



RESEARCH PAPER

A Recap of the Factors affecting Tax Evasion: Pakistan's Environment

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ABSTRACT

The purpose of this research is to present the results of qualitative analysis on the relationship between the determinants of tax evasion based on individual, social, economic, legal and departmental factors. This research synthesized 35 results from 25 individual articles from 2003 to 2022. For the convenience of policymakers, the maximum number of determinants of tax evasion are identified and further categorized into different groups. Only significant determinants of tax evasion are considered. The individual factors include the demographic as well as the ethical behaviour of taxpayers. The social factors include social behaviour, discrimination, corruption and political instability. These are some of the factors that lead to tax evasion. Level of unemployment and consumption expenditure are a few economic factors that trigger tax evasion as no amount is left, therefore taxpayer hide their actual income. Fear of punishment has a negative association with tax evasion, but this is dependent on the rule of law and legal enforcement. Poor governance and service quality are a few departmental factors that cause tax evasion. The results suggest, that there is a dire need for tax awareness campaigns, transparency in tax expenditure, mitigating corruption, simplification of the tax system, enhancement of economic quality, rule of law and its implementation, good governance and better service quality. These goals can be achieved by combining the efforts of the government and the tax department.

KEYWORDS Maladministration, Rule of Law, Tax evasion, Tax

Introduction

Taxation is vital for the smooth running of any state. It is the share of the state from personal income. Tax means any tax imposed and includes any penalty, fee or other charge or any sum or amount leviable or payable under the Income Tax Ordinance, 2001. Section 2(63) of Income Tax Ordinance 2001. The purpose of Tax is to achieve revenue as well as non-revenue objectives. For this, the taxes are classified into two broad categories, direct and indirect taxes. Direct taxes include Income Tax, Worker's Welfare Tax and Capital Value Tax and Indirect taxes include Sales Tax, Custom Duty and Federal Excise Tax (Kamal, 2019). While enactment, the legislatures kept in mind all the objectives set forth, that is revenue as well as non-revenue nature. Non-revenue objectives enclosed the social and economic impact of taxation.

The tax-to-GDP ratio is the measure of economic development as well as the performance of the tax department. As taxes are the main revenue source of the State income, therefore the income and expenditure gap is filled by the domestic and international debt. The average collection from 2011 to 2022 remains 5.42% and According to the World Bank, tax revenues above 15% of a country's gross domestic

product (GDP) are a key ingredient for economic growth and poverty reduction. This huge gap resulted in dependency on the International Monetary Fund (IMF) and the World Bank. The only way to get out of this debt cycle, the government has no option other than to enhance its tax collection. Tax evasion is one of the hurdles to achieving this goal.

Tax evasion is to minimize the tax liability, by hiding the actual income. It is to manage tax payments in illegal ways. In recent years tax evasion has become a global issue and gained importance because it leads to the budget deficit and ultimately the government is left with no choice other than debt financing. The dependency of the state on international financial institutions is the result of this menace that can result in default. Most of the countries failed to achieve the optimal Tax to GDP ratio because of this evil. As tax revenue is the main source of state income, its shortfall affects social welfare activities and deteriorates the standard of living of the people.

Literature Review

Tax Evasion

Tax evasion is defined by Wysłocka & Verezubova, 2016 as the evasion of taxes and duties owed to the state budget by hiding taxable income (Dwipayana & Putra, 2022). Tax evasion is an illegal arrangement to hide or ignore tax liability (Bourton, 2021). This means tax evasion is the hiding of actual income either by undervaluing the income or overvaluing the expense. Tax evasion is a criminal act that is a part of economic crime (Halil Arıç, 2020). Tax evasion is a global issue as it badly affects the national economies. Tax evasion is one of the main hurdles in the achievement of tax revenue targets. Individuals as well as corporations evade tax for personal gain but that deteriorates the economic condition of the country. The shortfall is managed by debt financing which widened the budget deficit.

Determinants of Tax Evasion

Individual Traits and Tax Evasion

Individual traits such as gender, age, educational status, source of income, and feelings of guilt and shame are considered significant variables in many studies. Females are more reluctant than males and are opposed to cheating if they get a chance (James et al., 2019). The male members of society especially the youngsters, are more attracted to and engaged in tax management, to save money. Gender, age, education and income sources are significant determinants of tax evasion (Richardson, 2006). Male married people are usually responsible for maintaining a family. The household-related expense burden leads to evading tax. According to Slemrod (2007) Married male persons evade more tax as compared to married females. Cost of compliance results in extra expense to pay tax as explained by Feltenstein and Cyan (2013) levy of value addition tax without any other tax concession results in a reduction of tax compliance in the services sector. Tax knowledge reduces tax evasion (Rashid, 2020). Taxpayers with accounting knowledge are less oriented towards tax evasion as compared to people with different educational backgrounds (Alwi et al., 2023). Taxpayer's perceptions and attitudes are significant relationship with tax evasion (Ojo & Shittu, 2023). The disposable income of individuals is the concern of the majority of taxpayers and as the tax reduces it therefore it can lead to tax evasion (Dey et al., 2023).

Social Factors and Tax Evasion

Social factors like social behaviour, corruption, misuse of funds by politicians and bureaucrats, discrimination in society and political instability are the main factors that lead to tax evasion. Social behaviours and trust in government are important factors that lead to economic growth (Rothstein & Uslaner, 2005). Utilization of funds by politicians and bureaucrats is negatively associated with tax morale and compliance and hence results in tax evasion (Torgler, 2003). The rule of law and control of **corruption** are positively associated and significant for tax revenue (Bani-Mustafa et al., 2022), hence they minimize tax evasion. Political stability shows a negative association with the tax-to-GDP ratio (Syadullah, 2015). According to Rashid (2020) corruption, **discrimination** and complex tax systems positively affect tax evasion. Political legitimacy affects social behaviour and people evade taxes when they have no access to the fundamental services being provided by the government (Ul Islam Khan et al., 2023).

Economic Factors and Tax Evasion

Economic quality, Level of unemployment, GDP and consumption expenditure are some of the economic factors discussed in the literature which have an association with tax evasion. Erul (2021) discussed economic quality as a determinant of tax evasion. According to him the higher level of economic quality results in a lower level of tax evasion. So there is an inverse relationship between economic quality and tax evasion. The level of unemployment is mentioned by Athanasios et al. (2021), the results identified that the level of unemployment, gross domestic product and consumption expenditure, along with other factors have a direct relationship with the size of tax evasion.

Legal Factors and Tax Evasion

Fear of punishment and penalties can reduce tax evasion. The rule of law and its enforcement can be an effective tool to get rid of the offence of tax evasion. According to Kamal (2019), the level of penalties has a significant association with tax evasion. He further suggested that public policy shall include the imposition of fines and penalties and also publish names of defaulters through media and tax department websites. The compliance of international financial reporting standards (IFRS), auditing rules and legal enforcement can minimize the menace of tax evasion. As discussed by Kurauone et al. (2021) countries that follow international financial reporting standards have less tax evasion and IFRS is only possible when there is strong legal enforcement. Similarly, legal enforcement is significant and negatively associated with tax evasion as International financial reporting.

Departmental Factors and Tax Evasions

Poor governance, high tax rates, multiple taxes, regressive tax system, Public trust, Fairness, Complex tax system, self-assessment system, information technology and service quality are the effective variables discussed in various studies. All these combined explain the departmental-level factors that significantly cause tax evasion. Syadullah (2015) explained that the quality of regulatory variables such as governance has a positive effect on tax to GDP ratio, hence effective in combating tax evasion. Feltenstein and Cyan (2013) raising tax rates too high drives firms into the underground economy, thereby reducing the tax base. Higher tax rates and poor administration lead to tax evasion (Awan & Hannan, 2014; Hussain et al., 2017). Athanasios et al. (2021) revealed that the level of tax rates significantly affects tax evasion. Improving service quality and increasing public trust are two effective instruments in fighting against tax evasion explored by (Nurkholis et al., 2020). Rashid (2020), highlighted fairness as an important variable that can control tax evasion. Other factors include a self-assessment system based on information technology. The shift from manual work to online

submission enhances the importance of information technology and is thus considered an important factor in causing tax evasion by different authors. By improving self assessment system and taxation technology, tax evasion can be reduced (Sinambela & Putra, 2021). Thuneibat et al. (2022) in his study envisaged that information technology, both in terms of system as well as user quality can assist in combating tax evasion. There must be a fair and transparent application of the law, Al-Rahamneh et al. (2023) in their studies explored that tax transparency is significant and negatively associated with tax evasion.

Material and Methods

Data Collection

The research is based on secondary data. The data is obtained from secondary sources such as published Articles, Books and Law Journals. The relevant research articles, published from the period 2003 to 2022 are analysed for shortlisting the significant and correlated determinants of tax evasion. Literature review analysis, based on the 25 historical scholarly articles that specifically explained the determinants of income tax evasion, has been done.

Results and Discussion

There are several factors which determine tax evasion. These include individual, social, departmental, and legal. The results of different studies show that gender, age, and tax awareness among people are significant factors along with the social behavior of people.

The role of the department cannot be ignored. Poor governance, high tax rates, and regressive tax structure lead to tax evasion. The different studies highlighted the significant relationship between the said factors.

Corruption, social behavior, and lack of trust in government depict a positive association with tax evasion. The study result shows that the root cause of the state's low revenue is corruption. This is the most significant determinant of tax evasion.

The rule of law is another variable that has a strong association with tax evasion. Strict compliance with rules and laws reduces tax evasion, so a negative relationship is confirmed by the literature.

Conclusion

Taxes are the backbone of any economy. These are the main sources of income for the state to run the government. Broadly taxes are divided into direct and indirect according to the burden of tax on taxpayers. Direct taxes include income tax as indirect taxes are based on sales tax. As the compliance is different therefore evasion is possible in both. Due to globalization, tax evasion has become a global issue. It is a menace that results in the budget deficit and reliance on international financial institutions, such as the World Bank and International Monetary Fund (IMF) has been inevitable.

It is the use of illegal ways, to reduce the tax burden. Tax evasion is an offence and punishable under relevant provisions of law. Several factors contribute to the tax evasion. These can be divided into different sectors such as individual traits, social and economic factors, and departmental and legal factors. This shows that tax evasion is a wide area which is caused by the number of players. The scope of tax evasion is very wide and there is a dire need to address it in all possible ways.

So to control this evil not only the individual but departmental effort is also necessary. The basic principles of law such as natural justice and the rule of law along with its strong enforcement are vital to controlling tax evasion. The departmental governance shall be improved along with compliance with the law. The delayed refunds reflect the maladministration from the departmental end and portray its bad image on taxpayers. The burden of taxes in multiple ways leads to tax evasion. There shall be a simple tax system with a progressive structure of taxation. Tax awareness and tax knowledge are also necessary to minimize the demographic effect of tax evasion. Some of the tax revenue shall be utilized to portray the good image of the department by advertising the amount spent on the well-being of the people.

Recommendations

- A tax awareness campaign shall be launched by the department in collaboration with the private sector, regularly.
- Taxation courses shall be introduced and be part of the undergraduate programme curriculum.
- Public spending, especially on social and economic development projects shall be transparent and the fundamental right to information shall be protected.
- Alternative documented receipts and payment systems shall be established and cash transactions shall be discouraged.
- Strict policy initiatives should be taken against the utilization of tax money by politicians and bureaucrats.
- Trust in government shall be restored by print, electronic and social media campaigns.
- Corruption is the root cause of all evil. Severe penalties shall be awarded across the board without any discrimination.
- A reasonable portion of tax revenue shall be dedicated to social development.
- Reliance on indirect taxation leads to unequal distribution of wealth, so a gradual shift toward direct taxation shall be considered.
- Tax relief shall be provided to increase Gross Domestic Product and reduce unemployment.
- Tax exemptions shall be provided on consumer goods so that the people are left with money to pay taxes.
- To ensure tax recovery, the offence of tax evasion shall be included in the list of Non-Bailable offences.
- Apart from the income tax laws, the offence of tax evasion shall be included in Pakistan Penal Code (PPC) through an enactment.
- Legal compliance and enforcement shall be ensured by the department.
- There shall be a rule of law and the deficiency of the tax system shall be addressed through legal procedure only.
- Punishment shall be awarded against maladministration and reward shall be provided for good governance.

- Rather than high tax rates, the tax base shall be large.
- There shall be simple and comprehensive taxation rather than multiple taxes.
- There shall be a progressive tax system with a minimum number of tax regimes.
- Departmental action shall be fair, without discrimination.
- The department's behaviour and service quality shall be appraiseable.
- There shall be an automated system and minimum involvement of the department in tax processing.
- Integration of all relevant sectors is necessary for accurate tax assessment.

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