Cameroon.⁴⁰¹

MT is also used in developed countries such as Canada in the form of allowing a standard deduction to individual taxpayers to arrive at net income. The tax is then charged at 17%. Such taxpayers then are not allowed any further deductions.⁴⁰² The tax so paid is the minimum tax liability of individual taxpayers in Canada.

4.4 Other PIT Regimes

This is a miscellaneous class of PIT regimes. In this subclass, a base other than operational performance indicators is used as a proxy for the actual income. For example, in Bolivia, a 3% levy on net worth was the presumed tax liability for corporations.⁴⁰³ This tax currently charged as MT. In Netherlands, some types of income such as capital income are presumed collectively at the rate of 4% from total assets and are then subjected to a fixed tax rate of 30%, called Single Tax.⁴⁰⁴

5. Conclusion

The review of concepts in this chapter confirms that the PIT is a compromise option to the normal income tax, particularly when the normal income tax faces serious difficulties in its effective implementation. In some specific situations, such as for taxing small business in informal sectors in developing countries, the PIT is perhaps even more useful because it does not rely on books of accounts for determination of tax liability. This can substantially reduce compliance and enforcement costs.

⁴⁰⁰ It shows that the choice of a proxy base in PIT design depends upon the nature of targeted population of taxpayers. A proxy base suitable for a small business operating informally may not be suitable for a large formal business registered with GST. For further discussion see chapters 4 and 7.

⁴⁰¹ Taube and Tedesse, above n 13, 5-12.

⁴⁰² For more details please see the Canadian government website http://www.fin.gc.ca/taxexp-depfisc/2000/taxexp00_4-eng.asp.

⁴⁰³ Wallace, above n 6b, 6.

⁴⁰⁴ Makedonskiy, above n 2a, 18.

The review of PIT regimes and their designs and features reveals that the PIT is a very flexible tool in income taxation which can be customized to meet the requirements of each jurisdiction. This may explain why different countries have been using various designs, sets of features and modes of enactment for their PIT. From another view, the multiplicity of PIT regimes also reflects the lack of interaction among developing countries that are facing the identical problem of tapping the revenue potential of small business in informal economies. In other words, countries which are trying to tax small business in their large informal economy through a PIT regime should (unless specific characteristics of a particular informal economy requires a different tax design) but do not have a fairly similar PIT design and features etc.

Therefore, in context of this thesis, the multiplicity of PIT regimes in developing countries to tax the identical problem of large informal economies may reflect the lack of interaction among them, particularly when that diversity does not have a rational basis. It suggests that these countries should learn from each other's experiences and develop a consistent and appropriately designed PIT to tax the small business sector in informal economies.

This chapter is subject to a number of limitations, particularly in citing examples for legislative forms only from the PIT legislation in Armenia, Bulgaria, France and Israel and Pakistan. The chapter does not make much reference to PIT legislation in countries from Africa and Southern America due to resource constraints.

Nevertheless, this chapter, by providing the experience of many developing countries may serve as the menu for the policy maker to choose the PIT design which is most suitable for taxing small businesses in the informal sector of developing countries. In this regard, however, it would be prudent to evaluate the merits and de-merits of all relevant PIT designs against the causes of the informal economy before choosing a PIT design for small business in developing countries. This task is taken up in the next chapter of this thesis (that is, Chapter 4).

CHAPTER 4 THE USE OF PIT FOR SMALL BUSINESS IN LARGE INFORMAL ECONOMIES

Scope of this Chapter: Once PIT is recommended to tax the large informal sector in developing countries by utilising policy guideline generated in Chapter 2, this Chapter reviews relevant literature and critically examines the role of PIT in addressing each of causes of the informal economy. This chapter also evaluates the comparative value of the diverse PIT designs and features enumerated in Chapter 3 for tackling informal economies. This comparative analysis entails frequent cross referencing and some repetition of arguments put forth in chapters 2 and 3.

1. Introduction

Consistent with Section 5.1 of Chapter 2, a small business dominated informal economy is a hurdle for revenue collection in developing countries. Tax policy is considered an important instrument to fight informality.⁴⁰⁵ The use of indirect taxes is discouraged because of their higher regressivity and deadweight loss⁴⁰⁶, which promotes the informal sector.⁴⁰⁷ However, consistent with what was stated in Chapter 1, although income tax is a preferred tax instrument, instead of securing compliance from small business, due to its complexity it stimulates the informal economy. Therefore, designing of an appropriate income tax regime for small business, in view of its compliance costs is quite challenging.⁴⁰⁸ There are international initiatives suggesting taking into account the needs of small business while framing an income tax design, in order to facilitate their integration into the formal sector.⁴⁰⁹ The driving concept behind the initiatives is ‘Think Small First’⁴¹⁰.

⁴⁰⁵ Marquez et al above n 24, 6 even consider that practically tax policy is the only instrument to combat informality; World Bank IFC Report 2007, above n 49, 103 also suggests appropriate tax policy for SME to encourage formalization.

⁴⁰⁶ Alm et al, above n 46, 25, 44.

⁴⁰⁷ Alm et al, above n 46, 25.

⁴⁰⁸ Stern and Barbour, above n 93, 4.

⁴⁰⁹ See OECD, ‘OECD Istanbul Ministerial Declaration on Fostering the Growth of Innovative and Internationally Competitive SMEs’ approved in Istanbul, 3-5 June 2004<http://www.oecd.org/document/16/0,3343,en_2649_34197_32020176_1_1_1_37461,00.html> at 22 April 2009.

⁴¹⁰ European Union, European Commission, Enterprise and Industry Document C (97) 1161 <http://ec.europa.eu/enterprise/entrepreneurship/support_measures/start-ups/rec_start-ups/rec_start-ups_97en.pdf> at 22 April 2009.

Marquez et al. found no evidence that the redesigning of the normal income tax can tackle the informal economy.⁴¹¹ For instance, the use of high marginal tax rates usually is counterproductive, leading to a vicious cycle that further promotes the informal economy.⁴¹² Some economic models suggest that progressivity in tax rates also encourages informality.⁴¹³ Further economists argue that the use of high penalties deters non-compliance and encourages formalization,⁴¹⁴ but the enforcement of penalties requires effective and honest administration, which is lacking in most developing countries. Even the reduction in tax rates and simplified income tax regimes in developing countries, as compared to developed countries, have not yielded positive results as evident from their persistent informal economies⁴¹⁵, perhaps because all such regimes require maintenance of accounts for determination of income. Consequently, consistent with Section 4.1 of Chapter 2, compliance costs remain high, which is a major reason of small business operating informally.

In view of the above, it is inferred that it is almost an un-achievable task to tax small business in the developing countries under the normal regime, that is, on the basis of actual income.⁴¹⁶ It may be because of the incapacity of small business to maintain accounts and the lack of a capable tax administration, which are essential for an accurate determination of income. Small business therefore prefers not to comply and the tax administration fails to ensure compliance.⁴¹⁷

Therefore, Shome recommends that a potential source of revenue of small business can be tapped by drastically simplifying income tax particularly in terms of accounting requirements.⁴¹⁸ Even the policy makers are justified in recommending the use of PIT regime based on proxies of income. PIT is accepted as a practicable choice for

⁴¹¹ Marquez et al, above n 24, 6.

⁴¹² Marquez et al, above n 24, 7.

⁴¹³ Trandel and Snow, above n 135, 222.

⁴¹⁴ Alberto Luigi Franzoni, 'Tax Evasion and Tax Compliance' University of Bologna, Italy, September 1998, 12 < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=137430 > at 12 October 2009.

⁴¹⁵ Schneider, above n 87, 137-152.

⁴¹⁶ Tanzi and Casanegra, above n, 32a, 15; also see Makedonskiy, above n 2a, 4.

⁴¹⁷ Makedonskiy, above n 2a, 4.

⁴¹⁸ Shome, above n 62a, 7.

successful implementation of income tax in the informal sector.⁴¹⁹ Many developing countries across the world, mostly on the advice of donor agencies, have substituted the normal income tax by PIT for their small businesses.⁴²⁰ However, the role of PIT and its outcome in the informal sector is still uncertain. This chapter therefore examines the role of PIT in addressing those causes which encourage small business to operate informally. During this analysis, all criticism regarding the use of PIT and the comparative value of common PIT designs is also discussed.

The analysis shows that PIT helps in addressing each of the tax related causes of the informal sector. However, the outcome of PIT for the informal sector is also dependent on the choice of its design and features. The analysis in this chapter shows that an asset based PIT, along with a set of recommended features, is superior to other PIT designs in this regard.

The remaining chapter is divided in three sections. Section 2 elaborates the inability of the normal income tax to tackle the informal economy. In Section 3, the ability of PIT to address causes of the informal economy as well as criticism on its use is analysed. In respect of each cause of the informal sector, the comparative merits of each of the common PIT designs and features are also assessed in this section. Lastly, Section 4 concludes this chapter.

2. Inability of the Normal Income Tax to Tackle Informal Economies

In a quest for taxing small business in the informal economy of developing countries, income tax has been reformed in different ways. For instance, consistent with the causes of the informal sector mentioned in Section 4 of Chapter 2, simplified income tax regimes have been introduced to reduce compliance costs and consequently break the vicious cycle of the informal economy.⁴²¹ But there is no evidence that these measures have been successful. On the contrary, the size of the informal economies in developing countries has been increasing.⁴²² The failure of the simplified regimes could

⁴¹⁹ Peter Burn, 'Tax and Small Business - The Way Forward' (2003) in Neil Warren (ed.) *Taxing Small Business: Developing Good Tax Policies* Australian Tax Research Foundation Conference Series 23, 217.

⁴²⁰ Engelschalk, above n 2b, 6.

⁴²¹ Marquez et al, above n 24, 9.

⁴²² Shome, above n 62a, 4.

be due to three main reasons. First, the simplified regimes still carries a requirement of keeping accounting records which is major contributor of high compliance costs. As mentioned in Section 4.1.1 of Chapter 2 the compliance costs associated with bookkeeping may be double the tax liability. Second, the simplified regimes do not absolve small business from audits, often undertaken in an environment where the integrity and capacity of the tax auditor is not satisfactory. Third, the tax administration does not effectively check the veracity of the returns, because of limited resources or due to rampant corruption.

It is pertinent to refer here to the Simplified Self Assessment Scheme (SSAS) under normal tax, which entails self assessment of income by taxpayers. Taxpayers under SSAS are then subjected to audit approximately every five years. As stated earlier, the audits of small business under this regime results in harsh administrative assessments because small businesses do not maintain accounts.⁴²³ It indicates that small business, for a number of reasons, such as cost of book keeping or lack of accounting knowledge, does not accept the spirit of the regime which demands maintenance of accounts. The author of this thesis, being a tax administrator, has found from experience that when small businesses that have been filing income tax returns under SSAS in Pakistan are audited, they are assessed harshly in the audit on the basis of some rough indicators of income: such assessments technically are administrative form of PIT.

Sometimes the normal income tax has been reformed in the form of a lower tax rate with the aim to reduce overall compliance costs and encourage businesses to register with the tax authorities. Economists do not find positive evidence that low tax rates can reduce the informal economy.⁴²⁴ On the contrary, developing countries have larger informal sectors, despite low tax rates as compared to developed countries. It may be because small businesses are still liable to maintain accounts, which is a major driving force to non-compliance.

Often, consistent with the tax evasion model, high progressive tax rates and high penalty rates have been introduced in the normal income tax to deter non compliance.

⁴²³ World Bank IFC Report, above n 49, 57.

⁴²⁴ Even reductions in tax rates do not decrease the informal economy substantially unless that is not accompanied with reduced complexity in the law (see Schneider, above n 79, 137-152; Schneider and Hametner, above n 18, 4).

However, studies based on economic models suggest that such measures tend to increase the tax burden on small business and promote the informal economy.⁴²⁵ Some cross country analysis shows that any attempt to increase revenue mobilization in developing countries by higher penalties may further erode tax morale and fails to achieve tax objectives.⁴²⁶ Consistent with Section 4.4 of Chapter 2, forceful enforcement does not help tackle the informal economy.

Further, above mentioned punitive measures do not reduce accounting requirements, which are main reason of non-compliance. On the contrary, such measures become counter productive by adding more costs to the costs of keeping accounts, and, small businesses therefore either cease to operate or ‘operate in informal economy’⁴²⁷.

Gordon argues that high penalties are effective in improving tax compliance only when the chance of audit is reasonable.⁴²⁸ In developing economies that suffer from weak administration, the chance of audit cannot be expected to be high.

Guenther is afraid that punitive measures deprive the economy of an indispensable source of growth and renewal available from the small business sector.⁴²⁹ In all, the aim of tax policy should not be to achieve one hundred percent compliance by forcing small businesses to shut down, but to ensure a level of compliance that does not impede their survival and growth.

3. PIT to Tax Small Business in Informal Economies

Many tax policy makers have suggested using PIT to reduce the size of the informal economy.⁴³⁰ The case of PIT rests on the rationale that it is ‘just not possible’ to tax

⁴²⁵ Trandel and Snow, above n 135, 217-222.

⁴²⁶ Richard Bird, Jorge Martinez-Vazquez and Benno Torgler, ‘Societal Institutions and Tax Effort in Developing Countries’ in James Alm, Jorge Martinez-Vazquez and Mark Rider (eds.) *The Challenges of Tax Reform in a Global Economy* (2006), 283.

⁴²⁷ Bird, above n 141, 5; Studies show that high marginal tax rate causes vicious growth of the informal economy (see Marquez et al, above n 24, 7). Under the theoretical models also, the progressivity of tax rates promotes informal economy (see Trandel and Snow, above n 135, 222).

⁴²⁸ Gordon, above n 10, 463.

⁴²⁹ Gary Guenther ‘*Small Business Tax Benefits: Overview and Economic Analysis*’ (2004) CRS Report for Congress, Order Code RL32254, The Library of Congress, United States, 3 March 2004, 20, 26 <<http://digital.library.unt.edu/govdocs/crs/permalink/meta-crs-7379:1>> at 6 August 2008.

⁴³⁰ Marquez et al, above n 24, 9; Suresh N. Shende, ‘*Informal Economy – Special Tax Regime for Small and Micro Businesses: Design and Implementation*’, December 2002 Third Regional Training

small business on actual income in informal economies in the developing countries⁴³¹, mainly due to high compliance costs. As mentioned in Section 4.1.1 of Chapter 2, those costs for small business in some cases are double the tax liability. Therefore, as a rule they find the costs associated with bookkeeping and other statutory requirements under the normal tax unacceptable.⁴³²

Further, the principle of cost effectiveness in financial reporting, which says that ‘the financial information should not be obtained at a cost higher than the value of the decision under consideration’⁴³³, supports the small business’s decision of noncompliance. More simply, as stated in Section 4.1.1 of Chapter 2, incurring costs of \$350 to determine tax payable by a small business, which is usually less than this cost, is not a wise financial decision.

Moreover, such noncompliance is also not deliberate, because, ‘the taxpayers themselves, unless their incomes are fully derived from wages, are often incapable of determining their own income with any degree of precision’.⁴³⁴ The task of determining actual income under the normal income tax regime is also difficult for the incapable tax administration in the developing countries, as stated in Section 4.4 of Chapter 2. The escalating number of small businesses due to recent growth in the service industry makes tax administrator’s job even harder.⁴³⁵

Workshop on Taxation (Brasilia: Department of Economic and Social Affairs United Nations and Centre for Inter-American Tax Administration; Richard M. Bird, above n 151, 7; Alm et al above n 46 also suggest PIT for HTT which is synonymous to the informal sector; Gandhi, above n 8, 3; Galmarini, above n 185, 2 also accepts this role of PIT; Bird and Zolt, above n 3, 30; Pashev above n 354, 401; Ulrich Thieben, ‘*Presumptive Taxes for Small Enterprises in Ukraine*’ (2001), Working Paper No.6 Institute of Economic Research and Policy Consulting, Berlin 1, 9; Makedonskiy, above n 2a, 35; Wallace, above n 6b, 1,2; Engelschalk above n 2b, 27 calls PIT an efficient tool to reduce informal activities; Jaramillo, above n 32d, 4, 22; Taube and Tedesse, above n 13, 26.

⁴³¹ Tanzi and Casanegra, above n, 32a, 15; also see Makedonskiy, above n 2a, 4.

⁴³² Makedonskiy, above n 2a, 4; Administration, therefore, mainly targets the large corporate sector for the revenue purpose, which is evident in the form of large corporate tax contribution in the total income tax collection (for details see Wallace, above n 6b, 1).

⁴³³ Peter Atrill and Eddie McLaney, *Management Accounting for Non-Specialists*, (Third edition, 2002) Chapter 1, 67.

⁴³⁴ Tanzi and Casanegra, above n, 32a, 4.

⁴³⁵ Tanzi and Casanegra, above n, 32a, 5.

As a result, income tax might not necessarily be applied to well defined and precisely measured concepts of the income.⁴³⁶ Alternatively, the potential source of revenue of small taxpayers may be harnessed by simplifying income tax to the most extreme possible extent.⁴³⁷ Consistent with Section 6 of Chapter 2, policy makers are justified in looking for proxies of income (the indirect rather than direct methods)⁴³⁸, which are easy to determine and can reduce compliance costs and meet the needs of efficient administration. Some commentators even suggest that, ‘a simple form of the head tax’⁴³⁹ (or equivalent) could be charged on individuals with little taxable capacity for equity and revenue purposes. Stern and Loeprick admit that although these are clear deviations from the normal income tax, they are justified for formalization of small businesses in large informal sectors⁴⁴⁰, under the premise that ‘near enough is good enough’ for the successful implementation of income tax.⁴⁴¹ Broadly, ‘if used judiciously’⁴⁴² PIT is the ‘only cost effective way’⁴⁴³ to tax small business for both compliance and enforcement purposes.

As stated earlier, PIT regimes are recommended only for a large number of individual taxpayers, who are at low income levels and operate in the informal economy where taxing them under the normal income tax is not cost effective.⁴⁴⁴ However, it is appropriate to exclude certain categories of the individuals irrespective of their size from PIT regimes due to their specific characteristics⁴⁴⁵ such as their ability to keep record of their activities.⁴⁴⁶ The exclusions from PIT would include, for example, accounting firms, drug stores, foreign exchange dealers, sellers of documented supplies

⁴³⁶ Tanzi and Casanegra, above n, 32a, 1; see Slemrod, above n 252, 32 for the trade off between the accuracy measurement and cost of that measurement.

⁴³⁷ Shome, above n 62a, 7.

⁴³⁸ Engelschalk, above n 2b, 6.

⁴³⁹ Richard M. Bird, *Taxing Agricultural Land in Developing Countries* (1974), 57.

⁴⁴⁰ Stern and Loeprick, above n 60, 11-12.

⁴⁴¹ Burn, above n 407, 217.

⁴⁴² Taube and Tedesse above n 13, 12.

⁴⁴³ Wallace, above n 6b, 4.

⁴⁴⁴ Marquez et al, above n 24, 10.

⁴⁴⁵ Engelschalk, above n 2b, 12, 13.

⁴⁴⁶ Engelschalk, above n 2b, 11.

(e.g. petroleum products) and GST registered businesses (e.g. manufacturers).⁴⁴⁷ These exclusions are justified on the grounds that all these businesses are carried out either by accounting literates or their activities are documented for one reason or another.

More broadly, Stern and Loeprick argue that the causes of informality should be targeted if the objective is to encourage formalization.⁴⁴⁸ The author of this thesis shows in subsequent sections that PIT can encourage formalization by targeting each of the causes of informality.

However, consistent with Section 3.3 of Chapter 3, a PIT regime can be constructed differently by selecting different designs and features depending upon the objective and the targeted taxpayers.⁴⁴⁹ For tackling informal economies, PIT is being used in developing countries including those in Latin America and Africa.⁴⁵⁰ Transitional countries, that have a large informal sector due to a shift to the market economy, also have PIT regimes in their tax structure.⁴⁵¹ Donor agencies such as the World Bank also recommend the use of PIT to tap the revenue potential of small business of the informal sectors.⁴⁵²

Regrettably, despite the massive use, there has not been much effort to find out which PIT design is the most appropriate to achieve the objective of taxing small business dominated informal economies. As a result, it is noted that PIT regimes that have been implemented in many countries are not simple⁴⁵³ and therefore fail to formalize small business and achieve tax objectives. PIT regimes to tax small business should have the design and features, which can attack the very causes of the informal economy and facilitate small business compliance.

⁴⁴⁷ Armenian Presumptive Tax excludes some of these categories from its ambit (see *Law of the Republic of Armenia on Presumptive Tax* 1998 (Armenia) Article 22).

⁴⁴⁸ Stern and Loeprick above n 58, 4.

⁴⁴⁹ Jaramillo, above 32d, 23.

⁴⁵⁰ See Yitzhaki, above n 95, 10; Steenekamp, above n 311, 183. On the other hand, in developed countries all prerequisites for determination of correct income are usually present.

⁴⁵¹ Engelschalk, above n 2b, 2.

⁴⁵² Engelschalk, above n 2b, 6.

⁴⁵³ Engelschalk, above n 2b, 27.

This section discusses the role of PIT in addressing each of the causes of the informal sector in developing countries and any criticism of its use. During this discussion, this section also evaluates the comparative value of common PIT designs and PIT features in targeting those causes. Further, in respect of each cause of the informal economy, all avenues of improving the remedial role of PIT are explored. The findings are expected to enable policy makers to choose an appropriate PIT design for taxing the informal economy.

3.1 High Administrative Compliance Costs and Enforcement Costs

The main rationale for the use of PIT in informal economies is its ability to reduce the compliance and enforcement costs related to the maintenance of accounts. Yitzhaki argues that the high compliance cost associated with bookkeeping ‘reduces desirability of maintaining them’⁴⁵⁴ by small business in developing countries. The consequential absence of books of account impedes the levying of normal income tax in the informal economy.⁴⁵⁵ Further, as discussed in Section 2 in the context of SSAS, the poor compliance records of small business suggests doing away with maintenance of accounts and their associated audit.⁴⁵⁶ Jaramillo, therefore, suggest that small entrepreneurs should be absolved from bookkeeping to alleviate the compliance burden.⁴⁵⁷ PIT which charges tax on the basis of a proxy base and does not require accounts for computation of actual income is recommended. Because of such simple and low cost mechanisms, some economic models⁴⁵⁸ also endorse the view that PIT may encourage compliance by small business⁴⁵⁹ and also reduce the enforcement burden on tax administration and opportunities of corruption.⁴⁶⁰

⁴⁵⁴ Yitzhaki, above n 95, 10.

⁴⁵⁵ Taube and Tedesse, above n 13, 4.

⁴⁵⁶ Faulk et al, above n 15, 13.

⁴⁵⁷ Jaramillo, above 32d, 2, 3.

⁴⁵⁸ Nuri S. Erbas, ‘*Presumptive Taxation: Revenue and Automatic Stabilizer Aspects*’ International Monetary Fund, August 1993, 1- 2 <<http://ssrn.com/abstract=883553>> at 7 July 2008.

⁴⁵⁹ Thuronyi, above n 38, 2; also see Wallace, above n 6b, 1.

⁴⁶⁰ World Bank survey shows that PIT reduces opportunity of corruption (see in Engelschalk, above n 2b, 19).

3.1.1 Reducing Administrative Compliance Costs

PIT promotes tax compliance by reducing administrative compliance requirements for small business. PIT saves small business from the complicated bookkeeping, which Thuronyi believes is redundant for its operations and is only needed for fulfilling tax obligations.⁴⁶¹ As discussed in Chapter 3, PIT uses a proxy for the determination of income and a taxpayer is asked only to keep the information relevant to that proxy. As a result, tax calculations become simple, because they only involve the information of a few production or economic indicators, ‘obviating the need for the complicated calculations through deductions for arriving at any net figures’⁴⁶².

There is some criticism of the exemption of maintenance of accounts under PIT for small business, a favour not available to any other sector, by arguing that the government should only intervene when there is market failure.⁴⁶³ Under normal circumstances, when there is no market failure, such exemption is unjustified. But this criticism is not valid because the very existence of small business is threatened by high compliance costs in developing countries as discussed in Section 4.1 of Chapter 2. For frightened small businesses in developing countries, circumstances are not normal. Moreover, cessation of small business activity due to high tax burdens deprives the economy of their innovative contribution.

Moreover, small business in the developing countries has low income (and little taxable capacity) when compared to the compliance costs associated with the normal income tax. More simply, even if it is assumed that small businesses keep accounts, that cost when allowed as an expense may turn their income into a loss or turn it to an amount Below Taxable Limit (BTL) and consequently no tax stands payable thereon. It therefore may be wise to require them to pay PIT roughly proportionate to their ‘pre-compliance cost’ income. This may have double advantages. First, it may collect some revenue, which otherwise might not have been possible, and create a greater sense of fairness in the tax regime. This in fact, as Jaramillo proves in his economic model, is an

⁴⁶¹ Yitzhaki, above n 95, 10.

⁴⁶² Shome, above n 62a, 20.

⁴⁶³ Guenther, above n 429, 21. Some other taxpayers such as foreign investors/insurers are also subjected to final WHT on gross income and consequently are exempt from bookkeeping. Although this type of exemption also intends to reduce complexity, is not further discussed here because this thesis has focus on taxing informal economies rather than international transactions.

efficiency gain in the form of an increase in tax revenue emanating from savings in the compliance costs.⁴⁶⁴ For example, a qualitative study suggests that the majority of small enterprises require at least one dedicated employee to meet tax obligations.⁴⁶⁵ The tax liability of quite a large number of small enterprises may be less than the annual salary expense of that employee. Second, PIT may save small business from undue time, psychological and monetary costs of compliance and give them a feeling of being governed fairly. Consequently, small business would actively participate in national economic growth. This explains another likely efficiency effect of PIT.⁴⁶⁶

On the other hand, when large businesses maintain the books of accounts, the cost is deductible from their profits and they are supposed to pay tax only on the 'post-compliance cost' income. The above analysis may justify exempting small business from maintaining books of accounts.

In terms of the comparative value of common PIT designs, all PIT designs save the costs of keeping accounts. However, instead of actual income, a taxpayer is assessed in respect of a proxy of income used in a PIT design. Since keeping track of changes in assets is less costly than maintaining sales records, an asset based PIT has relatively fewer compliance costs when compared to a turnover based PIT. On the other hand, a standard PIT design based on single or a few production inputs such as size of the shop or location should incur even less compliance costs than asset and turnover based regimes, because of the easy observability of these indicators.

However, apart from absolving small businesses from the maintenance of accounts, PIT designs for small business should preferably use a proxy base which is easy to understand for compliance. PIT regimes should also establish clear and transparent rules in order to eliminate any risk of the corruption thriving on its ambiguities.⁴⁶⁷ A proxy based on a single economic base or production input (Standard PIT) should be preferred

⁴⁶⁴ Jaramillo, above n 32c, 108.

⁴⁶⁵ World Bank, 'Business Environment in Ukraine' IFC World Bank 2007, 78 <[http://www.ifc.org/ifcext/uspp.nsf/AttachmentsByTitle/IFC_Ukraine_BE_Survey_+2007_ENG/\\$FILE/IFC_Ukraine_BE_Survey_2007_Eng.pdf](http://www.ifc.org/ifcext/uspp.nsf/AttachmentsByTitle/IFC_Ukraine_BE_Survey_+2007_ENG/$FILE/IFC_Ukraine_BE_Survey_2007_Eng.pdf)> at 7 October 2009. Even in Australia, which has higher literacy rate than many developing countries, small business employs one internal bookkeeper (for details see Australia Board of Taxation Report, above n 68, 69).

⁴⁶⁶ Guenther, above n 429, 26.

⁴⁶⁷ Engelschalk, above n 2b, 17.

over the use of multiple production indicators (Estimated PIT), which involve multiple calculations. Further, the presence of the categories and their definitions in a PIT regime (common in standard PIT regimes) creates ambiguities and becomes a source of corruption.⁴⁶⁸ Subject to having not many categories and definitions, gross assets or turnover or single indicator based standard PITs may be used as the proxy for small business and the academic qualifications for self-employed professionals.

Lastly, the appropriate choice of features in a PIT also should address the high compliance cost. The addition of certain features (for example, exclusivity, irrebuttable and mechanical) reduces costs related to compliance. Even PIT regimes envisaging audits of the proxy base would have lower costs of a normal income tax entailing audits of total accounts. Because of these features, PIT is a cost effective method of determining income tax liability by a tax payer. In all, when appropriately designed, PIT can substantially reduce tax compliance costs: a major cause of small business operating informally.

3.1.2 Reducing Enforcement Costs: Helping Weak and Corrupt Tax Administration

Newbery argues that tax administration facilities are relatively scarce in developing countries and thus more expensive. As a result, the range of cost effective taxes is limited in those countries.⁴⁶⁹ As discussed earlier in this section, the normal income tax is not a cost effective tax in developing countries. On the other hand, as with compliance costs, PIT reduces the enforcement costs of the tax administration by absolving it from the task of determining actual income and auditing of financial accounts under the normal income tax. Consistent with the discussion of cost effectiveness of tax administration in Section 4.4 of Chapter 2, PIT has a strong case in developing countries, where determining accurate income by tax administration is more expensive than the benefit in the form of revenue collection.⁴⁷⁰ As a result, it allows the administration to focus on large businesses and their evasive activities, which could be

⁴⁶⁸ Engelschalk, above n 2b, 18-19.

⁴⁶⁹ Newbery, above n 178, 200.

⁴⁷⁰ Taube and Tedesse, above n 13, 12.

more rewarding.⁴⁷¹ This is another advantage of using PIT. Because of these virtues Tanzi holds that PIT is used in most countries for administrative reasons.⁴⁷²

Besides the cost aspect, PIT can minimize the role of tax administration⁴⁷³, which may not be trusted for the implementation of the normal income tax due to corrupt practices. Rationally, PIT reduces discretion with the administration, because of the use of an easy to determine proxy base, which may reduce its role to encourage or discourage compliance. This discretion can further be reduced by choosing an appropriate proxy base.

A proxy should be chosen, which is difficult to tamper with by the taxpayers and is easy to monitor by the administration.⁴⁷⁴ Such an attribute of proxy base in PIT helps in framing a deterrence system through a higher probability of detection.⁴⁷⁵ For example, the determination of the gross assets or wealth is much easier for tax administrations than that of gross receipts.⁴⁷⁶ Further, the use of gross turnover may also not be suggested, because, besides the fact that it is easy to tamper with, it may increase economic gains of informality by providing the 'double incentive' to conceal gross receipts to evade the GST and income tax.⁴⁷⁷ In a turnover based PIT, the taxpayers are known to take advantage of weak administration.⁴⁷⁸ The failure of turnover based PITs with regard to their implementation is also evident from the introduction of measures targeting under-declarations e.g. the use of cash register, tax invoice lotteries and promotion of credit cards.⁴⁷⁹

⁴⁷¹ Engelschalk, above n 2b, 11; Dmitri Romanov, 'Costs and Benefits of Marginal Reallocation of Tax Agency Resources in Pursuit of the Hard-to-Tax', in James Alto, Jorge Martinez-Vazquez, and Sally Wallace (eds.) *Taxing the Hard to Tax: Lessons from Theory and Practice*, (2004), 161.

⁴⁷² Tanzi and Casanegra, above n, 32a, 1.

⁴⁷³ Bird and Zolt, above n 3, 9.

⁴⁷⁴ Rajarman Indira 'Presumptive Direct Taxation: Lessons from Experience in Developing Countries' (1995) 30(18-19) *Economic and Political Weekly* 1103, 1104.

⁴⁷⁵ The high probability of detection is essential for controlling informal economy (for details see Williams, above n 202, 228).

⁴⁷⁶ Tanzi and Casanegra, above n, 32a, 11.

⁴⁷⁷ Tanzi and Casanegra, above n, 32a, 11.

⁴⁷⁸ John Gray and Emma Chapman, 'Evaluation of Revenue Projects Synthesis Report' Volume-I, Evaluation Report, 636, Department for International Development, UK, February 2001, 10<<http://www.dfid.gov.uk/Documents/publications/evaluation/ev636.pdf>> at 7 October 2009.

⁴⁷⁹ World Bank IFC Report, above n 49, 66-67.

Moreover, a proxy base which is more permanent may be preferred. Economists argue that transactions within the industrial sectors (which are essential to determine turnover) are hard to tax and argue that for the same reason land, which is relatively easy to tax, has historically been an ideal tax base.⁴⁸⁰ In the same vein, using gross assets as a proxy base is a more permanent proxy base when compared to turnover. Thus, the use of gross assets may reduce the interface between taxpayers and tax administrators for its implementation. For instance, gross assets determined for one year can be applied in next few years⁴⁸¹ as assets, when compared to turnover, are not expected to change frequently (even their values, except for land and buildings, do not change very often). In all, assets are a better proxy to be used in the PIT. This is further discussed in Chapter 7.

On the other hand, in a PIT based on single or multiple production factors, tax liability is determined for all taxpayers of each profession on the basis of sectoral profit margins, which needs considerable input from the administration for creating and defining the categories. This means that considerable administrative expertise is required in initial calculations.⁴⁸² Though this ‘collective assessment’ is less likely to be corrupt than the individual assessment⁴⁸³ under the normal income tax, the enhanced role of the administration in this regard conflicts with the transparency objective⁴⁸⁴. Moreover, all new businesses may make tailored choices in respect of these indicators to permanently avoid tax and consequently defeat the implementation of this PIT. In view of these reasons, a PIT based either on single or multiple production inputs is not recommended for small entrepreneurs of the informal sector. The low compliance cost merit of single indicator (as discussed in 3.1.1) seems of lower value than its above mentioned demerit on implementation account, because, taxpayers can not be totally trusted for collection of taxes.

⁴⁸⁰ Newbery, above n 178, 202.

⁴⁸¹ Engelschalk, above n 2b, 5.

⁴⁸² Bird, above n 7, 143.

⁴⁸³ Wallace, above n 6b, 7.

⁴⁸⁴ Engelschalk, above n 2b, 8.

In terms of features, inserting anti-avoidance features in a PIT regime, (for example, open for auction⁴⁸⁵ and audits) can help the tax administration ensure correct declarations by small business.

Despite reducing tax administration's role in proportion to their capacity under PIT, it may be entrusted to successfully continue as a watchdog, because simple procedures in PIT make it easier for the administration to monitor and consequentially makes it harder for the small business to disappear into the informal sector.⁴⁸⁶ Effective enforcement is essential, because in some countries (for example, India), PIT regimes failed due to the absence of tax culture and PIT was even considered by small business as a ploy for their registration.⁴⁸⁷ There should also be penalties for non-compliance, which are essential in order to keep complying taxpayers satisfied with their compliance. The deterrence is also essential because in terms of benefits - not paying tax is always better than paying tax, even when the tax liability is less under a PIT regime and that may explain that why in Ghana where even after almost a decade only 99,000 out of an estimated 2.2 million self employed businessmen have been registered with tax authorities.⁴⁸⁸ Thus, PIT should be combined with a strengthened administrative capacity by allocating more resources to it⁴⁸⁹ in order to detect non-filers and consequently make it an efficient tool to reduce the informal activities.⁴⁹⁰ Besides that, 'the mandate of tax authorities may be expanded in other areas like the education of taxpayers'⁴⁹¹ regarding how to comply with the PIT regime and how their business can benefit by shifting to the normal income tax regime once it grows beyond a particular size.

⁴⁸⁵ For example see Sadka and Tanzi, above n 312, 4.

⁴⁸⁶ Wallace, above n 6b, 4.

⁴⁸⁷ Shome, above n 62a, 14.

⁴⁸⁸ Taube and Tedesse, above n 13, 28. Although deterrence approach is recommended for the developed countries (that is, consistent with the studies referred in Chapter 2), it can be equally useful for the developing countries along with a PIT regime. The use of PIT may reduce the likelihood of misuse of deterrence system by the corrupt administration.

⁴⁸⁹ Shome, above n 62a, 14.

⁴⁹⁰ Engelschalk, above n 2b, 27.

⁴⁹¹ See Stern and Barbour, above n 93, 15.

3.2 Tax Rates (Technical Compliance Costs)

Consistent with Section 4.1.2 of Chapter 2, low PIT rates are suggested for small business to encourage their formalization.⁴⁹² It is suggested that the lower tax rates on a broadly defined tax base reduce the distorting effects of taxes on behavior, including behavior related to non-compliance.⁴⁹³ Further in a study of USA the projected tax revenue of PIT based on potential income was estimated at 34% higher than the income tax revenue in USA.⁴⁹⁴ It shows that reducing the tax burden by corresponding it to average income increases the compliance and overall revenue collection. However, the estimated figures of developing countries are not available in this regard.

Although a lower tax rate can be incorporated even in normal income tax, there is risk of losing revenue which is already scarce in developing countries. On other hand, such revenue loss with low tax rates in PIT is expected to be compensated by more registrations with tax authorities. More simply, widening the tax base by registering more taxpayers through PIT in countries with large informal sectors will help in reducing the tax rate across the board for small and large businesses ‘which ultimately reduces technical costs for each individual taxpayer’⁴⁹⁵. Besides this, low PIT rates are helpful in ‘offsetting some of the regressivity’, which is inherent in PIT regimes, because taxing a proxy base in PIT may tax a small business, which either has no profit or even have a loss.⁴⁹⁶

Apart from lower tax rates across the board, both for small business under PIT and large businesses under the normal income tax, in order to encourage the voluntary compliance, the difference in the tax rates between the two regimes should be kept at minimum. The larger the difference, the more it may influence the decision to operate as a large or small business.

Further, a PIT can have negative impact on formalization both when its rate is even slightly higher and when its rate is significantly lower than the normal income tax

⁴⁹² Bulutoglu, above n 339, 258.

⁴⁹³ Alm, above n 191, 130.

⁴⁹⁴ Robert H. Haveman, Andrew Bershadker and Jonathan A. Schwabish, *Human Capital in the United States from 1975 to 2000: Patterns of Growth and Utilization* (2003), 115.

⁴⁹⁵ Stern and Loeprick, above n 60, 2.

⁴⁹⁶ For more details see the equity paragraph of this chapter.

regime. When it is higher, even by a small amount, then it may discourage small business to register. On other hand, when it is too low, it may create a separate class of taxpayers. Hence, a very low PIT rate is usually criticized for being ‘too much a subsidy’, which creates a separate class of taxpayers⁴⁹⁷ who never like to grow beyond a particular size in order to permanently avail themselves of the subsidized tax treatment. It even encourages the splitting of large businesses to small ones, which could be detrimental to economic growth.⁴⁹⁸

Additionally, very low tax rates adversely affect revenue collection, which is the prime objective of any tax regime. For example, in Bulgaria, 268,000 patent taxpayers in 2002 paid roughly BGL 56 million (\$35 million US dollars) in taxes, which was approximately 1% of all tax revenues.⁴⁹⁹ The very low tax rates for self employed professionals under PIT regime may also encourage the salaried individuals to shift to formal business and operate as independent contractors.⁵⁰⁰ Thus, the wider the gap between salaried and PIT regimes, the larger the erosion of the tax base.⁵⁰¹

Consequently, the PIT rate should be either equal or slightly lower than the normal income tax rate⁵⁰² and the normal income tax rate should be generally low to reduce overall disincentive effects of taxation.⁵⁰³ Further, the economic benefits of getting large, such as easy access to finance and insurance cover, would neutralize the differential tax gains arising from slightly lower tax rates in a PIT. This choice of tax rates would also be consistent with economic theory, which holds that the efficiency losses caused by income tax are minimized when all the returns to capital are taxed at the same rate.⁵⁰⁴ However, Schneider rightly suggests that low tax rates produce

⁴⁹⁷ Engelschalk, above n 2b, 22.

⁴⁹⁸ Engelschalk, above n 2b, 23.

⁴⁹⁹ Pashev, above n 359, 10.

⁵⁰⁰ Engelschalk, above n 2b, 23.

⁵⁰¹ Engelschalk, above n 2b, 1.

⁵⁰² Engelschalk, above n 2b, 23.

⁵⁰³ See Fjeldstad and Rakner, above n 111, 26.

⁵⁰⁴ Guenther, above n 429, 26.

positive results, particularly when applied after allowing a sufficient basic exemption to income of small businesses.⁵⁰⁵

Lastly, when compared to progressive tax rates, constant marginal tax rates (each extra dollar of income still will be taxed at the same rate e.g. proportional tax rate) are recommended for PIT in informal economies, because these reduce the administrative compliance costs by reducing the incentive to engage in tax shifting schemes.⁵⁰⁶ Under economic models also, constant marginal tax rates do not promote informal activities.⁵⁰⁷

3.3 Reducing Economic Gains for Encouraging Transition to Formal Economy

For fully fledged formalization and implementation of the normal income tax, small business may first be encouraged to join the formal sector under PIT and in the next stage they should be helped to graduate into the normal income tax regime.

3.3.1 Encouraging Transition to Formal Sector

Consistent with Section 4.2 of Chapter 2, a high tax burden, supply of cheap informal labor, and avoidance of extensive WHT are the major factors impacting on the cost benefit analysis of a taxpayer. The use of PIT, low tax rates for small business and labor, and a limited WHT regime takeaway these incentives to operate informally. However, as discussed in the preceding section, the tax rate in PIT should not be reduced too much that it discourages transition to the formal sector and cause ‘large businesses to fragment into small ones in order to avail themselves to the PIT regime’⁵⁰⁸.

Without prejudice to the above, as recommended by a cross country analysis in Africa the tax burden should be set on the income of poor performers, instead of the basis of true averages. Such a burden may avoid overtaxing small business and mostly has better performance in the revenue mobilization.⁵⁰⁹ Therefore, the tax burden at level slightly below an average rate of return or at the most at an average rate of return should be

⁵⁰⁵ Schneider and Torgler, above n 148, 8.

⁵⁰⁶ Alm, above n 191, 129.

⁵⁰⁷ Trandel and Snow, above n 135, 222.

⁵⁰⁸ Shome, above n 62a, 13.

⁵⁰⁹ Taube and Tedesse, above n 13, 14.

applied. However, for determination of average returns, the proxy bases, production inputs and other indicators have to be reviewed on a regular basis.⁵¹⁰

In all, the appropriate fixing of the tax rate for small businesses may discourage business disintegration, because the taxpayer's cost-benefit analysis, including gains of remaining small and losses due to not availing themselves to economies of scale or other benefits enjoyed by the large businesses, may change positively.⁵¹¹

Lastly, although large businesses may have a tendency to split into smaller businesses in order to gain access to small business tax benefits, a turnover based PIT has an offsetting 'cascading effect'⁵¹². More simply, when a large business fragments to become eligible for a turnover based PIT, then each of its split components would bear tax separately, which cumulatively could be more than what they paid as one unit. Moreover in any given situation, the incentive to fragment would be only to fall Below Taxable level (BTL) and that incentive is also available under the normal income tax regime. On the other hand, when businesses plan to enlarge through horizontal acquisition, they can save tax by cascading. That is a turnover based PIT may encourage small business to enlarge and promote economic growth and also provide fiscal dividend. The net impact of revenue loss due to cascading and revenue gain from economic growth is uncertain.

As compared to a turnover based PIT, an asset based PIT neither encourages cascading nor fragmentation because assets, unless below the taxable limit, would be liable to the same tax rate irrespective of their quantum. For example, take two businesses: business 'A' is engaged in cotton ginning and has a turnover of \$1.0 M, and business 'B' is engaged in spinning of cotton to yarn and has a turnover of \$1.2 M. They both pay tax under PIT at a rate of 1% of their turnover under a PIT regime, and the total tax payable by them stands at \$22,000 (that is, \$10,000 by 'A' plus \$12,000 by 'B'). Now, if 'B' acquires 'A', then 'B' would only pay tax on its supplies (that is, \$12,000). The cotton

⁵¹⁰ Taube and Tedesse, above n 13, 15.

⁵¹¹ After transfer to the normal income tax regime, a firm may have a relatively easy access to formal credit markets, government procurement and access to markets including for export (see Stern and Barbour, above n 93, 2).

⁵¹² Cascading tax is a turnover tax that is applied at every stage in the supply chain, without any deduction for the tax paid at earlier stages. Such taxes cause economic distortion because they create an artificial incentive for vertical integration.

now it purchases from 'A' as a raw material escapes taxation. Thus, due to the acquisition of 'A' by 'B' under turnover based PIT, tax revenue drops by \$10,000. This drop may not occur when an asset based PIT design is used, thus it does not encourage cascading.

Standard PIT based on indicators, on the other hand, can easily be defeated by taxpayers in this regard, particularly by selecting once for all a desired level of indicators at the start of business as discussed in Section 3.1.2 of this chapter. In view of the above, an asset based PIT seems more certain in achieving tax policy objective by not influencing the size of business.

3.3.2 Graduating to the Normal Income Tax

Besides the fragmentation issue, a greatly concessional PIT for small business may cause a 'notch problem', which is a hidden tax on business growth⁵¹³ and such a PIT creates a disincentive to grow beyond that limit. One study revealed that an average tax burden declined from 46% to 42% on medium businesses in just one year due to a lower tax liability under PIT, reflecting the increasing transfer of businesses from the normal income tax to PIT.⁵¹⁴ This tendency certainly has an adverse impact on overall economic growth.

As discussed earlier, a turnover based PIT encourages enlarging businesses due to tax savings. On the other hand, both an asset based PIT and indicator based PIT, if rates are close to the normal income tax regime, do not carry any incentive for business to remain small and therefore they tend to enlarge. Thus, most PIT designs could be used 'as a stepping a stone',⁵¹⁵ in order to encourage businesses to enlarge and ultimately shift to an ideal normal income tax.⁵¹⁶ This transient phase may be used for compiling a database of small businesses that will eventually help in their transfer to the normal income tax regime.⁵¹⁷

⁵¹³ Guenther, above 423, 25, 27.

⁵¹⁴ Engelschalk, above n 2b, 22.

⁵¹⁵ Wallace, above n 6b, 1.

⁵¹⁶ Shome, above n 62a, 17.

⁵¹⁷ Engelschalk, above n 2b, 6.

However, a critical question for PIT paying small business is that ‘how and under what circumstances they should enter into and graduate from the presumptive (which is the most simplified system) to the normal income tax system?’⁵¹⁸ The small businesses should not be allowed to continue paying tax under PIT, particularly when these grow beyond the size, where the compliance costs of the normal income tax regime are proportionally reasonable against their income. This objective can be achieved by inserting the incentives for the transition and ‘the eligibility conditions (including the imposition of time limit) in the PIT regime’⁵¹⁹. Sometimes, a progressive lowering of the eligibility conditions is recommended for transition as well as promotion of the normal income tax regime.⁵²⁰ These may be revised every 5-10 years depending upon the level of development in a country. In all, it should be ensured that PIT treatment should not extend to businesses that are large enough to keep books of accounts and meet other requirements of the normal income tax.⁵²¹ Lastly, as discussed in the preceding section, the setting of PIT rates slightly lower than those in the normal income tax regime is likely to make PIT less attractive than the economic benefits of becoming a large business.

Besides that, in order to make PIT for small business effective, small business should be taxed on the unified basis both for all their family members and partners to discourage their fragmentation. Moreover, in order to prevent ineligible persons benefitting from PIT, it is suggested that small businesses undergo audits to ensure that eligibility conditions such as entry and exit thresholds discussed in Section 3.6.4 of Chapter 3 are being followed strictly. The onus should be on the taxpayer to prove that he/she qualifies for PIT.⁵²² This audit would have less impact on total compliance costs, as it is limited to scrutiny of one production input or proxy base.

3.4 Tax Morale and Perception of Fairness

Consistent with Section 4.3 of Chapter 2, tax morale depends upon individual’s perception about the tax system based on tax compliance costs, corruption and

⁵¹⁸ Bird and Wallace, above n 183, 5.

⁵¹⁹ Wallace, above n 6b, 2.

⁵²⁰ Shome, above n 62a, 15.

⁵²¹ Engelschalk, above n 2b, 11.

⁵²² Jaramillo, above n 32d, 2.

compliance level in society. More broadly, tax morale depends on how taxes are collected. The presence of the informal sector de-motivates taxpayers in the formal sector and depletes tax morale. As discussed earlier, PIT helps to reduce compliance costs, corruption and encourages enforcement of income tax and consequently improves the perception of fairness. Under PIT, small businesses are not compelled to keep records which are beyond their capacity. Eligible taxpayers cannot avoid paying tax by playing on tax ambiguities or the tilting tax administration's discretion in their benefit by paying bribes.

It is noted that general acceptance of normal income tax is linked to equitable treatment of taxpayers and may be best achieved in a tax system wherein the tax base is accurately measured.⁵²³ Consequently, PIT may be blamed as inequitable as it does not tax income accurately. However, 98 years ago, Seligman rightly contested against the merits of accurate determination of income and income tax liability for securing fairness in the tax system in following words.

*"It is notorious, however, that of all taxes the income tax is perhaps the most difficult to assess with scrupulous justice and accuracy; so that what is conceived in justice often results in gross injustice."*⁵²⁴

This observation is consistent with the use of alternatives such as PIT for removing the economic disparity particularly in developing countries, where income tax might not be effectively enforced. In these countries, chasing every taxpayer for every dollar of revenue like a tax policeman, without proper consideration of equity and efficiency costs, is not wise.⁵²⁵ An economic model suggests that even lump sum tax, when enforced with less administrative errors in selecting the individuals for differential treatments, is superior to income tax.⁵²⁶

⁵²³ Tanzi and Casanegra, above n 32a, 4.

⁵²⁴ Edwin Robert Anderson Seligman, *The Income Tax* (2006, Elibron Classics), 18 [Originally published in 1911].

⁵²⁵ 'Tax Reform: The Road Ahead' A Framework Paper on Road Rules and Road Map for Better Tax Policy, CPA, Australia, February 2002, 26 <http://www.cpaaustralia.com.au/cps/rde/xbcr/SID-3F57FEDF-3DA184/cpa/the_road_ahead.pdf> at 17 May 2009.

⁵²⁶ For details see Nicholas Stern, 'Optimum taxation with Errors in Administration' (1982) 17 *Journal of Public Economics* 181, 183, 208.

Further, a recent study under the ‘individual utility function model’ for the relationships between the complexity of law and compliance costs⁵²⁷; compliance and equity costs; and compliance and efficiency costs also supported the use of less accurate determination of income. It concluded that the equity effect of disallowing a genuine expense or allowing it along with hefty documentation (incurring huge compliance costs) is the same. The taxpayer, who incurs this cost to claim the deduction, bears the same burden in case he/she decides not to claim the deduction. More simply, the genuine business expense could be denied due to the complex documentary requirements. Due to consequent unfairness, the study suggests for balance between the accuracy and compliance costs. Otherwise, the taxpayer would allocate his/her resources to another economic sector such as the informal sector, where this burden can be avoided. Therefore, this study suggests that equity and efficiency may be achieved to an optimum level by taxing the base less accurately.

The above mentioned study is less relevant to every business deduction. However, regarding the requirement of maintaining the accounts by small business in the informal sector, (where the cost of their maintenance is higher than the tax liability), it can be inferred that small business would prefer not to comply. More aptly, small business would prefer to shift to the informal sector in order to avoid this requirement permanently. Such an inference is supported by persistent large informal economies in developing countries. For effective enforcement, it is therefore suggested to have PIT, which incurs minimum compliance costs for determining tax liability, even if it is less accurate. PIT may bring more small businesses to the tax roll and consequently the ‘perception of fairness about the tax system would improve’⁵²⁸. Consequently, in long run, PIT would build tax morale and promote tax culture.

Another possible criticism of PIT could be that it causes inequity between small and large businesses, because the former are not required to keep accounts. This unequal treatment has two aspects. First, the compliance cost for small business, as compared to large business, would be low. This aspect of inequality has already been discussed in the compliance cost section. Second, small business, by not paying tax on profits as per

⁵²⁷ Louis Kaplow, ‘How tax complexity and enforcement affect the equity and efficiency of the Income Tax’ (2003) XI.IX :1 *National tax journal*, 135-150.

⁵²⁸ Wallace, above n 6b, 5.

accounts, has an advantage in terms of vertical equity. More simply, a small business paying tax under PIT does not have a marginal increase in tax liability when its profits go up. A survey of families shows that due to these concessions, an ‘average family owning a small business has wealth that is five times greater than the average family’⁵²⁹. However these criticisms do not seem valid, because the advantages of small business may be partly offset, as under the PIT, a small business will pay tax even when it incurs a loss.

The search for most suitable PIT design to achieve equitable tax treatment is not rewarding. A PIT based on single or multiple production indicators (like the location and size of the shop) is not suitable for equity, because these indicators are not closely reflective of profits. On the other hand, in respect of proxy based PIT, both turnover and assets yield different rates of returns for various industrial sectors. For example, a business with low operational gearing⁵³⁰ (such as service sector) has a high average rate of return on assets but a low tax liability when an asset based PIT is used. On the other hand, a manufacturer having high operational gearing and a relatively low rate of return on assets bears a higher tax liability under asset based PIT. The same is true, when turnover is used as the proxy. Nevertheless, assets and turnover change with a change in volume of business activity, therefore a proxy based PIT at least guarantees a minimal level of equity and therefore may be preferred over PIT based on production inputs. Lastly it may be noted that any attempt to individualize PIT to secure equal treatment of equals by prescribing differential tax rates for different taxpayers require defining more categories, which would make it difficult for compliance and enforcement. This would undermine the main reason for introducing PIT. (This equity issue is discussed further in Chapter 7).

In sum, PIT is more equitable and fairer than the normal income tax in large informal economies and should be considered as a first best compromise rather than a second best compromise.⁵³¹ The central argument to support PIT is that ‘PIT is not more unfair

⁵²⁹ Charles Brown, James Hamilton and James Medoff, *‘Employers Large and Small’* (1990), University of Illinois at Urbana-Champaign’s Academy of Entrepreneurial Leadership Historical Research reference in Entrepreneurship, 4 < SSRN: <http://ssrn.com/abstract=1496186>> at 5 December, 2009.

⁵³⁰ Low operational gearing means having low fixed costs or assets base.

⁵³¹ Jaramillo above n 32d, 23 mentions that PIT is still considered as a second best compromise.

than the normal income tax regime, which relies on theoretical concept of equity,⁵³² and in reality fails to tax the majority of informal businesses resulting in more inequity. Goode notes that even legislation which is attractive in principle is ineffective and inequitable in practice.⁵³³ On the other hand, PIT improves the equity between the compliant and eligible, but non-compliant small businesses.

Further, the self-employed, who generally escape taxation by operating within the informal sector, can be taxed under PIT. In some countries, the self employed contribute 50-75% less revenue than employees.⁵³⁴ PIT, by facilitating their taxation, enhances equity between them and salaried individuals.⁵³⁵ More simply, PIT helps to broaden the tax base and that alone yields enough benefits in terms of equity and efficiency that outweigh its disadvantages.⁵³⁶ In all, taxing small business in some form is better than letting them go untaxed completely.

Beyond that, an appropriate tax rate in the PIT, which is proportionate to sectoral average profits (that is, generating tax liability equivalent to that of normal tax on average profits), may incite small business to improve their performance to meet the sectoral average and achieve a fair degree of horizontal equity. Further, insertion of certain features may reduce the inequity caused by PIT. For example, insertion of a feature of 'maximum tax' in a PIT regime may allow victims of PIT to get relief by maintaining accounts. PIT should be also offered as a 'compulsory' regime to reduce the likelihood of being used as a ploy for reducing the tax liability, as happens with the 'optional' regime. As suggested earlier, PIT is not a permanent regime, hence should contain those features which encourage transition to the normal income tax. Finally, consistent with the judicial pronouncements in Section 3.2 of Chapter 3, the use of PIT may have some martyrs, but these martyrs can be compensated by inserting some conditional concessions in a PIT regime (for instance, a rebate in PIT liability when they can prove that they have no income in a tax year).

⁵³² Marquez et al, above n 24, 23.

⁵³³ Richard Goode, 'Obstacles to Tax Reform in Developing Countries' in Richard Bird and Oliver Oldman (eds.) *Taxation in Developing Countries* (Fourth edition, 1990), 128.

⁵³⁴ Terkper, above n 40, 214.

⁵³⁵ See Taube and Tedesse, above n 13, 10; Faulk et al, above n 15, 6; Tanzi and Casanegra, above n, 32a, 7.

⁵³⁶ Wallace, above n 6b, 5.

4. Conclusion

The above analysis suggests that PIT ‘is not a compromise’ or a ‘second best option’,⁵³⁷ (the similar view was taken, when PIT is examined against concept of income in Section 5 of Chapter 3), but is a realistic option for taxing small business in the developing countries. After detailed scrutiny of the needs of small business such as low compliance costs, it is discovered that PIT attacks the very causes of the operation of small businesses in the informal economy, and therefore is the most suitable alternative to the normal income tax. More aptly, PIT should not be considered as suboptimal compromise⁵³⁸, but should be used confidently as a viable option.

The flexibility in PIT, which emanates from its variety of designs and features, helps to address the causes of the informal economy, and makes the conviction of using PIT stronger. In this chapter, at every step throughout the analysis, selection is made of the designs and features which are relevant in framing an appropriate PIT regime for tackling the informal economies of developing countries. A PIT regime, having the following design and features, is expected to meet needs of small business and therefore can tackle the informal sector:

(i) Simple for compliance: The suggested PIT should not require the maintenance of accounts. The PIT design should be based on a proxy base or indicators such as gross assets or turnover or a few production inputs, which are easy for taxpayers to comply with and do not require complex computations. Moreover the liability, so computed, may be charged as a ‘fixed tax’ on a person for a few years. In order to ensure a further reduction of the compliance costs, the PIT regime should be combined with features such as being non-rebuttable, mechanical and exclusive.

(ii) Simple for enforcement: The recommended PIT regime should be easy to monitor and should not require large amounts of information. Though every PIT is relatively easier than the normal income tax to monitor, it is advised that a proxy base used in PIT must be hard to tamper with by the taxpayer and leave no scope for collusion between the taxpayer and tax administrator. The comparative analysis shows that turnover is easier than assets to tamper with, because it has less permanency and once concealed

⁵³⁷ Faulk et al, above n 15, 1.

⁵³⁸ Jaramillo above n 32c, 105.

from the books of accounts, leaves no track to trace. On the other hand, in a PIT based on tangible assets, the assets have permanence and therefore even when taken out of accounts can be traced and taxed by the capping provisions. An asset based PIT is therefore preferred for effective enforcement in the informal sector. Furthermore the chances of the evasion and corruption in this design can be minimized by adding features such as being mechanical, legal and open for auction and audit.

(iii) Transition to the formal sector and then to the normal income tax: The tax rates should generally be kept low across the board for both the normal income tax and PIT regimes. Moreover, for reducing the gain from operating informally, the difference in the tax rates between the normal and PIT regime should be kept at the minimum possible level. The minimum difference plays a crucial role in determination of the success of PIT in tackling the informal economy.

(v) Tax morale: An asset based PIT regime (or even a turnover based PIT), which taxes average rate of return, is somewhat equitable between various industrial sectors and those operating in both the informal and formal sector. It is also minimally equitable for all small businesses of the informal sector. The possibility of some martyrs in the process, however, is not ruled out but they can also be helped through some kind of well targeted rebates (This equity issue is more discussed in Chapter 7).

In all, the above recommendations mostly suggest using an asset based PIT design, which is charged as a fixed tax for a few years. The regime should contain a low but constant marginal tax rate commensurate to the average industrial rate of return on assets. Lastly, this regime should have some special features including exclusivity, being mechanical, non-rebuttable, non-optional, ‘a maximum tax’, open for auction and audits.

Moreover if current PIT regimes across the developing world are analysed against the designs and features proposed in this Chapter to address the informal economy, then those which do not match with the recommendations can be tailored to secure the objectives of developing countries. Thus, this chapter provides a guideline to tax policy makers to improve the existing PIT regimes, which are in practice across the world to address the informal economy. How far this guideline matches to the principles of a

good tax system is shown in Part II of this thesis, where common PIT designs are evaluated against those principles.

CHAPTER 5 PRINCIPLES OF A GOOD TAX SYSTEM IN CONTEXT OF LARGE INFORMAL ECONOMIES

Scope of this chapter: As Part II of the thesis deals with the analysis of common PIT designs against the principles of a good tax system, this chapter defines those principles in the context of the needs of small business in large informal economies. This chapter shows that each core principle has multiple facets, which all cumulatively play a role in making a tax system suitable. However, the relative importance of each principle and each facet varies in accordance with the needs of each economy.

1. Introduction

After analysing popular PIT designs against the causes of the informal economy in Chapter 4, it seems prudent to assess those designs against the principles of a good tax system. However, the range and scope of principles has always been a debatable matter. Moreover, most of the earlier literature in this regard pertains to developed countries.

This chapter therefore redefines the range and nature of principles of a good tax system in the context of the informal sector of developing countries. This chapter also sets out the approach for measuring the extent of success of any tax system in achieving each of those principles. More simply, the method of measuring the principles of a good tax system is laid down so that the adequacy of PIT designs or PIT legislation with respect to them can be analysed in a more objective manner.

In this chapter, the review of the literature and concepts on the subject reveals that there are three core principles of a good tax system. These are simplicity, efficiency and equity. Further, each core principle has multiple facets, which all cumulatively play a role in making a tax system suitable. However, the relative importance of each principle and each facet varies in accordance with the needs of each economy.

Assessing simplicity involves evaluating technical and operational complexity. In order to assess technical complexity in this thesis, it is suggested to follow a non-linguistic qualitative approach. A qualitative approach should also be followed to assess operational complexity. This approach is suitable both for a comparative analysis of PIT designs (Chapter 7) as well as the case study of Pakistan's PIT (Chapter 10).

Efficiency is primarily based on ten facets of neutrality in taxation. This chapter suggests that to assess efficiency, the provisions of tax legislation from a legal perspective be examined in order to know whether these are neutral in terms of tax treatment of all taxpayers or not. This approach is suitable for assessing Pakistan's PIT in this thesis. In respect of a comparative analysis of popular PIT designs, it is suggested a theoretical analysis be undertaken to determine the ability of each design and its proxy base to achieve neutrality.

To assess horizontal equity, this chapter recommends an approach almost identical to that for the efficiency principle, because the concept of equity is related to the concept of neutrality of tax treatment. However, in the concept of horizontal equity, neutrality is to be seen between individual taxpayers, whereas under the concept of efficiency, neutrality is to be seen in the context of industrial sectors. On the other hand, vertical equity may be assessed by looking at the degree of progressivity of tax rates.

The remainder of this chapter is divided into five sections. Section 2 provides background to principles of a good tax system and suggests a desirable set of principles for assessing a tax system in informal economies. Section 3 deals with the concept of simplicity. This section also sets out an approach as to how extent of simplicity can be assessed in a tax system. Section 4 analyses the efficiency principle and envisages an approach for determining efficiency in a tax system. Section 5 deals with equity both in terms of its concept and its approach to measure the level of equity in a tax system. Section 6 concludes this chapter.

2. Desirable Principles of Taxation

The range of principles of a good tax system has always been a matter of debate. Conventionally, every tax regime is evaluated against the attributes envisaged in Adam Smith's well known canons of a good tax system. A tax regime is considered as appropriate when it either religiously follows Smith's principles or pays some heed to them.⁵³⁹ However, these principles, which are called canons by Smith, are titled

⁵³⁹ Clinton Alley and Duncan Bentley, 'A Remodelling of Adam Smith's Tax Design Principles' (2005) 20 *Australian Tax Forum* 579, 580 referred to a quote of Dr. Johnson, who once said of an acquaintance, 'Campbell is a good man, a pious man. I am afraid he has not been inside a church for many years but he never passes a church without pulling of his hat. This shows that he has good principles' and argues that authors of new tax proposals in context of the principles of a good tax system are like Campbell.

differently by subsequent scholars⁵⁴⁰, perhaps as an attempt to convey the real spirit of the principles. For example, Smith's canons of taxation are also referred to as principles⁵⁴¹, criteria⁵⁴², characteristics⁵⁴³, or values⁵⁴⁴ of a good tax system.

Moreover, the range of principles, like taxation itself, has expanded during the course of time to incorporate requirements of an ever changing world. Even each principle has been under constant review to define its scope. During the evolution of tax systems across the world, on some occasions a new principle is added and on other occasions a new facet is discovered in an old principle.

On the other hand, many tax scholars clearly distinguish such principles from the 'objectives' of a tax system. This shows that all these principles are not an end in themselves, but rather a means to an end. More simply, tax policy objectives are intended to be secured by adhering to the above principles. In order to achieve a desired end, the right means must be used.

More broadly, like a business organization, the revenue agency of state can also have a vision, mission and set of values.⁵⁴⁵ The likely vision for any welfare state is to establish a prosperous and equitable society.⁵⁴⁶ The mission should more specifically set out the objectives of a tax system. These may include the generation of optimum revenue with

⁵⁴⁰ Even these are used in an inconsistent and ambiguous manner as referred to by Ken C. Messere, *Tax Policy in OECD Countries: Choices and Conflicts* (1993), 109.

⁵⁴¹ ICAEW, 'Towards a Better Tax System' (Report, Tax Faculty Institute of Chartered Accountants England and Wales (ICAEW), 1999), 2 <http://www.icaew.com/index.cfm/route/149757/icaew_ga/Technical_and_Business_Topics/Faculties/News/Thought_leadership_prospectus/pdf> at 6 October 2009; also James Simon and Nobes Christopher, *The Economics of Taxation: Principles, Policy and Practice* (Seventh edition, 2004), 242.

⁵⁴² Australia Taxation Review Committee, Full Report, Canberra, 1975 (the Asprey Report).

⁵⁴³ J.E. Meade, 'The Structure and Reform of Direct Taxation' (1978) (London: George Allen & Unwin), 7-22.

⁵⁴⁴ Alley and Bentley, above n 539, 582.

⁵⁴⁵ Alley and Bentley, above n 539, 582.

⁵⁴⁶ To maintain and strengthen the Canadian Federation was identified as the fundamental aim of the Canadian tax system (see Canada, *Report of the Royal Commission on Taxation*, Vol 2, Toronto, 1966 (the Carter Report), 7).

minimum economic and equity distortions.⁵⁴⁷ Lastly, while chasing the objectives, the tax code should adhere to certain values (the principles of a good tax system).

Though researchers have been using these principles for evaluation of specific tax measures, it is also essential to assess every tax system against the tax objectives. Therefore, every tax system should be assessed, both for their adherence to the principles and for their success in securing tax objectives (for example, optimum revenue collection and income redistribution). The objectives should be secured without the loss of any principles of a good tax system, because the neglect of principles may unleash many social and economic distortions. In long run, the distortions caused by the violation of these principles results in less than optimum revenue collection, which is the central aim for any state.

It is noted that in pursuit of the national tax objectives, there are often hurdles such as the existence of a large informal economy or evasion by the formal sector. These hurdles make absolute adherence to the principles of a good tax system a hard task. As a result, assigning a weight to each principle could enhance the ability of a tax system to address those hurdles. The assignment of weight to the various principles may eventually help in achieving tax objectives. For instance, consistent with Section 4 of Chapter 4, in order to tax the informal economy, a tax system should place a greater emphasis on low compliance costs (that is, simplicity) than on taxing similar persons or businesses equally (that is, equity). In all, a tax system should adhere to the principles of a good tax system in order of priority, and these priorities will vary based on the objectives of the particular tax system. More simply, a trade off among principles is required in light of the needs of each economy.

Besides the differing priorities in respect of the principles in different economies, even the essence of the principles varies from one economy to another. What is a simple tax for a formal economy could be very complex for an informal one. Much earlier literature on the principles of a good tax system was based on developed economies. It is, therefore, necessary to redefine these principles in the context of developing economies.

⁵⁴⁷ Carter Report, above n 546, 7.

As noted above, the principles of good tax system have been structured in many forms. It may be due to different perspectives on the subject by their authors. However, the close examination of them, including that of Smith's, reveals that each of their constituents fall in any of the three core principles of taxation; which are simplicity, equity and efficiency.⁵⁴⁸

For example, the convenience of payment in Smith's canons; the flexibility, stability and costs of administration and compliance in the Meade report⁵⁴⁹; administrative simplicity, flexibility and political responsibility in the Stiglitz's characteristics⁵⁵⁰; the certainty and flexibility in the OECD report⁵⁵¹; and the certainty, convenience of payment, economy in collection and transparency and visibility in the AICPA report⁵⁵²; are not separate and independent principles, but are different facets of one core principle, called simplicity; as follows in next section of this chapter.

Therefore, every tax system should be assessed against these core principles of simplicity, equity and efficiency.⁵⁵³ While assessing any tax system against the core principles, a comprehensive assessment should be made in respect of all facets of each core principle in order to produce valid, reliable and convincing findings. For example, for simplicity, a tax system should be evaluated against all of its above mentioned facets. However, some of these facets overlap and are just different names with the same intent and meaning. For example, 'economy of collection' in the AICPA report is

⁵⁴⁸ Michael Walpole, 'Proposals for the Reform of the Taxation of Goodwill in Australia' (PhD Thesis, University of New South Wales, 2006), 17; These core principles are also relied upon as the central pillars to a good tax system by other scholars (see Richard K. Vedder and Lowell E. Gallaway, 'Some Underlying Principles of Tax Policy' A report prepared for the Joint Economic Committee Washington DC, September 1998, 4 <<http://www.house.gov/jec/>> on 7th October 2009. The charter of business taxation in Ralph report also relies upon these three core principles (see Australia, Review of Business Taxation, 'A Tax System Re-designed: More Certain, Equitable and Durable', Report, July 1999, Canberra (the Ralph Review), 35 <<http://www.rbt.treasury.gov.au/publications/paper4/index.htm>> at 12 May 2009.

⁵⁴⁹ Meade Report, above n 543, 7-22.

⁵⁵⁰ Stiglitz, above n 3a, 390.

⁵⁵¹ OECD, 'Electronic Commerce: Taxation Framework Conditions' Report by Committee on Fiscal Affairs, 8 October 1998, 4 <<http://www.oecd.org/dataoecd/46/3/1923256.pdf>> at 12 February 2009.

⁵⁵² For further argument to this effect see AICPA, 'Guiding Principles of Good Tax Policy' A Framework for Evaluating Tax Proposals, Tax Policy Statement, American Institute of Certified Public Accountants at <<http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf>> at 24 March 2009, 12.

⁵⁵³ These principles are called the three dominant tests of the merit for individual taxes by Asprey Report, above n 542, 17.

another name for compliance and administration costs in the Meade report. Thus, for the purpose of the evaluation, only the distinct facets of each core principle should be identified and analysed.

In view of above, the adequacy of a PIT regime in this thesis is assessed against the core principle of simplicity, efficiency and equity. In this chapter, while defining the core principles, all the facets of each of the core principles are analysed in order to determine their appropriateness to the evaluation of PIT. Further, all facets of the core principles are examined to discover their comprehensive meaning. More aptly, the scope of each core principle for evaluating PIT is determined on the basis of that analysis. Although some researchers have used a common meaning for those core principles by focusing on their commonly agreed facets⁵⁵⁴ for evaluation of tax systems, in this thesis even the uncommon facets are included, whenever those are found relevant and are believed to add comprehensiveness to the core principle.

3. Simplicity

Although a few scholars claim that concept of simplicity is self-evident⁵⁵⁵, the literature is full of a wide range of definitions of simplicity, which emanate from its various facets. These facets represent the discoveries made by the researchers about simplicity, while examining particular tax system problems. Therefore, although it may be argued that the literal meaning of simplicity is clear, with reference to taxation the concept becomes multifaceted. Every facet of simplicity has its own value and bearing in tax policy objectives. Thus, it is reiterated that it is necessary not only ‘to find the common meaning and definition’⁵⁵⁶, but also to embrace comprehensiveness to the definition of simplicity.

⁵⁵⁴ Duncan Bentley, ‘A Model of Taxpayer’s Rights as a Guide to Best Practice in Tax Administration’ (PhD Thesis, Faculty of law, Bond University, 2006), 70.

⁵⁵⁵ Michael Dirgis, *Is it Australia’s? Residency and Source Analysed* (2005), 55; also see Michael Dirgis and Brett Bondfield, *Small Business; The First Casualty of Tax Reform Compliance Costs; A Qualitative Study of the Impact of Tax Reform on the Compliance Costs for Small Business* (2004) Taxation Institute of Australia, 9.

⁵⁵⁶ Bentley, above n 554, 70.

3.1 Definition

There is majority view among tax professionals that simplicity ‘is a complicated notion, which is not adequately addressed in one single paper’⁵⁵⁷. The use of PIT for small Business is mainly because of its simple nature. Therefore, it is necessary to define simplicity for this thesis in great depth, after reviewing its different definitions in earlier literature which follows below.

Smith defines simplicity as ‘the tax each individual pays ought to be certain and not arbitrary’⁵⁵⁸. In addition, his third canon says ‘tax ought to be levied at a time convenient to the contributor’⁵⁵⁹. It suggests that compliance costs should be low, an important facet of simplicity. Although this canon is tied by some scholars to ‘neutrality and economic efficiency’⁵⁶⁰, it seems a facet of simplicity, as rightly referred in the AICPA report.⁵⁶¹ Smith’s fourth canon states that ‘taxes should take out and keep out of the pocket of the payer as little as possible in excess of what they bring to the treasury’⁵⁶² which suggests that tax administration costs should be low. Essentially, Smith’s third and fourth canons suggest that the operational costs of a tax system should be low.

The Meade report included clarity, certainty, stability, coherence and low administration and compliance costs as the attributes of a simple tax system.⁵⁶³ The Meade report mentions the distinction between the administration costs and ease of administration and points out that these do not always go hand in hand.⁵⁶⁴ Sometimes, a tax system is simple to administer but is quite costly or vice versa. For reasons better known to the authors, the Meade report did not mention the similar relationship between the

⁵⁵⁷ Binh Tran-Nam, ‘Tax Reform and Tax Simplicity: A New and ‘Simpler’ Tax System’ (2000) 34:23(2) *University of NSW Law Journal*, 243.

⁵⁵⁸ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* in Kathryn Sutherland (ed.) (1993) 451-454.

⁵⁵⁹ Smith, above n 558, 451-454: A tax on consumption at the time of purchase of commodity and charge of income tax at source on salary would put minimum cost on the taxpayer for the compliance.

⁵⁶⁰ Walpole, above n 548a, 16-17.

⁵⁶¹ AICPA Report, above n 552, 10.

⁵⁶² Smith, above n 558, 451-454.

⁵⁶³ Meade Report, above n 543, 19.

⁵⁶⁴ Meade Report, above n 543, 20.

complexity of compliance and the costs of the compliance. It is possible that a tax system may not be complex in terms of clarity and certainty, but by imposing voluminous documentary requirements, compliance is costly. This is especially true for small business, which even when placed under the ideally clear and certain normal income tax, can find it hard to comply because of the costs of maintaining financial accounts. Thus, this thesis, as a central argument, advises simplifying the tax regime for small businesses both in respect of compliance costs and ease of compliance.

Regarding the principle of simplicity, the Meade report argues that it promotes acceptability for the tax system in the eyes of taxpayers. More aptly, it states that ‘a tax system must be acceptable to the public, and the simplicity of the system is necessary for its acceptability’⁵⁶⁵. Acceptability is not another facet of simplicity but it is an important manifestation of a simple tax. In order to be acceptable, a tax system should be simple in respect of all its facets. For the same reason and consistent with Section 4.1.1 of Chapter 2, this thesis argues that a clear and certain (i.e. linguistically simple) income tax can be rejected by small business, if it results in heavy costs of compliance by requiring maintenance of books of accounts.

Sometimes, simplicity has been defined by referring to its antonym i.e. complexity of tax system. Cooper identifies the following seven facets of simplicity by adopting this approach.⁵⁶⁶

1. Predictability: It sets out a rule’s intended scope. This element of simplicity is similar to certainty, which is included by both Smith and the Meade report as an element of simplicity.
2. Proportionality: Proportionality refers to the fact that the rules dealing with complex business transactions have to be necessarily complex. It is noted that proportionality is not a distinct facet of simplicity because it does not denote simplicity in a tax system. Nevertheless, proportionality could be a guide for a comparative analysis of different tax provisions.

⁵⁶⁵ Meade Report, above n 543, 19.

⁵⁶⁶ Graeme S. Cooper, ‘Themes and Issues in Tax Simplification’ (1993) 10, *Australian Tax Forum* 417, 424.

In this regard, the complexity of a rule should be measured in proportion to the complexity of the problem. More aptly, not all taxable events will have a similar level of complexity and therefore the tax provisions to tax them vary in their degree of complexity. Other scholars argue that simplicity is a comparative concept and should be measured by comparing one provision with another enacted to tax an identical taxable event.⁵⁶⁷ Nevertheless, when comparable legislation is not available, then an independent value judgement can be used.

3. Consistency: This suggests that similar tax treatment (i.e. without arbitrary distinctions) should be given to similar business transactions. Cooper's view⁵⁶⁸, by just restricting the scope of consistency to arbitrariness, appears limited. On the contrary, consistency is a broad concept, which besides ensuring non-arbitrariness of a tax code, depicts how coherent different sections of legislation in a tax code are. Thus, the less conflicting provisions in a tax code are, the simpler it would be to comply.

Besides that, there is no dispute that inconsistency in a tax code causes 'arbitrariness'. However, arbitrariness can arise due to other reasons as well. For instance, a lack of clarity can also lead to arbitrariness. The variety of reasons for arbitrariness indicates that lack of arbitrariness is a manifestation rather than a separate facet of simplicity. Cooper's suggestion of inclusion of non-arbitrariness in the concept of simplicity appears incorrect.

Although 'consistency' apparently conflicts with Smith's principle of 'stability', actually it does not for the reason that 'consistency' reflects identical tax treatment for identical business transactions and coherence in tax legislation whereas 'stability' depicts permanence in tax system to facilitate tax compliance. This comparison shows that stability and consistency are not contradictory but distinct features of simplicity.

4. Low compliance burden: This refers to low costs borne by the taxpayers in the discharge of their tax obligations.

⁵⁶⁷ Binh, Tran-Nam, 'Tax Reform, Tax Simplification: Some Conceptual Issues and a Preliminary Assessment' (1999) 21 *Sydney Law Review*, 506.

⁵⁶⁸ Cooper, above n 566, 425.

5. Easy administration: Regarding this facet, it is uncertain whether Cooper is referring to procedural simplicity to ease administration⁵⁶⁹ or administration costs. For, instance, a clear tax code could be easy to administer but may still entail huge costs due to expensive procedures.
6. Co-ordination: This is about a clear relationship among the rules. Most scholars commonly have labelled this aspect of simplicity as ‘consistency’. More simply, it refers to a tax rule’s coherence with other rules and parts of legislation.⁵⁷⁰ Cooper seems to have erred by mentioning it as a separate facet of simplicity.
7. Expression: A rule should clearly express its intent, and this concept basically refers to the clarity of language in the tax code.

Regarding simplicity, the Organization of Economic Cooperation and Development (OECD) states that, ‘the tax rule should be clear and simple to understand, so that taxpayers can anticipate the tax consequences in advance of a transaction’⁵⁷¹. It basically refers to clarity and certainty of a tax system which have already been discussed above.

Although the OECD mentions ‘flexibility’ as a separate principle, it is another important facet of simplicity, which ensures smooth operation of the tax code with changing times. It is also evident from its definition of flexibility given in the report. That is ‘the system of taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments’⁵⁷². Flexibility however, is a relative term and cannot be measured in absolute terms, because the law can only incorporate business dynamism to a limited extent. When it comes to incredible new inventions and technological advancements, the law should be suitably amended. Thus, for ensuring flexibility, the tax code should have mechanism for amendments in such circumstances. Such amendments jeopardize the stability of the tax code which requires a suitable balance in these two conflicting attributes of simplicity.

⁵⁶⁹ OECD Compliance Report, above n 551, 6 called it a separate principle of ‘effectiveness’ to emphasize the significance of effective revenue collection by tax administration.

⁵⁷⁰ Tran-Nam, above n 557, 243.

⁵⁷¹ OECD, ‘*The Implementation of the Ottawa Taxation Framework Conditions: The 2003 Report*’ 2003, 12 <<http://www.oecd.org/dataoecd/45/19/20499630.pdf>> at 12 October 2009.

⁵⁷² OECD Compliance Report, above n 551, 6.

The definition of simplicity provided by the American Institute of Certified Public Accountants (AICPA) report puts emphasis on the compliance and administration costs of the tax code. The AICPA defines simplicity as a simple tax code so that taxpayers understand the rules and can comply with them correctly and in cost efficient manner.⁵⁷³ It further adds another facet to it called convenience of payment, which refers to the fact that ‘a tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer’⁵⁷⁴. Both these principles are basically emphasized versions of Smith’s third canon. Another facet in the AICPA definition is ‘economy of collection’⁵⁷⁵, which matches both with Smith’s third and fourth canons of taxation. Besides putting emphasis on compliance costs, it refers to administration costs as a facet of simplicity. On the other hand, what is defined as simplicity by Smith is incorporated in the AICPA report as the principle of ‘certainty’ in these words: ‘tax rules should not be arbitrary and should clearly specify when the tax is to be paid, how is to be paid, and how the amount to be paid, is to be determined’⁵⁷⁶. Broadly, the contribution by the report to the concept of simplicity is its heavy emphasis on low compliance and administrative costs.

The AICPA report also mentions ‘minimum tax gap’ (that is, a tax should be structured to minimize non-compliance) and ‘appropriate government revenue’ as principles of taxation. A cursory view of these principles of AICPA report however, reveals that they are not principles of a good tax system, but are objectives of a good tax system, which a nation intends to achieve by its tax system.

For effective analysis in this thesis, it is necessary to harmonize all the above definitions and remove what some have identified as ‘irrationality in discussions of tax policy issues, because, terms and expressions are used in an inconsistent and ambiguous way’⁵⁷⁷. It is, nevertheless, acknowledged that the above interpretations of simplicity, despite overlaps among some facets and the use of different nomenclature for the same facets, have identified a range of distinct facets. After combining and sifting through the above definitions, this thesis identifies the following distinct facets of simplicity:

⁵⁷³ AICPA Report, above n 552, 12.

⁵⁷⁴ AICPA Report, above n 552, 10.

⁵⁷⁵ AICPA Report, above n 552, 10.

⁵⁷⁶ AICPA Report, above n 552, 11.

⁵⁷⁷ Alley and Bentley, above n 539, 581.

- i. Clarity
- ii. Certainty
- iii. Consistency
- iv. Stability
- v. Flexibility
- vi. Low compliance costs
- vii. Low administration costs

This list avoids duplication, and also excludes all those elements from the above definitions that are either manifestations of lack of simplicity or have no bearing on the scope of simplicity. A simple tax system should be the one which is clear, certain, consistent, stable, flexible and entails low compliance and administration costs.

The above mentioned scope of simplicity is subject to following comments:

(i) Certainty can be inconsistent with clarity.⁵⁷⁸ The more someone tries to bring clarity by incorporating individual situations to the tax code, the more uncertain it becomes for the situations still not covered. Thus, clearer and simpler language in tax code may create uncertainty. In fact, the complexity in law arises from attempting to mould the law ‘around the natural facts of economic life’.⁵⁷⁹ Thus, balance is needed between clarity and certainty. More simply, we cannot achieve best of both and therefore should plan to have a reasonable amount of each of these facets.

(ii) It is argued that certainty in taxation reduces both compliance and administration costs. But this is not always true, because to make tax liability certain, sometimes tax rules and legislation have to be complex, which does increase costs. Thus, a balance is needed between certainty and compliance costs. Beyond that, the distinction between the ease of compliance and the compliance costs is also relevant because procedural compliance costs are not due to uncertain rules.

(iii) As a compromise, the European Union (EU) suggests certain rules which ensure simple compliance. The reference to simple compliance here is in terms of ‘low

⁵⁷⁸ Hinnekens L., ‘International Taxation of Electronic Commerce: An Emerging Framework’ (1999) *Intertax* 440, 440.

⁵⁷⁹ John Prebble, ‘Why is the tax law incomprehensible?’ (1999) 8:4 *British Tax Review*, 731-747.

compliance costs'.⁵⁸⁰ The reference to simplicity in compliance, perhaps, is not in terms of the clarity in language, but easiness and low costs in the compliance procedure. But as discussed earlier, having both certainty and low compliance costs is a difficult task to achieve, and poses a real challenge for tax designers.

(iv) Non-arbitrariness⁵⁸¹ is not included in this list, because it is the manifestation of the lack of certainty and is not an independent attribute of simplicity. When the liability can be ascertained unambiguously, then tax law cannot be invoked arbitrarily. It is ambiguity in the tax law which creates loopholes for exploitation.⁵⁸²

(v) Though clarity, consistency, stability and flexibility are also attributes of 'certainty' and contribute to its enhancement, these on their own also reflect the simplicity of the tax code, and therefore have been retained as separate facets. Consistent with the above discussion, proportionality and acceptability, not being facets of simplicity, are not included in the above list, but still are useful and logical tools for evaluation of the tax code.⁵⁸³

3.2 Assessing Simplicity

What is an appropriate level of simplicity for a tax code is a practical matter and is discussed below.

3.2.1 Debate on Alternative Approaches

When it comes to assessing the simplicity of a tax code assessment can occur at two levels: first, at the level of source; and second, at the level of outcome. Tran-Nam splits the assessment of simplicity into 'legal simplicity' and 'effective simplicity' and argues

⁵⁸⁰ See European Union, '*E-Commerce and Indirect Taxation*' Communication by the Commission to the Council of Ministers, the European Parliament and to the Economic and Social Committee (COM (98)374final;17/6/980) 17 June 1998, 7 <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:51998DC0374:EN:NOT>> at 12 October 2009.

⁵⁸¹ The arbitrariness arises from the provisions, which give unbridled discretion to the tax authorities. For example, the assessing officer has discretion to fix the value of any transaction he/she deems fit under *Income Tax Ordinance* 2001 (Pakistan).

⁵⁸² Clinton Alley, Andrew Maples and John Veal, *New Zealand Taxation* (First edition, 2004), 54.

⁵⁸³ Tran-Nam, above n 567, 505.

that legal simplicity reflects the use of language and content of a tax code.⁵⁸⁴ The facets of stability, flexibility, consistency, clarity and certainty, being linked to the language, content and structure of the tax code are therefore covered in the concept of legal simplicity. On the other hand, effective simplicity is reflected in the sum of the operating costs, which are incurred by the economy as a whole in implementation of the tax code.⁵⁸⁵ It may be called ‘economic simplicity’.⁵⁸⁶

Tran-Nam takes the macroeconomic view of costs, after some initial reference to the costs borne by an individual taxpayer. He argues that legal simplicity influences overall costs including costs related to tax agents, both for filing of returns and tax planning, and consequently effective simplicity.⁵⁸⁷ Nonetheless, despite legal simplicity, compliance costs can still be high, especially when tax code imposes hefty regulatory and documentary requirements.

Similarly, the Ralph Review divided complexity in two partially independent parts. The first part comprises its theoretical framework, which is based on the language and content of tax code⁵⁸⁸ and is called ‘technical complexity’.⁵⁸⁹ The Ralph Review mentions the ‘structural complexity’⁵⁹⁰ separately, but it relates to consistency in tax code and therefore is encompassed within the concept of technical complexity. The second part is related to costs involved in implementing the tax code and its application in real life and is called ‘compliance complexity’.⁵⁹¹ For example, a tax code requiring maintenance of accounts for a small business could be simple from the technical complexity aspects, but complex from the compliance complexity perspective. This is consistent to earlier finding of this thesis in the preceding paragraph.

⁵⁸⁴ Tran-Nam, above n 567, 506.

⁵⁸⁵ Tran-Nam, above n 567, 508.

⁵⁸⁶ Tran-Nam, above n 557, 246.

⁵⁸⁷ Tran-Nam, above n 567, 509.

⁵⁸⁸ It is rightly said by Margaret McKerchar, Kristen Meyer and Stewart Karlinsky, ‘*Making Progress in Tax Simplification: A comparison of the United States, Australia, New Zealand and the United Kingdom*’ Working Paper No. 49, Research Series, Faculty of Law, University of New South Wales, 2008, 372 that policy makers are more confronted with theoretical purity rather than with practical aspect of its implementation involving the costs of compliance and administration.

⁵⁸⁹ Ralph Review, above n 548c, 106.

⁵⁹⁰ Ralph Review, above n 548c, 106.

⁵⁹¹ Ralph Review, above n 548c, 106; OECD Practice Note above n 96, 3 calls it as ‘administrative complexity’ as mentioned in Chapter 2.

The Ralph Review impliedly referred to compliance complexity at the individual level, whereas Tran-Nam viewed it as the total costs on the economy. The total economic costs of tax compliance is a less reliable measure to ascertain the simplicity of a tax code, because, it is influenced by tax behaviour regarding tax planning⁵⁹², level of compliance⁵⁹³, number of taxpayers⁵⁹⁴ and distribution of taxpayers⁵⁹⁵ etc. For example, lack of tax culture and non-compliance would reduce the total costs of compliance irrespective of the complexity in the tax system, just because, there is no compliance and consequently no costs. Similarly, the low compliance costs in the developing countries, as compared to the developed ones, do not necessarily indicate that these have more clear, certain, consistent and stable tax legislation.⁵⁹⁶ The low costs there may be explained by non-compliance, low economic activity, fewer tax agents and fewer taxpayers. Likewise, high compliance costs in developed countries may be partly due to more aggressive marketing and a growing number of tax agents and the use of expensive IT software etc. For these reasons, the measure of the individual compliance costs is a more appropriate reflection of the compliance complexity. This thesis therefore examines compliance from the individual perspective.

There are two components of compliance complexity for individual taxpayers. First is ease of compliance that depends on the bookkeeping requirements, size and level of computation in the return and other documentary requirements. Second is compliance costs that depend on the costs of tax agents required to comprehend and comply with the complex tax code and the costs for audit etc. It confirms that the compliance complexity partly arises from the technical complexity; and partly on account of voluminous documentary and other requirements. Though the latter costs are considered

⁵⁹² Tran-Nam, above n 567, 15.

⁵⁹³ Joel Slemrod, 'Did the Tax Reform Act of 1986 simplify matters?' (1992) 6(1) *Journal of Economic Perspectives* 45, 53.

⁵⁹⁴ Slemrod, Id, 50.

⁵⁹⁵ If there are a large number of small taxpayers where compliance is regressively high, the overall cost would be more.

⁵⁹⁶ However, it is admitted that due to advanced financial institutions and accounting practices in modern world, the tax authorities have to bring in a relatively complex law. Thus, the complexity of tax code depends on the nature of transaction it intends to tax (see Tran-Nam, above n 567, 507).

as unavoidable for corporations⁵⁹⁷ these can be drastically minimized for small business by reducing the documentary requirements and simplifying the law.

The Ralph Discussion Paper put less emphasis on ‘administrative complexity’⁵⁹⁸, which is very well emphasized by Tran-Nam. This complexity should also be examined for the ease of administration and costs of the administration, as suggested by the Meade Report.⁵⁹⁹ The simplicity of the tax code for administration is distinct from simplicity for compliance, and therefore should be examined independently for the better evaluation of any tax code. For example, any provision which requires collection of huge information from third parties for verification of taxpayer’s data increases the burden on the administration and may not be cost effective for the administration, but has little effect on the costs borne by taxpayers. This aspect of simplicity will be emphasized while analysing PIT systems in this thesis.

3.2.2 A Simple Approach to Simplicity

The discussion regarding the practical aspects of simplicity in preceding paragraphs suggests that for facilitating decision-making, simplicity should be divided into two types. First is technical complexity, which incorporates clarity, certainty, consistency, stability and flexibility in the language and content of tax code. Second is operational complexity, which covers both the administrative and compliance costs. It is also called ‘users’ complexity’.

More aptly, technical complexity basically reflects the causes of increased cumbersomeness in tax code. Operational complexity on the other hand, is the manifestation of technical complexity plus ‘the burden of documentary requirements’⁶⁰⁰. Moreover, in the context of the facets of simplicity, the first five facets are the causes of complexity and last two are the manifestation of those causes. For

⁵⁹⁷ Kenneth Stanton Johnston, ‘Corporations Federal Income Tax Compliance Costs: A Study of Small Medium and Large Size Corporations’ Bureau of Business Research, Ohio State University, (1963) 67.

⁵⁹⁸ Ralph J, Allert R and Joss B., ‘A Strong Foundation: Establishing Objectives, Principles and Processes’ Discussion Paper I, Review of Business Taxation, Commonwealth of Australia November 1998, 63, 80 (see the integrated user needs in Box 6.3) <www.rbt.treasury.gov.au> at 14 April 2009.

⁵⁹⁹ Meade Report, above n 543, 20.

⁶⁰⁰ It is referred to by Cooper as the number of tasks demanded from a taxpayer to perform (Cooper, above n 566, 447.

simplification, action is needed at both the levels in a manner which should ultimately reduce the costs of compliance and enforcement.

This break up of tax complexity clarifies ‘the intricate connection between complexity and compliance and administrative costs’⁶⁰¹. The above interpretation also explains how a simple rule can be expensive to comply with, if it puts a huge burden of documentary evidences.⁶⁰²

More broadly, the concept of simplicity in tax law should have three main dimensions for decision making: simple to understand, simple to comply with, and simple to administer. It is reiterated that the last two should not be seen only with reference to the costs related to tax advice on complex law, but also costs related to cumbersome procedural and documentary requirements.⁶⁰³

In all, simplicity can be measured through qualitative analysis by exploring the causes of technical complexity in tax code⁶⁰⁴, and through qualitative and quantitative analysis by assessing the burden it puts on the both users of tax code.

3.3 Approach Adopted in the Thesis

It is appropriate to include all facets of simplicity for the comprehensive analysis of a PIT regime. These include clarity, simplicity, consistency, stability, flexibility, low compliance costs and low administrative costs. The first five facets (that is, technical complexity) can be analysed qualitatively.

Consequently, in first stage, this thesis analyses popular PIT designs (Chapter 7) and Pakistani PIT (Chapter 10) qualitatively for all the facets of technical complexity. However, the analysis of the facets of technical complexity is made from the legal

⁶⁰¹ This connection is identified as a complex link in Simon James ‘*Tax Simplification is a not a Simple Issue: The Reasons for Difficulty and Possible Strategy*’ (2007) Discussion Paper No. 07/18 ISSN 1472-2939, School of Business & Economics, University of Exeter, 2007, 7.

⁶⁰² McKerchar et al, above n 588, 370.

⁶⁰³ That is the reason that most government reports suggest the reduction in un-necessary forms and record keeping requirements for small business (see New Zealand, ‘*More Time for Business – Tax Simplification for Small Business*’ A Government Discussion Document, May 2001, paragraph 2.7, 2.8 <<http://taxpolicy.ird.govt.nz/publications/files/html/mtfb/index.html>> at 8 March, 2009).

⁶⁰⁴ Christopher John Taylor, ‘*Beyond 4100: A Report on Measures to Combat Rising Compliance Costs Through Reducing Tax Law Complexity*’ (Report, Taxation Institute of Australia, 2006).

perspective (similar to the methodology used by Taylor)⁶⁰⁵, rather than from the linguistic perspective. Taylor examined complexity by examining redundancy, superfluousness and grouping according to rational scheme etc.

It is already recognized that sustainable simplification cannot be achieved if the focus is only on the linguistic reforms.⁶⁰⁶ Such attempts to rewrite the law in the past are criticized and even a few previously rewritten law provisions are sarcastically called ‘Kindergarten babble’⁶⁰⁷. It is rightly said that ‘the law of income tax can not, unfortunately, be limited to concepts that could be understood by a lay person without explanation, and the aim of those drafting income tax legislation should be to make the law clear to the professional reader, whose task it will be to explain the effect of the law to the lay person concerned’⁶⁰⁸.

Consequently, ‘other factors’⁶⁰⁹ in legislation including the number of provisions, redundant provisions, superfluous words and sentences, coherence and frequency of the changes etc are used for ascertaining clarity, certainty, consistency, stability and flexibility of the Pakistani PIT in this thesis. The Pakistani PIT is also examined for its acceptability in the public on the rational basis and for a balance between certainty and compliance costs; and certainty and clarity.

In the second stage, this thesis analyses popular PIT designs and Pakistani PIT for the last two facets of simplicity which are covered within operational complexity. This analysis is also done qualitatively based on the size of the return, the details of the computations, documentary requirements, audits and the requirement of keeping books of account and costs related to appellate procedures.

⁶⁰⁵ Taylor, above n 604.

⁶⁰⁶ Simon James and Ian Wallchutzky, ‘Tax Law Improvement in Australia and the UK: The need for a Strategy for Simplification’ (1997) 18 (4) *Fiscal Studies* 445, 445: James, above n 601, 13 also mentions that the complexity of language is only a small part of the problem.

⁶⁰⁷ Lehmann G., ‘The Reform that does not Reform and the Simplification that does not Simplify: the Tax Law Improvement Fiasco’ (1995) *Butterworth’s Weekly Tax Bulletin*, 530-533.

⁶⁰⁸ Sir Gibbs Harry, ‘Tax Law Improvement Project: The Current Perspective’ (1995) 42 *Butterworth’s Weekly Tax Bulletin*, 670-673; Nevertheless, it does not rule out a possibility that, for some category of taxpayers, who can not afford costs of tax professional to obtain the explanation, the policy and tax code ‘should be drastically changed’ to ensure the compliance (see James, above n 601, 13).

⁶⁰⁹ James and Wallchutzky, above n 606, 447.

This thesis does not emphasize ‘policy complexity’, an area of tax simplicity mentioned in the Tax Law Review Committee’s Final Report⁶¹⁰. Nevertheless, it is useful to align the simplicity with precisely ‘what is intended to [be] achieve[d] by particular tax legislation?’⁶¹¹. For example, if the policy objective is to harness the tax potential of the small business sector, then operational complexity has to be drastically reduced. Consistent with that, the Pakistani PIT is also analysed for its ability to address hurdles in implementation e.g. in the informal sector.

More simply, coherence is needed at all levels of simplicity. Consequently, the test to find whether a tax system is simple or not for the small business is the measurement of compliance costs for this group only.⁶¹² For instance, in the transitional countries, simplified regimes were found to have reduced the compliance costs of taxpayers.⁶¹³

Lastly, the results of analysis of Pakistani PIT in the thesis should be interpreted with the following two considerations. First, the results in this study should take the form of a continuum with simplicity at one end and the complexity at the other. Income tax, being an intrinsically complex tax regime, has to fall in the middle of the continuum between simplicity and complexity. More broadly, it is not logical to expect that the tax code can be absolutely simple or it would be costless for a taxpayer to comply, the administration to enforce and a stray reader to interpret.

Second, there is ‘a good reason to promote simplicity for all taxpayers’⁶¹⁴, but then we also have to acknowledge the difference among different categories of taxpayers. An old maxim which is still relevant is that ‘one size does not fit all’. Therefore, the results of the analysis should be seen with reference to the relevant category of taxpayers.⁶¹⁵ A tax code which is simple for a corporation to comply with might not be simple for a small business in terms of its compliance costs. An analogy can be drawn with an environment friendly solar energy plant which costs approximately A\$4000 in

⁶¹⁰ The Institute of Fiscal Studies, ‘*Final Report on Tax Legislation*’ Tax Law Review Committee, 11 June, 1996, 28 <<http://www.ifs.org.uk/comms/comm55.pdf>> at 8 October 2009; also see Cooper’s levels of simplicity (Cooper, above n 566, 459).

⁶¹¹ James and Wallschutzky, above n 606, 448.

⁶¹² OECD Compliance Report, above n 551, 6.

⁶¹³ See Stern and Barbour, above n 93, 4.

⁶¹⁴ James, above n 601, 14.

⁶¹⁵ Similar view is taken by Ralph et al (Discussion Paper), above n 598, 803, Para 6.99

Australia. This is considered cheap by some citizens, but too expensive by others, depending upon their income class. Likewise, what is not simple from a compliance perspective depends on the turnover and size of a business. Similarly, perception of the simplicity varies for the level of expertise available to a business entity. Therefore, the simplicity in a tax code should be viewed differently for different classes of taxpayers. For example, a very clear tax law requiring small businesses to determine income under financial accounting would impose a high compliance burden on them and hence cannot be called simple. The determination of income through a ‘few readily ascertainable facts’⁶¹⁶ would be more appropriate and simple for these businesses.

4. Efficiency

Justice John Marshall argued that taxes cast adverse effect on economic well being of people who ultimately bear the burden of taxation.⁶¹⁷ Though the adverse effect varies in extent from one type of tax to another, it is widely admitted that all taxes reduce the economic well being of the people.⁶¹⁸ Nevertheless, some of these negative implications are offset by the government expenditure financed by taxes.⁶¹⁹ The principle of efficiency is discussed below by reference to this perspective.

4.1 Role of Taxation in Economic Growth

In any economy, people assume one of the following three roles: consumers, who are in search of desired goods and services at low prices; workers, who seek remunerative employment; and investors or producers, who want to sell consumer preferred products with desirable profit margins. The behaviour of all these three groups of actors is a medium through which the economy mediates the complex process of allocating resources.⁶²⁰

⁶¹⁶ Cooper, above n 566, 421.

⁶¹⁷ David E. Wildasin, ‘Tax Reform in Kentucky: Principles and Practice’ Chapter 1 in *Financing State and Local Government: Future Challenges and Opportunities*, Kentucky Long Term Policy Research Centre, November 2001, 1 <http://www.kltprc.net/books/financinggov/Chpt_1.htm> at 12 June 2009.

⁶¹⁸ Wildasin, above n 617, 1.

⁶¹⁹ Carter Report, above n 546, 48.

⁶²⁰ Wildasin, above n 617, 2.

All taxes distort the choices of these three groups and result in a misallocation of resources. The distortion takes place in the form of the ‘substitution effect’. However, the extent of the substitution effect depends upon how one actor (usually an investor) shifts the tax burden to another actor (usually the consumer). It is generally believed that the degree of shifting of tax incidence depends upon the price elasticity of a product. The greater the price elasticity of demand, the less the tax burden will shift. The employees, when skilled labour is in short supply, can also shift the tax burden to the producer⁶²¹ who in turn, depending upon the price elasticity, shifts the burden to the consumer. The consumer cannot shift the burden because of being at the end of the economic lane. Consequently, the consumer substitutes one product for another one, which bears less tax. As a corollary, the investor would also change its production and the employees would also be attracted to the changed production line. Sometimes, as an extreme response, employees substitute leisure for work and investors substitute consumption for savings or investment.⁶²² This change in the choices results in a misallocation of resources.

The change in choices such as the choice of products consumed is called deadweight loss. The underlying concept is that the interference with the choices is a burden on the actors due to the imposition of tax, which is in addition to the actual money paid in the form of tax.⁶²³ More simply, the loss of utility due to the change of the decisions induced by tax causes the deadweight loss.⁶²⁴ It is acknowledged that no one benefits from this burden – neither government nor the above three actors. It is, therefore, an utter loss.⁶²⁵

⁶²¹ Meade Report, above n 543, 9.

⁶²² This, perhaps, explains the fact that taxes not only transfer private resources to the public sector ‘but they typically reduce the overall amount of [economic] activity’ (see Vedder and Gallaway Report, above n 548b, 6).

⁶²³ For further argument to this effect including the efficient market hypothesis and the assumption of rational behaviour see Keith Bain ‘*The Principles of Taxation- Part I*’ Notes on Public Finance, University of East London, Department of Economics, 2000, 4 at <<http://homepages.uel.ac.uk/K.Bain/tax1.pdf>> at 6 January 2009.

⁶²⁴ Bain, above n 623, 5. Economists refer to the deadweight loss as reduced consumer’s and producer’s surplus, which is estimated at approximately 40 or 50 cents of each one dollar raised in taxes (for estimates see Ballard CL, Shoven JB and Whalley J., ‘General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States’ (1985) 75(1) *American Economic Review* pp.128-138).

⁶²⁵ Some writers have restricted the term efficiency only to low compliance and administration costs of tax. Bentley, above n 554, 78 defines efficiency as compliance and administration costs and suggests

In view of the above, the tax impact on economic efficiency can be summarized as follows:

‘- a tax interferes with choice and thus causes a loss of utility by pushing the choice patterns of consumers and producers away from the ideal’⁶²⁶.

4.2 Aim of the Efficiency Principle

The Ralph Discussion Paper suggests:

‘.....the business tax system should interfere as little as possible with the best use of existing national resources... and with long term economic growth.’⁶²⁷

Similarly, the Asprey report stated:

‘...with a more efficient tax system, resources will be more likely to move into the activities where they will generate largest economic gains to the nation...’⁶²⁸

The above suggestions are consistent in the sense that in an ideal environment, the choices are made only by the utility consideration, which ensures allocation towards the largest economic gains. Taxes disturb this environment and create deadweight loss by the substitution effect. A good tax system is one which keeps this disturbance at minimum possible level.

Further, some of this loss may be offset when the change in the choice is towards another product.⁶²⁹ This is particularly true when the change in employment is towards

minimizing these costs through simplification of payment of tax. On the other hand neutrality is called by him as the principle of economic efficiency. The correct position is that the reduction in the compliance and administrative costs is an ‘administrative efficiency’ and is different from the ‘economic efficiency’, which is guided by the neutrality of choices. However, in the literature, the compliance and administrative costs are generally treated as part of the simplicity principle and a similar approach is adopted in this thesis. Moreover, the impact of these costs on economic growth is limited. For instance, the total compliance costs in the USA are \$225 billions (As quoted from the testimony of Arthur P. Hall before the Ways and Means Committee of the US House of Representatives in Vedder and Gallaway Report, above n 548b, 9, which constitute 2.1 % of its GNP (i.e. \$10,533 Billions); the data is obtained from National Economic Accounts, Department of Commerce, United States of America <<http://www.bea.gov/national/xls/gdplev.xls>> at 05 August 2009). In developing countries, there is massive non-compliance and lack of tax professional’s services, hence, the impact of such costs on the economic performance may be much lower.

⁶²⁶ Bain, above n 623, 4.

⁶²⁷ Ralph et al (Discussion Paper), above n 598, 63.

⁶²⁸ Asprey Report, above n 542, 16.

another employment instead of leisure and the change in investment is to another investment rather than consumption. Infrequently, as discussed in the following paragraph, the change is better for the economy and is welcome.⁶³⁰

The market does have some imperfections, which mainly emanate from the lack of information or even the lack of a level playing field.⁶³¹ For example, ‘Wealthy people may be able to invest their capital at higher rates of yield and to borrow at lower rates of interest than poor persons’⁶³². Though measures other than tax are suggested to address these imperfections, some well calculated tax measures are also approved⁶³³, especially when the substitution effect is beneficial to the society at large. For instance, tax incentives may be used to promote regional development by private enterprises, which may otherwise find the ventures unattractive in underdeveloped regions of a country.⁶³⁴ Similarly, small entrepreneurs in developing countries may be encouraged to undertake innovative economic activities by tax incentives such as reduced compliance burden. Nevertheless, the merits of tax concessions should be well balanced against their demerits.⁶³⁵

In view of above, taxes should be used for revenue collection with a caution not to have a large degree of economic distortion.⁶³⁶ It is conceded that all taxes do alter the economic choices and result in economic inefficiencies. On the other hand, taxes, like

⁶²⁹ The Meade report refers to the offset possibility with particular reference to encouraging those economic sectors which has less polluting effects on environment or have similar social and economic advantage (see Meade Report, above n 543, 11). But we can not rule out the possibility of the shift for good, when some useful and productive commodity substitutes another luxury and unproductive commodity. The shift from consumption of alcohol to drinks like red bull or even fruit juices are usually suggestive.

⁶³⁰ Walpole, above n 548a, 20.

⁶³¹ Meade Report, above n 543, 10.

⁶³² Meade Report, above n 543, 10.

⁶³³ Meade Report, above n 543, 11; Ralph et al (Discussion Paper), above n 598, 70 suggests that the business tax incentives should only be used, when they are assessed to be an essential or superior form of government taxation.

⁶³⁴ Meade Report, above n 543, 11. The initiative of offering incentives to encourage savings and investment, particularly for small business in Australia, may be a step in the same line (see Alley and Bentley, above n 539, 601).

⁶³⁵ Similar view is taken by Asprey Report, above n 542, 16.

⁶³⁶ Wildasin, above n 617, 2 specifically mentions that ‘An important objective of tax policy should be to limit the economic harm that the tax system causes through these inefficiencies’. AICPA Report, above n 541, 13 also defines the principle of economic growth and efficiency as ‘the tax system should not impede or reduce the impetus of the economy’. Alley and Bentley, above n 539, 622 also defined the principle of neutrality in the same words.

Poll Tax, which are economically efficient, suffer from other serious drawbacks like unfairness, which make them totally unacceptable.⁶³⁷ Thus, the objective of achieving complete economic efficiency is an un-achievable task. In all, the efficiency principle should only be aimed at limiting the economic harm of tax system rather than achieving an absolute degree of efficiency.⁶³⁸

4.3 How to Limit Economic Harm of Taxation? The Neutrality Criteria

The most pertinent question is: how can be the principle of efficiency in income tax or presumptive income tax secured? Although income tax is generally considered as having less deadweight loss (due to the uncertainty of its liability until the end of the financial period)⁶³⁹, in the modern financial world it is naïve to assume that the income tax does not distort choices.⁶⁴⁰ Every investment will be made after a detailed project evaluation including the impact of income tax in order to ensure that the rate of return in a project is higher than the cost of capital. The PIT, wherein liability is more definite and easier to determine before the start of the project, is more likely to be included in this project evaluation. Consequently, the influence on choices by income tax is difficult to avoid. Nevertheless, it can be kept at a minimum by appropriate tax design.

Rationally, for any tax, a two pronged strategy can be suggested to minimize choice distortions. Tax can be charged on goods and services which are inelastic to price; or alternatively, tax can be charged uniformly on every product, in order to neutralize the impact on choice. The former option may not be appropriate however, because most of the inelastic goods and services are essential commodities and high taxes on these goods can devastate the poorer sector of society. The latter is therefore the recommended option.⁶⁴¹ Following this recommendation, in income tax, all sources of income, all types of income and all entities' income should be taxed at identical rates in order to

⁶³⁷ In England, the imposition of the Poll tax, due to perception about its unfairness, resulted in widespread protest, which led to the end of the government of Mrs. Margaret Thatcher.

⁶³⁸ Read above n 637.

⁶³⁹ Bain, above n 623, 4, 5 states that: 'In a partial equilibrium framework, income taxes come out better because the income tax is a general tax, which does not distinguish between different goods and thus involves no excess burden through inducing a switch from a taxed product to an untaxed product'.

⁶⁴⁰ It is admitted that in tight labour markets, workers do demand higher wages to make up for the increased income tax (see Bain, above n 623, 4- 5). The concepts of net take home salary and 'grossing up' are common in this regard.

⁶⁴¹ Meade Report, above n 543, 9.

melt away all distinctions between them and exterminate all tax induced choices.⁶⁴² More simply, tax should be neutral for all choices of goods, employment and investments.⁶⁴³

The second part of the strategy is to prescribe low tax rates across the board⁶⁴⁴, because the deadweight loss rises progressively as the tax rates increase.⁶⁴⁵ In view of the above, the principle of efficiency is interchangeably used with the term ‘neutrality’.

As follows in the next section, neutrality is also a key component of the concept of equity.⁶⁴⁶ However there is a minor distinction. When discussing equity, neutrality refers to identical tax treatment of taxpayers, who are under similar economic circumstances. On the other hand, for efficiency, neutrality refers to the identical treatment of taxpayers grouped on the basis of industrial sectors or types of entities or sources of finance etc. For example, textile and sugar sectors are subjected to an identical tax treatment. More simply, neutrality under the equity principle primarily discerns the tax impact at the individual taxpayer level; and in the efficiency principle it refers to the tax impact at the collective level and affects a larger number of the choices. In respect of efficiency, Wildasin correctly says that:

⁶⁴² This is consistent with the Haig-Simon theory of taxing the comprehensive income, which suggests that all net accretions to wealth should be taxed (see the original contributions by Haig Robert Murray., ‘The Concept of Income – Economic and Legal Aspects’ in Musgrave R.A. and Shoup C.S. (eds.) *Readings in the Economics of Taxation* (1959), 54-76; Haig’s chapter was originally published in 1921.

⁶⁴³ Carter Report, above n 546, 8.

⁶⁴⁴ Meade Report, above n 543, 9; also see Wildasin, above n 617, 2, 3. The higher government spending, through higher tax rates, casts negative impact on the economic growth (see Vedder R and Gallaway L, ‘The Laffer Curve, Government and Economic Growth’ (1998) *Journal of Private Enterprise*, 63-72). However, it is sometimes argued that the ‘changes in economic circumstances require changes in the tax rates’ (see Stiglitz, above n 3a, 491). Some of the debatable facets of this argument, being not relevant to the thesis, are not emphasized here.

⁶⁴⁵ The high tax burden is considered as a responsible factor for the low US savings rate, as compared to other developed countries like UK, Germany, Italy and Japan (see Vedder and Gallaway, above n 548b, 11).

⁶⁴⁶ OECD Compliance Report, above n 551, 7 used the word ‘equitable’ in the principle of the neutrality. But its emphasis is on the whole group of taxpayers in a particular sector and its impact on economic performance. Moreover, it is with respect to the economic transactions rather than the taxpayers. Also in the AICPA report above n 546 the principle of ‘Achieving an Equitable Tax Policy’ covers the neutrality of taxation for all types of incomes, which is more close to the concept of economic efficiency. Ralph et al (Discussion Paper), above n 598, 75 broadly says that neutrality and equity go side by side. It is true, because, inequality at individual taxpayer level is cumulatively manifested later in the form of misallocation of resources in the sectors.

‘The term neutrality is often used to characterize a tax system that does not favour particular kinds of economic activity (such as employment, consumption or investment).’⁶⁴⁷

In view of the above, neutrality criteria are widely used as a strategic tool to control tax induced economic distortion. When one activity is more heavily taxed than another activity, then neutrality is commonly adopted by taxing the base comprehensively.⁶⁴⁸ The following ten facets of neutrality should be ensured through ‘close attention’⁶⁴⁹ in order to bring the neutrality in whole income tax base for securing economic efficiency:

- i. Neutrality of tax burden in all industrial sectors
- ii. Neutrality in tax treatment of losses and income⁶⁵⁰
- iii. Neutrality in tax burden for all classes of income
- iv. Neutrality in tax burden for all types of legal persons⁶⁵¹
- v. Neutrality in availability of tax avoidance opportunities
- vi. Neutrality in terms of tax rates⁶⁵², tax expenditures and other concessions⁶⁵³
- vii. Neutrality of tax burden irrespective of the risk in the sectors⁶⁵⁴
- viii. Neutrality in tax burden from different jurisdictions⁶⁵⁵
- ix. Neutrality in the tax burden with respect to the choice of capital structure⁶⁵⁶
- x. Neutrality in respect of even the compliance procedures and related costs

⁶⁴⁷ Wildasin, above n 617, 3.

⁶⁴⁸ Walpole, above n 548a, 20; the same view is taken in the Meade Report, above n 543, 9.

⁶⁴⁹ Wildasin, above n 617, 1 warrants to pay close attention to the issue of broadening the tax base.

⁶⁵⁰ Ralph et al (Discussion Paper), above n 598, 72.

⁶⁵¹ It is noted that the differences in the tax treatment between un-incorporated businesses and incorporated businesses can influence the choice of form of business organisation (see Meade Report, above n 543, 9).

⁶⁵² Progressivity in PIT has different meaning in PIT as it taxes the turnover or any other proxy base, which may not be true reflective of the profits as discussed in Section 3.4 of Chapter 4.

⁶⁵³ It is rightly advised not to indulge in multiplication of tax exemptions and reliefs, which erode the comprehensiveness of tax base (see Meade Report, above n 543, 9-10).

⁶⁵⁴ It is noted that taxation may cause substitution of less profitable but steady business for a more profitable but fluctuating business, because, the progressive tax system puts more burden on the latter (see Meade Report, above n 543, 9). This might results in more economic activity in commodities, which are necessities of life and less in areas which are innovative and challenging.

⁶⁵⁵ It is called fiscal competition by Wildasin, above n 617, 1 and is more important in international taxation and therefore is not more elaborated in this thesis.

⁶⁵⁶ Dirkis, above n 555, 48.

Warren suggests eight neutrality benchmarks for evaluating the efficiency principle. Most of them are already covered in the analysis above. He includes ‘taxpayer neutrality’, which factually is the mix of his ‘net income neutrality’ and institutional neutrality’.⁶⁵⁷ However, he does not include the ‘neutrality in compliance burden’ in his benchmarks. It may be because he considers them a part of administrative efficiency and consequently a part of the simplicity principle. But this benchmark is included in this thesis and is suggested not to be observed in small business taxation, because neutrality in compliance burden for small business vis-à-vis large businesses causes non-compliance by small business and consequent efficiency loss. This may be because the impact of this cost on small entrepreneurs is quite regressive.

This is consistent with position adopted by the Ralph Review, which stated that:

*‘26. In some cases practical concerns relating to administration and compliance costs have resulted in deviations from this general rule [neutrality in the impact of the tax system]. A tax system which was theoretically pure, but involved high compliance and administration costs would hamper rather than promote economic growth.....’*⁶⁵⁸

This is also consistent with the view taken in regards to simplicity for small businesses i.e. ease of compliance and lower compliance costs.⁶⁵⁹ Thus, the neutrality of compliance burden may be ignored in favour of small business in order to facilitate voluntary compliance, which may then reduce the size of informal economy and promote economic growth. The high level of compliance helps taxing the base comprehensively, which is a cornerstone of neutrality. More aptly, for small business, simple tax promotes neutrality by encouraging voluntary compliance.

⁶⁵⁷ For details see Neil Warren, ‘Modelling the Economic Outcomes from TVM: Is It Practical and Meaningful?’ (2001) Conference on Tax Value Method: Consultative Conference organized by ATAX and Board of Taxation Sydney <http://www.taxboard.gov.au/content/Tax_Value_Method/tvm_papers/downloads/warren.rtf> at 7 May 2009.

⁶⁵⁸ Ralph Review, above n 548c, 14.

⁶⁵⁹ Complexity, sometimes, is an opportunity for large business to avoid taxes, which small business can not afford to avail (see Cooper, above n 566, 458).

4.4 Assessing Efficiency

Despite the clarity of concept of deadweight loss, it is widely acknowledged that it is hard to measure the impact of any taxation in terms of deadweight loss or even ‘the quantum of the substitution effect’⁶⁶⁰. The Meade report mentions this limitation in the following words:

*‘It is not possible to take into account all the indirect effects of given tax arrangements on economic efficiency.’*⁶⁶¹

It is equally hard to make quantitative estimates of neutrality in a tax system. Consequently, for the evaluation of any tax system, reliance on qualitative judgments is necessary. The qualitative evaluation is also difficult in terms of the substitution and deadweight loss, because the behaviour of all the actors in the economy is quite unpredictable. It is therefore more appropriate to undertake a qualitative analysis by evaluating to what extent a tax measure is ‘neutral’ in its treatment of income. In this regard, all the facets of economic neutrality, which are laid down above, need to be judged. This approach would be consistent with the Ralph Discussion Paper, which says:--

*‘...tax design in a complex environment is as much art as science and one in which judgement is often as important as a fact and analyses.’*⁶⁶²

Besides that, economic efficiency can also be assessed from the burden of taxation⁶⁶³, unleashed by tax rates. It confirms the earlier suggestion that the lower the tax rates, envisaging a low tax burden, the lesser the distorting effect on choices and the lesser the adverse effect on the rate of economic growth.⁶⁶⁴

⁶⁶⁰ Bain, above n 623, 2.

⁶⁶¹ Meade Report, above n 543, 11.

⁶⁶² Ralph et al (Discussion Paper), above n 598, 67.

⁶⁶³ Dirkis, above n 555, 50.

⁶⁶⁴ Carter Report, above n 546, 118.

4.5 Approach Adopted in the Thesis

This thesis analyses qualitatively common PIT designs (Chapter 7) and the Pakistani PIT system (Chapter 10) from a legal perspective, against all the facets of the neutrality criterion. Additionally, for a comparative analysis of PIT designs, the thesis will examine which proxy base, when used in PIT, has more or less deadweight loss in terms of its ability to substitute it with another base to avoid tax; or shifting the tax burden (see Section 3.2 of Chapter 7). The thesis will also examine whether PIT, being a simple tax for reducing compliance costs, is adversely affecting the neutrality criterion.

5. Equity

The term equity is used for even-handed treatment of taxpayers in a tax system. The equity concept conventionally has two facets. First is known as horizontal equity, which says that taxpayers under identical economic circumstances should be taxed identically.⁶⁶⁵ Second is the concept of vertical equity, which postulates that taxpayers under different economic circumstances should be taxed differently.⁶⁶⁶ In other words, the better the economic circumstances (i.e. higher ability to pay) of a taxpayer the more he/she should contribute to the treasury.⁶⁶⁷

The equity principle is defined with respect to these facets in the following paragraphs.

⁶⁶⁵ Ralph Review, above n 548c, 63; also see ‘*Reform of Australian Tax System*’ Draft White Paper Australian Government Publishing Service, Canberra, 1985, 14.

⁶⁶⁶ Ralph et al (Discussion Paper), above n 598, 63; Draft White Paper, above n 665b, 14.

⁶⁶⁷ In order to bring fairness in income tax, the ‘theory of benefits’ was also propagated by many scholars (for details see Edwin Robert and Anderson Seligman *The Income: A study of History, theory and Practice of Income* (Third edition, 2005) 157-161; also see Edmund James Janes, Roland Post Falkner, Henry Rogers Seager and Emory Richard Johnson *Annals of the American Academy of Political and Social science* (1921) Volume 93-95 American Academy of Political and Social Science Cornell University, 169. The benefit theory suggests that a person should be charged income tax on the basis of level of the use of public services rather than income level, which means the greater the use the higher should be tax liability.

5.1 Choices for Vertical Equity (Distribution of Income)

Vertical equity requires for more contribution by those who have a higher ability to pay.⁶⁶⁸ In regard to vertical equity, Smith's canons lay down a principle⁶⁶⁹ that:--

*"The subjects of every state ought to contribute towards the support of the government, as nearly as possible in proportion to their respective abilities."*⁶⁷⁰

Although Smith mentions only one option, in order to raise more revenue, the state has three options: large income earners should pay progressively more⁶⁷¹ or proportionally more⁶⁷² or regressively more⁶⁷³. Depending on the nature of government spending and on the structure of the rate scale, each of those approaches can redistribute income from the rich to poor.

However, all these options are contradictory to the idea of neutrality in tax treatment i.e. the tax treatment should be even handed and fair for all taxpayers. As mentioned

⁶⁶⁸ In respect of the ability to pay, this thesis will follow the money concept of income and economic concept reflecting the ability to earn. Other economic and psychological concepts in this regard such as well being will not be adopted.

⁶⁶⁹ Musgrave says that this principle of Smith includes both 'ability to pay' and 'benefit' elements (see Richard A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (1959, McGraw – Hill London), 66).

⁶⁷⁰ Smith, above n 558, 451.

⁶⁷¹ Alley and Bentley, above n 539, 604 put it more clearly that progressive tax system require to pay more tax and also at a higher marginal tax rate.

⁶⁷² McCaw P.M., *New Zealand Report of the Task Force on Tax Reform* (1982), 68; it is also explained in the following words '.... A household with, say, twice as much income, would pay twice as much in taxes' (see Wildasin, above n 617, 3).

⁶⁷³ It is rightly opined that 'even with a somewhat regressive income tax--- one under which a household with twice as much income would pay, say, one and one half times as much in taxes ---- the tax system could still attach higher tax burdens to households with higher ability to pay' (see Wildasin, above n 617, 3). It shows that there is no need to follow the high marginal tax rates to meet the principle of vertical equity particularly, when it hurts the economic choices and growth. This approach includes both 'theory of sacrifice' and 'ability to pay'. Under this approach of equal absolute sacrifice, tax rates are to be adjusted to the phenomenon of declining marginal income-utility with increasing income. Where the utility decline is at the higher percentage rate at which income increases, progressive rate is recommended. Where the utility decline is at the same percentage rate at which income increases a proportional rate is required. Lastly where the decline of utility is at rate a less than that at which income increases regressive tax rate is required. More simply, economists, in order to achieve equity, recommend calibrating the tax rate structure on the basis of marginal income utility. Under this concept if marginal income utility is constant over the relevant range, equal amount of tax is required at different levels of income (that means, no distribution and all individuals are already equals). However, it is very difficult to practically implement this rate structure due to the involvement of measuring of utility (for details see Richard Musgrave, *The Theory of Public Finance: A study in Public Economy* (1959, McGraw Hill London), 96, 98, 99).

earlier, neutrality is a bedrock principle of equity. It means that the tax treatment should be 'neutral' for all taxpayers and should not discriminate between taxpayers.

Moreover, on the platform of neutrality, principles of equity and efficiency go hand in hand.⁶⁷⁴ The very idea of taxing a comprehensive income base confirms neutrality as the cornerstone for both these principles.⁶⁷⁵ Draft White Paper also argues 'that is to say, efficiency like equity is generally enhanced by the adoption of a comprehensive income base'⁶⁷⁶. It shows that observing the principle of neutrality secures both horizontal equity and efficiency.

On the other hand, all options in vertical equity, by taxing a person or business more for their higher ability to pay, jeopardizes the neutrality principle, discriminates between taxpayers and results in economic inefficiency. For example, two persons 'A' and 'B' were in the same economic circumstances at the beginning of a financial year. But at the end of the year, person 'B' is in a better economic position than person 'A' because he/she made more effort than person 'A'. A tax system that then imposes a higher burden of tax on 'B' favours the low performer against the high performer. Consequently, the high performer acting rationally would choose leisure over work in the next financial year.

This non-observance of neutrality generally violates both efficiency and horizontal equity principles. However, this clash is severe when the tax system is progressive (that is, higher tax rate on additional income) and is moderate when the tax system proportionally charges more on the high income earners (that is, taxing additional income at the same rate). The clash is mild under a regressive tax system which charges less tax on additional income (that is, lower tax rate on additional income).⁶⁷⁷

In order to prevent the above mentioned clash, it may be suggested that vertical equity should be achieved by taxing those which have higher opportunities such as assets or

⁶⁷⁴ Ralph et al (Discussion Paper), above n 598, 75.

⁶⁷⁵ Ralph et al (Discussion Paper), above n 598, 67.

⁶⁷⁶ Draft White Paper, above n 665b, 15.

⁶⁷⁷ Regressive tax does not undermine vertical equity, because the one who earns more is contributing more. Though the reduction in the tax liability with increasing income is questionable under pure equity considerations, but paying relatively less tax on each extra dollar earned is surely rewarding from an efficiency perspective.

qualifications⁶⁷⁸ at a higher rate; and horizontal equity should be secured by putting identical burden on persons having identical opportunities. But when tax is levied on opportunities it loses the character of income tax. On the other hand, in its actual form, income tax is prone to produce a disincentive for work and economic growth when taxed at progressive rates.⁶⁷⁹

In view of the above, the neutrality principle should be applied in the 'performance' of taxpayers and vertical equity should be sought in terms of 'opportunities'. In other words, both good and poor performers should be taxed identically and for achieving vertical equity, different levels of opportunities should be taxed differently (that is, neutrality be ignored). For example, there are two business entrepreneurs 'A' and 'B' having business assets of A\$100,000 and A\$200,000 respectively. If 'A' and 'B' earn profit of A\$30,000 and A\$20,000 respectively and pay tax for their income (performance) at progressive tax rates rather than identical tax rate, then person 'A' will pay more tax only because he performed better. Though 'A' will still pay more tax when identical tax rate would be applied, the impact would be less. Therefore, neutrality in tax rates may be recommended when tax is charged on performance. If tax is levied on assets (that is, opportunities) then progressive rates would result in higher tax liability for person 'B'. Persons having higher ability to earn should maintain higher ability to pay. Persons with higher economic resources should bear higher tax burden. This lack of neutrality due to progressivity of tax rates on assets achieves vertical equity and such tax on assets would encourage better performers as compared to income tax punishing better performers.

Subject to nature of tax, the choice of option as to whether the tax system should be progressive, proportional or regressive (i.e. tailored to encourage work without blatantly violating the equity principle), 'involve value judgements, which constitute a basic task for political decisions'⁶⁸⁰. In case the redistribution of income is the prime objective in a country, then the choice should be progressive tax and when efficiency is the objective then proportional or even a regressive tax could be fine. In all, it is a trade off between

⁶⁷⁸ It can only be charged as PIT.

⁶⁷⁹ This is not the case with the other taxes e.g. GST. For instance, higher GST on wasteful goods will even have beneficial substitution effects and would not impair the economic growth.

⁶⁸⁰ Meade Report, above n 543, 16.

the efficiency and the equity principle.⁶⁸¹ The extent of the trade off depends on how much equality⁶⁸² is seen as important for a good society (For details see Section 5.2 of Chapter 6).

5.2 Horizontal Equity for Promoting Voluntary Compliance

Besides the distribution of income, equity in general and horizontal equity in particular is crucial in the tax system for a number of reasons. First, it inculcates the perception of fairness about the system. An equitable tax treatment is synonymous with the fairness of the tax system and considered as a cornerstone for encouraging voluntary compliance.⁶⁸³ This aspect of the equity matches the definition of fairness adopted by the OECD that “... the potential of evasion should be minimized”⁶⁸⁴. This is especially required in the developing countries with a large informal sector, where the perception of unfairness and the lack of legitimacy of the tax system is the main cause of widespread non-compliance.⁶⁸⁵ Therefore, ‘it is important that the public perceives the tax system as fair’⁶⁸⁶. More importantly, if the unfairness of the tax system is left unchecked, then it even disrupts the social and political fabric of the country.⁶⁸⁷

The Meade report, by following the maxim that ‘an old tax is a good tax’, suggests the perception of fairness is tarnished when the law is frequently changed, even when the changes bring equality among post tax incomes.⁶⁸⁸ However, this may not be used as an excuse for continuously retaining the inequitable provisions of a tax code. A change to more equitable provisions would provide better economic choices in the future.

⁶⁸¹ Meade Report, above n 543, 12.

⁶⁸² Equality is the objective to achieve through the use of the redistribution principle of taxation, hence, it should not be considered as synonymous with equity.

⁶⁸³ Draft White Paper, above n 665b, 14 mentions that an equitable tax system is critical not only to the attainment of economic and social objectives, but also for the maintenance of a basic respect for a tax system, which consequently generates a high degree of voluntary compliance.

⁶⁸⁴ OECD Compliance Report, above n 551, 6; it shows that ensuring the compliance and eliminating tax evasion, which is common in the informal economy, is crucial for attaining equity.

⁶⁸⁵ Ralph Review, above n 548c, 15 says that a tax system, which tolerates significant levels of the avoidance, cannot be equitable and can be expected to fall into disrepute as the community witnesses the unfair outcomes.

⁶⁸⁶ Alley and Bentley, above n 539, 622.

⁶⁸⁷ For instance, the revolt of 1381 was ignited from hatred of the poll tax, in which, the Archbishop of Canterbury was beheaded (for details see David F. Burg, *A world History of Tax Rebellions: An Encyclopaedia of Tax Rebels, Revolts and Riots from Antiquity to the Present* (2004) 128-130).

⁶⁸⁸ Meade Report, above n 543, 13.

Some scholars are less sanguine about securing absolute horizontal equity.⁶⁸⁹ They believe that intending to do so usually makes tax complex, which causes erosion of simplicity.⁶⁹⁰ The lack of simplicity mostly results in non-compliance, which ultimately results in the unfairness of the tax system⁶⁹¹, as discussed in Section 4.1.1 of Chapter 2. The attainment of total equity in the tax system is therefore an almost unachievable task. Consequently, it is suggested that while fixing the equity principle, only extreme differences or inequitable treatments should be targeted.⁶⁹²

Further, it may be noted that achieving equity in some cases is harder than others. For instance, in the large corporate sector, it is easier to achieve neutrality in tax treatment, because most transactions are documented in this sector. In small businesses, who themselves do not accurately know their incomes, achieving absolute equity is mostly an unachievable objective. Beyond that, complexity may provide an opportunity to large taxpayers to avoid tax, which small business cannot afford to avail themselves of⁶⁹³ and this becomes a source of inequality.

Conclusively, the principle of horizontal equity needs to be adjusted to the types of taxpayers, level of simplicity required and the extent of non-compliance in the country (see Section 5.1 of Chapter 6 for trading off equity against simplicity). These suggestions are considered while drawing conclusion from an analysis of the Pakistani PIT in this thesis.

5.3 Approach Adopted in the Thesis

For making decisions regarding the sufficiency of equity in a tax system, it may be conceded in the beginning that ‘measuring equity is not easy’⁶⁹⁴. Empirical evaluation is

⁶⁸⁹ Dirkis, above n 555, 45.

⁶⁹⁰ Asprey Report, above n 542, 48. It is also noted that even if theoretical equity were possible it would be obtained, only if it is without adding to the complexities of the present system, which create difficulty in the administration and irate taxpayers, with the result that whole Act tends to get condemned as unintelligible and oppressive.

⁶⁹¹ Vedder and Gallaway, above n 548b, 7 also mentions that ‘as income tax code becomes more complex, there is a greater probability of creating significant horizontal inequities’; also see Ralph et al (Discussion Paper), above n 598, 65.

⁶⁹² Quoted from Review Business Taxation in Walpole, above n 548a, 23.

⁶⁹³ Cooper, above n 566, 427, 458.

⁶⁹⁴ Asprey Report, above n 542, 13; Meade Report, above n 543, 13 states that unfortunately, in considering the tax side of the budget equation neither ‘horizontal equity’ nor ‘vertical redistribution’

not possible due to the multiplicity of the variables involved and innumerable categories and levels of income in an economy.

Nevertheless, a qualitative analysis may be done in respect of a tax system to identify the areas where the horizontal equity principle is compromised. It may be acknowledged that the areas of neutrality to be tested in the efficiency principle will have repercussions in the analysis of horizontal equity as well. Nevertheless, as discussed in Section 3.3, when equity is concerned more emphasis is on the neutral tax treatment of individual taxpayers whereas under the concept of efficiency, the focus is on the neutral tax treatment of industrial sectors. The areas where it should be given more focus, particularly with reference to the informal economy are given below:

- i. Neutrality in tax treatment between employees and self-employed
- ii. Neutrality of tax treatment between taxpayers of services, manufacturing and trading sectors
- iii. Neutrality of tax treatment among low and high turnovers and incomes - are these treated as the identical economic circumstances?
- iv. Neutrality in the expenditures (exemptions) for various taxpayers
- v. Taxing all types of income: Comprehensiveness of income
- vi. The extent of progressivity of tax rates
- vii. Uniformity in administrative and compliance requirements⁶⁹⁵
- viii. Continuum of simplicity and fairness in relation to the type of taxpayers
- ix. The perception of fairness in controlling the evasion

This thesis examines horizontal equity in common PIT designs (Chapter 7) and in the Pakistani PIT system (Chapter 10) in this context of neutrality of tax treatment. This thesis examines vertical equity in the context of neutrality at the performance level and at opportunities level and progressivity of tax rates. Additionally, some value

are in fact straightforward simple objectives, and in judging any particular tax structure, it is necessary to consider in more detail, how these ideas should be interpreted.

⁶⁹⁵ Ross S and Burgess P, *Income tax: A Critical Analysis* (Second edition, 1996), 26; It suggests that the compliance burden on taxpayers should be proportionate to their ability to bear that burden. It supports simplified regime for small business. Alm, above n 191, 125 state that distribution of the burden (technical or operational costs) is the reflection of the fact that how far tax regime is equitable.

judgements may be made which the author believes should command the agreement of political thought in the developing countries.⁶⁹⁶

6. Conclusion

The review of the literature and concepts of principles of a good tax system shows that there are three core principles. These are simplicity, efficiency and equity. Each core principle has multiple facets. For a good tax system it is essential that it does well in respect of each principle as well as each facet. However, the relative significance of each principle and each facet varies in accordance with requirements of each economy.

For assessing simplicity, which reflect low technical and compliance complexity, it is advised to follow a non-linguistic qualitative analytical approach for its technical part; and qualitative analytical approach for its compliance part. This approach is appropriate both for the comparative analysis of PIT designs (Chapter 7) and the case study of the Pakistani PIT (Chapter 10) in this thesis.

For evaluating efficiency, which mainly is based on the ten facets of neutrality in taxation, it is recommended to examine provisions of tax legislation from a legal perspective in order to ascertain whether these are neutral in terms of the tax treatment or not. This approach is suitable for the case study of Pakistani PIT in this thesis. In respect of the comparative analysis of popular PIT designs, it is recommended that a theoretical analysis be undertaken to determine the ability of each design and its proxy base to achieve neutrality.

To estimate horizontal equity, this chapter recommends the approach almost identical to that for the efficiency principle, because the equity principle also rests on the concept of neutrality of tax treatment. However, for horizontal equity, neutrality is to be seen between individual taxpayers, whereas in efficiency, neutrality is to be seen in the context of industrial sectors. On the other hand, vertical equity may be assessed by looking at the degree of progressivity of tax rates.

Lastly, after defining the principles of a good tax system in this chapter, these can be prioritized against the needs of small business in large informal economies. Such a

⁶⁹⁶ Similar approach is taken in the Meade Report, above n 543, 16.

ranking of principles of a good tax system in context of large informal economies is attempted in the next chapter.

CHAPTER 6 PRIORITIZING PRINCIPLES OF A GOOD TAX SYSTEM FOR LARGE INFORMAL ECONOMIES

Scope of this Chapter: After defining the principles of a good tax system in the preceding chapter, this chapter ranks the principles of a good tax system in the context of large informal economies. This ranking suggests to placing simplicity, efficiency and equity as the first, second and third priorities respectively in order to successfully implement income tax in large informal economies.

1. Introduction

Following the analysis of the principles of a good tax system in Chapter 5, this chapter is concerned with ranking these principles in terms of tax policy priorities. It is widely acknowledged that adherence to these principles depends upon the facts and circumstances of each country, because it may not be possible to religiously meet all the principles in all circumstances of every country. Sandford rightly said that: ‘It is impossible to postulate entirely satisfactory principles’.⁶⁹⁷ Therefore, one principle can be foregone for the sake of another if the particular circumstances of a country demand so.

In this Chapter, the analysis of the synergies as well as clashes among the core principles of simplicity with equity and efficiency in the context of the informal economy shows that a simple tax is better than a complex one in controlling losses on the equity and efficiency fronts. Further, simplicity and efficiency should be held dearer than equity in informal and developing economies for fostering economic growth. In a similar vein, vertical equity may be foregone for the sake of securing efficiency in the tax system. Finally, this chapter suggests the use of the same ranking for comparative analysis of popular PIT designs and the examination of Pakistani PIT legislation in subsequent chapters of this thesis. More broadly, the ranking of simplicity, efficiency and equity as first, second and third priorities in order of their importance for tackling the informal economy should be the corner stone of analysis for PIT designs and legislation.

⁶⁹⁷ Cedric Sandford, *Economics of Public Finance* (Fourth edition, 1992), 112.

The remainder of this chapter proceeds as follows. Section 2 mentions the need of prioritizing the principles of good tax system. Section 3 identifies the complementary principles of a good tax system, with Section 4 explaining the conflicts amongst these principles. Section 5 attempts to reconcile the conflicting principles in the context of needs of small business in the informal sector. Here priorities are also set in framing tax policy for large informal economies. Section 6 summarizes the approach to be adopted in this thesis for the comparative analysis of popular PIT designs; and for an analysis of Pakistani PIT against the principles of a good tax system. Section 7 concludes this chapter.

2. Need for Ranking the Principles of a Good Tax System

The review of the principles in the preceding part shows that some principles have complementary tendencies while others have competing tendencies. The virtue of good tax policy is to reconcile the competing principles without losing synergies with the complementary principles of taxation. When the reconciliation appears an unachievable task, then the principle which most closely matches the national policy objectives may be preferred over the other. The national policy objectives are the primary goals to be secured and principles may need to be traded off against others in order to achieve those goals. In the words of the Carter Commission: ---

*“We realize that some of the objectives [Principles] are in conflict, in the sense that movement towards one goal means that others might be achieved less adequately.”*⁶⁹⁸

Thus, not achieving all of the principles of a good tax system should not be treated as a failure of the tax policy, as long as it is admitted after drawing a consensus based on a value judgement. It is rightly held that

*‘..For development of tax policy, judgement[s] has to be made and accepted about tradeoffs between particular objectives [principles]’*⁶⁹⁹.

⁶⁹⁸ Carter Report, above n 546, 17.

⁶⁹⁹ Ralph Review, above n 548c, 13.

Walpole called this prioritising ‘subject to the values and perceptions of the compiler of the list’,⁷⁰⁰ but in reality, they are the reflection of the national policy objectives and relevant political choices. It is also viewed that the country’s tax system is a reflection of the fundamental political and philosophical choices.⁷⁰¹ The rankings of the principles involving compromises of this sort should match the specific circumstances of the jurisdictions, for which the tax policy is designed.⁷⁰² The Ralph Discussion Paper stated that the weightings in this regard are based on the relative importance of the each principle.⁷⁰³ It is acknowledged that the determination of the relative importance of each principle in tax design is a prerogative of the government and politicians.⁷⁰⁴ Nevertheless, academics and researchers can pass value judgements for given circumstances, which they hope would command a political consensus and ‘concerns of taxpayers rights’,⁷⁰⁵ as well.⁷⁰⁶

The first step towards the ranking of principles for tax design of the developing countries, which suffer from large informal economies, is to identify the synergies and conflicts among the principles.

3. Identifying the Complementary Principles

Dirkis identifies the synergism between horizontal equity and efficiency.⁷⁰⁷ As discussed in Section 5.1 of Chapter 5, neutrality in tax treatment is a bedrock principle of both equity and efficiency. Horizontal equity, by taxing equals, equally helps to secure efficiency by neutralizing the commercial choices.⁷⁰⁸

⁷⁰⁰ Walpole, above n 548a, 30.

⁷⁰¹ Bird, above n 439, 93.

⁷⁰² Wildasin, above n 617, 7 advises sensible balance among all principles. It may be pointed out that this is not a matter of achieving mechanical balance, but this is necessary to give one principle more weight and preference against another in accordance with the requirements of a particular jurisdiction. Even Alley and Bentley, above n 539, 582 stated that these principles could be mutually exclusive. The value judgements may be applied in setting out the priorities.

⁷⁰³ Ralph et al (Discussion Paper), above n 598, 65.

⁷⁰⁴ Ralph et al (Discussion Paper), above n 598, 66.

⁷⁰⁵ Bentley, above n 554, 83.

⁷⁰⁶ Meade Report, above n 543, 16.

⁷⁰⁷ Dirkis, above n 555, 77.

⁷⁰⁸ Australia, ‘*Review of International Tax Arrangements*’ The Treasury Commonwealth of Australia, 19 September 2002, 84.

Simplicity has synergies with efficiency by neutralizing the tax avoidance opportunities particularly between large and small business. That is, not every taxpayer has an equal ability to thrive on complexities/ambiguities of tax system. In a complex tax system, large businesses benefit through tax planning whereas small businesses cannot take advantage of such tax planning opportunities. Further, a complex tax system puts proportionately higher compliance costs on small business as mentioned earlier. Consequently, a complex tax system ultimately results in a loss of neutrality where as a simple tax system brings neutrality in that context.

In the same vein, simplicity can also complement horizontal equity, because taxpayers under identical circumstances, irrespective of their tax planning abilities, would pay the same tax. In other words, a complex tax system provides opportunities – particularly to large businesses – to pay less tax through tax planning. Thus, simplicity in the tax system ensures that equals be treated equally by reducing tax avoidance opportunities and promotes horizontal equity.

Further, simplicity also complements efficiency by reducing compliance and administration costs. The broadening of the tax base through improved compliance by simplicity also complements efficiency. These synergies of simplicity with efficiency are in addition to those arising from its ability to reduce tax avoidance opportunities. However, the simplicity linked synergies turn into conflicts when a tax system becomes too simple or too complex, as discussed in the subsequent section.

4. Identifying the Competing Principles

The competing tendencies are more commonly seen among the principles. A brief account of these tendencies is given below.

4.1 Simplicity and Equity

Although it is generally believed that simplicity is in contradiction with equity⁷⁰⁹, the relationship between these two principles is actually quite convoluted. When tax is too simple in technical terms, then there is a possibility that some of the circumstances of

⁷⁰⁹ Dirkis, above n 555, 74; Tran-Nam, above n 557, 248.

taxpayers will not be captured⁷¹⁰, resulting in a loss of neutrality and consequently horizontal and vertical inequities. On the other hand, when all possible scenarios of individuals are incorporated, the law becomes so complex that it creates opportunities for tax avoidance, which will also result in a loss of neutrality and inequity.⁷¹¹ This conflict is more serious for small businesses due to their inability to take advantage of tax avoidance opportunities.⁷¹² This shows that simplicity in either extreme (both high levels of simplicity and high levels of complexity), can clash with the principle of equity.

4.2 Simplicity and Efficiency

Consistent with Section 5.1 of Chapter 5, equity and efficiency go hand in hand, with extremes in simplicity having the same repercussions on efficiency as they will on equity. This is primarily because both horizontal equity and efficiency rests on the concept of neutrality, which is disturbed by both very simple and very complex tax systems.

However, it may be noted that some loss of neutrality in a very simple tax system, on account of not being able to incorporate all individual situations, may be offset by improvements in neutrality due to fewer tax avoidance opportunities, fewer tax incentives (which are a major source of complexity) and low compliance costs (which are relatively high for small businesses in a complex tax system). More simply, a loss of neutrality due to simplicity in the tax system is better than the neutrality lost under a complex tax system. More pertinently, when compared to a complex tax system, a simple tax promotes equity and efficiency by neutralizing tax related economic choices, which thrive on its complexities. This is specifically true in respect of the small business sector.

A contrasting view is put forward by Tran-Nam, who considers that the broadening of taxpayer base through simplicity increases the compliance costs of the economy as a

⁷¹⁰ Dirkis, above n 555, 77 called this an attempt to individualize the tax system: Ralph et al (Discussion Paper), above n 598, 65 mentions that complexity in the tax system is created for the same reason.

⁷¹¹ Cooper, above n 566, 458.

⁷¹² Tax incentives also create complexity and these are inherently against equity and even accentuating this conflict.

whole and causes ‘tension between economic efficiency and effective simplicity’.⁷¹³ His view is inconsistent with the fact that registering more taxpayers on the tax roll has offsetting effect by taxing a comprehensive income base, which consequently meets the neutrality criterion and promotes economic efficiency. Therefore, an increase in compliance costs is not a sufficient reason not to broaden the tax base. Moreover, a simplified PIT regime would incur relatively fewer compliance costs than the normal income tax regime, and would not have a significant impact on overall economy.

4.3 Efficiency and Vertical Equity

Consistent with Section 5.1 of Chapter 5, the principle of vertical equity, which is based on the ability to pay, tends to seriously clash with the principle of neutrality and consequently with the efficiency principle. This conflict is recognized as a rule rather than an exception.⁷¹⁴ This may be because collecting more tax from those who are making more profits has caused a disincentive to work and invest. Consequently, this conflict may have a serious negative impact on developing countries, which have been struggling to improve their economic growth rates.

5. Resolution of the Conflicts

Consistent with the preceding section, there are two major conflicts in the principles. The first conflict is the one between simplicity, equity and efficiency, which fundamentally emanates from the clash of simplicity and neutrality (which is bedrock for both equity and efficiency). The second conflict is between efficiency and vertical equity. Suggestions for resolving these conflicts are provided below.

5.1 Simplicity versus Equity (Horizontal) and Efficiency

The pursuit of equity is the hardest of all tasks, even in developed economies. As a result, some of these countries primarily focus on improving efficiency and simplicity.⁷¹⁵ The Asprey Committee admits that this conflict is irreconcilable, perhaps in context of neutrality, and as a result priorities have to be determined. The report

⁷¹³ Tran-Nam, above n 567, 527.

⁷¹⁴ Wildasin, above n 617, 7.

⁷¹⁵ James and Wallschutzky, above 606, 450.

stated: ‘A country may have a simple and efficient taxation system or an equitable one but not both’⁷¹⁶

Despite this admission, it is noted that in the conflict between simplicity and neutrality (which is bedrock of equity and efficiency) the extremes of simplicity are the source of conflict. Further, as compared to a complex tax system, a simpler one is better, because it has some offsetting positive effects as well.

Further, it is argued that the extent of this conflict is overstated, because a large amount of complexity in the tax code arises from provisions which are complex as well as inequitable. Such complexity in tax codes may be eliminated without disturbing the equitable provisions.⁷¹⁷ More aptly, those complex provisions in the tax code, which may also be inequitable and detrimental to economic growth, should be omitted immediately.

Similarly, it is noted that the achievement of neutrality is not only connected with the complexity of the tax system, which is a result of an attempt to include individual situations in tax code, because neutrality has some facets which are completely unrelated to complexity. These facets include neutrality in tax rates, neutrality in risk taking, neutrality in capital structuring, and neutrality for all classes of income.⁷¹⁸ Therefore, a good degree of neutrality in the tax system can be achieved without making it complex. More simply, choosing to prioritise simplicity would not result in the entire tax system being inequitable.

For the informal economy, it is appropriate that the tax system should be simple in order to reduce compliance costs. Consistent with Section 4.1.1 of Chapter 2, tax complexity, by encouraging avoidance, usually creates serious injustices between those who are able and those who are unable to take advantage of tax avoidance opportunities.⁷¹⁹ Moreover, the tax system should be simple both in terms of technical and operational complexities in order to encourage voluntary compliance. This recommendation is

⁷¹⁶ Asprey Report, above n 542, 21.

⁷¹⁷ Cooper, above n 566, 429.

⁷¹⁸ Guenther, above n 429, 26 states: ‘Economic theory holds that the efficiency losses caused by income tax are minimized, when taxes do not distort production arrangements within the firms and all returns to capital are taxed at the same rate’.

⁷¹⁹ Tanzi and Casanegra above n 32a, 5.

based on the prevailing inequity and inefficiency, which emanates from the high level of non-compliance in the informal sector and the inability of the tax administration to implement a complex tax system due to the perception of unfairness. The Ralph Review categorically stated that:--

*'A tax system, which tolerates significant levels of avoidance, cannot be equitable and can be expected to fall into disrepute as the community witnesses the unfair outcomes',*⁷²⁰

This disrepute of the tax system is well experienced in developing countries. Even in a 1999 UK Report, fairness is only referred to in terms of the effectiveness of taxation. It is argued that 'the tax rules should not result in either double or unintentional non-taxation',⁷²¹. Even the AICPA have coined a new principle, suggesting that the tax structure should be designed to minimise non-compliance.⁷²² The equity and efficiency achieved by ensuring compliance and encouragement of formal activities through a simple regime should be preferred over theoretical ideals of equity and efficiency under a complex system. Essentially, a simple tax system meets most of the principles of a good tax system by reducing the compliance and tax administration costs, and this is a sensible way to resolve conflicts among them.

Alm endorses this viewpoint in a novel way. He excludes the simplicity principle and recommends tradeoffs in the other three principles, which include revenue yield, equity and efficiency. The revenue yield here depicts the importance of compliance. In his view, the complexity of the tax system is reflected in equity and efficiency by influencing the behaviour of the taxpayers and tax administrator.⁷²³ Thus, non-compliance and an inability to enforce the tax regime causes both equity and efficiency losses. It shows that compliance and enforcement, both of which hinge upon simplicity, are crucial for achieving all other principles. Alm even alleges complexity is retained in

⁷²⁰ Ralph Review, above n 548c, 15.

⁷²¹ I. Lejeune, M. Joostens and Bert Mesdom, 'VAT on Electronically Supplied Services: The Rules are known – What is the reality?' (2004) 2 (1) *Tax Planning International Indirect Taxes* 7, 9: Though this argument is specifically given in context of GST/ VAT regime, it is equally applicable in income taxation, where rules affect profit and loss by influencing the admissibility of deductions.

⁷²² AICPA Report, above n 552, 13.

⁷²³ Alm, above n 191, 125-126.

the law, despite its equity and efficiency costs, for the vested interests of some groups in society.⁷²⁴

Consistent with Section 4 of Chapter 4, in order to ensure compliance, particularly in informal economies, it is even recommended that taxpayers, who are incapable of keeping accounts, may be exempted from the normal income tax by setting a high tax free threshold or may be subjected to the simplest of tax systems such as presumptive tax.⁷²⁵ This is advised because the underlying causes of high compliance costs (such as the cost of proving deductions being higher than the tax liability)⁷²⁶ show that it is not possible to tax small businesses under the normal income tax in developing countries. Without effective implementation of a tax system, the entire issue of complexity and equity becomes virtually irrelevant.

The Ralph Discussion Paper also recommended that ‘substantially increased weighting be accorded the national objective of simplification’⁷²⁷. This is more appropriate for developing countries with large informal sectors for the reasons enumerated earlier when discussing the causes of an informal economy. For small businesses, the Bell Task Force suggests a simplification and reduction of compliance costs, in order to ensure compliance. It states:

*‘the complexity of regulations, the frequency of complying and coping with constant changes, and the time needed to comply with the record keeping requirements, added to the frustration felt by small business’*⁷²⁸

The preference for simplicity is also in line with Warren’s argument that ‘because each criterion is often in conflict, what constitutes good tax design is overall problematic... [consequently] then what reforms are good reforms is problematic’⁷²⁹. He, therefore,

⁷²⁴ Alm, above n 191, 131.

⁷²⁵ Lee Burns “*Taxation of the Small Business Sector*” paper presented at the Third Annual Meeting of the Pacific Islands Tax Administrators’ Association, Raratonga, Cook Islands, 8 August 2006, 2; The PIT is also recommended and accepted as a right balance between the equity and simplicity (see Stern and Loeprick, above n 60, 10).

⁷²⁶ As discussed in detail in the causes of informal economy in Chapter 2.

⁷²⁷ Ralph et al (Discussion Paper), above n 598, 66.

⁷²⁸ Australia, ‘*Time for Business*’ Canberra, 1 November 1996, 16 <http://www.daf.gov.au/reports_documents/pdf/time_for_business.pdf> at 10 October 2009, (the Bell Report).

⁷²⁹ Warren, above n 657, 8.

suggests developing more practical and limited criteria by focusing on only one of the good tax system criteria.⁷³⁰ In the case of the informal economy, keeping in mind its causes, the single most practical principle for the tax system should be that of simplicity.

Moreover, consistent with Section 3.4 of Chapter 4, in the informal sector, de-facto equity and efficiency should be an aim of the tax system. This is because theoretical targets for these principles under the ideal regime, if followed in developing countries, result in more inefficiencies and inequities. In the same vein, Newbery argues that one of the most important features of developing countries with large informal economies is that many taxes, including income tax, have only partial coverage and this significantly alters their incidence and consequently their equity. He further adds that personal income taxes are relatively ineffective instruments when covering only a small percentage of the population.⁷³¹

Beyond that, what may be an agreed position of the most powerful economies in respect of the principles of a good tax system may not be suitable for developing economies. Alm rightly suggests that the reforms and tradeoffs in tax policy should take into account the relevant circumstances of the country in question.⁷³² Therefore, the recommendation of Tran Nam that ‘tax simplification at the expense of other objectives of the tax system may not be a desirable thing’⁷³³ could be suitable for Australia rather than a developing country with a large informal sector. In a similar vein, ‘placing the simplicity next to the equity and efficiency’⁷³⁴ may be appropriate in developed countries, but may not be appropriate for developing ones.⁷³⁵ Developed countries can afford a more complex tax system, because of proportionally low costs of compliance, and the presence of high literacy and compliance culture. Developed countries can

⁷³⁰ Warren, above n 657, 9; Sandford, above n 697, 112 also emphasized a need for a practical compromise for achieving a suitable trade off.

⁷³¹ Newbery, above n 178, 203.

⁷³² Alm, above n 191, 118.

⁷³³ Tran-Nam, above n 557, 249.

⁷³⁴ Sandford, above n 697, 112.

⁷³⁵ In Australia, Asprey Report, above n 542, 45 at Para 3.19 also puts simplicity after equity. Slemrod, above n 583, 46 also gives the equity highest preference against the other principles of taxation.

afford to lose simplicity for the sake of fairness.⁷³⁶ However, this is not recommended for developing countries, where it is better to forego some degree of fairness for the sake of simplicity. Not doing so leads to a higher degree of non compliance and consequently more unfairness. The same is recommended by Toye in context of Indian land tax, a type of direct tax.⁷³⁷

An alternative choice is to make the tax system more complex by individualizing the system while ensuring the neutrality of tax burden. However, as discussed in Section 3 of Chapter 4, it is virtually impossible to tax the small incomes of many individuals in developing countries on an actual basis, particularly without making it a complex and costly process. Thus, perception of fairness may be improved by a less ideal and simple tax which promote compliance and generate optimum revenue.⁷³⁸

As discussed in Section 2, trade off among principles of a good tax system should be made in accordance with requirements of each economy. Therefore, in developing countries with large informal economies, simplicity should be preferred over equity and efficiency.. However, this preference should be subject to the earlier finding that absolute simplicity is not the objective, and a suitable place in the continuum of simplicity and complexity may be preferred for each developing country in light of its particular circumstances. Finally, the recommendation of simplicity does not mean that all facets of neutrality can be ignored. Simplicity here is specifically recommended to reduce compliance costs resulting from technical complexity and the regulatory burden.⁷³⁹ For example, the costs of filing a return can be avoided for taxpayers whose tax is deducted at source.⁷⁴⁰

⁷³⁶ The equity is preferred over efficiency for Canada, another developed country (see Carter Report, above n 546, 182.

⁷³⁷ J.F.J. Toye, 'Equity v. Ease in Indian Land Tax Policy' in J.F.J Toye (ed.) *Taxation and Economic Development* (1978), 222.

⁷³⁸ It is suggested to collect revenue and make appropriate expenditure programmes more robust to redistribute income (see Richard Bird and Eric M. Zolt, 'The Limited Role of Personal Income Tax in Developing Countries' (2005) 16(6) *Journal of Asian Economics* 928, 929-931) and improve perception of fairness.

⁷³⁹ Vedder and Gallaway, above n 548b, 14 noted that massive complexity of a tax system increases horizontal inequity by promoting non-compliance.

⁷⁴⁰ James, above n 601, 11.

The recommendations made here for tax systems in developing countries are consistent with the findings in Section 4.2 regarding simplicity, which suggests that simplicity reduces compliance costs, helps weak administration in tax enforcement, and improves the perception of fairness in the tax system. All these factors help in tackling the informal economy.

Besides that, as discussed earlier in this section, in many occasions loss of neutrality in tax treatment, (which results in inequities and inefficiencies), arise from factors other than not capturing individual situations. More simply, inequitable and inefficient facets of tax system, which are completely unrelated to complexity, should be eliminated. Moreover, the Asprey Committee suggested that some inequities caused by a simple tax can be offset by suitable measures in expenditure policy.⁷⁴¹ This coordination of a country's tax and economic policy (including expenditure programs) could be helpful in resolving inequities and inefficiencies caused by a simple tax system.

In all, in large informal economies, despite giving more weight to the principle of simplicity, it is possible to achieve a reasonable level of efficiency and equity. Efficiency can further be reinforced by inserting additional features in the tax system such as a zero marginal rate of taxation and taxing the ability to pay in form of potential income taxation. However, some degree of technical complexity may be retained by striking a balance between clarity and certainty. This is necessary to ensure fairness; otherwise the tax system may have the similar fate as the 'Poll Tax' in the UK.⁷⁴² It is also acknowledged that the extraordinary simplified regimes introduced for encouraging compliance should only be used in the short term until countries with large informal economies are prepared to adopt a more complex and fairer tax regime.⁷⁴³

5.2 Efficiency versus Vertical Equity

The inculcation of vertical equity in a tax design, in order to achieve a redistribution of income, clashes with the principle of efficiency. As discussed in Section 5.1 of Chapter

⁷⁴¹ Asprey Report, above n 542, 21. Although the Asprey committee also suggests social service expenditure policy for eradication of poverty, that too needs funds, which can only be collected by an effective tax system rather than by complex tax system to ensure compliance from informal sector (see page 30); Carter Report, above n 546, 45 calls it the use of compensating policies.

⁷⁴² See above note 637.

⁷⁴³ Shome, above n 62a, 30.

5, this clash is severe when the tax system is progressive, and moderate when the tax system proportionally charges more on higher income earners. The clash is mild in a regressive tax system, which charges less tax on additional income. As discussed in Section 5.1 of Chapter 5 making the choice as to whether the tax system should be progressive, proportional or regressive depends on how much level of equality is essential for the society in question.

There is a broad consensus that ‘the living standard of the poor should be lifted to a normal level’⁷⁴⁴. Therefore, for redistribution of income, income tax should only be applied on those taxpayers who earn more than what is necessary for the normal living standard. Beyond that threshold, any of the above mentioned choices of vertical equity can be inserted in a tax system depending upon the revenue needs and equity and efficiency objectives of the country. In developed countries, most of the population is already living above the normal living standard, hence there is lesser requirement of the redistribution to the lower income class for parity purposes.⁷⁴⁵ However, the upper income class might be asked to contribute more for other reasons, such as financing a project such as improving health cover for all. In developing countries, most population lives below poverty line and that can be much helped by transferring from a small upper class as discussed in subsequent paragraphs. More simply, the need for vertical equity depends on circumstances of each country.

For the same reason, the perception about vertical equity is ‘a subjective concept’⁷⁴⁶ which varies from a country to country. For example, the majority of Americans do not favour “a tax system that has a ‘soak the rich’ dimension to it”⁷⁴⁷ and do not see the role of the government as being to reduce the differences between the rich and the poor.⁷⁴⁸ The Ralph Discussion Paper in Australia, another developed country, also does not emphasize vertical equity much and recommends horizontal equity for business

⁷⁴⁴ Meade Report, above n 543, 15.

⁷⁴⁵ Though some writers believe that many people view a tax as fair, if taxpayers with the greatest ability to pay have the highest tax burdens (see Greenheld J, Hopper Kieth C. and Somerfield, *Tax Policy and Principles: A New Zealand Perspective* (1998) 79), the political decision makers need not to be carried away by this interpretation of the fairness, particularly when it clashes with economic neutrality and is not required in light of the distributions of populations in the developing countries.

⁷⁴⁶ Vedder and Gallaway, above n 548b, 7.

⁷⁴⁷ Vedder and Gallaway, above n 548b, 7.

⁷⁴⁸ Vedder and Gallaway, above n 548b, 7.

incomes. It has left vertical equity to be dealt with in the personal income tax⁷⁴⁹ with this principle being “sacrificed at the altar of policy necessity”.⁷⁵⁰ In some European countries also, flat tax rate is used in the income tax.⁷⁵¹

On the other hand, developing countries have wide disparity within their population. A few are living a very luxurious life and the majority are having a miserable life in extreme poverty. However, the majority of persons in developing countries may not have a wide difference in their incomes quantitatively and the ratio of income inequality (that is, Gini’s Coefficient) may be similar to or better than the developed countries.⁷⁵² More simply, in terms of inequality statistics, a country having one percent of population in the upper economic class and ninety nine percent in the lower economic class may have the same results as compared to a country having ninety nine percent of the population in the upper class and one percent in the lower economic class. Consequently, tax policy in a poor country might not achieve income distribution by transferring it from a few upper class entrepreneurs to the masses in lower economic class; or by transferring it from one low income taxpayer to another low income taxpayer below the poverty line. Further, the number of persons in the top income group in most developing countries is so small that the additional revenue collected by a progressive tax system would be too meagre to satisfy revenue requirements.⁷⁵³

Thus, tax policy objectives in developing countries should be directed towards securing prosperity rather than income equality. A tax system which acts as a propellant of the economic growth may be preferred over a progressive tax system. Further, a tax system should be efficient and proportionate or mildly regressive in terms of income

⁷⁴⁹ Ralph et al (Discussion Paper), above n 598, 63, 69; Ralph Review, above n 548c, 15 also mentions horizontal equity as a more central concern.

⁷⁵⁰ Alley and Bentley, above n 539, 601.

⁷⁵¹ ‘Reaping the European Harvest’ *The Economist* 8 January 2005, 42 <http://www.economist.com/displayStory.cfm?Story_ID=E1_PVPGTDS> at 17 April 2009.

⁷⁵² Ke-young Chu, Hamid Dawoodi and Sanjeev Gupta, ‘Income Distribution and Tax and Government Social Spending Policies in Developing Countries’ Working Paper No. 62 International Monetary Fund March 2000, 34 <<http://www.imf.org/external/pubs/ft/wp/2000/wp0062.pdf>> at 8 October 2009.

⁷⁵³ For example in Australia (see Asprey Report, above n 542, 29)

redistribution. It should be coupled with a large basic exemption in order to lift poor from below the poverty line.⁷⁵⁴

For the resolution of this conflict, vertical equity, (particularly through the use of a progressive tax regime), should not be the goal in developing countries. In a large informal economy with predominant small business, any attempt to tax progressively would be like robbing Paul to pay Peter⁷⁵⁵ most of these entrepreneurs fall within the lower economic class. Those, who are slightly above, may slide into lower economic class, with a progressive a regime. It is also against 'the social policy objective not to let people fall below a level of income that would deprive them of basic food, clothing, housing and education'⁷⁵⁶.

Further, consistent with the discussion of causes of the informal economy in Section 4 of Chapter 2, it is difficult to tax the low income population and therefore it is advisable to focus on efficiency rather than vertical equity. That is, neutrality in tax treatment should be preferred for the sake of economic efficiency as against the ideal standards of vertical equity. Nevertheless, the dividends of fiscal growth may later be more spent towards achieving redistribution of income. This strategy of achieving equity through efficient economy may explain why the trend of promoting equity in the 1950s was replaced by the trend of promoting efficiency since 1970.⁷⁵⁷ Consequently, equity is no longer 'at the centre of the tax universe'⁷⁵⁸. This is especially true for the developing countries, where efficiency losses of high progressive tax rates are large.⁷⁵⁹ It is better to try to secure equity through well designed expenditure policy.

Besides the above, it should be acknowledged that taxes, irrespective of their level of adherence to equity, cause a redistribution of income, because those who do not

⁷⁵⁴ Musgrave, above n 670, 67.

⁷⁵⁵ Simplified regimes are recommended for large number of taxpayers with small incomes, and often fall below the normal living standard (see Taube and Tedesse, above n 13, 11-12).

⁷⁵⁶ Alley and Bentley, above n 539, 585; Moreover, consistent with Section 5.1 of Chapter 5, horizontal inequity in terms of identical opportunities increases tremendously with high marginal tax rates (for more discussion on this see Vedder and Gallaway, above n 548b, 13).

⁷⁵⁷ See Bird and Zolt, above n 738, 930.

⁷⁵⁸ See Bird and Zolt, above n 738, 930.

⁷⁵⁹ Bird and Zolt, above n 738, 937.

contribute at all also benefit from governmental spending.⁷⁶⁰ The vigorous use of progressive taxes to remove income inequality has rarely been successful.⁷⁶¹ On the contrary, average tax rates have a better effect on redistributing income.⁷⁶² Further, in developing countries, most of the inequality is due to non-compliance. It is a gap in the tax treatment between the compliant and non-compliant taxpayers. Thus, the primary goal in these economies should be to achieve horizontal equity by ensuring compliance.

Finally, a reasonable degree of vertical equity may be achieved by just following the proportionate increase in taxation as the ability to pay grows. For this purpose, implementing vertical equity through constant marginal tax rates is recommended⁷⁶³, which has two merits. First, the higher contribution in the proportionate manner would not discourage more work. Second, it reduces the incentive of tax planning to fall in lower tax rate slabs and consequently the efficiency costs of the economy.

6. Approach Adopted in this Thesis for Large Informal Economies

In light of the competing and conflicting tendencies among principles of a good tax system, prioritizing principles of a good tax system is not easy exercise. Some believe that the choice of weights for the principles is painful⁷⁶⁴, but yet has to be made. The choice should be designed to achieve tax objectives with minimum conflict.⁷⁶⁵ But in order to make the right choice as to the weightings it is necessary to assign information regarding the nature of taxpayers, level of compliance, extent of evasion and revenue potential etc.⁷⁶⁶ More simply, prioritizing of principles of a good tax system should vary from one economy to another depending upon its specific circumstances.

⁷⁶⁰ Meade Report, above n 543, 12.

⁷⁶¹ See Bird and Zolt, above n 738, 929, 936.

⁷⁶² Eduardo M.R.A. Engel, Alexander Galetovic and Claudio E. Raddatz, 'Taxes and Income Distribution in Chile: Some Unpleasant Redistributive Arithmetic' (1999) 59 *Journal of Development Economics* 155, 187.

⁷⁶³ Although it could be argued that implementing vertical equity through constant marginal tax rates is contrary to the traditional meaning of vertical equity, it is one of the competing meanings of vertical equity and is discussed thoroughly in this thesis along with its other meanings.

⁷⁶⁴ Carter Report, above n 546, 21.

⁷⁶⁵ Carter Report, above n 546, 25.

⁷⁶⁶ Carter Report, above n 546, 223.

In developing countries with large informal sectors, as discussed in Section 5.1 of Chapter 2, there is a low level of compliance, scarcity of funds for expenditure policy, and poor living standards for most citizens. As mentioned earlier, the low level of compliance primarily arises from the complexity of tax code in these countries. In these circumstances, in order to improve living standards, government funds are required, which demand an effective and well complied tax system coupled with sound economic growth. Once funds are raised, appropriate living standards can be secured by a sound expenditure policy.

Therefore, it is suggested that simplicity in the tax system should be given top priority in order to ensure a maximum level of compliance. A simple tax system would also help the weak tax administration; another major cause of unsuccessful implementation of income tax in developing countries. As a result of successful income tax implementation, tax collection is expected to rise. Further, since tax is a direct share from the economic performance of a country, hence full attention should also be paid to the efficiency of the tax system.

Focusing on equity makes sense once people are lifted to a minimum living standard level. Consequently, equity may be considered as the last priority when compared to the first two principles of a good tax system. Nevertheless, as discussed earlier in the context of the informal economy, the level of equity expected to be achieved through a simple and efficient tax system is higher than what could be secured through a theoretically ideal but practically unenforceable complex normal tax. The approach for prioritizing the principles of a good tax system suggested here is in accordance with the discussion with respect to each principle made in the context of the large informal economy in Chapter 5 of this thesis.

Any alternative prioritizing of the principles as compared to what is suggested in the preceding paragraph may not help developing countries tackle the informal sectors or collect sufficient revenue. For example, giving equity more weight requires capturing individual situations which would make the tax code complex. As a result, compliance costs would rise and consequently the level of compliance would fall. Low compliance would reduce revenue collection, which developing countries desperately need. Low compliance would also increase inequity between compliant and non-compliant

taxpayers. This all would cause poor developmental programmes by government and increase in informal activities, which ultimately lead to economic inefficiency.

Similarly, giving more weight to efficiency may not stop the downward slide of developing countries. For example, achieving one hundred cent percent neutrality in tax treatment may make the tax system complex, particularly when the economy is predominantly cash based. Moreover, economic growth at some stage is dependent on simultaneously laying down compatible infrastructure in a country, which requires massive government expenditure. The development projects to lay down infrastructure need optimum revenue collection. Non-compliance in large informal sectors in developing countries would hamper revenue collection and the hope of achieving economic growth. Developing countries may not achieve economic take off in an efficient but complex tax system.

In view of this, it seems appropriate to implement a tax code that encourages compliance and prevents growth of the informal sector. The discussion in chapters 2 and 5 explicitly also suggests a simple tax code for that purpose. The simple tax reduces compliance costs and ensures compliance and consequently tackles the informal sector, which is the major hurdle in the successful implementation of income tax in developing countries. Nevertheless, such a simple tax should not hamper economic growth to ensure capital formation, which is essential for developing economies. As a last priority, utmost care should be taken that while securing simplicity and efficiency, equity is not completely ignored.

7. Conclusion

It is well known that the adherence to core principles of a good tax depends upon the facts and circumstances of each country. For example, developing countries with scarcity of funds have to ensure an effective and efficient tax system as compared to an equitable but complex tax system, which is practically ineffective. More simply, policy makers are inclined to agree that one principle can be foregone for the sake of another, in case that is a requirement of circumstances of a country.

In this Chapter, the analysis of conflicting tendencies among the core principles in the context of the informal economy shows that a simple tax is better than a complex one

for controlling losses of a tax system on the equity and efficiency front. Further, simplicity and efficiency should be held dearer than equity in developing economies for fostering economic growth. In a similar vein, vertical equity may be foregone for the sake of securing efficiency in the tax system. Finally, this chapter recommends the use of this same ranking for a comparative analysis of common PIT designs and evaluation of Pakistani PIT legislation against the principles of good tax system in the subsequent chapters. More specifically, the ranking of the principles in order of their importance for tackling the informal economy – that is, ranking simplicity, efficiency and equity as first, second and third priorities respectively - should be the corner stone of analysis of PIT designs and legislation.

The principles of a good tax system have been defined and ranked in the context of large informal economies in preceding chapters 5 and 6 respectively. The next chapter compares common PIT designs and features against these prioritized principles in order to determine the most appropriate PIT design and a set of features for small business in large informal economies.

CHAPTER 7 COMPARATIVE ANALYSIS OF PIT DESIGNS AND FEATURES AGAINST PRINCIPLES OF A GOOD TAX SYSTEM

Scope of this chapter: After defining and ranking the principles of a good tax system in chapters 5 and 6 respectively, this chapter compares common PIT designs against these prioritized principles in order to determine the most appropriate PIT for small business in large informal economies. This chapter concludes that an asset based PIT design is superior to all other PIT designs for taxing large informal economies. Further, the incorporation of the idea of 'potential income taxation' is suggested to enhance the successful use of an asset based PIT in taxing the informal sector.

1. Introduction

Consistent with sections 3.3.2 and 3.6 of Chapter 3, when designing an appropriate PIT regime to address large informal economies tax policy makers have available a range of PIT designs and features. However, consistent with Section 3 of Chapter 1, there is little in earlier literature in this regard, which systematically evaluates these designs against the principles of a good tax system.⁷⁶⁷ On the contrary, some scholars, being cautious, suggested not using PIT, because of various problems in selecting the design of PIT'.⁷⁶⁸ Although a few studies suggest that the design should be chosen depending upon the objective of the tax system⁷⁶⁹, they do not take into account the importance of the principles of a good tax system in this regard. Further, PIT regimes are compared in the context of some of their features while other important features are completely ignored. More simply, the value of comparative analysis of PIT designs and features vis-à-vis tax principles in choosing the design for informal economies is ignored.

The comparative analysis of PIT designs against the principles in this chapter would help policy makers choose an appropriate design for tackling the informal economy.

⁷⁶⁷ For example, Engelschalk, above n 2b, 14-26 analyses the designs in context of expectations of small businesses and tax administration, particularly regarding stability and predictability; clarity and simplicity for reducing the compliance burden; tax burden and revenue potential, broadening tax net; and business perception. Broadly, this study examines PIT for the simplicity and performance indicators rather than in the context of all principles of a good tax system.

⁷⁶⁸ Richard Bird, *Taxation and Development: Lessons from the Columbian Experience* (1970), 213.

⁷⁶⁹ Jaramillo, above 32d, 3; Thuronyi, above n 38, 5, 28.

While selecting the design, policy makers should reconcile recommendations made here with those made in Chapter 4 for addressing the causes of the informal economy. The design, so chosen, may be effective in tackling the informal sector without compromising the principles of a good tax.⁷⁷⁰ Lastly, a standard deduction type of PIT regime, being linked to the turnover may be deemed as included in the discussion of turnover based PIT design in this chapter.

Initially in this chapter, PIT designs are compared for their individual merits and demerits in respect of the simplicity, efficiency and equity. The analysis is directed to determine which PIT is appropriate for the simplicity principle and which is appropriate for the efficiency and equity principles respectively. In this analysis, specific criteria identified in the literature were used to evaluate the PIT regimes, particularly where the specific criteria were relevant to core principles. Later, a PIT design that is suitable to meet the recommended balance of principles, as mentioned in Chapter 6, is chosen for tackling informal economies.

Later in this chapter, each PIT feature is analysed to determine its appropriateness in terms of the principles of a good tax system and the informal sector. A set of features is recommended for insertion in the chosen design on the basis of this analysis in order to effectively tackle informal economies.

This chapter concludes that an asset based PIT design is superior to all other PIT designs for taxing the large informal economy in developing countries. Further, the incorporation of the idea of ‘potential income taxation’ is suggested to enhance the successful use of an asset based PIT in taxing large informal economies.

The remaining chapter is divided in five sections. Section 2 makes a comparative analysis of common PIT designs in the context of the simplicity of tax system. This section also enumerates common reasons of complexity in PIT designs. Section 3 discusses common PIT designs in terms of economic efficiency, with particular focus on its neutrality aspect. Section 4 highlights the relative importance of common PIT designs in achieving horizontal and vertical equities. Later, Section 5 compares the PIT

⁷⁷⁰ It may be noted that PIT designs used for investment income, which is mostly earned in documented sectors of the economy, are beyond the scope of this thesis focusing on the role of PIT in the informal sector. Consistent with Chapter 1, PIT designs which target evasion of the formal sector (for example, minimum tax) are also beyond the scope of this thesis.

features in context of the needs of small business in informal economies. This section also suggests a set of features for PIT design in this regard. Finally, Section 6 concludes this chapter.

2. Simplicity

It has been observed that PIT designs, which are in currently practice in most countries, are not simple.⁷⁷¹ Therefore, it is important to explore which of the PIT designs, as listed in Section 3.3 of Chapter 3, is simplest and should replace the currently used PIT designs which are relatively complex. Consistent with the evaluation strategy recommended in Section 3.3 of Chapter 5, all the facets of the simplicity may be used in the comparative analysis of the available PIT designs. These include clarity, certainty, consistency, stability, flexibility, low compliance and administrative costs. In the first stage, PIT designs may be analysed qualitatively for the first five facets (i.e. technical complexity). In the second stage, PIT designs may be analysed qualitatively for the last two facets (i.e. operational complexity).

2.1 Factors Influencing Complexity

Before proceeding to this analysis, some factors which influence both technical and operational complexity of PIT regimes are worthy to be mentioned. It is noted that the clarity and certainty in PIT designs is influenced by the following factors, which consequently increase operational complexity.

- i. Number of categories of the activities/taxpayers covered: When large numbers of categories are prescribed for individualizing the tax system, then the complexity in the design increases. Moreover, the need to prescribe a separate tax burden for each category to match its economic circumstances further increases complexity.

Rationally, too many categories are prone to increase the number of provisions, redundant provisions, superfluous words and sentences, incoherence and frequency of the changes etc in the legislation, which increases the complexity. Another disadvantage of multiple categories is

⁷⁷¹ Engelschalk, above n 2b, 27.

that one taxpayer may fall into more than one category, which also increases the level of cumbersomeness in the tax system.

Consequently, a PIT with many categories generates complexity and becomes contradictory to the very purpose for which it is created.⁷⁷² Moreover, taxpayers within the same income class, but who are excluded from the prescribed categories and taxed under the normal income tax regime, may develop a perception of unfairness and prefer to operate in the informal economy.

- ii. Clarity of definitions for the categories: It is noted that the currently used PIT designs, which individualise the tax system to define each prescribed category, inadvertently results in ambiguities in their application, perhaps due to the nature and range of businesses operating in the informal sector. Those definitions are also usually ‘inclusive’ in nature, which makes them more ambiguous and uncertain in their application.

Engelschalk reproduces one typical example of the ambiguities emanating from the definition of one category in the Albanian regime as follows:

*“Photographing services, photocopying, beauty salons, restaurants, hotels, motels, discos, cafes, driving schools, auto repairs, parking, agencies, computer courses, gambling and other similar activities”*⁷⁷³

The words ‘agencies’ and ‘similar activities’, in this definition, provides ample room for different interpretations to suit self interest. More broadly, the preceding specific words are not part of an identifiable common class, hence it is not possible to limit the interpretation of the general words by the ‘ejusdem generis’ rule.

Similarly, in Armenian presumptive tax, it is hard to comprehend the scope of computer games from the given definition. The relevant article says,

⁷⁷² Makedonskiy, above n 2a, 20.

⁷⁷³ *Albanian Fixed Tax regime Law No.8213* (Albania) Article 3 as quoted by Engelschalk, above n 2b, 19.

‘Persons who organize business activity related to computer games’⁷⁷⁴. The article is ambiguous, as to whether trading and manufacturing of computer games and/or their consoles are covered in this category or not. More simply, the scope of this business activity is not clear from content of the definition.

Moreover in Bulgarian PIT regime, there are a couple of activities which, while looking similar, are categorized separately with distinct tax burdens. For instance, the categories of activities in precious metals, hairdressers and household repairs look similar to the categories of metal processing, cosmetic services and repairs of locks and sewing machines respectively.⁷⁷⁵ Taxpayers falling in one of these two similar categories may argue that they fall into the other if that bears lesser tax burden. These ambiguities become a source of uncertainty and high compliance costs in the tax system.

- iii. Presence of multiple PIT option for each category: Although very uncommon, some tax systems such as that of Ukraine offer different PIT regimes based on separate designs to each different category of taxpayers.⁷⁷⁶ Consequently, a taxpayer has the option to choose the one that fits his or her requirements. This opportunity of ‘tax shopping’ increases the complexity of the regime by increasing the number of provisions and redundancy of provisions etc.⁷⁷⁷ It may also increase uncertainty and unfairness, because all taxpayers may not be equally well versed with the details of the regime.

⁷⁷⁴ *Law of Republic of Armenia* 1998 (Armenia) Article 87 of Chapter 16.

⁷⁷⁵ *Law on Taxes on the Income of Natural Persons of Bulgaria* 2007 (Bulgaria) clauses 7, 9, 10, 12, 20, 28 and 29 of s I to the Appendix.

⁷⁷⁶ Engelschalk, above n 2b, 18.

⁷⁷⁷ Engelschalk, above n 2b, 18.

2.2 Analysis of Common PIT Designs

In line with the discussion in Chapter 4, PIT designs are analysed here against the technical and operational complexity in general, and the above mentioned specific causes of the complexity in PIT in particular.

2.2.1 Analysis of Technical Complexity

Regarding technical complexity, it is pertinent to mention that the designs in isolation can not be analytically compared for simplicity's three facets of flexibility, consistency and stability. The detailed analysis for these facets in line with the approach set out in Section 3.3 of Chapter 5 requires the examination of the relevant legislations containing these designs. It entails an examination of legislation of multiple countries, which cannot be done comprehensively due to the time and resource constraints of the thesis. As mentioned in Chapter 1, it is one of limitations of this study. Nevertheless, these facets are examined in the case study of the Pakistani PIT in Chapter 10.

In this chapter, a detailed comparative analysis of the common PIT designs in their isolated form is made for the remaining two facets of technical complexity i.e. clarity and certainty.

2.2.1.1 PIT Designs Using another Economic Base as a Proxy for Income

These designs use either turnover or assets as the proxy base for income. While reviewing literature the author finds that in the modern world, assets as a proxy base in PIT designs is rarely used (in Latin American countries, such as in Mexico and Bolivia) and mostly such PITs had the feature of 'minimum tax'.⁷⁷⁸ Despite the lack of an example in recent past of the use of assets as a proxy base in PIT regime with an exclusive feature (which makes it applicable to all taxpayers), this kind of PIT could still be considered. The recommendation of considering this choice is based on the fact that the prosperity in Milan in 16th century is linked to such a PIT regime.⁷⁷⁹

Consistent with Section 4.1 of Chapter 3, turnover based PIT designs are commonly used as 'standard regimes' and are claimed to help in tackling the informal economy.

⁷⁷⁸ Sadka and Tanzi, above n 312, 1.

⁷⁷⁹ Sadka and Tanzi, above n 312, 2.

However, when turnover is used as a proxy base it would not be appropriate to tax all activities at an identical rate as net profit margins vary from one activity to another. Consistent with Section 3.4 of Chapter 4, when a single rate is applied, variations in profit margins in different sectors distort neutrality in this design. The tax rate for each sector has to be commensurate with its respective profit margin, if the PIT aims to achieve neutrality.

Consequently, against the view held by some ‘that turnover based system does not need to establish detailed lists of businesses covered’,⁷⁸⁰ it is essential, in order to meet the neutrality objective, to prescribe the number of categories in terms of tax rates and tax burdens. Moreover, the rates have to be updated or indexed frequently to take inflationary developments into account. The sector wise adjustment of rates helps to reduce the regressivity of a turnover based PIT.⁷⁸¹ Not doing so would make it unacceptable, as admitted by even the supporters of this regime⁷⁸² and consequently would result in a perception of un-fairness and in non-compliance. However, to do so compounds the complexity linked to categorisation.

When categories are created, these are required to be defined. Once there are a number of categories, there is a likelihood that a taxpayer may fall in more than one category. Consequently, as mentioned in Section 2.1, there would be an increase in the length of legislation, the likelihood of redundant provisions and frequent changes etc. These factors cumulatively cause more ambiguity, uncertainty and may even open the door to arbitrariness.

On the other hand, as discussed in Section 3.3.1 of Chapter 4, an asset based PIT which uses a single tax rate, equivalent to the average rate of returns, could be prescribed for all the sectors. Although the assets employed in different sectors may not produce the identical profit margins, it is not uncommon in the business world to rely on a general risk free rate of return or average rate of return on capital for decision making. For the risk free rate, government’s interest bearing securities are used. For the risk based rate of the return, the average yield of the stock market indices may be used. Only an

⁷⁸⁰ Engelschalk, above n 2b, 10.

⁷⁸¹ Taube and Tedesse, above n 13, 15.

⁷⁸² Engelschalk, above n 2b, 8.

entrepreneur who earns those levels of returns can survive. More simply, an asset based PIT is constructed to tax average profitability through a uniform rate.

This attribute of reliance on a single rate of return of the assets, as a proxy base in PIT design, makes it unique. Consequently, there is no need to have different categories, because the tax burden in this design would be neutral for all, which is not the case when turnover is used a proxy for income with a single rate. Beyond that, the absence of the categories obviates the need for a range of definitions. Taxpayers would not be required to distinguish between the categories, thus making their lives easier. The length of the law, redundancy, superfluousness and incoherence in legislation containing this design would be relatively less. This design would be simpler in terms of clarity and certainty. Unfortunately, despite its uniqueness, an asset based PIT is not used as an exclusive tax any where in the world, perhaps due to lack of research in this area.

In an asset based PIT, professionals may be taxed for their human capital assets i.e. qualifications, instead of tangible assets. However, professionals cannot be subjected to identical tax rates, because the average of rate of return varies among them. Therefore, for this class of taxpayers there is the need to have some categories. Consequently, it may be admitted that PIT for professionals would be relatively complex. Nevertheless, asset based PIT may not be any more complex than the turnover based design in this regard. Moreover, professionals are easy to categorize, because their qualifications are well documented as compared to the information available for other self employed taxpayers.

2.2.1.2 PIT Designs Using Production Indicators for Income Tax Liability

Consistent with Section 4 of Chapter 3, PIT designs, which are based on the production indicators, may be shaped as either 'standard' or 'estimated' regimes. The standard regimes, based on economic indicators, use just one or two production indicators for determining the average income and consequent tax liability. The common standard regimes are 'patent' and 'license'. The indicators used in them, however, are logically different for each of the activities covered. Consequently, a range of categories is normally identified in these regimes. Furthermore, each category is also defined, and they have to be updated or indexed frequently to take inflationary and other

developments in to account.⁷⁸³ Consequently, the length of the law, the redundancy, superfluousness and incoherence in the legislation containing this design is likely to be higher.

The complexity in the standard regimes based on production indicators is therefore higher than an asset based PIT design. It is even higher than the turnover based design because of the multiplicity of indicators. However, a turnover based design may be difficult at the designing stage, because a lot of data is required to determine the average profit margin for each activity and perhaps gives more discretion to the administration.

On the other hand, the estimated regimes involve some method of assessment. A wide range of production inputs are used for the determination of income tax liability, through the active participation of tax administration. This makes the PIT regime complex in terms of clarity and certainty. The length of the law, redundancy, superfluousness and incoherence in legislation based on this design would, consequently, be relatively higher than the single proxy based PIT designs.

Consequently, taxpayers and administrators even prefer the normal income tax regime over an estimated regime,⁷⁸⁴ perhaps because despite high documentary requirements, the normal income tax regime is certain from a technical complexity point of view. The estimated regimes, therefore, should not be used for taxing the informal sector of developing countries, at least from the simplicity perspective. However, these should be used for large and medium enterprises to prevent understatement of tax⁷⁸⁵, particularly when either no accounts are maintained or when the accounts that are maintained are not reliable due to massive discrepancies.

2.2.2 Analysis of Operational Complexity

In regard to operational complexity, the compliance and enforcement burden of each PIT design should be assessed. Consistent with Section 3.2.2 of Chapter 5, operational complexity should be looked at both from the ease of compliance and enforcement, as well as the costs of compliance and enforcement. Consistent with Section 3.3 of Chapter

⁷⁸³ Taube and Tedesse, above n 13, 28.

⁷⁸⁴ Engelschalk, above n 2b, 24.

⁷⁸⁵ Makedonskiy, above n 2a, 28.

5, this analysis should be based on size of the return; extent of computations; nature of audit; requirement of books of account and other documents; and costs related to appellate procedures.

Although exact operational costs, related to the documentary requirements and computation, can only be evaluated by examining a PIT design along with its legislation, a rough assessment can be made by examining the design in isolation. Due to resource and time constraints, the common PIT designs are compared in their abstract ideal form for their operational complexity in the following paragraphs.

2.2.2.1 PIT Designs Using another Economic Base as a Proxy for Income

In terms of compliance costs, proxy based PIT designs generally are better than the normal income tax regime, which require financial accounts for the determination of income. Also, when compared to the indicator based PIT designs, proxy based designs are clear and certain, because they involve just one proxy base. Consequently, all compliance requirements should logically be less in these designs, which may then reduce the compliance costs (as mentioned in Section 3.1.1 of Chapter 4), a main cause of the informal economy.

Among proxy based PIT designs, a turnover based PIT design, despite using one proxy indicator, has many categories and a taxpayer may incur tax planning costs in order to fall within the category which bears the least tax. The higher technical complexity in a turnover based PIT is also, to some extent, reflected in its operational complexity. Further, a taxpayer has to keep a documentary record of sales to substantiate his/her declared version, which has some associated compliance costs. Consequently, a turnover based PIT would have both administrative and compliance costs higher than an asset based PIT. The ease of compliance and enforcement in a turn over based PIT would also be less than under an asset based PIT.

Moreover, when choosing a proxy base in a PIT design, it is generally agreed that a base which is easy to comply with and difficult to tamper with should be chosen.⁷⁸⁶ Both these factors depict the operational ease and costs of a PIT regime. The latter

⁷⁸⁶ Indira, above n 474, 1104.

attribute is suggested for the effective administration of tax.⁷⁸⁷ Although turnover is relatively easy for the taxpayer to determine, the administration costs in this design would be higher than the asset based design. More aptly, the correct determination of turnover of taxpayers would be challenging for the tax administration in cash economies. For example, a survey of restaurants in Georgia revealed that the real monthly turnover of the surveyed restaurants was 3.8 times higher than the official turnover.⁷⁸⁸

It is also difficult to audit turnover effectively, which ultimately leads to erosion of revenue.⁷⁸⁹ This finding is also consistent with the fact that the revenue yield in Georgia from this type of PIT constitutes just 1% of all tax revenues.⁷⁹⁰ The situation in other transitional European countries is similar.⁷⁹¹ Most turnover-based PITs therefore do not demonstrate good results in terms of revenue collection. The quantum of turnover is easy to tamper with in the cash economy and ‘it is the most favoured method of tax evasion in the developing country’⁷⁹² and therefore may not be the best choice of PIT design.⁷⁹³

Contrary to turnover, a PIT design using assets as a proxy base is relatively easy to comply with and difficult to tamper with.⁷⁹⁴ For example, rarely a taxpayer, especially a low income earner, logically could be unaware of the annual increase in his/her wealth or total quantum of assets. Even in the case when assets are in the form of inventory, only a one-time stock take at the end of the year is required. For the same reason, an asset based PIT can help a weak tax administration in taxing the informal economy. For the administration, it is also much easier to keep a record of assets of taxpayers. An asset based PIT is therefore an efficient method of detecting shadow income and

⁷⁸⁷ Balestrino and Galmarini above n 185, 1.

⁷⁸⁸ Report GE51 GR01, “*Informal Economy*” in Engelschalk, above n 2b, 22.

⁷⁸⁹ Thuronyi, above n 38, 11.

⁷⁹⁰ Engelschalk, above n 2b, 22.

⁷⁹¹ Engelschalk, above n 2b, 22.

⁷⁹² Tanzi and Casanegra, above n 32a, 11.

⁷⁹³ Thuronyi, above n 38, 11.

⁷⁹⁴ Sadka and Tanzi, above n 312, 4.

concealed cash.⁷⁹⁵ In all, an asset based PIT is called ‘a panacea for tax administration’, when it is attempting to improve tax compliance.⁷⁹⁶

Consistent with Section 3.1.2 of Chapter 4, assets have permanence, which leave their trail behind for an investigator to follow, which is not the case for turnover. Due to this permanent nature of assets, they would not even be required to be assessed every year, and as a rule the assessment period lasts for a few years (at least three years), which reduces the administration costs.⁷⁹⁷ Moreover, concealing assets is not cost free for a taxpayer. Even hoarding assets underneath the floor or in electronic lockers costs the taxpayer in terms of the loss of income which would be received by investing the hidden assets in the market. Concealing assets for ten years may be economically more disadvantageous for a taxpayer than paying only once the tax on the average rate of return when the income is earned.⁷⁹⁸

For example, in a developing country like Pakistan, say a taxpayer earned income of PKR 100,000. In this case, the taxpayer pays tax on the income under PIT at the rate of 10%. He/she would still have PKR 90,000, which he/she can invest in National Defence Saving Certificates⁷⁹⁹ at the compound interest rate of 15% and triple the invested amount after seven years. Therefore, there may be less incentive for concealing income or assets.

Further, in developing countries, there is a general tendency to save money for children perhaps due to lack of a good social security system in such countries. Consequently, there is less likelihood for a small entrepreneur to spend his/her income extravagantly. In all, assets based PIT may encourage rational individuals to pay tax.

⁷⁹⁵ Makedonskiy, above n 2a, 32.

⁷⁹⁶ Tanzi and Casanegra, above n 32a, 11.

⁷⁹⁷ Makedonskiy, above n 2a, 32.

⁷⁹⁸ Giving loans to relatives could be one way to hide assets but is not followed commonly for the reason that the recipient of loan has to explain it in its accounts. Moreover, since lending even to a relative involves risk of counter-claim of ownership of the money by that relative, lenders usually record such transactions as per law for their own interest.

⁷⁹⁹ These are interest bearing bonds, which are issued by the Government of Pakistan.

2.2.2.2 PIT Designs Using Production Indicators for Income Tax Liability

Like technical complexity, operational complexity is higher for the estimated PIT design, which is based on the multiple production indicators. This design usually involves negotiations with the administration in respect of a number of input factors, and each of them has to be settled on the basis of some documentary evidence. Consequently, compliance costs increase. The use of ‘outward’ signs and ‘production’ inputs are also difficult to administer and have been a source of corruption.⁸⁰⁰

On the other hand, standard PITs in this group are based on one or two indicators. In most cases, those indicators are simpler than even turnover or assets. For example, type of occupation, size of store, telephone and electricity bills or even labour costs, which are commonly used indicators, are easy to observe. For taxpayers it is easy to measure the area of the shop or working days etc. Thus, the compliance costs are significantly less than other designs. The administrative costs would also be less, because it is easy for the administration to monitor these indicators. Further, it is also easy to maintain a record of these indicators for both taxpayers and tax administrators. More simply, these indicators are easy to enforce, particular when compared to turnover and assets, which could be concealed relatively easily.⁸⁰¹

The choice of indicators however, is crucial in this regime, because there is a strong likelihood that taxpayers will shift to other inputs in order to reduce their tax liability⁸⁰². For example, they may deliberately keep shops with a smaller area, or work for a fewer number of days, but for longer hours, or hire a smaller number of employees.⁸⁰³ This change of indicators for tax sheltering purposes will not be costless for taxpayers. Further, there may be efficiency and equity costs, because only a new business could adjust these factors of business at the time of establishment in order to pay less tax forever. This opportunity would not be present with the old businesses. Thus, consistent with Section 3.1.2 of Chapter 4, this kind of PIT is not cost effective for administrative purposes.

⁸⁰⁰ Tanzi and Casanegra, above n 32a, 11-13.

⁸⁰¹ Balestrino, above n 185, 1.

⁸⁰² Finkelshatin, I., *‘Income Tax in the Family Farm’*, (M.A. Thesis, Department of Agricultural Economics, Hebrew University, 1985).

⁸⁰³ Makedonskiy, above n 2a, 20.

Moreover, high technical complexity, emanating from the need of categorization in a single indicator based PIT, is also reflected in an increase in operational complexity. All these factors undermine the cost effectiveness of this design which arises from its use of an easily observable indicator.

An asset based PIT, however, does not suffer from such weaknesses, because the assets cannot be replaced by any other indicators so easily. For example, a retailer cannot replace his/her pool of assets, which include stock, location and size or premises by any other indicator. Similarly, a medical practitioner may find it hard to substitute his/her qualification by any other economic base and still be able to operate as a medical practitioner. An asset based PIT, therefore, checks the opportunities for tax avoidance more effectively than other standard regimes.

2.3 Findings

The discussion finds that an asset based PIT has low technical and compliance complexity as compared to other PIT designs. It can be contained in the legislation with a lesser number of provisions or more simply in shorter legislation. Further, it is also easy for taxpayers to comply with, because it does not require a large amount of documents. It is also easy to administer because it is relatively easy to trace, unless assets are shifted to tax havens. But that too would not be economical for an average income earner in the informal sector. Therefore, it can be concluded that an asset based PIT is the simplest of all PIT designs.

Lastly, it has been aptly said by Engelschalk that simplicity of a PIT design (unless it is accompanied by high tax rates) should manifest in the form of a reduction in the size of the informal economy, improved revenue collection and broadening of the tax base.⁸⁰⁴ His advice is based on the fact that as compared to other tax principles a reduction in compliance costs through simplicity is rated highest by taxpayers⁸⁰⁵ and it encourages voluntary compliance. The choice of PIT design in an informal economy should be made in the light of this advice.

⁸⁰⁴ Engelschalk, above n 2b, 24.

⁸⁰⁵ Engelschalk, above n 2b, 14.

3. Efficiency

Consistent with Section 4.5 of Chapter 5, efficiency is to be measured against the tax burden, deadweight loss and neutrality criteria.

3.1 Neutrality

In order to be neutral, a PIT design should include an identical treatment in respect of the following ten neutrality facets:

- i. Neutrality of tax burden in all industrial sectors
- ii. Neutrality in tax burden for all classes of income
- iii. Neutrality in tax burden for all types of legal persons
- iv. Neutrality in availability of tax avoidance opportunities
- v. Neutrality in terms of tax rates, tax expenditures and other concessions
- vi. Neutrality in tax burden from different jurisdictions
- vii. Neutrality in the tax burden with respect to the choice of capital structure
- viii. Neutrality in tax treatment of losses and income⁸⁰⁶
- ix. Neutrality of tax burden irrespective of the risk in the sectors
- x. Neutrality in respect of the compliance procedures and related costs

Due to the inherent regressivity (because those who earn more do not pay more under PIT) and generalized (uniform) treatment of all taxpayers irrespective of their actual income, PIT regimes are conceded as inferior to the normal income tax regime in respect of the above mentioned last three neutrality aspects.

This inferiority is visible when we compare the tax treatment of the persons taxed under PIT with those taxed under the normal income tax regime. For example, a taxpayer under a PIT regime cannot adjust his/her losses against income, whereas taxpayers under the normal income tax regime can do so. Similarly, a taxpayer taxed under the normal income tax regime bears the costs of keeping accounts whereas a taxpayer taxed under PIT does not bear this cost. PIT even fails to neutralize the tax impact in this regard among the persons who fall within the ambit of PIT. For example, taxpayers

⁸⁰⁶ It means if a tax system taxes income in one year it should also allow loss of a year to be adjusted against income of other year. More simply, a tax system should not discriminate by only taxing positive income and completely ignoring negative income (that is, loss).

under PIT bear same tax irrespective of loss and income, and irrespective of level of fluctuations of their incomes on account of the riskiness of their ventures (see more details in Section 2.2.1 of Chapter 10).

In respect of the remaining seven aspects of neutrality, a PIT regime can be tailored to achieve some neutrality and consequently some degree of overall economic efficiency. The details are given below.

3.1.1 PIT Designs Using another Economic Base as a Proxy for Income

The neutrality in the remaining seven aspects can be secured by taxing comprehensive income, which is a corner stone of efficient taxation. Further, neutrality in tax rates (which virtually reflect tax burden), generally improves neutrality in all those seven aspects. Neutrality in tax rates, both in the turnover and asset based PIT, can be achieved through appropriately setting tax rates for the number of taxpayer categories.

In an asset based PIT, consistent to the discussion in the simplicity section, neutrality in tax burden can be secured by prescribing a single rate for all economic sectors. In this design, the single tax rate can be designed for all sectors on the basis of taxing the average rate of return on assets, irrespective of the sectoral rate of return on those assets. For example, if the average of return on assets is presumed to be 6%, then a tax rate of 2% taxes every business in a neutral manner in terms of equal opportunities.

Beyond that, any taxpayer earning income above this average profit would receive that income without any additional tax. This means the marginal rate of tax is zero, which provides an incentive to work more. This type of tax is called Potential Income Tax⁸⁰⁷, which is more closely reflective of the actual tax base⁸⁰⁸ (that is, an economic concept of income), which is linked to ability to earn as discussed in Section 3.1 of Chapter 3.

Further, as discussed earlier, an asset based PIT ensures the identical treatment for identical opportunities rather than identical performance, which is hard to achieve when taxing actual income. Moreover, a tax on assets, due to its neutrality, increases the

⁸⁰⁷ Faulk et al above n 15, 2.

⁸⁰⁸ Economists consider some forms of PIT, which tax the potential income, as the first best solution in terms of theory of optimal taxation. PITs taxing potential income are in fact those PIT designs wherein proxy base is either assets or production capacity, which represent a potential of a taxpayer to earn income (for details see Tanzi above n 1, 193-209).

efficient allocation of resources.⁸⁰⁹ The inefficient use of resources in developing countries due to evasion⁸¹⁰ can also be reduced by this design, as is expected from every PIT regime, through improved taxpayer compliance.

Asset based PIT design has identical efficiency advantages when they are applied on the qualifications of the self employed i.e. human capital assets.⁸¹¹ However, in an asset based PIT design, the investment in human capital, as compared to other assets, would be influenced more adversely when the return is risky.⁸¹² In the developing countries, this may be serious issue, because of high non-employment and under-employment rates.

More broadly, an asset based PIT is consistent with the principle of taxing the ability to earn. It refutes the impression about PIT created in some papers that ‘it [PIT] violates the principle that taxation should be according to ability to pay’⁸¹³. It may be noted that ability to earn, which is worked out on the basis of assets, is relatively stable, when compared to determining the ability to earn from turnover, which fluctuates every year and the profit margin does not remain the same.⁸¹⁴ Consequently, consistent with the discussion in the simplicity section, an asset based PIT may reduce the operational costs of the tax system, which are a burden on the economy.

On the other hand, in a turnover based PIT, for the purpose of securing the idea of ability to pay, a single tax rate is difficult to prescribe because profit margins vary among different activities. More simply, a single tax rate in a turnover based PIT cannot correspond to average profit margin for all industrial sectors. Therefore, there is a greater likelihood that the choice of single uniform tax rate on a proxy base in PIT will violate the ‘neutrality’ principle in taxation.

⁸⁰⁹ Sadka and Tanzi, above n 312, 8; also see Faulk et al, above n 15, 7, 14.

⁸¹⁰ Tanzi and Casanegra, above n, 32a, 5-7.

⁸¹¹ Faulk et al, above n 15, 2.

⁸¹² It is generally believed that, tax on assets in general and human capital in particular, reduces investment in them (for details, see Faulk et al, above n 15, 5).

⁸¹³ Yitzhaki, above n 95, 9.

⁸¹⁴ Reference here to ‘on the basis of assets’ and ‘from turnover’ explains that the utility of a PIT design in terms of its adherence to the idea of ability to pay depends on the proxy used in its design.

Consequently, the tax rate in a turnover based PIT should be adjusted to sectoral profit margins. Such an exercise could be gigantic because it is difficult to comprehend the basis of differentiation⁸¹⁵ in tax rates, particularly when the regime is too individualized. For example, a World Bank Report refers to the Ethiopian PIT, which lists 69 different professions and 19 turnover bands. Consequently, the Ethiopian PIT collectively envisages 1,311 tax rates.⁸¹⁶ Such a complicated approach raises doubts about the accuracy of determination of those rates with reference to average profits and transparency. Further, when different tax rates can be prescribed for different activities, this may influence the choice of activity an entrepreneur would like to carry out.

Moreover, under a turnover based PIT, these different tax rates also distort the neutrality of opportunities (a concept discussed in Section 5.1 of Chapter 5 and is fairly provided by an asset based PIT), because despite identical economic resources some are taxed at higher rate than others. That may be the reason that a turnover based PIT has been called distortionary and evasive.⁸¹⁷ Nevertheless, these worked out tax rates, irrespective of the tax burden, have a marginal tax rate of zero. This provides the incentive to work more, particularly when the overall burden is not higher than under the normal income regime (as seen in some PIT regimes).

In an asset based PIT, differential tax rates can be prescribed to tax the different average rate of return of each activity, but that would lose the uniqueness of taxing identical opportunities identically and consequently the incentive to work more. Such adjustment of rates may harm neutrality in choices of economic activities, with entrepreneurs' choices potentially being driven by the tax advantages.

Another disadvantage of turnover tax is that a taxpayer who works more may have a higher turnover (that may not necessarily yield more profits) and resultantly more tax payable on it. This may discourage a taxpayer from working more. This is not the case with an asset based PIT, which taxes the opportunities and a taxpayer who works more would obtain more benefits for himself/herself. Further, an assets based PIT would not

⁸¹⁵ Engelschalk, above n 2b, 10 refers to identical situation in Bulgaria, where too many categories are created to distinguish all economic activities.

⁸¹⁶ World Report IFC Report, above n 47, 63.

⁸¹⁷ Jaramillo above n 32d, 3.

encourage a taxpayer to let assets lie idle, because idle assets would also bear tax. Consequently, assets would be put to use for the growth of the economy.

The basic exemption from tax is an essential feature of an efficient and equitable tax system. Therefore, a certain level of assets may be exempted from tax in an asset based PIT in order to ensure that the relatively poor section of the population fall under the tax exemption level.

It could be difficult to construct such a basic exemption in a turnover based PIT because the pattern of profits in relation to turnover is bizarre. Until the breakeven point (which varies among businesses - for instance, the break even point is higher for a capital intensive business), there would be no profits and then it increases exponentially as turnover increases up to full production capacity. For example, there are two businesses 'A' and 'B' engaged in advertising and manufacturing activities respectively. Business 'A' and 'B' have fixed cost (FC) of A\$100,000 and A\$5,000,000 respectively. Assume that variable cost (VC) and selling price (SP) for them is same for both businesses that is \$10 per unit and \$50 respectively. Now in order to meet the total costs (that is FC + VC or a breakeven) business 'A' and 'B' must sell 2500 units (that is, turnover of A\$125,000) and 125,000 units (that is, turnover of A\$6,250,000) respectively. Thus both businesses should have different basic exemption levels.

For the same reason, turnover tax is unduly tilted to favour high performers instead of being neutral. For example, there are two businesses 'A' and 'B' engaged in manufacturing activities respectively. Business 'A' and 'B' has same FC of A\$100,000. Assume that VC and SP for them is same for both businesses that is \$10 per unit and \$50 respectively. Now if 'A' and 'B' sell 2500 units (that is, turnover of A\$125,000) and 5000 units (that is, turnover of A\$250,000) respectively then 'A' will just meet its breakeven point, whereas 'B' will make profits. It shows that irrespective of tax rate, higher is the turnover the higher is income. It is for a reason that the fixed cost spreads to number of units sold. In the given example, for business 'B' with a sale price of 50, each sold unit (after deducting VC per unit of A\$10 and FC per unit of A\$20) would contribute A\$20 to profit. On the other hand, each sold unit by A (after deducting VC per unit of A\$10 and FC per unit of \$40) would contribute A\$0 to profits. It shows that if a business turnover is higher, the higher is per unit contribution towards profit. In a turnover tax, tax on sale of each unit will be the same. Consequently, it is detrimental in

the early years of business, when turnover is generally low. This is especially true with small businesses, which generally have a low survival and turnover rate. Moreover, the different break even point requires different levels of exemptions for different sectors, which may further increase the complexity of a turnover based PIT.

Under an asset based PIT, capital intensive activities are likely to bear a higher tax burden than labour intensive activities. However, this can be resolved relatively easily in an asset based PIT design by either taxing the professional assets of the service industry as well or by using two different tax rates for labour intensive and capital intensive industries.

Consistent with discussion in Section 3.3.1 of Chapter 4, a turnover tax also has a cascading effect causing the coalescing of small firms to become large and save tax.⁸¹⁸ This is especially seen in contractual income in Pakistan, when the contractors combine as a consortium to take a contract as a ‘turnkey’ and pay relatively less tax, as compared to when they would have executed the contract separately. This cannot, however, happen in an asset-based PIT, because the total quantum of assets and tax thereon would remain same irrespective of the fact that these assets are divided among a number of taxpayers or unified to a one taxpayer.

In view of the above, an asset based design is appropriate from a potential income taxation and neutrality perspective. More aptly, it is an efficient tax measure when compared to a turnover based PIT.

3.1.2 PIT Designs Using Production Indicators for Income Tax Liability

Indicator based ‘estimated PIT’ designs are almost identical to the actual income tax and therefore cast identical effects on efficiency. Even for human capital, indicator based estimated PITs attempt to determine potential income on the basis of multiple indicators other than qualifications.⁸¹⁹ More simply, like the normal income tax, an estimated PIT is quite complex. Thus, for securing neutrality, if a complex tax system is to be chosen, it is better to use the normal income tax instead of a complex PIT.

⁸¹⁸ Thuronyi, above n 38, 10.

⁸¹⁹ Various techniques in this regard are evolved (for details see Faulk et al, above n 15, 7).

On the other hand, indicator based ‘standard PIT’ designs, which taxes average income is similar to the asset based PIT, because they tax identical opportunities and have marginal tax rate of zero. Although standard assessments try to be adjusted to the average income⁸²⁰, they usually miss this objective, because such a production indicator is not a close reflection of profits. Consequently, standard PIT is not as neutral as an asset based PIT. For the same reason, even as compared to turnover based PIT; a more detailed analysis is required to ascertain average profits of various sectors under an indicator based standard assessment.

3.2 Deadweight Loss

Regarding the deadweight loss, the turnover based PIT is similar to GST and excise tax, which can be shifted with each item of product sold. However, when assets are used as a base, it is relatively hard for the taxpayer to either shift the burden or to substitute it, because asset tax is not directly linked to each product unit sold and service unit rendered. In other words, an asset based PIT is similar to the lump sum tax. Consistent with Section 4.2 of Chapter 5, when appropriately calibrated, a lump sum tax is always considered superior in terms of their effect on choice substitution.⁸²¹

It is also true when qualifications are used as a proxy base in PIT for professionals. The situations when tax incidence of an asset based PIT can be shifted are similar to those when the incidence can be shifted in the normal income tax (for example, tight labour supply or project evaluation at the commencement of a business venture).

3.3 Tax Burden

Consistent with Section 3.2 of Chapter 4, a low tax rate for both the normal income tax and PIT regimes is generally advised to achieve efficiency and keep technical complexity at a minimum level. Therefore, a tax rate envisaging the tax burden proportionate to the average of return is recommended. However, it is recommended that the tax rate for the PIT regime should be only slightly less than the normal income tax rate to encourage transition to the formal sector. The slightly lower tax rate should reduce the economic gains of operating within the informal sector and also reduce the

⁸²⁰ Faulk et al, above n 15, 7.

⁸²¹ Rosen, above n 5b, 309-333.

technical compliance burden, which is considered as the main cause of the informal sector. More simply, such a tax could not provide an incentive for creating a permanent class of subsidised taxpayers.

It is commonly seen that a large difference in tax rates between the normal income tax and PIT regimes create tax arbitrage opportunities and resultantly reduce efficiency. For example, professionals pay less tax when they choose to work as an independent contractor instead of as an employee to a corporation. This arrangement is financially beneficial to both employee and employer.⁸²² For example, in an independent contract of \$10,000 per year, a professional pays tax of \$500 (if the presumed turnover tax rate is 5%). Alternatively, providing the same service through an employment arrangement bears a tax rate of 25-40% depending upon the tax rate on salaried income. In view of this marked distinction in tax treatment, the professionals and corporations are likely to structure the transaction in order to obtain tax savings. For example, a contractual arrangement between these parties for the same services at \$9,000 (rather than \$10,000) would produce a win-win situation for both of them because each of them is better off by \$1,000 under the new arrangement. The low burden PIT regime, when coupled with an 'option' feature⁸²³, results in the transfer of many businesses from the normal income tax to the PIT regime, as has happened in the case of Tahshiv in Israel.⁸²⁴

3.4 Findings

The discussion in this section shows that an asset based PIT, being a tax on potential income, is the best choice in terms of the efficiency principle. The uniqueness of assets as a proxy base by allowing the determination of an identical average income for all taxpayers without categorizing them makes an asset based PIT design superior to the other designs from an efficiency perspective.

⁸²² Engelschalk, above n 2b, 23.

⁸²³ However, for controlling evasion in the informal sector, a taxpayer's declarations should be 'open for auction' and should be sold to one, who bids 50% higher than the declared value.

⁸²⁴ Tanzi and Casanegra, above n 32a, 8.

4. Equity

Consistent with Section 5.3 of Chapter 5, neutrality is a key feature of equity. However, like efficiency, neutrality in the context of equity might also not be secured under a PIT regime in the following three aspects:

- i. Neutrality in tax treatment of losses and income
- ii. Neutrality of tax burden irrespective of the risk in the sectors
- iii. Neutrality in respect of even the compliance procedures and related costs

For the remaining seven aspects of neutrality (as stated in Section 3.1 of this Chapter) the common PIT designs in context of equity are analysed as under.

4.1 Horizontal Equity

In a PIT design, neutrality in the remaining seven aspects can be achieved by developing categories of taxpayers. The neutrality secured through such categories would be equally satisfactory for efficiency and horizontal equity. It is reiterated that categories for securing neutrality are hard to construct in the turnover and indicator based standard PIT designs. On the other hand, in an asset based PIT, not many categories are required to meet the neutrality objective.

Further, the neutrality between the taxpayers falling within the ambit of the PIT regime and those falling under the normal income tax regime is important not only for equity and efficiency purposes, but is also crucial for transition to the formal sector. Without this neutrality, taxpayers under a PIT would prefer to stay in the informal sector indefinitely. More aptly, horizontal equity between the normal income tax and PIT taxpayers helps in controlling the size of the informal sector. The neutrality for this purpose can be secured by fixing the tax rate under a PIT slightly below that in the normal income tax regime. However, achieving that tax burden for various sectors is easier in an asset based PIT as compared to other designs.

Consistent with Section 4.3 of Chapter 2, the perception of fairness and equity is important to control the informal economy. However, in the informal economy, de-facto neutrality is more relevant than the theoretical one. For example, the normal income tax is ideal in terms of equity, but in reality, mostly fails to deliver results due to massive

non-compliance in the informal sector. More simply, the real challenge in the informal economy is inequity between the compliant and non-compliant. That is, non-compliance by the informal sector takes away most of theoretical equity under the normal income tax.

Consequently, consistent with Section 5.2 of Chapter 5, a PIT design which promotes voluntary compliance by reducing the compliance burden is more appropriate for the informal sector than a strictly neutral PIT design. A PIT design which has low operational complexity (low compliance and enforcement costs), should be suggested. Lower enforcement complexity also helps in raising the compliance level through better implementation.

Overall, the above discussion recommends that some neutrality may be compromised due to exceptional nature of the informal sector. Consistent with the section discussing simplicity, an asset based PIT design is the simplest design for both compliance and administrative purposes, and therefore is also suitable in this regard.

4.2 Vertical Equity

Without prejudice to the conclusions about vertical equity in Section 5.1 of Chapter 5, there are three options for achieving vertical equity: progressive or constant or regressive tax rates. The option of progressive tax rates is detrimental to efficiency and therefore should not be suggested. Besides that, progressivity in PIT designs is almost an unachievable task. In a turnover based PIT, the high turnover does not necessarily yield high margins. Beyond that, any attempt to introduce progressivity in this design requires the creation of more categories through grading in the rates.⁸²⁵ Consequently, a progressive turnover based design would shed the merits of simplicity, the reason for which it was introduced in the first place. The indicator based PIT also suffers from the identical problem as discussed earlier. In an asset based PIT, each extra dollar of investment (increase in assets) yields extra revenue and therefore by default, taxes those proportionally more who have more assets: a form of vertical equity.

Moreover, any attempt to achieve vertical equity by grading the rates above the level commensurate with average income may cause further loss of neutrality in those three

⁸²⁵ It is suggested by Makedonskiy, above n 2a, 10.

facets (those are neutrality in loss/income, risk and compliance burden as mentioned in Section 3.1)), where PIT regimes generally do not fare well anyway. Consequently, the harmful effects of such an approach may outweigh the merits.

On the other hand, consistent with Section 5.2 of Chapter 6, using a constant marginal tax rates secures a reasonable degree of vertical equity through a proportionate increase in tax burden with increasing income. This also reduces tax planning incentives and consequent inequities. Further, a constant marginal tax rate is also relatively easy to incorporate in an asset based PIT, because it is difficult to find a single tax rate for all business sectors in other PIT designs.

Lastly, as concluded in Section 5.1 of Chapter 5, vertical equity should be secured in terms of opportunities rather than income, which could be detrimental to the efficiency principle by distorting economic choices. An asset based PIT is recommended on this account too.

4.3 Findings

The comparative analysis suggests that horizontal equity can be better achieved by having the simplest and most neutral PIT design. The appropriate design suggested for equity is the same as for the simplicity and efficiency i.e. an asset based PIT design. A simple and neutral asset based PIT would produce more de-facto equity than any other design.

Regarding vertical equity, it is suggested that progressivity in tax rates is detrimental for economic efficiency. For the same reason, despite the fact that progressivity in tax rates can be constructed in an asset based PIT design (which tax opportunities instead of performance and as a result have less distortionary effects), a reasonable level of vertical equity is recommended by using constant marginal tax rates in an asset based PIT design.

5. Analysis of the Features

All features, without exception, can be inserted in any of the designs. However, only those features which do not jeopardize the principles of a good tax system (except when it is completely unavoidable) should be chosen.

5.1 Exclusivity and Minimum Features

The exclusivity feature in a PIT regime, which basically is a fixed tax liability, besides having marginal tax rate of zero, is simpler than the minimum tax, which makes it ‘efficient for the economy by encouraging more work’⁸²⁶. This exclusive feature, both in the proxy based and the indicator based PIT, even disregarding the tax rate, yields simplicity and efficiency benefits. However, higher rates generally reduce the acceptability of PIT.

A minimum tax on the other hand, requires maintenance of accounts and double computations of income (one under the normal income tax regime and another under PIT), which makes it complex.⁸²⁷ Even when an asset based PIT (the simplest of designs), is used with a minimum tax feature, it loses a great deal of its efficiency and simplicity advantage.⁸²⁸ That may explain why minimum taxes are usually used for the corporate sector to curb evasion and transfer pricing⁸²⁹, rather than to tax the informal sector. More simply, minimum taxes, due to their higher compliance and enforcement costs, are not usually used for small business.⁸³⁰

5.2 Rebuttable and Irrebuttable Features

A rebuttable feature would ‘take the teeth out’⁸³¹ of a PIT and make it ineffective in collecting some revenue from the informal sector, particularly when most taxpayers contest its liability. Such litigation may also increase compliance costs and consequently promote informality. The rebuttable feature, despite being crucial a right of taxpayers, may also increase corruption and kill the very purpose for the use of PIT in developing countries.⁸³²

⁸²⁶ Makedonskiy, above n 2a, 8.

⁸²⁷ Thuronyi, above n 38, 11.

⁸²⁸ Sadka and Tanzi, above n 312, 13.

⁸²⁹ Makedonskiy, above n 2a, 23; Thuronyi, above n 38, 11.

⁸³⁰ Wallace, above n 6b, 1-2.

⁸³¹ Thuronyi, above n 38, 11.

⁸³² Makedonskiy, above n 2a, 8; even in judiciary, there is rampant corruption in the developing countries (see Transparency International, ‘*Global Corruption Report: Corruption and the Private Sector*’ (Report, Transparency International, 2009) <http://www.transparency.org/publications/gcr/gcr_2009#6.3> at 10 October 2009).

The feature of irrebuttability, on the other hand, has also resulted in a large number of lawsuits, reflecting unacceptability among taxpayers of PIT with an irrebuttable feature.⁸³³ This unacceptability could be ignited due to a high tax burden/rate rather than because of this feature or even this design. Although it is argued that rebuttable PIT results in more legal costs⁸³⁴, this factually depends upon how simple PIT legislation is in general and on the appellate system in particular. For instance, a rebuttability feature in a PIT consisting of poorly defined categories certainly causes more legal costs. Under a simple and appropriately designed PIT, there are expected to be fewer ambiguities demanding judicial pronouncements and consequently such a PIT can have less legal costs.

Logically, as discussed in the context of simplicity and perception of fairness, when the tax burden under such a regime is appropriately adjusted, it can have more acceptability even if that regime is irrebuttable. In that way, taxpayers' rights can be safeguarded by setting the tax burden at appropriate level. Further, it may also have more acceptability because it saves taxpayers from cost of bookkeeping, which, as discussed earlier in this thesis, can be as much as double the actual tax liability. In the case of small taxpayers, the cost of keeping accounts and negotiations with tax administration is proportionately higher; therefore, having a PIT which is 'irrebuttable' and 'exclusive' with an appropriate tax burden is simple and economically efficient.

Lastly, a 'maximum tax' feature may be offered so that those who are not happy with the exclusive and irrebuttable features can submit the accounts to the administration and be taxed on their actual income. The insertion of the maximum tax feature in conjunction with irrebuttability would make the PIT design fairer and more acceptable.

5.3 Mechanical and Discretionary Features

All standard PIT regimes (both the proxy and indicator based) are usually mechanical in nature. When the tax burden is appropriately fixed, a standard PIT design is simpler than a PIT with a discretionary feature (that is, estimated PIT design)⁸³⁵, which increases participation of tax authorities and consequently the potential of corruption.

⁸³³ Makedonskiy, above n 2a, 7; also see Wallace, above n 6b, 2.

⁸³⁴ Wallace, above n 6b, 2.

⁸³⁵ Makedonskiy, above n 2a, 20.

Among the standard PIT designs, more discretion is involved in turnover and indicator based PIT, because of ‘creating and defining the categories’⁸³⁶, as compared to the asset based PIT. This may result in corruption, particularly at the higher level of tax administration.⁸³⁷ This discretion for defining categories is especially true in respect of estimated PIT designs.⁸³⁸ Therefore, these designs, due to the large degree of discretion afforded to the tax administration, are neither simple nor appropriate for developing countries.

On the other hand, a PIT design with a mechanical feature is simple, both to comply with by small business and to administer. Although some believe that the mechanical feature puts an excessive burden⁸³⁹ on some taxpayers (not being an individualized tax) this can be resolved in two ways. First is by combining it with the maximum feature, which gives taxpayers an alternative option. Second is by inserting some relief provisions in the PIT legislation, which the tax administration can apply in given situations (for example, where a taxpayer submits a representation of genuinely high burden).⁸⁴⁰ These remedial actions would bring more simplicity, fairness and efficiency to the system.

5.4 All other Features

All other features, including ‘optional’, ‘entry and exit thresholds’, ‘audit’ and ‘open for auction’ etc., have no distinctions with respect to designs of PIT. These can be used along with any PIT design conveniently and therefore do not influence the choice of PIT design for informal economies. Nevertheless, these features, consistent with Sections 3.1.1 and 3.1.2 of Chapter 4, are quite important for tackling the informal economy and therefore must be incorporated into PIT irrespective of the choice of design.

Although in terms of simplicity, ‘audit’ and ‘open for auction’ features would increase compliance requirements, without them enforcement would be difficult and the very

⁸³⁶ Makedonskiy, above n 2a, 20.

⁸³⁷ Taube and Tedesse, above n 13, 16.

⁸³⁸ Taube and Tedesse, above n 13, 16.

⁸³⁹ Makedonskiy, above n 2a, 9.

⁸⁴⁰ See *Law on Taxes on the Income of Natural Persons of Bulgaria* 2007 (Bulgaria) s 3.3.2 of Chapter 3.

purpose of the PIT regime would be jeopardized. Moreover, complexity in these features should be lower than under the normal income tax. Therefore, by ensuring compliance, these features promote equity and efficiency aspects of PIT. The capping provision in the regime would also ensure some degree of vertical equity (For more details see Section 2.2.1.4 of Chapter 10). Having a bottom entry threshold increases chance of fragmentation of large businesses and can result in efficiency losses.⁸⁴¹ Broadly, this feature, which is basically linked to the eligibility of taxpayers to use PIT and is crucial for all principles of a good tax system⁸⁴², should be set with due diligence.

6. Conclusion

The discussion in this chapter shows that an asset based PIT is superior to other PIT designs in terms of all three core principles of a good tax system. Consequently, the prioritized order of the principles in the informal economy can be better achieved under an asset based PIT.

An asset based PIT prescribed for the informal economy should also contain the features of exclusivity, irrebuttability, mechanical and the maximum tax in order to inculcate simplicity and fairness in the regime. The additions of entry and exit thresholds are also important to limit the benefits to small businesses. The addition of open for auction, capping and audit provisions may add complexity, but are recommended for the efficiency and vertical equity of tax system.

In addition to the above features, the typical form of asset tax (as mentioned in Section 3.3.2 of Chapter 3 and practised in Milan) may be an appropriate choice for large informal economies (that is, taxing only gross physical assets as per estimated values declared by taxpayers and monitoring the regime with anti-avoidance features such as an open for auction). After an appropriate basic exemption, such asset tax should be charged on the unified basis with constant marginal tax rates commensurate to average rate of return, as recommended in sections 3.3.2 and 4 of Chapter 4. Further, as recommended there, this tax can be charged as a fixed tax for every couple of years.

⁸⁴¹ Makedonskiy, above n 2a, 15.

⁸⁴² Thuronyi, above n 38, 6.

An empirical study of countries such as Bolivia, Columbia and Netherland, who adopted asset based PIT regimes in the recent past as mentioned in Section 4.4 of Chapter 3, is recommended in order to improve the exact form of an asset based PIT with reference to the use of gross or net assets, the use of tangible or intangible assets, asset valuation techniques etc. The incorporation of such a study in this thesis is beyond the scope of thesis due to the time, resource and cost constraints. Therefore, the proposed study is a potential future research area.

In all, in this Part of the thesis, after defining and ranking the principles of a good tax system in the context of large informal economies and comparing common PIT designs against these principles, it is concluded that an asset based PIT design is superior to all other PIT designs. Now it is important to apply the same principles of a good tax system on current PIT regimes in developing countries to assess their effectiveness in the context of large informal economies. In this regard, the Pakistani PIT regime is analysed in the Part 3 of this thesis.

CHAPTER 8 PIT IN THE PERSPECTIVE OF PAKISTANI INFORMAL ECONOMY

Objective of this chapter: This chapter provides the perspective in which PIT was introduced in the Pakistani informal sector, which is essential before describing and analysing the Pakistani PIT legislation in subsequent chapters. The literature review in this chapter describes the content and characteristics of the Pakistani informal sector, problems faced by its small businesses and the background to the introduction of PIT in Pakistan.

1. Introduction

As a natural consequence to the recommendations of Chapters 4 and 7 regarding appropriate PIT design for large informal economies, it is essential to test them against some prevailing PIT legislation of a developing country. Such a test would reveal whether PIT legislation which conforms to these recommendations does well in achieving tax objectives or not. Similarly, do PIT regimes which are not in line with the recommendations fail to secure the tax objectives? Moreover, consistent with Section 2.2.1 of Chapter 7, in order to evaluate certain facets of the principles of a good tax system, a PIT design is required to be examined within its legislative context rather than as an abstract ideal form.

In view of above, this thesis analyses the Pakistani PIT system. Before proceeding with the analysis of the Pakistani PIT in subsequent chapters in this part of thesis, this chapter reviews earlier literature regarding the content and characteristics of the Pakistani informal sector, problems face by its small businesses and the background to introduction of PIT in Pakistan.

The literature review in this chapter reveals that the causes of growth and sustenance of Pakistan's informal sector are similar to those mentioned in Chapter 2. Small businesses in Pakistan face identical impediments as small businesses face in other developing countries. Therefore, the consequential effects of such impediments are also the same. Even the remedy identified is the same i.e. the use of PIT to tax small business. However, no positive results have been achieved in Pakistan despite the use of PIT for the last two decades.

The remaining chapter has four sections. Section 2 describes the relationship of small business within the informal economy and services sector and its role in economic growth of Pakistan. This section also mentions the hurdles faced in the smooth operation of small business. Section 3 deals with the level of tax non-compliance and evasion in Pakistan. Section 4 provides details of the step by step introduction of the PIT regime in Pakistan. Lastly, Section 5 concludes the chapter.

2. Informal Economy: Service Sector in Pakistan

Pakistan is one of the emerging economies of the world. Pakistan's economic growth is based on a wide range of sectors. In recent years, the major contribution in the economy has been from the service sector.⁸⁴³ In terms of percentage points of Gross Domestic Product (GDP), which was 7.0 in the year 2006-07, the services sector alone contributed 4.2 points, whereas agriculture contributed just 1.1 points. This suggests that Pakistan is no longer an agriculture based economy, as it happened to be a decade ago.⁸⁴⁴

However, most business establishments in the service sector are small in size and these operate in the informal sector. This is reflected in the fact that a large share of country's GDP comes from the informal economy. Pakistan has no quantitative data regarding the contribution of the informal sector to GDP except employment data. The data shows that the share of the informal sector in employment in the non-agricultural sector increased from 65% in 2002 to 73% in 2006.⁸⁴⁵

Consistent with Section 5 of Chapter 2, the large informal sector in Pakistan also casts negative implications on the economy in general and tax compliance in particular.

⁸⁴³ United Nations, '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.

⁸⁴⁴ Pakistan, 'Economic Survey of Pakistan 2006-07' Government of Pakistan <<http://www.accountancy.com.pk/docs/economic-survey-of-pakistan-2006-07.pdf>> at 12 March 2008.

⁸⁴⁵ ADB, 'Private Sector Assessment of Pakistan' Asian Development Bank, December 2008, 49 <<http://www.adb.org/Documents/Assessments/Private-Sector/PAK/Private-Sector-Assessment.pdf>> at 1 August 2009.

Despite the size, growth and implications of the informal economy, ADB comments that the Pakistani government has no vision or strategy for its resolution.⁸⁴⁶

2.1 Small Business is Synonymous to Service Sector in Pakistan

The service sector, which has emerged as a single large contributor to GDP in Pakistan, is basically predominated by small business. More specifically, the service sector contributes 53.3 % to GDP through 2.65 million enterprises.⁸⁴⁷ According to the Economic Census of Establishment of Pakistan total number of enterprises in Pakistan is 3.2 million.⁸⁴⁸ Most of these businesses are small in size, as is evident from the following details.

In terms of the size, 2.96 million of the enterprises in Pakistan (which make up 93% of the total enterprises that is, 3.2 million) are Small Medium Enterprises (SMEs).⁸⁴⁹ That is why it is stated that Pakistan's economy is an economy of SMEs.⁸⁵⁰ Since 80% of total enterprises operate in the service sector, most SMEs are presumably engaged in the services sector. Within the services sector, trade (retail, wholesale, restaurants etc), personal services, transport, forestry and finance comprise 53.0%, 22.3%, 1.7%, 1.6% and 1.7% respectively of these enterprises.⁸⁵¹

The statistics reflect that most of firms in the SME sector are basically small firms. It is noted that 98% of SMEs involved in trade (retail and wholesale etc) employ less than 5 persons. Similarly, 87% of SMEs in the manufacturing sector employ less than five persons.

Moreover, the average turnover in the services sector is in range of PKR 60,000-400,000⁸⁵² (equivalent to A\$ 923-6,154). On other hand, the Small Medium Enterprises Development Authority (SMEDA) estimates that the 84% of enterprises have sales

⁸⁴⁶ ADB Private Sector Report, above n 845, 49.

⁸⁴⁷ Pakistan Economic Survey, above n 844.

⁸⁴⁸ Pakistan Economic Survey, above n 844.

⁸⁴⁹ Pakistan, '*Economic Census of Establishment of Pakistan*', (2005) Federal Bureau of Statistics, Pakistan.

⁸⁵⁰ Pakistan SME Task Force Report, above n 89, 1.

⁸⁵¹ Pakistan Economic Survey, above n 844.

⁸⁵² Pakistan Economic Survey, above n 844.

below PKR 0.5 million (A\$7,692) and 93% report sales below PKR 1.0M (A\$15,385).⁸⁵³ More specifically, for retailers, wholesalers and restaurants the average turnover is PKR 216,000 (A\$3,323); PKR 480,000 (A\$7,385); and PKR 180,000 (A\$2,769) respectively.⁸⁵⁴

On average, the capital investment in the SME sector is less than PKR1 million (A\$15,385).⁸⁵⁵ Further, it may be noted that 96% of these businesses are organized as sole proprietorships.⁸⁵⁶ In view of these facts, the Asian Development Bank (ADB) rightly holds that ‘M’ has not yet been developed in ‘SME’ in Pakistan.⁸⁵⁷ Therefore, the ADB recommends a friendly policy framework to help small business to enlarge and become medium size business.

2.2 Importance of Small Business in the Economic Growth

Despite the fact the government has been supporting the large scale businesses sector in general and manufacturing in particular, the SME sector has shown robust growth throughout the history of Pakistan. Recently this sector has surged, perhaps due to the worldwide growth in the service sector.⁸⁵⁸ It seems that SMEs and the service sector synergise to promote economic growth.

Since the small business is labour intensive and Pakistan has a continuously growing labour supply, it is an opportunity for efforts to be made towards the growth of the services sector and consequently towards economic growth.⁸⁵⁹ Individuals, whose

⁸⁵³ Khawaja, above n 88, 2.

⁸⁵⁴ *Economic Census of Pakistan* (2005) Federal Bureau of Statistics of Pakistan – tabulated by SMEDA and quoted in ITC report, above n 843, 145.

⁸⁵⁵ Khawaja, above n 88, 2.

⁸⁵⁶ Khawaja, above n 88, 2.

⁸⁵⁷ ADB Private Sector Report, above n 845, 53.

⁸⁵⁸ For example, the SME in manufacturing sector grew at rate of 5.5, 10.5 and 7.2 in 1970s, 1980s and 1990s respectively (see Faisal Bari, Ali Cheema and Ehasan ul Haq, ‘*Barriers to SME Growth: An Analysis of Constraints*’ Working Paper No.3 Asian Development Bank, October 2005, 6 <http://www.adb.org/Documents/PRM/Working_Papers/wp-03.pdf> at 12 March 2009).

⁸⁵⁹ Pakistan, ‘*SME Development in Pakistan: Issues and Remedies*’ 2005, 4 at <http://www.gcu.edu.pk/Publications/VC-SME.pdf> at 10 August 2009.

majority is shy of undertaking business ventures and is more inclined to employment, should be assisted to take the former course, which will improve their livelihood.⁸⁶⁰

Moreover, the growth achieved by promoting SMEs is better for the objective of redistribution of income, as compared to the growth achieved through the large industrial sector.⁸⁶¹ SME growth simultaneously creates jobs and reduces poverty, which may help Pakistan, 'a country at the threshold of achieving middle-income status'⁸⁶², in the structural transformation. The ADB report for Pakistan argues that 'SMEs act as catalysts of change, and at the very least, as enablers of structural change that is triggered by large scale enterprises'⁸⁶³.

Lastly, it is noted that successful transformation to the developed economy is not smooth without active participation of the SME.⁸⁶⁴ It may be because they generate higher levels of competition, mobility and consequently learning, which make them more innovative and a catalyst to economic growth.⁸⁶⁵ The SME sector therefore needs to be encouraged by the government to accelerate their economic growth. But unfortunately, Pakistan is one of the countries which have not done much to harness the potential of small business in their informal economy.

2.3 Problems Confronting Small Business

Like small business in any other developing country, the SME sector in Pakistan suffers from a number of problems. Some are of a strategic nature. For example, SME is defined differently under different Acts and disciplines. It, therefore, may be feasible to have a harmonized definition of SMEs in order to combine efforts to promote this sector.⁸⁶⁶ On the other hand, one harmonized definition might not be appropriate because separate definitions for different disciplines may be useful to meet distinct

⁸⁶⁰ Because, government can not generate sufficient jobs due to the scarcity of capital.

⁸⁶¹ Pakistan, 'SME Led Economic Growth – Creating Jobs and Reducing Poverty: SME Policy 2007' SMEDA, Ministry of Industries, Productions and Special Initiatives, Government of Pakistan, 2007, 8 <http://www.smeda.org/downloads/SME_Policy_2007.pdf> at 10 October 2009.

⁸⁶² Bari et al, above n 858, 9.

⁸⁶³ Bari et al, above n 858, 12.

⁸⁶⁴ Khawaja, above n 96, 2.

⁸⁶⁵ Bari et al, above n 858, 13.

⁸⁶⁶ Pakistan SME Task Force Report, above n 81, 15; Pakistan SME Policy, above n 861, 11.

dimensions and requirements of each discipline. Thus, the presence of the range of definitions is not a problem and even could be useful to frame separate strategies for helping small business in each discipline. Other problems, which are more serious and require a concerted effort by the government for their resolution, are given below.

2.3.1 Peculiarities of Small Business

Despite their large contribution to Pakistan's economic growth, most of the SMEs in Pakistan are very small and their real concern is their survival.⁸⁶⁷ More simply, 'due to the size and resulting peculiarities, SMEs are far less capable of adjusting and carrying on successful businesses'.⁸⁶⁸ It may be because these SME use outdated technology, which reduces their productivity level⁸⁶⁹ and explains their low profit margins when compared to the large sector.

2.3.2 Lack of Finance

It is noted that the inability to obtain finance from banks is one of the most significant hurdles in the growth of SMEs. Therefore, 93% of the funds in small businesses are retained earnings or the personal finance of the business.⁸⁷⁰ It is suggested to assist SMEs to enlarge their size to a point where they can borrow from banks and consequently become large formal businesses. It is like nurturing a baby to become the responsible and self reliant citizen of tomorrow. Infants, before they become adults, are subjected to juvenile treatment and same is suggested for budding businesses. The SME sector may be expected to serve as the 'breeding ground'⁸⁷¹ for the formal firms, if encouraged to grow and make the transition to the formal economy.

2.3.3 Language Gap and Illiteracy

The language gap is also considered as a major hurdle for the survival of small businesses.⁸⁷² All material related to government regulations including taxation is in the

⁸⁶⁷ Pakistan SME Development Report, above n 859, 2.

⁸⁶⁸ Khawaja, above n 96, 8.

⁸⁶⁹ Pakistan SME Development Report, above n 859, 2.

⁸⁷⁰ Pakistan SME Task Force Report, above n 89, 10.

⁸⁷¹ Khawaja, above n 96, 2.

⁸⁷² Pakistan SME Task Force Report, above n 89, 6.

English language, which is hard for the uneducated entrepreneurs to understand. Although ignorance of law is not a legally acceptable excuse, in many cases it is a real cause of non-compliance in Pakistan. Thus, SMEs should be facilitated by provided Urdu versions of tax related brochures etc. Finally, many business entrepreneurs are completely uneducated, as evidenced through the low literacy rates in Pakistan.⁸⁷³ These entrepreneurs need to be communicated to methods other than the written material.

2.3.4 Taxation and Other Regulatory Burdens

SMEs do not have a favourable regulatory environment in Pakistan.⁸⁷⁴ For example, it is naïve to expect that an uneducated entrepreneur will be able to deal with 56 laws.⁸⁷⁵ Regarding tax matters, among all countries, Pakistan ranks at 140th on the ease of paying taxes.⁸⁷⁶ A business establishment has to make as many as 47 tax payments to different agencies of the government.⁸⁷⁷ Moreover, as compared to the large sector, the SME sector does not get any tax concessions and are placed under a proportionally higher tax burden, perhaps due to their lack of representation in the decision making bodies.⁸⁷⁸ More simply, small firms in Pakistan are discriminated vis-à-vis the large firms by government⁸⁷⁹ and therefore cannot compete and survive.

More specifically, taxation is identified as the main constraint in the growth of SMEs.⁸⁸⁰ 67% of the enterprises termed the tax regulations as the most problematic of all government regulations.⁸⁸¹ Tax may be ranked so high because the labour laws and other licensing regulations are not effectively enforced.⁸⁸² Tax related problems are

⁸⁷³ Bari et al, above n 858, 34.

⁸⁷⁴ Khawaja, above n 96, 4.

⁸⁷⁵ Pakistan SME Task Force Report, above n 89, 8.

⁸⁷⁶ Usman Khan, 'Assessment of the Provincial Legal and Policy Framework Related to Private Sector Development' Final Report of the Economic Advisor, Commerce and Investment Department, Government of Punjab, 2007, 6.

⁸⁷⁷ ADB Private Sector Report, above n 845, 41.

⁸⁷⁸ Pakistan SME Development Report, above n 859, 13.

⁸⁷⁹ Atif Saleem Malik and Aalia Gogi, 'Creating a Policy Environment Conducive to Employment Growth within the MSMEs in Pakistan', Report Submitted to ILO/SEED Geneva, Small and Medium Enterprise Development Authority (SMEDA), Government of Pakistan, December 2001, 65.

⁸⁸⁰ Khawaja, above n 96, 5.

⁸⁸¹ Pakistan SME Task Force Report, above n 89, 7.

⁸⁸² Bari et al, above n 858, 37.

relatively more serious for small business than problems related to other regulations. It is noted that among all firms 69% of firms, having assets worth less than PKR 1.0M (A\$15,385), face the greatest of tax related problems⁸⁸³

However, there is a disagreement as to which part of taxation is causing the most impediments for the SME sector. Some argue that the high tax burden and compliance costs are the main factors which encourage informal activities.⁸⁸⁴ Another view suggests the administrative and corruption related issues, which costs small business a large percentage of their sales, are responsible for SMEs' informality.⁸⁸⁵

A qualitative study by ADB 'made it clear that the noncompliance was due to the time and pecuniary costs involved in organized corruption'⁸⁸⁶. Some respondents in the survey have also pointed out the uncertainty in policy as a cause of the regulatory burden.⁸⁸⁷

In addition, consistent with Chapter 2 and as discussed later in Chapter 10 in respect of Pakistan, the corruption and the discretion within the authorities is a natural sequel to the complex tax law and assessment as per accounts. The costs of maintenance of accounts are higher than the tax liability and give the administration the opportunity to harass taxpayers. It was found that small entrepreneurs spend 17% of its time dealing with tax issues, which is higher than developing countries in the transitional Europe and Latin America.⁸⁸⁸

The maintenance of books of account and hiring a professional for tax compliance is not possible for small businesses due to cost constraints.⁸⁸⁹ Further, sole proprietors of small business are also deficient in accounting skills.⁸⁹⁰ Consequently SMEs, which are already struggling to survive, are reluctant to keep normal books of accounts.⁸⁹¹ Instead

⁸⁸³ SME Policy Note of the World Bank.

⁸⁸⁴ Pakistan SME Task Force Report, above n 89, 7.

⁸⁸⁵ Khawaja, above n 96, 11.

⁸⁸⁶ Bari et al, above n 858, 41.

⁸⁸⁷ Bari et al, above n 858, 39.

⁸⁸⁸ Bari et al, above n 858, 39.

⁸⁸⁹ Khawaja, above n 96, 9; Pakistan SME Task Force Report, above n 89, 7.

⁸⁹⁰ Khawaja, above n 96, 12.

⁸⁹¹ Pakistan SME Development Report, above n 859, 13.

of being helped, these are evidently harassed by tax authorities, ‘who hold excessive discretion’⁸⁹² regarding the assessment of income.⁸⁹³ This usually results in constant confrontation between SMEs and tax authorities.⁸⁹⁴ Consequently, many SMEs cease to operate⁸⁹⁵ or keep changing their operations in order to hide from tax authorities. More simply, such an environment increases the costs of taxation, which results in inefficiency, inequity and revenue loss.

2.4 Implications

In the wake of the above problems, small businesses are not willing to register and prefer to remain informal. It may explain why the SME sector in Pakistan is composed of a few formal and many informal establishments.⁸⁹⁶ For example, in 2002-03 the informal sector provided 70% of the employment outside the agricultural sector and most of this employment was in retail and wholesale trade.⁸⁹⁷ Further, less than 4% of SMEs supply services or goods to the government⁸⁹⁸, which may suggest that most of them want to ‘fly under the radar’ by not supplying goods and services to the government.

Moreover, the informal sector tends to grow,⁸⁹⁹ with even large firms fragmenting into smaller ones in order to evade tax.⁹⁰⁰ The risk of being caught is almost negligible because tax administration is weak. Even in case someone is caught, he/she can get away without a penalty by giving the tax official a bribe which is just a fraction of the actual penalty. More simply, both the severity and certainty of punishment is very low, hence, ‘tax evasion is rife in Pakistan’⁹⁰¹. Consequently, growth in the tax base, which

⁸⁹² Khawaja, above n 96, 9.

⁸⁹³ Pakistan SME Development Report, above n 859, 13.

⁸⁹⁴ Pakistan SME Task Force Report, above n 89, 7.

⁸⁹⁵ Pakistan SME Development Report, above n 859, 13.

⁸⁹⁶ ITC report, above n 843, 150.

⁸⁹⁷ Pakistan SME Development Report, above n 859, 5: It is stated that 43.6 percent of this population is self employed.

⁸⁹⁸ Pakistan SME Task Force Report, above n 89, 6.

⁸⁹⁹ Khawaja, above n 96, 8.

⁹⁰⁰ Pakistan SME Development Report, above n 859, 21.

⁹⁰¹ Pakistan SME Development Report, above n 859, 21.

is the manifestation of taxpayers' compliance, is stagnant.⁹⁰² This all helps explain why the Pakistani informal sector is consistently growing.

2.5 Realisation at Last

In recent years, the government has identified the SME and services sector as the top priority agenda.⁹⁰³ SMEDA therefore suggests fiscal concessions and 'simplification in the regulatory environment'⁹⁰⁴ or 'an overall pragmatic revision of the relevant policies'⁹⁰⁵ for the SME sector.⁹⁰⁶

The ADB, in its report, suggested the Self Assessment Scheme (SAS) for the reduction of the interface between the tax officials and the payers.⁹⁰⁷ It further suggests backing up the SAS with effective audit mechanisms.⁹⁰⁸ However, a similar system of optional SAS has been in practice in Pakistan for almost 15 years, before the submission of the ADB recommendations,⁹⁰⁹ but it could neither generate any significant revenue nor did it compliance by small business (statistically elaborated in Section 4 of Chapter 10). It may be because the tax agency in Pakistan has been among the top corrupt organizations⁹¹⁰, and the 'checklists for audit'⁹¹¹ suggested by ADB could not convert a 'dysfunctional audit'⁹¹² into an effective audit. Even the tax agency has scarcity of resources as against the large number of small taxpayers.

Tax scholars in Pakistan, therefore, suggested the use of a 'fixed tax' based on assets in order to help small businesses in the retail, restaurant and hotel sector.⁹¹³ Such a tax

⁹⁰² Pakistan SME Task Force Report, above n 89, 6.

⁹⁰³ Pakistan SME Policy, above n 861, 8.

⁹⁰⁴ Pakistan SME Policy, above n 861, 15.

⁹⁰⁵ Khawaja, above n 96, 12.

⁹⁰⁶ Pakistan SME Development Report, above n 859, 16; also see Pakistan SME Policy above n 861, 13.

⁹⁰⁷ Bari et al, above n 858, 65.

⁹⁰⁸ Bari et al, above n 858, 65.

⁹⁰⁹ The repealed *Income Tax Ordinance* 1979 (Pakistan) s 59.

⁹¹⁰ Shameim Kazmi, 'Nature & Extent of Corruption in the Public Sector' (Report, Transparency International Pakistan, March 2002), 34 <<http://www.transparency.org.pk/documents/csr.pdf>> at 11 October 2009.

⁹¹¹ Bari et al, above n 858, 65.

⁹¹² Bari et al, above n 858, 65.

⁹¹³ Khawaja, above n 96, 9.

would reduce the need of the ‘ADB’s recommended dissemination of audit related information’⁹¹⁴, which requires efficient tax administration. Such information requires explanations, which can only put uneducated taxpayers under further difficulties.

Unfortunately, despite the realisation of the problem and having the ‘SME Development Vision’ in the 2007 SME policy, (which clearly suggests rationalizing taxation requirements)⁹¹⁵ concurrent measures in the fiscal area have not been taken. It displays the lack of coherence in the government ministries. The tax administration reforms are considered inadequate to address the root causes of the informal economy.⁹¹⁶ This suggests revisiting tax policy to ensure compliance by small businesses in the informal economy.

3. Informal Economy and Evasion in Pakistan

There are no reliable statistics of evasion in Pakistan. However, a poor tax to GDP ratio in Pakistan clearly indicates that a large component of national income escapes taxation (see Table 1).

Table 1
GDP and Tax to GDP ratio of Pakistan

Figures in millions of PKR

YEARS	GDP * (mp)	DIRECT TAXES		INDIRECT TAXES	
		Collection (Net)	Tax/GDP Ratio (%)	Collection (Net)	Tax/GDP Ratio (%)
1999-00	3,826,111	112,950	2.95	234,154	6.12
2000-01	4,209,873	124,585	2.96	267,692	6.36
2001-02	4,452,654	142,505	3.20	261,565	5.87
2002-03	4,875,648	151,898	3.12	308,729	6.33
2003-04	5,640,580	165,079	2.93	355,764	6.31
2004-05	6,499,782	183,372	2.82	407,015	6.26
2005-06	7,623,205	224,988	2.95	488,454	6.41
2006-07	8,723,215	333,737	3.83	513,499	5.89

Source: Statistical data (Historical) 2006-07 Source: Statistical data (Historical) Fiscal Research and Statistics, Directorate Research & Statistics accessed <<http://www.fbr.gov.pk/DRS/Default.asp>> at 17 November 2008.

More recently, the overall tax collection as a percentage of GDP in Pakistan is 14.5 and 14.7 for financial years 2008-09 and 2009-10 respectively.⁹¹⁷ When the tax to GDP ratio

⁹¹⁴ Bari et al, above n 858, 67.

⁹¹⁵ Pakistan SME Policy, above n 861, 13.

⁹¹⁶ Pakistan SME Task Force Report, above n 89, 8.

⁹¹⁷ Pakistan Economic Survey 2009-10 <http://www.finance.gov.pk/survey_0910.html> at January 24 2011.

of Pakistan is compared with other regions in the world, the picture appears bleak because it is even lower than other developing regions in the world (see Table 2).

Table 2
Tax Levels: Tax Revenues as a Percent of GDP

Country Groups	1970s	1980s	1990s	2000s
Industrialized	30.1	33.7	35.5	33.4
Developing	16.2	17.3	17.0	17.0
Transition	n.a.	47.7	29.6	29.1
Total	19.8	21.6	22.6	21.8

Source: Roy Bahl, "How to Approach Comprehensive Tax Reform: Have the Rules of the Game Changed?" pp. 447-471. In *The Challenges of Tax Reform in a Global Economy* edited by James Alm, Jorge Martinez-Vazquez and Mark Rider, New York: Springer, 2006.

Economists, who look at the tax collection in terms of national tax effort (that is, a degree to which taxable capacity of a country is used), also rank Pakistan almost at the bottom when compared to other countries in its own region (see Table 3).

Table 3
Tax Effort Indices – Low Income Countries

Country	Tax- GDP ratio	Tax Effort
Pakistan	12.999	1.228
India	10.645	1.455
Egypt	20.704	1.369
Sri Lanka	17.886	1.240
Syria	16.334	1.121
Thailand	15.620	0.950
Romania	21.053	1.333

Source: Marcelo Piancastelli, *Measuring the Tax Effort of Developed and Developing Countries: Cross Country Panel Data Analysis 1985-95* (2001) Working Paper No.818 Institute of Applied Economic Research, Directory of Macroeconomic Policy and Studies, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=283758> at 9 August, 2009.

The National Tax Reforms Committee (NTRC) showed on the basis of national accounts that PKR 50.8 billion escaped taxation in one year.⁹¹⁸ Over the years the size of Pakistani tax gap has been manifoldly increased and the recent World Bank report mentions that loss of revenue every year in Pakistan is approximately PKR 700 billion. More specifically, the World Bank estimates that the tax gap from small entrepreneurs

⁹¹⁸ Pakistan, *The Final Report of the National Tax Reforms Committee* (NTRC) Karachi 1986, 103-104.

is around PKR 7.3 billion, but then by realizing the fact that this figure is ‘astonishingly’ small it points out weaknesses in its estimation methods.⁹¹⁹

The above estimate of the tax gap for small businesses also contradicts the report’s own findings that in countries with large informal economies, it is very easy for the self-employed to conceal their income.⁹²⁰ More aptly, if the USA tax gap in respect of this sector is 40 percent of the tax liability as mentioned in another report of the World Bank, then it should be much higher in Pakistan. The low estimates may be partly because in the said report, a large chunk of WHT is attributed to collection from the non-salaried or self-employed taxpayers.⁹²¹

Besides the estimates of the informal economy which roughly depict the tax gap, in order to have a fair idea of the level of evasion and non-compliance, this thesis prefers to use a count of the number of persons who are not yet registered with tax authorities. The total number of SMEs, as per the Economic Survey of Pakistan, is 3.2 million.⁹²² But the total number of taxpayers registered with the Federal Board of Revenue is 2.28 million, which constitutes only 1.2% of the total population.⁹²³ The total number of returns filed in 2008 is 2,056,137, among which 616,395 were from salaried individuals. The net business returns were 1,439,742. Thus, the difference between the total number of establishments and tax return filers is 1,760,258. This reflects that significant number of business entities which are certainly defying the statutory requirements, because they cannot all be assumed to have incomes below taxable limits. Besides that, persons who do not maintain establishments for rendering professional services are also outside the tax roll. Consequently, their tax burden probably falls onto the registered taxpayers,

⁹¹⁹ Robina Ather Ahmed and Mark Rider, ‘Pakistan’s Tax Gap: Estimates by Tax Calculation and Methodology’ Working Paper No. 08-11, Andrew Young School of Policy Studies, December 2008, 36.

⁹²⁰ Ahmed and Rider, above n 919, 6.

⁹²¹ Jorge Martinez-Vazquez and Kasper Richter, ‘Pakistan Tax Policy Report: Tapping Tax Bases for Development’ Working paper No. 09-08, Andrew Young School of Policy Studies, August 2009, 112.

⁹²² The actual number of self-employed is estimated at 7.8 million by using Labour Force Survey (LFS) (see Umar Wahid and Sally Wallace, ‘Incidence of Taxes in Pakistan’, Working Paper No. 08-13, December 2008, 57). If this number is true, then all subsequent estimates of evasion made in this chapter would be accordingly high.

⁹²³ James Alm and John Martinez-Vazquez, ‘Short and Medium-term Tax Policy Options for the 2007-08 Pakistan Budget’ (Report, Andrew Young School of Policy Studies, Georgia State University, 2007), 7.

who are being squeezed more and more by the authorities to improve the tax to GDP ratio.

In terms of the revenue loss, this thesis explores just one large sector of SMEs to reflect the gravity of the problem. According to the Economic Census of Pakistan, the total number of retailers is 1,439,340 and the total sales revenue of these retailers is PKR697,299,877,664 (i.e. PKR 697.299 billions – equivalent to A\$10.73 billion).⁹²⁴ The Financial Investment Advisory Services (FIAS) of the World Bank has estimated the turnover of retailers at PKR 2,100 billion (A\$32.3 billion) (which is 55% of GDP).⁹²⁵ The same report revealed from retailer interviews that their average profit margins are 7.5%.⁹²⁶ Thus, the income of this sector from the sector's sales volume should stand at PKR 52.3 billion (A\$0.697 billion) for sales figure provided by the census; and PKR 157.5 billion (A\$2.1 billion) for the sales figure provided by the FIAS. The latter seems more reliable, because turnover cannot be expected to have been declared correctly by businesses in the census.⁹²⁷ Consequently, the tax paid by this sector at the rate 5% should be either around PKR2.6 billion (A\$0.035 billion) or PKR 15.0 billion (A\$0.20 billion) annually, depending upon the profits under the census or FIAS. It may be noted that this calculation is on the basis of average profit rate admitted by retailers in the FIAS survey; the actual rate is expected to be higher (in view the culture of concealment in Pakistan).

As compared to above estimates, FBR statistics reveal that 36,378 retailers paid tax of PKR 114.3 million (A\$1.52 million) in 2005.⁹²⁸ By 2008, the number of the retailers filing returns increased steadily to 1,171,656, but the tax paid amount increased to only PKR 165.8 million (A\$2.21 million). This means that every new registered taxpayer paid only PKR 4.5 (06 Australian cents) as its annual tax liability, which is ridiculous. Perhaps the non-compliant tax population has started exploiting the recently introduced

⁹²⁴ *Economic Census of Pakistan* (2005) Federal Bureau of Statistics of Pakistan – tabulated by SMEDA and quoted in ITC report, above n 843, 145.

⁹²⁵ FIAS Report for Pakistan, above n 260, 30.

⁹²⁶ FIAS Report for Pakistan, above n 260, 36.

⁹²⁷ The weak element of these estimates of income is that these do not take into account tax threshold, which is below taxable limit.

⁹²⁸ CBR Quarterly Reviews for Jan-March, Fiscal Research and Statistics, Directorate Research and Statistics <<http://www.fbr.gov.pk/DRS/Default.asp> on 17/11/2008> at 10 August 2009.

very low tax bearing retailers regime as mentioned later in Section 4.2.6 of Chapter 9. More simply, this regime seems to have translated the evasion to erosion of revenue.

On the other hand, more revenue receipts could be secured from this sector by prescribing the presumed tax on assets at a rate of 2.5%. Since the average assets employed in this sector are PKR 0.5 million, every taxpayer would be expected to pay PKR 12,500 (A\$192) in order to discharge their tax liability.⁹²⁹ The total amount of tax collected from all the retailers at this rate would be PKR 17.991 billion (A\$0.277 billion) (calculated on the basis of 1,439,340 business returns multiplied by tax payable of PKR 12,500). When this liability is compared to the turnover of this sector, the tax rate stands at 2.58% for the census figures and 0.86% for the FIAS figures. Traders, under the formal sector, when subjected to withholding tax, bear a tax rate equivalent to 3.5 % of turnover.⁹³⁰ It shows that the tax on assets recommended for SMEs is slightly less than the turnover tax PIT which is charged under s 153 on the formal sector (see Chapter 9).

Moreover, consistent with Section 2.2.1.1 of Chapter 7, a tax on assets is easy to monitor as taxpayers cannot easily conceal their assets, as compared to existing turnover based regime, which evidently provide such opportunities as seen in the above details of retailers' tax returns. Finally, the rate of return on assets in the industrial sector (even risk free rate of return) is 6%, therefore, charging retailers at tax corresponding to this average income is quite appropriate.

The impact of the proposed fixed tax regime on the SME sector would be much more evident from the revenue estimated for the whole sector. The total number of the SMEs is 2.96 million, and in the case each pays the average tax of PKR 12,500 (A\$192), the total revenue expected would be PKR 37 billion (A\$0.57 billion).

This reflects the level of the annual revenue loss due to a lack of a suitable tax regime for small business. More importantly, not taxing the SME sector is tantamount to

⁹²⁹ When worked back, it shall reflect the annual turnover of 1.6 million, annual income of 250,000 and effective tax rate of 5%.

⁹³⁰ See *Income Tax Ordinance 2001* (Pakistan) s 153.

leaving 4.0 percentage points of the GDP untaxed, which could be main cause of the lower tax to GDP ratio in Pakistan.⁹³¹

4. Background of PIT in Pakistan

PIT, in conjunction with withholding tax at source, was introduced in Pakistani tax law in the 1980s to tax non-resident shipping and airline businesses. The PIT has been in use due to the difficulties involved in accurately ascertaining the profits of these activities at every port around the world. PIT was later extended to the technical fees earned by non-residents in Pakistan.⁹³² In the same decade, in order to detect tax evasion, the withholding tax regime was expanded to a number of points of accrual of income. These included interest income of financial institutions from government securities, income of contractors, suppliers and importers. Later, the National Tax Reform Commission Report (1987) envisaged a fixed tax of PKR 600 for small retailers; whose annual income and the turnover exceed PKR 36,000 and PKR 350,000 respectively.⁹³³ But this proposal, being against the principles of a good tax system, was abandoned.⁹³⁴

The beginning of the 1990s coincided with the election of the Islami Jhamoori Itihad (IJI) government in Pakistan. It was also coupled with large budget deficits due to the end of Afghan war and consequently the loss of financial aid from United States. The IJI government responded by constituting a high powered Resource Mobilization and Tax Reform Commission (RMTRC).⁹³⁵ It was the beginning of the realization of the importance of taxation in the economy and it continues to this day in the form of the Tax Administration Reform Project (TARP).

⁹³¹ Alm and Martinez-Vazquez, above n 923, 7.

⁹³² *Income Tax Ordinance* 1979 (Pakistan) s 80A. However, under s 163 of this ordinance, avoidance of double taxation agreements between Pakistan and other countries have an overriding effect on determination of tax liability of non-residents.

⁹³³ Ahmad Khan, 'Presumptive Tax as an alternative Income Tax Base: A Case Study of Pakistan' (1991) 32:4 *The Pakistan Development Review*, 997.

⁹³⁴ Khan, above n 933, 997.

⁹³⁵ Abdul Hafeez Pasha, 'Political Economy of Tax Reforms: The Pakistan Experience' Applied Economics Research Centre, University of Karachi, 1 <www.aerc.edu.pk/pjae.htm> at 10 August, 2009.

In light of the recommendations of the RMTRC, through the Finance Bill of 1991, withholding taxes were expanded to include interest income from financial institutions, income of dividends and rental income. Later, through the Finance Bill of 1992, withholding tax was extended to income from exports as well.⁹³⁶ These withheld taxes were also treated as the final discharge of tax liabilities in respect of the corresponding business and investment activities. The later years of the 1990s witnessed further expansion of the withholding tax regime.

However, the range of activities falling within the ambit of the final regime is not only increasing but also kept changing from year to year in response to lobbying of various business groups. This phenomenon is in full swing till today and some changes in WHT and PIT are witnessed with every Finance Bill.

Today, as mentioned later in Chapter 9, most of receipts of a person are subjected to withholding and all the inputs and outputs of every activity bears withholding tax. For more than 50% of the activities, this withholding tax is the final discharge of tax liabilities.

In addition, Minimum Tax (MT) was introduced for the corporate sector, which later expanded to the registered partnership firms. Minimum tax intends to collect some tax from the corporate and formal entities, which in most cases pay no tax for different reasons such as concealing declarations in income tax returns. The statistics also confirm this. For example, out of the 440 public quoted companies in the Karachi Stock Exchange, only 112 paid any income in 1988-89.⁹³⁷ The situation could be worse in the non-listed public and private companies, because, these are much less regulated by corporate regulatory authorities such as the Securities Exchange Commission of Pakistan. The MT regime, therefore, is in place even today. However, it is beyond the scope of this thesis to elaborate on this regime further.

In 1991, a fixed tax regime was introduced for small shopkeepers, traders etc of any business or profession for reasons that existing tax compliance procedures are too

⁹³⁶ 'Finance Act 1992: Explanation of Provisions relating to Withholding and Presumptive Tax' Circular No. 22 dated July 1, 1992 <<http://www.fbr.gov.pk/newdt/circulars/circulars.asp?year=1992>> at 29th June, 2010.

⁹³⁷ Hafeez A Pasha, Aisha G, Rafia G and Rizwanullah K, 'Fiscal Policy in Pakistan' (Report, No.1, QuideAzam University, 1992), 44.

cumbersome for them.⁹³⁸ The separate tax liability was fixed for rural and urban entrepreneurs.⁹³⁹ This scheme was later quickly abandoned in 1992 without any concrete reasoning. It may be because there was an addition of only 1,882 new taxpayers in that year, who contributed only PKR 1.5 million (A\$23,077) to the national exchequer.⁹⁴⁰

The tax system prevalent at that time was considered as inefficient, complex and corrupt.⁹⁴¹ These above changes in the income tax were aimed at ‘broadening the tax base and simplification of the tax system by removing causes, both legal and administrative, which may inhibit voluntary tax payments and mitigating the exposure of taxpayers to protracted and open-ended assessment and appellate procedures’.⁹⁴² It was expected that PIT regimes would generate more revenue from hard to tax taxpayers, which otherwise was un-collectable due to large scale evasion. Further, it was hoped that the system would become more equitable by taxing the untaxed economy.⁹⁴³

Like India, the provisions of PIT in the Income Tax Ordinance 1979 were challenged in Pakistan, on the ground that it is not tax on income and therefore is constitutionally infirm. The matter went to the Supreme Court of Pakistan which decided the case in favour of the Revenue Authority through the earlier mentioned landmark judgement of *Ellahi Cotton Mills v Federation of Pakistan*⁹⁴⁴. This judgement was given in respect of appeals which have been filed against the judgements of various benches of the Lahore High Court issued to dispose of writ petitions. Those writ petitions challenged the PIT provisions of Income Tax Ordinance 1979 of Pakistan (hereinafter called the repealed ordinance) such as Sections 80D, 80C, 80CC as unconstitutional.⁹⁴⁵ The main and relevant findings of the court are reproduced below.

⁹³⁸ Khan, above n 933, 997.

⁹³⁹ Khan, above n 933, 997.

⁹⁴⁰ Khan, above n 933, 1000.

⁹⁴¹ Pasha, above n 935, 8.

⁹⁴² Sidat Hyder & Co. Chartered Accountants, ‘*Comments on the Finance Bill*’ (1991), Pakistan .

⁹⁴³ Pasha, above n 935, 3, 4, 6.

⁹⁴⁴ *Ellahi Cotton Mills Decision*, above n 292.

⁹⁴⁵ The PIT provisions of repealed Income Tax Ordinance identical in design with PIT provisions of the current Income Tax Ordinance 2001 and is available at <www.fbr.gov.pk>.

“We are inclined to hold that presumptive tax, is in fact akin to capacity tax i.e. capacity to earn. In this view of the matter, we will have to read Entry 47 in conjunction with Entry 52, which provides taxes and duties on production capacity of any plant, machinery, undertaking, establishment or installation in lieu of the taxes or duties specified in Entries 44, 47⁹⁴⁶, 48 and 49 or in lieu of any one or more of them. Since under Entry 52⁹⁴⁷, tax on capacity in lieu of taxes mentioned in Entry 47 can be imposed, the Presumptive tax levied under Sections 80C and 80CC of the Ordinance is in consonance with the above two entries, if read in conjunction.

....., it may be observed that reasonable classification does not imply that every person should be taxed equally. It may be pointed out that reasonable classification is permissible provided it is based on an intelligible differentia, which distinct persons or things that are grouped together from those who have been left out and that the differentia must have rational nexus to the object sought to be achieved by such classification.

....Additionally, while examining a fiscal statue the court should not be carried away with the fact that the same may be disadvantageous to some of the taxpayers. If such a fiscal status is beneficial to the country on the whole, the individual's interest would yield to the national interest

The impugned provisions of the Ordinance are based on reasonable classificationIt also has rational nexus to the object sought to be achieved by such classification i.e. to broadening the tax base ...” (See Ellahi Cotton Mills Ltd. v. Federation of Pakistan (1997) PTD 15555).

The above decision is self explanatory in accepting the use of PIT regimes particularly when it is designed appropriately. Recently the Supreme Court of Pakistan in another case of *Call Tell (Pvt) Ltd v Federation of Pakistan*⁹⁴⁸, wherein the constitutionality of withholding of taxes on sale of prepaid telephone cards was challenged as no income had arisen to buyers, has reiterated the above mentioned causes of the introduction of PIT and also validated the collection of tax on turnover as an income tax:--

⁹⁴⁶ Entry 47 of the *Constitution of Pakistan* says, ‘Taxes on income other than agricultural income’.

⁹⁴⁷ Entry 52 of the *Constitution of Pakistan* says, ‘Taxes and duties on the production capacity of any plant, machinery, undertaking, establishment or installation in lieu of the taxes and duties specified in entries 44, 47, 48 and 49 or in lieu of any one or more of them’.

⁹⁴⁸ *Call Tell (Pvt.) Limited v Federation of Pakistan* 2004 PTD 3032.

“The word ‘income’ is susceptible as to include not only what is in ordinarily parlance it conveys or it is understood, but what is deemed to have arisen or accrued. It is by working out the net income tax after adjusting the admissible expenses and their items, but the same may also be levied on the basis of gross receipts, expenditure etc. There are new species of income tax namely, presumptive tax and minimum tax.”

These decisions of the Supreme Court of Pakistan set out the legal basis for the levy of PIT, on lines identical to those of Indian Supreme Court mentioned in Section 3.2 of Chapter 3. While arriving at the conclusion, the Pakistani Supreme Court eloquently referred to the report of the National Tax Reform Commission (1986) and statistics of Federal Board of Revenue showing massive corruption in tax machinery, large scale evasive practices in taxpayers and the stagnant tax base of the country. The supreme court of Pakistan was convinced that the PIT intends to simplify the tax system, reduce the interface between the taxpayer and tax agency and raise the required revenue for the country.

Although the Supreme Court rightly endorsed the tax measure, it did not suggest improvements in the PIT design or identify the weaknesses in the existing design, perhaps as it was beyond its jurisdiction. The weaknesses, however, are identified later in Chapter 10 of this thesis while analysing the same against the principles of a good tax system.

The background to the introduction of PIT reveals that despite claims of using PIT for the objectives of equity, efficiency, simplicity and revenue sufficiency, no comprehensive effort has been made to identify the sources of the complexity, inefficiency and inequity in the tax system before making the suggestions. Moreover, turnover was hastily used as proxy for all types of income, without comparing the alternative proxies. Even the literature for the choice of the proxies and the relevant experience of other countries in this regard was not utilized.

As a result of lack of preliminary research, some incongruent measures in the shape of the PIT were taken. The introduction of minimum tax made the tax system more complex. The simplified tax for small business was discontinued without giving it an ample chance, or amending it appropriately, or making the tax administration efficient

enough to administer such a simplified tax. Taxing capital income such as interest and dividend income also taxes the income of many individuals, who otherwise would have fallen under the basic exemption. More simply, the notion of equality, which was claimed in the Pakistani PIT was not achieved because the criterion of neutrality, which is the backbone of efficiency and equity principles, was completely ignored.⁹⁴⁹

Simplicity to improve compliance was not ensured in the regime, which consequently resulted in no improvement in voluntary compliance or the tax to GDP ratio. Taxation remains at the top of the list of impediments of business growth. This is consistent with fears expressed by tax professionals at that time.⁹⁵⁰ Even the business environment did not become conducive with these changes. It was rightly said that the PIT introduced was ‘an attempt of mopping more revenue’⁹⁵¹ without designing a multi-pronged principle based approach. In all, what Yitzhaki stated, that the intention of the legislator is not always well defined⁹⁵², seems true in the case of Pakistan. Nevertheless, in general terms it appears that the Pakistani PIT was introduced to grab some revenue from the informal sector.

The testimony to the failure of the PIT introduced in 1990s is the re-start of tax reforms in Pakistan at a larger scale in 2001 under the name of Tax Administration Reform Project, which is continuing till this date.⁹⁵³ The latest reforms have resulted in the substitution of the old income tax ordinance with a new one. Regrettably, the new ordinance contains a squarely identical set of PIT regimes. The complexity, inequity and inefficiency of the tax system during these reforms were considered as arisen from the language of the law rather the procedures and the operational costs. The mistake of not doing preliminary research about the causes of the failure of the earlier PIT was repeated. Consequently, a new law with simple language but mostly the same content was introduced. Since 2001, when these reforms began, the situation has not changed – both in terms of tax to GDP ratio and compliance costs.

⁹⁴⁹ Khan, above n 933, 1001.

⁹⁵⁰ Ahmad Khan mentioned that PIT in Pakistan is fraught with the possibilities of ultimately complicating the system more than simplifying it (see above Khan, above n 931, 1001).

⁹⁵¹ Khan, above n 933, 1001.

⁹⁵² Yitzhaki, above n 95, 2.

⁹⁵³ For details of the 2001 reforms see documents available at Fiscal Research and Statistics Division Federal Board of Revenue government of Pakistan website < <http://www.fbr.gov.pk/frs/>>.

5. Conclusion

The review of the Pakistani informal sector reveals that the causes of its growth and sustenance are mostly similar to those mentioned in Chapter 2. Small businesses in Pakistan face identical impediments as small business face in other developing countries. Therefore, the consequential effects of such impediments are also same. Even the remedy identified is also the same i.e. the use of PIT to tax small business.

However, no positive results have been produced in Pakistan despite the use of PIT for the last two decades. The lack of research in PIT could be the reason that Pakistani tax administration is not skilled enough to redesign its PIT. The legal research undertaken in the preceding parts of this thesis provides the basis for evaluation of PIT legislation in Pakistan and making recommendations for its redesign accordingly. This task has been taken up in Chapter 10 after describing the legislation in next chapter.

Having provided the reasons for the PIT introduction in the Pakistani informal sector, the next chapter describes the provisions of the Pakistani PIT legislation before analysing them against the principles of a good tax system in chapter subsequent to the next.

CHAPTER 9 OVERVIEW OF PAKISTANI PIT LEGISLATION⁹⁵⁴

Scope of this Chapter: After describing the reasons for the introduction of PIT in the Pakistani informal sector, this chapter describes the relevant provisions of the Pakistani legislation before analysing them against the principles of a good tax system in Chapter 10. This Chapter shows that taxpayers in Pakistan bear one of three distinct tax treatments. Some pay tax under the normal income tax regime only. Others pay tax under the PIT regime only. Another group of taxpayers discharge their tax liability partly under the normal income tax regime and partly under the PIT regime.

1. Introduction

Pakistani PIT is selected in this thesis to study as a test case for evaluating PIT mechanisms in context of the principles of good tax system. Therefore, it is pertinent to describe briefly the provisions of the Pakistani PIT before embarking upon an assessment of its adequacy for the informal sector. However, due to the limitation of the size of the thesis, only the most relevant provisions, in terms of design and classes of income, are described in this Chapter.

The Pakistani PIT lacks uniformity of design and its provisions, instead of being a separate tax code, are spread across the Income Tax Ordinance 2001 of Pakistan (hereinafter called ITO 2001)⁹⁵⁵. Pakistani PIT affects the tax liability of both corporate and non-corporate sectors, but this chapter focuses only on those provisions which are related to non-corporate sector. This focus is consistent with the definition of small business and the informal sector in Section 2.1 of Chapter 2 of this thesis. This chapter does not discuss those Pakistani PIT provisions, which are available to non-resident taxpayers as an option, because double tax treaties have an overriding effect on tax liability of non-residents and the informal sector is dominated by resident taxpayers.

The description of the Pakistani PIT in this chapter reveals that the Pakistani PIT uses three different PIT designs to tax small business. First is WHT based PIT, which uses a turnover tax design: where turnover is used as proxy of income and then subjected to a

⁹⁵⁴ The cut off date for the overview is 31st July 2008. The author can not take into account subsequent every day changes which are being made in the law through rulings issued by the tax authorities.

⁹⁵⁵ The complete legislation of *Income Tax Ordinance 2001* (Pakistan) can be accessed at <www.fbr.gov.pk>.

prescribed tax rate. The second is also a turnover tax but is not linked to WHT. In this design the fixed percentage of turnover is paid as tax by retailers and in some cases by rent earners. The tax so paid supplants income tax liability without using any proxy for income. Third is a single indicator based PIT, where weight of vessel or vehicle is used as proxy of income for shipping and transport businesses.

It is further revealed that taxpayers in Pakistan bear one of the three following distinct tax treatments. Some pay tax under the normal income tax regime only. Others pay tax under the PIT regime only. Another group of taxpayers discharge their tax liability partly under the normal income tax regime and partly under the PIT regime.

The remaining chapter has six sections. Section 2 deals with the basis of charging income tax in Pakistan. Section 3 explains three distinct mechanisms of determining the income tax liability for small business. Section 4 describes the withholding tax based PIT provisions for different classes of income. This section also mentions other Pakistani PIT regimes, which are not based on WHT. Section 5 discusses those withholding taxes, which do not fall under the PIT regime. Section 6 enumerates the variety of tax concessions for small business under Pakistani PIT. Finally, Section 7 concludes this chapter.

2. Basis of Income Tax Charge

In Pakistan, a resident person is liable to tax in respect of his/her global 'taxable income' under subsection 1 and 2 of s 4 of ITO 2001.⁹⁵⁶ The taxable income for a tax year, as laid down in s 9, is 'total income' for the year as reduced by all deductible allowances under the tax code.⁹⁵⁷

⁹⁵⁶ 4. Tax on taxable income:- (1) Subject to this Ordinance, income tax shall be imposed for each tax year, at the rate or rates specified in Division I or II of Part I of the First Schedule, as the case may be, on every person who has taxable income for the year.

(2) The income tax payable by a taxpayer for a tax year shall be computed by applying the rate or rates of tax applicable to the taxpayer under this Ordinance to the taxable income of the taxpayer for the year, and from the resulting amount shall be subtracted any tax credits allowed to the taxpayer for the year.

⁹⁵⁷ 9. Taxable income:- The taxable income of a person for a tax year shall be the total income of the person for the year reduced (but not below zero) by the total of any deductible allowances under Part IX of this Chapter of the person for the year.

The ‘total income’ of a person for a tax year under s 10 is the sum of the person’s income under each of the heads of income for the year. For the purpose of charge of tax, income is classified in following heads under s 11 of ITO 2001.⁹⁵⁸

- (i) Salary
- (ii) Income from property
- (iii) Income from business
- (iv) Capital gains
- (v) Income from other sources

The income of each head, before adding to taxable income, is computed after deducting the admissible expenses under that head independently. What constitutes admissible expenses under each head are separately defined in ITO 2001 and, being beyond the scope of the thesis, are not mentioned here.

3. Mechanism for Determination of Tax Liability

From the heads of income identified above, tax is charged on taxable income by three distinct mechanisms. These mutually exclusive mechanisms are described below (also see figure 2).

3.1 Normal Tax Regime

The normal tax regime is the usual method of taxation, whereby income tax is charged on the taxable income as set out in the previous Section. Under this regime, taxable income is worked out after a deduction for allowable allowances, perquisites, deductions, etc. The resulting income is then subjected to taxation at the prescribed rate of tax. The tax rate under this regime, other than for taxpayers who have 50% or more of the income from salary, is given in Annexure I.

Under this regime, loss under one head of income can be set off against the income from any other head in same tax year. In the case of business and professional income, a loss of one year can be set off against similar income of the subsequent five years.

⁹⁵⁸ 10. Total Income:- The total income of a person for a tax year shall be the sum of the person’s income under each of the heads of income for the year.

The second schedule of ITO 2001 contains innumerable concessions for some classes of taxpayers falling within the ambit of this regime. Some special sectors like insurance are assessed under a special regime contained as separate schedules in ITO 2001.

Under the normal income tax regime, taxpayers are required to file their return under s 114 and are assessed in Universal Self Assessment Scheme (USAS) under s 121. A return filed under s 114 is liable to audit and if audited, a taxpayer has to prove the veracity of the declared version by keeping books of accounts. More simply, a taxpayer is exposed to vagaries of the whole ordinance and consequently their compliance costs increase enormously.

3.2 Presumptive Tax Regime

Under the presumptive tax regime, income includes any amount which is subjected to collection of tax under sections 148 (imports), 150 (dividends), 151(1) (profits on debt), 153 (some types of business receipts), 154 (exports), 156 (prizes winnings), 156A (petroleum products), 233 (brokerage and commission), subsection 5 of Section 234 (transporters) and 234A (CNG stations). This is a collection of tax at source by withholding tax (WHT) agents and is treated as a discharge of the income tax liability under s 169.

The taxes collected from the receipts of taxpayers, under each of the above WHT sections, are treated as discharging the tax liability for the corresponding income under the 'charging' provisions of subsections 4 and 5 of s 4. Since this method of determination of income is not consistent to the normal charging Section of the ordinance, it is called 'separate taxation' and is not included under any heads of income mentioned above. The tax so collected is the final discharge of tax liability, because no deduction is allowable for any expenditure incurred in respect of the corresponding income nor is any amount of the collected tax refundable. This separate taxation is also called the final tax regime under s 169.

The amount subjected to collection of tax under these sections can not be treated as income under accounting concept, because these are the gross receipts of taxpayers from their business and investment activities. But the definition of income under clause 29 to sub-section 2 of ITO 2001, through the legal fiction, takes such gross receipts into

the concept of income.⁹⁵⁹ More simply, the gross receipts subject to WHT under these sections are treated as income through the legal fiction contained in the definition of income in ITO 2001. The relevant part of the definition, as reproduced below, also has an omnibus provision, whereby any provision in the ordinance can deem any amount as an income and subject it to tax.

*‘ income includes any amount which is subjected to collection or deduction of tax under Section 148, 150, 152(1), 153, 154, 156, 156A, 233, 233A and sub Section 5 of Section 234, any amount treated as income under any provision of this ordinance,.....’*⁹⁶⁰

The legal fiction about the concept of income in the above definition clause provides the bedrock for Pakistani PIT. Consistent with Section 3.1 and 3.2 of Chapter 3, this is one of the forms of compromise for taxing the informal sector. Nevertheless, gross receipts are subjected to tax rates much lower than the tax rates under the normal income tax regime in order to compensate for disallowance of deductions under this regime.

In addition to the above WHT based PIT, Sections 113 A and 113B envisage a similar regime for retailers, whereby retailers pay a fixed percentage of their turnover as income tax and that is treated as a final discharge of tax liability. There is no collection of taxes at source under this scheme and the retailers are expected to comply voluntarily. Like the WHT based PIT, no deductions are allowed against these gross receipts.

A similar regime was recently introduced for rental income under s 15, whereby taxpayers are required to voluntarily pay a fixed percentage of gross receipts for discharge of their tax liabilities. However, when rental income is received from corporations, it is subjected to WHT under s. 155, and tax so collected is a final discharge of tax liability. More simply, rental income is subjected to tax under a fixed tax or under WHT based PIT regime, depending upon whether the receipts are subjected to WHT or not.

⁹⁵⁹ [(29) “income” includes any amount chargeable to tax under this Ordinance, any amount subject to collection [or deduction] of tax under Section 148, [150, 152(1), 153, 154, 156, 156A, 233, 233A and], sub-Section (5) of Section 234, [any amount treated as income under any provision of this Ordinance] and any loss of income but does not include, in case of a shareholder of a [] company, the amount representing the face value of any bonus share or the amount of any bonus declared, issued or paid by the company to the shareholders with a view to increasing its paid up share capital;]

⁹⁶⁰ It seems that Section 234A is not included in this definition due to an omission rather an intention.

Under another regime, a taxpayer who is engaged in shipping business is liable to 'tonnage tax' at a fixed rate per gross registered tonnage of ship, tug, dredger and survey vessel etc. The tax so paid is also a final discharge of tax liability. Similarly, transporters also pay fixed tax to the motor registering authority on the basis of laden weight of their vehicles. Both these regimes are single indicator based PIT regimes.

For incomes falling within the ambit of any of the above PIT regimes, a taxpayer is only required to file a single page statement along with the 'certificate of WHT deduction' or 'tax payment receipt' under s 115(4). This regime is simple due to exemption from maintenance of accounts and audit. Consequently, taxpayers under this regime bear substantially lower compliance costs.

It may also be noted that schedular taxation is distinct from the above mentioned PIT regimes, because under the latter regimes no deduction is allowable for any expenditure and no amount of the withheld tax is refundable.

Finally, with respect to the above Pakistani PIT mechanisms, two observations may be made as follows:

(i) Pakistani PIT uses three different PIT designs for taxing small business income. First, WHT based PIT uses a turnover tax design: where turnover is used as proxy of income and then subjected to prescribed tax rate. Second, the fixed percentage of turnover is paid as tax by retailers and in some cases by rental income earners, which supplants income tax liability without using any proxy for income. Third, for shipping and transport businesses a single indicator based PIT is used, where the weight of the vessel and vehicle respectively is used as a proxy of income.

(ii) All WHT based PIT can take effect only, when tax is collected at source. In cases where taxpayers manage to escape WHT, they can avoid PIT. Consequently, income of the informal sector from activities which are liable to collection under sections 148, 150, 151(1), 153, 154, 156, 156A, 233, subsection 5 of Section 234 and 234A only fall in the ambit of the final tax regime, when tax is collected at source under these Sections. Since under the provisions of these sections, tax is only collectable by 'prescribed' WHT agents, only the transactions of informal sector involving WHT agents can suffer WHT and fall in the ambit of final tax regime. When a taxpayer in the informal sector

does not transact with the WHT agents (who invariably operate in formal sector) then, they can escape WHT and consequently avoid paying PIT. Once PIT is avoided, it is much easier for small entrepreneur to operate under the radar with or without collusion of tax authorities, which has a limited capacity to tax a large number of small income earners under the normal income tax regime.

3.3 Dual Tax Regime

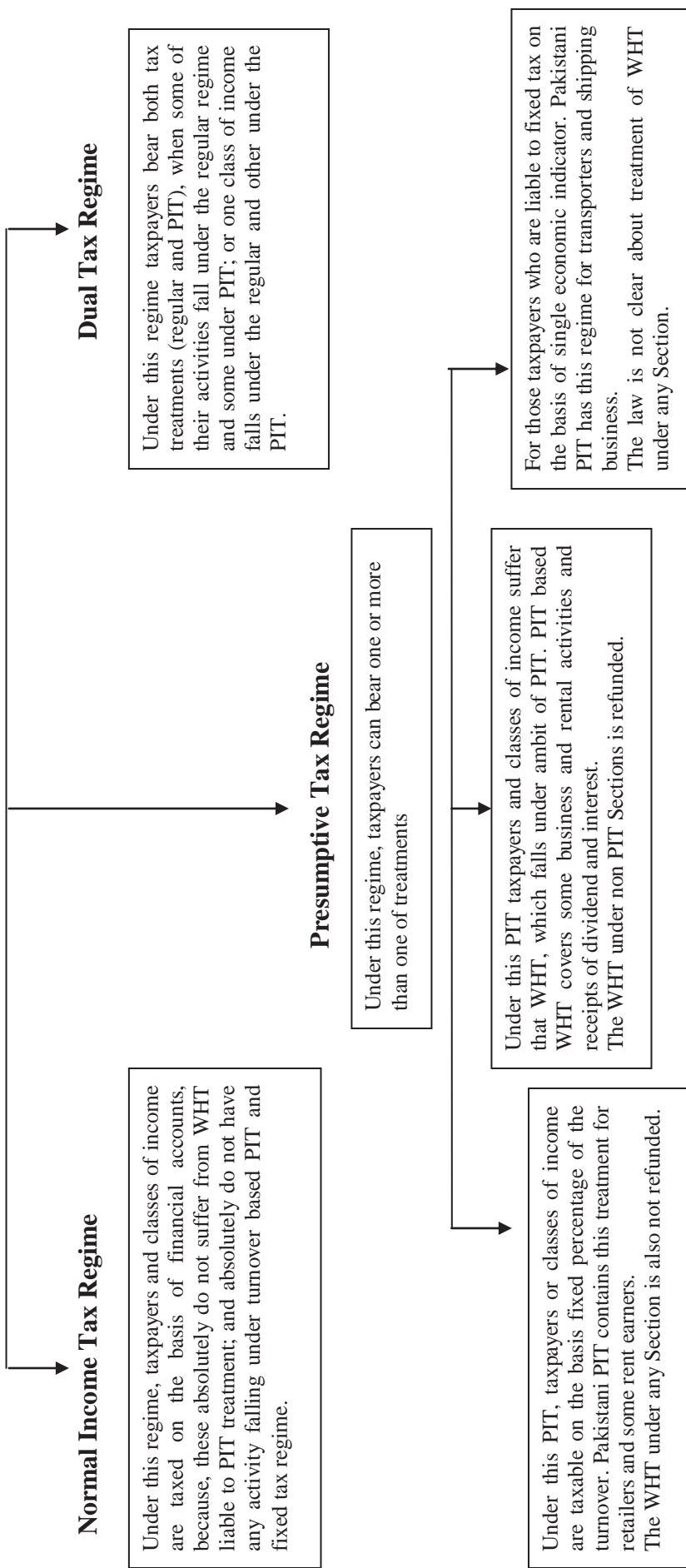
Regarding above mentioned WHT provisions, a small entrepreneur may suffer from three different tax treatments depending upon with whom he/she is transacting. Since corporations, registered firms and Associations of Persons (AOPs) are the usual prescribed WHT agents under most of WHT provisions, only those transactions of small entrepreneurs can suffer from WHT if they executed by these designated WHT agents.

When all the transactions of a small business are exclusively with WHT agents, all are subjected to collection of tax and the taxpayer would only fall within the ambit of the final tax regime. Alternatively, when a taxpayer has no business transactions whatsoever with the WHT agents, then, he or she would not suffer WHT and in that case the taxpayer would fall under the normal income tax regime. Both these tax treatments are already discussed separately in Section 3.1 and Section 3.2.

Third, the most complicated tax treatment arises when a taxpayer has some of his or her activities with WHT agents and some with other persons. In that case some of the transactions would suffer WHT and some would not. Consequently, some of taxpayer's income would fall under the final tax regime and some under the normal income tax regime. In this scenario, the operating expenses would be apportioned to each of these parts for the determination of the profits.

Figure 2

Types of Tax Treatment for Resident Small Business



For the apportionment of the expenses the allocation method is prescribed in s 67 read with Rule 15 of Income Tax Rules 2002.⁹⁶¹ The method of allocation of the costs hinges upon the accounting information. Consequently a taxpayer has to keep accounts for both of the activities. Moreover a taxpayer with hybrid activities has to file both a return and a statement and is also liable for audit. For the normal return, the taxpayer has to prove the declared version through financial accounting. This all substantially increase compliance costs for a small business.

Finally, it is noted that last two tax treatments (the normal income tax and dual regimes) bearing high compliance costs can hit even a very small businesses, irrespective of turnover and legal status, when part of its total receipts fall within the ambit of the normal income tax regime.

A retailer or rental income earner can also have multiplicity of tax treatments depending upon the nature of its business activities. For example, it is not infrequent that a retailer is also additionally rendering some services like providing a telephone booth. In that

⁹⁶¹ Section 67 provides :- (1) Subject to this Ordinance, where an expenditure relates to – (a) the derivation of more than one head of income; or

(ab) derivation of income comprising of taxable income and any class of income to which sub-Sections (4) and (5) of Section 4 apply, or;

(b) the derivation of income chargeable to tax under a head of income and to some other purpose, the expenditure shall be apportioned on any reasonable basis taking account of the relative nature and size of the activities to which the amount relates.

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

Rule 13 provides that (1) This rule applies for the purposes of Section 67, which provides for apportionment of expenditure incurred for more than one purposes. (2) Any expenditure that is incurred for a particular class or classes of income shall be allocated to that class or classes, as the case may be.

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

$$A \times B/C$$

where –

A is the amount of the expenditure incurred;

B is the total amount gross receipts (without deduction of expenditures) for the tax year for the class of income; and

C is the total amount gross receipts (without deduction of expenses) and net gains for the tax year of all classes of income;

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

case the retailer has to suffer from two different tax treatments. One in respect of income from retail business, which would fall within the final tax regime and another for the telephone service which would fall within the ambit of the normal income tax regime.

4. Types of Income Subject to Presumptive Tax Regime

The detailed overview of incomes, which are liable to final tax regime, is given below.

4.1 Income from Investment

The investment income including profits on debt (that is, interest income), dividend and rental income may be liable to PIT as discussed below.

4.1.1 Profit on Debt (Section 151)

Under s 151, the person paying any profit on debt should deduct tax out of such amount in accordance with the following rules:⁹⁶²

- a) A person who pays profit on a deposit or a certificate under the National Saving Scheme or under the Post Office Saving Scheme shall deduct tax at 10% as laid down in Div. I Part III to First Schedule of the ordinance.
- b) A bank or financial institution, a company or finance society who pays any profit on its deposits, bonds debenture, certificate, security etc shall deduct tax at 10% as laid down in Div. I Part III to First Schedule of the ordinance.

⁹⁶² Section 151 (1) provides that where (a) a person pays yield on an account, deposit or a certificate under the National Savings Scheme or Post Office Savings account;

(b) a banking company or financial institution pays any profit on a debt, being an account or deposit maintained with the company or institution;

(c) the Federal Government, a Provincial Government or a Local Government pays to any person profit on any security other than that referred to in clause (a) issued by such Government or authority; or

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

- c) Federal Government, a Provincial Government or a local authority who pays profits on the securities issued by them to any person, shall deduct tax at 10% as laid down in Div. I Part III to First Schedule of the ordinance.

The tax amount so deducted is full and final discharge of tax liability for all taxpayers except a corporation. When the operators in the informal sector invest in the interest bearing deposits, securities and certificates, they suffer WHT based PIT. On the other hand, corporations despite bearing WHT, pay tax on this income under the normal income tax regime after deducting all those expenses incurred in earning this income. The tax withheld under s 151 is credited against tax liability under the normal income tax regime.

In the case of non-corporate entities, the tax collected on profits from all the above sources is charged as income tax liability by treating all these gross profits as income. It is a final tax regime; a legal form of PIT, which is enacted through the deeming provisions contained in Sections 151(3)⁹⁶³ and 169(1)⁹⁶⁴ read with clause 29 of s 2.

⁹⁶³ Section 151(3) provides that Tax deducted under this Section shall be a final tax on the profit on debt arising to a taxpayer other than a company from transactions referred to in clauses (a), (b) and (d) of sub-Section (1)

⁹⁶⁴ Section 169 (1) provides that this Section shall apply where – (a) the collection of advance tax is a final tax under sub-Section (7) of Section 148 or sub-Section (5) of Section 234 or Section 234A on the income to which it relates; or (b) the deduction of tax is a final tax under 11[clauses (a), (b) and (d) of sub-Section (1) of Section 151, sub-Section (1B) or sub-Section (1BB)] of Section 152,] 1[sub-Section (6)] of Section 153, Section 153A, sub-Section (4) of Section 154, Section 155, sub-Section (3) of Section 156, subsection (2) of Section 156A or sub-Section (1) and (3) of Section 233 on the income from which it has been deducted.

A lacuna in the ordinance is noted here. Section 169 also treats 151(1) as final discharge without even excluding companies. This could be contradictory to 151(3) and ignite litigations.

Further subsection 2 of this Section refers to computation of liability under PIT regime

(2) Where this Section applies –

- (a) the income shall not be chargeable to tax under any head of income in computing the taxable income of the person;
- (b) no deduction shall be allowable under this Ordinance for any expenditure incurred in deriving the income;
- (c) the amount of the income shall not be reduced by –
 - (i) any deductible allowance under Part IX of Chapter III; or
 - (ii) the set off of any loss;
- (d) the tax deducted shall not be reduced by any tax credit allowed under this Ordinance; and
- (e) there shall be no refund of the tax collected or deducted [unless the tax so collected or deducted is in excess of the amount for which the taxpayer is chargeable under this Ordinance.]

4.1.2 Dividends (Section 150)

Under s 150 resident companies are obligated to deduct tax while paying any amount of dividends to any person. The rate of deduction at source for dividends is 10% under Div. III Part I to First Schedule of the ordinance.

The tax amount so deducted is full and final discharge of tax liability for all taxpayers. Like interest income, it is also a legal form of PIT, which is enacted through the charging section, that is s 5 (1).⁹⁶⁵ Although it is a final tax regime, it is created without using a deeming provision.⁹⁶⁶

4.1.3 Tax on Rental Income (Section 15)

Rent, irrespective of the quantum and the legal status of the recipient, is liable to WHT @ 5% under s 155. Governments and Corporations are the prescribed WHT agents.

⁹⁶⁵ Section 5 provides that (1) subject to this Ordinance; a tax shall be imposed, at the rate specified in Division III of Part I of the First Schedule, on every person who receives a dividend from a company.

(2) The tax imposed under sub-Section (1) on a person who receives a dividend shall be computed by applying the relevant rate of tax to the gross amount of the dividend.

A lacuna in the law is noted here that the tax rate is applied on the gross dividend without creating a legal fiction about the tax base. In income tax, tax rate only can be applied constitutionally on the income and unless the receipts are not deemed as income in the legislation it would be ultra vires. Though in the income definition there is a blanket deeming provision which says that any amount treated as income under the ordinance is an income but charging Section misses out to label the gross dividend as income. Consequently it may be inferred that the legislator is taxing gross dividends without allowing deductions which is not the income tax.

Further the method of computation of liability in this regard is given in s 8 of ITO 2001.

8. General provisions relating to taxes imposed under Sections 5, 6 and 7.- Subject to this Ordinance, the tax imposed under Sections 5, 6 and 7 shall be a final tax on the amount in respect of which the tax is imposed and²³

(a) such amount shall not be chargeable to tax under any head of income in computing the taxable income of the person who derives it for any tax year;

(b) no deduction shall be allowable under this Ordinance for any expenditure incurred in deriving the amount;

(c) the amount shall not be reduced by –

(i) any deductible allowance; or

(ii) the set off of any loss;

(d) the tax payable by a person under Sections 5, 6 or 7 shall not be reduced by any tax credits allowed under this Ordinance; and

⁹⁶⁶ A question that the drafters of these provisions need to answer is that how can gross receipts be taxed as income without even incorporating it in the definition given in the ordinance.

The tax so deducted is the final discharge of the tax liability through the deeming provision of s 155(2).

Those landlords, who do not transact with WHT agents, are required to pay tax without any deductions or credits, under s 15⁹⁶⁷ at the rates specified in the Div. VI of Part I to the First Schedule (see Annexure II).

4.1.4 Income from Wining Prizes (Section 156)

Under s 156, any person paying prize money on account of winning of a lottery or raffle prize etc is liable to withhold tax at 10% and 20% respectively as prescribed in Div. VI of Part III of the First Schedule. It is a final tax regime, a legal form of PIT which is enacted through the deeming provision contained in the Sections 156(3) and 169(1) read with clause 29 of s 2.

4.2 Income from Business and Professional Activities

The business and professional incomes falling under the PIT regime are as follows.

4.2.1 Income from Supply of Goods, Rendering of Services and Execution of Contracts (Section 153)

Under s 153, if a person has to make any payment on behalf of the government, partnership, company, foreign contractor or consultant, consortium or joint venture, an exporter or export house and an association of persons (AOP) {having an annual turnover of PKR 50 millions (1PKR is equivalent to 0.0132A\$ as on 29th July 2010)}, on account of ‘supply of goods’⁹⁶⁸, ‘rendering of services’⁹⁶⁹ or for the ‘execution of contract’⁹⁷⁰, he/she must withhold the tax at the prescribed rates.

⁹⁶⁷ Section 15 provides (1) The rent received or receivable by a person for a tax year, other than rent exempt from tax under this Ordinance, shall be chargeable to tax in that year under the head “Income from Property”. Income under this Section shall be liable to tax @ specified in Division VI of Part I of the First Schedule.

⁹⁶⁸ Section 153 (9) provides that in this Section “sale of goods” includes a sale of goods for cash or on credit, whether under written contract or not.

⁹⁶⁹ Section 153 (9) provides that in this Section, – “services” includes the services of accountants, architects, dentists, doctors, engineers, interior decorators and lawyers, otherwise than as an employee.

⁹⁷⁰ No definition is provided in the tax code.

Tax is required to be withheld only when payment on account of goods supplied exceeds PKR 25,000; and on account of rendering of services and execution of contract exceed PKR 10,000.

The manufacturers who supply their own products within the organization are not liable to provisions of this section.⁹⁷¹ The advertisement services provided by newspapers and magazines are excluded from the purview of final tax.

The tax collected on receipts from all the above sources is charged as income tax liability by treating all these gross receipts as income. It is a final tax regime, a legal form of PIT, which is enacted through the deeming provision contained in the sections 153(6)⁹⁷² and 169(1) read with clause 29 of s. 2. However, it is not a final tax for corporate entities, which are engaged in the service industry. Similarly, the supplies of goods by companies, who are themselves manufacturers of those goods, are excluded from the ambit of final tax treatment under s 153(6A). Consequently, even small manufacturers in the informal sector pay tax under the normal income tax regime, which substantially increase their compliance costs.

The rates of collection of tax for this Section, as laid down in Div. III Part III to First Schedule, are as follows:

Nature of Receipts	Tax rate
For sale of rice, cotton seed or edible oils	1.5%
For sale of any other goods	3.5%
For transport services	2%
For any other services	6%
For contract receipts	6%

⁹⁷¹ Doctrine of mutuality operates here.

⁹⁷² Section 153 (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.]

The tax amount so deducted is the full and final discharge of tax liability for most small taxpayers. When operators in the informal sector supply goods, render services or execute a contract to any of the above categories of persons, they fall within the ambit of this regime.

4.2.2 Income from Brokerage or Commission (Section 233)

Under s 233, a person who has to make any payment on behalf of the government, local authority, company or partnership, on account of brokerage or commission must withhold tax at the prescribed rate of 10% as per Div II to Part IV to First Schedule.

The tax collected is charged as income tax liability by treating all the brokerage and commission as income. It is a final tax regime, a legal form of PIT, which is enacted through the deeming provision contained in the sections 233(3) and 169(1) read with clause 29 of s 2.

4.2.3 Income from Commercial Imports (Section 148)

Under s 148, the collector of customs, at the time of collection of customs duty, shall collect tax from the importer on the value of imported goods at the rate of 2% as prescribed in Part II to First Schedule. Large import houses (having turnover exceeding 500 million) and manufactures importing machinery and raw materials for their own use are exempt from the application of this Section.

The tax so collected is charged as income tax liability by treating all the import value as income; though it is not even a gross turnover of a taxpayer. It is a final tax regime; a legal form of PIT, which is enacted through the deeming provision contained in the sections 148 (7) and 169(1) read with clause 29 of s 2.

4.2.4 Income from Export and Export Related Activities (Section 154)

Export related business activities are liable to final tax regime in following circumstances:

- a) Every authorized dealer of foreign exchange is required to collect tax from the exporter at the time of his/her realisation of foreign exchange for the exports at the rate of 1% of the proceeds under paragraph I of Div. IV of Part III to the First Schedule.

- b) Every authorized dealer of foreign exchange is required to collect tax from the exporter at the time of realization of foreign exchange for commission to the indenting commission agent at the rate of 5% of the proceeds under paragraph 2 of Div. IV of Part III to the First Schedule.
- c) Every banking company is required to collect tax from the person at the time of realization of foreign exchange on account of sale of goods to an exporter under an inland back-to-back letter of credit for the exports at 0.5% of the proceeds under paragraph 3 of Div. IV of Part III to the First Schedule.

The tax collected on all the above proceeds is charged as income tax liability by treating all the export related receipts as income. It is a final tax regime, a legal form of PIT which is enacted through the deeming provision contained in the Sections 154 (4) and 169(1) read with clause 29 of s 2.

4.2.5 Income from Sale of CNG and Petroleum Products (Sections 156 and 234A)

Under s 156 and s 234A every person consigning petroleum products and compressed natural gas (CNG) to the petrol and or CNG pumps respectively is liable to collect tax at the prescribed rates on the amount of commission allowed to those pump operators. The WHT rate in respect of petroleum products and CNG is 10% and 4% under Div. VIA, VIB to Part III to the First Schedule respectively.

The tax collected on receipts from the above sources is charged as income tax liability by treating all the receipts as income. It is a final tax regime, a legal form of PIT which is enacted through the deeming provision contained in the sections 156A (2), 234A (3) and 169(1) read with clause 29 of s 2.

4.2.6 Tax on Retailers (Sections 113A and 113B)

Retailers, which are organized as individuals or AOP, can avail themselves the option of paying tax at 0.75% of their turnover (as prescribed in Div. IA of Part I to first Schedule I) under s 113A.⁹⁷³ However, only retailers having turnover less than PKR5 million in a tax year can avail themselves of this regime. Those retailers who do not opt for this

⁹⁷³ Section 113A provides that (1) Subject to this Ordinance, where a retailer being an individual or an association of persons has turnover up to 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.

regime shall have to pay tax under the normal income tax regime. Consequently, they have to bear the costs of maintenance of accounts.

Similar retailers having turnover of more than PKR5.0 million are liable to pay tax at 1% of the turnover under s 113B. This is an obligatory regime and forms part of the single stage sales tax collected at 3% of the turnover. This is a typical form of single tax substituting multiple levies.

It is pertinent to mention that the retailers taxed under this regime are not allowed to take credit of withheld taxes under any of the provisions of ITO 2001. This denial of credit of all withheld taxes is completely inconsistent with the principles of a good tax system (Further discussion in this regard follows in item (vii) of Section 2.1.1.6 of Chapter 10; also in Section 2.1.2 of Chapter 10).

4.2.7 Income of Transporters (Section 234)

A person (i.e. government agency) responsible to collect Motor Vehicle Tax (MVT) is liable to collect tax for each vehicle at the prescribed rate depending upon the registered laden weight of vehicle. In the case of a goods/commercial vehicle which is not older than ten years, the tax so collected is final discharge of tax liability.⁹⁷⁴ The tax rate for this purpose is prescribed in Division III Part IV of First Schedule of the ordinance (Annexure III).

It is a fixed type of PIT using a single indicator i.e. weight of vehicles. It is a final tax regime, a legal form of PIT which is enacted through the deeming provision contained in the sections 234(5) and 169(1) read with clause 29 of s 2.

4.2.8 Tax on Shipping Activities

Under clause 21 of Part II to Second Schedule, a taxpayer who is engaged in a shipping business is only liable to pay tonnage tax at a fixed rate per gross registered tonnage of

⁹⁷⁴ The exclusion of transport vehicles with laden weight of less than 8120 Kilograms, which are older than 10 years, from this PIT seems not prudent. Moreover such WHT should be taxed under PIT as final discharge of tax liability. This recommendation is because transport sector contributes 4% GDP but almost nil to the revenue in Pakistan (see *CBR Quarterly Review*, Jan-March 2007 Fiscal Research and Statistics, Directorate Research & Statistics <<http://www.fbr.gov.pk/DRS/Default.asp>> 17_November, 2008).

ship, tug, dredger and survey vessel etc.⁹⁷⁵ This is also a fixed type of PIT using a single indicator i.e. weight of vessel.⁹⁷⁶ The ships which are registered inside Pakistan and those which are registered outside Pakistan are subjected to different tax rates. In this regime, the law is not clear as to what happens to the withheld tax in case this business bears WHT under any provisions of the law.

5. Widespread WHT Regime

Besides the above withholding of taxes, which fall within the ambit of PIT regimes, a small entrepreneur is also liable to WHT under other provisions of ITO 2001 in respect of the following activities.

Under Section	Nature of Payment	Withholding Agent	Tax Rate in Part IV of the First Schedule
231A	Cash Withdrawal from Bank	Banking Company	See Div VI of Part IV
236	Telephone Bill	Service Provider	See Div V
235	Electricity Bill	Service Provider	See Div IV
234	Registration of Motor Vehicles	Vehicle Registering Authority	See Div III
231B	Purchase of Motor Vehicles	Vehicle Registering Authority	See Div VII

Recently even a small business, which is organised as a firm or an AOP and has a turnover over PKR50 million is required to act as a WHT agent. Consequently, a small business is responsible to deduct and deposit tax on more than a dozen types of

⁹⁷⁵ [(21) In the case of any resident person engaged in the business of shipping, a presumptive income tax shall be charged in the following manner, namely:-

(a) ships and all floating crafts including tugs, dredgers, survey vessels and other specialized craft purchased or bare-boat chartered and flying Pakistan flag shall pay tonnage tax of an amount equivalent to one US \$ per gross registered tonnage per annum; and

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

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

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

⁹⁷⁶ This is a novel tax treatment wherein the legal fiction about the income is created in the schedule of the tax code. Neither there is any charging Section in the law for this tax levy nor there Section in the law which equivocates this as income under this ordinance to meet the requirements of the definition of income.

payments, which it may make during the course of its operating activities. This responsibility increases compliance costs for small taxpayers.

6. Concessions in PIT Regime for Different Economic Sectors

The concessions in the ITO 2001 are generally grouped in the form of reductions in tax rates, reductions in the tax liability and exemptions from the application of the provisions through insertions in the Part II, III and IV to Second Schedule respectively.⁹⁷⁷

Further, income of some taxpayers is exempt from tax completely under Part I to Second Schedule. In such cases, income bears no tax under any of the regimes of ITO. For example, any taxpayer receiving interest from National Saving Certificates/Deposits, when their value does not exceed PKR150,000, is not liable to tax. This exemption is also provided for the monthly saving scheme, if monthly accretion does not exceed PKR1000. Similarly, tax exemption is also provided to some industrial sectors. The exempted businesses and persons are not liable to file the return or statement under any of the regimes envisaged under ITO 2001.

The concessions in final tax regime, particularly those for small entrepreneurs, are discussed below with the corresponding sections of ITO 2001.

6.1 For Income Covered Under Section 150

In respect of dividend income, the following concession is provided in the tax code.

- a) Reduction in the rates: Dividends paid by privatized or other companies engaged in power generation are subjected to 7.5% of tax under the clauses 17 and 20 respectively.⁹⁷⁸

⁹⁷⁷ These concessions are in addition to the complete exemptions from tax provided to some sources of income in the Part I to Schedule II of the ordinance. Since the exempt income does not fall in the ambit of either of the tax regimes, hence these provisions are not discussed here.

⁹⁷⁸ The clause 17 for privatized companies has become redundant as the blanket reduction in rate is given subsequently to all companies engaged in power generation under clause 20.

6.2 For Income Covered Under Section 153

In respect of the income covered under s 153, the following concessions are provided in the tax code.

a) Reduction in the rates:

- i. The tax rate is reduced to 1% for the service and construction contracts for income earned outside Pakistan under the clauses 3 and 3A respectively.
- ii. The tax rate on purchase of locally produced edible oil for the manufacture of cooking oil is 2% under clause 13C.
- iii. For the sale of the rice by Rice Export Corporation of Pakistan to Utility Corporation of Pakistan, the rate is 1% under clause 13HH.

b) Exemption from application of some provisions:

- i. Under clause 47A, provisions of s 153 (WHT on supplies) are made inoperative in respect of supplies, which are made from commercial imports and which are already subjected to collection of tax under s 148 (commercial imports). More simply, when the commercial imports are sold or supplied, then, these are prevented from double taxation.
- ii. The provisions of subsection 6A of s 153 do not apply to cotton ginners under clause 47D. Consequently, cotton supplies by ginners even by corporations fall in the ambit of WHT based PIT: a treatment not provided to supplies of all other manufacturers.
- iii. The provisions of subsection 6 of s 153 do not apply to manufacturers of steel under clause 46A of Part IV of Second Schedule. Consequently, supplies of steel manufacturers even by non-corporate persons fall under the normal income tax regime.
- iv. The provisions of subsection 6 of s 153 do not apply to operator of container, oil and chemical terminal under clause 41B of Part IV of Second Schedule. Thus, services and other receipts of this sector would fall under the normal income tax regime.
- v. The provisions of subsection 6B of s 153 do not apply to sale of goods made by individual and AOP under clause 46B. It may be noted that

subsection 6B is already omitted; hence, exemption provided in clause 46B is of no effect.

- vi. Under clause 43B, provisions of clause (a) of subsection (1) s 153 are made inoperative for payment on sale of air tickets. Consequently, air travel agents are exempted from PIT irrespective of their form of business organization.
- vii. Under clause 57, sections 148 and 153 are not applicable on large corporate trading houses with an annual turnover PKR300 million (other conditions are also laid down in the clause). Consequently, this class of taxpayers falls within the ambit of the normal income tax regime.
- viii. Under clause 57A, the provisions of s 153 are held inoperative for single object corporate import houses with turnover over PKR500 million (other conditions are also laid down in s. 148).⁹⁷⁹ Consequently, this class of taxpayer fall under the normal income tax regime.
- ix. Under clause 60, the provisions of s 153 are held inoperative for trade of partly assembled cypher devices. Consequently, this class of business falls under the normal income tax regime, irrespective of its form of organization.
- x. Under clause 43A, the provisions of s 153 are held inoperative for sale on account of imported petroleum products. Thus, this class of importers is saved from double tax at the supply stage, once tax is already withheld at import stage.
- xi. Under clause 46, the provisions of s 153 are held inoperative in respect of supply of oil by oil distribution companies. Though this provision is not clear, it seems that under this clause oil distribution companies are exempted from PIT.

6.3 For Income Covered Under Section 154

In respect of the income covered under s 154, the following concessions are provided in the tax code.

⁹⁷⁹ When exemption was already available in clause 57 the insertion of 57A is not understandable. Moreover, the concept of the import house and trading house is quite ambiguous.

- a) Reduction in the tax liability: Under clause 47c, the provisions of subsection 1 of s 154 shall not apply on exports to Afghanistan for cooking oil on which tax is already paid under s 148. The intention of the clause is to prevent double tax at export stage once tax is collected at the import level.

6.4 For Income Covered Under Section 148

In respect of the income covered under s 148⁹⁸⁰ the following concessions are provided in the tax code.

- a) Reduction in the rates: The rate of WHT on imports of some items is reduced as follows:
 - i. 1% on the import of all fibres and yarns under clause 9
 - ii. 1% on the import of potassic fertilizers and urea fertilizers under clause 13 E and c. 23
 - iii. 1% on the import of mobile phones, gold and silver under clause 13G
- b) Reduction in tax liability: The liability under s 148 in respect of import of used motor vehicles is capped at different levels depending upon the engine power under clause 4.
- c) Exemption from application of some provisions: In respect of certain categories of imports the provisions of s 148 are held inoperative under clause 56. These include goods imported by direct and indirect exporters; and goods which are temporarily imported for subsequent export etc.

6.5 For Income Covered Under Section 233

In respect of the income covered under s 233 the following concessions are provided in the tax code.

- a) Reduction in the rates:
 - i. The commission of the export indenting agent shall be charged at 1% of the exports under clause 5.

⁹⁸⁰ It is pertinent to mention that tax collected u/s 148 is not final tax in case the goods are imported for purpose of using in own manufacturing activities.

- ii. Tax rate for commissions received by advertising agents is 5% under clause

26

7. Conclusion

The summary of Pakistani PIT for purpose of the case study in this thesis reveals that the Pakistani PIT uses three different PIT designs for taxing small business income. First is WHT based PIT, which has a design of turnover tax: where turnover is used as proxy of income and then subjected to prescribed tax rate. Second is also a turnover tax design, but is not linked to WHT. In this design the fixed percentage of turnover is paid as a tax by retailers and in some cases by rental income earners. The tax so paid, supplants income tax liability without using any proxy for income. Third is a single indicator based PIT, where the weight of vessel or vehicle is used as a proxy of income for shipping and transport businesses.

It is further revealed that taxpayers in Pakistan bear any of three distinct tax treatments. Some pay tax under the normal income tax regime only. Others pay tax under the PIT regime only. Another group of taxpayers discharge their tax liability partly under the normal income tax and partly under PIT regime.

As the provisions of Pakistani PIT have been described in this Chapter, the next chapter analyses them against the principles of a good tax system and also against the recommendations regarding an appropriate PIT for large informal economies made in Chapter 7.

Annexure - I

Rates of Tax for Individuals and Associations of Persons

The rates of tax imposed on the taxable income of every individual {except a salaried taxpayer} or association of persons to which sub-Section (1) of Section 92 applies shall be as set out in the following table, namely:–

Taxable Income	Tax Rate
1. Where taxable income does not exceed PKR100,000	0%
2. Where the taxable income exceeds PKR100, 000 but does not exceed PKR110,000	0.5%
3. Where the taxable income exceeds PKR110,000 but does not exceed PKR125,000	1.0%
4. Where the taxable income exceeds PKR125,000 but does not exceed PKR150,000	2.0%
5. Where the taxable income exceeds PKR150,000 but does not exceed PKR175,000	3.0%
6. Where the taxable income exceeds PKR175,000 but does not exceed PKR200,000	4.0%
7. Where the taxable income exceeds PKR200,000 but does not exceed PKR300,000	5.0%
8. Where the taxable income exceeds PKR300,000 but does not exceed PKR400,000	7.5%
9. Where the taxable income exceeds Rs.400,000 but does not exceed PKR500,000	10.0%
10. Where the taxable income exceeds PKR500,000 but does not exceed PKR600,000	12.5%
11. Where the taxable income exceeds PKR600,000 but does not exceed PKR800,000	15.0%
12. Where the taxable income exceeds PKR800,000 but does not exceed PKR10,00,000	17.5%
13. Where the taxable income exceeds PKR10,00,000 but does not exceed PKR13,00,000	21.0%
14. Where the taxable income exceeds PKR13,00,000	25.0%

Source: reproduced from Income Tax Ordinance 2001 (Pakistan).

Tax Rates for Income from House Property

Gross amount of rent	Rate of tax*
(1) Where the gross amount of rent does not exceed PKR150,000	Nil.
(2) Where the gross amount of rent exceeds PKR150,000 but does not exceeds PKR400,000	5 per cent of the gross amount exceeding PKR150,000
(3) Where the gross amount of rent exceeds PKR400,000 but does not exceed PKR1,000,000.	Rs.12,500 plus 7.5 per cent of the gross amount exceeding PKR400,000
(4) Where the gross amount of rent exceeds PKR1,000,000.	Rs.57,500] plus 10 per cent of the gross amount exceeding PKR1,000,000

Source: reproduced from Income Tax Ordinance 2001 (Pakistan).

* Same are the rates for withholding of tax on rental income in case of individuals and AOPs under Division VI Part III to First Schedule

Annexure - III

Tax on Motor Vehicles

Rates of collection of tax under Section 234

Registered Laden Weight of Goods Transport Vehicles	Fixed Tax in PKR*
1. Less than 2030 kilograms.	1,200
2. 2030 kilograms or more but less than 8120 kilograms	7,200
3. 8120 kilograms or more but less than 15000 kilograms	12,000
4. 15000 kilograms or more but less than 30,000 Kilograms	18,000
5. 30,000 kilograms 7[or] more but less than 45,000 Kilograms	24,000
6. 45,000 kilograms or more but less than 60,000 kilograms	30,000
7. 60,000 kilograms or more	36,000

Source: reproduced from Income Tax Ordinance of Pakistan 2001

* In the case of goods transport vehicles with laden weight of 8120 kilograms or more, advance tax after a period of ten years from the date of first registration of vehicle in Pakistan shall be collected at the rate of PKR 1200 per annum.

CHAPTER 10 ANALYSIS OF PAKISTANI PIT SYSTEM

Scope of this Chapter: The Pakistani PIT regime, which is described in the preceding chapter, is analysed in this chapter against the principles of a good tax system and also against the recommendations of Chapter 7 regarding an appropriate PIT for large informal economies. This analysis helps in drawing out recommendations in Chapter 11 for redesigning the Pakistani PIT for the large informal economy. The analysis finds that the Pakistani PIT is neither adequate for small businesses in terms of simplicity, efficiency and equity principles, nor in revenue collection and taxpayer registrations.

1. Introduction

As a natural consequence to the recommendations of Chapters 4 and 7 regarding an appropriate PIT design for large informal economies, it is essential to test these findings against existing PIT legislations of developing countries. It should be determined whether the design and features recommended in those chapters also do well in real life. Similarly, it also needs to be determined whether PIT regimes which are not in line with the recommendations, fail to secure desirable tax objectives. More specifically, consistent with Section 2.2.1 of Chapter 7, for the evaluation of certain facets of simplicity such as stability and flexibility, a PIT design needs to be examined in its legislative context rather than in an abstract ideal form.

In view of that, this chapter analyses the Pakistani PIT system both against principles of a good tax system and for its ability to meet the requirements of small business in the informal economy. The analysis makes frequent references to various judicial decisions to support its findings. Since it is expected that the findings of analysis should empirically be vindicated by the data of well known performance indicators, the outcome of Pakistani PIT is also evaluated against the increase in the size of taxpayer base, the size of informal economy and revenue collection.

The analysis finds that the Pakistani PIT is not adequate for small business in terms of simplicity. The Pakistani PIT also does not meet the efficiency and equity principles sufficiently. Consequently, the indicators of performance such as revenue collection and expansion of the tax base also show bleak picture. It may be inferred that performance of PIT in Pakistan can be improved by replacing it with the design and features recommended in Chapters 4 and 7.

This chapter has three further sections. In Section 2, the Pakistani PIT is analysed against the principles of a good tax system. In Section 3, the Pakistani PIT is compared to the recommended PIT design to address the causes of informal economy and to meet the principles of a good tax system. In respect of the latter, the prioritized set of principles for the informal sector are given due consideration as well. Finally, in Section 4, the Pakistani PIT is analysed against the well known performance indicators to evaluate PIT regimes for their success in the informal economy.

2. Pakistani PIT and Principles of a Good Tax System

In the first part of analysis, the Pakistani PIT is discussed against the principles of simplicity, equity and efficiency. Additionally, level of adherence by Pakistani PIT to these principles is also compared to the prioritized balance of principles for small business as determined in Chapter 6. Despite describing the Pakistani PIT in Chapter 9, for better comprehension, a reader is advised to have the ITO 2001⁹⁸¹ available alongside due to numerous referencing to bare legislation in this analysis. Besides that, this analysis frequently refers to seven annexures at the end of this chapter, which contain illustrations and statistics to support the analysis.

2.1 Pakistani PIT and Simplicity

In this section, initially the Pakistani PIT is analysed for its simplicity, which is the most important principle for addressing the informal sector, through the methodology set out in Section 3.3 of Chapter 5. Consistent with that Chapter, simplicity in the Pakistani PIT is initially 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 a pattern adopted by Taylor⁹⁸² and is already laid down in Section 3.3 of Chapter 5.

Later, the operational complexity of the Pakistani regime is analysed qualitatively in terms of the compliance burden e.g. bookkeeping and other documentary requirements, the length and the level of computation etc. The role of operational complexity is crucial

⁹⁸¹ The link to the Income Tax Ordinance 2001 of Pakistan is <<http://www.fbr.gov.pk/newdt/ITOrdinance/ITOrdinance2009/ITaxOrdinance2001ut28-10-2009.pdf>>.

⁹⁸² Taylor, above n 604.

in the context of the informal sector to encourage voluntary compliance. However enforcement costs, although a significant aspect of operational complexity, will be discussed in detail in the second stage of the analysis for the sake of avoiding duplication.

2.1.1 Technical Complexity

Consistent with Section 3.3 of Chapter 5, the clarity, certainty, consistency, stability and flexibility of Pakistani PIT is assessed through the total number of provisions, the number of redundant provisions, superfluous words and sentences, frequency of changes in the regime and its coherence. Additional aspects such as the ambiguity of interpretative rules; rules rendered unnecessary due to subsequent developments; grouping other than by a rational scheme; and the existence of provisions where the literal meaning is never or rarely enforced; are also examined while evaluating the technical complexity of Pakistani PIT.⁹⁸³

2.1.1.1 Number of Provisions

Consistent with Chapter 9, the Pakistani PIT system has very large number of substantive provisions. Although the Pakistani PIT system contains three regimes, it is primarily based on the direct and reverse withholding of taxes (WHT). There is a wide range of economic activities which are subjected to withholding tax and for each of them, the ITO 2001 contains a separate fully fledged Section. Sometimes it is the payer and on other occasions it is the payee who collects the tax on behalf of the government. For example, in respect of a sale of CNG and petroleum products, it is the recipient of the payment who also collects the tax; and in case of any other supplies it is the payer who is responsible for withholding the tax.

In respect of WHT, in total, there are ten different activities which are subjected to WHT based final tax regimes. All the remaining WHTs are allowed as a credit against assessed income tax liability.

A small business is influenced by most WHT provisions, because it usually has bits of different activities which suffer WHT. Sometimes the same activity is subjected to tax

⁹⁸³ It would be on the pattern followed by Taylor, above n 604.

twice. For example, when imported goods are supplied by the business, then they are subjected to WHT both at the import and supply stage. Consequently, the law contains provisions for exemption from application of the WHT at one of the stages. For example, clause (a) of subsection 5 of s 153 deals with exemption from WHT when tax is already deducted at time of import under s 148. It adds another series of the provisions to the law in order to prevent taxpayers from suffering this double withholding.

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

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

In short, the Pakistani PIT system has three types of PIT regimes, which operate through numerous provisions of ITO 2001 and consequently make tax compliance technically complex.

2.1.1.2 Rules Rendered Unnecessary Due to Subsequent Developments

There are not many provisions in the Pakistani PIT which have become completely redundant due to subsequent amendments in the regime. The author could only find one such example. After the omission of subsection 6B of s 153, there is no need to retain the exemption from application of this provision by clause 46B of Part IV of the Second Schedule. Its presence only adds to the technical complexity. In view of this single redundancy it can be concluded that Pakistani PIT does well in this regard.

2.1.1.3 Grouping According to a Rational Scheme⁹⁸⁴

An appropriate grouping of the provisions, for instance in accordance with the nature of the income and type of statutory obligation, helps in quick compliance. It also reduces the uncertainty and the time consumed in cross referencing the legislation. It is recognized that the basic choices in tax design involve grouping according to a rational scheme. For instance, all incomes of identical nature and incomes liable to identical tax treatments should be grouped together.

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

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

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

⁹⁸⁴ Vann called it grouping by mechanical function (see Richard J. Vann, 'Improving Tax Law Improvement: An International Perspective' (1995) 12 *Australian Tax Forum* 193, 193).

2.1.1.4 Superfluous Provisions, Words and Sentences

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

(i) Despite the presence of Section 169(1), which eloquently lists withheld taxes that are a final discharge of tax liability, the following separate provisions are inserted in the respective withholding tax Sections. These are nothing but a duplication of legislative intention and policy.

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

(ii) In s 148, it is noted that its subsection (2), which deals with issuance of exemption from application of WHT under this Section is redundant, because, subsection (3) of s 159 empowers the Board⁹⁸⁵ 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 for the brevity of legislation and reducing the time needed to comply with the legislation. Thus, subsection (2) of s 148 should be omitted.

(iii) Despite the presence of s 152 (1A)(c), which deals with WHT on advertising services rendered by T.V. satellite channels, a separate s 153A was introduced in 2008 for

⁹⁸⁵ Federal Board of Revenue: the income tax authority under *Income Tax Ordinance* 2001 (Pakistan) s 207.

collecting WHT from non-resident media persons. This insertion could have been avoided by a suitable amendment to the existing provisions of s152.

(iv) In s 153, subsection (4), which deals with exemption from WHT under this section by order of the Commissioner is superfluous, particularly in the presence of the wide ranging powers for issuance of exemption vested in the office of the commissioner under subsection (1) of s 159. For the same reason, the provisions of subsection (1A) of Section 159 are also redundant in the presence of subsection (1) of s 159.

(v) Further, clause (a) of subsection 153(5) which deals with exemption from WHT on supplies under this section when tax is already deducted at the time of import, is redundant in the presence of the similar exemption for imported goods in a well grouped clause 47A in Part IV of the Second Schedule of the Ordinance. Similarly, clause 43A in Part IV of the Second Schedule, providing an exemption from the application of s 153 for sale of imported petroleum products, is also superfluous, because an overall exemption in this regard is already provided under clause 47A of the same Part to all the commodities, which are subjected to tax under s 148. These repetitions and superfluity in the substantive provisions consumes more taxpayers' time and increases technical complexity.

(vi) The scope of contract in subsection (1) of s 153 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 4[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 down above, shows that it is nothing but 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” do not bring any clarity to the concept of the ‘contract’ in general and the constituents of the ‘contract’ in particular. It may be because every contract does involve some kind of services and sale of goods, which are to be rendered and installed in the project. 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 are basically artificially created and have no commercial distinctions on many occasions and therefore add to ambiguity and uncertainty.

In the case of *Assessee v Department*⁹⁸⁶, 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:--

“...if seen from the context of the literal meaning of contract, then every contract would include any type of services which is rendered during the performance of that contract”

The judicial member further refers to a mixed contract as follows and suggests its tax treatment to somewhat resolve the ambiguity in the provision:--

*“It is also recognized by the Supreme Court of India in the case of Brij Bhushan Lal Parduman Kumar v. CIT reported as (1978) 115 ITR 524 wherein it has been held that in case of the composite contracts the deduction of tax shall be made under Section 194C (Indian Income Tax Act, which deals with deduction of tax) under which deduction of withholding taxes are made on account of contract receipts other than services”*⁹⁸⁷

The recent decision of the Sindh High Court in the case of *M/S Premier Mercantile Services v CIT Karachi*⁹⁸⁸ adds to the ambiguity arising from the superfluous words in

⁹⁸⁶ ITA No. 1850/KB to 1852/KB of 2002 (2004 PTD 2749) decided on 24th May, 2004. The matter was decided in the favour of the cricketer that such receipts are contractual in nature and fall within the ambit of PIT regime.

⁹⁸⁷ ITA No. 1850/KB to 1852/KB of 2002 (2004 PTD 2749) decided on 24th May, 2004.

⁹⁸⁸ See *Premier Mercantile Services v CIT Karachi* 2007 PTD 2521.

the clause related to the scope of contracts. In this case stevedoring services of the taxpayer were taxed by the department under the normal income tax regime as services, which fall outside the ambit of PIT. However, the taxpayer contended that its services were a contract as per law and only those service contracts, whose services are categorically mentioned in the definition of services in s 153 (which include services of professionals such as accountants, doctors etc), are the service contracts which are excluded from the scope of contracts and the ambit of PIT. More simply, the taxpayer linked the scope with the definitions of contract and services given in subsection (9) of s 153.

The relevant clauses of the subsection (9), which set out scope of contracts by exclusion of ‘services’ and ‘sale of goods’ from its scope, are reproduced below for quick reference.

“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.

The court 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 fails to give a logical reason to include 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 split between those falling in clause ‘b’ and those falling under clause ‘c’ on the basis of the definition given in its subsection (9) particularly when that definition is ‘inclusive’ in nature.

(vii) Regarding the PIT regime for dividends and other non-resident incomes mentioned in sections 5, 6 and 7, the regrouping of these sections inside Chapter X (this chapter is titled as Procedure) may obviate the need of s 8, because it is nothing but a duplication of the content of s 169. Both sections, as mentioned in Chapter 9, define the nature and method of determining tax liability under the PIT regime. However, s 169

can be slightly amended to incorporate the incomes and policy intentions of ss 5, 6 and 7.

Further, subsections (4), (5) and (6) of s 4, which envisage chargeability of income of certain classes of income like dividends, are completely redundant. These legislative intentions are already provided in the definition of income under clause 29 of s 2 and the computation details in subsection 2 of s 169. The repetition of the same intention is superfluousness in the legislation, which increases the ambiguity and consequently compliance time.

(viii) 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 PIT by the first proviso to subsection (6) of s 153. Since all the operators of the terminals in Pakistan currently are organized as companies, and sea terminal businesses fall within the ambit of the service industry, they already enjoy the exemption by the first proviso to subsection (6) to s 153. Thus, clause 42 stands redundant.

(ix) Clause 47 of Part IV of the Second Schedule, which deals with exemption from the application of the WHT provisions, is redundant in the presence of the fully fledged power provided to the Commissioner in subsection (1) of s 159 of the ordinance for issuing an exemption from application of WHT.

2.1.1.5 Frequency of Changes in the Regime

Despite the fact that the Pakistani PIT in ITO 2001 is the replica of the earlier PIT regime contained in the repealed ordinance it still has been undergoing multiple amendments. This is being done against the expectation that a new regime should have been more stable because it was a result of a renewed effort after a long experience with the old regime.

Almost every Finance Bill brings repeated changes in every activity covered under the PIT, which manifoldly increases the underlying uncertainty. Some amendments are made in the substantive provisions of the law. Others are made in the schedules and are related to the reduction in tax rates and liabilities and exemptions etc. Though some of the changes represent unnecessary attempts to bring artificial clarity in the

corresponding provisions, most of the amendments reflect frequent changes of tax policy intentions. This all makes the tax code quite unstable and unascertainable. Some examples on this tendency follow:

(i) The deduction of tax on profit on debt under s 151 for a non corporate taxpayer was not a final discharge until an insertion of subsection (3) in s 151 through Finance Bill 2006. This changed the tax liability for a non-corporate taxpayer. It is pertinent to mention that even under the repealed ordinance, WHT on profit on debt for a non-corporate taxpayer was a final discharge of tax liability.

(ii) The insertion of clause (bb) to s 153(5) through Finance Bill 2007 provides exemption to ginner from application of subsection (1) of s 153, albeit in a novel manner. The said subsection is reproduced as below:-

“(bb) a cotton ginner who deposits in the Government Treasury, an amount equal to the amount of tax deductible on the payment being made to him, and evidence to this effect is provided to the “prescribed person”

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

(iii) In respect of s 153, until 2002 only professional services were liable to withholding of tax. Later, all types of services were subjected to WHT through Finance Bill 2002. Subsequently, the tax so withheld was treated as a final discharge of tax liability by amending subsection (6) in Finance Bill 2006. This was also one of the issues raised in the above mentioned case of *M/S Premier Mercantile Services v CIT Karachi*⁹⁸⁹ as to in which tax year the professional services are excluded from the normal income tax assessment.

⁹⁸⁹ See *Premier Mercantile Services v CIT Karachi* 2007 PTD 2521.

Additional amendments made in this respect were the insertion of words “or providing of” in the clauses (b) and (c) of s 153(1) by Finance Bill 2005. Further, the words “supply” in the clause ‘c’ are replaced by word ‘sale’ by the Finance Bill 2003, perhaps to make the language simple in terms of commercial use. However, repeated change of the words, instead of clarifying the matter, increases the ambiguity.

The use of more words to incorporate each situation under the same economic activity may not add to the clarity of the tax code. For example, rendering of insurance services is separately inserted as subsection (1AA) in s 152, which deals with non-residents. The same activity in respect of resident taxpayers is not separately mentioned under s 153 and presumably is covered within the services under s 153(1) (b). Alternatively, it suggests that s 152 should be amended once for all to cover all possible business scenarios instead of making insertions now and then, such as clause (c) to s 152 which was inserted in 2006 for advertisement services.

(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 of exports. 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) Another amendment, through Finance Bill 2006, shifted some WHT on payments to non-residents related to contracts from subsection (3) of s 153 to s 152. However, a few payments to non-residents such as payments to permanent establishments of non residents providing services to exporters still fall within the ambit of Section 153. The policy intention of this amendment is unclear.

(vi) By inserting the second proviso to subsection (6) of s 153, 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 PIT. In context of principles of a good tax system, although the exclusion of listed companies is explicable, it is difficult to understand rationale of exempting a type of business (that is, print media) from the PIT regime. Moreover, this exemption should have been inserted in the Second Schedule where other exemptions are grouped.

(vii) Manufacturers cum suppliers (only companies) were exempted retrospectively from the ambit of PIT through insertion of subsection (6A) of s 153 by Finance Bill 2005; which was further amended in 2008 to terminate the retrospectivity of the exemption. Further, this subsection still uses the words ‘supply’, despite the fact that in some provisions of this Section the word ‘supply’ is replaced by word ‘sale’.

(viii) The insertion of clause 47D in Part IV of Second Schedule allowing the PIT regime to cotton ginnerers coincided with the omission of clause 40 vide Finance Bill 2005, which contained the option of PIT for all manufacturers. This option was initially withdrawn retrospectively in order to curb tax avoidance through transfer pricing by pharmaceutical industry, who used to file returns under PIT option. But later for unclear reasons, a clause 41A was inserted vide Finance Bill 2005, which again offered the option for all activities concluded before 2005. This clause was later also omitted by Finance Bill 2008. This shows that whole exercise of frequent amendments becomes a comedy of errors.

This repeated intervention increased uncertainty and ambiguity in compliance. The policy and legislative intention should have been clear from the beginning about the issue of curbing tax evasion, which is planned through transfer pricing, because transfer pricing is not restricted to manufacturing only. Transfer pricing is also employed by contractors and traders and they still fall within the ambit of the PIT regime. Thus, repeated manipulations of the PIT regime only in respect of the manufacturing sector do not seem to be due to a clear policy objective.⁹⁹⁰

(ix) The insertion 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 omitted by the Finance Act 2008. This type of hasty insertions and subsequent omissions only add complexity to the law.

(x) Subsection (8A) of s. 153 vide 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.

⁹⁹⁰ Due to ongoing development work, most developing countries such as Pakistan have huge contracts and trading activities with MNCs, which usually involve transfer pricing at a scale much higher than in manufacturing activities.

Its retention could have helped the documentation and bringing some fiscal discipline to taxpayers. However, it seems that the government could not withstand the pressure from business lobbies.

In all, the Pakistani PIT has been bearing the massive onslaught of 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 include 22 new insertions, 35 omissions and 11 substitutions. Moreover, even the definition of the prescribed person in s 153 has been amended 6 times. Finally, in the simplest regime of retailers, more than seven amendments have been made since its introduction in 2004. These amendments are in respect of the rate as well as the categories of retailers, which increase the uncertainty and ambiguity in the regime. This all reflects how frequently the PIT legislation is being amended in Pakistan which has served no purpose except to make the law more complex. In view of the above, it seems that what was opined by Ahmad and Stern in 1991 still holds true. They said:

*'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.'*⁹⁹¹

2.1.1.6 Ambiguity of the Interpretative or Explanatory Provisions

Some interpretative and explanatory provisions which suffer from ambiguities are as under.

(i) As mentioned in the definition of income in clause 29 of s 2, there is a blanket deeming provision which says that any amount treated as income under the ordinance is income, but s 5⁹⁹², the charging provision for dividends, does not treat gross dividends as income.

⁹⁹¹ Ahmad and Stern, above n 275, 2.

⁹⁹² 5. Tax on dividends:- (1) Subject to this Ordinance, a tax shall be imposed, at the rate specified in Division III of Part I of the First Schedule, on every person who receives a dividend from a 3[] company 4[or treated as dividend under clause (19) of Section 2].

Further, as mentioned in the definition clause, income is defined as including any amount which is subjected to tax under the ordinance, but for clarity each charging Section should mention that the amount subjected to tax under that section is income. For example, in respect of other WHT which fall within the ambit of PIT, the definition clause says that the amount in respect of tax collected at source is income, and then the respective charging section (that is, s 169) also mentions that tax so collected is the final discharge of tax liability. But in respect of WHT on dividends under s 150, the deeming of receipt of dividends as income is omitted from the charging sections 5 and 8⁹⁹³ as well as s 169, despite the fact that it is treated as income under the definition of income.

Consequently, it may be inferred that the legislator is taxing gross dividends without allowing deductions, which is against the spirit of income tax. How can gross receipts be taxed as income without incorporating the legal fiction in the charging section in this regard? This creates a legal anomaly.

(2) The tax imposed under sub-Section (1) on a person who receives a dividend shall be computed by applying the relevant rate of tax to the gross amount of the dividend.

(3) This Section shall not apply to a dividend that is exempt from tax under this Ordinance.

⁹⁹³ 8. General provisions relating to taxes imposed under Sections 5, 6 and 7:- Subject to this Ordinance, the tax imposed under Sections 5, 6 and 7 shall be a final tax on the amount in respect of which the tax is imposed and-

- (a) such amount shall not be chargeable to tax under any head of income in computing the taxable income of the person who derives it for any tax year;
- (b) no deduction shall be allowable under this Ordinance for any expenditure incurred in deriving the amount;
- (c) the amount shall not be reduced by –
 - (i) any deductible allowance; or
 - (ii) the set off of any loss;
- (d) the tax payable by a person under Sections 5, 6 or 7 shall not be reduced by any tax credits allowed under this Ordinance; and
- (e) the liability of a person under Sections 5, 6 or 7 shall be discharged to the extent that –
 - (i) in the case of shipping and air transport income, the tax has been paid in accordance with Section 143 or 144, as the case may be; or
 - (ii) in any other case, the tax payable has been deducted at source under Division III of Part V of Chapter X I[:]

[Provided that the provision of this Section shall not apply to dividend received by a company.]

(ii) 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 treating tax withheld on it as the final discharge of tax liability under s 169 as mentioned earlier.

(iii) Although the definition of services and sale of goods is provided in subsection (9) of s 153, (reproduced earlier in this chapter), the definitions have created more uncertainty and ambiguity. The definition of the contract is not provided, 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 chapter.

(iv) Since manufacturers are excluded from the ambit of PIT under s 153, a manufacturer is defined in subsection 9 of s 153. This definition is reproduced below for quick reference.

“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 8[] or preparation of goods in any other manner.

But 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 final tax regime in the Second Schedule for shipping business is ambiguous regarding the assessment and filing requirements in this regard. All other incomes falling within the ambit of final tax regimes are deemed to have been assessed under s 120 of the ordinance and consequently taxpayers are absolved from filing a return of income tax under subsection (3) of s 169. The ectopic insertion of the 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. This increases the uncertainty and ambiguity in the PIT regime.

(vi) The PIT regime for the manufacturers of edibles under subsection (8) of s 148 read with its explanation envisages only taxing the import of raw materials. However, it is noted that these manufacturers are not provided an exemption from withholding under s 153 despite the fact they are treated on par with commercial importers in terms of the mechanism for the discharge of their tax liability.

(vii) Regarding the retailer's regime, it seems that under subsection (3) of s 113A and clause (c) of s 113B, retailers are not allowed to adjust for any tax withheld in respect of their business transactions. These provisions are reproduced for quick reference.

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 2[(1)]. 3[The retailer shall not be entitled to claim any adjustment of withholding tax collected or deducted under any head during the year.]]

113B(c): The retailer shall not be entitled to claim any adjustment of withholding tax collected or deducted under any head during the year

More simply, in a case where the retailer suffers from the deductions while transacting with another person, those deductions cannot be refunded. The additional tax burden for the retailer would depend upon volume of transactions with WHT agents.

Consequently, the retailer's regime has efficiency costs, because every retailer would try to avoid transacting with the withholding agents so as to reduce their tax burden. In the case where a WHT agent has to transact with them, then they have to bear the tax burden of withholding. More aptly, retailers would prefer to restrict themselves to the informal sector only. For instance, they would not put money in bank, which suffers tax on withdrawals and interest income; and they would not make commercial imports, because then they would bear double tax, both at the time of import and then at the sale of the same goods. Precisely, this regime would make life complex for retailers unless this regime is beneficial in saving a lot of tax on their retail activity.

2.1.1.7 Provisions Where the Literal Meaning is Never or Rarely Enforced

The pertinent example here is clause (d) to 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. The literal meaning of ‘manufacturer’ can also not be applied to the definition under s 153. The same is true for the definitions of contract, sale of goods, and services given under s 153. More aptly, it is hard to strictly restrict all business activities to the literal meanings of these terms. The use of such words therefore only adds to the technical complexity.

2.1.2 Operational Complexity

Consistent with Section 3.3 of Chapter 5, the operational complexity of the Pakistani PIT regime will be analysed qualitatively in terms of the compliance burden e.g. bookkeeping and other documentary requirements, the length and the level of computation etc. Since the compliance costs actually reflect the compliance burden, which is to be borne by small income earners of the informal economy, this burden must be low to make any tax regime successful in developing countries. It will be examined in the context of the average liability of a small business (that is, the ratio of compliance costs to tax liability).

As discussed in Section 3.3 of Chapter 9, small taxpayers in Pakistan mostly have to maintain books of accounts⁹⁹⁴, because the probability that all the transactions would fall within the ambit of the PIT regime is very low.⁹⁹⁵ Taxpayers usually have income from transactions both with WHT agents and others. Consequently, a taxpayer is required to keep accounts for the allocation of expenses, when he or she has two streams of incomes. One stream from an activity which falls within the ambit of PIT and another

⁹⁹⁴ Internal costs on the recording data and acquiring knowledge to comply with tax obligations are virtually all the compliance costs (see Cynthia Coleman and Chris Evans, ‘Tax Compliance Issues for Small Business in Australia’ (2003) in *Taxing Small Business: Developing Good Tax Policies* Neil Warren (ed.), Australian Tax Research Foundation Conference Series 23, 163). There is a general business perception that the prime use of the financial statements is in tax compliance rather than in financial management (see Chris Evans et al, ‘*A report Into the Incremental Costs of Taxpayer Compliance*’ prepared for the Revenue Analysis Branch of the Australian Taxation Office (Australian Government Publishing Service Canberra, 1996, 3)). This perception seems more prevalent in small business sector.

⁹⁹⁵ It may be, because, only a few business activities are covered under PIT. Moreover, transactions with formal sector only suffer WHT, which is a prerequisite to be eligible for PIT. Thus, activities, which do not suffer WHT fall outside the ambit of PIT.

stream from an activity covered under the normal income tax regime. More simply, the taxpayer is obliged to maintain books if more than 20% of their receipts have not suffered WHT.⁹⁹⁶ A taxpayer is therefore also required to keep records for compliance to the normal income tax regime, when his/her receipts do not suffer any withholding. The only exception when a taxpayer is not required to keep accounts is, when 80 percent or more of his or her receipts are subjected to WHT.

As discussed in Section 4.1.4 of Chapter 2, in small businesses, compliance costs associated with the maintenance of accounts are regressive. Compliance costs are similar for taxpayers who have a turnover of 1 or PKR50 million in a year. It is noted that the cost to maintain accounts takes away a large percentage of income earned by a taxpayer. Compliance costs can even be higher than the tax liability itself. For instance, a taxpayer having income at PKR 192,000⁹⁹⁷ (which is maximum income of individuals constituting 65% population) shall bear a tax liability of PKR 7,680 under the normal income tax regime, which is equivalent to approximately one fourth of the compliance costs related to bookkeeping etc.

Further, the WHT on those activities, which are not covered under PIT, require small businesses (even those who fall under PIT) to interface with the tax administrator in order to get a refund of tax withheld on those activities. In the absence of an electronic refund mechanism, many small businesses do not even apply for the refund due to fear of being harassed by the tax administration. The mismatch in total number of SMEs in Pakistan and total number of registered taxpayers mentioned in Section 3 of Chapter 8 supports this connotation. Byrne describes such withheld taxes in Latin American countries as *de facto* final assessment regimes.⁹⁹⁸ This loss of refund amount for taxpayers is nothing but an addition to tax compliance costs and consequently could be an additional reason for the small businesses to stay informal.

It is noted that in the Pakistani PIT system, there is no sufficient simplified regime for small entrepreneurs in Pakistan. The PIT based on WHT is not simple, as compared to

⁹⁹⁶ *CBR Circular NO: 12 of 1991*, Federal Board of Revenue of Government of Pakistan.

⁹⁹⁷ PKR192,000 is the maximum income of 65 percent population in Pakistan (see '*Nature and Extent of Corruption in Pakistan*' Transparency International Pakistan, March 2002, 20).

⁹⁹⁸ Peter D. Byrne, 'The Business Asset Tax in Latin America – No Credit Where It Is Due' (1994) *Tax Notes International* 529, 533.

other PIT designs enumerated in Section 3.3.2 of Chapter 3, even when all the taxpayers' receipts suffer WHT, because taxpayers have to keep records for turnover as well as taxes withheld throughout the year. The taxpayer has to keep records for all withholding types, some of which are a final discharge of tax liability and some of which are not. For the latter, the taxpayer has to obtain a refund from the tax authorities.

Further, the compliance is increased by volume and is complicated due to the separate treatment for each class of income. As discussed above, small business in Pakistan is subjected simultaneously to different tax regimes for different classes of income. The same was noted recently by the World Bank – that in Pakistan small business may be required to comply with five different tax regimes depending upon the nature of income.⁹⁹⁹ This all increases compliance costs including the costs of tax agents and gratitude payments. More simply it is an unreasonably high magnitude of statutory compliance, which is required from a small entrepreneur.

On the other hand, retailers who fall under the simplified non-WHT based turnover tax regime have to keep a record of turnover, which increases the cost of compliance and consumes the time of these uneducated entrepreneurs. Moreover, the tax liability is uncertain in this regime, because the adjustment for amounts withheld under the WHT is not allowed under this regime. It means that the retailer bears an additional tax burden both for WHT which is a final discharge of tax liability and for other WHTs, which are not a final discharge of tax liability. More simply, for the retailers, any tax deducted under the WHT regime is the final discharge of tax liability. This tax is over and above the tax which the retailer has to pay under the retailer's regime. Consequently, as discussed in section 2.1.1.6, to benefit from the regime, the retailer has to organize its activities in such a manner that he or she should bear minimum WHT. This all increases compliance costs.

Another simple regime has been enacted for rental income earners. Since the tax on property income is simple even under the normal income tax regime, subjecting the same income to PIT was unlikely to have been for the purpose of simplicity. The low tax rate under the PIT for rental income earners suggests that it was enacted to favour the real estate sector.

⁹⁹⁹ Martinez-Vazquez and Richter above n 921, 21.

Further, the technical complexity in the Pakistani PIT, as discussed in the preceding section, is likely to increase the uncertainty and ambiguity which consequently increases a taxpayer's costs of tax filing and tax planning.

Lastly, small businesses organized as AOPs and firms are obliged to act as WHT agents under s 153 for various payments they make. This role of collecting taxes for the government increases the costs for small taxpayers in the formal sector, which may promote informality.¹⁰⁰⁰ The use of a WHT regime is therefore not suggested for taxing the small business sector.¹⁰⁰¹

Conclusively, low compliance costs, which are crucial to facilitate voluntary compliance from small business, are largely ignored in the Pakistan PIT. Consistent with Section 3.3.1 of Chapter 4, any PIT which is not simple and does not reduce compliance costs, is not the solution for the informal economy.

For the sake of avoiding duplication, the enforcement cost aspect of operational complexity is discussed in the second stage in Section 3 of this Chapter, which analyses the Pakistani regime against the recommended designs features.

2.2 Pakistani PIT and Efficiency

Consistent with Section 4.3 of Chapter 5, neutrality is bedrock of the efficiency principle. Therefore, the Pakistani PIT is analysed in this Section initially against all facets of neutrality. Later, the deadweight loss, which has significant value in determining the efficiency of a tax system and is linked to tax design, is assessed in respect of the Pakistani PIT. Besides that, the overall tax burden unleashed by the Pakistani PIT on its taxpayers is also evaluated.

2.2.1 Neutrality

Consistent with Section 3.1 of Chapter 7, PIT intrinsically cannot be neutral in tax treatment with respect to the following three facets of neutrality:

¹⁰⁰⁰ An empirical study of such compliance costs, as to whether these costs are more than the taxpayer's tax liability, may be a potential future research area for confirming this observation.

¹⁰⁰¹ Australia ATO Report, above n 56, vii.

- (i) Neutrality of tax treatment of losses and income
- (ii) Neutrality of tax burden irrespective of the risks in the sectors
- (iii) Neutrality in respect of compliance procedures and related costs

This is also true when we compare the tax treatment of individuals falling within the ambit of PIT and those within the normal income tax regime. PIT also fails to neutralize the tax impact in these facets among taxpayers who are covered under the PIT. This loss of neutrality in PIT is because PIT is a fixed tax disregarding actual income, and PIT does not allow any carry forward and consequent adjustment of losses. More simply, PIT taxes a taxpayer irrespective of whether he/she has income or makes a loss. The Pakistani PIT does not differ from other PIT designs in this regard.

In respect of risk also, the normal income tax regime allows taxpayers to offset losses of one year against the income of another year to minimize the effect of risk related fluctuations in income and tax thereon. The PIT regime inherently has no such buffer to absorb the shocks of high tax liability in boom years. Thus, a risky business falling within the PIT regime bears more fluctuation in Earnings after Interest and Tax (EAIT), as compared to other similar risky business, falling in the normal income tax regime (see numerical illustration annexure I). However, the extent of fluctuation in PIT is proportionate to the level of risk in a particular industrial sector. Consequently, it discourages entrepreneurs who fall within the ambit of PIT, from undertaking highly risky ventures.

In terms of compliance procedures and costs, taxpayers exclusively falling within the ambit of PIT are favoured, as compared to those who fall within the normal income tax regime, because, the normal income tax regime taxpayers invariably are required to keep books of accounts. This causes loss of neutrality in statutory compliance between these classes of taxpayers. However, the compliance costs would be the same among the taxpayers who fall within the ambit of PIT regime.

The Pakistani PIT is analysed below against each of the remaining seven aspects of neutrality enumerated in Section 4.3 of Chapter 5. The analysis regarding the neutrality among the industrial sectors is included in the neutrality aspect concerning tax rates, expenditures and concessions.

2.2.1.1 Neutrality in Tax Rates, Expenditures and Concessions

Tax rates, which determine the tax burden in any tax system in general and the PIT regime in particular, should be chosen on some logical basis. Consistent with Section 3.1 of Chapter 7, the rates in PIT for small business should be fixed in proportion to the average income of relevant sectors or any other rational basis. More simply, different profit margins demand different tax rates for each business activity in order to bring neutrality in tax treatment. Thus, a turnover based Pakistani PIT should have classifications and rates on the same basis or a similar logical basis. But regrettably, this aspect is completely ignored in the Pakistani PIT.

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

Moreover, within WHT based PIT regimes, some activities are taxed at high and other at very low rates. The exports are taxed at 1%, imports at 2%, but fabrics imports at 1%. Transport services are taxed at 2% and other services at 6%.¹⁰⁰² The difference in tax rates is without any sufficient economic rationale (like one of an average income). Even the difference in tax rates does not correspond to differences in the profit margin from these activities. Robina and Rider show that contractors pay 20 percent of federal tax receipts in Pakistan, even though they account for only 2.3 percent of its GDP.¹⁰⁰³ This discriminatory treatment of different activities in terms of different tax rates, without paying any heed to the actual or average income of those activities, causes allocation of resources to low taxed sectors at the expense of high taxed ones and consequently economic distortion.

¹⁰⁰² The textile related services for exports are taxed @ 0.5% u/s 153(1A). The tax rate on import of fabric is reduced from 2 to 1% by clause 9 to the Part II of Second Schedule.

¹⁰⁰³ See Ahmed and Rider above n 919, 27.

It is worthy to refer to decision of the Indian Supreme Court in case of *Kunnathat Thathunni Moopil Nair etc. v State of Kerala and another*¹⁰⁰⁴ which lays down broad guidelines for taxation in this regard. The facts of the case were that 22 petitions under Article 32 of the Indian Constitution were directly filed with this court challenging the constitutionality of Travancore-Cochin Land Tax Act 15 of 1955 as amended by Act 10 of 1957. Section 4 thereof provided that subject to the provisions of this Act, there shall be charged and levied in respect of all lands in the state of Kerala of whatever description and held under whatever tenure of uniform rate of tax to called the basic tax.

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”

The classification and rates in the Pakistani PIT is without any rationale and therefore appear confiscatory because the lack of rational basis results in unequal tax burdens on different classes of businesses. Regarding the confiscatory nature of taxation, the Indian Supreme Court in the same case made the following observation:---

“It is a common ground that the tax ... has no reference to income either actual or potential from the property sought to be taxed. Hence, it may be rightly remarked that the Act obliges every person, who holds the land to pay tax at the flat rate prescribed, whether or not he makes any income out of the property, or whether or not the property is capable of yielding any income ... Ordinarily, a tax on land or land revenue is assessed on the actual or the potential productivity of the land sought to be taxed. In other words, the tax had reference to the income actually made, or which could have been made, with due diligence, and, therefore is levied with due regard to the incidence of taxation.”

¹⁰⁰⁴ *Kunnathat Thathunni Moopil Nair etc v State of Kerala and another* AIR 1961 SC 552; 3 SCR 67.

“Under the Act in question we shall take a hypothetical case to a number of persons owning and possessing the same area of land. One makes nothing out of the land, because it is arid desert. The one could not make any income, but could raise some crop after a disproportionately large investment of labour and capital. A third one, in due course of husbandry in making the land yield just enough to pay for the incidental expenses and labour charges besides land tax or revenue. The fourth is making the large profits, because the land is very fertile and is capable of yielding very good crops. Under the Act, it is manifest that the fourth category in our illustration would easily be able to bear the burden of tax. The third one may be able to bear the tax. The first one and the second one have to bear from their own pockets, if they could afford the tax. If they can not afford the tax, the property is liable to be sold in due process of law for the realisation of the public demand.”

“It is clear that inequality is writ large on the Act and is inherent in the very provision of the taxing Section. It is also clear that there is no attempt at the classification in the provisions of the Act, hence, needs to be seen as to what could have been the basis for a valid classification. It is one of those cases, where lack of classification creates inequality. It is, therefore, clearly hit by the prohibition to deny equality before the law contained in Article 14 of the constitution.”

In another case, *The State of Kerala v Haji K. Kutty Naha and Others etc*¹⁰⁰⁵, the High Court of Kerala held that the legislature had acted ultra vires in the Kerala Building Tax Act 19 of 1961 as it infringed the equality clause of the constitution. The said Act purported to levy a tax on every building, the construction of which was completed on or after 2-3-1961 and which has a floor area of 1000 sq. ft. or more. The rates provided in the schedule of this Act were provided on the basis of the commercial area without taking into the consideration the location and the commercial value of the building. The Indian Supreme Court, while affirming the High Court judgement, also pointed out that the legislature, in imposing the tax the class to which a building belonged, had not taken into consideration the nature of construction, the purpose for which it was used, its situation and its capacity for a profitable use etc and therefore the Act was clearly discriminatory in its effect.

¹⁰⁰⁵ *The state of Kerala v Haji K. Kutty Naha and Others etc* AIR 1969 SC 378.

The findings of the Court here are identical to the findings in her decisions referred to in Section 3.2 of Chapter 3 and Section 4 of Chapter 8 regarding the validity of the use of PIT. It 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 also destroys the legitimacy of such legislation. The use of turnover only without further distinguishing the economic activity is not a neutral classification.

Further, in the Pakistani PIT, even earlier there were some sub categories for the different types of exports and some subcategories in terms of the different value of the contract. This shows that there is a scope of improving the classification and developing sub-classifications in order to make tax incidence neutral and equitable. It is pertinent to refer below, the suggestion made by the Supreme Court of Pakistan, in its decision in case of *Ellahi Cotton Mills Ltd v CIT*, on the point of confiscatory nature of the PIT legislation:--

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

In addition, it is noted that some sectors are favoured by various types of concessions. This is all done through insertions in the Second Schedule of ITO 2001. Besides the total exemption from tax provided to some classes of income in Part I to the Second Schedule, a number of concessions are inserted in the form of lower tax rates, rebates in tax liability and exemption from the application of the PIT regime. Besides the Second Schedule, a few concessions are provided by amending the substantive provisions of the law, as mentioned earlier in the simplicity section. The total number of the concessions, with respect to taxes collected at source, is 30 in the ITO 2001.

Most of the concessions appear completely without any economic rationale. For example, the concession provided in clause 43B and proviso to subsection (6) of s 153

is for air tickets and print media (advertisements) respectively. These concessions exclude these activities from the ambit of PIT. Some concessions are in the form of taking some activities into the fold of PIT by just undoing the earlier exemptions. For example, the cotton ginneries are taken into PIT regime by exempting them from the exemption under clause 47D of Part IV of Second Schedule. The taking in and taking out of sectors from the ambit of PIT raises concerns about the transparency of the regime, which ultimately adversely affects neutrality and taxpayers' acceptance.

Regarding the exclusion from the application of PIT regime, unless PIT tax rates are too low, the author believes that these exclusions are used to promote collusive tax evasion rather than for any tax objective. This is because in the presence of the corrupt tax authorities, the PIT may be considered as a definite channel to collect some tax from taxpayers. On the other hand, under the normal income tax regime, taxpayers generally pay much less tax through collusive arrangements with the tax authorities. As discussed in Section 4 of Chapter 8, the statistics of the tax paid under the normal income tax regime, even by the public limited companies endorse this view. Further, the levy of MT in this sector evidently confirms it. The PIT regime can be the only choice for the honest taxpayers, who want to avoid the mental distress of interacting with the tax authorities. More aptly, the real tax expenditure or concession in the Pakistani PIT is the one where a taxpayer is taken out of the PIT rather than when he/she is brought into the PIT, unless tax rates are too low under PIT regime.

Moreover, some concessions can be more easily regarded as reflective of discriminatory practices. For examples, clause 64 of Part IV of the Second Schedule provided an exemption from withholding of tax on motor vehicles under s 231B for the period falling between 21/2/2008 to 20/3/2008 on purchase of vehicles. It is hard to find the rationale of this clause for that magic period. The authors of these exemptions may be questioned for the objective of this clause, if other than to favour a particular taxpayer in a specific period.

2.2.1.2 Neutrality in all Classes of Income

The Pakistani PIT regime is not neutral for all classes of income. The tax rate for the interest income falling within the ambit of WHT based PIT under s 151 is 10 percent. As laid down in Section 4.1.1 of Chapter 9, all non corporate taxpayers are taxed under

this regime irrespective that they are engaged in money lending businesses or have interest income on their investments. Similarly, the tax rate for the rental income is 5 percent. In both these PIT regimes gross receipts are relatively closer to the actual income, because only a few deductions are admissible against the receipts. Consequently, the tax burden on taxpayers falling within the ambit of these PIT regimes is low.

On other hand, gross receipts of business or professional activities, when subjected to the Pakistani PIT under s 153 and others at the prescribed tax rates (which fall in a range of 1-10 percent as laid down in Section 4.2 of Chapter 9), may bear a higher effective tax liability on business income, because the income from these activities constitutes a relatively small part of their overall receipts. More simply, interest receipts are somewhat equal to profits from investment; whereas profits from investment in a business venture reflect only a small component of its receipts.

For example, Mr. A receives interest income of PKR65,000 from his interest bearing securities. This income/ receipts are taxable under PIT at 10% and consequently bear tax at PKR 6500. The effective tax rate for this income is also 10%, because no deductions are admissible against the receipts of PKR65,000, which are earned on the securities financed by his savings. On other hand, Mr. B receives receipts of PKR 650,000 on account of supplies he makes to his customers. These receipts also fall within the ambit of PIT at 3.5% and consequently bear tax of PKR 22,750. In case net profit margin of this trading activity is assumed at 10%, then Mr. B's income of PKR65000 suffered tax liability of PKR22,750 – that is, an effective tax rate of 35%.

It is also observed that the preferential rate for rental income (see Annexure II), as compared to other sectors like contracts, favours the allocation of the resources in real estate. This discourages entrepreneurial diversity, which is already scarce in developing countries. Similarly, the low tax rate on interest income as compared to other sectors also encourages keeping funds idle in banks, which causes economic inefficiency. The high collections under s 151 as compared to other investments small entrepreneurs such as retail businesses endorse the view (see Table 3 in Annexure III).

2.2.1.3 Neutrality in Tax Burden for all Types of Legal Persons

The Pakistani PIT is not neutral in terms of its treatment for different types of legal persons. This may cause an allocation of resources towards particular forms of business organization, which may not produce the highest yield for the economy. It is also important to note while inserting these discriminatory tax treatments in the law, no official policy explanations were issued. There are numerous examples in this regard, but the most important ones are mentioned below:

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

(ii) Services income under s 153 in respect of corporations is taken out from the ambit of PIT by the first proviso to subsection (6). This is consistent with the earlier finding that exclusion from PIT provides an opportunity to evade taxes under the normal income tax regime by having a collusive arrangement with the tax authorities. This discrimination opens a door for tax planning and ultimately influences the way the business may be organized.

Moreover, small entrepreneurs in the service industry, which are considered a hub of innovation and engine for economic growth, may find it hard to compete with the corporate sector in the presence of this discriminatory treatment and may consequently prefer not to pay any tax by staying in the informal sector. This cumulatively results in the misallocation of resources to the less productive informal sector.

(iii) The income from a supply of goods by a corporate manufacturer is taken out of the ambit of PIT by subsection (6A) of s 153. This provision creates distinction in 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 taken out from 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 economic decision making regarding the choice of form of business organization, seems unprecedented.

(v) The income from commercial imports by large import houses, irrespective of the form of business organization, is taken out of PIT by clause (d) to subsection (7) of s 148. This favourable treatment to large importers may become detrimental for small entrepreneurs and ultimately may wipe them out from the market.

(vi) Those corporations, which are conducting trading houses, are exempt from both PIT regimes under sections 148 and 153, in case they meet certain conditions. Thus, a non-corporate business would be discriminated against not only for the purpose of the PIT, but also for their role as a WHT agent. This treatment would be detrimental for trading houses organized as an AOP or as partnership.

2.2.1.4 Neutrality in Availability of Tax Avoidance Opportunities

The Pakistan PIT creates evasive opportunities, which substantially distorts economic decision making. These opportunities arise both when all or even a part of a taxpayer's receipts fall within the ambit of the PIT regime. For example, there are separate tax rates for services, contracts and supplies and these 'terms', as reproduced earlier in the simplicity Section of this chapter, are not clearly defined in the tax code, which creates many tax arbitrage opportunities.

(i) Taxpayers can split the contract to label part of their receipts as being from supplies rather than the contract so as to bear less tax. For example, Mr. Z has contracts for the supply and installation of solar energy equipment. If it is assumed that the cost comprises PKR 1,500,000 for equipment and PKR 500,000 for installations, this makes a total of PKR 2,000,000. In case Mr. Z makes one deal for the sale and installation then he bears tax at 6% and the total liability stands at PKR 120,000. Alternatively, in the case he makes separate deals both for sale as a supply and installation as service charges then supply of the equipment bears tax at 3.5% and its installation services bear tax at

6%. Consequently, the total tax liability by splitting the contract would stand at PKR 52,500 (for supplies) plus PKR 30,000 (for services), a total of PKR 82,500.

This shows that by reshaping the transaction, tax liability can be significantly reduced. Moreover, the larger the value of transactions, the more attractive is it for tax planning.

(ii) Sometimes a taxpayer may make choices by playing on the ambiguities in definitions of the different activities. For example, services are not distinguished from the businesses of providing services such as airlines, couriers etc. It is noted that when taxpayers earn more profits, then they prefer to be assessed under PIT; and when they earn low profits, they want to be assessed under the normal income tax regime, by claiming that they are just a business and do not fall within the definition of services under s 153. The tax administration, in order to collect more revenue or sometimes for dishonest motives, also capitalizes on the same loopholes. For instance, manufacturing activities such as dyeing have been taxed by the 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 the simplicity section of this Chapter, also has created another series of litigations and taxpayers are interpreting them in a manner to serve their self interest.

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, upheld that the taxpayer fell under the ambit of PIT as a contract and that its services were not those covered within the definition provided in subsection (9). The court based its decision on the following argument:--

“9. From the combined reading of these subsections it emerges that initially professional services and then services have been defined to include the services of accountants, dentists, doctors, engineers, interior decorators and lawyers only and does not include other services. We can not subscribe to the arguments of the learned counsel for the respondent that all services will fall under clause b of subsection 1 of Section 153 as the services which have been defined in subsection (9) are services of those persons who require

professional qualification to provide these services, and therefore according to the rule of ejusdem generis which is one of the principles of interpretation only such type of professional services, which require the person to have a professional degree may be included in this definition and in our opinion stevedoring services does not require professional degree and will therefore not fall in the definition of services which have been excluded from the provisions of clause c.”

On the other hand, the services of the cricketer, as mentioned earlier in the case of *Assesse v Department*¹⁰⁰⁶, 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 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, which was completely different than the reasoning followed in the earlier decisions:--

“12. We are of the view that the specialized services contract be placed at par with general services. The services provided by the cricketer are specialized services and depend upon the individual natural talent and speciality of the individual sportsman. On the other hand, professionals like doctors, engineers, lawyers, architects, accountants etc. are educated through institutions having specific courses and degrees in this regard. The cricket team is selected on the basis of individual natural talent and they may be specialist batsmen, bowlers, wicketkeepers etc. but, this specialization can not be judged on the basis of some university course or settled degree issued by the academic institutions.”

Another argument relied upon by the tribunal to arrive at its decision of treating the cricketer's services as a contract was as follows:

“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’.”

¹⁰⁰⁶ ITA No. 1850/KB to 1850/KB of 2002 (2004 PTD 2749).

Conversely, in the case of *CIT v Khursheed Ahmad*¹⁰⁰⁷, the taxpayer filed a return under the normal income tax regime for its income from janitorial services and the department taxed it as 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”.*¹⁰⁰⁸

The above conflicting claims and counter claims and conflicting judicial pronouncements are evident of the embedded complexity in the regime, which provide a breeding ground of tax arbitrage opportunities and corruption. The twists in the arguments in the above cases depict the complexity of law, which can be moulded in the manner it suits the interest of the taxpayer or the administrator as the case may be.¹⁰⁰⁹

Under the repealed ordinance, even in respect of what constitutes a sale, the matter went into the court to decide whether the consistent sale through a contract with a marketing company is chargeable to tax under PIT as supplies or not. In the case of *Pak Saudi Fertilizers Ltd v CIT*¹⁰¹⁰, in which Saudi Fertilizers had a contract to sell its products through a marketing company, the Sindh High Court decided that the matter was a question of law and needed to be examined in light of the nature of the contract between the parties. Although the word ‘supplies’ in s 54 is replaced by the word ‘sale’ in ITO 2001, this still remains an ambiguous issue which might generate similar litigations.

Similarly, the sale and buy back transaction executed between businesses and leasing companies to raise finance was taxed by the department under PIT as a sale. The Lahore

¹⁰⁰⁷ *CIT v Khurshid Ahmed* 2008 PTD 1243.

¹⁰⁰⁸ This case pertains to the repealed ordinance which has almost identical PIT regime.

¹⁰⁰⁹ 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. Similar finding was given while describing the scope of ‘income’ in the constitution (where income has an inclusive definition) by the SC of Pakistan in the famous case of *Ellahi Cotton Mills Ltd v Federation of Pakistan*. The SC held that ‘the fact that the word ‘includes’ has been employed and not the word ‘means’ indicates that the definition given in Article 260 for the above term is not exhaustive’.

¹⁰¹⁰ See *Pak Saudi Fertilizers Limited v CIT* 2005 PTD 1607.

High Court decided the matter against the department in the case of *CIT v JD Sugar Mills Ltd*¹⁰¹¹. In this case the taxpayer JD Sugar Mills Ltd sold and bought back part of its plant with a leasing company. Subsequently, the legislature inserted the remedial provisions, which are even carried into the ITO 2001 as clause c to ss (5) of s 153, to exempt such transactions from the ambit of PIT. But that adds to the complexity of the tax code. It is pertinent to mention here that in this case the court observed that WHT agents deduct tax on behalf of the tax agency even if the payment does not fall in the ambit of any of the items (services, supplies and contracts), perhaps because of the fear of incurring penalties for non-compliance of the WHT regime under the law.¹⁰¹²

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

(iii) Furthermore, when a taxpayer's activities fall partly under the normal income tax and partly under the PIT regime, there is an opportunity for tax avoidance by pulling most of the expenses inside the normal income tax. The allocation of expenses to PIT related receipts are not deductible due to the finality of the regime. This is achieved by manipulating the rule for allocation of expenses, which is ambiguous as mentioned in Section 3.3 of Chapter 9. Even when the cost of goods sold is measurable in single product operations, the prescribed allocation method, if manipulated, produces distorted results. This is a tax avoidance opportunity, commonly seized on by exporter cum manufacturers, but is also used by other sectors. For an illustration, see Annexure IV. Consequentially, voluminous litigation is pending in the courts, which increase tax planning costs and compromises economic performance.

(iv) The Pakistani PIT also encourages tax evasion and avoidance through collusive arrangements. For instance, big manufacturing units create sister concerns to obtain all services from them at inflated costs (as sister concerns fall within PIT) and reduce their overall tax liability. These avoidance arrangements cannot even be prevented by the general anti-avoidance provisions in the law.

¹⁰¹¹ See *CIT v J.D Sugar Mills Ltd* 2009 PTD 481.

¹⁰¹² See *CIT v J.D Sugar Mills Ltd* 2009 PTD 481.

Similarly, professionals can take advantage of the PIT for services income by substituting regular employment with a service contract. More simply, they prefer a service agreement, which falls under PIT under s 153 read with s 169. The tax burden for the same receipts under the PIT is much less as compared to tax payable under the salary regime.¹⁰¹³ Employers might also prefer this collusive arrangement with the professionals to reduce employer's costs. This causes loss of revenue, whose quantum is yet to be ascertained. Some companies even use service contract arrangements as a channel to siphon out profits out side the company, by hiring friends and relatives under these contractual arrangements. Such friends are then paid high sums as service fees to claim huge deductions against profits of the company (depending upon type, company tax rate is in range of 30-40%). Moreover, due to the lack of imputable income, a taxpayer may camouflage profits from other activities as arising from an activity falling within ambit of PIT.¹⁰¹⁴

(v) Under clause 13C of Part II to the Second Schedule, the tax rate on purchase of locally produced edible oil for the manufacture of cooking oil is 2%, but it is not clear whether it is for a reduction of the tax rate for imports under s 148 or for local purchase under s 153. Consequently, it creates an ambiguity about the treatment of such withheld tax. The oil manufacturers prefer to treat it as a final discharge of tax liability, as is the case with imported edible oil for them. It is pertinent to mention that WHT rate on imported edible oil is 3% and consequentially manufacturers are now using locally produced edible oil. This provides an opportunity for tax evasion and can become a new series of litigation. The matter is even raised by business dailies in Pakistan.¹⁰¹⁵

Lastly, these evasive opportunities created by the Pakistani PIT are not equally availed by all the taxpayers. Who can utilize the most of the benefit depends upon the size of

¹⁰¹³ The services are taxed at rate of 6%, whereas the tax rate for the highest slab of salary income is 20% under Para 1A of DIV I of Part I to Schedule I.

¹⁰¹⁴ It is recommended to introduce the concept of imputable income in the PIT as it was present in the Section 80C(5A) of the repealed ordinance, which provides that where an assessee derives income from any source which is subject to tax in accordance with the provisions of this Section, and the tax liability is less than the tax payable on such income had it not been chargeable to tax under this Section, the difference in tax shall be payable in accordance with Section 54 along with the return of income, provisions of sub-Section (4) notwithstanding (For details see repealed Income Tax Ordinance 1979 of Pakistan).

¹⁰¹⁵ See Muhammad Ali, 'Flaws in Ordinance: Ghee Manufacturers Evading Billions of Rupees' Daily Business Recorder <<http://www.brecorder.com>> at 29 September 2009.

the business, education level and degree of risk aversion etc. Consequentially, economic resources are directed and redirected for tax saving instead of high economic output.

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

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

2.2.1.6 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 it cannot be done without incurring time and monetary costs. On the other hand, when some business is specifically exempted from performing that role, then, it means it has been favoured in terms of the compliance costs. It is also favoured in terms of its interface with the tax authorities, because, such business now would not face audit in respect of withholding taxes. For example, AOP is required under the law to act as a WHT agent for withholding under s 153 whereas other legal persons such as individuals are exempted from this role. This places AOP at a disadvantageous position as compared to individuals in terms of compliance burden.

2.2.2 Overall Tax Burden

The Pakistan PIT is detrimental to work and entrepreneurship for a few 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. This results in efficiency losses, which are yet to be measured. Second, the tax burden created through ill designed tax rates is effectively higher than the normal income tax

regime, which creates a disincentive to work because increasing turnover (which is reflection of more efforts being to sales) results in higher tax liability irrespective of level of actual profits (see Annexure II). 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, consistent with Section 3.2 of Chapter 4, 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. Thus, the Pakistani PIT is not appropriate in this regard. However, despite the higher burden, the marginal tax rate, after the given rates, in the Pakistani PIT is zero which is an incentive for the high performers.

2.3 Pakistani PIT and Equity

Consistent with Section 5.3 of Chapter 5, horizontal equity in the PIT regime can be qualitatively assessed by analysing its impact on the following aspects of neutrality.

- (i) Neutrality in tax treatment among various sectors (like services, manufacturing and trading etc) and categories of taxpayers (employed and self employed)
- (ii) Neutrality in tax treatment for all forms of business organizations
- (iii) Neutrality in tax rates and expenditures for all taxpayers
- (iv) Neutrality in all classes of income (taxing the income comprehensively)
- (v) Neutrality in the compliance costs for all taxpayers
- (vi) Neutrality in tax treatment of high and low turnover businesses

Most of these neutrality aspects have already been discussed in the efficiency part of this analysis, which has shown that the Pakistani PIT is not neutral in its treatment of various categories of taxpayers. In this part, those aspects of neutrality, which have a direct impact on horizontal equity, are discussed. These include neutrality in tax treatment of the employed and self employed taxpayers; and neutrality in tax treatment of taxpayers with different turnovers.

On the other hand, as discussed in Section 5.3 of Chapter 5, vertical equity can be assessed by the level of progressivity of tax rates in the PIT regime.

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

The Pakistani PIT for self-employed violates the equity principle. The main concern is that those who are falling within PIT are not allowed any basic exemption. Thus, a taxpayer under the regime which has turnover of just PKR 1 million may have to pay tax at 5 percent under the PIT i.e. PKR 50,000, which is more than double the tax liability of another taxpayer who declares net income of a half million rupees under the normal income tax; or is equivalent to the liability of a retailer opting for fixed retailer tax and has turnover of PKR 50 millions. Alternatively, under the normal income tax regime, this taxpayer would have taxable income of approximately PKR 100,000 which is below the taxable limit, even if we assume that the net profit margin is 10 percent of his turnover. It reflects the heavy and discriminatory tax burden on those small businesses, which fall within the ambit of PIT. More simply, the Pakistani PIT lacks the feature of 'entry threshold', which protects very small entrepreneurs by providing a basic exemption.

An illustration comparing the tax liability of self-employed persons between PIT and normal income tax for various activities; and of tax liability between employed and self employed persons is given in Annexure V. This illustration clearly demonstrates discriminatory treatment in the Pakistani tax system. The self employed medical doctor bears different tax when compared to an employed medical doctor. Even a medical self employed doctor, who falls under the normal income tax regime, pays differently than the one who falls under PIT.

Further, self employed professionals of different sectors also bear different tax burdens and that differential treatment is not supported by any logic. Similarly, the unequal treatment among rental PIT, retailers PIT and the normal income is evident in the difference in tax burdens. It shows that the current Pakistani PIT may widen the existing disparity of income and is detrimental to fairness of tax system.

Finally, it is noted that the Pakistani PIT fails to secure voluntary compliance as evident from low registrations (see Annexure VI) and revenue collection even in major cities of Pakistan (see Annexure III). Therefore, the objective of securing de-facto equity, which should be the aim of any PIT as discussed in Section 3.4 of Chapter 4, might not be

achieved. Consequently, the informal economy might not be controlled in Pakistan by improving the perception of fairness through the existing PIT system.

2.3.2 Neutrality among Taxpayers with Different Levels of Turnover

Identical tax rates in PIT do not reflect identical treatment because they are applied on turnover rather than on actual income. Consistent with the findings in Section 3.1.1 of Chapter 7, businesses even in the same sector with different turnovers may not have identical profit margins due to difference in their break even points in accordance with the concepts of costing; and different business strategies of their owners (for example, selling more at low margins or selling less at high margins).

Thus, a turnover based PIT should have different tax rates based on different levels of turnover for businesses in the same sector. That is, there should be an equal tax burden for equal income, which usually is different at different levels of turnover due to different profit margins both due to difference in breakeven points or different business strategies. This feature, unfortunately, is completely ignored in the Pakistani PIT. Consequently tax burden is not fairly distributed on businesses in the same sector. For instance, it may favour taxpayers with high turnover, who have crossed the breakeven point much earlier than those with low turnover. For example, a taxpayer with turnover of PKR 25,000 is subjected to a tax rate similar to that of taxpayer from identical sector, which has turnover of PKR 5,000,000, despite the fact that both may not have similar profit margins. The taxpayer with a very low turnover may not yet have achieved the breakeven point, but still has to bear tax burden. Such a regime would favour taxpayers with high turnover. On the other hand, this regime is detrimental to those businesses which follow strategy of selling more at low margins compared to those selling less at high margins.

On the other hand, two taxpayers even with identical turnovers can also have different profit margins due to the difference in their industrial sectors and breakeven points, so imposing the same tax rates on them is unfair.

Therefore, in a turnover based PIT, it is not only necessary to group taxpayers in accordance with the sector, but also with regard to the turnover in order to charge tax close to tax on the actual income. However, such groupings results in numerous sectoral

categories, which make the turnover design quite complex in terms of the administrative execution, as discussed in Section 2.2.1.1 of Chapter 7. In the Pakistani PIT, some grouping is made by categorizing businesses in supplies and services but that is not broad enough to ensure horizontal equity across the board.

2.3.3 Progressiveness of Tax Rates

Consistent with Section 5.2 of Chapter 6, progressive tax rates are not suggested due to the inherent conflict between vertical equity and efficiency principles. In respect of the vertical equity, it was only recommended there that the taxpayer, who earns more, should proportionally pay more to the national exchequer. It may be because proportional vertical equity generates a sensible balance between two tax objectives; the ability to pay and incentive to work.

In view of above, in the Pakistani PIT, a similar rate for all levels of turnovers is appropriate in terms of the recommended ideal of vertical equity, particularly if it is reconciled to the issues related to break even point and other costing concepts affecting profit margins as discussed earlier in the horizontal equity section.

2.4 Analysis of Findings against the Prioritized Principles

Consistent with the discussion in the preceding sections, the Pakistani PIT is not simple from both the technical and operational complexity perspectives. Consequently, there is a large scale non-compliance resulting into consequential efficiency and equity losses. Moreover, in the conflict of simplicity vis-à-vis equity and efficiency, no attempt is made in the Pakistani PIT towards reconciliation. In the Pakistani PIT, simplicity is also not given a higher priority in order to help the informal sector, in line with the reasons given in Section 6 of Chapter 6. On the contrary, the Pakistani PIT is made complex without securing more equity and efficiency in the trade off.

Moreover, for the efficiency and equity principles also, no visible effort is made to bring neutrality into different aspects of taxation, which has resulted in further losses on both the equity and efficiency fronts. In all, the Pakistani PIT does not meet the recommended balance of the principles as mentioned in Section 6 of Chapter 6. It also fails to address the causes of the informal economy, for which PIT is recommended in Chapter 4.

In view of the above the following recommendations are made:

- (i) The Pakistani PIT for small business should be completely segregated from the normal income tax. This measure is likely to reduce voluntary compliance costs substantially, particularly those related to the bookkeeping. Consequentially, it may improve tax compliance and secures equity and efficiency.
- (ii) The Pakistani PIT should be reformed to make it technically simple, an element which is crucial for encouraging voluntary compliance in the informal economy. This measure would also help in reconciling the conflict of simplicity with equity and efficiency on the lines set in Section 5.1 of Chapter 6. In this regard, besides the appropriate grouping and omitting of the superfluous provisions of the legislation, the simplification may be achieved by appropriate design, as discussed in the subsequent section of this chapter.
- (iii) Finally it is reiterated that neutrality may be secured in all its aspects, other than those which are in conflict with simplicity, as discussed in Section 5.1 of Chapter 6. Although the change of design of the Pakistani PIT may be more helpful as discussed in subsequent section of this chapter, the adjustments in the existing PIT in line with the above recommendation can also help to some extent.

3. Pakistani PIT and the Recommended Design and Features

As a second part of the analysis, the Pakistani PIT is discussed below against the design and features recommended in Chapter 7 as suitable for large informal economies, while still meeting the criteria of a good tax system. The recommendations made in Chapter 4 regarding appropriateness of PIT design to address the causes of the informal economy are also used in the analysis.

3.1 Pakistani PIT and the Design Recommendations for Simplicity

Consistent with the discussions in Section 2.1 of Chapter 7, a simple PIT regime is one which has fewer categories of taxpayers, fewer definitions for explaining the categories and fewer options in PIT for each category. It was also noted there that both for the operational and technical complexity, an asset based PIT is a preferable design. On

other hand, turnover based and indicator based PITs are almost at par in terms of the appropriateness of design.

As mentioned in Section 3.2 of Chapter 9, the Pakistani PIT basically has a turnover based PIT design and as a consequence, has different subtypes for different categories of taxpayers. There are around ten PIT regimes, which are based on mechanisms for collection of tax at source. Additionally, there is one turnover based regime for retailers and for rent income earners. There is also a fixed regime for shipping and transport business. The presence of these categories results in the insertion of extra definitions. This all adds to the technical complexity in the Pakistani PIT. Thus, being a turnover based PIT design, the Pakistani PIT is ranked second among all designs in terms of technical complexity, as discussed in Section 2.2.1.1 of Chapter 7.

As a result of its technical complexity, the Pakistani PIT also has high operational costs. In terms of the compliance facet of operational complexity, consistent with Section 2.2.2 of Chapter 7, an assets based PIT is the best design, followed by an indicator based PIT, and then a turnover based PIT. The Pakistani PIT, being a turnover based PIT, ranks third in that order. The ease of compliance plays a significant role in this ranking.

For the enforcement aspect of the operational complexity, consistent with Section 2.2.1 of Chapter 7, the best design is the assets based PIT, followed by the indicator based PIT and then the turnover based PIT. Once again, the Pakistani PIT, being a turnover based PIT, is rated third. Further, Pakistan, like other developing countries, has a weak tax administration. Thus, it would have been desirable that its PIT regime for small business be easy to enforce. Unfortunately, the Pakistani PIT is a turnover tax, which is not easy to monitor in cash based economies.

Additionally, the Pakistani PIT is hard to enforce and comply with, because, most taxpayers either fall in the normal income tax regime or have to face hybrid treatment. Only a small number of taxpayers fall within the ambit of PIT, when their total receipts suffer from WHT. Under the normal income tax and hybrid treatments, taxpayers have to keep books of accounts. Consequently, neither the compliance burden for small business nor the role of the weak administration is reduced as recommended in Section 3 of Chapter 4 for addressing the informal economy. Thus, the Pakistani PIT does not

address the high compliance cost problem, which is the main cause of the informal economy. Also, tax rates in under the Pakistani PIT, as discussed in earlier Sections, do not correspond to the tax burden recommended for small entrepreneurs in Section 3.2 of Chapter 4.

The Pakistani regimes for retailers and rental income are also difficult to monitor. For instance, it is a daunting task to determine the turnover of cash-based retailers under the retailer's regime. Similarly, the administration is not facilitated by the rental regime in terms of the documentation and determination of receipts. Moreover, both the regimes do not have features similar to 'open for auction' for ensuring correct declarations. For the same reason, despite the increase in the number of statements filed, revenue collection is negligible (see Annexure VI).

Moreover, formal businesses obtaining any of services or supplies taxable under WHT based PIT from the informal sector (which usually do not claim a credit of WHT, because of their reluctance of becoming formal) have to bear the burden of WHT, which increases their operational costs. Alternatively, they may choose either not to transact with informal businesses or to not comply with the WHT regime. Such outcomes are also not appropriate for a good tax system.

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

3.2 Pakistani PIT and the Design Recommendations for Efficiency

Consistent with Section 4.5 of Chapter 5, the efficiency of a design depends upon neutrality, minimal deadweight loss and tax burden. Neutrality generally is difficult to secure in a PIT due to non-taxing of actual income. However, taxing average income or

the ability to earn income (that is, potential income tax) is suitable alternative in this regard. Taxing average income, besides helping achieve some form of neutrality, also promotes economic growth by encouraging work through a zero rate of marginal tax, which is inherent in this design.

The best of the PIT designs, which can secure the most virtues of potential income taxation, is the asset based design. Moreover, as discussed in Section 3.1 of Chapter 7, an asset based design, in comparison to the turnover and indicator based designs, is much easier to frame for taxing average income because of its characteristic of having a single tax rate for all sectors. The turnover based Pakistani PIT is equivalent to an indicator based design; wherein the taxing of the average income requires a number of categories and that too with different tax rates, which causes economic misallocations.

Turnover based PIT design also has other weaknesses. For instance, this design is not neutral in terms of equal treatment of equal opportunities, because it puts more burdens on taxpayers, who have high turnover due to their better performance and consequently discourages more work. Consistent with Section 3.1.1 of Chapter 7, a turnover based PIT is also not suitable in the early years of business due to the break even issue. Additionally, a turnover based design also has cascading effects. The Pakistani PIT, being a turnover based design suffers from all these shortcomings.

Regarding deadweight loss, the turnover based Pakistan PIT¹⁰¹⁶ and retailer's regimes are similar to GST in terms of the tax incidence. More simply, the burden is passed on to the consumer and reduces demand, which means higher levels of deadweight loss. Most collections in PIT under s 153 are from contracts, services and supplies and it is naïve to assume that contractors, services providers and suppliers would not include PIT liability in the project evaluation. Rationally, they would not enter into contracts unless return on investment (ROI) is more than the costs inclusive of PIT liability. Consistent with the earlier discussion in Section 2.2, this may explain why, despite high tax rates on contracts as compared to other economic sectors, the investment interest in this sector has not reduced. On the other hand, the asset based PIT, as discussed in Section 3.2 of Chapter 7, has less deadweight loss.

¹⁰¹⁶ Impact of tax of PIT design under s 148 is not much different from customs duty.

The Pakistani PIT, despite having a couple of categories, makes no attempt to tax the average profit of each sector. The tax rates have no relationship with the sectoral average rate of return and in some cases they are too high, which can be detrimental to economic growth. For example, the tax rate on supplies is 3.5%, where the average profit margin in many cases of trading could be less than the tax rate. This results in a misallocation of resources.

3.3 Pakistani PIT and the Design Recommendations for Equity

Consistent with Section 3.4 of Chapter 4, the normal income tax fails to achieve equity in the informal economy due to massive non-compliance, hence, PIT is recommended for de facto equity. Thus, the simplest of the PIT designs should be the best option for securing equity in the informal sector. Consistent with the earlier discussion in sections 2.2.1 and 2.2.2 of Chapter 7, Pakistani PIT is not rated high in the context of reducing the compliance costs for two main reasons. First, it is a turnover based design, which requires many categories to obtain neutrality among different individuals. Second, it is interwoven with the normal income tax regime; hence, in the majority of cases, a small business still has to keep books. In view of these facts; an independent (that is, not interwoven with the normal income tax regime) asset based design should have been preferred over the existing hotchpotch design.

While using the simplest PIT, neutrality is also advised to be incorporated in the design in order to make tax treatment horizontally equitable for all industrial sectors. Consistent with Section 3.1.1 of Chapter 7, the best design in terms of equity is an asset based PIT design, because of its ability to tax the average income of all industrial sectors. The Pakistani PIT, being a turnover based design, is difficult to be adjusted to tax the average income of all the sectors, and is therefore not the best design to achieve equity. As mentioned in Section 2.2.1.1, despite choosing a second best option in terms of efficiency and neutrality, no effort has made to calibrate the same to bring maximum possible neutrality.

In terms of vertical equity, consistent with Section 4.3 of Chapter 7, progressive rates are not recommended for PIT regimes because of their clash with the efficiency

objective. The Pakistani PIT design abides with this recommendation and therefore may be considered appropriate in this regard.¹⁰¹⁷

Lastly, consistent with Section 2.2.1.1 of Chapter 7, a turnover based PIT is not recommended for addressing the causes of informal economy, because of the difficulty in prescribing numerous tax rates for various sectors in order to tax their respective average income. The Pakistani PIT also suffers from the same problem and consequently fails to improve tax morale and tax compliance by reducing complexity. Consequently, equity becomes harder to secure.

3.4 Pakistani PIT and Recommended Features

Consistent with Section 5 of Chapter 7, the Pakistani PIT can be discussed in respect of five sets of the features. The first three includes exclusive and minimum; mechanical and discretionary; rebuttable and irrebuttable. The fourth set includes those encouraging transition to the formal sector such as maximum tax, entry and exit thresholds and time frame. The fifth set includes those which prevent misdeclarations and evasion in the informal sector such as open for auction and audit. .

Regarding the first three, consistent with Section 3.1.1 of Chapter 4, the Pakistani PIT design seems appropriate, because, it is exclusive, mechanical and irrebuttable, which are the recommended features for informal sectors. However, most of the taxpayers do not fall completely within the ambit of PIT, hence, they have to keep books of accounts and consequently face proceedings under the normal income tax. Thus, the exclusiveness, mechanical and irrebuttable features do not exist in all situations.

Regarding the fourth set of features in the Pakistani PIT, consistent with Section 3.3.2 of Chapter 4, it is noted that the absence of exit threshold allows every business, even very large ones, to use PIT, which should be restricted to small business who are unable to keep accounts. Large businesses should be encouraged to keep accounts and be part of the normal income tax regime. Further, as discussed in Section 3.1.1 of Chapter 7, a turnover based PIT promotes cascading, which large businesses in the Pakistani PIT can capitalize upon to obtain tax benefits. Due to the lack of entry threshold, the Pakistani

¹⁰¹⁷ Previously, there happened to be two different rates for the income from contract depending upon the turnover of the contract (for details see omissions in Schedule I to *Income Tax Ordinance 2001* (Pakistan)).

PIT may not encourage fragmentation of large businesses. However, its absence causes hardship for those small businesses that otherwise would have been exempt from tax under the normal regime.

The absence of a maximum tax feature, which encourages small business to keep financial records and pay tax in accordance with them, particularly when PIT liability is higher than the normal income tax, may not be considered as appropriate in terms of promoting documentation and reducing unfairness caused by the PIT.

Finally, the fifth set of features include ‘audit’ and ‘open for auction’, which are absent in the Pakistani PIT and consequently, consistent with Section 5 of Chapter 7, reduces its enforcement capability. However, it is a positive development that the ‘optional’ feature has been omitted from the Pakistani PIT recently for some taxpayers, because it has always been used when the income tax liability happened to be higher under the normal income tax regime. The example of the pharmaceutical industry in respect of PIT under s 153 is the most important in this regard.

3.5 Findings

Pakistani PIT design is not the best among the available design options both in terms of principles of a good tax system and causes of the informal economy. The Pakistani PIT might have been much highly rated if it had been based on assets as a proxy for income.

Regarding the tax rate, it is concluded that it is not prudently fixed in Pakistani PIT, hence besides the efficiency losses, it causes a loss of revenue and tax arbitrage opportunities. These rates should be neutralized in proportion to the average rate of returns for various economic sectors.

In terms of features for tackling the informal economy, as discussed above, the Pakistani PIT has some good features and no unwanted features such as optional PIT. However, a few important features may be further added that can help in tackling the informal economy. These include the audit, time frame, entry and exit thresholds and the open for auction features.

4. Pakistani PIT and Well Known Performance Indicators

In earlier literature, besides having an easy to measure and monitor proxy base¹⁰¹⁸, the criteria for the evaluation of PIT were partly derived from the principles of a good tax system and partly from the well known performance indicators for any tax system.¹⁰¹⁹ The performance indicators consist primarily of three benchmarks. First is the ability of PIT to generate revenue. Second is its ability to broaden the taxpayer base, through transition of businesses from the informal to formal sector. Third is the reduction in the size of the informal economy, which actually is a by-product of the second benchmark. A increase in revenue collection and increase in taxpayer registrations reflect a successful PIT regime in the informal sector. The Pakistan PIT is therefore also evaluated in the following paragraphs for these three performance outcomes as well.

4.1 Revenue Collection

The Pakistan PIT fails to significantly increase revenue collection in general and from the informal sector in particular. This is verifiable by a number of figures. In terms of tax to GDP ratio, in the year 2006-07 Pakistan's ratio was 10.2, where in other emerging countries such as Egypt, Thailand and India the ratio was 15.8, 16.3 and 17.7 respectively.¹⁰²⁰ Tax collection in Pakistan (see Annexure VI) reflects the extent of loss of revenue at the national level. Furthermore, Table 1 of Annexure III shows the low tax collection from small business jurisdictions of Karachi and Lahore, which are two major commercial hubs of Pakistan.

There are many reasons to for this poor performance, some of which follow below:

(i) A turnover based PIT design is difficult to enforce, and the high PIT rates under s 153 which cover most business activities, discourage formal activities. Resultantly, there is reluctance to transact with the formal sector which is evident in the form of low collections under s 153 from small business jurisdictions in Karachi and Lahore as compared to that of national collections (see Table 2 in Annexure III).

¹⁰¹⁸ Indira, above n 474, 1944.

¹⁰¹⁹ Engelschalk, above n 2b, 14-25; also see Bird and Wallace, above n 2c, 145-146.

¹⁰²⁰ Martinez-Vazquez and Richter, above n 921, 11.

(ii) A few Pakistan PIT regimes are more of a subsidy than an effort to encourage a tax paying culture. PIT for rental income results in the erosion of the tax base. The tax liability under the rental income vis-à-vis other sectors is illustrated in Annexure II, which manifests the extent of the subsidy for real estate. Tax collection at 5% on total rental receipts is low compared to that collectable under the normal income tax regime and therefore causes erosion of the tax base.¹⁰²¹ When rental income is not subjected to WHT it also enjoys a basic exemption of PKR150,000/- and has effective tax rates lower than those for income of other sectors.

Retailers PIT also erode the revenue, because of the low tax rate and the difficulties in its enforcement. The loss of revenue under both regimes may be gauged from the figures of revenue collected (see Table 3 in Annexure III). Empirically, gross revenue from individual income tax has declined from 1.5 percent of GDP in year 2000-01 to 1.1 percent in 2005-08.¹⁰²² It shows that Pakistan is moving backwards in terms of taxing the informal economy.

(iii) A wide spread WHT regime fails to increase revenue collection. The information on the recipients obtained through WHT statements is so voluminous that it can not practically be used by the weak administration for the purpose of detecting non-compliance. Although some of their transactions bear WHT, it may be that many taxpayers might be inclined not file the returns/statements and not obtain National Tax Numbers (NTN) because they might prefer to remain informal. That perhaps explains why the Pakistani nation, with a population of 160 million, has just 2.28 million registered taxpayers (see Section 3 of Chapter 8).

(iv) Additional factors encouraging non-compliant behaviour might be that the risk of being caught is negligible and the benefit of tax evasion is enormous compared to the compliance costs. More simply, every prudent person makes a decision on the basis of the risk-reward relationship and it goes in favour of non-compliance in the given scenario. For the above reasons, the Pakistani PIT fails to fully harness the revenue potential of the country.

¹⁰²¹ Immovable property is already exempt from capital gains tax.

¹⁰²² Martinez-Vazquez and Richter, above n 919, 102.

4.2 New Registrations or Expansion of the Taxpayer Base

Since the Pakistani PIT design, as compared to other available designs, is not simple and equitable, it seems to have failed in luring small businesses from the informal economy to the formal one. Beyond that, the possibility of small business suffering high compliance costs either from a hybrid normal/PIT regime or solely the normal income tax regime under the Pakistani tax system may be responsible for persistent informal economy. These tax treatments increase compliance costs which discourage a taxpayer from operating in the formal economy. Even the tax rates are not rationally framed and in most cases cast a high burden.

Some increase in registration of retailers with a low turnover or only property income is due to the fact that the PIT operates as a huge subsidy and there is no mechanism for them to transfer to the normal income tax regime (see Annexure VI). On other hand, large retailers, who are already registered under sales tax, are also provided subsidised PIT without a realization that the large turnover businesses should preferably be taxed in the normal income tax regime. The absence of the exit threshold and time frame features has caused the creation of a separate class of ‘special’ taxpayers in retailers and property sectors with subsidized tax treatment.

In all, it is likely that many taxpayers often prefer not to transact with the formal sector, unless high profit margins are involved, because that takes them into the tax roll and consequentially their informal activities are likely to be taxed as well, which they otherwise were carrying with impunity. This may explain at least partly why only 4% of government procurement is from small business in Pakistan.¹⁰²³ The same is evident by low tax collection under s 153 in the non-corporate jurisdictions (see Table 2 in Annexure III). Moreover, the number of the registered taxpayers, as mentioned in Section 3 of Chapter 9, constitutes just 1.2% of the total population despite the lapse of 17 years from the introduction of PIT. More simply, two different economies, formal and informal, are surviving side by side under this regime.

¹⁰²³ Pakistan SME Task Force Report, above n 89, 6.

4.3 Changes in Size of Informal Sector

The size of the informal economy in Pakistan has been continuously increasing as seen from its estimates. Its estimated size was 36.8 percent, 37.2 percent, 37.9 percent, 38.7 percent, 39.2 percent, and 39.5 percent of the total economy in the years 1999-2000, 2000-01, 2001-02, 2002-03, 2003-04 and 2004-05 respectively.¹⁰²⁴ This reflects at least partly the failure of the Pakistani regime to encourage transition to the formal sector.

5. Conclusion

The analysis of the Pakistani PIT shows that it is not adequate for small business in terms of simplicity. The Pakistani PIT also does not sufficiently meet the efficiency and equity principles. Consequently, the indicators of performance such as revenue collection and expansion of the tax base also provide a bleak picture. It may be inferred that the performance of PIT in Pakistan can be improved by replacing it with the designs and features recommended in light of comparative analysis of designs in Chapter 4 and 7. In view of these findings the next chapter puts forth recommendations for redesigning the Pakistani PIT regime for addressing large informal sector.

¹⁰²⁴ 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](http://www.economics-ejournal.org/economics/journal%20articles)> at 16 November 2008.

Annexure I

Illustration of Increased Fluctuation of Take Home Income under PIT as compared to that under the Normal Income Tax Regime

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

Source: The author's own calculations.

Annexure II**Comparison of Tax Liabilities of Different Classes of Income Generated by Identical Volume of Activity**

	Trading Business under the Normal Income Tax regime*	Trading business under PIT u/s153**	House Property income u/s 15	House Property income u/s 156
Income or Turnover (level I)	200,000	10,000,000	200,000	200,000
Tax liability	Tax at 4% =8,000	<u>Tax at 3.5%</u> =350,000	Tax at 5% on amount exceeding 150,000 =2,500	Tax at 5% =10,000
Income or Turnover (level II)	400,000	20,000,000	400,000	400,000
Tax liability	Tax at 7.5% =30,000	<u>Tax at 3.5%</u> =700,000	Tax at 5% on amount exceeding 150,000 =12,500	Tax at 5% =20,000
Income or Turnover (Level III)	600,000	30,000,000	600,000	600,000
Tax liability	Tax at 12.5% =75,000	<u>Tax at 3.5%</u> =1,050,000	Tax at 7.5% on amount exceeding 400,000 plus 12500 =27,500	Tax at 7.5% on amount exceeding 400,000 plus 20,000 =35,000
Income or Turnover (Level IV)	800,000	40,000,000	800,000	800,000
Tax liability	Tax at 15% =120,000	<u>Tax at 3.5%</u> =1,400,000	Tax at 7.5% on amount exceeding 400,000 plus 12500 =42,500	Tax at 7.5% on amount exceeding 400,000 plus 20,000 =50,000
Income or Turnover (Level V)	1,000,000	50,000,000	1,000,000	1,000,000
Tax liability	Tax at 17.5 =175,000	<u>Tax at 3.5%</u> =1,750,000	Tax at 7.5% on amount exceeding 400,000 plus 12500 =57,500	Tax at 7.5% on amount exceeding 400,000 plus 20,000 =65,000

Source: The author's own calculations.

* It is assumed that 2% net profit is declared on the turnover in trading business (see adjustment comparable column of PIT which has turnover figures). In practice, however, most small businesses usually declare losses under USAS to avoid tax and they do not have records to support their declared version.

** The figures here are of the turnover. Moreover it is presumed that the trading is not in rice, cotton seed, or edible oil.

Annexure III

Table 1
Collection from Non-Corporate Tax Administration Jurisdictions of Karachi, Lahore

Figures in millions of PKR

Commissioner Zone	2001-02	2002-03	2003-04	2004-05	2005-06
CIT, `A' Zone, Karachi	851	956	1,046	1,237	1,138
CIT, `B' Zone, Karachi	559	606	678	822	437
CIT, `C' Zone, Karachi	1,670	1,596	1,824		
CIT, `E' Zone, Karachi	741	837	895	962	885
CIT, `A' Zone, Lahore	966	1,209	1,299	1,888	2,988
CIT, `B' Zone, Lahore	2,035	2,120	-	-	-
CIT, `C' Zone, Lahore	6,506	6,803	7,301	8,243	10,207

Source: Statistical data (Historical) Fiscal Research and Statistics, Directorate Research & Statistics
<http://www.fbr.gov.pk/DRS/Default.asp> at 17 November 2008.

Note: The table reflects the low tax collection from the small business jurisdictions of tax administration representing two largest commercial cities of Pakistan which has national collection target of approx. 1 trillion rupees. This reflects that small business of two big cities are not availing the PIT regime offered in the tax code.

Table 2
Collection u/s 153 in Non-Corporate Tax Administration Jurisdictions of Karachi, Lahore

Figures in millions of PKR

Commissioner Zone	2001-02	2002-03	2003-04	2004-05	2005-06
CIT, `A' Zone, Karachi	532	737	960	1,290	1,265
CIT, `B' Zone, Karachi	404	430	595	861	975
CIT, `C' Zone, Karachi	1,201	1,1,162	1,492		
CIT, `E' Zone, Karachi	527	683	744	915	847
CIT, `A' Zone, Lahore	670	789	1,015	1,497	2,712
CIT, `B' Zone, Lahore	369	412			
CIT, `C' Zone, Lahore	1,017	1,090	1,316	2,005	2,706
NATIONAL COLLECTION	18,850	22,963	24,956	34,703	46,813

Source: Statistical data (Historical) Fiscal Research and Statistics, Directorate Research & Statistics
<http://www.fbr.gov.pk/DRS/Default.asp> on 17/11/2008 at 17 November 2008.

Note: The table reflects the low collection u/s 153 from the non-corporate small business jurisdictions of tax administration from two largest cities of Pakistan as compared to the total collection at the national level. This reflects that small business of two big cities are not availing the PIT regime offered in the tax code.

Table 3
Comparative Tax Collection from Retailers, Rental Income and Profit on Debt

Figures in millions of PKR

Nature of Tax	2001-02	2002-03	2003-04	2004-05	2005-06
u/s 113 (Retailers)	549	808	1,605	1,714	1,491
u/s 155 (Rental Income)	194	246	192	211	316
u/s 151 (Profit on Bank Deposits)	6,466	5,702	4,766	4552	6,528

Source: Statistical data (Historical) Fiscal Research and Statistics, Directorate Research & Statistics
<http://www.fbr.gov.pk/DRS/Default.asp> on 17/11/2008 at 17 November 2008.

Annexure IV**Illustration of Allocation of Expenses in Single Product Operation Cases**

ABC Ltd. sold 100 metric tonnes of PTA (a substance used in manufacture of polyester) in 2008. The 60% of sales are export sales at sale price PKR 28,000/= per metric tonne. And remaining 40% of sales are local sales at sale price PKR 35, 000/= per metric tonne. The cost of goods sold assumed for each metric tonne is PKR30,000/: which is same for both local as well as export sales (as is the case with most of single product manufacturers). The general and administration expenses are assumed at PKR50,000 for total operations. The accounting Profit & Loss of the business would be as under.

Receipts

Exports 60 x 28,000 =	1,680,000
Local 40 x 35,000 =	1,400,000
Total	3,080,000

Less: Costs of Goods Sold

100 x 30,000 =	(3,000,000)
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Gross Profit

	80,000
--	--------

Less General & Administration Expenses	(50,000)
---	-----------------

Net Profit

	30,000
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Apportionment of Profits two divisions under Management Accounting Principles

Allocation to Exports Taxable under PIT	Allocation to Local Sales Taxable under the Normal Income Tax
Receipts Exports 60 x 28,000 = 1,680,000 Less: Costs of Goods Sold 60 x 30,000 = (1,800,000) Gross Profit (120,000) Less Gen. & Admin. Expenses at 60:40 ratio (30,000) Net Profit (150,000)	Receipts Exports 40 x 35,000 = 1,400,000 Less : Costs of Goods Sold 40 x 30,000 = (1,200,000) Gross Profit 200,000 Less Gen. & Admin. Expenses at 60:40 ratio (20,000) Net Profit 180,000

Apportionment of Profits under Income Tax Ordinance of Pakistan 2001

Allocation to Exports	Allocation to local Sales
Gross Profit at 60:40 ratio 48,000 Less Gen. & Admin. Expenses at 60:40 ratio (30,000) Net Profit 18,000	Gross Profit at 60:40 ratio 32,000 Less Gen. & Admin. Expenses at 60:40 ratio (20,000) Net Profit 12,000

Source: The author's own calculations.

The above analysis reflects that the taxpayer actually under management accounting had profit of PKR180,000 from the local sales which should have been subjected to the normal income tax. But under the allocation procedure in the tax code it is artificially changed to profit of PKR12,000. It is noted that tax on exports is very low and situations like this cause loss of revenue and evasive opportunities.

Annexure V

Table 1
Illustration of Comparative Tax Liability between an Employed and a Self-Employed Professionals

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

Source: The author's own calculations.

Table 2
Illustration of Comparative Tax Liability between Self –Employed Taxpayers of Different Professions Falling Within the Ambit of PIT u/s 153

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

Source: The author's own calculations.

Table 3
Illustration of Comparative Tax Liability between Suppliers of Different Commodities falling within the ambit of PIT u/s 153

Self- Employed trader of rice	Self –Employed Trader of yarn
Receipts 300,000 PIT tax at 1.5% 4,500	Receipts 3 00,000 PIT tax at 3.5% 10,500

Source: The author's own calculations.

Annexure VI**Income Tax Returns/Statements During 2005 to 2008**

Figures in millions of PKR

Taxpayers	Up to October 2005		Up to October 2006		Up to October 2007		Up to October 2008	
Returns	No. of Returns Received	Tax Paid	No. of Returns Received	Tax Paid	No. of Returns Received	Tax Paid	No. of Returns Received	Tax Paid
AOPs	21,826	87.3	20,300	99.6	21,702	107	24,876	103.5
Salaried Individuals	62,896	154.4	61,274	183.5	64,174	199.9	102,871	91.6
Non-Salaried Individuals	510,189	1,540.00	521,644	1,714.70	545,966	2,085.00	616,395	1,461.50
Statements								
Salary certificates/statements	495,090	71.25	779,073	58.3	275,593	66.7	82,436	15.8
Importers	9,826	2.55	13,176	2.6	13,473	0.2	15,425	0.9
Exporters	8,967	13.92	8,261	12.5	10,028	2.6	10,212	1
Contractors/ Suppliers	33,993	6.62	30,201	10.1	33,183	12.4	32,266	6.2
Other (including Retailers and rent income earners)	36,378	114.43	37,547	131.6	584,262	118.6	1,171,656	165.8
Total	1,179,165	1,990.47	1,471,476	2,212.90	980,713	2,592.40	2,056,137	1,846.30

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

Note: The table reflects the negligible increase in the returns filed by the non-salaried class under the normal income tax regime. The decrease in number of statements filed under the PIT u/s 153 (that is, contracts and supplies) is also noted. The collection of tax from the non-salaried class is also negligible in country having a tax target of approximately one trillion rupees.

It is worthy to note that under the retailer's regime (even if we assume that all are retailers) the number of statements is increased by many hundred times (i.e. from 36,378 to 1,171,656) but the tax collection is just increased from 114.43 to 165.8 million, which reflects that the regime is a subsidy causing loss of revenue. It shows that this regime is also hard to enforce because turnover of cash based retailers is difficult to be monitored.

CHAPTER 11 RECOMMENDATIONS REGARDING AN ASSET BASED PIT FOR PAKISTAN

Scope of this Chapter: In light of the analysis of the Pakistani PIT in the preceding chapter, this chapter makes recommendations for redesigning the Pakistani PIT to specifically address the large informal economy in Pakistan. Besides setting out the tax base and other details of the asset based PIT design, this chapter recommends adopting a multipronged approach by involving other national organizations and policy initiatives in order to successfully implement the proposed PIT.

1. Introduction

The analysis of the Pakistani PIT system in Chapter 10 found that its existing design is not suitable for taxing the large Pakistani informal economy. Therefore, consistent with Section 6 of Chapter 7, an asset based PIT design may be a suitable choice for Pakistan.

The redesigning of PIT from a turnover to an asset base is definitely a challenging task. Despite all the theoretical merits of an asset based design identified in the analysis in Chapters 4 and 7, there is no successful example of a country which uses this PIT design to address the needs of small business in the informal sector.¹⁰²⁵

Moreover, most asset based taxes are charged as alternative minimum taxes to supplement the normal income tax, hence most of the existing literature is related to that policy objective rather than taxing small business in large informal economies. Nonetheless, the weaknesses and strengths of assets based systems used in AMT have identical relevance for small business in context of the principles of a good tax system. For example, the preference of gross assets as compared to net assets for charging AMT on corporations due to its simplicity is equally valid for small business.

In view of the above, some suggestions are made in this chapter with respect to designing of an asset based PIT for Pakistan. The remaining chapter comprises of two sections. Section 2 makes recommendations about the design of asset based PIT with particular reference to determination of assets base, valuation of assets, PIT features and

¹⁰²⁵ Some countries use assets tax as MT for corporate sector and others use it for non-corporate sector as business tax (for details see Russel Krelove and Janet Stotsky, 'Asset and Wealth Taxes' in P. Shome (ed.) *Tax Policy Handbook* (1995), 182)

level of tax burden. Section 3 would make suggestions regarding implementation of the proposed asset based PIT in context of specific jurisdiction of Pakistan.

2. Construction of an Appropriate Asset Based PIT

Construction of an appropriate asset based PIT in Pakistan requires making appropriate choices regarding the following design aspects.

2.1 Choice of PIT Features

The PIT design should essentially contain features as recommended in Chapters 4 and 7. As discussed, these features address the causes of the informal economy and are consistent with the prioritized principles of a good tax system for developing countries. These features include irrebutability, mechanical, exclusivity, well defined entry and exit thresholds, and audits of the declared version of assets every 3-5 years. The audit would also help in determining the fixed tax for next 3-5 years period.

There should not be a time limit in terms of eligibility. Thus, taxpayers should not leave the regime simply because they have been under it for a certain time. Instead, they should leave automatically when they accumulate assets exceeding the exit threshold. The offer of the feature of a maximum tax is a great incentive if they keep books, as they can then pay a smaller amount tax. However, it is presumed that once accounts are presented these have to be presented for every year. Otherwise, PIT would become an optional regime and taxpayers would keep switching between PIT and the normal income tax depending on what suits them.

Lastly, for controlling evasion in the informal sector, the taxpayer's declarations should be open for auction and should be sold to anyone who bids 50% higher than the declared value.

2.2 Determination of Tax Base

'Assets', which are used as the economic base in an asset based PIT, has a number of connotations, types and valuation requirements. Thus, ascertaining the quantum of assets that is to be subjected to tax requires choices in respect of the following.

2.2.1 Gross Assets or Net Assets

Thuronyi argues that choice of the assets to be taxed is a most critical question in designing of asset tax.¹⁰²⁶ For levying tax on assets there are there are two options. First, it should be charged on gross assets. Some scholars distinguish between total assets and gross assets by treating the former as written down value of gross assets.¹⁰²⁷ Second, it should be charged on net assets, which is equivalent to the equity component in business as laid down in central accounting equation (that is, Assets = Equity + Liabilities).¹⁰²⁸

The use of gross assets is easy to comply with and enforce because there is no requirement for determinations relating to deductions for debts, which even could be fraudulent.¹⁰²⁹ As a result, under the simplicity principle gross assets could be a suitable choice.¹⁰³⁰ In terms of neutrality, also subjecting assets to same tax rate irrespective of the fact that whether these are financed by equity or debt, makes gross assets a preferred choice.¹⁰³¹ In view of the fact that neutrality is bedrock for equity and efficiency, it can be said that gross assets based design is more equitable and efficient.

Some scholars argue against a gross assets based tax on the ground that such taxes can double tax inter-firm debts.¹⁰³² This argument may not be considered as material because quantum of such debts is not expected to be high in the small business

¹⁰²⁶ Thuronyi, above n 38, 13.

¹⁰²⁷ Indira Rajarman and T Koshy, 'A Minimum Alternative Asset Based Corporate Tax for India' (1996) *Economic and Political Weekly*, 1941, 1942. Stotsky, above n 397, 265 mentions that gross assets are generally used. While quoting the Katz Commission's report in South Africa, Steenekamp also recommends gross assets for this purpose (for details see Steenekamp, above n 311, 179).

¹⁰²⁸ Krellove and Stotsky, above n 1025, 182. There is third choice also and that is, net working capital (see Krellove and Stotsky, above n 1025, 182) but that is not appropriate for the reason that net working capital (that is equivalent to current assets less current liabilities) is reflective of liquidity of company rather than its ability to earn. Argentina has AMT on gross assets (see Thuronyi, above n 38, 12). In 1974, Columbia had introduced business tax on net assets (Tanzi and Casanegra, above n 32a, 8).

¹⁰²⁹ Thuronyi says that these frauds are analogous with thin capitalization in the normal income tax (for details see Thuronyi, above n 38, 13).

¹⁰³⁰ Rajarman and Koshy, above n 1027a, 1944-1945 says gross assets put less administrative task.

¹⁰³¹ Rajarman and Koshy, above n 1027a, 1943, 1945

¹⁰³² Rajarman and Koshy, above n 1027a, 1942; Stotsky, above n 397, 265.

sector.¹⁰³³ There is also the issue of verifying such debts in informal sector, as doing so will make the entire regime complex. This will kill the very purpose for which PIT is used for small business. On the other hand, it is generally considered that net assets taxes encounter great difficulties in administration.¹⁰³⁴ Therefore, instead of taxing the net assets it is advised that gross assets should be taxed relatively at a lower rate.¹⁰³⁵ The suggestion to apply lower tax rates is for two reasons. First the impact of the double taxation in gross asset based PIT (that is taxing same assets in hands of borrower and lender) will be less. Second the business entrepreneur, even when mostly financed by debt, can still have some take home returns after paying interest charges.

The above analysis suggests using of gross assets as an economic base in an asset based PIT design with relatively lower tax rates. Such a choice is made because of its higher adherence to simplicity and neutrality principles.

2.2.2 Current or Long Term Assets and Tangible or Intangible Assets

Once it is decided to use gross assets another choice to be made is in respect of types of assets. Types of assets may be classified in two ways. The first form of classification is current (that include cash balances, inventories etc) and long term assets (that include land, structures, machinery etc). The second form of classification is Tangible (that include all physical assets) and intangible (that include goodwill, brand etc) assets.

Regarding the current and long term assets it is suggested to only tax the long terms assets and leave current assets for five reasons.¹⁰³⁶ First, most of current assets are not primarily related to earning ability of the firm or the production process.¹⁰³⁷ In other words only operating assets should be taxed which are mostly fixed in nature.¹⁰³⁸

¹⁰³³ In the corporate sector, where assets tax is used as AMT, this could be taken care of by excluding those sectors which high debt based operations such as financial institutions (see Rajarman and Koshy, above n 1027a, 1943; Thuronyi, above n 38, 14; Steenekamp, above n 311, 179). The introduction of exemptions for small business is not suitable because it may jeopardize simplicity which is most highly ranked principle of a good tax system in this sector.

¹⁰³⁴ Noboru Tanabe, 'The Taxation of Net Wealth' Staff Papers, International Monetary Fund, Vol. 14, No.1, 141.

¹⁰³⁵ Sadka and Tanzi, above n 312, 12.

¹⁰³⁶ Sadka and Tanzi, above n 312, 10, Tanzi and Casanegra, above n 32a, 10 also mentions about the difficulties in this regard.

¹⁰³⁷ Sadka and Tanzi, above n , 10

¹⁰³⁸ Rajarman and Koshy, above n 1027a, 1942.

However, tax on the fixed assets only (that is, by excluding other operating assets) is also not recommended because of its negative effect on further investments in fixed assets.¹⁰³⁹ Second, current assets are easy to conceal and difficult to monitor. Third, some of the current assets can be taxed separately in form of interest or dividends under separate class of income under the normal income tax: an incidental or 'other income' which does not arise from the main operations of business.

Fourth, current assets include some types, such as inventory, which is one of the most difficult among all assets to be taxed. Some scholars specially mention about difficulties in measuring inventory.¹⁰⁴⁰ Fifth, current assets can quickly change the form and a taxpayer may doctor with its figures on the valuation date to alter the overall picture. Thus, Sadka and Tanzi argue that current assets by their very nature are transitory.¹⁰⁴¹

To sum, the reason for exclusion of current assets from the ambit of asset tax may be a lack of practical or meaningful way to measure them.¹⁰⁴² For the above reasons most countries, which adopt an asset tax, used long term assets in this regard.¹⁰⁴³

Despite the difficulties in measuring and tracing of current assets' there is no rationale under the principle of equity to exclude them from the proposed asset based PIT. Rajarman and Koshy also reject the use of long term assets on the basis that the normal income tax is also on total profits and therefore total assets should be included in assets tax.

In view of the above, for designing an asset based PIT, it is recommended that both the long term and current assets be taxed. However, on account of the measurement difficulties, there may be lesser success in implementation of the current assets component of this regime particularly in initial days of its introduction.

On the other hand, the choice between tangible and intangible is relatively difficult. More specifically, the actual choice to make in this regard is whether or not to tax

¹⁰³⁹ Krellove and Stotsky, above n 1025, 182.

¹⁰⁴⁰ Krellove and Stotsky, above n 1025, 182.

¹⁰⁴¹ Sadka and Tanzi, above n 312, 10.

¹⁰⁴² Sadka and Tanzi, above n 312, 9; Steenekamp, above n 311, 179.

¹⁰⁴³ Rajarman and Koshy, above n 1027a, 1942

intangibles. Intangibles are difficult to value even in the corporate sector, thus in most tax systems even under the normal income tax these are taxed only when these are sold.¹⁰⁴⁴ In respect of PIT also Sadka and Tanzi suggest that intangibles should only be taxed at time of their trade in hands of a buyer as part of its assets because the price paid by the buyer could be known at that point of time (like a capital gains tax).¹⁰⁴⁵ However, they admitted that such a treatment would be inequitable¹⁰⁴⁶, because those who do not sale these assets will not suffer tax on the increase in their value of assets.

The author of the thesis believes that intangibles have a substantial value in the small business sector. Many small businesses, which may not have a large fixed assets base, may still have a large income due to their goodwill or historical credibility in a particular market. This is consistent with the argument of Sadka and Tanzi that intangibles ‘certainly have their own contribution to the firm’s ability to pay’.¹⁰⁴⁷ If asset based PIT is in place with an ‘open for auction’ feature, then the value of such business in terms of tangible assets would be low and that business could be vulnerable to purchase by a predator who would like to pay more because of its unrecorded goodwill (intangible). The author, therefore, suggests including intangibles particularly goodwill in asset base. This issue is further discussed in the section of valuation of assets.

The above discussion recommends taxing long term assets and intangibles for the sake of simplicity, equity and revenue considerations.

2.2.3 Qualifications: the Assets of Professionals

For professionals, tax liability should be determined with reference to their qualifications. For example, in respect of medical practitioners graduate or postgraduate degrees may be subjected to tax as intangible assets. For example, as discussed in Section 3.3.2 of Chapter 3 the Pennsylvanian government uses occupational skills for its Occupational Assessment Tax. Another example, given there is of Ghana which charges fixed tax on professional qualifications. A similar regime could be designed for

¹⁰⁴⁴ Einaudi in Sadka and Tanzi, above n 312, 3 recommends tax only on physical assets; perhaps that intangibles were not well defined at that time.

¹⁰⁴⁵ Sadka and Tanzi, above n 312, 11.

¹⁰⁴⁶ Sadka and Tanzi, above n 312, 11.

¹⁰⁴⁷ Sadka and Tanzi, above n 312, 10.

Pakistan. For businesses, which use labour (unskilled/informal skilled work force) such as mechanics, plumbers and electricians etc, the years of experience may be used as an indicator substituting assets.

2.2.4 Valuation of Assets

Once it is decided that gross long term assets (both tangible and intangible)¹⁰⁴⁸ should be taxed, the next choice to be made is regarding the valuation method to be adopted in this PIT design. Thuronyi considers the valuation of assets as an Achilles heel of the assets tax.¹⁰⁴⁹ Krelove and Stotsky identified following reasons for the difficulties in this regard.¹⁰⁵⁰

- i) the value of business assets may vary.
- ii) Many assets have long life span and are not regularly traded.
- iii) Inflation distorts the value of assets.
- iv) Some small assets are sufficiently costly to value.

There are six options for valuing assets. First is Historical cost.¹⁰⁵¹ Second is book value.¹⁰⁵² Third is inflation adjusted values. Fourth is replacement cost.¹⁰⁵³ Fifth is Net Realizable Value. Sixth is discounted cash flow basis.¹⁰⁵⁴

Although the historical cost is the most reliable method due to presence of purchase invoices of the assets¹⁰⁵⁵, it is not accurate because of not taking into account inflationary effects and the effects of wear and tear and technical obsolescence. The solution to these deficiencies is available in form of admitting depreciation to arrive at

¹⁰⁴⁸ Net assets can be determined in corporate sector by inequity figure (see Krelove and Stotsky, above n 1025, 182).

¹⁰⁴⁹ Thuronyi, above n 38, 19.

¹⁰⁵⁰ Krelove and Stotsky, above n 1025, 182.

¹⁰⁵¹ Rajarman and Koshy, above n 1027a, 1948 mentions about South American countries using historical costs for valuation of assets for their AMT.

¹⁰⁵² Steenekamp, above n 311, 179.

¹⁰⁵³ Sadka and Tanzi, above n 312, 11.

¹⁰⁵⁴ Sadka and Tanzi, above n 312, 12.

¹⁰⁵⁵ One can argue that records (invoices etc), which are required in the historical costing method, undermines the very basis for which PIT is suggested in first place. However, proponents of historical method say that there is a difference between keeping invoices of all business activities, including those of sales and purchases, and keeping invoices for assets only. Retention of the former, which is required for determination of income is much complex than the latter.

book value (the option 2 mention above) or inflation adjusted values (the third option). These both options, however, are not suggested for small business sector in order to keep the PIT regime simple: a major reason for the use of PIT for small business.

The fourth option of using replacement cost is also not suitable as it is only applicable when buying exactly the same kind of assets and therefore can be applied for inventory (which is already excluded from the ambit of the regime) or some new assets. More simply, all business assets do not need replacement hence application of replacement values for charging tax will not be appropriate.

The fifth option of using net realizable value is realistic in the sense that it adopts the value, which an asset can fetch when it is sold in the market. However, it requires a significant role of tax administration particularly in the wake of the volatility of markets. Krelove and Stotsky also argue that long term assets are less frequently traded so it is difficult to determine their value.¹⁰⁵⁶

This left the policy makers with the sixth option of discounting the cash generating ability of assets and thereby determining their value. Even when this method is done for total assets as a lot (in form as a 'going concern'), it requires accounting expertise. The author argues that in case of small business there is no need to adopt this method as it is. However, the author suggests that if a taxpayer is himself/herself required to submit the value of his/her business¹⁰⁵⁷ as a going concern (the block of assets chosen to be taxed in PIT as laid down above)¹⁰⁵⁸ then that taxpayer will take into account the total earning abilities of his/her business assets for estimating its value. More simply, the taxpayer is expected to estimate the value, which reflects its potential to generate income, because a going concern is an income generating apparatus. When combined with open for auction feature this mechanism of valuation of business by the taxpayer himself concern

¹⁰⁵⁶ Krelove and Stotsky, above n 1025, 182. One can argue that market value of a particular asset may not always be readily identified for determination of net realizable value. This is a valid argument and because of it this method is not suggested in the thesis.

¹⁰⁵⁷ As recommended by Einaudi in Sadka and Tanzi, above n 312, 3.

¹⁰⁵⁸ Although Einaudi recommended that each asset should be valued separately (see Sadka and Tanzi, above n 312, 3), that may make the regime complex.

would be a mix of Net Realizable Value and Discounting of Cash Flow methods.¹⁰⁵⁹ Sadka and Tanzi call similar value as the market value of assets.¹⁰⁶⁰

The above suggested method of valuation, which is based on self assessment of income generating ability of one's own assets, is relatively simple to administer. When combined with open for auction feature it reduces chances of evasion.¹⁰⁶¹ However, the bidder may like to inspect assets and that could increase the complexity of the whole regime. Nevertheless, such a possibility can be avoided by adopting policy of 'what is and where is basis' for auction after the inclusion of some basic details of assets such as year of make or purchase.

This type of method when used for small business would also take care of appropriate valuation of intangibles particularly goodwill, which Thuronyi mentions as a particular problem in asset based PIT.¹⁰⁶² For example, sole small grocery store near 5 blocks of apartments (with total 1000 units) may not have huge assets base. The sole proprietor of that store may have premises on rent and most inventory on credit. Despite that low level of his ownership of the business assets he/she makes huge profits due to the monopoly and goodwill in that area over years. His/Her estimate of the value for his/her business assets is likely to be proportionate to income/cash flows generated by tangible and intangible assets of that business every year. Otherwise, he/she will run the risk of takeover the business by a successful bidder under the proposed PIT.

More simply, under the proposed valuation mechanism a taxpayer is required to make a declaration of value of assets because he/she is person who has the best information regarding income generating ability of his/her assets and he/she can not be dishonest as

¹⁰⁵⁹ One can criticize the recommendation of the DCF method on the basis that it is hardly tenable to expect SMEs to undertake DCF calculations. This thesis admits this criticism is justified and therefore does not recommend typical forms of DCF calculations. Due to lack of any perfect solution, this thesis recommends that the method should be adopted whereby the value of a small business along with its goodwill is determined in our every day life (that is the value at which a small business is sold and purchased as a going concern in real market). This is atypical form of DCF. Although actual DCF calculations are not made under this atypical form of DCF method, every seller and buyer of a small business determines the value of its business by incorporating its cash generating ability.

¹⁰⁶⁰ Sadka and Tanzi, above n 307, 9.

¹⁰⁶¹ As argued by Maurice Allais in Sadka and Tanzi, above n 312, 4.

¹⁰⁶² Thuronyi, above n 38, 20.

any other person (more specifically a competitor) might acquire the assets through successful bidding in open for auction.

It is suggested that all assets should be collectively valued under this method because valuation of each separately as envisaged by Eugendi may make the regime complex due to higher administrative task. Lastly, as recommended by Rajarman and Koshy, the timing of declaration of value should be at the closing date of each financial year. The average value of assets, which another possible alternative, could make the regime complex and therefore is not recommended.¹⁰⁶³

The above discussion suggests relying on taxpayers for declaring value of their assets on basis of their own estimates, which automatically involve Net Realizable Value and Discounting of Cash Flow methods. The misdeclarations can, however, be checked by the feature of ‘open for auction’ in the regime. This recommendation is made solely for simplicity preference in taxing small business.

2.3 Fixed or Assessable Tax

Consistent with concluding sections of chapters 4 and Chapter 7 an asset tax, once calculated, should be fixed for 3-5 years because of stable character of assets as a base. This would reduce the compliance costs for small business and alleviate tax administration from burden of assessing large number of small businesses in every year.

2.4 Tax Burden

Steenekamp has rightly said that tax rate in assets tax depends upon the policy objective of a country.¹⁰⁶⁴ For example, tax rate could be very low when assets tax is being levied as AMT to supplement the normal income tax. Regarding small business in large informal economies, as discussed in Chapter 4 and 7, the tax rates should be proportionate to average profits and marginal tax rate should be constant. This is consistent with concept of ability to earn or potential income taxation and has efficiency gain due to marginal tax rate of zero.

¹⁰⁶³ Rajarman and Koshy, above n 1027a, 1941; Thuronyi, above n 38,15 also endorses this view.

¹⁰⁶⁴ Steenekamp, above n 311, 179.

The assets tax liability should be designed to be roughly equal to a taxpayer's income tax liability for an average income. For example, if a taxpayer is assumed to earn at average a six percent return on assets and business income tax rate is 35, then a 2 percent tax on assets should be applied.¹⁰⁶⁵

For asset based businesses, tax rates should be correlated to an average rate of return on assets. Lastly, there is strong recommendation for keeping the rates even slightly lower than the corresponding average rate of return for three reasons. First, as discussed above to avoid double taxation when it is being charged on gross rather than net assets. Second to encourage small businesses to register. Third, being tax on potential income rather than actual income it may not harm much to those who have no income or have a loss.

For professionals, some detailed analysis is needed to fix the appropriate tax rate for each profession. Thus, extensive classification for the professionals sector is expected with different tax rates for each class. These need to be ascertained after the detailed consultation with the various stakeholders of society.

For businesses using unskilled labour, the classification and rates should also be determined partly on the basis of similar consultations regarding the years of experience and partly on the basis of the tangible assets employed. This category may prove hardest among all taxpayers in terms of setting tax burdens in the PIT regime. Lastly, it may be conceded that those who do not have business premises and just act like jobbers are hard to be taxed. Nevertheless, the low tax rates on salaries would reduce the supply of labour to the informal sector and encourage the transfer of some of this labour from informal to formal sector.

2.5 Basic Exemption

The basic exemption from tax liability is also crucial for helping very small entrepreneurs and from an efficiency perspective. Consistent with Section 3.1.1 of Chapter 7, the incorporation of this attribute in the PIT design is hard in a turnover based PIT as compared to an asset based PIT. In an asset based PIT, even one identical

¹⁰⁶⁵ For AMT in Mexico tax rate of 2 percent is applied on the same basis (see Stotsky, above n 397, 265). For other examples of assets tax rate in South American countries see Rajarman and Koshy, above n 1027a, 1948.

basic exemption is appropriate from a neutrality and equity perspective for all economic sectors, which is hard to achieve in other PIT designs.

In respect of Pakistan, it is suggested that taxable limits of assets should be set slightly above the average level of assets held by a small entrepreneurs. The statistics in this regard are already given in Section 2.1 of Chapter 8.

2.6 Unified Basis

After an appropriate basic exemption, such asset tax should be charged on the unified basis with constant marginal tax rates commensurate to average rate of return, as recommended in sections 3.3.2 and 4 of Chapter 4. This will prevent disintegration of family businesses.

3. Additional Suggestions for Administering PIT in Pakistani Jurisdiction

Some of these suggestions are linked to some Pakistani governmental institutions and therefore do not as such arise from discussions in the preceding chapters of the thesis and are incorporated here because these are relevant to the Pakistani jurisdiction and could be helpful in effective implementation of asset based PIT in Pakistan.

- (1) This regime, however, may be started in the beginning as a pilot project in one city and then depending upon the outcome, may be replicated in other cities and eventually the whole country. The beginning at a pilot project level may also help in calibrating asset based PIT regarding details of its exact form such as the inclusion of intangibles. Such an implementation plan will also serve as an experimental study and can be coupled with the future empirical study of countries such as Bolivia as recommended in this regard in Section 6 of Chapter 7 for refining the asset based PIT.
- (2) Although completely distinct, the proposed PIT regime should be inserted as a chapter in income tax legislation so that it is not perceived as a new tax or imposing a new burden on taxpayers. It is generally perceived that the fewer the number of taxes the more convenient it is for small business to carry out its business activities. Consequently, it may even be suggested that PIT on small business should replace all other taxes (including federal, provincial and local)

except social security and withholding tax on salaries in order to facilitate small business.

- (3) As discussed in Section 3 of Chapter 4, this PIT should exclude those categories of professionals who can or do maintain accounts for whatsoever reason. Accountants and lawyers are typical examples. Similarly, businesses which for any reason have to keep detailed information should also be excluded (for example. money exchanges, distributors or GST registered taxpayers).

It is suggested here that the National Database and Registration Authority (NADRA) should compulsorily record the qualification of citizens and its database should be linked to the database of the revenue agency. This is essential for excluding those accounting and finance graduates from the ambit of PIT, who are self employed. Similarly proprietors of small businesses, who have similar qualifications, should be excluded from the PIT regime.

- (4) A limiting of WHT to a minimum possible number of activities would reduce the economic gains of operating informally. The advantage of getting supplies without tax being withheld in the informal sector as compared to those who operate in the formal sector would be mitigated.
- (5) There should be effective control mechanisms to check evasion or undue advantage of PIT. As discussed in Section 2.2.1.4 of Chapter 10, the capping provisions will prevent taxpayers from showing disproportionately high imputed income from assets. These capping provisions are more required for professionals, because there is likelihood that professionals or self employed may conceal income from some activities as been already subjected to tax under the PIT or have huge income and should contribute more to treasury. Such capping provisions would limit the undue advantage of the PIT. As mentioned earlier the automatic accretions in wealth also tax income of current year in future year and reduce impact of tax evasion.
- (6) The contract payments reporting system in high risk sectors of informal activity may help in catching those who do not comply despite the PIT regime.
- (7) A tax evasion hotline should be established on similar lines as it is in developed countries so that any citizens can pass on the information of informal activity to the tax authorities at a low cost.

- (8) The PIT on transport vehicles should be collected annually at the time of their registration. Similarly, a tenancy deposit protection scheme should be introduced to document rental activity. Besides ensuring the rights of tenant and landlord, this shall help in collecting assets based PIT at the time of the registration of the deed.
- (9) Another measure which can play a central role in curbing evasion is the well maintained database of all individuals in the country who are income earners or potential income earners. Pakistan already has developed the database in respect of 70 million of its population who are above 18 years of age, which is managed by NADRA.¹⁰⁶⁶ There is need to use this valuable database for tax policy purposes.

It is suggested that NADRA, besides mentioning qualifications of taxpayers, should also record the name and address of employers or business premises of each citizen. The change of the employer or business should be reported immediately.

The unemployed individuals, adult students and jobbers may be given Computerized National Identity Cards (CNIC) with different colour and serial numbers. Moreover, the mention of such details in their passports may restrict their international travel by making their obtaining of a tourist visa difficult. Such identification as a non-taxpayer would represent a lower income group and may deprive such persons of many privileges reserved exclusively for high income earners. In other words, after such changes in the identification documents, a tax evader and a non taxpayer would not be able to spend untaxed income.

Lastly, every business owner, jobber and professional should obtain a trade license from the Federal Board of Revenue (FBR) and their CNIC should bear that number. The databases of FBR and NADRA should be interlinked for the purpose cross referencing. This is likely to increase the probability of detection and consequently control informal activities.

¹⁰⁶⁶ Information is available at www.nadra.gov.pk/index.php?option=com_content&view=article&id=1&Itemid=3 at 28 September 2009

- (10) In order to attract small business to transit from the informal to the formal sector, it is advised to offer some incentives and privileges to the formal sector such as low air and train fares, low entertainment tickets, priority in bookings and government services including health and priority in loan sanctions (preferably offering loans at lower rates than for taxpayers under PIT). Loans especially are needed for business expansion and could promote economic growth. Further, a discount on GST on daily use items may encourage a transfer to the normal income tax.

Moreover, these benefits need to be advertised. In developed countries, this is done at an overall return of 4.5:1 (that is, 4.5 times more revenue is collected than the cost of benefits offered).¹⁰⁶⁷ Even if the government in Pakistan saves net 50%, the PIT should be called a success because it would help in developing a tax paying culture. More simply, it may serve like 'cash back' in marketing.

- (11) This thesis recommends that minimum but effective administration is required to act as watchdog for the database. The information from professional organizations, banks and property registering authorities should be scrutinized in conjunction with the NADRA database to collect the tax on average profits. With these checks and controls in place, taxpayers are expected to get tired of hide and seek games and may prefer to pay the due tax on average level of profits.

The administration should also be assigned the responsibility to educate taxpayers about the regime and their rights and obligations. The audit of assets every 3-5 years would also be less cumbersome and does not provide many collusion opportunities¹⁰⁶⁸, because tangible assets owned by taxpayers need gratitude payments each year and to each changing tax officer, until the taxpayer disposes of the asset.

¹⁰⁶⁷ United Kingdom, '*HM Revenue & Customs: Tackling the Hidden Economy*' (Report, , National Audit Office UK, 3 April 2008), 5.

¹⁰⁶⁸ As one can argue that audit of assets even after 3-5 years still provides collusion opportunities between taxpayers and tax administrators hence it is worthy to admit that it is rarely possible to completely eliminate interface between taxpayers and tax administrators and the suggestion given in the thesis is a relatively better option in given circumstances.

- (12) It is also suggested that the government should spend the collected money in the town/city where it is generated. Seeing an improvement in town services will improve a taxpayer's commitment to pay taxes and the tax paying culture would flourish. However, such a suggestion needs political consensus at national and sub-national level for overall betterment of the country.

CHAPTER 12 CONCLUSION OF THE THESIS

Scope of this Chapter: In light of the analysis of the informal economies, various PIT designs for small business and the case study of Pakistani PIT in preceding chapters, this chapter summarizes the recommendations for redesigning the PIT for any large informal economy in general and for Pakistan in particular.

The examination of the causes of the informal economy and the inability of the normal income tax to achieve the objectives suggests that PIT is the best alternative to the normal income tax. However, not every PIT design and feature may be suitable for taxing small business in large informal economies. Consequently, not every PIT regime will be able to harness revenue potential of informal economies with minimum efficiency losses, which should be the central aim of tax policy.

This thesis examined the very root causes of the informal economy in order to analyse the suitability of each PIT design for addressing this malaise. PIT designs were also assessed individually against the weighted balance of principles of a good tax system. The analysis suggests that an asset based PIT is generally best option in this regard. An asset based PIT does well against all the causes of informality particularly high compliance costs. Similarly, an asset based PIT stands high in terms of the principles of a good tax system. Other designs might be good in one aspect but are completely unacceptable from another perspective.

This thesis holds that the tax burden in the PIT regime is also crucial for its successful performance in large informal economies. The analysis in Chapters 4 and 7 suggests that the tax burden should be proportionate to the average rate of returns to ensure neutrality. Such tax burden/rates have marginal tax rate of zero, which promotes economic growth. Moreover, such average tax burdens mitigate incentive of operating informally.

Further, tax rates in the normal income tax regime should generate a tax burden close to that of PIT regime, because the wide differences between the two regimes would cause the reverting of business from the formal to informal sector. The analysis in this thesis reveals that such a level of tax liability is also easy to incorporate in an asset based PIT, without adding any complexity to it. In all, this thesis suggests that under an asset based

PIT, it is relatively easy to observe neutrality and keep the tax system simple to discourage informality.

The basic exemption from tax liability is also crucial for helping very small entrepreneurs and from an efficiency perspective. This thesis suggests that the incorporation of this attribute in the PIT design is hard in a turnover based PIT as compared to an asset based PIT. In an asset based PIT, even one identical basic exemption is appropriate from a neutrality and equity perspective for all economic sectors, which is hard to achieve in other PIT designs.

In terms of equity, progressivity of tax rates is not suggested for its clash with efficiency and simplicity. Moreover, as discussed in sections 3.1.1 and 4.2 of Chapter 7, the insertion of the progressivity in PIT may increase complexity of PIT regime and worsen the clash between equity and simplicity. For instance, in case of a turnover based PIT, it is difficult to insert progressivity because of the inconsistent relationship of turnover with profits. Similarly, an indicator based PIT is not advised as indicators do not usually have a sufficient and stable correlation with profits. On the other hand, in an asset based PIT, accretion of assets in a year results in an increase in tax payable in subsequent year. In other words, some degree of progressivity may be present in an asset based PIT by default.

However, progressive tax rates for different brackets of assets in asset based PIT is not recommended due to likely efficiency loss as discussed in Section 5.2 of Chapter 6. It is argued there that redistribution of income and eradication of poverty in developing countries should be obtained by simple and efficient tax system which may enhance economic growth and generate optimum revenue for well targeted expenditure programs.

It is also conceded that PIT is not as equitable and neutral as the normal income tax. Therefore, as expounded in the thesis, this regime, like any other noble cause, may have a few ‘martyrs’. Nevertheless, they may be helped by tax rebates or through government expenditure programmes.

As discussed in Section 3.1.2 of Chapter 4 and Section 5.4 of Chapter 7, the recommended PIT design can be combined with the deterrence approach through a

reasonable penalty system, audits and by inserting the relevant features in PIT regime. It is expected that such deterrence would produce better results in PIT than the normal income tax, because very efficient administration is not required to detect non-reporting in PIT. The normal income tax gives a lot of discretion to tax administrators, particularly in the absence of adequate accounting information and is a source of corruption. In contrast, a PIT with an easy to measure base may reduce the chances of collusion between taxpayers and administrators which otherwise is rife in developing countries.

Further, the analysis in this thesis also sets out the basic benchmarks for assessing the adequacy of any PIT regime in respect of the informal sector. One is PIT's ability to cope with the causes of the informal economy. Second is its level of adherence to the prioritized principles of a good tax system for large informal economies. As a test case, the Pakistani PIT regime is evaluated against these benchmarks in this thesis. The results suggest that the Pakistani PIT does not perform well against these principles as well as the causes of informal economy. This may be because the Pakistani PIT uses a turnover based design, which is not the recommended design for the informal sector as determined by a comparative analysis of the designs in Chapter 4 and 7. Moreover, no effort whatsoever is made even in the turnover based design of the Pakistani PIT to inculcate neutrality and equity in the regime. It also does not provide a basic exemption for the relatively poor section of the population. The Pakistani PIT also has a tax burden completely unrelated to the profitability of a taxpayer. The categories introduced in the regime for securing neutrality in tax treatment are without any sound basis, as they do not represent the economic sectors.

The Pakistani PIT, particularly with reference to dual tax treatments (that is, a taxpayer may have some income falling within the ambit of the PIT and other income falling under the normal income tax regime), is also interwoven with the normal income tax, which has made its compliance costly: the main cause of large informal economies. Lastly, although the Pakistani PIT has some good features such as exclusiveness, irrebuttability, it misses out some crucial features essential for preventing misdeclarations such as audits, open for auction and limiting benefits to imputable income.

Consequently, despite being in practice for approximately two decades, the Pakistani PIT fails to harness optimum revenue and tackle informality. The tax base is also stagnant. This all is reflected in Pakistan's low tax to GDP ratio, as compared to other Asian developing economies and persistent large informal sector.

In view of the above this thesis recommends an asset based PIT for informal economies in general and for Pakistani informal economy in particular. However, despite all the theoretical merits of an asset based design discovered in the analysis, there is no successful example of a country which uses this PIT design to address the needs of small business in the informal sector. This makes the designing fully fledged asset based PIT is a challenging task.

After a detailed analysis, this thesis suggested that long term gross assets inclusive of intangible nature should be the tax base for the proposed asset based PIT regime. The value of assets should be estimated by the taxpayers themselves (which is a mix of Net Realizable Value and Discounting of Cash Flow Methods), subject to them being forfeited by a successful bidder under the 'open for auction' feature in case the declared value is equal to or less than 50% of the bid. Once determined the tax should be fixed for 2-3 years. In respect of professionals, tax liability should be determined on the basis of qualifications through a detailed sectoral analysis. Lastly, the proposed asset based PIT should envisage a tax burden proportionate to the normal income tax on an average income.

Lastly Consistent with Section 6 of Chapter 7, an empirical study of countries such as Bolivia, Columbia and Netherland, who adopted asset based PIT regimes in the recent past as mentioned in Section 4.4 of Chapter 3, is recommended in order to further improve the design of an asset based PIT with reference to the use of gross or net assets, the use of tangible or intangible assets, asset valuation techniques etc. The incorporation of such a study in this thesis is beyond the scope of thesis due to the time, resource and cost constraints. Therefore, the proposed study is a potential future research area.

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