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Understanding tax morale of SMEs: A qualitative study

Recep Yücedoğlu¹ and John Hasseldine²

Abstract

This article investigates the factors that influence Small and Medium-Sized enterprises' (SMEs) tax morale and focuses on the factors that stem from concerns of SME owner-managers about their company's wellbeing that may influence tax morale. Prior literature suggests that there are six relevant factors/constructs that influence SMEs' tax morale, namely: compliance costs, professionalism, tax advisors' effect, company structure, size of economic obligation and risk aversion. Drawing on a conceptual model of tax morale, we utilise an exploratory qualitative methodology and provide findings based on a thematic analysis of twenty semi-structured interviews with SMEs owners-managers in Turkey. Our study contributes to the literature by explaining the six constructs and by being one of the very few research studies of tax morale in SMEs in a non-western country.

Keywords: tax morale, SMEs, risk aversion, compliance costs, qualitative analysis, interview analysis

¹ Ph.D., Faculty of Economic and Administrative Sciences, Bülent Ecevit University, Zonguldak, Turkey.
Email: recep@yucedogru.com.

² Professor, Paul College of Business & Economics, University of New Hampshire, Durham NH 03824, U.S.A. Email: john.hasseldine@unh.edu.

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1. INTRODUCTION

Identifying and understanding the causal variables of voluntary tax compliance has been an interest of many tax scholars over the last several decades. The extant literature discusses many independent variables of taxpaying behaviour, including: those derived from expected utility models of tax evasion such as tax audits and the fear of being caught and penalised (Allingham & Sandmo, 1972; Andreoni et al., 1998; McKerchar & Evans, 2009), compliance costs (Hasseldine, 2001), and equity and fairness of the tax system (Spicer & Becker, 1980). Nevertheless, moral and cultural motivations of taxpaying behaviour which can play an effective role on taxpayers' compliance are relatively underexplored (McGee, 2006; Torgler, 2007). Specifically, in the tax morale literature, nearly all prior research has focused on the tax morale of individuals (Pope & McKerchar, 2011). There are only very few exceptions to our knowledge such as the studies of Alm and McClellan, (2012), Ahmed and Braithwaite (2005), Abdixhiku, (2013) and Mickiewicz et al., (2012) which investigated the tax morale in the firm level. Despite very few exceptions in the literature (Ahmed & Braithwaite, 2005), there are no studies which have especially focused on SMEs tax morale and its effect on their taxpaying behaviour.

Given this literature gap, our study addresses tax morale at the firm level. Specifically, we target SMEs, due to their importance and overall economic contribution in many OECD countries (OECD, 2014). For instance, in Australia, UK, and Turkey, 67 per cent, 60 per cent and 73 per cent of the labour force, respectively, is employed by SMEs, and SMEs account for more than 95 per cent of all businesses in these countries (OECD, 2014).

In contrast, the contribution of SMEs to total tax revenues is much smaller than their share of the work force. The Pay As You Earn (PAYE) contribution of SMEs in the UK was only 21 per cent in 2011 (Ward & Rhodes, 2014). Similarly, SMEs' contribution to Turkey's corporation taxes was just 29 per cent in 2014 (OECD, 2014).

Tax compliance research has neglected SME taxpaying behaviour as a research topic and an analysis of the factors that affect SME tax compliance and tax morale could prove useful for policy development and tax research. Additionally, this study aims to contribute to tax morale research by examining an unexplored culture: Turkey. According to Torgler (2003), culture has a significant effect on individuals' tax morale and as the majority of current tax morale research has been conducted on Western societies, which have mainly Christian backgrounds (Pope & Mohdali, 2010), there is a gap in the literature for Muslim societies. Hence, in this respect Turkey represents a different cultural context with a majority Muslim population.

This study analyses qualitative data gathered from interviews with twenty SME owner-managers in Turkey in order to investigate the factors that influence tax morale at the SME level. Although there are some factors highlighted in the literature as drivers of tax morale of individual taxpayers such as religiosity (Boone et al., 2013; Torgler, 2006), fairness (Gerbing, 1988; Hartner et al., 2011) and patriotism (Konrad & Qari, 2012; MacGregor & Wilkinson, 2012), we discuss tax morale from a firm perspective by focusing on the factors that affect the corporate tax morale of SMEs.

Corporate constructs/factors that influence SMEs' tax morale have not, hitherto, been addressed in prior literature, with the exception of a few studies such as Alm and

McCelellan (2012) and Yucedogru (2013). Particularly, the latter study identified corporate factors as normative beliefs of owner-managers of SMEs about their company and its wellbeing. Hence, the factors that stem from the concerns of a company's wellbeing can influence the SME tax morale. The factors were identified from the extant tax literature were listed as compliance costs, professionalism, tax advisors' effect, company structure, size of economic obligation and risk aversion. Hence, this study is an investigation of these six factors through qualitative analysis in a primarily Muslim population, which is rarely discussed in the tax literature.

This article is structured as follows. Section 2 outlines prior literature on tax morale from a SME perspective. Section 3 explains details methodological considerations and analysis of our interviews. Section 4 presents our results supplemented with narrative quotes and the last section contains our concluding remarks.

2. TAX MORALE LITERATURE

2.1 Background research

Tax morale research stems from the tax compliance literature. One of the first definitions of tax compliance was framed by Jackson and Milliron (1986, p.128) who defined a compliant taxpayer as a person who files an 'accurate, timely and fully paid return without Internal Revenue Service enforcement efforts'. This broadly represents the definition provided by the US Internal Revenue Service (IRS) in relation to the reporting obligations of taxpayers:

Compliance with reporting requirements means that the taxpayer files all required tax returns at the proper time and that returns accurately report tax liability in accordance with the Internal Revenue Code, regulations and court decisions applicable at the time. (Roth et al., 1989, p.43.)

Although tax compliance is commonly acknowledged as meeting with requirements, non-compliance is more nuanced and relates to failures in meeting the obligations of tax law regardless of whether these behaviours are intentional. Therefore, some scholars define tax compliance on the basis of tax non-compliance (Torgler, 2007). Nevertheless it can be argued that both definitions fail to incorporate taxpayers' motivation and social conditions towards taxpaying behaviour that may cause non-compliance or over-compliance, and non-compliance. Hence, the motivation of tax compliance has gained prominence in the literature.

2.2 Development of tax morale literature

Tax morale as a term, was coined in the 1960s by Schmolders (1960) and Strümpel (1966) and demonstrated in the work of the Cologne School of Tax Psychology. They emphasised that tax morale is a crucial factor to explain tax compliance (Alm & McClellan, 2012). While it was first stressed in the 1960s, it was not until criticisms of economic deterrence models of tax compliance surfaced (for example, Frey & Feld, 2002), that published studies of tax morale became more widespread (Torgler, 2007). Consensus in the literature defines tax morale as an *intrinsic motivation* to pay taxes (Frey, 1994; 1997; Torgler, 2007). Nevertheless, 'willingness' does not refer to *intention* behind the taxpaying behaviour. Therefore the literature links tax morale

with other constructs such as ‘social norms’ (Alm et al., 1999), perceptions of ‘power’ and ‘trust’ (Kirchler et al., 2008) and ‘fiscal exchange’ (Feld & Frey, 2002).

Tax morale and related constructs, such as social and moral aspects of taxpaying behaviour, are not widely discussed in the literature (Frey & Torgler, 2007; Kornhauser, 2006; Alm & McClellan, 2012). Further, as most prior work has taken place within Western economies, a gap in the literature to study tax morale in a non-western society, such as Turkey, became more apparent as some of the literature already suggests (McGee et al., 2011; Tekeli, 2013).

Ahmed and Braithwaite (2005) were one of the first to investigate tax morale in a small business context. They used survey data on Australian small firms to test tax morale with other constructs such as procedural fairness. They found that tax morale did not differ from any other group of taxpayers however they found evidence that small firms viewed interventionist tax policies as an obstacle. Alm and McClellan (2012) analysed firm tax morale using the Business Environment and Enterprise Performance Survey and the World Enterprise Survey for 8500 companies in 34 countries. They tested whether factors closely related to the corporate perspective were obstacles to firms’ tax morale. They found that the tax morale of firms corresponds with the findings of prior research conducted on individuals, when they tested for: tax complexity, government trust and tax inspection effects on tax morale. They noted that tax inspection had no significant effect while all other factors significantly correlated with tax morale which they measured as sympathy towards taxpaying.

Mickiewicz et al. (2012) use Latvian small business owners to examine tax morale as a dependent variable while testing for the effects of trust in formal institutions, tax system fairness, national identity, social norms and perceptive deterrence. They found that all constructs are positively correlated with tax morale except the likelihood of being caught from unreported income.

Although prior literature examines concepts related to tax morale at a corporate level, such as tax evasion (Alm et al., 2014; Crocker & Slemrod, 2005; Marrelli & Martina, 1988; Slemrod, 2003; Yusof et al., 2014), apart from the three examples cited above, literature that investigates tax morale at a corporate level is very rare, which is a motivation for the present study.

2.3 Tax morale factors

A comprehensive understanding of how tax morale is shaped and what factors are influential on shaping it is an important task for tax researchers. However, the literature is limited (Alm & McClellan, 2012; Torgler, 2012). Feld and Frey (2002) discuss this gap in the literature:

[M]ost studies treat ‘tax morale’ as a black box without discussing or even considering how it might arise or how it might be maintained. It is usually perceived as being part of the meta-preferences of taxpayers and used as the residuum in the analysis capturing unknown influences to tax evasion. The more interesting question then is which factors shape the emergence and maintenance of tax morale. (Feld & Frey, 2002, pp. 88–89.)

Kornhauser (2006) correctly points to the direction of tax morale through ‘carrot’ factors rather than ‘sticks’ for encouraging tax compliance. Accordingly, tax morale correlates with tax compliance in many studies (Ahmed & Braithwaite, 2005; Alm & McClellan, 2012; Babu & Chariye, 2015; Frey, 1997; Frey & Torgler, 2007; Halla, 2010; Kornhauser, 2006; Lewis, 1979; McKerchar et al., 2013; Pope & McKerchar, 2011; Riahi-Belkaoui, 2004; Strümpel, 1966; Torgler, 2002; Torgler et al., 2008b, 2009; Vogel, 1974; Yew et al., 2015).

There are, however, some studies that show the relationship between tax morale and the particular factors/constructs that affect it, such as characteristics of taxpayers that are found to influence tax morale (Daude et al., 2012; Torgler, 2005). Aside from individual characteristics, prior literature discusses different key factors that may influence tax morale. Torgler (2007) highlights three key factors, namely: moral rules and sentiment, fairness and the relationship between government and taxpayer. The literature also discusses the effect of religiosity and finds it to affect tax morale (Boone et al., 2013; Stack & Kposowa, 2006; Torgler, 2006). In addition to religiosity, cultural differences are also found to influence tax morale (Alm & Torgler, 2006; Ashby & Webley, 2008; Coleman & Freeman, 1997). Furthermore, the literature shows that a high level of trust towards government motivates taxpayers and increases their tax morale, hence lifting voluntary compliance (Aguirre & Rocha, 2010; Feld & Frey, 2002; Torgler, 2003). Similarly, satisfaction with the government and received service from the tax authority also positively encourages taxpayers to comply with tax regulations (Adams et al., 1996; Mulenga, 2004; Vigoda-Gadot, 2007).

With some notable exceptions, prior literature has generally not offered a wide range of conceptualisation on how tax morale is shaped. One of the first frameworks was introduced by Pope and Mohdali (2010) who divided factors that can affect tax morale into external and individual categories. According to their model, the external environment consists of government (tax administration, legislation) and society (culture, traditions) which influence individual attitudes of taxpayers. Individual attitudes are considered as moral and religious beliefs. However in the model, the difference between moral and religious beliefs is not clearly delineated and relevant elements of intrinsic payment of taxes such as fairness perceptions (Torgler, 2007), patriotism, and ideological perceptions of government are ignored.

Pope and McKerchar (2012) then developed a conceptual model of tax morale which addresses tax morale as a phenomena that can reveal taxpayer over-compliance which economic deterrence models fail to explicate. Their model of tax morale comprises six variables; individual attitudes, family and friends, religious beliefs, society, tax administration and government tax policies. The model does not explain whether the six variables influence tax morale positively or negatively (presumably this would be determined through empirical testing).

The tax morale of SMEs is relevant to the compliance decisions of corporate taxpayers’ concerns which may be different to those of individual taxpayers. Consequently, a different set of constructs/factors is more likely to be effective on their tax morale. This different set of constructs/factors can be defined as company related concerns which company owner-managers take into account while they are managing their company.

Yucedogru (2013) models SME tax morale based on Ajzen's (1991) theory of planned behaviour. The main rationale of the model is to explain SMEs' tax morale as a result of the decision-making process of owner-managers by highlighting the two different roles of SME decision makers as a manager and an individual.

As an individual, SME owner-managers make their managerial decisions under the influence of their personal beliefs, norms and social positioning (personal norms). However, in parallel to personal norms, SMEs bring them the responsibility and accountability of a firm. Therefore, alongside personal norms, owner-managers feel the pressure of additional factors essential to SMEs' survival. Consequently, the model (see Appendix 4) presents these factors as 'corporate norms' and identifies these as compliance costs, professionalism, tax advisors' effect and company structure. Additionally, perceived behavioural control factors that are explained as SMEs' ability to exhibit tax morale in their taxpaying decisions is also incorporated under these corporate factors because the size of economic tax obligations and risk preferences are related with SMEs rather than the personal stance of owner-managers.

The focus of this study is the six factors posited to influence SMEs' tax morale:

1. *Compliance costs* refer to the level of cost that the SME manager thinks his/her company has to bear to meet with the regulations of the tax law
2. *Professionalism* refers to an ability of the SME to employ capable staff and resources to comply with the tax system
3. *Tax advisors' effect* explains the influence of the company's tax advisor on SME tax morale and compliance decisions
4. *Company structure* is the management structure and culture in the SME that affects how it reaches its decisions (for example, through its departments or via a family structure model heavily influenced by a small number of individuals)
5. *Size of economic obligation* is defined as the perceived size of tax burden that the SME has to afford
6. *Risk aversion* refers to the manager's perceived possibility of being caught evading tax on unreported income

In light of the literature above, this study aims to investigate the six factors on the tax morale of SMEs to shed light on the corporate side of the 'black box'. Specifically, it uses an exploratory qualitative approach to address the literature gap on the corporate factors influencing tax morale.

3. METHODOLOGY

The sample was selected from the database of Turkey's Small and Medium Enterprises Development Agency (KOSGEB) and the lead researcher selected fifty SMEs aiming to achieve wide coverage of the target population of this research. Therefore, SMEs were selected from three different cities in Turkey: Bursa, Istanbul and Ankara. In addition, sample representativeness was considered by selecting participants with different educational backgrounds, business experience and sectors.

Saunders et al. (2003) state that a structured interview is more appropriate for a descriptive or explanatory based study while a semi-structured interview is more suitable for exploratory based studies. They further argue that the in-depth interview is more useful for studies which are exploratory in nature and one of the most common qualitative approaches. This is probably due to its flexibility (Bryman & Bell, 2011) since even though the researchers has a list of questions and themes to be covered these may vary from one interview to the other (Saunders et al., 2003). It also has the ability to disclose important aspects of human behaviour (Qu & Dumay, 2011) because a semi-structured interview could reveal not only the 'what' and 'how' but also the 'why' (Saunders et al., 2003).

Selected SMEs who participated in semi-structured interviews were contacted by telephone based on the particulars provided by the agency. The details provided for fifty SME owner-managers were their name, telephone number, sector and number of employees. Participants were contacted in advance to explain the nature and process of the interview and to obtain their agreement to take part in the qualitative study. Thirty-two SMEs were contacted by phone and 29 agreed to be interviewed. Two pilot interviews were initially conducted to improve the interview guide before recorded interviews were conducted. Between 10 July 2013 and 31 August 2013, 20 interviews were conducted in Turkey. After these interviews were conducted, the researchers decided that the collected data was satisfactory and the saturation rule was applied (Glaser & Strauss, 1967). The saturation rule is described as the process in which the researcher continues interviewing new participants until there are no new theoretical insights derived from the additional data (Baker & Edwards, 2012). Hence, the remaining 18 participants were not contacted once the saturation rule was satisfied.

An interview protocol consisting of a list of questions based on the six constructs in the model was used as a guideline for each interview to ensure it was systematic and focused (Hunter, 2006; Patton, 2002; Qu & Dumay, 2011). Since the lack of standardisation in a semi-structured interview-based study may result in lack of reliability in its findings, interview protocols are helpful in improving reliability (Saunders et al., 2003). Despite the themes being determined a priori in the interview protocol, the nature of a semi-structured interview is flexible (Bryman & Bell, 2011), and allows some freedom for other themes to emerge during the interview which is relevant to understanding the taxpaying behaviour of SMEs. The interview protocol used in this study is provided in Appendix 1.

This article presents an analysis of 20 interviews conducted with SME owner-managers. The qualitative, semi-structured interviews were conducted with owner-managers from 11 different sectors, all with more than 10 employees. Interview length ranged from 36 minutes to 1 hour 25 minutes and all interviews were recorded following consent from the participants. Transcriptions were thematically analysed using NVivo 10 software. To preserve the anonymity, participants were assigned a case number from 1 to 20 and these numbers are used to refer to the participants in subsequent discussion. Interviews were conducted in Turkish because English is not commonly used in commerce, especially by SMEs. Demographic details of the participants and the length of the interviews are shown in Appendix 2.

Data was analysed using the steps suggested by Braun and Clarke (2006, p.87). First, the researchers transcribed the recording into written text. The second phase was the

process of coding the data according to the described framework, and third, finding related themes and analysing the themes to check for consistency.

The process of transcribing the recording is important because it reflects how the researchers interprets the data (Bailey, 2008). On average, it took approximately six to eight hours for the first author to transcribe the recording of each interview. This is because, as suggested by Bailey (2008), transcription involves close observation of the data through repeated careful listening to the audiotape. Since all interviews were conducted in Turkish, all analyses were run in the same language and the results of the analyses have been translated into English.

Validity in qualitative research is defined according to how accurate the data represents the realities of the interview participants toward understanding social phenomena (Creswell & Miller, 2000; Patton, 2002). One common method to determine validity in a qualitative study is to use the 'member checking procedure' (Creswell, 2009; Creswell & Miller, 2000; King & Horrocks, 2010). Member checking involves requesting the interview participants to confirm the credibility of the information by asking the participants to check the data, whether the themes are correct and the overall information is accurate (Creswell & Miller, 2000). Although the literature does not suggest a rule of thumb for the number of participants for member checking procedures, Creswell (2009) argues that a minimum of two members is preferred. In order to determine participants for the member checking procedure, the researchers emailed the interview participants with the information about the research aims and how the analysis is carried out and asked them about their participation. Three participants agreed to participate. Following the suggestion by Creswell (2009), the researchers requested those participants to check the transcripts, identified themes and their feedback as a procedure to determine the validity of the findings. The feedback confirmed validity and the feedback were used to increase the validity of the interview analysis. Lastly, expert feedback was used to determine the coding validity of the interview analysis. Expert feedback is highlighted in the literature as a quality checking procedure (King & Horrocks, 2010). Therefore the researcher preferred a tax academic to critically review the thematic analysis. The received feedback from the expert helped the researchers to develop thematic consistency. The expert evaluation provided positive feedback overall. In addition, the same expert was asked to check for the accuracy of the translation of the quotes that are used and suggested changes were made.

4. FINDINGS

In this section, the interview analyses based on six corporate factors of SMEs are provided. A common method that is as suggested by King and Horrocks (2010) was obtained for writing up results of the analysis. For each factor/construct, a brief literature review is provided at the beginning of each sub-section and thematic analysis of each factor follows. Quotes have been selected to illustrate and aid understanding of the thematic analysis.

4.1 Compliance costs

Scholars (for example, Hasseldine, 2001) often stress compliance costs as an influential factor for tax compliance and tax morale. Coleman and Evans (2003)

suggest that a heavy compliance burden negatively affects tax compliance and tax morale of small firms. Moreover, Alm (1988) notes that compliance costs might lead to tax evasion.

According to the OECD (2005), the general awareness of compliance costs in Turkey is considerably lower than the majority of OECD countries. Moreover, neither Turkish tax literature nor the Turkish revenue administration has quantified the compliance costs for small businesses.

The interview analysis revealed, consistent with the OECD's (2005) findings, that participants' awareness of compliance costs seemed to be low. In particular, 12 participants suggested that they did not acknowledge/identify the compliance costs that they have, rather they saw them as operational costs of their company. Furthermore, some admitted they have not previously considered these costs might be directly related with tax compliance. In this case, the researchers explained compliance costs as the level of cost that an SME owner-manager thinks his/her company has to bear to satisfy the tax law requirements. The following quotes were enlightening about the unidentified perception of compliance costs by the participants.

I have never thought these costs (Tax advisor cost) in that way before. (Participant 10)

We were not thinking tax advisor cost; bookkeeping costs and so on in that way (compliance costs), but we realised compliance cost recently as the requirements of the state have increased. (Participant 19)

The participants who were not aware of their compliance costs suggested that the approximate volume of these costs was lower than 1 per cent of their turnover after the interviewer briefly explained compliance costs. Thus, the awareness level of compliance costs might be correlated with the level of compliance costs. In other words, unawareness of tax compliance costs might be the result of inconspicuously low compliance costs for SMEs. Nevertheless, these participants did not show that their perception of compliance costs was influential in their tax morale/tax compliance.

During the interview analysis, seven participants insisted that compliance costs should not be understood as an additional burden because of their managerial benefits. They suggested that the cost that they have to bear in order to meet tax regulations, such as book keeping or consulting a tax advisor, is beneficial for them, not only for tax related purposes, but also for managing their firms.

Tax also helps us with knowing our business. For instance, am I keeping my books just for paying taxes? No, I want to see my position. Even if state tells me that he is no longer taxing my company, I would still bear these costs in order to get the benefits. (Participant 15)

I do not see them as harmful costs (meaning compliance costs). My staff, who are obligated to keep my books and arrange my tax duties, are also benefitting me on many other occasions. They are increasing my company's efficiency and quality. Thus, I see the money that I pay to them as useful costs and it does not bother me. (Participant 9)

Analysis also showed different approaches to compliance costs that are not strongly stressed in the literature. Participants 1, 5 and 9 mentioned that financing taxes heavily affects their compliance cost burden rather than other compliance costs. Financing taxes mainly referred to paying VAT which is due on the 26th of the following month after the invoice date of their sales. However, the average due date of invoices varies between two and four months in many sectors. Consequently, small companies that lack working capital find it difficult to pay their taxes on time because their taxes are due before their debtors pay.

Additionally, procedural difficulties to solve tax problems with the Turkish Revenue Administration (TRAD) were also mentioned as generating unforeseen compliance costs by participants 4 and 9, such as reaching authorised tax officers on duty, solving problems without dealing with further paperwork etc.

They (TRAD) flagged my 100 Turkish Liras (TL) tax debt into enforcement. For some reason, I had forgotten it. I had not remembered, nobody reminded me. I went there to pay the amount. I realised they put an enforcement annotation on three of my cars that is worth 90 000 TL in total. They sent me to two different enforcement offices to release the commitment first. I paid 90 TL to each. Then I came back and paid my overdue tax. It cost me half a day, which means more than ten times the amount I owe. I understand they can run enforcement but why not on one car, but three? Although, one single reminder would suffice to make me pay happily, they chose to make me spend half of my day. (Participant 4)

Participants were asked to assess the approximate percentage of their compliance costs relative to turnover. A majority (13) of the participants commented that their compliance costs were lower than 1 per cent of their annual turnover but not lower than 0.1 per cent. While three others claimed that their compliance costs were more than 1 per cent of their annual turnover but less than 5 per cent. Only four suggested their compliance costs were lower than 0.1 per cent of their annual turnover. Hence, lack of awareness might also be an indicator of the low level of the compliance costs in Turkish SMEs.

Overall, participants highlighted different perspectives on compliance costs, despite their low level of awareness. Some participants perceived managerial benefits of compliance costs for their firm, which might suggest that compliance costs can have an indirect positive influence on tax compliance. In addition, a few participants also highlighted issues of procedural difficulties and financing VAT payments as an obstacle to their tax compliance and tax morale. In short, although the majority of the sample shows compliance costs are not significant related to tax morale, analysis revealed some differential impact on tax compliance intentions.

4.2 Professionalism

Professionalism is defined as embracing staff and resources with a claim of specialised knowledge or practice in companies (Fournier, 1999). Tax literature commonly agrees that a lack of professional staff and resources negatively affects tax compliance (Alm and McClellan, 2012; Torgler, 2007). McLisky (2011) found evidence that taxpayers who suffer from a shortage of available resources are more likely to face tax

penalties. In support, Marrelli and Martina (1988) claim that staff capability in companies is negatively correlated with tax evasion.

Participants were asked about their understanding of professionalism and whether they would define their company as a professional one. In the sample, projections of professionalism vary amongst the participants. The majority of participants underlined similar aspects of professionalism such as carefully recording every transaction (14 participants), convenient traceability of assets (11 participants), professional management (eight participants), obtaining and implementing professional accounting standards (seven participants), employing highly skilled workers (13 participants), teamwork and having an ERP system that helps the organizational capacity of the company (12 participants).

I do understand professional company as a company that has certain rules and records. It also has determined borders of staff responsibilities. (Participant 12)

In professional companies, you can track every stock and every sale is recorded. Emotions generally come second. I do not think my company is like that. We are trying to get there. However, as I said, we are a family business and it is harder to get there in family businesses. (Participant 13)

Considering the wide definition/perception that appears from the interviews, it is not surprising to see eighteen participants not defining their companies as a professional one. Hence, a majority of the participants were critical of their companies' professionalism.

I cannot define this company as a professional one. Hence, 80 to 90 per cent of all companies in Turkey are not professional for me. They are all person-(manager) dependent companies or family businesses. I think this is related with our traditional family structure. Father gives the company to his son and it goes on. For my company, I can say we are 60 per cent professional [Laughs]. After all I am the key decision-maker and my employees cannot sell anything without [asking] my advice. (Participant 20)

I cannot say we are a professional company, because we are a family business. (Participant 9)

Considering the wide definition/perception apparent from the interviews, it is not surprising to see that 18 participants did not consider their companies to be a professional one.

Nevertheless, although 11 participants admitted their companies' lack of professional attitude, they declared their major goal was improving their company to meet the professional standards. Moreover, they see this goal as a way of developing the company and making it sustainable for future generations. Seven participants narrowly defined being a professional company as avoiding operating in the shadow economy and having a reliable bookkeeping system. Some stressed their intentions of being a professional company starts with recent inspection, probability of increased inspection of their sectors and institutional changes in Turkish revenue administration. Although they commonly frame professionalism as only keeping true records and declaring them when it comes to tax compliance related concerns, this might be

evidence of the influence of the state on SMEs' behaviour to encourage them to comply and improve their managerial ability.

I understood the need for professionalism after my tax advisor told me about its importance and I saw the change in seriousness of the state. After then, I started to change my mind. In the past, nobody told me anything about it, maybe they do not know the importance either. I have reshaped my company since then. Everything is under my control now, invoices, stocks etc. To be honest, I felt relaxed. I might be paying more but I am at ease now. (Participant 19)

Another participant stressed that being a professional company is one way to be in charge of the company and some others agreed that becoming professional by avoiding the shadow economy might increase their tax bill but they are pleased to be fully in charge of their company. Considering this fact, being a professional company can also be understood as a tax compliance process therefore professionalism costs might be considered as SME compliance costs.

Your business is pulling you to be a professional one. You should be professional and pay your taxes otherwise you will be swindled by your employee, or someone will steal from you, so you cannot be 100 per cent in charge of your company. Result: you will be bankrupted. It is like enjoying the uncontrolled power. If I knew that professionalisation is a good thing, I would have been trying to be a professional ten years ago. I did not have that conscience and understanding before. Nobody advised it to us. They told me, "Are you crazy, you cannot afford to pay that tax bill if you declare everything". I had thought recording everything would bankrupt me. That is why I postponed it. But now, if I pay 5 per cent extra to the state, I have prevented to spend on hidden expenses up to 10 per cent of my turnover. Good, isn't it? (Participant 19)

Controversially, two participants explained professionalism beyond keeping records robustly and acknowledged it as employing a professional executive manager who targets increasing profit levels. Moreover, they claimed that professionalism might damage their amateur spirit that gives them entrepreneurial flexibility. That is why they found professionalism rather harmful to their companies. Although, they accept developing their systems will provide them with a better ability to control the company, they acknowledge that this will also increase their tax bill. Additionally, they emphasised the importance of being professional in their production processes.

Overall, the participants highlighted different perspectives of professionalism such as traceability, ability and capability of their staff and utilising the resources of the company. A majority agreed that the combined understanding of the professionalism construct is effective on their tax morale and tax compliance. Moreover, they admit that improvements to meet the needs of professionalism might increase their willingness to comply with the tax system. In short, the analysis showed that combined understanding of the professionalism construct affects tax morale and they view professionalism as a way to improve tax compliance.

4.3 Tax advisors' effect

Roth et al. (1989) defined tax advisors as professionals with whom taxpayers discuss tax matters and from whom they receive advice about actual risks and rewards of the tax compliance. Tax advisors provide three sorts of services: return preparation, tax advice and risk advice. Each of these advice types has potential effects on tax compliance and tax morale of taxpayers (Hasseldine et al., 2007). The importance of tax advisors on the tax compliance decisions of taxpayers is widely discussed in the tax literature (Hasseldine et al., 2007; Marshall et al., 1998; Roth et al., 1989; Sakurai & Braithwaite, 2003; Torgler, 2005). Hite and McGill (1992) suggest that small businesses need tax advisors because they want assurance that they are correctly fulfilling their tax obligations. Additionally, they found that small business owners commonly follow the recommendations of tax advisors.

In Turkey, the accounting books of every company must be kept by a tax advisor (Certified Public Accountant [CPA]) or by someone under their supervision. Some corporate taxpayers might seek advice from a Sworn-in CPA to get their books audited and clear their position under Turkish tax law. In some cases a Sworn-in CPA might be compulsory, for example, if a declaration of an export tax rebate is needed. Therefore, it can be assumed that understanding the effect of tax advisors is vital to understand SME tax morale.

Participants were first asked about their trust in their tax advisors. Thirteen participants expressed confidence and trust. Moreover, some participants (1, 6, 13 and 17) underlined the importance of their tax advisor in their corporate lives as their confidants. Interestingly, Participant 9 expressed the importance of the trust for the relationship, saying that he had decided to work with his tax advisor even before he started his company. During the interviews, it was noted that participants with many years of experience commonly expressed their trust in their CPAs compared to other participants. Twelve participants acknowledged working with the same tax advisors from the starting date of their company (or for more than ten years). Demographics of participants' relationship with their tax advisors are provided in Appendix 3.

Participants explained their reasons for confidence and trust mainly as a result of having developed a personal as well as professional relationship. Although in some cases (Participants 3 and 11) it was suggested that the tax advisors were employed because they had a pre-existing relationship with the owner-managers, the remainder of the participants' confidence was understood as having developed through the professional relationship. The SME/tax advisor relationship can extend to a very personal level that may even involve family bonds thereby indicating a significant level of trust in Turkish culture.

Of course, I trust him. We gave our sister to him. (SME owner-manager's sister married to the tax advisor.) (Participant 6)

In addition to personal relationships, seven participants added that they chose their tax advisers following a referral from trusted colleagues or friends. Thus, the primary criteria while employing the tax advisor appeared to be trust rather than any formal qualifications of the advisor. Participants 14 and 15 underscored the necessity of trust as a condition because of the risk that comes with the unique access of tax advisors to company records and awareness of its activities within the shadow economy.

Nobody changes an accountant (CPA) because of his poor service. Change can only be exceptional as a result of a major mistake or very big harm that is caused to the company. I did not seek a high quality accountant when I started my company. I asked my trusted friends' reference about their accountants. It [decision to employ an accountant] must be made through advice or reference otherwise it will not work. Because he will know everything about you; your system, off-record activities, everything! (Participant 15)

It is clear that the trust factor creates interdependency between SMEs and tax advisors, leading to long-standing relationships. Considering the fact that CPAs are not mutually responsible for the company's tax penalties, the possible risk of sharing knowledge about a company's activities with third parties might be one reason for these long-standing relationships. In addition, it appears that tax advisors who were ex-civil servants (experts or inspectors) in TRAD established trust and confidence with SME owner-managers more than other tax advisors. Two participants highlighted that CPAs with former civil servant experience are preferable because they know the 'inner circle' of tax offices better than others.

However, three participants admitted they could not develop a trustworthy relationship with their CPAs. Although they are not the majority in the sample, motives of mistrust were associated with negative experiences of former CPAs and their disorganised services. Therefore, these participants indicated that they are hesitant to follow the advice of their CPAs, although they encourage them to comply with the tax system. On the other hand, participants who trust their CPAs said they are inclined to follow their accountant's advice even if it involves paying more tax.

My accountant (CPA) is an old fox. He smells the air better than me especially when it comes to tax. (Participant 12)

He [his CPA] asked me to apply for the 2011 tax amnesty.³ Initially I thought there was no need to apply for it and pay more taxes. However, I decided that he had a better understanding of the tax office. Therefore, I applied and paid an additional eleven thousand liras just to avoid the risk of facing a tax penalty. (Participant 16)

Participants were asked about their tax advisors' intermediary position in tax compliance in order to understand their positions between small firms and the state. Interview analysis revealed that tax advisors adopted one of three positions of client advocacy, namely: predominantly advocating for the client, acting as an advocate for the government/state, or maintaining a neutral position. Among these groups, the CPAs taking a neutral intermediary stance appeared to be more common than those who favoured either side of the tax compliance relationship. Eleven participants agreed that their CPAs do not provide aggressive tax planning or advice on over-compliance. Five participants complained that their tax advisors usually favour the state and even consider over-compliance to avoid possible inspections or inconvenient interactions with the tax office. These participants suggested possible the reasons for

³ Briefly, the 2011 tax amnesty (Tax Code 6111) provided an opportunity to companies to increase and pay their declared tax in the last five years and, in return, the government provided an exemption for those periods of time from tax inspection.

over-compliance as fear of making mistakes, uncertainty of meeting required bookkeeping criteria, and/or uncertainty about tax procedures. Either way, participants reported that tax advisors should aim for minimal interactions with the tax office.

My accountant (CPA) is statist (meaning he favours the state first). He thinks paying a few more liras is better than to be called in. For a long time, he did not even record my own car (used for business) in the company accounts while others are writing (claiming) their son's car expenses in their books. (Participant 3)

Conversely, four participants admitted that their accountants advise them to utilise legal loopholes and get involved in suggested tax avoidance schemes. However, the quality of received tax service towards utilising legal loopholes was found to be unsatisfactory by these participants, therefore three of them explained that they sought further advice from their colleagues in the sector before taking any steps. In short, the influence of CPAs on participants was found to be effective, although advice on tax compliance or tax avoidance varied.

Participants were asked about their tax advisors' ability to arrange their tax bills to understand the influence of advisors in planning or avoidance schemes. A majority admitted they are capable of arranging a payable amount of tax with their CPAs. However, some did believe that their CPAs could only increase the tax bill rather than decrease it.

I think he might reduce my tax bill up to 10 per cent. Not more than that. Otherwise it can be illegal [immoral]. (Participant 12)

We are arranging our tax bill (Corporation Tax) according to our financial situation with my CPA. (Participant 15)

Participants were asked about how they would benefit from better tax advice. Responses differed between participants who had CPAs as opposed to Sworn-in CPAs. Participants with a Sworn-in CPA declared that they were confident with their tax advisors. This may be due to increased liability and responsibility of Sworn-in CPAs under Turkish tax legislation. Additionally, the Sworn-in CPAs provide advanced tax advice, therefore, these tax advisors are more likely to comply with legislation and satisfy their clients. Consequently these participants were happy with their tax advice. Some indicated that better tax advice would be more costly and unnecessary at this stage of their company.

On the other hand, participants who were working with CPAs were concerned that the cost of better tax advice might outweigh its benefits, and is therefore illogical to obtain. Surprisingly, their expectation of better tax advice did not refer to tax avoidance. However, they would expect organised and tidy records that would provide them with a better performance profile of their firms. Some participants said they could afford a better tax advisor, however trusting a new professional was an obstacle for them. A majority stressed that they would be more informed about incentives and legal opportunities with a better tax advisor.

Apart from tax advisors, some participants also sought advice from trusted colleagues who were generally older and more experienced. This advice tended to be more concerned with processes and relationships rather than tax legislation or technicalities.

Overall, the analysis suggests that the influence of a tax advisor on tax compliance decisions has several different dimensions such as trust and the capability of CPAs to influence a tax bill. Certainly, there is clear evidence of the effect of tax advisors on tax compliance of SMEs.

4.4 Company structure

Prior literature suggests that the structure of small firms has an effect on their tax compliance behaviour (Hanlon et al., 2005; Rice, 1992). Although empirical studies concerning tax morale are limited, (Alm & McClellan, 2012), a few studies document the effect of company structure on tax compliance (for example, Hanlon et al., 2005). Company or organisational structure is defined as levels of management and division responsibilities within a business (Child, 1972) with the organisational structure literature suggesting that better structure leads to improved organizational behaviour (Ouchi, 1977). Hence, understanding the company structure of SMEs might uncover the dynamics of decision making processes. Hence, participants were asked to briefly describe their companies and their backgrounds so as to understand the main structural factors of the company that might influence SME tax morale.

Fifteen participants described their company as a 'family business'. Considering the majority of the sample stressed the notion of family business, it is necessary to define this term and to assess whether participants' intention when defining their enterprise is similar with the description of family business in the literature. Poza (2007) defines a family business as a unique synthesis of ownership control (at least 15 per cent) by two or more members of a family or a partnership of families, strategic influence by family members on the management of the firm, a concern for family relationships, and a dream or possibility of continuity across generations. He states that family businesses need to hold onto the owner's dream of having a successful business in the family and ensuring its continuity across generations. Some participants' comments support Poza's (2007) definition, which suggests that they are running their business to satisfy and sustain their family success and to make their family pride. Consequently, any decision that is taken by the SMEs, including tax-related ones, should be seen in light of their family values.

For us, for second generations, it is very important to protect and improve our company's name as it was inherited from our father and uncles. Preserving and improving capital, credibility and unstained name of the company are vital for us. Our father taught us in this way. I would rather die than to hear people say "these sons could not sustain their father's job".
(Participant 10)

A majority of participants made it clear that a family-owned business limits their intentions. Another structural feature that participants mentioned were the motivational visions of the SMEs. Eight participants stressed their entrepreneurial spirit was their most valuable asset. In addition, some participants complained that entrepreneurial spirit is attenuating in today's business environment for many reasons and shouldering a high tax burden is more likely to accelerate this decline. Moreover,

facing the psychological pressure of meeting with tax regulations and high tax bills was stressed as a fear in starting a business or increasing investment within their companies by Participants 17 and 20.

Many participants underlined their passion to their businesses and described their role of being a company owner as source of pride. Attributed reasons emerging from the interviews included: job creation, being useful to society and contributing to the country, acquiring merit in God's side and developing the business.

Of course, I am not doing this job just for the money. I have money for all my family to the rest of my life. More important thing is to commit a good deed. Conduce someone to earn his bread money and being useful to our family, neighbourhood, and all Muslims. (Participant 17)

Neither earning much money, nor having yachts or houses motivates me. I am with my forty employees personally pedalling this business. I believe we are servicing to the people of this city very well. (Participant 19)

The motives mentioned above spanned all backgrounds and religious affiliations. This may be linked to the values of some participants, who had referred to themselves as 'Anatolians'. Anatolia refers to a peninsula that is now in Turkey and surrounded by the Black Sea and Mediterranean and which was a homeland for Turkish society for centuries. Being Anatolian and having emigrated from Anatolian rural areas is likely to associate with different cultural values than those possessed by urban residents of large cities such as Istanbul. It is important for many entrepreneurs to retain the value of being Anatolian because this means protecting their own honesty and humility within their businesses.

Structural population change in Turkey has been impressive with a shift from 20 per cent urban and 80 per cent rural to 80 per cent urban and 20 per cent rural since 1980 (Kaya & Sahin, 2007). The effect of this emigration can be felt in many parts of Turkish society and it marks a cultural difference for many entrepreneurs to maintain the values related to being Anatolian. However, being Anatolian can also refer to being inexperienced in the business environment and unaware of necessary procedures due to a lack of education.

I am a craftsman who emigrated from Anatolia. I do not know what are my advantages and disadvantages [in the tax area]. (Participant 18)

They [his father and uncles] emigrated from Konya to this city in 1958. So to say, they come to this position by digging with their nails from apprenticeship. (Participant 13)

Overall, the interview analysis for company structure highlights the perceived importance of family business, entrepreneurial motivations and satisfaction, and social values that are described as Anatolian, as being influential on participants' attitudes and behaviours. The findings for this construct suggest that additional influences on tax morale and corporate tax compliance include company structure and organisational culture.

4.5 Size of economic obligation

Taxes are economic obligations and consequently the tax burden that taxpayers face has been the subject of many studies (Andreoni et al., 1998; Roth et al., 1989). The literature is unanimous that the perceived size of tax burden significantly affects tax compliance and tax morale (Andreoni et al., 1998; Bernasconi et al., 2014; Kirchler, 2007; Strümpel, 1966; Tanzi & Shome, 1993). Torgler (2007) documented a negative correlation between the size of economic obligation and voluntary tax compliance.

Fifteen participants reported that tax burdens were high for their companies. Six participants even admitted that the scale of their tax burden forced them to investigate tax avoidance/evasion possibilities in the last year.

Our bigger shareholder is the state. He takes his share regardless of what we earn. He does not care whether you actually earn any money or you actually sell anything. The only thing he cares [about] is his slice (share) in my cake. (Participant 17)

I paid more [taxes] than I earned last year. You might think [do] how I compensate [for] the difference. I accepted the fact that I have to work for my company within the working hours, I have to work at evenings, and Saturdays for [the] state only. That is how I managed it. (Participant 19)

Thirteen participants complained that they constantly struggle to comply with the monthly payment of VAT. The collection of VAT in Turkey is organised monthly from the previous month's sales. However, the majority of sectors operate on an average of two to six months' maturity terms for their sales. Hence, some participants described postponing sales and in some cases just issuing the invoice of the transaction in the following month to avoid immediate VAT cost. Additionally, the normal rate of VAT (18 per cent) is criticised for being very high.

VAT payments are a nightmare for me. I am sometimes postponing my sales to the next month if I think I might struggle for the next payment. (Participant 7)

I feel the burden of VAT very much. Eighteen per cent is one fifth of my sales. I believe it is cruel. (Participant 11)

Six participants stressed they have to pay disproportionate amounts of tax as a company, increasing their tax burden. Four participants mentioned that the current tax burden is harming their business and pushing them to search for financing opportunities to pay their tax bill. Therefore, even if they want to pay their taxes they struggle to manage their finances under pressure from the current tax burden. Some participants indicate that the personal taxes they pay are high and make them feel double-taxed. Participants 4, 13 and 15 stressed that the income tax they pay annually for receipt of bonuses or premiums and corporation tax are levied on the same source of income.

Overall, the participants highlight different perspectives of the size of the economic obligation. They suggest that the tax burden, especially VAT, is high and a high tax burden negatively affects their willingness to pay taxes. Additionally, the number of taxes and their unjust due dates before the maturity of their payments discourages

them from complying with their tax obligations. Consequently, a majority of participants suggest that the perceived size of their economic obligation influences their tax morale.

4.6 Risk aversion

SME risk aversion is considered a factor that shapes corporate behaviour towards voluntary tax compliance and tax morale. In the early literature, risk aversion was viewed as an influential factor of tax compliance—defined as the probability of being caught under-reporting income (Allingham & Sandmo, 1972). Related concepts include audit probability (Cronshaw & Alm, 1995) and the probability of detection (Andreoni, 1996). In this research, participants were asked about their risk aversion to understand their prediction of the possibility of a tax inspection of their companies. Moreover, their understanding of the inspection process was also investigated so as to understand possible motivations behind risk aversion behaviour.

The frequency of the participants' previous inspections was assessed primarily to understand their experiences and expectations about tax inspection and their perception of risk of being caught by TRAD. Fourteen participants said they have not been inspected in the last three years. Eight declared they have never experienced a tax inspection. Four participants were inspected in the last three years and the remaining participants were inspected but not during the last three years. Considering the audit rate is 2.42 per cent amongst all active taxpayers in 2013 according to TRAD's annual report (Gelir İdaresi Başkanlığı, 2014), the sample mean was above average.

Participants were asked about their perceptions on possibly facing a tax audit in the next three years. Over half admitted that it might happen any time. Moreover, they assessed next year's probability as higher than previous years because of improvements in TRAD's policy on tax inspection. This indicates that their awareness of audit possibility is high.

Inspection mechanisms are improved spectacularly. They used to come and check our accounts in person. Now they are using any devices and opportunities that they can find. (Participant 18)

Despite high expectations of inspection, Participants 1, 3, 12 and 16 were confident that their companies would not be inspected if they increase their declared amount of tax gradually. They feel that if they declare more taxes compared to previous years, a small amount of excess paid can prevent them from the attention of TRAD when selecting candidates for inspection.

I do not think we will be inspected. We are paying a reasonable amount of extra money every year. (Participant 16)

When I look at [the] tax inspection issue, I understood it as apple farming. If the government and I were happy with the amount of the apples that I give to them, this would bring 'détente'. We have always been careful to satisfy our government and we believe tax should be paid. In order to keep the peace, we have our measures and we are careful about not falling below that limit even though we went in to the red. Hence, we can set our own standards. (Participant 1)

Five participants mentioned that they agreed to increase their declared tax to reduce their inspection probability because their tax advisors advised them to do so even when they made a loss during the declaration period.

Even if our profit decreased, we tend to keep our tax at least the same level as last year and may be a little higher if possible. There is a belief among bosses (SME owner-managers) that if you start with one (referred to paid tax amount) and increase it to three for the second year, for the third year you should keep it at least three again and do not go down to two. That might attract attention. (Participant 4)

My accountant advised me to stand below. I tend to increase tax a little just to stay in the grey zone. (Participant 13)

Participants 2, 5 and 7 suggested that the motivation behind the unnecessary tax bill increase is not only avoiding cost of inspection, but also preventing distractions from the inspection process such as demoralisation, 'red tape' and, in some rare cases, even corruption.

Interestingly, on the other hand, two participants admitted that they did not declare their unexpected profit in past years to avoid unwanted attention from the TRAD. Considering these facts, it is reasonable to suggest that participants are trying to avoid being an outlier within their sectors or neighbourhood and like to show a slightly increasing trend of their yearly declarations to avoid being 'spotted by TRAD' regardless of changes in their income. Consequently, risk aversion might lead not only to over-compliance but also, in some cases, encourage tax avoidance and even tax evasion.

At the time that I started my business, I earned very much from one project. However, it was a one-off thing. I asked my accountant whether to declare it or not. He said, "Leave it, next year if you cannot declare same amount, they will come over you. Be logical, stay in the middle lane". (Participant 14)

The psychology of tax inspections appears to be another major concern of the participants. The majority of participants (seventeen participants) were convinced that all inspections certainly conclude with a tax penalty. The apprehension of participants influenced their views on tax inspectors. Two dominant perceptions about tax inspectors were detected during analysis. The first view suggests that tax inspectors can impose tax penalties even if they cannot find any faults in the company's books. In other words, they believe that tax law is flexible if deemed necessary by inspectors. The TRAD's annual report states that 98 per cent of taxpayers who were targeted on suspicion of tax evasion also received a penalty (Gelir İdaresi Başkanlığı, 2014), which shows that this viewpoint has valid grounds.

Once a tax inspector visited you, he or she will definitely impose a tax penalty. Even if you do not have anything wrong in your books, he can issue a penalty notification if he wanted. (Participant 13)

The second view suggests that it is not possible to produce a perfect record in the eyes of inspectors because of complex legislation; therefore, a tax inspector is more likely to act according to his or her ethical stance when it comes to issuing a tax penalty.

Moreover, four participants suggest their education and experience do not help them to understand tax liabilities comprehensively, therefore they cannot check the work of their tax advisors and accountants for mistakes which may result in a fine. Consequently, they admitted that they found themselves passive and powerless.

The first view is more dominant among participants who have experienced a tax inspection. They found tax inspections to be an annoying process particularly because of inspectors' attitudes. Some participants believe tax inspectors are prejudiced and see taxpayers as tax evaders in advance.

The mentality of tax inspectors is different. They see you as thieves at the moment they knock on your door. (Participant 18)

Tax man, tax inspector etc., they are all searching for excuse to impose tax penalty ... This deters me from complying, even paying taxes. (Participant 12)

Five participants found the tax inspectors' behaviours more irritating than tax inspection itself. Interestingly, Participant 20 admitted that he was so irritated by an inspector during a tax inspection in 1995 that he thought about shutting down his business permanently. He took action however, and other inspectors realised the situation and convinced him to continue in business. This is a remarkable effect of risk aversion and inspection on tax compliance and tax morale that requires further research to look into the effects of harsh tax inspection policies.

Participants feel that tax inspectors do not understand the nature of their businesses and sectors. Participants 12 and 20 suggest that in recent years, tax inspection was used as a threat to companies thereby exerting political pressure on various political classes. Since then, the reputation of a fair tax inspection and inspector has been damaged. In addition, participants stressed that tax penalties are intimidating and some suggest they faced tax penalties that they could hardly shoulder.

Four participants said decisions about the amount of tax penalty were predominantly influenced by the tax inspector, although tax inspection process and penalties are enacted by Turkish tax law (Nas, 2012). In other words, they suggested that set rules of tax inspection could be misused.

I heard from one of my friend's phone while he was on the phone with an inspector. He said, "I can write whatever amount on this (tax penalty) paper that I wish without coming to your company. I have the authority". We used to fear the police, but now tax inspectors have replaced them. (Participant 2)

Despite negative perceptions of the tax inspection process, the majority of participants agreed that tax inspection processes are improving and the prejudice of the tax authority is easing. However, they admitted that progress is slow. Four participants suggest that tax inspection could even be an opportunity to find mistakes in their records and make them see a clearer picture of their companies. Hence, they welcomed constructive and corrective inspection that could make them more efficient if organised with positive attitude that is similar to other inspections, such as quality certificate audits.

Overall, the analysis provided different perspectives of risk aversion of SMEs on audit probability and inspection processes. SMEs perceive inspection probability as a manageable risk and the possibility of being caught seems to be low for them. Although, risk aversion is not necessarily increasing their tax morale, it is influential on their taxpaying behaviour. Considering the findings of the analysis, the researchers argue that this construct influences SMEs' tax morale.

5. CONCLUDING REMARKS

Understanding taxpaying behaviour and its motivational factors is a complex problem. Although tax research has provided many answers for the motivations of tax morale of individuals, it is evident that companies' tax morale is yet to be thoroughly researched (Alm & McClellan, 2012). Little research has focused on SMEs, which constitute a majority of firms in most economies. Therefore, SME's tax morale and the factors that influence it are considered an appropriate focus of this study. Additionally, this study is one of the few to adopt a qualitative method to explore corporate influences on tax morale in SMEs in a non-western country.

Qualitative research is particularly important because it provides rich and elaborative data that is appropriate when exploring new areas. Moreover, this study provides evidence on six key factors affecting tax morale and thus provides a 'snapshot' of attitudes to tax compliance amongst Turkish SMEs. Turkey, as a predominantly Muslim country, has not been studied anywhere near as extensively as western countries such as Australia, Canada, the UK or the US. Based on a conceptual model presented by Yucedogru (2013), this study provides evidence on the corporate constructs that potentially influence SMEs' tax morale, namely: compliance costs, professionalism, tax advisors' effect, company structure, size of economic obligation and risk aversion.

The first factor explored in the study was compliance costs. Despite the common agreement in the literature that the compliance costs were an obstacle to taxpayer compliance, our analysis suggested a different perspective, in that the awareness of these costs is also an influential factor. Participants seemed to accept these costs in a different category and did not relate them to the tax burden because of their side benefits. It might also be a result of the relative amount of SME compliance costs being estimated at less than 1 per cent of SMEs' turnover by a majority of participants; therefore they are perceived as relatively harmless.

Professionalism was referred to amongst the participants in terms of traceability, organisational capacity, ability and capability of their staff and utilising the resources of the company. Most participants acknowledged their firms as unprofessional and a majority mentioned their efforts to improve their company. They agreed that a professional company should be traceable and transparent; therefore, the company should be fully compliant with the requirements of law. Interestingly, there was common agreement among the participants that their efforts in becoming a professional company were also likely to increase their company's tax compliance. Although this increases their tax bills at the same time, they perceived this as a bearable cost because of the managerial benefits of a professional company, such as traceability that allows them better managerial control over their SMEs. Therefore, it seems that professionalism influences tax morale, and policymakers should benefit

from the new perspective of professionalism if the benefits of it are introduced to more SMEs.

Analysis of the effect of tax advisors mapped a different dimension for SMEs. There are two roles played by tax advisors: first, being a confidant; and second, being an intermediary. A confidant role suggests that trust between two sides is vital for the relationship. In some cases the trust bond is more likely to create a better relationship, however it also brings interdependency for the SMEs as they think that their tax advisors are aware of all of their off-the-record activities. Hence tax advisors are intricately involved in SMEs' tax morale and tax compliance decisions. Secondly, participants accept that their tax advisors have an ability to manipulate their tax bill and they can encourage them to comply in order to avoid inspection and tax penalties. Both tax advisor roles show that the advisor is a critical determinant of SMEs' tax morale, a finding which requires more research in the field.

The company structure construct showed that cultural roots of SMEs are influential. Participants highlighted that avoiding shameful acts to protect their personal values such as their family name and identity is extremely important for them. Especially for the family businesses, preserving their inherited values is a source of pride for some participants. This finding sheds light on a novel issue in tax morale research because no prior studies have documented a link between corporate culture and tax morale.

The size of economic tax obligation was found to decrease tax morale. Some of the participants complained that the tax burden that they have to shoulder is very high. Excessive regulations can demoralize SMEs and strain the trust bond between the state and SMEs.

Lastly, the findings on risk aversion reveal a very interesting perspective for SMEs. Strangely enough, the SMEs believe that their future audit possibility is a 'manageable risk' although they believe the possibility of being audited is increasing. A majority believe that reporting an increasing trend of declared income may prevent unwanted attention from the tax authority. Such a view may be simultaneously positive and negative for the SMEs. Nevertheless, to our knowledge, this is an original finding in the tax morale literature.

Although this study provides rich and detailed insights from uncharted factors of SMEs' tax morale, it is subject to the usual limitations of qualitative research. First, the interview method requires close interaction with participants and a common criticism about this method relates to a researcher's objectivity (Punch, 2013). To reduce this concern, a detailed analytical procedure for qualitative data analysis was adopted. Secondly, the participants were limited by those who were willing to participate in the study, therefore those who were unwilling to discuss tax matters represent another limitation of the study. This limitation however is common in tax research (Kirchler, 2007; McKerchar, 2010; Trivedi et al., 2005). As the majority of the participants provided both positive and negative perceptions about taxes during the interviews, it is believed that this limitation had only a limited effect on the findings. Lastly and more importantly, these qualitative findings do not allow for generalisations and statistical inferences. Nevertheless, our study provides a new perspective for further research on the determinants of SMEs' tax morale.

Overall, the findings of this study provide a basis for future research. This study investigates the corporate factors of tax morale using a qualitative approach, and is valuable for documenting evidence of the six factors in a relatively unexplored area of tax research. Further research might explore any or all of these factors in more detail. In addition, we hope this study will be followed by a more extensive survey-based empirical study. The results of a large-scale survey of Turkish (or other countries') SME owner-managers on this topic would provide a 'baseline' which could then act as a benchmark for future studies, and even potentially be used in international comparisons, which might provide useful evidence for governments' tax and business policies.

6. BIBLIOGRAPHY

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7. APPENDICES

Appendix 1: Interview Protocol

Thank you for agreeing to be interviewed. I am carrying out a number of interviews to understand tax morale effect on taxpaying (compliance behaviour). I have a number of questions to ask you that will generally take 45 to 60 minutes. Please feel free to just talk. If you are comfortable, I would like to record the interview, so that I can concentrate on listening to you and asking questions rather than taking notes. Your talk records (Voice or Type) will be kept anonymous and will be treated under protection of *Data Protection Act 1998* and *Turkish Data Protection Act 2007*. This is also a requirement of the University of Nottingham Code of Research Conduct and Research Ethics. Some quotes may be used, but these will not be attributable to you. My contact details will be provided after interview. Please indicate if you need any clarification for the process.

Are you happy for me to do the interview?

Demographics:

1. Could you please tell us about yourself?
2. What kind of business are you in and how long have you been in the business?

Corporate Behaviour:

1. Could you please tell me about your business in general?
2. Could you please tell me what is like to be a small business operator in Turkey?
3. Do you think that SMEs should be favoured by state? Why?
4. Can you define your company as a professional one? Why?
5. Do you think that are you going to be inspected in next three years?
6. How do you think that inspection probability is effecting your tax compliance decision?
7. Have you ever inspected or received tax penalty?
8. Do you think that you will receive a fine if you have an inspection? Or inspector can find anything from your book which can be counted as evasion?
9. Do you trust your tax advisor?
10. How long have you been working with your current tax advisor?
11. Have you ever experienced problems on tax issues with your accountant as result of miscommunication?
12. Do you think better quality tax advice will reduce your tax bill?
13. Do you believe that your accountant may increase or decrease you tax bill, if desired?

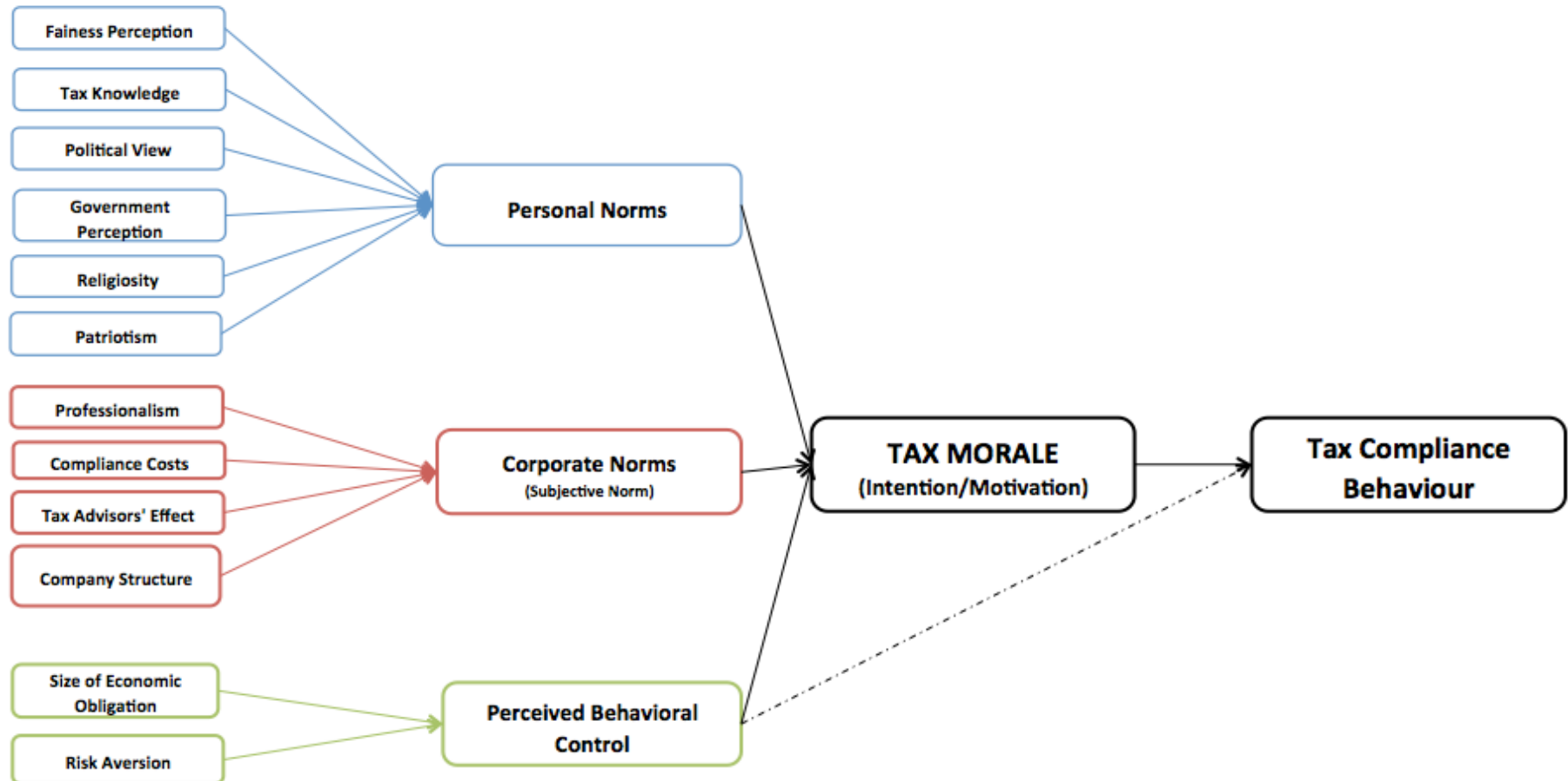
14. Do you think that you have an ability to arrange you tax bill?
15. What proportion of your turnover does your company spend for meeting tax obligations?
16. Have you ever heard of shadow economic transactions in your sector?
17. Have you ever sold or bought anything without recording it in your tax return?
18. Have you ever unintentionally made a mistake on your tax obligations? If so, what was the reason?
19. Do you think sizes of tax penalties are dissuasive?
20. How have tax amnesties affected your taxpaying behaviour so far?
21. Do you think the tax that you paid last year was fair for your company?

Appendix 2: Interview Participants

Interviewee number	Sector	Experience in sector (years)	Education status	Interview length
1	Automotive	11	University	00:56:17
2	Machinery	23	High School	01:15:29
3	Metal	16	University	00:36:11
4	Construction	11	University	01:09:20
5	Metal	13	High School	01:10:55
6	Publishing	17	University	00:47:20
7	Retailer	3	University	00:48:22
8	Construction	9	Masters	01:00:50
9	Metal	4	University	00:48:30
10	Furniture	20	High School	01:12:16
11	Textile	6	High School	01:17:39
12	Metal	16	University	01:31:33
13	Catering	34	Masters	01:11:58
14	Law	8	Master	01:13:01
15	Services	2	University	01:01:00
16	Textile	23	Masters	01:02:11
17	Textile	30	University	01:14:24
18	Services	6	High School	00:59:18
19	Publishing	17	High School	01:10:00
20	Construction	21	High School	01:25:38
				21:52:12

Appendix 3: Current Tax Advisors of the Participants

Interviewee Number	Sector	Experience in sector (years)	Trust in accountant	Years with current CPA	Sworn-in CPA
1	Automotive	11	Yes	From start	No
2	Machinery	23	Yes	10	No
3	Metal	16	Yes	From start	No
4	Construction	11	No	9	No
5	Metal	13	Neutral	6	No
6	Publishing	17	Yes	From start	No
7	Retailer	3	Neutral	2	No
8	Construction	9	Neutral	8	No
9	Metal	4	Yes	From start	No
10	Furniture	20	Yes	19	Yes
11	Textile	6	Yes	From start	Yes
12	Metal	16	Yes	From start	No
13	Catering	34	Yes	10	Yes
14	Law	8	No	6	No
15	Services	2	Yes	From start	No
16	Textile	23	Yes	17	Yes
17	Textile	30	Yes	12	Yes
18	Services	6	Neutral	2	No
19	Publishing	17	Neutral	5	No
20	Construction	21	Yes	8	Yes

Appendix 4: Model of Tax Morale of the SME and its Determinants

Source: Yucedogru, 2013

Business process management as a tax risk identification and management method

Evadne Bronkhorst¹ and Elze Leask²

Abstract

In the current economic climate, corporate governance is a priority for enterprises globally. Corporate governance aims to create value for affected stakeholders. One way in which this can be achieved is through risk identification and management. Where risks are properly identified and managed, the threats posed to the achievement of enterprises' strategic goals are mitigated. Tax is one of the aspects that create a need for the implementation of appropriate risk identification and management methods. Although prior research has been conducted regarding possible tax risk identification and management methods, very little is known about Business Process Management (BPM) as a tax risk identification and management method. This article contributes by using an exploratory case study to highlight that BPM can be a valuable risk identification and management method within the tax risk arena. BPM allows for risk identification and management of processes that cut across functional lines. Because BPM is process-driven, it accounts for process variances and can therefore be used as a tax risk identification and management method by any enterprise in relation to any tax type.

Keywords: Tax risk management, corporate governance, Business Process Management, excise tax, risk identification and management.

¹ Senior Lecturer in Taxation, Department of Taxation, Faculty of Economic and Management Sciences, University of Pretoria, Gauteng, RSA. Email: bronkhorstevadne@gmail.com

² MCom Taxation Alumni, Department of Taxation, Faculty of Economic and Management Sciences, University of Pretoria, Gauteng, RSA.

1. INTRODUCTION

During the 1980s and 1990s, tax functions mainly focused on cost management and shareholder value creation. While these objectives remain important, tax risk management is becoming a more significant part of modern day tax functions. This is attributable to an increase in tax risk due to an increase in the complexity of the current tax environment. Globalisation, technological innovation and the risk-based regulatory compliance initiatives of revenue authorities are just some of the factors that have created a more complex tax environment.³

Tax risk management has recently been classified as a separate element of corporate governance.⁴ Because this is a recent phenomenon, a dearth of empirical research exists on how enterprises rate various types of tax risks and how they have incorporated tax risk management into their governance policies and procedures.⁵ This implies that enterprises are becoming aware of a separate tax risk environment and the importance of managing and containing this environment.

Tax risks can be identified, managed and mitigated in a variety of ways. However, little is known about Business Process Management (BPM) as a tax risk identification and management method. Usually, BPM research focuses on enterprise wide process management improvement without specifically considering the impact on tax risk identification and management.⁶

Each enterprise, irrespective of its size and where it is incorporated and located, consists of certain functions and processes. Typically, an enterprise will have the following functions: revenue and receipts, purchases and payments, inventory and production, human resources, investment and financing, as well as accounting and finance. The tax function is usually included in the accounting and finance function.⁷

Processes cut across functional lines. Processes are those activities that convert inputs into outputs in order to achieve the goals of the enterprise and to satisfy its customers. Customers can be internal or external to the organisation.⁸ Internal customers are represented by the different functions in an enterprise. The tax function is an internal customer of all the other functions of an enterprise, as it relies on the processes executed by other functions to produce the information required to complete tax returns and perform other tax compliance related tasks. As the tax function relies on

³ S James, 'Behavioural Economics and the Risks of Tax Administration' (2012) 10 *eJournal of Tax Research* 2, 347; C Lavermicocca, 'Tax risk management practices and their impact on tax compliance behaviour-The views of tax executives from large Australian companies' (2011) 9 *eJournal of Tax Research* 1, 89; B Wood 'Tax Governance: The New Priority in Risk Management' (2004) 80 *Chain Store Age* 9, 1.

⁴ James, above n 3, 349; HF Wunder, 'Tax Risk Management and the Multinational Enterprise, (2009) 18 *Journal of International Accounting, Auditing and Taxation*, 15.

⁵ Wunder, above n 4, 15.

⁶ RG Lee and BG Dale, 'Business Process Management: A Review and Evaluation' (1998) 4 *Business Process Management Journal* 3, 215-217.

⁷ P Von Wielligh and F Prinsloo (eds), *Auditing Fundamentals in a South African Context* (Oxford University Press, 2014).

⁸ Lee and Dale, above n 6.

outputs from a number of processes within the enterprise, tax risk could be better addressed by managing processes instead of functions.⁹

The complexity of these processes and the manner in which they are managed will undoubtedly differ from enterprise to enterprise due to factors such as operational requirements, risk appetite, organisational structure and the type of business philosophy adopted by management. One thing that will not differ, however, is the need for effective and efficient process management.

BPM is one of the methods that can be used to improve process management through the documentation and analysis of organisational processes. BPM focuses on processes rather than functions. BPM is flexible as it allows for process management improvement of both complex and less complex processes in both large and small enterprises. This makes it possible to illustrate that BPM can be applied as a tax risk identification and management method by any enterprise situated anywhere in the world.

2. PURPOSE STATEMENT

The aim of this research is to use a case study to highlight whether or not BPM can be a valuable tax risk identification and management method.

In the next section the research design and methods will be discussed. The succeeding sections will provide a brief background on excise taxes in the South African oil and gas industry, as well as relevant tax risks and the management thereof. This will be followed by a discussion of BPM as a risk identification and management method and the role it can play in tax risk management. The article then concludes with a discussion of the research process and results.

3. RESEARCH DESIGN AND METHODS

An exploratory case study was chosen for this qualitative research. A case study is normally chosen where the research needs to determine how something operates.¹⁰ Therefore a case study was appropriate to achieve the aim of this research, as it was necessary to understand the actual tax processes of an enterprise, as well as the risks and internal controls relating to such processes in an open real-time environment. To allow for a more in-depth analysis, the case study subject matter was limited to one specific tax type within one enterprise.

The identified knowledge gap required a case study subject that has not yet implemented BPM in its tax processes. Company A (a multinational enterprise operating in the South African oil and gas industry) was chosen because of the availability and accessibility of case study data. At the time of the research, Company A was about to implement BPM within certain areas of the company (including its tax function).

⁹ Lee and Dale, above n 6.

¹⁰ P Baxter and S Jack, 'Qualitative Case Study Methodology: Study Design and Implementation for Novice Researchers' (2008) 13 *The Qualitative Report* 4, 548.

Company A is well known in the global oil and gas industry. Its headquarter company was founded more than one hundred years ago. Within the South African environment, Company A operates not only by importing and refining crude oil, but also by importing refined products that can be used directly within the market. For tax risk identification and management, Company A currently makes use of tax control frameworks and a global tax strategy. Due to risks associated with intellectual capital and other areas, it was agreed with the national tax manager of Company A that the identity of Company A would not be made known in this research.

Excise taxes were elected as the focus of the case study. Excise taxes present one of the biggest tax risks to enterprises in the oil and gas industry. This is attributable to a variety of causes, among others the fact that their main source of profit emanates from excisable products, such as diesel, and the consequential sheer monetary risks that can arise from non-compliance with tax legislation. Arguably, it would therefore be in the interest of enterprises within this industry to manage their excise tax risks effectively and efficiently.

The key stakeholders in the South African oil and gas industry are: BP Southern Africa, Chevron South Africa, Engen Petroleum, PetroSA, Sasol Oil, Shell South Africa and Total South Africa.¹¹ Until very recently there were very few non-refining wholesalers in South Africa.¹² The refining capacity of these key stakeholders is outlined in Table 1.

Table 1: Refining Capacity of Seven Key Stakeholders in the South African Oil and Gas Industry¹³

Name	Crude throughput (barrels per day)	Market share	Ownership
Chevref	100 000	14.5%	Chevron South Africa
Enref	105 000	15.3%	Engen Petroleum
Natref	108 000	15.7% (10%:5.7%)	Sasol/Total South Africa (64:36)
Sapref	180 000	26.2% (13.1%:13.1%)	Shell South Africa/BP Southern Africa (50:50)
Sasol Secunda	150 000	21.8%	Sasol
PetroSA	45 000	6.5%	PetroSA
TOTAL	688 000	100%	

¹¹ Company A is included among these seven key stakeholders.

¹² South African Petroleum Industry Association, *2013 Annual Report*, (2013), 1
<<http://www.sapia.co.za/publications/annual-reports.html>>.

¹³ South African Petroleum Industry Association, above n 12, 39.

Apart from PetroSA, the capabilities of the key stakeholders are distributed relatively evenly (refer Table 1). Therefore, it is submitted that each of these stakeholders would be exposed to similar excise tax risks, and any of these stakeholders would therefore be a valid case study subject. Company A, as one of the key stakeholders in the oil and gas industry, can be regarded as representative of the industry and consequently viewed as a valid case study subject.

Therefore it was considered appropriate to limit the case study to one company in the South African oil and gas industry. This helps to establish clarity in data gathering and allows more research monitoring capacity to ensure that data is not manipulated.¹⁴ The complete end-to-end process of the excise tax environment of Company A was analysed. This assisted in creating a tax risk register that is as complete as it can possibly be and facilitated achievement of the research objectives.

4. BACKGROUND

This article will focus on the identification of and response to risks, as part of the overall risk management process. The aim of this article is not to suggest a 'one-size-fits all' framework, but rather a starting point for modifying risk mitigation systems to suit the needs of the enterprise concerned. It is submitted that the underlying principles of this research can be considered for application to any tax type and by any enterprise.

The case study was based on the operational and compliance tax risks in the excise tax environment of a South African enterprise in the oil and gas industry. Consequently, a brief overview of the South African excise tax environment, its impact on tax risks and also relevant tax risk management strategies will aid an understanding of the research process and results.

4.1 South African excise taxes in the oil and gas industry

Revenue from taxes and levies is the main source of governmental income in South Africa. For the 2013–14 financial year, 88.9 per cent of governmental revenue emanated from taxes and levies.¹⁵ There has been an increase in annual revenue collections and a consequent increase in the tax risk exposure of enterprises as a result of an increase in the monetary value of their tax liabilities.¹⁶ This exposure can be even further magnified if tax risks are not properly managed.

One of the taxes that have contributed to an increase in enterprises' South African tax risk exposure is excise taxes. These taxes generated total revenue of R72.7 billion in the 2013–14 financial year. Of this total, fuel levies accounted for R43.7 billion and other excise taxes for R29.0 billion. For each of the financial years included in the period from 2009 to 2014, revenue from fuel levies and other excise taxes has experienced nominal growth averaging 10.9 per cent and 8.1 per cent per annum respectively. Nominal growth represents the growth rate unadjusted for inflation.¹⁷

¹⁴ Baxter and Jack, above n 10, 548.

¹⁵ National Treasury and South African Revenue Service *2014 Tax Statistics*, (2014), 5
<<http://www.treasury.gov.za/publications/tax%20statistics/2014/TStats%202014%20WEB.pdf>>.

¹⁶ Ibid.

¹⁷ Ibid, at 17.

In addition to the significant monetary exposure, regular changes in legislation and operational requirements further contribute to widening risk exposure. Therefore, effective excise tax risk management should be clearly defined to address compliance and operational risks.

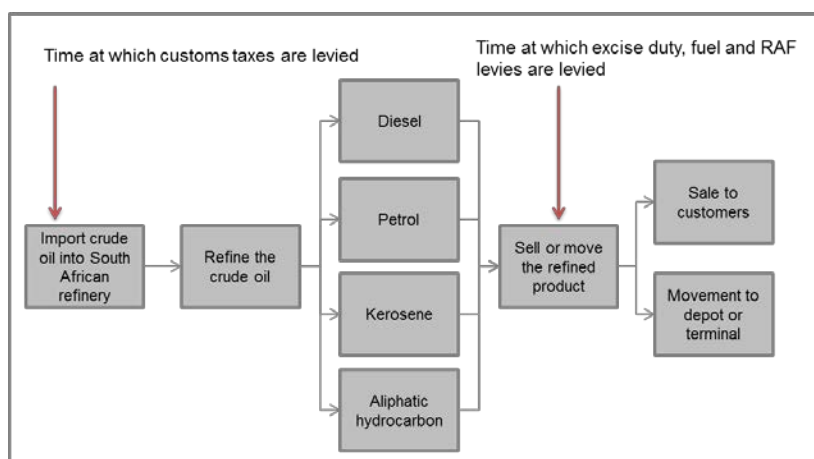
Owing to the imposition of a number of excise taxes on fuel, risks originating from South African excise taxes are particularly relevant for enterprises in the oil and gas industry. For this research, excise taxes refer to those excise taxes administered by the South African Revenue Service (SARS) that are relevant to the oil and gas industry. Excise taxes include excise duties, fuel levies and Road Accident Fund (RAF) levies which are imposed on a duty at source basis (DAS) on every movement of excisable goods out of a refinery or duty-free storage facility.¹⁸

The liability and payment dates for different excise taxes may vary, which in turn influences the complexity of an enterprise's tax environment. A typical supply chain of a South African enterprise in the oil and gas industry will normally comprise of the following:

1. Importation of crude oil for further processing in South Africa (Part 1)
2. Refining of the crude oil into any of the four main fuels, namely diesel, petrol, kerosene and aliphatic hydrocarbon solvent (Part 2)
3. Movement of the fuel product to the recipient/customer (Part 3).¹⁹

Figure 1 provides an overview of the supply chain of an enterprise in the oil and gas industry and highlights the relevant taxing points.

Figure 1: Supply Chain of an Enterprise in the Oil and Gas Industry



In the absence of rebates and refunds, Part 1 of the supply chain will create a customs tax liability, while Part 2 will create an excise tax liability. These liabilities are determined having regard to the relevant legislative framework.

¹⁸ South African Revenue Service, *Frequently Asked Questions: Duty at Source* (2014) <<http://www.sars.gov.za/FAQs/Pages/608.aspx>>; South African Revenue Service, *Excise Duties and Levies* (2015) <<http://www.sars.gov.za/ClientSegments/Customs-Excise/Excise/Pages/default.aspx>>.

¹⁹ S Oladunjoye, R Price, N Rahman and J Wells, 'Transfer Pricing: Transfer Pricing in the Oil and Gas Sector: A Primer' (2012) *International Tax Review*, July, 1–20.

4.1.1 Compliance and operational risk in the South African excise tax environment

Within a South African excise tax context, the key legislative framework consists of the *Customs and Excise Act No. 91 of 1964* (the Act), and the relevant Schedules and Rules to the Act. In accordance with the Act, the purpose of the legislative framework from a risk management, as well as the automation of processes perspective is to facilitate:

1. Movement of excisable goods entering or exiting the borders of the Republic of South Africa
2. Imposition of taxes on excisable goods manufactured locally as well as their imported equivalents.

This gives rise to compliance and operational risks.²⁰ Compliance risk is the risk associated with an enterprise's tax compliance obligations and that arise primarily from the timely submission of compliant tax returns. Operational risk is the risk associated with the manner in which tax law and regulations are applied in the business and operations of an enterprise.²¹

In recent years, the compliance and operational risks in the South African customs and excise tax environment are more pronounced due to tax modernisation initiatives.²² The Modernisation Programme was formulated during ten years of planning and research. After becoming a Party to the Revised Kyoto Convention, issued by the World Customs Organization, SARS had to make substantial changes to its business model.²³

The idea behind the modernisation was for SARS to change the manner in which it operates and collects customs and excise taxes. This includes approaching the customs and excise tax environment from a risk management perspective, as well as the automation of processes.. The modernisation project was originally launched in 2009, with an initial five-year plan, in order to address problems within the operating environment of SARS.²⁴ These changes also contribute to the operational complexity of excise taxes, since processes need to adapt, not only to the change in administrative requirements, but also to the stricter policies of SARS.

An enterprise's monthly excise duty, fuel levy and RAF levy liabilities are based on the volume of product sold to customers or transferred to a depot or terminal (refer to Figure 1), reduced by allowable deductions and rebates afforded in accordance with Schedule No. 4, Schedule No. 5 and Schedule No. 6 to the Act. Consequently,

²⁰ Lavermicocca, above n 3, 96.

²¹ PricewaterhouseCoopers, *Tax Risk Management*, (2004), 4 <<https://www.pwc.co.za/en/assets/pdf/pwc-tax-risk-management-guide.pdf>>.

²² South African Revenue Service, *Excise Modernisation* (2014) <<http://www.sars.gov.za/ClientSegments/Customs-Excise/Excise/Pages/Excise-modernisation.aspx>>.

²³ M Poverello, *Customs Modernisation* (2011) <<http://mpoverello.com/sars-customs-modernisation/comment-page-1/#comment-426>>.

²⁴ South African Revenue Service, above n 22; South African Revenue Service, *Customs Modernisation* (2014) <<http://www.sars.gov.za/ClientSegments/Customs-Excise/AboutCustoms/Pages/Modernisation.aspx>>.

allowable deductions and rebates reduce an enterprise's excise tax liability.²⁵ This determination is depicted by the following formula:

$$[\text{Bulk volume (litres)} - \text{rebates} - \text{deductions}] \times \text{relevant rates of duty / levy} \\ (\text{determined annually in April})$$

$$= \text{Total duty / levy payable (Excise duty, fuel levy and RAF levy)}$$

The enterprise then transfers the determined liability for each of these excise taxes to a DA160 return (*DA160: Petroleum Products Account for Manufacturing Warehouses—external form*) on a monthly basis. This is a prescribed SARS return that includes supporting schedules and fixed formulas.²⁶

The proper completion of the monthly DA160 return is crucial to ensure that the correct amount is paid to SARS. Until September 2013, the return was filed manually. In September 2013, the online e-filing system was launched and now the DA160 return is filed electronically.²⁷

South African excise tax risks for enterprises are high, given the magnitude of these enterprises' exposure to excise taxes and the importance of taxes as a source of governmental revenue. Excise taxes account for 8.1 per cent of collected revenue and have increased consistently.²⁸ An enterprise's excise tax risk exposure is further increased by the significant penalties that can be imposed in the event of non-compliance. According to section 80 of the Act, the possible penalties for non-compliance include fines and/or imprisonment of persons involved in the management of the enterprise.

Table 2 provides a summary of the key excise tax risks of South African enterprises and associates them with the relevant risk categories.

²⁵ South African Revenue Service, *Legislative Framework* (2013)
<<http://www.sars.gov.za/ClientSegments/Customs-Excise/Pages/Legislative-Framework.aspx>>.

²⁶ South African Revenue Service, *Excise External Directive Oil Industry*, (2014), 5
<<http://www.sars.gov.za/AllDocs/OpsDocs/Policies/SE-FL-04%20-%20Oil%20Industry%20-%20External%20Directive.pdf>>.

²⁷ South African Revenue Service, *Excise Modernisation and E-filing*, (2013)
<<http://www.sars.gov.za/ClientSegments/Customs-Excise/Excise/Pages/Excise-Modernisation-and-eFiling.aspx>>.

²⁸ National Treasury and South African Revenue Service, above n 15, 8.

Table 2: South African Excise Tax Risks of Enterprises in the Oil and Gas Industry

Type of risk	Description
Compliance risk	- South African excise taxes are governed by a complex legislative framework which increases the likelihood of non-compliance due to incorrect interpretation and application of legislative provisions. - Incorrect rates and levies may be used. This risk is more prominent after the rate changes that normally occur annually on the first Wednesday in April. - Non-compliance with reporting standards as defined in the Act. - Incorrect information included in the DA160 return.
Operational risk	- The modernised electronic filing (e-filing) system has not been in place for very long. This may lead to unexpected risks where all the different return scenarios have not been tested. - Incorrect information received from other functions. - Information/supporting documentation not supplied to the tax function in a timely manner, thus causing delays in reporting. - The operational requirements of the South African excise tax environment are complex and require detailed and accurate record-keeping, thus increasing the likelihood of not being able to satisfy relevant requirements.

By identifying and managing the risks that relate to the South African excise tax environment, a tax function can ensure that the enterprise is governed in such a manner that compliance and transparency are enhanced and organisational objectives achieved.

Although most of the excise tax risks are external to the tax function's operations, accountability rests with the tax function. It is thus necessary to manage and mitigate these risks with appropriate risk identification and management methods.

4.2 Tax risk management

Value is created by identifying opportunity, taking risks, and generating a return on such opportunities. Value generation lies in the pursuit of strategic opportunities. In pursuing these opportunities, enterprises encounter risks. While taking risks are part of any enterprise's day-to-day functioning, the key to success is to effectively manage and mitigate risks that threaten the achievement of the enterprise's objectives. For example, where legislative compliance is one of the enterprise's objectives, it is important to identify and manage those risks which can hamper the enterprise from complying with relevant legislative requirements.

The risk management process consists of the six steps, as depicted in Table 3.

Table 3: Steps in the Risk Management Process²⁹

Step	Objective
1. Risk identification	To produce a comprehensive list of risks
2. Develop assessment criteria	To develop common assessment criteria having regard to the impact and likelihood of each risk
3. Assess risks	To assign a value to each identified risk, having regard to the developed criteria
4. Assess risk interactions	To use appropriate techniques to manage risk interaction
5. Prioritise risks	To prioritise risks by comparing the risk level with its overall impact
6. Respond to risks	To develop response plans based on a cost / benefit analysis, a risk strategy and exploration of different response options

It is advisable to manage tax risks in a proactive manner. In other words, tax risk management should be a precautionary step rather than a defence mechanism.³⁰

It is the authors' opinion that precautionary tax risk management requires an enterprise to proactively engage in understanding the interdependencies between the tax function and other functions. Proactive engagement enables an enterprise to ensure that its tax risk management practices are sufficiently comprehensive.

Furthermore, tax risk management should not only be seen as a corporate governance obligation. An enterprise should recognise that the tax function relies on all processes for information, and that processes sometimes involve more than one function within an enterprise. This requires the incorporation of risk management as a key part of the strategic planning processes done by each function within the enterprise. By incorporating risk management at an operational level, operational risks can be addressed more effectively.³¹ This can only be achieved if the enterprise has the knowledge and expertise to enable this. To ensure that risk management is incorporated at an operational level, it is advisable to task specific individuals within each function with the responsibility to oversee the integration process.³²

It is only when an enterprise incorporates tax risk management within each process in the enterprise (irrespective of what function is involved), that the tax function can be empowered to attain key objectives such as transparency, sound governance, risk management, organisational alignment, as well as tax planning.³³

²⁹ Committee of Sponsoring Organisations of the Treadway Commission, above n 29, 2.

³⁰ DN Erasmus, *Tax Intelligence: The Seven Habitual Tax Mistakes Made By Companies*, 1 <<http://www.erasmusontax.com/>>; R Hoyng, S Kloosterhof and A MacPherson, *Tax Risk Management: From Risk to Opportunity*, (2010), 23 <http://www.ibfd.org/IBFD-Products/Tax-Risk-Management#tab_0>.

³¹ KPMG, *No Paper Chase: Transforming Risk Management at Energy and Resource Companies*, (2013), 2–3 <<http://www.kpmg.com/global/en/issuesandinsights/articlespublications/documents/no-paper-chase.pdf>>.

³² Ibid, at 4.

³³ Wood, above n 3.

As stated earlier, this research aims to highlight whether or not BPM can be a valuable tax risk identification and management method. The focus will therefore be on Step 1 and Step 6 (as per Table 3), as these are the steps where BPM can add the most value.

4.2.1 *Shortcomings of traditional tax risk identification and management methods*

Tax risks can be identified, managed and mitigated in a variety of ways. The methods that are commonly applied and well researched are tax strategies and tax control frameworks.³⁴

A tax strategy is the plan of action that is created to achieve the specific tax aims or goals of an enterprise. It should be aligned with the general organisational strategy and should clearly define and reflect the tax function's activities, vision, mission and priorities.³⁵ An enterprise's tax strategy will invariably be influenced by the tax control framework. A tax control framework is a data structure that organises and categorises an enterprise's internal controls, thereby creating business value and minimising risk.³⁶ Appendix A provides a brief summary of the strengths and shortcomings of tax strategies and tax control frameworks.

By implementing BPM, the effectiveness of tax strategies and tax control frameworks may be improved. This is because BPM assists an enterprise in improving the documentation of its processes. Where an enterprise is able to better understand all the processes that have an impact on the tax function, the enterprise would be better informed on how the tax function's plan of action should be amended to contribute to the achievement of an enterprise's strategic goals. This improved understanding of business processes may also enable an enterprise to improve the tax control framework by highlighting the functions that will be better positioned to implement and monitor certain internal controls.³⁷

4.2.2 *Business Process Management*

In the last decade, enterprises have become more aware of the importance of their business processes.³⁸ This has contributed to the popularity of BPM. BPM is a method that can be used to analyse and document organisational processes, so that they may be monitored, measured and controlled. The aim of BPM is to redesign, modify and improve organisational processes where necessary. By redesigning and modifying the existing processes, BPM assists an enterprise in meeting strategic goals. BPM is beneficial because it establishes consistent and uniform processes, supports timely risk identification and good management practice, and enables enterprises to

³⁴ Erasmus, above n 30; Hoyng et al., above n 30; A Johnston, 'The Explosion of Tax Risk' (2006) 17 *International Tax Review* 10, 24.

³⁵ Erasmus, above n 30, 10; Oxford Dictionaries, *Strategy* (2014) <<http://www.oxforddictionaries.com/definition/english/strategy>>.

³⁶ TechTarget, *Control Framework* (2014) <<http://searchcompliance.techtarget.com/definition/control-framework>>.

³⁷ Hoyng et al., above n 30, 43.

³⁸ J Natovich, 'Business Process Management Systems: The Internal Control Perspective' (2009) 6 *ISACA Journal* <<http://www.isaca.org/Journal/archives/2009/Volume-6/Pages/Business-Process-Management-Systems-andnbsp-andnbsp-The-Internal-Control-Perspective.aspx>>.

operate in efficient and effective environments.³⁹ The benefits of BPM far outweigh its disadvantages (refer to Appendix B).

Traditionally the focus was on the operational and functional aspects of BPM. BPM recently evolved from being used for the re-engineering of business processes to focusing on the following:

1. Providing a competitive advantage through business processes: It is of the utmost importance that business processes should be well designed in order to ensure the success of any enterprise.
2. The management of processes: In order to avoid the division of different functions within an enterprise, it is vital to be reminded that, more often than not, processes are cross-functional. Thus, enterprises should focus on the end-to-end management of processes.
3. The agility of processes: Any enterprise should thus focus on the improvement and adaption of their processes. To ensure agility, the automation of business processes is suggested.⁴⁰

Within BPM lies knowledge management which will assist in, as the concept suggests, the management of the gathered processes in such a manner that information assets are distributed and utilised to their full capacity. Knowledge management originated in the consulting community after enterprises started to realise the value that could be created by sharing and linking knowledge across geographic locations.⁴¹ The most central idea relating to knowledge management is to capture current knowledge within an enterprise and to effectively distribute and retain such knowledge across the enterprise.⁴²

Transparency is one of the greatest benefits of knowledge management because it opens clear and defined channels of communication. Knowledge that was once hidden will now be openly and explicitly available across the enterprise; lessons learned and best practice can be shared globally. Teams are encouraged to share knowledge, rather than reinventing the wheel.⁴³

If BPM and knowledge management are implemented correctly, the response to tax risks can be improved as a result of transparent processes and improved knowledge availability. This will also enable enterprises to create unique knowledge assets, such as knowledge relating to products, available markets, technology and competition.⁴⁴ The identification and mitigation of tax risks can be shared internationally and

³⁹ Association of Business Process Management Professionals, *What is BPM Anyway? Business Process Management Explained* (2007) <<http://www.bpminstitute.org/resources/articles/what-bpm-anyway-business-process-management-explained>>.

⁴⁰ Natovich, above n 38.

⁴¹ MED Koenig, *What is KM? Knowledge Management Explained* (2012) <<http://www.kmworld.com/Articles/Editorial/What-Is-.../What-is-KM-Knowledge-Management-Explained-82405.aspx>>.

⁴² M Rouse, *Business Process Management (BPM)* (2011) <<http://searchcio.techtarget.com/definition/business-process-management>>.

⁴³ Knowledge Management Online, *Knowledge Management Online* (2005) <<http://www.knowledge-management-online.com/the-importance-of-knowledge-management.html>>.

⁴⁴ A Macintosh, *Knowledge Management* (1999) <<http://www.aii.ed.ac.uk/~alm/kamlnks.html>>.

expertise surrounding specific risk mitigation processes will be retained within the enterprise.

BPM can be implemented by mapping processes in an end-to-end manner. These maps highlight possible gaps within processes which can be indicative of risks. Mapping also provides enterprises with a succinct view of the current and desired state of processes, and facilitates focused risk management and resource allocation.⁴⁵

Another method of BPM implementation that facilitates knowledge management and knowledge sharing is the creation of standard operating procedures (SOPs) that support the visually mapped processes. SOPs are implemented to describe the processes, and to assist with role and responsibility assignment.⁴⁶ An effective SOP will not only describe how policies should be implemented but also describe the details relating to the who, the what, the where, the when and the how.⁴⁷

The use of BPM is not a familiar topic within tax risk management circles. Likewise, knowledge management, as it relates to taxation, has received little attention. Different areas exist within tax functions that could be impacted by knowledge management, namely: legislative knowledge, administrative knowledge, awareness and correct interpretation of tax legislation, and administrative constraints relating to legislation.

Although both tax strategies and tax control frameworks are beneficial, risk and internal control gaps may still be overlooked. Such gaps may cause risk scenarios that materialise if they are not addressed. It is advisable that risk and internal control gaps should be identified and managed as broadly and as soon as possible.

By aligning BPM with other risk identification and management methods, risk and internal control gaps may be addressed at an earlier stage. This is due to BPM creating a broader perspective by mapping the applicable process in an end-to-end manner. The broader perspective creates the opportunity for an enterprise to view multiple layers of internal control and to further identify duplicated internal controls where they exist.

The research results discussed in the next section highlight that BPM can be used as an ideal complement to other tax risk identification and management methods.

5. RESEARCH PROCESS AND RESULTS

The research conducted for this project was done over a period of seven months. Data regarding the risks and internal controls in the original excise tax processes of Company A (before the implementation of BPM) were made available in the form of the latest tax risk register of Company A. Company A updates this register on a quarterly basis and the latest available information before the implementation of BPM was dated 31 March 2014.

⁴⁵ D Cracknell, H Messan, M Moulick and H Sempangi, *Process Mapping in Practice*, (2005), 4 <http://www.microsave.net/files/pdf/Process_Mapping_in_Practice.pdf>.

⁴⁶ Interfacing, *Standard Operating Procedures (SOP)* (2014) <<http://www.interfacing.com/business-process-management-solutions/standard-operating-procedures-SOP-Mapping>>.

⁴⁷ Iowa State University, *Overview of standard operating procedures (SOPs)*, (2015), 1 <<https://iastate.app.box.com/s/729ez60hcojs55ag9osd>>.

5.1 Research process

As part of the research process, one of the researchers spent time with the following employees of Company A:

1. The national tax manager: The national tax manager is the head of the tax function of Company A's Southern African operations. This includes both the direct and indirect tax streams for countries in Southern Africa, such as South Africa and Mozambique.
2. The subject matter expert: For this case study, the subject matter expert is the Indirect Tax Specialist (specifically relating to South African excise taxes). The subject matter expert is responsible for ensuring that Company A complies with all its excise tax duties.
3. The process owner: The process owner is the individual ultimately responsible for the South African excise tax processes. In this case study the national tax manager is also the process owner. It is not always the case that the head of a department within Company A will also be the process owner.

The research process essentially entailed the following:

1. One of the researchers obtained the tax risk register that was created by Company A prior to the implementation of BPM.
2. One of the researchers spent time with the subject matter expert and national tax manager/process owner of Company A to observe the performance of the excise tax processes. The researcher then documented the observed processes.
3. To confirm the accuracy of the observations documented by the researcher, the subject matter expert and national tax manager/process owner of Company A then reviewed the documented excise tax processes.
4. One of the researchers then created a visual representation of the documented excise tax processes by using the BPM feature of the software that Company A uses for recording processes and risk management. Although the software is an off-the-shelf product that is available for purchase by any enterprise, it has been customised to suit the specific needs of Company A. Company A used the BPM feature of the software to record tax processes for the first time during this case study. The visual representation consisted of a process flow diagram. A process flow diagram effectively converts written processes into pictures. It allows users to link separately documented processes with each other, which makes it easier to view an entire process in one centralised place.
5. To confirm the accuracy of the visual representations created by the researcher, the visual representations were reviewed by the subject matter expert and national tax manager/process owner of Company A.
6. The tax risk register (as mentioned in Point 1) was then updated to reflect the risks evident from the process flow diagram. This update was done by the national tax manager/the process owner, the subject matter expert, and one of the researchers.

7. One of the researchers then compared the tax risk register created after BPM (as mentioned in Point 6), with the tax risk register that existed before BPM was implemented (as mentioned in point 1). The results of this comparison are documented in Table 4 in Section 5.2 of this article.

By being able to view the entire process in one document, an enterprise can form a comprehensive view of risks and better evaluate whether or not all the desired internal controls are in place. A process flow diagram highlights:

1. The links between different processes within an enterprise
2. Risks that span across more than one function in the enterprise and that requires cross-functional internal controls to address the shared risks
3. The unnecessary duplication of internal controls
4. Risks that the enterprise thought were mitigated but are not currently being mitigated through appropriate internal controls, that is, internal control gaps.⁴⁸

The BPM software that was used by Company A also includes a functionality that enables one to embed SOPs within the process flow diagram. As stated above in Section 4.2.2, SOPs are another method of BPM implementation that facilitates knowledge management and knowledge sharing. SOPs are separate written documents that define each step within a documented process. They also state the official procedures that should be followed in specifically identified scenarios in order to mitigate compliance or operational risks. Just as the BPM software can be used to convert the documented written processes into a visual representation, the BPM software can be used to embed the SOPs in the process flow diagram.

The SOPs also clearly define the function that is responsible for the relevant part of a process, as well as the roles and responsibilities of each individual involved. This enables an enterprise to evaluate whether or not there is appropriate segregation of duties, by highlighting those areas of a process that need to be executed by different employees. Segregation of duties assists in strengthening an enterprise's internal control framework.

By embedding SOPs in a process flow diagram, it also empowers the enterprise to identify those parts of the process that do not have SOPs in place, but that requires SOPs.

As part of the creation of the process flow diagram, Company A also used the BPM software to embed its current SOPs in the process flow diagram. These SOPs are accessible in an un-editable format throughout Company A. This ensures that knowledge sharing takes place.

Where possible, the process flow diagram and SOPs may be made available to external parties as well, such as the revenue authorities, to aid understanding of the excise tax processes that are followed. Even where it may not be possible to share the process flow diagram and SOPs with external parties, personnel may be better equipped to assist external parties with queries. This is because personnel can use the

⁴⁸ KJ Henderson, 'What Are the Benefits of Business Process Mapping?' (2016), *Houston Chronical* (online), <<http://smallbusiness.chron.com/benefits-business-process-mapping-3246.html>>.

process flow diagram to identify the relevant function responsible for a specific part of a process. They can then refer the external parties to the function that is in the best position to assist them with their query. Because the responsible function has a working knowledge of the SOPs that relate to the specific part of the process, the responsible function will then also be in a better position to explain the SOPs to the external parties.

The following measures were taken to ensure the accuracy and completeness of the collected data:

1. The official current process risks and internal controls of Company A (in the form of a risk register) were obtained.
2. The appropriate personnel of Company A were interviewed to confirm their understanding of the process.
3. Company A's internal BPM software and methodology was used to document processes. The software allows enterprises to map organisational processes visually, assists in the creation of SOPs, and the creation of organisational data in one central storage system.⁴⁹
4. The accuracy of the documented processes was confirmed through a review performed by the relevant personnel of Company A.

5.2 Research results

The research results analysis will focus on the effect of the implementation of BPM on the identification and management of risks. The findings are documented in Table 4.

Table 4: Summary of the Effect of BPM on the Excise Tax Risk Environment

Number of additional risks identified	Number of additional internal controls identified	Number of internal controls re-designed	Number of internal controls removed
1	3	7	0

Table 4 indicates that the implementation of BPM positively influenced the risk environment of Company A. While the impact of BPM may appear to be nominal, the value of BPM should not be judged merely by the number of additional controls or the number of controls re-designed, but rather by its ability to facilitate the process which underscores the design of internal controls.

Before BPM, the tax function had to rely on the processes and SOPs that the tax function had documented in isolation, not knowing whether or not risks that impact the tax function are being addressed by other functions. The process flow diagram created a comprehensive view of the processes that influence the tax function. It also

⁴⁹ Software AG, *ARIS Business Process Analysis* (2015)
<http://www.softwareag.com/corporate/products/aris_alfabet/bpa/overview/default.asp>.

identified those functions that are involved in these processes. Therefore, BPM empowers an enterprise to convert from function-based management to process-based management. This has important implications for the tax function. The tax function takes responsibility for tax compliance of the enterprise as a whole but is not responsible for producing all the information required to facilitate tax compliance. The tax function is dependent on information produced by other functions. For example, the tax function of Company A needs information about volume movements from other functions to enable it to determine Company A's monthly excise tax liability.

The process flow diagram of the excise tax processes of Company A, allowed the tax function to link its own processes with that of other functions within Company A. By identifying the interfacing processes as they relate to other functions, the opportunity was created to implement cross-functional controls.

The process flow diagram and embedded SOPs can be supplied to both internal and external auditors as well as to the revenue authorities when reviews of the processes are performed. Due to the detailed nature of the SOPs, the internal auditors have a benchmark against which any reviews can be performed. The auditors and the revenue authorities may use the SOPs to attain a faster and better understanding of the internal excise tax processes of Company A, as well as the identified risks and the related internal controls, thus leading to more effective and efficient audits. The use of reviews by internal and external auditors is one of the broader internal controls that the tax function of Company A relies on for assurance of the excise tax processes followed and the internal controls that are implemented to address identified excise tax risks.

Another benefit stemming from BPM is the attainment of improved segregation of duties. Clearly defined segregation of duties is one of the controls within the tax risk management strategy of Company A that was not clearly defined before the implementation of BPM. This resulted in instances where proper segregation of duties was not achieved. BPM influenced the ability of the tax function to segregate duties, not only within the tax function but also in functions that work closely with the tax function. BPM created a comprehensive view of the processes performed by the tax and other related functions and made it possible to define the specific roles and responsibilities of the individuals involved. These newly defined roles and responsibilities created the opportunity to address the following:

1. The elimination of the possibility that activities are performed by more than one person or more than one function.
2. The incorrect utilisation of resources due to not having a comprehensive end-to-end process view.

In this case study the value of BPM emanated from the manner in which it facilitated tax risk identification and management. BPM did not dictate the flow of the process or the controls that were implemented; it simply became a facilitative method to provide a framework within which effective tax risk identification and management can function. Each enterprise may choose to implement this in a different manner which will influence the outcomes thereof.

6. CONCLUSION

The research set out to highlight whether or not BPM can be a valuable tax risk identification and management method. The research results indicated that the implementation of BPM leads to the ability to share knowledge and create a broader view of tax processes. Industry specialist knowledge can be easily shared with external parties such as internal auditors, external auditors and the revenue authorities because of the creation of a process flow diagram and SOPs, as part of BPM.

The creation of formal documentation of tax processes that cuts across functional lines mitigates one of the most important risks that the tax function faces. The tax function relies on information from other functions that are not specifically geared for tax purposes. The formal documentation strengthens the communication and information components of the internal control environment. The SOPs act as an internal control vehicle that contributes by way of creating a clearer view of the cross functional roles and responsibilities. This enhances accountability and improves corporate governance.

Therefore, BPM may be an ideal complement to popular tax risk management methods, such as tax strategies and tax controls frameworks, because it highlights the role that the tax function and other functions play in managing the enterprise's tax risk. BPM acknowledges that an enterprise is a collection of functions. It is all of these functions that impact upon the strategy of the enterprise. A greater awareness of the role of other functions in the enterprise empowers the tax function to improve its formulation of its tax strategy, which should be a constituent of the overall strategy. It also provides the tax function with a better understanding of what internal controls have been implemented by other functions in the enterprise. This knowledge may equip the tax function to create a more comprehensive tax control framework by incorporating those internal controls that are the responsibility of other functions.

7. APPENDICES

Appendix A: Strengths and shortcomings of tax strategies and tax control frameworks⁵⁰

Tax strategy		Tax control framework	
Strengths	Shortcomings	Strengths	Shortcomings
Enables an enterprise to specifically identify those risks that may hamper the achievement of the enterprise's strategic goals	Does not focus on operational procedures and risks	Supports the objective of creating an effective, efficient and transparent environment	Understates internal controls, because it is not always possible to view the entire internal control framework at once
	Operational risks may be overlooked	Supports organisational strategy through tax planning and pre-mitigation of risks	
Enables the identification of different groups of risks	Lacks detailed focus which may hamper the achievement of a function's goals within an enterprise	Facilitates resource allocation	

⁵⁰ Erasmus, above n 30, 1; Hoyng et al., above n 30, 22 and 43; Johnston, above n 34, at 2; M Leitch, M. *Why the COSO Framework Needs Improvement* (2005) <<http://www.irmi.com/expert/articles/2005/leitch04.aspx>>; TechTarget, above n 36.

Appendix B: Advantages and disadvantages of BPM⁵¹

Advantages
Increased accountability between functions and individuals
Improved reliability of individuals and teams
Healthier relationships with stakeholders, specifically revenue authorities, due to early identification and disclosure of risks
Easier regulatory compliance
Improved functional (tax and others) resource management, specifically the defining of roles and responsibilities of individuals relating to tax risk management
Greater staff satisfaction which leads to knowledge being retained within the enterprise, thus creating a knowledgeable and capable tax function
Improved processes and greater efficiency
The creation of consistent and standardised processes throughout the enterprise
Earlier risk and opportunity identification
Greater transparency of processes, which influences the creation of tax controls for identified process gaps and risks
Prevention of negative impacts of tax risks due to early mitigation and elimination
Alignment of the tax strategy with the organisational strategy
Disadvantages
Requires specific skills and knowledge in order to be performed and implemented properly
BPM may become expensive where the enterprise decides to source external expertise to help with BPM implementation
If employee buy-in is not obtained and the BPM strategy is not properly explained to employees, BPM implementation may cause lowered employee morale due to changes in employees' roles and responsibilities
BPM may lose its impact where the enterprise does not dedicate resources to regularly updating processes by using BPM methods. This may cause the knowledge gained to be lost when employees leave the employ of the enterprise

⁵¹ Business Analyst Learnings, *The Top 3 Benefits of BPM and More* (2013) <<http://businessanalystlearnings.com/blog/2013/1/7/tk94nt1hjqprr6edqjpuqqjywmzr87>>; Natovich, above n 38, 1; K Nixon, 'Top 5 Benefits of Good Business Process Management' on Comindware, *Collaborative Minds Blog* (13 February 2015) <<https://www.comindware.com/blog/leadership/benefits-of-business-process-management/>>; University of San Francisco, *Benefits of Business Process Management*, (2015) <<http://www.usanfranonline.com/resources/business-process-management/benefits-of-business-process-management/#.U1eaCfmSy8w>>; Yourdictionary, *Process Management: Advantages and Disadvantages* (2014) <<http://www.yourdictionary.com/process-management>>.

Effects of tax reform on average personal income tax burden and tax progressivity in Germany under the particular consideration of bracket creep

Chang Woon Nam¹ and Christoph Zeiner²

Abstract

This study primarily aims to contribute to the ongoing debates on bracket creep and examine whether Germany needs to integrate inflation indexation into its personal income tax system in order to reduce distortions of tax liabilities and additional tax burdens. Germany has continuously flattened the personal income tax rates in the context of a series of tax reforms and modified its tax system. Under the consideration of the major goals of these reforms, this study compares the extent to which previous reform efforts, made in this country since 1958, led to changes in the real, inflation-adjusted average personal income tax burden of single earners in 2014. Furthermore this study examines the changes in progressivity of tax rates over the same period of time, which is measured by the coefficient of residual income progression (CRIP). According to the long-term real view adopted in this study, the evolution of the German personal income tax system made middle-income single earners worse off, while both the lower and higher income groups are significantly better off.

Keywords: personal income taxation; bracket creep; real average tax burden; single earners; tax progressivity; coefficient of residual income progression; Germany

JEL-Classification: H21, H23, H24, H31

¹ Ifo Institute Munich, CESifo and University of Applied Management Erding, Poschingerstrasse 5, 81679 Munich. Email: nam@ifo.de.

² Ifo Institute Munich, Poschingerstrasse 5, 81679 Munich. Email: zeiner@ifo.de.

1. INTRODUCTION

Personal income tax generates a major share of tax revenue in Germany, whereas it has traditionally been adopted as a policy instrument aimed at rectifying inequality in disposable income and achieving better redistribution among rich and poor households worldwide (Atkinson, 1970; Bach, Corneo & Steiner, 2013; Mirrlees, 1971; Slemrod, 1992; Tuomala, 1990). On the other hand, personal income tax system affects economic growth as well as the labour supply decision of households, since it distorts the relative price for leisure and consumption (Aaberge & Colombino, 2008; Atkinson & Stiglitz, 1980; Boeters, 2010; Triest, 1990).³ For this reason, progressivity and efficiency of the income tax system and their changes in the context of income tax reform have always been a popular topic of academic research and political discussion (see also Egger et al., 2013; Heady, 2004; Keen et al., 2000).

While the conservative and liberal parties in Germany have recently suggested the compensation of extra income tax burden in the middle and higher income groups caused by the so-called ‘bracket creep’, the left-wing parties would like to see stronger income tax reductions for the lower-income households and a significant increase in income tax for high incomes, emphasising the growing income divergence in this country (Bach, Haan & Ochmann., 2013). Although annual inflation rates have recently been quite modest in this country, the extra bracket-creep tax burden emerging over the period of continuous growth in the country’s tax revenue has been assessed as unfair (Broer, 2011; Heer & Süßmuth, 2013; Lemmer, 2014). In this context, the real, that is, inflation-adjusted, personal income is also widely seen in Germany as the indicator that more appropriately reflects the individual taxpayer’s ‘ability to pay’ (see also Rietzler et al., 2014).

Bracket creep is not a new tax policy issue. The term refers to the situation where inflation pushes income into higher tax brackets, although real income remains unchanged, and consequently this fictitious extra income causes increases in the real tax burden for taxpayers (see also, Altig & Carlstrom, 1991; Bailey, 1976; Immervoll, 2005; Jarvis, 1977; Sunley & Pechman, 1976; von Furstenberg, 1975). Taxpayers near the top-end of a tax bracket in particular are more likely to creep into a higher bracket and thus experience a rapid rise in marginal rates (Saez, 2003). Since the 1970s there have been intensive discussions over the possibilities of an indexation by adopting various measures, including (i) lowering statutory tax rates aimed at eliminating nominal income increase due to inflation; (ii) cost-of-living adjustments; (iii) the introduction of price escalators into the income tax structure, to name a few. In a number of countries such efforts have remained less successful, partly due to the problems of time lag between current inflation and the rate reflected in the adjustment index, as well as the time lag between the earning of income and the collection of taxes (see also Gutierrez et al., 2005; Johnson, 2015⁴; OECD, 1976; Tanzi, 1976).

³ ‘A high degree of tax progressivity means high marginal tax rates at the upper end of the income distribution. This leads to large labour supply distortions in the high-income group and, as a result, decreases the overall scope for redistribution’ (Boeters, 2010, p. 1).

⁴ Highlighting the needs of tax reform in the UK, Johnson (2015) urges an introduction of a coherent system of inflation indexation into the tax system. He argues that increasing indirect taxes in line with the retail price index and most direct tax thresholds in line with the consumer price index erodes confidence in the honesty of policymaking in this country.

Furthermore, international experiences demonstrate that ‘lower income taxpayers and those with more dependents have generally experienced larger *percentage* increases in average tax than have high-income families or those with few dependents, both because inflation erodes the real value of exemptions and because the rate structure are progressive’ (Tanzi, 1976: 215–216). As a result, the annual adjustment of the statutory tax rate in combination with tax deduction according to the price trend has recently been the most popular means adopted in many OECD countries to rectify the negative effects caused by bracket creep (Lemmer, 2014). In countries like Germany a personal income tax reduction and other changes (including those to the basic personal allowance) carried out in the context of tax reform (see Table 1), for example, barely improve the net income of taxpayers in a high inflation phase as originally intended without such an indexation, but merely compensate for their increased income tax liability.

Table 1: Evolution of German Personal Income Tax System

Period	Basic personal allowance (nominal in €)	Basic tax rate (%)	Top income threshold (nominal in €)	Highest tax rate (%)	Solidarity surcharges (% of nominal income tax liability in €)
1958–1964	859	20	56 263	53	
1965–1974	859	19	56 263	53	
1975–1977	1549	22	66 478	56	
1978	1702	22	66 478	56	
1979–1980	1887	22	66 468	56	
1981–1985	2154	22	66 468	56	
1986–1987	2319	22	66 484	56	
1988–1989	2430	22	66 484	56	
1990	2871	19	61 376	53	
1991–1992					3.75
1993–1994	2871	19	61 376	53	0.00
1995					7.50
1996–1997	6184	25.9	61 376	53	
1998	6322	25.9	61 376	53	5.50
1999	6681	23.9	61 376	53	
2000	6902	22.9	58 643	51	
2001	7206	19.9	54 998	48.5	
2002–2003	7235	19.9	55 008	48.5	
2004	7664	16	52 152	45	
2005–2006	7664	15	52 152	42	
2007–2008	7664	15	52 152 from 250 001	42 45	
2009	7834	14	52 552 from 250 401	42 45	

Period	Basic personal allowance (nominal in €)	Basic tax rate (%)	Top income threshold (nominal in €)	Highest tax rate (%)	Solidarity surcharges (% of nominal income tax liability in €)
2010–2012	8 004	14	52 882 from 250 731	42 45	
2013	8 130	14	52 882 from 250 731	42 45	
2014	8 354	14	52 882 from 250 731	42 45	

Source: Authors' compilation based on information from German Federal Ministry of Finance (<https://www.bmf-steuerrechner.de/ekst/>).

At first glance, when a 'nominal view' is applied (Immervoll, 2005), the performance of a number of German personal income tax reforms made between 1958 and 2014 appears to be quite promising. The tax-free basic personal allowance (*Grundfreibetrag*) increased steadily from 859 euros to 8354 euros, the basic tax rate has gradually decreased from 20 per cent to 14 per cent (with the exception of the 1996–1998 period where the rate reached 25.9 per cent). In 1958 the highest statutory income tax rate of 53 per cent was due on a taxable income of 56 263 euros. In 2014 the highest tax rate of 42 per cent was imposed on amounts from 52 882 euros, whereas the rate further increases to 45 per cent of a taxable income of 250 731 euros (see Table 1). However, this is not the end of the story, but only the beginning—such a nominal view alone does not adequately take account of all the partly unfavourable, real changes in the average tax burden, when the serious tax distortion emerges due to inflation.

There are two major motivations for this study. Firstly, although inflation rates have recently been quite low, the additional integration of inflation-adjustment mechanisms into the personal income tax system still appears to be necessary in this country to reduce the distortions in tax liabilities that lead to additional tax burdens. Secondly, Germany's personal income tax system has never been equipped with any kind of inflation-indexation mechanism, which, in turn, suggests that various tax reforms and modifications in the last sixty years have been carried out without adequately considering the effect of bracket creep (see also Boss et al., 2014; Immervoll, 2005). Adopting CPI deflation, this study attempts to investigate the extent to which all of these previous reform efforts made in this country since 1958, have contributed to changes in the real, inflation-adjusted average personal income tax burden, as well as to changes in progressivity of the tax rate on single earners in 2014.⁵

⁵ Repeatedly this study primarily aims to highlight the long-term income tax distortions caused by the lack of an inflation-indexation mechanism in the German personal income tax system. To this end, the application of CPI deflation appears to be suitable. In the case of additional consideration of the increases in real personal incomes, it would certainly be more appropriate to compare average tax rates and CRIP measures for average income or tax rates/CRIP on different quintiles or deciles of income. However, the consideration of historical real income development (and standards of living) is beyond the scope of this study.

2. SOME SIMPLE MODELS FOR CALCULATING AND COMPARING THE REAL AVERAGE INCOME TAX BURDEN

Paragraph 32a of German income tax law (§ 32a EStG - *Einkommensteuergesetz*) prescribes how income tax will be calculated each year according to the different tax-base brackets with a top taxable income threshold. This tax schedule also contains a basic personal allowance. When T denotes income tax and Y shows annual taxable income (measured in nominal term), the computation of the income tax liability of single taxpayers in a given year is carried out on the basis of the following simple formulas:

For the period of 1958–1964⁶

- a) Y to 1680 DM: $T = 0$;
- b) Y ranges from 1681 DM to 8009 DM: $T = 0.20 \cdot (Y - 1680)$;
- c) Y ranges from 8010 DM to 23 999 DM: $T = 1264 + 272 \cdot \{(Y - 8000)/1000\} + 2.9 \cdot \{(Y - 8000)/1000\}^2$;
- d) Y ranges from 24 000 DM to 110 039 DM: $T = 6358 + 382 \cdot \{(Y - 24 000)/1000\} + 1.572 \cdot \{(Y - 24 000)/1000\}^2 - 0.006 \cdot \{(Y - 24 000)/1000\}^3$; and
- e) Y from 110 040 DM: $T = 0.53 \cdot Y - 11 281$

For the fiscal year 2014 the calculation scheme has been changed:⁷

- a) Y to 8354 euros: $T = 0$;
- b) Y ranges from 8355 euros to 13 469 euros: $T = [(974.58 \cdot \{(Y - 8354)/10 000\} + 1400)] \cdot \{(Y - 8354)/10 000\}$;
- c) Y ranges from 13 470 euros to 52 881 euros: $T = [(228.74 \cdot \{(Y - 13 469)/10 000\} + 2397)] \cdot \{(Y - 13 469)/10 000\} + 971$;
- d) Y ranges from 52 882 euros to 250 730 euros: $T = 0.42 \cdot Y - 8239$; and
- e) Y from 250 731 euros: $T = 0.45 \cdot Y - 15 761$

The splitting rule is applied when married couples are taxed, ‘a tax rate for a single taxpayer with taxable income Y equals the tax rate of couple with a taxable income of $2Y$ ’ (Corneo, 2005: 161) in the aforementioned computation schedules.

It is generally acknowledged that a progressive tax system should be defined as one whereby the average rate of taxation increases with income before tax. Such a system is structured with marginal tax rates exceeding average rates and increasing with the tax base (Boeters, 2010; Jakobsson, 1976; Kakwani, 1977). This paper adopts a widely-used method for the purpose of measuring and comparing the degree of progression between the investigated years 1958 and 2014: the coefficient of residual income progression (CRIP).

⁶ In Germany the current income of family taxation with income splitting for spouses was introduced in 1958.

⁷ The calculation schedule was changed a total of twenty-five times between 1964 and 2014 (see <<https://www.bmf-steuerrechner.de/ekst/?>>>).

The CRIP shows the elasticity of net, that is, after-tax, income to taxable income, and is defined as:

$$\begin{aligned}\rho(Y) &= \{\Delta(Y-T) / (Y-T)\} / \{\Delta Y / Y\} \\ &= (1 - t_{mar}) / (1 - t_{ave}) \\ &= [d \ln \{(1 - T/Y) Y\}] / [d \ln Y]\end{aligned}$$

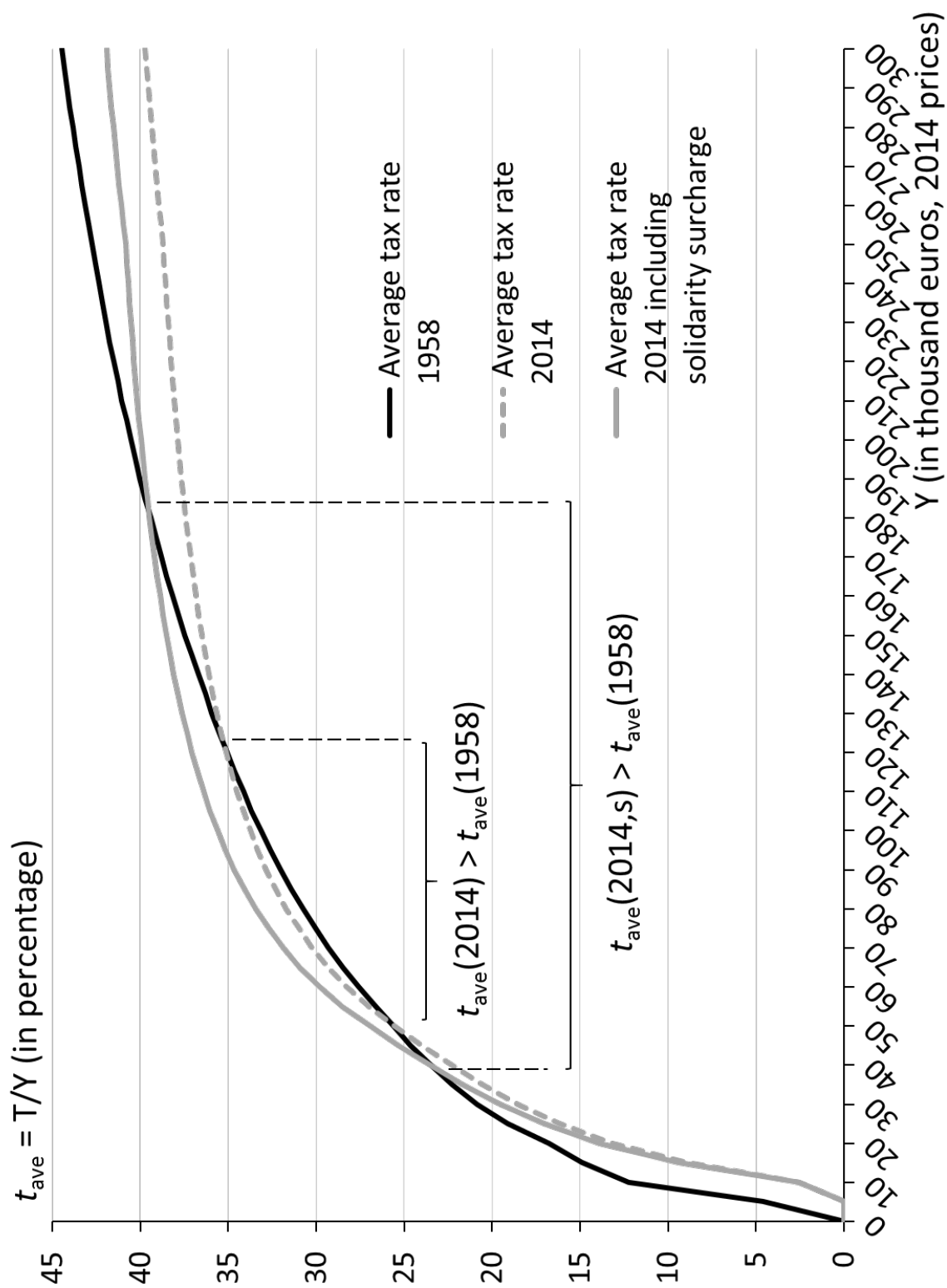
where Y = taxable income; t_{mar} = marginal tax rate; and t_{ave} = average tax rate. Hence, in a proportional tax regime the CRIP is 1. The tax progressivity exists at a certain level of taxable income Y , when $\rho(Y) < 1$. The smaller this coefficient, the higher the degree of progressivity (see Boeters, 2010; Bovenberg, 2006; Corneo, 2005; Jakobsson, 1976).

3. REAL EFFECTS OF GERMAN PERSONAL INCOME TAX REFORMS BETWEEN 1958 AND 2014

In the following section the real average income tax rates of German single earners are measured and compared for the years 1958 and 2014. In this context the nominal tax base has to be firstly adjusted and expressed in real terms (see also Boss & Ente, 1988; Brügelmann, 2008). Such an inflation-indexation comparison between the two selected years is carried out in this study via the cumulative inflation rate which is calculated based on the ‘official’ annual average CPI in the same period of time (see also Institute on Taxation and Economic Policy, 2011). Secondly, changes in tax-deductible professional outlays and expenses, as well as other types of tax-free allowances over the course of time can lead to significant differences in taxable incomes, although the gross income remains unchanged. For this reason the following analysis is based on information on taxable income, which is also applied by Boss and Ente (1988).

Figure 1 compares the real average personal income tax burden of the year 1958 with that of 2014; both are computed using the tax-bases expressed in terms of 2014 prices. As mentioned above, Germany has experienced a number of changes to the personal income tax system, mainly motivated by a desire to generally reduce the overall tax burden, as well as to better guarantee income redistribution. In contrast to this political intention, the same chart demonstrates rather surprisingly that a segment within the taxable income group of German single earners with the increased real average tax burden is currently worse off due to a series of tax reforms implemented between 1958 and 2014. This group’s taxable income ranges from approximately 50 000 to 120 000 euros (and from 40 000 to 180 000 euros when the solidarity surcharge is additionally considered in the calculation of average tax rate). With an income of 70 000 euros, for example, the average tax rate amounts to 29 per cent in 1958, which delivers an after-tax income of 49 491 euros (again in 2014 prices). By comparison, the average tax rate was 30 per cent in 2014 (and 32 per cent with the solidarity surcharge) while net income decreased to 48 839 euros (and to 47 675 euros with the solidarity surcharge).

Figure 1: Real Average Personal Income Tax Burden for Single Earner: Comparison between 1958 and 2014



Source: German Federal Ministry of Finance; German Federal Statistical Office; own calculations by authors.

By contrast, the real average tax rate on a taxable income of 15 000 euros amounted to 15 per cent in 1958, while the figure for 2014 was approximately 9 per cent (regardless of whether the solidarity surcharge is taken into consideration in the calculation). As a result, from this sum of taxable income, for example, a net income of 12 768 euros was obtained in 1958. This figure grew to 13 657 euros (or 13 583 euros including the solidarity surcharge) in 2014. In this context the obvious real income tax reductions for the lower-income single earners⁸ can be observed, which appears to correspond closely to the basic idea of the German personal income tax reform (see also Boss et al., 2014). At an income level of around 40 000 euros and at an average tax rate of 24 per cent, the real average tax curves of 1958 and 2014 (with the solidarity surcharge) intersect.⁹

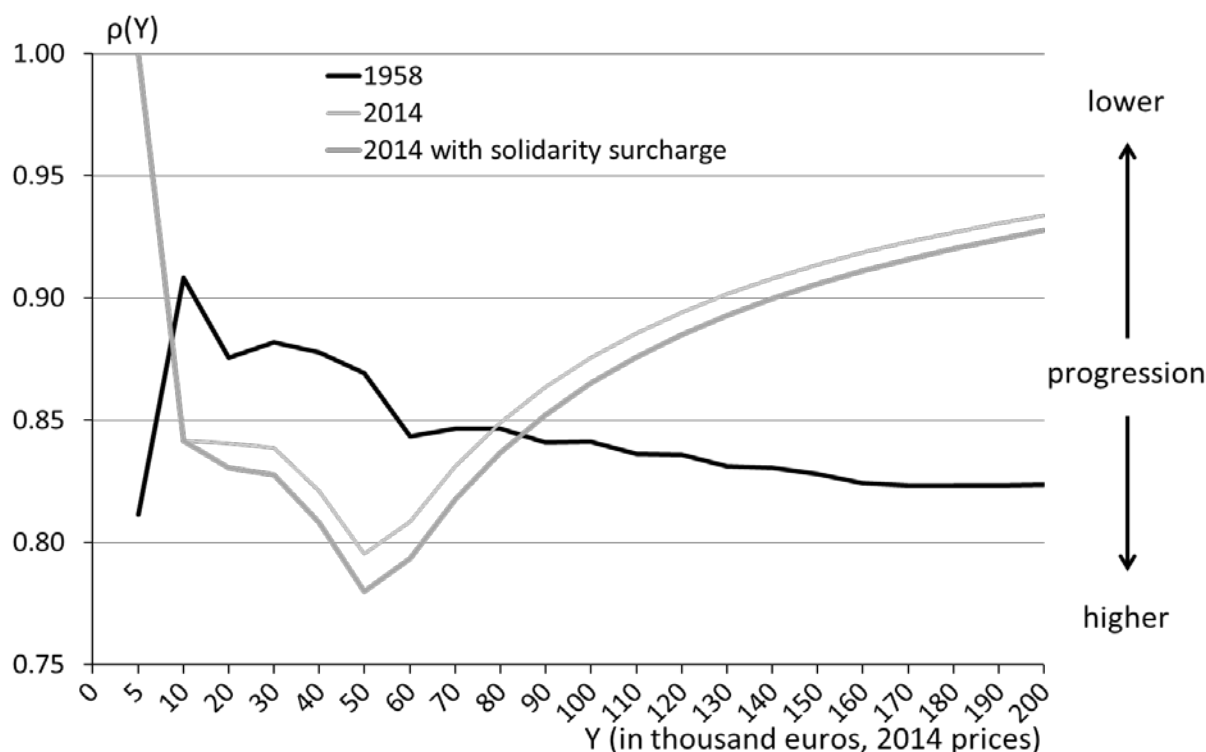
The series of German personal income tax reforms implemented since 1958 have also helped to reduce the real average tax burden for the upper-income class in Germany. The average personal income tax gap continued to grow between 1958 and 2014 and becomes more significant as taxable income rises, starting from approximately 120 000 euros (and 180 000 euros if the solidarity surcharge is taken into account), as shown by Figure 1. For example, a taxable income of 160 000 euros (in 2014 prices) is subject to an average tax rate of 37 per cent (without the solidarity surcharge) in 2014, resulting in an after-tax income of 101 039 euros; the valid tax rate for the same taxable income amounted to 38 per cent in 1958, which led to a reduction in net income to 98 949 euros. All these facts suggest that, in real terms, the current German personal income tax system makes those upper-income single earners considerably better off compared to the system in 1958.

Apart from the increased basic personal allowance and the lowered top taxable income threshold, from which the highest statutory personal income tax rate applies in 2014 (see Table 1), the increased real average tax burden in this year (compared to that of 1958) for those single earners whose taxable income ranges from approximately 50 000 to 120 000 euros (and from 40 000 to 180 000 euros with the solidarity surcharge) can also be explained by changes in tax progressivity. For this purpose, the coefficients of residual income progression (CRIP) at the given level of taxable income are compared between 1958 and 2014 (Figure 2).

⁸ According to the calculation made by the German Federal Statistical Office in cooperation with the *Frankfurter Allgemeine Zeitung*, around 75 per cent of the tax payers in Germany earn an annual income of less than approximately 38 200 euros (expressed at 2014 prices). Moreover, the average gross salary of German employees is around this level. In comparison, those who earn a gross income of more than approximately 148 000 euros (in 2014 prices) annually belong to the upper class in Germany (*Frankfurter Allgemeine Zeitung*, 2011).

⁹ It has always been an uneasy task to estimate the average personal-income-tax functions (Gourveia & Strauss, 1994). Despite that we attempted to statistically identify this function for the taxable personal income of German single earners, ranging from 10 000 to 300 000 euros (see Table A1 in annex).

Figure 2: Comparison of the Coefficient of Residual Income Progression (CRIP) between 1958 and 2014



Source: Authors' own calculation and Table A2 in Annex.

The development of CRIP, shown in Figure 2 as well as in Table A2 in the annex, clearly reveals that there was a significantly higher progression in 2014 in the range of taxable income between 10 000 to 80 000 euros, compared to the situation in 1958. A more 'compressed' personal income tax system in 2014, equipped with the increased basic personal allowance, calls for a greater progression in the lower taxable income group to reach a higher real average tax rate at the given higher level of taxable income. More precisely, a faster and more excessive increase in marginal tax rate in relation to the prevailing average tax rate existed in 2014 for the range of taxable income mentioned above, which is reflected by the CRIP curve of 2014 running below that of 1958, and by changes in the CRIP-gap. This also implies that the lower and middle-income single earners currently pay relatively higher taxes than those upper-income earners when there is a marginal change in the taxable income. Moreover, when this process slows down and becomes less significant as taxable income grows, the CRIP of 2014 starts to grow, indicating shrinking tax progressivity. This phenomenon becomes increasingly apparent when the taxable income exceeds 80 000 euros.

4. CONCLUSION

This brief study aims at to contribute to the ongoing political and scientific debates on bracket creep and examines whether Germany needs to integrate inflation indexation into its personal income tax system to reduce distortions of tax liabilities and

additional tax burdens. At present, such an inflation accounting system is lacking in Germany. On the other hand, in the context of a series of tax reforms, Germany has continuously flattened its personal income tax rates and modified its tax system. The major political motives for all of these previous reform efforts appear to have been to generally reduce the overall tax burden, as well as to better reflect the ability-to-pay principle in the personal income tax system and to better guarantee the income redistribution among the different income groups in this country. In view of the aforementioned goals of these reforms, this study compares the extent to which previous reform efforts made in this country since 1958 have led to changes in the real, inflation-adjusted average personal income tax burden of single earners in 2014. By doing so, it highlights that understanding the tax reform from a ‘nominal’ point of view alone can fail to capture all of the real changes in the average tax burden, when the ‘hidden’ distortion caused by inflation prevails.

The comparison of real average personal income tax rates in 1958 and 2014 demonstrates that the annual taxable income group earning around 50 000 to 120 000 euros (and from 40 000 to 180 000 euros with the solidarity surcharge both expressed in terms of 2014 prices) are worse off under the previously implemented series of tax reforms, for example, for a taxable income of 70 000 euros, $t_{ave} = 29$ per cent in 1958, while the tax rate slightly grew to 30 per cent (and 32 per cent with the solidarity surcharge) in 2014. Over the same period, by contrast, there were clear real income tax reductions for lower-income single earners (that is, $Y < 40\,000$ euros), even although solidarity surcharges also prevail. In addition, the previous tax reforms accompanied by the solidarity surcharge also reduced the real average tax burden for the upper-income class (with $Y > 180\,000$ euros) in Germany (see Figure 1). Moreover, a comparison of the coefficient of residual income progression (CRIP) between 1958 and 2014 indicates that a higher degree of progressivity applies for the taxable income from 10 000 to 80 000 euros in 2014, compared to that of 1958, which, in turn, implies that lower and middle-income single earners currently pay relatively higher taxes than upper-income earners when there is a marginal change in taxable income (see Figure 2). Such rather surprising effects on different income groups not only violate the basic ability-to-pay principle and disturb the smooth progressivity development, but also make the entire German personal income tax system less equitable in the long run, particularly for the middle-income group. More precisely, this study demonstrates the mismatch between the policy intention and the long-term real effects of personal income tax reforms in Germany and, at the same time, questions the effectiveness of income tax as a policy instrument aimed at rectifying inequality of disposable income and achieving greater redistribution among rich and poor single earners.

Timely inflation-indexation and its integration into the personal income tax system appears to be necessary in Germany, not only to effectively prevent the emergence of an extra bracket-creep tax burden in the short term, but also to avoid some of the adverse effects caused by individual tax reforms from a ‘real’ point of view, and ultimately to better shape its progressive tax system in the long run.

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6. APPENDICES

6.1 Appendix 1

Table A1: Estimated Real Average Personal Income Tax Function for Taxable Personal Income Range between 10 000 and 300 000 euros: 1958 and 2014

	Real average tax function	R ²
1958	$t_{ave} = -0.00000902725594x^4 + 0.00151268116206x^3 - 0.09349617017108x^2 + 2.79155224693159x + 4.06269344903740$	0.9931
2014	$t_{ave} = -0.00001506601961x^4 + 0.00257502270136x^3 - 0.15836489559227x^2 + 4.25412262468126x - 5.87076390678340$	0.9928
2014 (with solidarity surcharge)	$t_{ave} = -0.00001593188675x^4 + 0.00272259717316x^3 - 0.16740281526725x^2 + 4.49525620537543x - 6.24337980875862$	0.9926

Note: $x = Y/5000 + 1$, where Y = taxable income.

Source: Authors' own calculation.

6.2 Appendix 2

Table A2: Coefficients of Residual Income Progression (CRIP): A Comparison between 1958 and 2014

Taxable income (€ in 2014 prices)	CRIP 1958	CRIP 2014	CRIP 2014 with solidarity surcharge
5000	0.8115	1.0000	1.0000
10 000	0.9081	0.8415	0.8415
20 000	0.8756	0.8407	0.8305
30 000	0.8819	0.8387	0.8277
40 000	0.8778	0.8210	0.8081
50 000	0.8691	0.7953	0.7799
60 000	0.8435	0.8086	0.7936
70 000	0.8465	0.8313	0.8177
80 000	0.8466	0.8492	0.8367
90 000	0.8409	0.8637	0.8522
100 000	0.8411	0.8756	0.8650
110 000	0.8362	0.8856	0.8757
120 000	0.8360	0.8942	0.8849
130 000	0.8313	0.9015	0.8928
140 000	0.8305	0.9079	0.8997
150 000	0.8281	0.9135	0.9058
160 000	0.8242	0.9185	0.9111
170 000	0.8235	0.9229	0.9159
180 000	0.8232	0.9269	0.9202
190 000	0.8233	0.9304	0.9241
200 000	0.8237	0.9337	0.9276

Source: Authors' own calculation.

The implementation of informal sector taxation: Evidence from selected African countries

Godwin Dube¹ and Daniela Casale²

Abstract

This paper adds to a growing literature on informal sector taxation in developing countries by describing and analysing the experiences of four African countries (Ghana, Tanzania, Zambia and Zimbabwe) that have implemented informal sector taxes in recent decades. These taxes are analysed in terms of their revenue, technical (that is, administrative effectiveness, equity and efficiency) and governance implications. The evidence suggests that the revenue potential from informal sector taxation is low, in part because of the difficulty in designing and administering effective informal sector tax regimes. Based on the experiences in these countries, negotiating with informal sector associations might be a useful strategy to improve administrative effectiveness and state-citizen relations.

Keywords: informal sector taxation, presumptive taxes, Africa

¹ Postdoctoral Fellow, School of Economic and Business Sciences, University of Witwatersrand, Johannesburg, South Africa. Email: godwin.dube@wits.ac.za, telephone: +27 11 7178238.

² Associate Professor, School of Economic and Business Sciences, University of Witwatersrand, Johannesburg, South Africa. Email: daniela.casale@wits.ac.za, telephone +27 11 7178267.

1. INTRODUCTION

There is a growing interest, in both academic literature and policy arenas, in the possibility of taxing the informal sector in developing countries. This has been precipitated in part by the fiscal pressures experienced in many of these countries in the face of changing global trade and labour markets. Many developing countries traditionally relied on trade taxes as their main source of tax revenue (Bahl & Bird, 2008; IMF, 2011). With trade liberalisation (and the consequent drop in tariff rates) an important source of tax revenue has been undermined, creating concerns in the tax community around how developing countries can overcome the shortfall (Baunsgaard & Keen, 2005; Glenday, 2006). In addition, the large, and often growing, informal sector in many developing countries has resulted in a significant erosion of the formal tax base (Bird & Zolt, 2008). Given the limited tax revenues being generated from the small formal sector, there have been a number of calls to consider taxing informal sector enterprises (Bird & Zolt, 2008; Gupta & Tareq, 2008; Joshi et al., 2014).³

The existing literature on informal sector taxation can be divided into two main strands. The first, and larger body of work, focusses on the rationale for taxing those in the informal sector, with the main motivations including revenue collection, equity, efficiency, and governance considerations. Although the informal sector is difficult to tax because of administrative challenges, it is increasingly viewed as a potential source of tax revenue due to its large contribution to Gross Domestic Product (GDP) in many developing countries (Benjamin & Mbaye, 2012; Taube & Tadesse, 1996). In terms of equity, taxing those in the informal sector would alleviate concerns among formal sector taxpayers who view the non-payment of taxes by those with similar incomes in the informal sector as unfair (Fjeldstad & Heggstad, 2011; Terkper, 2003). From an efficiency perspective, it is argued that informal firms, in attempts to avoid the attention of tax authorities, may engage in behaviour that leads to lower output (Demenet & Razafindrakoto, 2013). The recent literature has also emphasised political and governance considerations in taxing the informal sector in developing countries. Taxation is seen as a way of promoting good governance because taxpayers will be motivated to hold leaders accountable (Joshi & Ayee, 2008; Joshi et al., 2014; Prichard, 2009).

The second strand in the literature analyses the general approaches that can be used to tax those in the informal sector. While extending existing indirect or direct taxes that apply to formal firms (but at lower rates, for example,) are possibilities in taxing the informal sector, the most common approach has been the use of presumptive taxes specifically designed to tax informal sector activities (Bird & Zolt, 2003; Joshi et al., 2014; Loeprick, 2009; Pashev, 2006). Presumptive taxes are generally based on presumed, rather than actual, income. For example, a fixed lump-sum amount paid quarterly by minibus taxis based on their carrying capacity (that is, number of seats) would constitute a presumptive tax. This type of tax is relevant for the informal sector because actual incomes are notoriously hard to monitor.

However, in the growing literature on informal sector taxation, very little has been written on the actual implementation of these taxes in countries where they have been

³ Also, there are increasing demands by international finance institutions for developing countries to finance their own development by mobilising domestic resources (IMF, 2003; OECD, 2015a).

introduced (see Bruhn & Loeprick, 2014).⁴ This paper aims to contribute to this area by describing and analysing the experiences of four African countries that have implemented informal sector taxes in recent decades, namely Ghana, Tanzania, Zambia and Zimbabwe. In particular, the paper will interrogate the revenue, technical (that is, administrative effectiveness, equity and efficiency) and governance implications of informal sector taxes based on the evidence available for these four country case studies. Drawing on the findings of this work, we also make suggestions for future research that is more policy-oriented in nature.

The paper is organised as follows. Section 2 clarifies the terminology used in this literature and defines key concepts, while Section 3 provides a brief review of the existing literature on the rationale for informal sector taxation in developing countries. Section 4 describes the policy and implementation of informal sector taxes in each of the four country case studies. Section 5 synthesises the findings, evaluating the general experiences in these countries in terms of the revenue, technical and governance criteria, and suggests areas for future research. Section 6 contains the conclusion.

2. INFORMAL SECTOR TAXATION: TERMINOLOGY AND KEY CONCEPTS

The concept of informal sector taxation is often met with some confusion, not least because the informal sector itself is a contested construct, but also because informal sector taxation can refer to quite different practices in tax policy, and often these are not clearly delineated in the literature. In this section we specify our definition of the informal sector and we attempt to shed some light on the different approaches that have been used in informal sector taxation.

We use the most common approach to defining the informal sector, namely the enterprise approach, which classifies as informal, businesses or operations that are not registered under the relevant national regulations, such as taxation or social security laws (Hussmans, 2004; ILO, 2002). The terms ‘informal sector’ and ‘informal economy’ (the latter term used to collectively refer to unregistered enterprises and workers without formal contracts in formal and informal enterprises) are often used interchangeably in the tax literature. However, we prefer to use the term ‘informal sector’ here, as taxing the informal economy (which usually also includes social security contributions for workers) will involve a different set of considerations from taxing unregistered enterprises falling outside the standard tax system. In addition, tax policy in most countries that have attempted to collect revenue from those outside the standard tax regime, concentrates on unregistered enterprises.

Some scholars find the concept of informal sector taxation confusing, precisely because of the common association of informality with tax evasion or being unregistered. However, as Joshi and Ayee (2008: 186) point out, informal sector taxation, is not an ‘oxymoron’. A common misperception is that taxing the informal sector always has as its main goal formalisation (that is, simply drawing unregistered firms that are eligible into the standard tax system), but in reality there are a range of practices which fall along a spectrum. At the one end, is what we might call ‘taxation

⁴ Two possible reasons suggested by Bruhn and Loeprick (2014) for the dearth of literature on the implementation and impact of presumptive taxes are the small contribution of informal sector taxes to total revenues, and the scarcity of information on the operations of small firms.

as formalisation', where informal sector tax policy is indeed mainly concerned with registering eligible firms and/or bringing them into the standard tax net. At the other end, informal sector taxation refers to simplified taxes specifically designed to raise revenue from informal businesses without the intention of necessarily formalising these enterprises.

In some countries the implementation of simplified taxes specifically meant for those in the informal sector is viewed as a kind of formalisation by governments and researchers, placing them somewhere along the spectrum (Bruhn & Loeprick, 2014; De Mel et al., 2012; Fajnzylber et al., 2011). For example, in Brazil, the *Simples Nacional* (for firms with gross revenues between US\$120 000 and US\$1.2 million) and *Microempreendedor Individual*, taxes covering even the smallest enterprises (and workers in those enterprises) with gross revenues below US\$20 000, are viewed as a process of formalisation. Similarly, in Uruguay, the simplified *monotributo*, a tax which is supposed to be paid by all microenterprises in the informal economy, has as its principal goal formalisation (ILO, 2014: 6–8; OECD, 2015b).

In this paper, we focus on countries in which informal sector tax policy has involved the levying of administratively simple taxes, where unregistered businesses are allowed to remain in the informal sector as long as they pay the taxes designed specifically for their sector. The distinction between this form of informal sector taxation on the one hand and 'taxation as formalisation' on the other is important, as these two approaches are likely to have different policy goals and implications. For example, the taxation as formalisation literature (De Mel et al., 2012; McKenzie and Sakho, 2010) emphasises the benefits of formalisation on firm growth (for example, greater access to markets, credit and finance) and looks at the possible ways in which incentives for this growth can be implemented. However, growth may not be important to informal sector firms that have a small optimal size (Kanbur, 2014). Therefore, these firms will require different (that is, non-growth related) incentives for tax compliance, such as the provision of services specific to this sector or the opportunity to engage policy-makers on matters of concern to their operations (such as crime or harassment by officials) (Joshi et al., 2014).

Collecting taxes from small unregistered operators clearly comes with its own set of challenges, which is why taxing the informal sector through the standard tax regime is difficult.⁵ Enterprises in this sector are usually highly mobile, with high churn out rates, informal business structures and weak accounting systems. Also, determining which firms, in a highly heterogeneous sector (Kanbur, 2014; Zinnes, 2009), have incomes that are high enough to be eligible for the standard tax system (but are simply not paying these taxes), and which cannot reasonably be expected to pay at standard rates, is not easy, especially when incomes in this sector are highly variable.

An increasingly popular way of taxing the informal sector in developing countries, therefore, is through a 'single tax', generally in the form of a presumptive tax that replaces the various taxes that are usually paid separately under the standard tax

⁵ It is possible to collect revenue from small informal firms through the extension of existing taxes by, for example, using reduced corporate income tax (CIT) rates for microenterprises below the VAT registration threshold (Bird & Wallace, 2003). However, Loeprick (2009) argues that this approach is unlikely to be appropriate in developing countries that have large informal sectors, as the filing of returns would make it difficult for many small businesses to comply.

system (that is, VAT on sales⁶, personal income tax, corporate income tax, and so forth). According to Ahmad and Stern (1991: 276), ‘the term presumptive taxation covers a number of procedures under which the “desired” base for taxation (direct or indirect) is not itself measured but is inferred from some simple indicators which are more easily measured than the base itself’. For example, presumptive tax rates can be based on turnover (for firms that maintain records of sales), estimates of taxable income based on indicators of income capacity or business performance (for example, a minibus taxi’s carrying capacity), a fixed lump-sum tax (that is, standard assessment) for all operators in a particular informal sector activity, or a combination of these approaches (OECD, 2015b). Although presumptive taxes may introduce equity and efficiency concerns, the main objective of these taxes is to simplify tax administration through reducing both compliance and collection costs, while raising some revenue from informal enterprises (Bird and Zolt, 2003; Pashev, 2006; Taube & Tadesse, 1996).⁷

3. MOTIVATIONS FOR TAXING THE INFORMAL SECTOR

An important question, given the inherent difficulties in collecting taxes from the informal sector, is why then do governments engage in this practice? The most obvious, and it seems the most common motivation, is to raise revenue. The informal sector’s contribution to GDP in developing countries is large, and in some cases, growing (Benjamin & Mbaye, 2012; Schneider et al., 2010). For instance, in sub-Saharan Africa, the informal sector’s contribution to GDP rose from 24.1 per cent in the 1990s to 31.3 per cent in the 2000s, while in Latin America the increase was from 13.6 per cent in the 1990s to 24 per cent in the 2000s (Charmes, 2012: 119–120, 128). However, the focus on the share of GDP as an indicator of revenue potential may obscure the fact that this sector has numerous small enterprises with low incomes (Djankov et al., 2002; Phiri & Nakamba-Kabaso, 2012). Therefore, segmenting this sector into firms that cannot be expected to pay taxes and those that can is a challenging but important consideration in informal sector tax policy (IMF, 2007).

Very few studies give an indication of the tax revenues collected from the informal sector. Data, even on basic revenue information, is often difficult to obtain in many developing countries. However, the available evidence indicates that revenue collections from the informal sector are low (Araujo-Bonjean & Chambas, 2004; Mwila et al., 2011). The costs of administering informal sector taxes can be high though, both in terms of the costs incurred by the tax authorities in identifying taxpayers and collecting the taxes, and the costs incurred by informal enterprise owners in complying (Loeprick, 2009). It is therefore not surprising that in the past decade many governments have focused on improving administrative effectiveness by making presumptive tax systems simpler, in an effort to improve the revenue to cost ratio of collection.

⁶ Informal firms will pay VAT on their inputs purchased from the formal sector, as they will not be able to claim a refund for the VAT on inputs. However, if informal enterprises purchase a significant portion of their inputs from other informal traders or produce these themselves, they would be able to escape the VAT net too.

⁷ Methods using turnover are generally fairer than those using estimates of income or lump-sum amounts (especially if profit rates are similar across businesses in the informal sector activity in question), however, they require those in the informal sector to keep records of sales, and many informal businesses do not.

From an equity perspective, there have been arguments for an almost total exemption from direct taxes for the informal sector, particularly those taxes paid to central government (Pimhidzai & Fox, 2012; Prichard & Bentum, 2009). Pimhidzai and Fox (2012) argue that informal sector taxes tend to be regressive, threatening the viability of the smallest enterprises (considering that most of them might already be paying local taxes such as trading licenses, operating permits or user fees). Informality may be the only viable alternative for many people in developing countries who have been 'excluded' from participating in the formal sector. In such cases, attempts to tax these enterprises may not only result in inequity (Carroll, 2011) but may also destroy informal jobs (La Porta & Shleifer, 2014).

While this may be true for the smaller enterprises, there is evidence that those in the informal sector are not always poor (Gurtoo & Williams, 2009; ILO, 2002). Not taxing these informal enterprises similarly gives rise to inequities and dissatisfaction among those with similar or lower incomes in the formal sector (Fjeldstad & Heggstad, 2011). There is a dearth of empirical evidence on the equity implications of presumptive taxes in countries where they have been implemented. The few existing studies have mostly just highlighted that the lack of tax-free thresholds in many presumptive tax systems, a feature common to most personal income tax (PIT) systems, is likely to result in inequity vis-à-vis the PIT (Memon, 2013; TRA, 2011).

Economic efficiency refers to the optimal allocation of resources in the economy. Taxes may distort economic decisions resulting in misallocations and a loss of welfare over and above the revenues collected—the excess burden of taxation (Rosen, 1995). By not paying taxes, informal enterprises are therefore escaping the distortionary effects of taxation, and bringing these firms into the tax net may actually hinder their operations through tax-induced behavioural changes that result in reduced output (Alm et al., 2004).

However, while informal enterprises may escape taxation (and its distortionary effects), non-compliance can create inefficiencies too. Informal firms often have to devise means of avoiding attention (and harassment) by the police and government authorities. Corrupt payments to government officials may be higher than tax liabilities (Joshi & Ayee, 2008). Also, for those informal firms that want to grow, not paying taxes may exclude them from accessing larger product markets, formal credit, or business training and support programmes. This is likely to result in such firms operating at a sub-optimal level. However, apart from the taxation as formalisation literature with its focus on firm growth and productivity (Fajnzylber et al., 2011; Leal Ordonez, 2014), very little has been written on the efficiency implications of informal sector presumptive taxes.

Increasingly, attention is being paid in the literature to the potential political and governance benefits of informal sector taxation, with the suggestion that informal sector tax policy should go beyond revenue and technical considerations (Fjeldstad & Heggstad, 2011). Joshi et al. (2014) identify from this literature a number of channels through which these benefits may transpire. The state, as a way of encouraging quasi-voluntary compliance, may be more responsive to taxpayers (Bodea & LeBas, 2014; Moore, 2004), and taxpayers may be more likely to make demands from the state and hold government officials to account (Prichard, 2009). In addition, taxing informal enterprises may encourage bargaining between the state and its citizens, through the involvement of informal sector associations, for example, a benefit which may not be

insubstantial in countries where the informal sector accounts for a large share of GDP or employment (Joshi & Ayee, 2002).

4. TAXING THE INFORMAL SECTOR IN PRACTICE

According to the IMF (2007: 27), more than 25 countries in sub-Saharan Africa and 14 countries in Latin America have a special tax regime for small enterprises (which includes the informal sector). The literature on informal sector taxation described above has focused mainly on conceptual issues, however, with little empirical evidence available on how these taxes have been implemented, and with what effect. In this section, we describe the various practices and experiences of four countries that have implemented presumptive taxes in recent decades—Ghana, Tanzania, Zambia and Zimbabwe. These countries were selected as there was relatively more evidence available in the literature and in government records on the presumptive tax policies implemented in these countries, including changes in coverage over time and revenue collected. It goes without saying however, that the experiences of these countries may not be representative of informal sector tax implementation more generally, and at the very least, will provide some insight into presumptive taxation in sub-Saharan Africa specifically.⁸

4.1 Identifiable Grouping Taxation (IGT) in Ghana

Efforts to tax the informal sector in Ghana began as early as 1963 with a standard assessment that was levied on individuals and small businesses on the basis of their activities (requiring quarterly lump-sum payments regardless of turnover) (Joshi & Ayee, 2002: 5). Ghana's Internal Revenue Service (IRS), after consulting with informal sector associations, replaced the standard assessment with a new presumptive tax system called Identifiable Grouping Taxation (IGT) in 1987. The main motivation for collecting revenues from the informal sector under this new system, using associations as agents, was to broaden the tax base and 'ensure a fairer distribution of the tax burden' (Ayee, 2007: 4). The IGT, which Joshi and Ayee (2002: 184) refer to as 'associational taxation', in which associations were used as agents in the collection of taxes (essentially a form of tax farming),⁹ replaced a system which had been riddled with corruption (Joshi & Ayee, 2008). This new arrangement, first implemented in the transport sector, was extended to associations in 32 other informal sector activities later in 1987 (Joshi & Ayee, 2002: 6).

⁸ Although the implementation of informal sector taxation has been documented for some Latin American countries (Fajnzylber et al., 2011; ILO, 2014; OECD, 2015b), as noted earlier, the practice in these countries is closer to 'taxation as formalisation' which we do not focus on in this paper.

⁹ This form of tax farming is different from the practice of many colonial administrations (that required colonies to be self-financing) where traditional leaders or native administrators were used to collect hut and poll taxes (Bräutigam et al., 2008). Although there are similarities between the collection of hut taxes and associational taxation (that is, both involve a delegation of authority to collect taxes on behalf of the state), there are important differences. Firstly, the hut tax applied to every male over eighteen years of age in a village (Konczacki et al., 2016) whereas associational taxation in Ghana was only collected from the members of that association operating in the informal sector (Ayee, 2007). Secondly, chiefs and native administrators in Africa were part of the government administrative structure and therefore should have been, at least in theory, interested in both the process and outcome of tax collection (Boahen, 1985; Stella, 1993) whereas associations in Ghana were not part of government administration and were concerned only with the outcome of tax collection (Joshi & Ayee, 2002).

In the transport sector, the tax was initially levied daily and later weekly (as a way of reducing daily printing and monitoring costs), and only when vehicles were actually operating. This allowed the tax authority to keep its collection costs at 2.5 per cent of the total revenue collected, as this was paid to the informal sector associations as a collection fee (Ayee, 2007: 10).¹⁰ In this new system, taxi-cabs and minibus taxis paid a fixed amount related to the vehicle's capacity while long distance vehicles paid a percentage of their turnover per trip (Joshi & Ayee, 2002).

The arrangement was a result of the good relations that the Ghana Private Road Transport Union (GPRTU) had with the Rawlings regime (1981–2000). As a result of this arrangement with associations, tax revenues from the informal sector (as a percentage of total tax revenue) gradually rose from 0.97 per cent in 1988 to 1.6 per cent in 1991 (Ayee, 2007: 15). Although these figures are low, they are still much higher compared to the other countries reviewed.

Nonetheless, the system was not without its problems. Even though tax revenue collection was outsourced to the associations, the IRS's administrative capacity was weak and it did not effectively monitor the associations (Joshi & Ayee, 2002). According to Ayee (2007), in many instances, these associations failed to pass on revenue collections to the IRS and were often not internally democratic. Ayee (2007: 15) points out that from a peak of 1.6 per cent in 1991, the following years saw decreases in the revenues collected and by 2002 these amounted to only 0.39 per cent of total revenues. This resulted in the abolition of this system in 2003 and its replacement with a new presumptive tax, the Vehicle Income Tax (VIT). The VIT is a lump-sum tax that is paid quarterly, with presumptive tax amounts ranging from US\$3 to US\$60 depending on the type of vehicle (ATAF, 2014a: 10).¹¹ Ayee (2007: 15) reports that in Ghana in 2003, revenue from these presumptive taxes increased to 5.3 per cent of total revenues after the tax authorities stopped using associations in the collection of revenues.

These changes in the presumptive tax system in Ghana point to the difficulty in taxing the informal sector in a fair and administratively effective manner, even in a country with relatively well-organised informal sector associations. Nonetheless, according to Ayee (2007), although the use of associations in the collection of tax revenues from transport operators was discontinued, important lessons had been learned. The experiences in Ghana showed that informal sector associations can, under certain circumstances, be used to collect taxes from their members. By the time it was abolished, the system had also inculcated a taxpaying culture among those in the urban informal transport sector. The compliance rate in the transport sector in 2010 was estimated at 85.5 per cent (ATAF, 2014a: 14). Further, it showed the importance of bargaining and negotiations around taxation between the state and those in the informal sector.

¹⁰ Although these collection costs are much lower than those incurred by other tax authorities that have implemented similar taxes (for example, Zambia, discussed later in this section), they are higher than collection costs in the formal sector in countries such as South Africa at 0.97 per cent in 2013–14 (National Treasury/South African Revenue Service, 2014: 13) and the Organisation for Economic Co-operation and Development (OECD) countries where collection costs ranged from 0.30 per cent in Switzerland to 1.72 per cent in Poland (OECD, 2011: 126–127).

¹¹ For example, for a commuter omnibus with a carrying capacity of 19 people, the quarterly tax amount in 2013 was US\$7 (ATAF, 2014a: 21).

However, as Joshi and Ayee (2008) point out, the effectiveness of this approach is likely to depend on contextual factors. These factors include such things as the informal activity in question (for example, associational taxation might not be possible with cross-border traders), the level and depth of organisation within the informal sector associations, the willingness of the state to engage these associations, and its ability to monitor their performance. The last point is particularly important if corruption is not merely to be transferred from the tax authority to associations.

4.2 The block management system: Tanzania

According to the Tanzania Revenue Authority (TRA)¹², presumptive taxes were introduced in 2001 as a way of widening the tax base and simplifying registration procedures (TRA, 2011). These taxes were levied on small individual traders with an annual business turnover of not more than Tshs 20 million (US\$9359)¹³ (TRA, 2015). Although traders are not required to maintain audited accounts, the system aims to encourage basic record-keeping by levying higher rates on those with incomplete records. In the absence of complete records, turnover is estimated by the commissioner (TRA, 2015). The progressive turnover-based presumptive tax rates are divided into five bands as shown in Table 1

Table 1: Presumptive tax rates in Tanzania

Annual turnover	Tax payable if records are incomplete	Tax payable if records are complete
Not exceeding Tshs 4 Million	NIL	NIL
Above Tshs 4 Million but not exceeding Tshs 7.5 Million	Tshs 150 000	3% of the turnover in excess of Tshs 4 Million
Above Tshs 7.5 Million but not exceeding Tshs 11.5 Million	Tshs 318 000	Tshs 135 000 + 3.8% of the turnover in excess of Tshs 7.5 Million
Above Tshs 11.5 Million but not exceeding Tshs 16 Million	Tshs 546 000	Tshs 285 000 + 4.5% of the turnover in excess of Tshs 11.5 Million
Above Tshs 16 Million but not exceeding Tshs 20 Million	Tshs 862 500	Tshs 487 000 + 5.3% of the turnover in excess of Tshs 16 Million

Source: TRA (2015).

¹² This section draws largely from a research report investigating informal sector taxation conducted by the Tanzania Revenue Authority (TRA, 2011).

¹³ US\$1:Tshs 2137 in November 2015.

As a way of strengthening the implementation of presumptive taxes, the TRA in 2005 introduced the block management system (BMS). The main objective of this system was to ensure tax compliance by identifying, registering and collecting tax information from all eligible small and medium-sized businesses in a particular sector or geographic location (ATAF, 2014b). Where there are many informal traders, city blocks were mapped and divided into small segments consisting of a few streets or a specific geographical area.

This focus on small unregistered enterprises necessitated a reorganisation of how the TRA operates and efforts were made to develop the human resources required for this new approach to informal sector taxation. Each block, under a team leader, was tasked with managing all the tax functions (that is, identifying, registering, educating and collecting taxes) for that particular block, with these teams being rotated after a certain period. Specific revenue targets were set as a way for measuring performance.

The evidence suggests an increase in the number of businesses registering for tax purposes as a result of the BMS. Of the new enterprises that registered in the period 2006 to 2007, 16 per cent did so through the BMS. This increase continued in 2007 to 2008 and 2008 to 2009 where the new registrations resulting from the BMS grew by 43 per cent and 41 per cent respectively (Joshi et al., 2014: 1343). The BMS is also partly credited with the increase in the number of presumptive tax payers from 199 448 in 2005 to 2006 to 376 673 in 2009 to 2010 (TRA, 2011: 81).

Although the BMS has shown some apparent success in terms of the number of businesses covered, there are still concerns around viability. Revenues from these taxes have been low, with presumptive tax revenues as a percentage of total direct taxes remaining below 1 per cent for much of the period between 2003 and 2011 (they rose slightly above 1 per cent only in 2005 to 2006 and 2006 to 2007) (TRA, 2011: 88). Research by the TRA also indicates that there have been two major problems in administering these taxes. The first has been that of human resource constraints, with some blocks only having 20 per cent of the required manpower and others being administered remotely (TRA, 2011: 75). The second problem is that concentration of all the tax functions of identification, registration and assessment under a single tax officer may lead not only to poor internal controls and corruption but also the arbitrary use of power.¹⁴

Although the BMS has been lauded by the African Development Bank (AfDB, 2010) and the Africa Tax Administration Forum (ATAF), with the ATAF recommending its implementation in member countries, it has been criticised by the OECD. Labelling the system ‘invasive and probably counter-productive’ and illustrating ‘the potential for conflict between revenue collection, governance, and administrative efficiency’, the OECD (2012: 100) argued that the BMS is not an effective way of administering taxes due to the high costs incurred in raising tax revenues. However, we could not find any indication of the actual costs of administering the BMS as a percentage of revenue in Tanzania.

¹⁴ Although the BMS system concentrated the functions of taxpayer identification, registration and assessment with one officer, there are parallels with the problems experienced in Senegal and (other francophone countries) where functions were concentrated to some extent in a local tax office (see Benjamin & Mbaye, 2012; Dafflon & Madies, 2012).

In terms of equity, a TRA report opined that the BMS system is regressive as it penalises those who do not record their business transactions. These are the informal entrepreneurs who are more likely ‘to lack the capacity to keep proper accounts’ (TRA, 2011: 84). However, record-keeping (for tax purposes) is not only important in the implementation of fairer taxes but could also result in business performance improvements. Despite these various concerns, the BMS is still being used to collect taxes from Tanzania’s informal sector (ATAF, 2014b).

4.3 Informal sector taxes in Zambia

The Zambia Revenue Authority (ZRA) started implementing informal sector taxes in 2004 to raise revenues (Phiri, 2013). There are four main types of informal sector taxes in Zambia. First, there is the Turnover Tax (TOT), which is levied at 3 per cent on individuals and small firms with an annual turnover of up to ZMK200 million (US\$50 000)¹⁵. Second, there is the presumptive tax on minibus taxis, with annual taxes ranging from ZMK600 000 (US\$150) for a seating capacity below 12 to ZMK7.2 million (US\$1 800) for a seating capacity of 64 or above in 2009 (Mwila et al., 2011: 16). Third, ZRA levies the Advance Income Tax (AIT), a withholding tax collected from cross-border traders of 6 per cent of the value of imports exceeding US\$500. Fourth, there is the base tax of ZMK500 a day (US\$0.13), collected from marketeers (Mwila et al., 2011: 76–77). The TOT and presumptive tax on minibus taxis were introduced in 2004 with the base tax and AIT introduced in 2005 and 2007 respectively (Phiri, 2013).

The aim of the TOT is to make compliance easy for taxpayers by only requiring enterprises to keep track of total sales. The AIT is levied on the imports of those who are not registered with ZRA or who cannot provide proof of tax compliance. ZRA appoints agents to collect the base tax and presumptive tax on minibus taxis. These agents are selected through a competitive tender process and they are paid a commission commensurate with their bid which ranges from 10 per cent to 15 per cent of collections. In order to make compliance easy, the presumptive tax on minibus taxis was designed to allow operators to pay a fixed amount on days that the bus is in operation and they are not required to file any tax returns (Mwila et al., 2011).

According to Mwila et al. (2011: 77–78), whose report covered the implementation of informal sector taxes between 2004 and 2009, informal sector tax revenues rose from ZMK5.4 billion (US\$1.35 million) in 2004 to ZMK90.9 billion (US\$22.7 million) in 2009. As a share of total income tax collected, the informal sector contributed 0.3 per cent in 2004, reaching 0.9 percent in 2007, and 1.8 percent in 2009. In 2009, most of the presumptive tax revenue came from AIT (71 per cent) and TOT (27 per cent), with the tax on minibus taxis and the base tax contributing 2 per cent and 0.03 per cent respectively.¹⁶

Zambia segmented its revenue authority into three specialised offices dealing with large, medium and small taxpayers. However, the comparatively large small tax office (STO) has not brought in much revenue. For example, according to Phiri (2013: 34–35), the ZRA’s STO consists of 14 per cent of all employees but collects 2

¹⁵ US\$1:ZMK4000 in 2009.

¹⁶ Interestingly, the base tax collected from market traders, even though it provided very low revenues, was only successfully collected in areas where agents worked with local authorities, suggesting that the administration of this tax could be ceded to local government (Mwila et al., 2011).

per cent of total income tax revenue with many in the informal sector going untaxed in Zambia. In contrast, the medium taxpayers' office has 10 per cent of the ZRA's employees and collects 18 to 23 per cent of the income tax revenue. The LTO has a staff complement of 3.3 per cent of total employees but collects 75 to 80 per cent of the income tax revenues. Clearly, given the difficulty of implementing and enforcing presumptive taxes among informal businesses, the cost-benefit ratio related to collecting taxes from small taxpayers in Zambia is much higher compared to that related to collecting taxes from larger taxpayers, as is the case in many countries (see Benjamin & Mbaye, 2012; TRA, 2011). Mwila et al. (2011: xi) suggest the ZRA engage informal sector associations as the STO on its own is unlikely to collect significant revenues from this sector.

Mwila et al. (2011) argue that three main factors contributed to the limited success in collecting revenues from the informal sector in Zambia. First, poor record-keeping among those in the informal sector, many of whom are poorly educated, resulted in low revenues from the TOT. Second, the labour-intensive nature of informal sector tax administration in a sector where many people are not aware of these taxes, resulted in low revenues relative to collection costs. In the case of the base tax for example, the high collection costs operated as a disincentive to agents required to collect this tax from numerous marketeers in geographically dispersed areas. Third, agents who were appointed to collect presumptive taxes were not always viewed as legitimate by marketeers and minibus taxi operators, and were not able to impose sanctions on non-compliant informal sector taxpayers.

4.4 Presumptive taxes in Zimbabwe

The political and economic crisis in Zimbabwe has resulted in a large and growing informal sector, increasingly viewed as a potential source of tax revenue by the government (Government of Zimbabwe, 2005; Utaumire et al., 2013). The introduction of presumptive taxes, first implemented in 2005, was informed by research carried out by the Zimbabwe Revenue Authority (ZIMRA) on informal urban transport operators in particular. Other informal sector activities were later added to the presumptive tax schedule, such as hairdressing salons and cross-border traders in 2008, and cottage industry and bottle-store operators in 2009, although, unlike with the transport industry, no research was done by ZIMRA on the profitability of these sub-sectors.¹⁷ Table 2 shows Zimbabwe's presumptive tax schedule for 2010 to 2011, which includes ad valorem and lump-sum presumptive taxes, depending on the sector of activity.

¹⁷ The Ministry of Finance did not consult ZIMRA on presumptive tax amounts for the various sectors after dollarisation in 2009, and the Ministry went on to set the fares charged by minibus taxis at levels many in the informal sector felt were not feasible (Dube, 2014b).

Table 2: Presumptive taxes in Zimbabwe, 2010 to 2011

Type of activity	Description	Presumptive tax (USD per quarter) 2011
Minibuses	8 to 14 passengers	150
	15 to 24 passengers	175
	25 to 36 passengers	300
	From 37 passengers and above	450
Taxi-cabs	All	100
Goods vehicles	More than 10 tonnes but less than 20 tonnes	1000
	More than 20 tonnes	2500
	10 tonnes or less but with combination of truck and trailers of more than 15 but less than 20 tonnes	2500
Cross-border traders (VDP)	10% of value of goods imported	
Hairdressing salons	All	1500
Cottage industries	All	300
Bottle-stores	All	300
Small-scale miners	2% of value of minerals	
Driving schools	Class 4 vehicles	500
	Class 1 and 2 vehicles	600
Informal traders	10% of rental amount (for those renting premises and cannot provide proof of having paid any of the above presumptive taxes)	

Source: ZIMRA (2011)

Note: For minibuses, taxi-cabs and goods vehicles, the tax is charged per vehicle.

There has been some limited success in the implementation of presumptive taxes in Zimbabwe. Revenue from presumptive taxes increased from US\$1.39 million in 2009 to US\$13.3 million in 2011, although this represented only 0.14 per cent and 0.45 per cent of total tax revenues in 2009 and 2011 respectively (Dube, 2014a: 51). These figures suggest that the presumptive taxes collected are below the potential revenue from this sector given the extent of informality in Zimbabwe (as pointed out by many within ZIMRA itself).

There have been numerous challenges in the collection of informal sector presumptive taxes in Zimbabwe. The evidence indicates that resource constraints within ZIMRA, corruption, the selective application of regulations, high tax amounts in some sectors relative to earnings, and low tax morale have made the administration of these taxes difficult. In a survey of 150 informal traders conducted between 2011 and 2013 in Harare, 23 per cent of informal entrepreneurs reported not trusting the government, 41 per cent reported that tax revenues were 'ill-spent and mismanaged by government' and the majority did not feel that there were any programmes that benefitted the informal sector (Masarirambi, 2013: 170). Also based on interviews with informal traders (in the area encompassing Kariba, Chinhoyi, Kurima House Station and

Municipality of Kariba), Utaumire et al. (2013) found that a large number of traders were not even aware of informal sector taxes, and many expressed concern that they were not consulted in the setting of these taxes. In qualitative work by Dube (2014b), where around 50 informal operators in Harare were interviewed at length, there were also reports of coercive tax collection methods and frequent payments that had to be made by informal entrepreneurs to non-state actors such as touts and ruling party-aligned militias and 'committees' (Dube, 2014b).¹⁸ These actions are likely to undermine the potential, discussed in the literature (Meagher, 2013; Prichard, 2015), for informal sector taxation to promote better state-citizen relations.

In the study by Dube (2014b) the equity implications were also assessed, with respect to equity both within the informal sector and between informal sector operators and those in the formal sector. The study found that informal entrepreneurs generally bore a higher tax burden than those with similar incomes in the formal sector, given high presumptive tax rates and the lack of minimum income thresholds. However, there were income levels at which the CIT and PIT were inequitable vis-à-vis presumptive taxes in some informal activity classes (for example, taxi-cab and minibus taxi operators), with informal traders paying less in taxes than those paying CIT/PIT with comparable incomes. In addition, within the informal sector, operators in certain activity classes were eligible for much higher taxes than operators in other activity classes at the same income level (hairdressing salons bore a particularly high tax burden for example). The selective enforcement of presumptive tax collection (sometimes politically motivated) was another major source of inequity within the informal sector, and acted as a disincentive to continue paying taxes for those who were compliant.

Using the reported and observed behavioural changes resulting from the implementation of presumptive taxes, Dube (2014b) found that economic efficiency was potentially being undermined. Public passenger operators reported using long circuitous routes and parking their vehicles to avoid the police checkpoints, which would also result in man-hours being wasted if workers are not transported to their workplaces on time. An observation made by ZIMRA officials concerning hairdressing salon operators was that some of them were moving from areas of high visibility, such as the central business district, to residential areas. This could result in a reduction in output if clients can no longer get to the new site or the new site is not visible to potential customers.

5. DISCUSSION

In all four of the country case studies, the quest for revenues appeared to be the main motivation for introducing presumptive taxes. While the evidence indicates that the introduction of these taxes did result in increased revenues for the fiscus, presumptive tax revenue as a proportion of total revenue is nonetheless reported to be very low. It is possible that the sector's revenue potential has not been fully tapped, with many informal enterprises escaping the tax net, however, the challenges experienced at the administrative level suggest that this is unlikely to be easily remedied. The nature of

¹⁸ Corruption was identified as a particularly serious problem in Dube (2014b). One example of this was the practice of police officers, whose job it is to enforce the collection of presumptive taxes in the informal transport sector, also owning minibus taxis. According to the transport operators, this led to extortion and the harassment by police of their 'competitors'.

the informal sector makes it hard to tax. It is difficult to identify potential taxpayers, particularly when informal operators do not always have a fixed location, and many informal businesses have highly variable incomes and weak accounting systems.

Discussion on how to improve informal sector tax administration in the tax literature has included the setting up of STOs, tax farming (using agents to collect taxes) and fiscal decentralisation (using local authorities to collect tax revenues) (Kiser & Baker, 1994; Loeprick, 2009; Terkper, 2003). According to this literature, an STO can improve enforcement and offer targeted taxpayer services (for example, education, feedback, and a channel for handling complaints and appeals). However, an STO on its own is unlikely to have a significant impact on administrative effectiveness. Tax authorities in most developing countries do not have the resources and manpower to effectively monitor and enforce compliance in the large informal sectors on their own (Araujo-Bonjean & Chambas, 2004; Mwila et al., 2011). As the case studies show, staff shortages were cited by tax authorities as a major constraint even in a country like Zambia with an STO.

Tax farming and fiscal decentralisation are the other approaches that have been suggested to improve the administration of presumptive taxes. The main objective of these approaches is to free the tax authority to focus on monitoring and selective audits.¹⁹ However, the Zambian and Ghanaian examples show that the effectiveness of tax farming depends on the capacity of the agents tasked with this collection and the ability to eliminate corruption.²⁰ Although there is growing literature on the importance of empowering local governments to collect taxes as they are closer to the informal sector (Bodin & Koukpaizan, 2008; Teobaldelli, 2011), this approach is likely to face the same challenges as those of tax farming if there are capacity constraints within local authorities, many of which are viewed as 'highly corrupt' (Fjeldstad, 2004: 10).

A possible way of improving informal sector tax administration is through the use of information technology. Internet-enabled phones, which are proving popular for such things as e-banking and e-payments in developing countries, could be used to allow taxpayers to pay their liabilities online, thus not only reducing the administrative burden but also reducing opportunities for rent-seeking behaviour among tax officials (Loeprick, 2009; Mwila et al., 2011). Investigating the ways in which information technology can be used in administering presumptive taxes is potentially an important area of further research.

There are indications that improvements in the administration of presumptive taxes, especially the encouragement of quasi-voluntary compliance, are likely to depend on the state engaging those in the informal sector (Joshi et al., 2014). The evidence suggests that involving informal sector associations may not only facilitate the acceptance of these taxes (a possible explanation for the relatively higher revenues

¹⁹ There are parallels between tax farming and public-private partnerships where agents are contracted by the government to provide services. There is a vast amount of literature on private-public partnerships which may prove useful in better understanding (and identifying solutions to) the problems of implementation in tax farming, and this may be an interesting area for future research. Further reading on this topic can be found in Osborne (2002), Bovaird (2004), and Hodge and Greve, (2007).

²⁰ While tax farming provides incentives for the maximisation of enforcement and collection, it is prone to abuse and corruption and has often resulted in overzealous tax collection. This is largely due to its incentive scheme which allows the tax collector to retain a portion of the taxes collected (Stella, 1993).

from presumptive taxes in Ghana) but also reduce administrative costs and improve state-citizen relations.

However, more research is needed on what Bräutigam et al. (2008: 3) refer to as the 'governance dividend' from informal sector taxation and, from the review of the literature, two main threads are suggested. First, while the few examples in the literature suggest that informal sector associations are important (Joshi & Ayee, 2002; Meagher, 2013; Prichard, 2015), very little has been written on the contextual factors that would result in fruitful negotiations and improved state-citizen relations. The specific ways in which these associations can be used (for example, involvement in tax design, tax collection or education campaigns) are likely to vary depending on the informal activity and various country-specific factors. Secondly, there are many informal sector operators who cannot be expected to pay presumptive taxes to central government on equity grounds (and who may not belong to associations). However, these operators are likely to pay various user and license fees to local authorities. There is therefore a need to investigate the type of (probably non-associational) bargaining that could occur at the local level, possibly through street committees (Mkhize et al., 2013), so as to allow operators who are not organised into associations to have a legitimate voice in negotiations.

Another way in which quasi-voluntary compliance might be encouraged is through the provision of amenities and work related infrastructure (a function that should be performed by local government but rarely is), business support and training, and the development of trade specific tax negotiation forums (which are consulted regularly as is often the case in formal sector/tax authority consultations) (Meagher, 2013; Prichard & Bentum, 2009). Quasi-voluntary tax payment is likely to be higher if taxpayers feel that they will get 'value for money' for the taxes that they are paying (Coolidge & Ilic, 2009; Therkildsen, 2006).

Understandably, there are many concerns around whether it is equitable to tax the informal sector, especially given perceptions that informal sector operators are mostly survivalist in nature. Presumptive taxes can result in inequities between informal and formal sector firms at comparable incomes, but also within the informal sector itself because of uneven coverage and differential rates by activity. In addition, because of their simple structure (often lump sum taxes, with no minimum thresholds), presumptive taxes tend to be regressive, taxing those with lower incomes proportionately more. Also, when based on (presumed) turnover or capacity, these taxes do not take into account losses in a particular month. Progressive presumptive taxes that are based on actual turnover, such as those implemented in Tanzania, go some way in addressing equity issues, but they require operators to keep basic records of sales. Even with good recordkeeping however, there could be inequities resulting from differences in profit margins among informal traders.

Issues of equity in taxation go beyond the facts; tax morale is important. The evidence suggests that many in the informal sector perceive presumptive taxes to be unfair vis-à-vis formal sector taxes even in cases where they are not. For example, in Zimbabwe, there were instances where the CIT and PIT were inequitable vis-à-vis presumptive taxes (with those on the CIT/PIT paying more at comparable incomes). In spite of this, some respondents in the informal sector who were receiving favourable treatment still felt that these taxes were unfair (Dube, 2014b). These misperceptions can discourage those in the informal sector from paying, resulting in low revenue collection. This incomplete coverage leads to disenchantment among

those in the informal sector who are compliant (or who cannot avoid the tax net). Outreach programmes, possibly using informal sector associations, may be an important way of increasing taxpayer awareness of the equity implications of these taxes.

The public finance literature shows that there is a direct relationship between tax rates and the economic inefficiency or excess burden created by taxation (Slemrod & Yitzhaki, 1996). Presumptive taxes at low rates therefore potentially can minimise the economic inefficiency associated with taxation. Basing the tax rate on average ratios (profits to sales) and average income may even be able to incentivise these enterprises to be more efficient in their business operations, as the marginal tax rate on the additional income above the average would be zero (Pashev, 2006).²¹ However, the evidence suggests that in some countries (for example, Zimbabwe), poorly researched presumptive tax design and high effective rates (which are sometimes so high that no enterprise can reasonably be expected to pay them), have been counter-productive. Indeed, there are reports of operators reducing operations or moving to less visible areas in order to avoid the attention of the tax authorities (Dube, 2014b). Few studies mention economic efficiency in informal sector taxation (Dube, 2014b; Memon, 2013; Taube & Tadesse, 1996), pointing to the need for more work in this area.

In summary, presumptive taxes, which are designed to reduce both collection and compliance costs in informal sector taxation, will inevitably result in trade-offs between administrative effectiveness and equity, and potentially efficiency. Informal sector tax implementation has largely focused on simplification (and enforcement) without sufficiently considering the equity and efficiency implications of raising revenue through these taxes. Pashev (2006: 418) argues that this focus is justified as presumptive taxes should not try to 'compete' with the standard tax system and trying to make these taxes fairer may result in a complicated tax system. However, there are both theoretical and empirical reasons for the inclusion of equity and efficiency considerations, as poorly designed presumptive tax systems which do not address these issues may actually compromise collection and compliance efforts.

While the challenge of balancing the need for simplicity with equity and efficiency also exists in formal sector taxation, the unique nature of informal sector activity presents additional complications. The encouragement of basic recordkeeping among operators, more research on informal sector operations by the relevant authorities, the engagement of informal sector associations, and the constant monitoring of tax rates/amounts (given high inflation rates in many developing countries), are some of the factors that may contribute to better designed informal tax systems.

²¹ However, there is very little empirical evidence in support of this argument (Skinner, 1991). Also, the heterogeneous nature of informal enterprises means it is difficult to make reliable estimates on the appropriate tax level that would increase productive efficiency (Rajaraman, 1995).

6. CONCLUSION

In this paper we described the experiences of four African countries (Ghana, Tanzania, Zambia and Zimbabwe) that have implemented informal sector presumptive taxes in recent decades, assessing the revenue, technical and governance implications of these taxes. We found that although presumptive tax collection has increased revenues for the fiscus in these countries, informal sector revenue as a percentage of total tax revenues has remained low. This is in part due to the weak administration of often poorly designed tax systems, with resource constraints in revenue collection resulting in widespread evasion. In addition, there is some evidence that these taxes are generally viewed by informal sector operators as inequitable vis-à-vis formal sector taxes (even if in some cases they may not be, at comparable incomes) and that they tend to be regressive due to the lack of minimum thresholds, the use of flat rates, and the reliance on presumed income. Varying tax rates and uneven collection across different activity classes in the informal sector further contributes to inequity within the sector. There are also some indications that these taxes may be compromising efficiency as they are perceived to be too high leading to behavioural responses that reduce output, and in turn welfare.

Based on the country case studies, we have shown that relying only on reforms within the tax authority (for example, establishing STOs) or outsourcing the collection of taxes to agents has not resulted in effective tax administration or necessarily strengthened state-citizen relations. The high number of informal sector enterprises in developing countries, and the variability and mobility in their operations, is likely to make it difficult for even the most capable tax authorities to effectively administer these taxes. There is some evidence that negotiating with those in the informal sector on taxation issues through associations, and perhaps even at the local government level, might not only improve administrative effectiveness but may be an important way of increasing the governance benefits of informal sector taxation. Quasi-voluntary compliance may also be encouraged if the costs of taxation were more clearly linked to the benefits, such as the provision of services specifically tailored to those operating in the informal sector. Education campaigns that raise awareness about the benefits that result from the taxes collected, and about the efforts made by tax authorities to reduce unfairness (such as introducing low but graduated tax rates according to turnover for instance), may also improve tax morale and ultimately revenue collection.

Nonetheless, our paper highlights the need for much more research in this area, particularly of a policy-oriented and context-specific nature, where the focus is on practical solutions to overcoming the challenges in implementing informal sector taxation in specific countries. Given the legitimate need for governments to raise revenue in developing countries in the face of (growing) informality, how to design and implement informal sector tax systems without further disadvantaging or alienating those who can least afford it, is paramount.

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The UK general anti abuse rule: Lessons for Australia?

Benjamin Kujinga¹

Abstract

Australia and the UK have general anti-avoidance rules (GAAR) in their respective income tax legislation. The UK GAAR is relatively new, while the Australian GAAR, bar a number of amendments over the years, was introduced in 1981. This article comparatively analyses these two GAARs with a view to determining whether certain aspects of the UK GAAR provide lessons for certain perennially controversial aspects of the Australian GAAR. In this regard, this article particularly focuses on the way these two GAARs define an arrangement or a scheme, identify a tax benefit and target impermissible or abusive tax avoidance, before concluding with the lessons that can be learned from the UK GAAR.

Keywords: Tax avoidance, general anti-avoidance rule, general anti-abuse rule, Part IVA, tax benefit, tax avoidance scheme/arrangement, judicial anti-avoidance doctrines, substance over form, double reasonableness test, predication test

¹ Senior Lecturer, University of Pretoria Faculty of Law, Department of Mercantile Law. Email: benjamin.kujinga@up.ac.za.

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1. INTRODUCTION

General anti-avoidance rules (GAARs) are used as broad mechanisms to curb impermissible tax avoidance in many jurisdictions. Australia and the UK are two of these jurisdictions. Due to the dynamic and complex nature of the target of GAARs, GAARs isolate or define impermissible tax avoidance in different ways, even though there are certain broad similarities. When it comes to GAARs, Australia has a significantly longer history than the UK. This implies that the UK had the advantage of drawing lessons from this history in drafting its own GAAR. It also means that Australia might derive lessons from the UK GAAR in return. This article will discuss the UK and Australian GAARs in detail for the purposes of determining whether there are any lessons for Australia in the UK GAAR. The GAARs will be discussed separately followed by a comparative analysis of the concepts in the GAARs.

The UK GAAR will be discussed in Section 2. The discussion will start with the background to the GAAR in the UK. Aspects of this background that have influenced the nature and scope of the UK GAAR will be highlighted. The provisions of the UK GAAR will be referenced and discussed. The discussion will be limited to the core provisions of this GAAR and supporting provisions will only be discussed to the extent that they help to clarify the core provisions. The UK GAAR requirements that must be established before the GAAR can apply will also be covered in Section 2. The definition of tax arrangements, the purpose requirement, the tax advantage requirement and, most significantly, the provision that sifts impermissible tax avoidance from the sea of avoidance transactions will be considered.

Section 3 of this article will review the Australian GAAR. This part will start with a background analysis and how this background has affected the current Australian GAAR. The analysis of the GAAR will also focus on the core provisions. Possible upcoming amendments to the Australian GAAR, which add provisions on diverted profits and a new multinational anti-avoidance law, are beyond the scope of this article and will therefore not be considered. The emphasis will be on the provisions on purpose, tax benefit, and the establishment of the scheme, and how these provisions have been interpreted by the courts.

Section 4 will establish and analyse three main points of comparison between the Australian and the UK GAARs. The aim of this comparative analysis will be to determine whether certain approaches taken in the UK GAAR should be considered in Australia.

2. THE UK GENERAL ANTI ABUSE RULE

2.1 Background

To understand the tenets of the UK GAAR, it is important to analyse its unique background. Unlike the Australian and other GAARs, the UK GAAR was introduced after a period of extensive consultation on whether the UK needed a GAAR and, if so, the type of GAAR that would best suit the UK. This background can be divided into two distinct periods, namely the judicial period, where the need for a GAAR was not considered until 1998, and the period which followed when there was acceptance that the GAAR was needed in the modern world.

The judicial period was arguably largely based on the *Ramsay* approach to tax avoidance schemes.² This *Ramsay* approach was a reaction to the unintended effect of Lord Tomlin's submission in the famous *IRC v Duke of Westminster*³ case where he stated that:

It is said that in revenue cases there is a doctrine that the court may ignore the legal position and regard what is called "the substance of the matter", and that here the substance of the matter is that the annuitant was serving the Duke for something equal to his former salary or wages, and that therefore, while he is so serving, the annuity must be treated as salary or wages. This supposed doctrine (upon which the Commissioner apparently acted) seems to rest for its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned, for the doctrine seems to involve substituting "the uncertain and crooked cord of discretion" for the golden and straight metwand of the law. Every man is entitled if he can to order his affairs ... the substance seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.⁴

The reaction to this submission was the widespread use of tax avoidance schemes purchased from promoters. These schemes contained composite transactions that contained a series of transactions that appeared to be independent but were, in reality, connected and aimed at avoiding tax by cancelling out one another. The taxpayers argued that the *Duke of Westminster* case was authority for the proposition that the courts were obliged to recognise the independence of each transaction in the composite transaction, meaning that the fiscal reality of the whole transaction was to be ignored. In other words, the legal position was that the transactions were separate, but the substance was that the transactions were connected and self-cancelling. Lord Tomlin's statement above appears to have done away with the substance and promoted the legal separation of transactions in a series.

The *Ramsay* approach basically countered this trend and stated that self-cancelling transactions could be disregarded for tax purposes if there was evidence of the fact that the transactions were preordained to take place in a particular order.⁵ As time went on, the *Ramsay* approach evolved to include the application of purposive statutory interpretation to composite transactions, and not to individual transactions in the composite transaction.⁶ It was therefore a judicial anti-avoidance rule that negated

² Derived from *WT Ramsay Ltd v IRC*; *Eilbeck v Rawling* [1981] 1 All ER 865 HL.

³ [1936] AC 1 (HL).

⁴ Ibid 22.

⁵ While the *Ramsay* case is widely credited with the introduction of the judicial anti avoidance approach in the UK, it must be stated that the seeds for viewing composite transactions with self-cancelling individual transactions as a whole were sown in *Floor v Davis* (1979) 52 TC 609. The majority in this case stated that the Crown's argument that the self-cancelling transactions had to be viewed as whole was contrary to the principles in *IRC v Duke of Westminster*. In a dissenting judgment, Everleigh J stated at 609 that 'I see this case as one in which the court is not required to consider each step taken in isolation'.

⁶ The purposive approach under *Ramsay* is encapsulated in *Collector of Stamp Revenue v Arrowton Assets Ltd* (2004) 6 ITLC 454. In *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51 [53] it was stated that 'the driving principle in the *Ramsay* line of cases continues to involve a

the need for a GAAR in the UK. The *Ramsay* approach, being more of a general anti-avoidance mechanism, was not the only anti-avoidance mechanism in the UK. Reliance was also placed on a network of specific anti-avoidance rules (SAARs).

A part of the judicial period was also characterised by consultations on introducing a statutory GAAR in the UK. In 1997, the Tax Law Review Committee (TLRC) document, *Tax Avoidance*, stated that the plethora of SAARs should continue but the question whether these SAARs needed the support of the deterrent effect of a GAAR required consideration.⁷ In answering this question, the TLRC stated that it preferred a 'sensibly targeted statutory general anti-avoidance provision with a considered framework and appropriate safeguards for taxpayers'.⁸ The safeguarding of the rights of taxpayers was of particular importance to the TLRC. To reinforce this position, the TLRC stated:

[a] statutory provision that fails to address satisfactorily the issues to which we draw attention or to meet the criteria we identify (in particular for safeguarding taxpayer's rights) will inhibit the conduct of ordinary commercial and personal affairs and prove an administrative nightmare for the Revenue authorities. The Committee will vehemently oppose such a provision.⁹

The Inland Revenue submissions on the potential introduction of a GAAR, *A General Anti-Avoidance Rule for Direct Taxes: Consultative Document*, stated that the *Ramsay* approach created by the courts and legislation had put some limits on tax avoidance but 'new devices for avoiding tax' continued to be created.¹⁰ The Inland Revenue acknowledged that the UK was 'unusual among developed countries in having neither a statute nor an established legal principle to counter tax avoidance in general'.¹¹ Like the TLRC, Inland Revenue accepted that the UK needed a GAAR that would 'put a stop' to costly corporate tax avoidance.¹² Another key similarity between the submissions of the TLRC and the Inland Revenue is that the Inland Revenue stated that while 'the aim of a GAAR would be to reduce tax avoidance, it should not unduly harm the level of certainty of tax treatment enjoyed by businesses that are not engaged in avoidance'. The Inland Revenue went further and stated that '[a]n important criterion of the success of a GAAR would be that it should not unduly harm the levels of certainty which companies currently have about the tax treatment of a transaction'. In this regard, it can be said that the Inland Revenue strongly believed in a balanced GAAR whose success would not only be measured by the extent to which it deterred taxpayers from engaging in avoidance, but also by the extent to which it created certainty for taxpayers. However, the GAAR that Inland Revenue proposed was

general rule of statutory construction and an unblinkered approach to the analysing of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically'.

⁷ Available at <<http://www.ifs.org.uk/publications/1908>>.

⁸ Ibid vii–viii.

⁹ Ibid.

¹⁰ Available <<http://www.ifs.org.uk/comms/comm77.pdf>> [4.1].

¹¹ Ibid [4.3].

¹² Ibid [4.5].

rejected by the TLRC, which opined that the proposed GAAR was not ‘sensibly targeted’ and did ‘not offer appropriate safeguards for the taxpayers’.¹³

The 1998 discussions for the introduction of a GAAR in the UK ended with the TLRC’s response to the Inland Revenue’s proposed GAAR. While the TLRC unequivocally rejected the Inland Revenue’s proposed GAAR, a move that can be interpreted as showing a divided opinion on the scope and characteristic of a GAAR for the UK, the two parties were united in their view that the GAAR needed to be balanced, certain and protective of the rights of the taxpayer. This was a consistent theme from the main protagonists in the 1998 discussions on a GAAR for the UK.

More than a decade later in 2011, it was acknowledged that the UK needed a GAAR. Another round of consultations on a GAAR in the UK was initiated when the UK government agreed to establish a study group chaired by Graham Aaronson QC. The group published its report, *GAAR Study: A study to consider whether a general anti-avoidance rule should be introduced into the UK tax system* (the Report).¹⁴ The Report concluded that the UK needed a GAAR and provided reasons in support. On the *Ramsay* approach that had served as a general anti-avoidance mechanism, the Report opined that the approach was ‘a very positive development’ when it was created.¹⁵ The Report however indicated that the purposive construction of statutes that the *Ramsay* approach gradually embraced was exposed unfavourably since the courts had, in some cases, shown a tendency to use it to ‘stretch the interpretation of tax legislation in order to thwart tax avoidance schemes which they regard as abusive’.¹⁶ As a result, the Report stated that a new general anti-avoidance mechanism was required.

On the other forms of legislative anti-avoidance, the targeted anti-avoidance rules (TAARs) and the provisions requiring the disclosure of tax avoidance schemes (known as DOTAS), the Report stated that there were more than 300 TAARs. The Report also noted that the DOTAS were a useful source of information for HMRC on trends in tax avoidance schemes.¹⁷ However, the Report concluded that TAARs, DOTAS and purposive interpretation under the *Ramsay* approach combined were incapable of dealing with some abusive tax avoidance schemes.¹⁸ An example was given of the so-called SHIPS 2 scheme, which had seven steps that led to the creation of a tax loss that could be used to neutralise or reduce a taxpayer’s taxable income. This scheme was challenged in *Mayes v HMRC*,¹⁹ but due to the detailed and prescriptive nature of the statutory provisions relied on in the scheme, the court could not establish the purpose that had been violated and had to allow the tax advantages obtained.

¹³ TLRC, *A General Anti-Avoidance Rule for Direct Taxes: A response to the Inland Revenue’s Consultative Document*, vii <<http://www.ifs.org.uk/comms/comm77.pdf>>.

¹⁴ Available at <http://webarchive.nationalarchives.gov.uk/20130605083650/http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.pdf>.

¹⁵ Ibid [3.13].

¹⁶ The particular case that gave rise to these concerns is *HMRC v DCC Holdings* [2010] UKSC 58. See [25], where it appears that the court would stretch the statutory provision in question in order to avoid what it saw as an absurd result.

¹⁷ Above n 13, [3.17], [3.18].

¹⁸ Ibid [3.20].

¹⁹ [2011] EWCA civ 407.

In keeping with the conclusions of the TLRC and the Inland Revenue in 1998, the Report found that the question whether the UK needs a GAAR must be answered in the affirmative and comprehensively, namely that the UK needs a GAAR but one that adheres to certain principles.²⁰ This was consistent with the conclusions of the TLRC and the Inland Revenue in the sense that the Report concluded that a suitable GAAR for the UK needed to be targeted and not too wide as to affect permissible transactions. The Report noted that the GAAR needed to be guided by an overarching principle which required the GAAR to target ‘highly abusive, contrived and artificial schemes which are widely regarded as intolerable, but not affect the large centre ground of responsible tax planning’.²¹ Other principles proposed to guide the GAAR were, inter alia, the reduction of uncertainty, the counteraction of abusive schemes, distinguishing between responsible tax planning and abusive schemes.²²

In expanding on one of the principles mentioned above, namely distinguishing between responsible tax planning and abusive tax avoidance, the Report came up with an unusual way of drawing the line between what is permissible and what is not. It concluded that the preferable principle to distinguish between permissible and impermissible tax avoidance is one that focuses on what makes responsible tax planning permissible, and basing the analysis of abnormal transactions that have been set aside for further analysis on whether they contain elements of responsible tax planning.²³ This view is opposed to the approach followed in many GAARs of drawing this line by attempting to define impermissible tax avoidance. In this regard, the Report noted that the approach of the Hong Kong Court of Final Appeal in *Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue*,²⁴ that ‘the statutory purpose of s°61A is not to attack arrangements made to secure benefits which are legislatively intended to be available to the taxpayer’, was the right one for the UK. The principle that was proposed to distinguish between permissible and impermissible tax avoidance was thus whether a transaction can be said to be a reasonable response to the choices offered by tax legislation to obtain tax benefits.²⁵

On 12 June 2012, the UK government accepted the recommendation of the Report that a GAAR targeted at artificial and abusive tax avoidance was needed.²⁶ It then published *A General Anti-Abuse Rule Consultation Document*²⁷ (the Document) for consultation on the draft GAAR contained therein. This Document stated that the government accepted the conclusion in the Report that a broad GAAR would not be beneficial for the UK as a place to do business. The government also reaffirmed its desire that the GAAR must establish enough certainty for business and individual taxpayers to know the tax implications of transactions without incurring undue costs.²⁸

²⁰ Above n 13, [3.24].

²¹ Ibid [5.1].

²² Ibid section 5 of the Report.

²³ Ibid [5.19].

²⁴ FACV No 29 of 2008 [101].

²⁵ The Report, above n 13 [5.21]. The Report also contained an illustrative GAAR embodying the principles identified. For a discussion of this illustrative GAAR, see generally Helen Lethaby, ‘Aaronson’s GAAR’ (2012) 1 *British Tax Review* 27.

²⁶ See generally <http://www.hm-treasury.gov.uk/tax_avoidance_gaar.htm>.

²⁷ Ibid.

²⁸ Ibid [1.5] and [1.6].

In this regard, the Document stated that the proposed GAAR would have a narrower ambit than the GAARs in other countries.²⁹

2.2 The provisions

The UK GAAR was introduced in 2013 following the aforementioned consultation process. The scheme is detailed in Part 5 of the *Finance Act 2013* (UK). To reinforce that the GAAR is targeted at abusive tax avoidance, as opposed to tax avoidance, s°206(1) states that '[t]his Part has effect for the purpose of counteracting tax arrangements that are abusive'. Section°206(2) continues in the same vein, providing that '[t]he rules of this Part are collectively to be known as the general anti-abuse rule'.

Section°207(1) defines tax arrangements as those that can reasonably be said to have a sole or main purpose of obtaining a tax advantage. An objective sole or one of the main purposes to obtain a tax advantage is not the sole focus of the UK GAAR, which requires more. This is in line with its intended exclusive focus on abusive tax avoidance. Section°207(2) defines abusive tax arrangements as follows:

Tax arrangements are abusive if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances including:

- (a) Whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions
- (b) Whether the means of achieving those results involves one or more contrived or abnormal steps, and
- (c) Whether the arrangements are intended to exploit any shortcomings in those provisions.

This section contains the so-called 'double reasonableness' test. Its reference to 'a reasonable course of action in relation to the relevant tax provisions' shows that it is partly based on the principles in the Report by Aaronson QC, that the focus of the GAAR must be on what makes responsible tax planning permissible. The indicators listed under s°207(2)(a)-(c) direct the enquiry into the abusive nature of an arrangement to focus on whether there are any policy objectives that have not been complied with, any contrived or abnormal steps or any exploitation of weaknesses in the provisions. These indicators of abuse are more akin with characteristics of abusive tax avoidance, which shows that the GAAR is not solely based on what makes responsible tax planning permissible, as suggested in the Report.

²⁹ Ibid [2.3]. The draft GAAR contained in Annex D of the Document incorporates some of the conclusions of the advisory committee. It targets abusive tax arrangements, and defines what the terms 'abusive' and 'tax arrangement' mean in ss°2(2) and 2(1), respectively. This draft GAAR was accepted by Aaronson, who noted in the *GAAR Study: A Study to Consider Whether a General Anti-Avoidance Rule Should be Introduced into the UK Tax System: Supplementary Report* (2012) at [2.1] that '[w]e are agreed that the consultation draft GAAR embodies all of the main principles which we consider need to be incorporated in, and to form the framework of, a GAAR that would be appropriate for the United Kingdom'. Available at <http://www.hm-treasury.gov.uk/tax_avoidance_gaar.htm>.

Section°207(4) refers to the provisions quoted below as indicating the abusive nature of an arrangement:

- (a) The arrangements result in an amount of income, profits or gain for tax purposes that is significantly less than the amount for economic purposes
- (b) The arrangements result in deductions or losses of an amount for tax purposes that is significantly greater than the amount for economic purposes
- (c) The arrangements result in a claim for the payment or crediting of tax (including foreign tax) that has not been, and is unlikely to be, paid

but in each case only if it is reasonable to assume that such a result was not the anticipated result when the relevant tax provisions were enacted.

Given the UK experience with complex composite arrangements, the UK GAAR recognises that an arrangement can be part of a composite, multi-step arrangement, or be the wider arrangement itself. Section°207(3) provides that if a targeted arrangement is part of a wider multi-step arrangement, then ‘regard must be had to those other arrangements’ before the arrangement can be targeted for GAAR purposes.

In line with other GAARs, the GAAR in s°207(1) requires the existence of a tax advantage. Under s°208, a tax advantage includes:

- (a) Relief or increased relief from tax
- (b) Repayment or increased repayment of tax
- (c) Avoidance or reduction of a charge to tax or an assessment to tax
- (d) Avoidance of a possible assessment to tax
- (e) Deferral of a payment of tax or advancement of a repayment of tax
- (f) Avoidance of an obligation to deduct or account for tax.

Sections°209–215 contains supporting provisions such as provisions for the counteraction of the tax advantages, interpretation of terms in the GAAR and other provisions that are beyond the scope of this article.³⁰

³⁰ For more discussion of the UK GAAR, see generally Malcolm Gammie, ‘Moral Taxation, Immoral Avoidance —What Role for the Law’ (2013) 4 *British Tax Review* 577; Judith Freedman, ‘GAAR as a Process and the Process of Discussing the GAAR’ (2012) 1 *British Tax Review* 22; Judith Freedman, ‘Designing a General Anti-Abuse Rule: Striking a Balance’ (2014) 20 *Asia-Pacific Tax Bulletin* 167; D Roxburgh, ‘United Kingdom: General Anti Abuse Rule’ (2014) 55 *European Taxation* 113.

3. THE AUSTRALIAN GENERAL ANTI-AVOIDANCE RULE

3.1 Background

Unlike the UK, Australia is not a newcomer to a statutory GAAR system and has had possibly the longest experiences with a GAAR of all the countries in the world.³¹ The first Australian GAARs are said to have been contained in the *Income Tax Act 1895* (Vic) and the *Land and Income Tax Act 1895* (NSW), and were succeeded by s°53 of the *Commonwealth and Land Tax Assessment Act 1910* (Cth). Section°53 was itself succeeded by s°260 of the *Income Tax Assessment Act 1936* (Cth). After a series of restrictive judicial interpretations of the literally wide s°260, Part IVA of the *Income Tax Assessment Act* took over from s°260 in 1981.³²

As a jurisdiction that never relied on judicial anti-avoidance doctrines in the manner that the UK did, there was no alternative to a GAAR in Australia. Consequently, there was no question of discussing the need for a GAAR in Australia throughout its GAAR history. The judicial restriction of s°260 has been alluded to. However the same judiciary that annihilated s°260 as a potent GAAR laid the foundations of the one of the central concepts of Part IVA. Regarding s°260, the Privy Council in *Newton v FCT* stated:

In order to bring the arrangement within the section you must be able to predicate—by looking at the overt acts by which it was implemented—that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.³³

This is the so called ‘predication test’ that was created as a way of limiting the literally wide s°260. From this test it is clear that the GAAR would apply to a transaction where it could objectively be said that it was structured in a particular way to enable it to result in tax benefits. As will be seen, the predication test is encapsulated in an integral section of Part IVA. Part IVA and the UK GAAR are partially based on judicial principles advanced in GAAR cases.

Another similarity is the fact that both were introduced amidst assurances that they would target abusive transactions only. While it would be untrue to say that the focus on abusive transactions was identical in both jurisdictions, (because the focus on abusive transactions in the UK was much stronger and sustained over a longer time transcending two periods of consultations on the need for a GAAR and into the legislated introductory comments of the GAAR itself), Part IVA was introduced in 1981 with John Howard, then Treasurer stating in his Second Reading Speech in the House of Representatives that:

³¹ See GT Pagone *Tax Avoidance in Australia* (The Federation Press, 2010) 24.

³² These cases are *WP Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66, *Mullens v Federal Commissioner of Taxation* (1976) 135 CLR 290, *Slutzkin v Federal Commissioner of Taxation* (1977) 140 CLR 314, and *Cridland v Federal Commissioner of Taxation* (1977) 140 CLR 330. These cases involved the creation of the choice doctrine that stated that taxpayers have a right to exercise choices available in tax legislation when seeking to minimise tax.

³³ (1958) 98 CLR 1 8–9.

[t]he proposed provisions ... seek to give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs. Some writers on the subject suggest that tax avoidance involves conduct entered into for the sole or dominant purpose of obtaining a particular tax advantage. That description could be expected to cover the types of tax avoidance that, again using the language of social and political debate, are blatant, artificial or contrived, and which are indeed intended to be covered by this Bill. But it is also apt to describe other arrangements, including some family arrangements, which are beyond the appropriate scope of general anti avoidance measures ...³⁴

Part IVA was also designed to overcome the difficulties encountered with the application of s°260. The commitment to creating a GAAR that targeted so called ‘blatant, artificial or contrived’ arrangements was aimed at correcting the anomaly of s°260, which, when literally interpreted, could be used to target all schemes where tax was avoided.³⁵

3.2 The provisions

Section°177D of Part IVA provides as follows:

1. this Part applies to a scheme if it would be concluded (having regard to the matters in ss2) that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of
 - (a) enabling a taxpayer (a relevant taxpayer) to obtain a tax benefit in connection with the scheme; or
 - (b) enabling the relevant taxpayer and another taxpayer (or other taxpayers) each to obtain a tax benefit in connection with the scheme;

whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers.

³⁴ Quoted in Michael Kobetsky et al *Income Tax; Text, Materials and Essential Cases* (The Federation Press, 2006) 642.

³⁵ While words such as ‘blatant, artificial and contrived’ were used to describe the schemes targeted by Part IVA, they were not inserted into the GAAR itself. This would have been a difficult exercise. As Justice Richard Edmonds notes, ‘whether a particular arrangement or scheme can be so described will be much a function of perception on the part of the beholder, it is unlikely that anyone would suggest that the Commissioner of Taxation in his administration of the ITAA, has confined his application of Part IVA to schemes which are “blatant, artificial or contrived”’. The reason, according to Justice Edmonds, is that ‘nowhere will you find these words in the text of the relevant provisions of the statute’. (See, Richard Edmonds, ‘Judicial Construction of Part IVA: What to Expect from the Application of Existing Principles Going Forward’ (2013) 42 *Australian Tax Review* 213.) This can be partly contrasted with the UK GAAR where the word ‘abusive’ was incorporated in the provisions introducing the GAAR, and where the word ‘contrived’ forms part of the provisions under s°207(2), which provide indicators of abusive arrangements.

Have regard to certain matters:

2. For the purpose of subsection (1), have regard to the following matters:
 - (a) the manner in which the scheme was entered into or carried out;
 - (b) the form and substance of the scheme;
 - (c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
 - (d) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
 - (e) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
 - (f) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
 - (g) any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out;
 - (h) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in paragraph (f).

This part can be said to be the core of the GAAR itself. Concepts mentioned in this part are defined in-depth in supporting sections of Part IVA.

3.2.1 Scheme

Section 177A(1)(a) and (b) define a scheme respectively as ‘any agreement, arrangement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable, or intended to be enforceable by legal proceedings’ and ‘any scheme, plan, proposal, action, course of action or course of conduct’. A scheme is defined widely because it provides a basis for the application of the GAAR.³⁶ A tax benefit and a purpose cannot be ascribed to anything other than a scheme.

The width of the definition of a scheme poses a critical question; whether a single scheme that is part of a broader course of action can be isolated for the purposes of applying the other provisions of the GAAR to it or whether the whole course of action, not part thereof, must be targeted. If the former question is answered in the affirmative, it gives the Commissioner of Taxation (Commissioner), much more flexibility when targeting schemes. If the latter question is answered in the affirmative, the Commissioner’s advantage from the wide definition of a scheme will be limited. Moreover, taxpayers will be able to place schemes that could be the target of the GAAR into broader multi-step commercial schemes or courses of action for the

³⁶ See *Macquarie Finance Ltd v Federal Commissioner of Taxation* (2004) 57 ATR 115 137.

purposes of using the commercial nature of these broader schemes to effectively launder the potentially abusive single schemes. Most, if not every, broad commercial schemes or courses of action have a part that is decisive in obtaining a tax benefit. Isolating this part could render the scheme liable to the GAAR and lead to the denial of tax benefits obtained in terms of the broader scheme.

As Krever notes:

Perhaps the most important question to be determined is what constitutes the scheme. Taxpayers rarely act solely for tax reasons. Most often, taxpayers act to realize a profit through investment, business or some other arrangement. Naturally they seek to realize that profit in the most tax-advantaged way possible, but almost always, if the transaction or scheme is taken to be the overall arrangement entered into by a taxpayer, it will have a bona fide commercial objective, namely, to derive a profit. Identification of the correct transaction is thus the first threshold that must be crossed before the general anti avoidance provision can be applied. Is it the entire transaction or just the tax effective element in the larger transaction?³⁷

The courts have dealt with the isolation of a scheme within a broader scheme, albeit in two contrasting ways. In *FCT v Peabody*,³⁸ the court stated that a scheme within a scheme will not qualify as a scheme for Part IVA purposes if it cannot stand independently without losing its practical meaning.³⁹ The court, in rejecting the so-called 'sub-scheme' approach relied on *IRC v Brebner* where Lord Pierce stated that:

[i]t would be unrealistic and not in accordance with the subsection to suppose that [the taxpayer's] object has to be ascertained at each step in the arrangements ... The subsection would be robbed of all practical meaning if one had to isolate one part of the carrying out of the arrangement, namely, the actual resolutions which resulted in the tax advantage, and divorce it from the object of the whole arrangement.⁴⁰

The court accepted that the Commissioner may identify alternative schemes, including steps in a broader scheme. However, it stressed that such scheme must be capable of being taken from the main scheme and standing on its own without being rendered meaningless.

In another decision, *Hart v FCT*,⁴¹ the court stated that the Commissioner could not isolate a part of the broad scheme that had been entered into. The court followed the approach taken in *Peabody* and held that since the sub-scheme targeted by the Commissioner could not stand alone without being absurd, it could not be isolated for GAAR purposes. However, on appeal, this approach was unanimously rejected. Gummow JJ and Hayne JJ stated:

³⁷ R Krever, 'The Ghost of the Duke of Westminster Laid to Rest in Australia?' (1997) 45 *Canadian Tax Journal* 122, 123.

³⁸ (1994) 181 CLR 359.

³⁹ For an analysis of how this approach can limit the application of Part IVA, see Julie Cassidy, 'Peabody v FCT and Part IVA' (1995) *Revenue Law Journal* 197, 200.

⁴⁰ [1967] 2 AC 18 27.

⁴¹ (2002) 50 ATR 369.

The reference to circumstances being “robbed of all practical meaning” appears to have been understood in the Full Court in the present matters as a criterion which must be applied in deciding whether there is a scheme to which Part IVA applies. That is not right. First, it is far from clear what legal test is intended by saying that a scheme must “stand on its own feet”. It is not clear how the metaphor is to be translated into legal principle. Secondly, as the Full Court pointed out in the present matters, the words “robbed of all practical meaning”, which were adopted in *Peabody*, were taken from *IRC v Brebner*. There they were used in a very different context and with a clearly intended meaning ... thirdly, and most importantly, there is no basis to be found in the words used in Part IVA for the introduction of some criterion additional to those identified in the Act itself. There is no reference to a scheme having some commercial or other coherence.⁴²

The approach taken by the appeal court in *Hart* is the correct one according to the provisions of Part IVA. Nevertheless, *Peabody* should not be taken as the antithesis of *Hart*. This is because the court in *Peabody* did not state that a sub-scheme should never be isolated, but that such isolation should only take place where the sub-scheme does not lose its practical meaning in the process.

3.2.2 Tax benefit

Part IVA requires a tax benefit to exist before it can apply.⁴³ Section 177C defines a tax benefit. The determination of whether a tax benefit has been obtained is quite detailed under Part IVA. The starting point is that a comparison between two schemes is required before it can be said that a tax benefit has been obtained. In this regard, the two schemes are the scheme that has been entered into and the so-called alternative postulate. As is noted in the Explanatory Memorandum, ‘it is necessary to compare the tax consequences of the scheme in question with the tax consequences that either would have arisen, or might reasonably be expected to have arisen, if the scheme had not been entered into or carried out’.⁴⁴

This approach to identifying tax benefits led to taxpayers in some cases arguing that they had not obtained tax benefits for Part IVA purposes because they would either have entered into schemes with similar tax results, with higher tax benefits or would not have entered into any scheme at all. In one of these cases, *AXA Asia Pacific Holdings Ltd*,⁴⁵ the identified tax benefit arose from the capital gain that the taxpayer did not make because of claimed rollover relief. The court heard that the alternative postulate, a disposal yielding the tax benefit assessed by the Commissioner, would have taken place if the scheme in question had not been entered into. However, evidence showed that the participants in the scheme would not have entered into the alternative postulate because it was not commercially viable to do so. Consequently, a tax benefit could not be established.

⁴² (2004) 55 ATR 712 725–726.

⁴³ In line with the more targeted nature of Part IVA when compared with the old s 260, the mere fact that a tax benefit has been obtained, hence the avoidance of tax, does not lead to the application of this GAAR. The tax benefit must have been avoided in a scheme to which Part IVA applies, and that involves another step, namely the establishment of the sole or dominant purpose of the scheme.

⁴⁴ Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 [1.29].

⁴⁵ (2010) 189 FCR 204.

In another case, *FCT v Futuris*,⁴⁶ the taxpayer decided to sell one of its divisions. Through a series of transactions involving the transfer of shares between subsidiaries and the declaration of rebatable dividends from the profits obtained from the transfers, the end result was a rise in the cost base of the shares in the division sold. This meant that the capital gain obtained was lesser and the Commissioner included the capital gain that would have been obtained if the division had been disposed of without any cost base increase. The taxpayer contended that the alternative postulate advanced by the Commissioner was not reasonable, as it would have resulted in two disposals (one internal between the subsidiaries and the other external), hence, two instances where capital gains tax could have been levied for the same economic result. The taxpayer argued that it was not a reasonable alternative that its directors would have committed to, as it would have meant facing double capital gains taxation. The court accepted this argument, and a tax benefit could not be established.⁴⁷ In these cases, the court accepted the taxpayer's proposition that there was no reasonable basis for entering into an alternative scheme that would have led to higher taxation and, but for the scheme entered into, the tax payer would have adopted a different course or have done nothing at all.⁴⁸

In order to remove the possibility of the taxpayer arguing as above, Part IVA was amended in 2013. Section 177CB was added, which provides the bases for identifying tax benefits. Section 177CB(2) states that:

[a] decision that a tax effect would have occurred if the scheme had not been entered into or carried out must be based on a postulate that comprises only the events or circumstances that actually happened or existed (other than those that form part of the scheme).

Section 177CB(3) and (4) state that:

[a] decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into or carried out must be based on a postulate that is a reasonable alternative to entering into or carrying out the scheme.

(4) In determining for the purposes of subsection (3) whether a postulate is such a reasonable alternative:

(a) have particular regard to:

(i) the substance of the scheme; and

(ii) any result or consequence for the taxpayer that is or would be achieved by the scheme (other than a result in relation to the operation of this Act); but

(b) disregard any result in relation to the operation of this Act that would be achieved by the postulate for any person (whether or not a party to the scheme).

⁴⁶ (2012) 205 FCR 274.

⁴⁷ See also *RCI Pty Ltd v FCT* (2011) 84 ATR 785.

⁴⁸ AH Slater QC, 'The 2013 Part IVA "Reforms"' (2013) 42 *Australian Tax Review* 221–224.

Section^{177CB(2)(a)} empowers the Commissioner to annihilate all the steps in the scheme before focusing on the surrounding events or circumstances that actually occurred or existed. This excludes any speculation on what could or may have happened but for the scheme. Section^{177CB(3)} and (4) are a direct response to the cases discussed above namely *RCI*, *Futuris* and *AXA Asia Pacific Holdings*. These provisions make it clear that an alternative postulate need not be one that the taxpayer considered. It must only be reasonable taking into consideration the substance of the scheme and any result that the taxpayer would have achieved. This determination of a tax benefit allows some speculation regarding what could have taken place but for the scheme.⁴⁹

According to the Explanatory Memorandum, s^{177CB} offers two alternative ways of determining the existence of a tax benefit.⁵⁰ The above extracts from this section present two ways of determining the tax benefit. However, there is nothing in this section that indicates that the two tests are alternative. As it stands, the Commissioner can determine the existence of a tax benefit by referring to both tests. Moreover, as Justice Edmonds notes:

there is nothing in the legislation, as distinct from the EM, to indicate the type of scheme to which subs(2) is to apply, the type of scheme to which subs (3) is to apply and, most importantly, to prevent the Commissioner from applying both, potentially giving rise to two distinct tax benefits, one quantified by reference to the statutory postulate coming out of subs(2) following the annihilation of the scheme, and the other quantified by reference to the reconstructed postulate, that is, the reasonable alternative, coming out of subs (3). The Commissioner could defend either or both under one assessment by making an adjustment by reference to the larger but the taxpayer would have to fight the assessment on two distinct fronts.⁵¹

It remains to be seen whether the amendments to the determination of a tax benefit will solve the issues raised in the cases discussed above.⁵² Some commentators argue that the amendments were unnecessary because ‘Part IVA was not broken, and did not need fixing’.⁵³ Section^{177CB(3)} and (4) function on the premise that the alternative postulate must be reasonable and in determining whether it is so, one must look at the substance of the scheme and any result that is or would be achieved by the scheme. A potential problem can be identified in this amendment. On one hand, it allows the

⁴⁹ Justice Edmonds, above n 35, 218 and Frank Gilders et al., *Understanding Taxation Law* (LexisNexis, 2014) 1135.

⁵⁰ Explanatory Memorandum, above n 44, [1.33]–[1.35].

⁵¹ Justice Edmonds, above n 35, 219.

⁵² Gilders et al., above n 49, 1135.

⁵³ Slater, above n 48, 221. Slater further states that the cases lost by the Commissioner were lost as a result of the factual findings of the court, not as a result of any weakness in Part IVA. This view has merit. If one is to analyse the cases lost one can see a commercial objective in each of the cases and the commercial objective was achieved in a tax effective manner. These cases prompted the Treasury to issue Media Release No 10/2012 (5 March 2012), ‘Maintaining the Effectiveness of the GAAR’. In this statement, Treasury stated that ‘[s]uch an outcome can potentially undermine the overall effectiveness of Part IVA and so the government will act to ensure such arguments will no longer be successful. The government amendments will confirm that Part IVA was always intended to apply to commercial arrangements which have been implemented in a particular way to avoid tax. This also includes steps within broader commercial arrangements’. The accuracy of Treasury’s implied view that these cases would be decided differently under the amendments will be seen with time.

Commissioner to speculate that if the substance of the scheme is considered, the taxpayer could have achieved the same economic objective(s) in an alternative scheme that would have resulted in less tax benefits. On the other hand, taxpayers can argue that the provisions of s°177CB(3) and (4) primarily require reasonableness, so if an alternative postulate is advanced on the basis of these provisions, it must be reasonable, and it is unreasonable to expect a taxpayer company, for instance, to subject itself to achieving commercial objectives through a scheme that leads to higher taxation. Arguably most commercial schemes with tax benefits have alternative postulates that lead to higher taxation. Will the courts find these alternative postulates reasonable under these provisions all the time, considering that taxpayers are entitled to enter into commercial schemes with the most tax benefits?⁵⁴ It remains to be seen, and this is a potential source of more litigation on the determination of a tax benefit.

3.2.3 *Sole or dominant purpose*

The existence per se of a scheme and a tax benefit is insufficient for Part IVA purposes. The scheme and the tax benefit must be entered into with the sole or dominant purpose of obtaining a tax benefit. Section°177D(2) contains an inexhaustive list of eight factors that can be used to determine the sole or dominant purpose of a scheme. This means that this determination is objective, and that the subjective views of the taxpayer in question will only be accepted if they are in line with the objective evidence. A review of the list shows that the enquiry is, inter alia, focused on the nature of the scheme and the facts and circumstances associated with the scheme. In this regard, the manner in which a scheme was entered into, its timing, its appearance and reality, and the changes that it makes in the financial position of the taxpayer or any related party are some of the factors considered when determining the sole or dominant purpose of the scheme.

As mentioned before, the determination of the sole or dominant purpose of a scheme is partly derived from the predication test created in the *Newton* case. In summary, the predication test states that for a scheme to be struck down, one must be able to predicate, by looking at what was done, that the scheme was entered into in a particular way in order to obtain a tax benefit. The s 177D(2) enquiry requires a look at, for example, the manner in which the scheme was entered into. If this points to the pursuit of a tax benefit then a conclusion that the sole or dominant purpose of the scheme was to avoid tax will follow. The alternative postulate that is used to determine the existence of a tax benefit is also used to determine the sole or dominant purpose of the scheme.⁵⁵ The sole or dominant purpose test is the provision in Part IVA that draws the line between impermissible tax avoidance and responsible tax planning.⁵⁶

⁵⁴ Section°177C(2) provides exclusions from the definition of a tax benefit, and one of these exclusions is where taxpayers avail themselves of an expressly allowed declaration, election, selection or choice available under legislation. This means that all tax benefits obtained through choices exercised in terms of legislation must be expressly provided for.

⁵⁵ See generally, *British American Tobacco Australian Services Ltd v FCT* [2010] FCAFC 130. In this case the court referred to the manner in which the scheme had been entered into and found that a comparison between the scheme entered into and the alternative postulate showed that the only plausible explanation for the scheme was tax avoidance.

⁵⁶ Explanatory Memorandum, above n 44, [1.22] describes this test as ‘indeed the fulcrum upon which Part IVA turns’. Pagone, above n 30, 72 reiterates this view, and states that the purpose test is the ‘lynchpin’ of Part IVA.

In practice, the application of the sole or dominant purpose test has shown one significant characteristic of Part IVA. In *FCT v Spotless Services Ltd* it was stated that the dominant purpose is the 'ruling, prevailing or most influential purpose'.⁵⁷ This case showed that Part IVA could apply to schemes with both commercial objectives and tax benefits. The court unanimously applied Part IVA to strike down an investment that offered good after-tax returns in the Cook Islands. The taxpayer's argument that the purpose behind the scheme was to secure the investment of a large sum was rejected by the court, which stated that the required purpose lay in the particular means the taxpayer adopted to obtain the commercial advantage. The court held that the presence of a rational commercial decision was irrelevant to the question whether a taxpayer had operated a scheme with a dominant purpose to obtain a tax benefit.⁵⁸ In stating this, the court made it clear that s°177D required a close inspection of the particular method(s) utilised to obtain the tax benefit.⁵⁹ An examination of the scheme in this case reveals that it had a commercial basis. The taxpayer invested a huge sum and got a considerable return. This means that it was not the lack of a commercial purpose that led to an adverse conclusion for the taxpayer. The inquiry turned on the particular method the taxpayer relied on to obtain the tax benefit. Since the particular method was complex and involved a series of planned steps the court opined that the method could largely be explained by reference to the tax benefits obtained.

This decision demonstrates that Part IVA can be used to strike down an ordinary commercial scheme if the scheme is 'elaborate' and has 'attendant circumstances' that 'lead inevitably to the conclusion that the scheme was not merely tax-driven but that its purpose was to enable the taxpayer to obtain a tax benefit by participating in the scheme'.⁶⁰ The reasoning behind the decision was that the most influential, prevailing, or ruling purpose of the transaction was to obtain a tax benefit.⁶¹ In another case, *FCT v Consolidated Press Holdings Ltd*, it was stated that:

[t]he fact that the overall transaction was aimed at a profit making does not make it artificial and inappropriate to observe that part of the structure of the transaction is to be explained by reference to a s°177D purpose. Nor is there any inconsistency involved, as was submitted, in looking to the wider

⁵⁷ (1996) 34 ATR 183 192. For more discussion of this case, see generally John Passant, 'Spotless: Removing the Stain of Tax Avoidance in Australia' (1997) 2 *British Tax Review* 131, who describes the case as an 'outstanding victory for the Revenue'. See also Michael D'Ascenzo, 'Part IVA Post Spotless' (1998) *Journal of Australian Taxation* 3 <<http://www.austlii.edu.au/au/journals/JLATax/1998/3.html>>.

⁵⁸ *FCT v Spotless Services Ltd*, above n 57, 184.

⁵⁹ *Ibid.*

⁶⁰ *Ibid* 194.

⁶¹ *Ibid* 192. The court stated that by operating a scheme with investments in tax havens such as the Cook Islands, the taxpayers possessed, 'as their most influential and prevailing or ruling purpose, and thus their dominant purpose, the obtaining thereby of a tax benefit, in the statutory sense'. Krever, above n 37, 127 notes that this reasoning appears to suggest that the term 'dominant' in the ITAA does not require a purpose accounting for more than half of the taxpayer's purpose, as long as it is the single most significant purpose driving the scheme.

transaction in order to understand and explain the scheme, and the eight matters listed in s°177D.⁶²

The Explanatory Memorandum states that the mere fact that Part IVA is targeted at schemes with a sole or dominant purpose to avoid tax does not mean that it ‘is incapable of applying to arrangements that also have wider commercial objectives’.⁶³ If such commercial objectives are pursued in a way that progresses over to a tax avoidance purpose, Part IVA will apply. This has been praised by some commentators as a reflection of the efficacy of Part IVA as a GAAR.⁶⁴

However, the tendency of Part IVA to apply to schemes that have commercial elements has drawn some criticism from others. One of the criticisms is that it is uncertain when actions to secure a favourable tax result in a commercial scheme trump the commercial objectives of the scheme, and turns the sole or dominant purpose of the scheme to tax avoidance. In *Spotless*, the court noted that the elaborate nature of the scheme was decisive towards the decision against the taxpayer. According to Dabner, this is not necessarily a sound guide because ‘what is elaborate for one person may not be for another’.⁶⁵ The fact that Part IVA has shown in the past that it can be used to strike down commercial schemes with tax benefits means that it is not exclusively targeted at ‘blatant, artificial or contrived schemes’, as indicated when it was introduced. Due to this, Orow states that ‘[i]f Pt IVA is considered to be directed at transactions which can truly be described as tax avoidance, being transactions which result in a tax benefit contrary to the purpose and policy of the Act, then its presence in the Act cannot be justified’.⁶⁶

⁶² (2001) 207 CLR 235, 264. See also *Cummins v FCT* (2007) 66 ATR 57, where the timing of the scheme was held to have been decisive in showing that the sole or dominant purpose of the scheme was to avoid tax.

⁶³ Explanatory Memorandum, above n 44, [1.15]. It is stated in the Explanatory Memorandum at [1.16] that the High Court has repeatedly confirmed that if an arrangement is structured in way that shows a tax avoidance purpose, Part IVA will apply. This is an apparent reference to cases discussed above such as *Spotless Services Ltd*, *Consolidated Press Holdings Ltd* and *British and American Tobacco Services Australia Ltd*.

⁶⁴ See Chris Evans, ‘The Battle Continues: Recent Australian Experience with Statutory Avoidance and Disclosure Rules’ (Paper presented at the Oxford University Centre for Business Taxation Conference: Corporation Tax Battling with the Boundaries, 28–29 June 2007) <http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Events/conferences/summer_conference/2007/evans.pdf>. Evans states that ‘[a]fter *Peabody*, the High Court has subsequently heard three cases (*Spotless*, *Consolidated Press Holdings* and *Hart*) relating to the application of Part IVA. In addition there have been many cases on Part IVA heard in the lower Federal and Full Federal Courts. The Commissioner has enjoyed success in most of these Part IVA cases. In particular, outright High Court victory in *Spotless* and in *Hart*, and partial success in *Consolidated Press Holdings*, has provided the Commissioner with a weapon of mass destruction that is not only perceived to be a potential threat, but which actually is a powerful threat’.

⁶⁵ Dr Justin Dabner, ‘The Spin of a Coin—In Search of a Workable GAAR’ (2000) 3 *Journal of Australian Taxation* 232 <<http://www.austlii.edu.au/au/journals/JIATax/2000/12.html>>. See also Nabil F Orow, ‘Part IVA: Seriously Flawed in Principle’ (1998) 1 *Journal of Australian Taxation* 57 <<http://www.austlii.edu.au/au/journals/JIATax/1998/5.html>>. Describing sole or dominant purpose in terms of s°177D, Orow notes that it ‘create[s] a major difficulty in determining the stage at which the relevant tax purpose passes the requisite threshold of dominance because that threshold is a matter of impression and degree and hence there will be significant differences in opinion as to what constitutes a dominant purpose. Further, there is greater difficulty in determining the relevant purpose to be considered so as to ascertain whether it passes the threshold of dominance’. Thus, ‘dominant purpose conclusions can arguably be made in many ordinary tax planning arrangements’.

⁶⁶ Orow, above n 65.

The criticism of Part IVA can be tempered by reference to cases such as *Eastern Nitrogen Ltd v Commissioner of Taxation*.⁶⁷ This case involved a sale and leaseback scheme. The finance proposal presented to the taxpayer had a lower after-tax cost than other borrowing methods. The Commissioner sought to apply Part IVA to this scheme and to disallow the deduction sought for rentals paid by the taxpayer. The court rejected the Commissioner's contentions and stated that:

[d]ue and proper management of the business required assessment to be made of the net cost of finance after taking into account the extent to which any outgoings associated with that cost were allowable deductions from assessable income. In the circumstances of this case, to say that the appellant was attracted by a proposal that provided finance at a lower after-tax cost than other means of obtaining funds for the business would not, without more, support an objective conclusion that the appellant obtained finance for the dominant purpose of obtaining the tax benefit constituted by the deductibility from assessable income the outgoings incurred in connection with the obtaining of that finance.⁶⁸

This shows that the Commissioner has not been able to successfully apply Part IVA to all commercial schemes with tax benefits.⁶⁹ Nevertheless, the concerns that Part IVA sets a low threshold, and that it can apply to many inoffensive commercial schemes that contain tax benefits are valid.

4. COMPARATIVE ANALYSIS BETWEEN THE UK AND AUSTRALIAN GAARS

There are similarities and differences between the UK and Australian GAARs. The GAARs have similar foundations in the sense that they all require the existence of at least three of the following:

1. An arrangement, scheme, transaction
2. A tax benefit or advantage
3. A sole or main or dominant purpose to obtain a tax benefit, objectively determined
4. An indicator of impermissible tax avoidance, which differs from GAAR to GAAR.

In the case of Part IVA, the indicator of impermissible tax avoidance would be (c) above. The enquiry ends at (c) and a decision on whether or not Part IVA will be applied will be made at that point. The UK GAAR goes beyond that and requires the double reasonableness test under (d) above to be applied before an arrangement can be struck down.

⁶⁷ (2001) 46 ATR 474.

⁶⁸ Ibid 478.

⁶⁹ For instance, in *FCT v Metal Manufacturers Ltd* [2001] FCA 365, a case with similar facts to *Eastern Nitrogen*, the court held that even though one of the purposes of the scheme was to obtain a tax benefit, the dominant purpose was to obtain a huge amount of finance in the most tax-effective way. See also *Commissioner of Taxation v BHP Billiton Finance Ltd* [2010] FCAFC 25.

The differences between the GAARs lie in this broad similarity. Apart from the minor differences in the terms used, there are differences on how an arrangement or a scheme is defined, how a tax benefit is determined and on how impermissible tax avoidance transactions are targeted.⁷⁰ These differences, and possible lessons for Part IVA, will now be addressed.

4.1 Scheme/sub-scheme and arrangement

As noted above, the definition of a scheme in Australia is broad. It is broad enough to cover a scheme within a wider scheme. In other words, many tax benefits are obtained from wide schemes that can be broken down into smaller parts or sub-schemes. One of these smaller parts is usually decisive in obtaining the tax benefit. The definition of a scheme under Part IVA is such that even the smaller parts or sub-schemes can constitute schemes. This narrow view of a scheme has two advantages from the Commissioner's perspective. Firstly, it allows the Commissioner to focus on the action, or part of the wider scheme, that is most closely linked to the tax benefit. This makes the duty to link the tax benefit and the scheme easier to discharge. The second advantage is connected to the first; and allows the Commissioner to apply Part IVA to sub-schemes of a wider commercial scheme. This is so because the commercial purpose of the wider scheme will be irrelevant when the purpose of the isolated sub-scheme is determined. The narrow view of a scheme can be useful where taxpayers try to launder impermissible schemes by placing them within wide commercial schemes, and basically using the commercial purpose or nature of the wider scheme to effectively neutralise or launder the tax avoidance purpose of the inserted scheme.

In the UK GAAR, the discussion above shows that an arrangement that is part of a series of arrangements can only be targeted after a consideration of the other arrangements in the series. This is a different approach to the one that can be followed under Part IVA, where there is no requirement to consider the wider scheme before isolating the sub-scheme. The UK GAAR approach denies Her Majesty's Revenue and Customs (HMRC) automatic access to the advantages available to the Commissioner in Australia. However, it is submitted that the UK GAAR approach is more neutral as it favours neither the taxpayer nor HMRC. This is especially the case where isolating an arrangement that was meant, from the beginning, to work in tandem with other arrangements would change the nature of the arrangement and render it subject to the GAAR. HMRC will not be able to automatically isolate such an arrangement where it is clear that the series of arrangements have commercial purpose and that the isolated arrangement would lose its commercial character if it was to be isolated. The UK approach will also not allow taxpayers to launder an abusive arrangement with commercial arrangements as described above because it will be clear, after all arrangements have been considered, that the abusive arrangement has a different nature and was placed with commercial arrangements for the purposes of laundering it.

There is no judicial interpretation of the definition of an arrangement in the UK GAAR as yet. However, in Australia, the discussion above shows that there have been conflicting judicial opinions on the isolation of a sub-scheme. In *Peabody* the

⁷⁰ The differences in terminology are minor in the sense that what is known as 'scheme terms' of Part IVA is an 'arrangement' in the UK GAAR. What is referred to as a 'tax benefit' in Australia is referred to as a 'tax advantage' in the UK.

court stated that the sub-scheme must be capable of standing alone, which is related to the UK GAAR approach because a consideration of the other schemes would determine whether the sub-scheme makes sense when isolated. This approach was rejected in *Hart*. It is submitted that the UK GAAR approach to arrangements would not weaken Part IVA if it was to be adopted in Australia. This is because sub-schemes would still be isolated and sole or dominant purpose ascribed to them where, after considering the wider scheme, it is seen that the scheme has a different sole or dominant purpose. It would deny the Commissioner certain advantages currently enjoyed but it would ensure more parity with the taxpayer, especially in cases where the isolation of a sub-scheme would change the nature of the sub-scheme.

4.2 The determination of a tax benefit

One of the things that is immediately obvious after a comparative analysis of the two GAARs is the differences in the determination of a tax benefit. In the UK GAAR, a tax advantage is defined in s°208 by reference to different instances where tax is either reduced, deferred or not paid at all. There is no reference to an alternative postulate or an alternative transaction that results in more tax and consequently shows that what the taxpayer did resulted in a tax benefit. In contrast, the discussion in Section 3.2.2 shows that Part IVA dedicates detailed sections such as ss°177C and 177CB to the determination of a tax benefit.

The approach to a tax advantage in the UK is that the taxpayer would not have obtained a tax advantage but for the arrangement. In other words, the focus is on the arrangement and its tax effect. HMRC will look at a taxpayer's acts or omissions in an arrangement and conclude that due to these, a tax advantage was obtained. This, it is submitted, involves a reference to some form of an alternative postulate in the sense that an act or omission that resulted in a tax advantage is removed and the tax consequences of that removal are considered. If a tax advantage as defined under s°208 has been obtained, then a tax advantage can be linked to the arrangement. There is no possibility of a taxpayer arguing that a tax advantage has not been obtained because an alternative arrangement would not have been entered into, or an arrangement with even more tax advantages would have been entered into.

Section°177CB(2)(a) of Part IVA has a similar approach. It essentially states that a tax benefit exists if it is clear that it would not have been obtained but for the scheme entered into. This subsection requires an analysis of what actually happened or existed and establishes a tax benefit by annihilating the action or omission that led to a tax benefit. If it is clear that as a result of the annihilation, more tax would be payable a tax benefit will be established.

Sections°177CB(3) and (4) present a very different method of identifying a tax benefit. In short, these subsections state that an alternative postulate is reasonably expected to have happened (therefore applicable to the taxpayer whether or not the taxpayer would have entered into that postulate) if it is reasonable considering the substance of the scheme entered into and any result or consequence for the taxpayer that is achieved through the scheme. As noted above, these subsections were added to stop a taxpayer company, for instance, from arguing that it would not have entered into any alternative scheme with higher tax consequences. It remains to be seen whether these subsections will counter such submissions from taxpayers. However, it is submitted that taxpayers might still be able to argue that the alternative postulate advanced is unreasonable since taxpayers are not expected to enter into commercial

schemes with the least tax benefits. If problems are encountered with these subsections, the UK approach to establishing a tax advantage, which focuses only on the actual arrangement, must be considered. This will not necessarily require much change since s°177CB(2) already encapsulates the UK approach and can be used as the sole test for a tax benefit in Australia.⁷¹

4.3 The identification of impermissible tax avoidance and the threshold

GAARs ideally should not affect all schemes or arrangements where tax is avoided, so the identification of impermissible tax avoidance is critical to the efficacy of a GAAR. Part IVA basically defines impermissible tax avoidance as a scheme that has a sole or dominant purpose, objectively determined, to obtain a tax benefit. In case law on Part IVA, discussed in Section 3.2.1, it is clear that taxpayers have lost Part IVA cases on the basis of the facts surrounding the implementation of their schemes. The courts have held that if a scheme is implemented in a particular way in order to obtain tax benefits, Part IVA will apply. Some commentators state that this standard has enhanced the efficacy of Part IVA. Slater states that:

Part IVA has achieved the objectives for which it was introduced in 1981: it has been a strikingly “effective general measure against those tax avoidance arrangements that ... are blatant, artificial or contrived ... where, on an objective view of the particular arrangement and its surrounding circumstances, it would be concluded that the arrangement was entered into for the sole or dominant purpose of obtaining a tax advantage.”⁷²

Slater states further that ‘the Commissioner has, generally speaking, won cases that he should have won, but more importantly (from the viewpoint of the Revenue) the presence and potential of Pt IVA has acted as a deterrent to the implementation of tax avoidance arrangements’.⁷³ Comparing Part IVA to other GAARs, Slater states that Part IVA can be set apart for its effectiveness when invoked and its greater certainty on what it will apply to or not.⁷⁴

While Part IVA has been successfully invoked in many cases, some of those cases have raised serious questions about its potential to affect commercial schemes with tax benefits. For tax benefits to be obtained in a commercial scheme, something has to be done. If the action taken to secure the tax benefits passes a certain threshold, Part IVA will apply. This threshold is unknown, which has created uncertainty.⁷⁵ If one is to

⁷¹ Section°177CB as a whole is not only different from the approach taken in the UK GAAR. GAARs in countries such as South Africa, Canada, New Zealand, Ireland do not refer to the alternative postulate. See Graeme S Cooper, ‘Taxation by Analogy’ (2013) 42 *Australian Tax Review* 255, 267.

⁷² AH Slater, ‘Part IVA: An International Perspective’ (2013) 42 *Australian Tax Review* 149, 149.

⁷³ Ibid.

⁷⁴ Ibid. At 159, Slater states that ‘[m]easured against its international counterparts, Part IVA is at least their equal, and in many cases preferable, if the measures of quality are taken to be balance and clarity; protection of the Revenue without undue inhibition of commercial activity or personal choices, and (subject to the inevitable differences of perspective as to the characterisation of given facts) sufficient certainty that both revenue officers and the community understand when the rule comes into operation and what is its effect’.

⁷⁵ Cooper and Russell state that the primary aim of any GAAR is to deter impermissible tax avoidance, and that this purpose is served best when the scope and application of the GAAR is uncertain or unknown. They state further that ‘[o]nce the unknown becomes the familiar, then fear will diminish’. (Gordon Cooper and Tim Russell, ‘The New Improved Part IVA-With Extra Tax Benefit!’ (2013) 42 *Australian Tax Review* 234, 236.) Nevertheless, while uncertainty can serve as a deterrent, it affects

pair the success of Part IVA with its propensity to apply to some commercial schemes, one may come up with this question: since it has proven to be impossible, to date, to create a perfect GAAR, is an approach that targets impermissible tax avoidance by setting a low threshold and affecting some commercial transactions that have tax benefits the best way to curb impermissible tax avoidance? This question will be answered below.

In the UK, part of the background to the introduction of a GAAR was characterised by one consistent theme; that the UK needs a GAAR that is targeted and narrow, rather than broad and uncertain. This led directly to the introduction of the UK general anti-abuse (as opposed to avoidance) rule that targets abusive tax avoidance.⁷⁶ The emphasis on abuse is patent. Abusive tax avoidance is basically singled out as an arrangement with a sole, or one of the main purposes, to obtain a tax advantage in a manner that cannot reasonably be said to be a reasonable exercise of choices offered by legislation. The double reasonableness test is the one that draws the line between permissible tax avoidance and abusive tax avoidance. This test gives effect to the long held views on the ideal GAAR for the UK, that it must be narrow and targeted. The test does this through the following:

1. Instead of attempting to draw one thin, clear line between permissible and abusive tax avoidance, the test creates three scenarios. One is permissible tax avoidance which is acceptable to everyone. The second is tax avoidance that can be described as permissible by one person, and as abusive by the next person. The third is abusive tax avoidance that is unanimously accepted as such.
2. Focusing on clearly abusive arrangements. As stated by Gammie in relation to these arrangements, '[i]t does not matter whether a person considers the particular arrangement an unreasonable course of action: no reasonable person should be able to regard the course of action as reasonable'.⁷⁷

This shows that the UK GAAR approach to impermissible tax avoidance is narrow and targeted at abusive arrangements that leave no doubt about their abusiveness. The UK GAAR was introduced after a period of consultation that involved consideration of the experience with a GAAR in various countries, Australia included. The test for impermissible tax avoidance preferred after this consultation shows that the UK authorities did not want to hazard a GAAR that can affect commercial arrangements that confer tax benefits.

The UK GAAR clearly sets a high threshold. Its approach is substantially different from the approach taken in Part IVA. It is essentially that in targeting abusive tax avoidance, commercial arrangements should not be affected at all and some arrangements that may be considered abusive will not be struck down unless no

everyone. It might cause the Commissioner to challenge schemes that should not be challenged, leading to losses. It might also provoke the courts into restrictively interpreting the GAAR in order to protect taxpayers, as happened in relation to s^o260 before the introduction of Part IVA.

⁷⁶ Malcolm Gammie states that all tax avoidance is abusive and using the word abusive instead of avoidance does not change anything, (M Gammie, 'When is Avoiding Tax Not Abusive? Comparative Approaches to a GAAR in Australia and the United Kingdom' (2013) 42 *Australian Tax Review* 279, 279).

⁷⁷ Ibid.

reasonable person would find them reasonable. There is no case law on the UK GAAR yet but the application of this test could result in some arrangements that could be found impermissible in, for instance, Australia under Part IVA being accepted under the UK GAAR because the degree of abusiveness does not cross the high threshold. This leads to another fundamental question: considering that there is no knowledge of where the line between permissible and abusive tax avoidance is, is it better to curb abusive or impermissible tax avoidance by focusing exclusively on arrangements or schemes that are unanimously abusive and allowing borderline arrangements to thrive? To answer these two questions, it is submitted that no GAAR is perfect and it is distinctly possible that perfection in this area of tax law will never be found. However, it is submitted that the better approach to the design of a GAAR, from the approaches discussed here, is one where the GAAR sets a lower threshold that could affect some commercial arrangement with tax benefits, solely because the tax benefits in these commercial arrangements were pursued in a way that changes the commercial character of the arrangements. Setting a high threshold as in the UK GAAR has its advantages such as the attraction of foreign business, but this could backfire as the very same businesses start entering into abusive arrangements that raise the ire of the public and HMRC but do not cross the high threshold. As stated by the Trades Union Congress (TUC):

What this means is that the vast majority of the tax abuse by large and multinational companies is completely outside the scope of the Rule. That is because while there is no doubt that many companies do abuse the principles and provisions of such [double taxation] agreements (which form part of UK law) the very fact that many do so means that such abuse is not exceptional and as a result it is reasonable to think it is accepted practice, and for that reasonable, the GAAR does not apply. We think this is an extraordinary definition of abusive. In effect, it says that if abuse has become habitual it is by definition acceptable.⁷⁸

Therefore, regarding the targeting of impermissible tax avoidance, there is no need for Part IVA to raise its threshold to the levels set in the UK GAAR.

5. CONCLUSION

This article has substantially analysed the GAARs of the UK and Australia. It has been established that the UK has created a GAAR with a unique approach to curbing abusive tax avoidance that is in line with the long held views in the UK that a GAAR should have a narrow and targeted scope and that targets undoubtedly abusive arrangements. This GAAR, created after consultation on the experience with GAARs in many countries, has certain points that Australia can learn from and these are summarised below:

1. The UK GAAR has steered clear of the controversy associated with isolating arrangements within a series of arrangements before considering the other arrangements in the series. In Australia, where

⁷⁸ TUC, *The Deficiencies in the General Anti-abuse Rule*, 5

<<https://www.tuc.org.uk/sites/default/files/GAAR.pdf>>. At 1, the TUC states that the UK GAAR only targets abusive tax avoidance which 'is so narrowly defined that the number of occasions on which the rule will be used will be few and far between'.

the word scheme is used, the Commissioner can target a part of a composite scheme when establishing a scheme to apply Part IVA to, without reference to the composite scheme as a whole. After analysing both GAARs, it is submitted that when considering the existence of a scheme and isolating a scheme within a scheme, Part IVA should follow the approach taken in the UK GAAR of considering the wider scheme before isolating a scheme within the composite scheme. This approach is balanced as it protects individual parts of a composite commercial or non-tax scheme from being isolated and losing their commercial or non-tax character as a result of the isolation, and also allows the Commissioner to target an abusive part of a composite scheme where a taxpayer has tried to launder that part by placing it into a composite commercial or non-tax scheme.

2. The UK GAAR does not extensively define a tax advantage, instead focusing on the actions or omissions that actually occurred and that result in a tax benefit being obtained. In Australia, Part IVA extensively defines tax benefit and establishes a tax benefit by referring to an alternative postulate that the taxpayer could have derived less tax benefits from. The current provisions defining tax benefit in Part IVA are motivated by the fact that taxpayers have in some cases survived a Part IVA attack by arguing that they would not have entered into alternative postulates with higher tax costs, or would have entered into alternative postulates with similar or even higher tax benefits. The recent amendments to Part IVA were aimed at eliminating these arguments, but it remains to be seen whether these amendments have actually done away with the possibility of taxpayers making the same arguments. It also submitted that the definition of tax benefit in Part IVA after the amendments might cause even more litigation from taxpayers arguing that it is unreasonable for them to enter into or to be expected to enter into schemes with higher taxes than the one entered into. If problems with the new legislation are encountered, the approach taken in the UK GAAR of focusing on what was done and determining the tax advantages that flow from it could be adopted in Australia.
3. Regarding the Australian GAAR, it has been seen that this GAAR targets schemes that result in tax benefits and that have a sole or dominant purpose to obtain the tax benefits, objectively determined by reference to an inexhaustive list of factors in Part IVA. Objective sole or dominant purpose is the indicator that draws the line between what is permissible and what is impermissible. When establishing the sole or dominant purpose of a scheme, the Commissioner can attack commercial schemes if they are entered into in such a way that it can be said that obtaining the tax benefits is at least the dominant purpose of the scheme. This means that Part IVA can affect commercial schemes that have substantial tax benefits. The UK GAAR can be said to be the opposite. Its double reasonableness test is designed to ensure that it targets only the most abusive arrangements, while allowing arrangements that are not abusive enough or that could be

found to be abusive in terms of a GAAR with a lower threshold. An ideal GAAR should not target commercial arrangements. It should also not target only the most abusive arrangements. Due to the fact that the ideal GAAR is elusive, is a GAAR that targets abusive arrangements and, in the process, affects commercial arrangements better than a GAAR that targets only the most abusive arrangements while allowing less abusive ones? It is submitted that the approach in Part IVA, which has been successfully applied in a number of cases, is a greater deterrent than the approach taken in the UK GAAR. It is also submitted that considering the fact that a perfect GAAR has not been drafted yet, a GAAR whose indicator affects some commercial arrangements in targeting abusive tax avoidance is better than one that allows some abusive arrangements in targeting only the most abusive arrangements.

Overall, the UK GAAR, being one of the newest GAARs in the world, has been drafted to avoid the controversy and problems associated with isolating a part of a composite tax avoidance arrangement and with having an extended definition of a tax benefit. Australia can draw lessons from the UK approach on these two concepts. GAARs typically have one element that is meant to indicate impermissible tax avoidance. This element is arguably the most important part of the GAAR, and it is in respect of this element that the UK GAAR, it is respectfully submitted, is lacking when compared to Part IVA. In a world where taxpayers are becoming more and more aggressive in avoiding tax, it is better to have a GAAR that is founded on a provision that could possibly affect some commercial transactions in targeting abuse, than one that is founded on a provision that targets only the most abusive transactions. In this regard, while some provisions in Part IVA are problematic and lessons on eradicating these problems should be drawn from the UK, Part IVA retains strength on the element that is ultimately relied on to attack impermissible tax avoidance.

Are Australians under or over confident when it comes to tax literacy, and why does it matter?

Toni Chardon¹, Brett Freudenberg² and Mark Brimble³

Abstract

The concept of financial literacy and capability is seen as important in modern economies. An important part of financial capability is a person's confidence in dealing with financial decisions. It has been argued that financial literacy should be extended to include knowledge and understanding of the tax system, given it can influence investment strategies and wealth outcomes. We examine how Australians' confidence relates to their tax literacy. The findings suggest that lower confidence is more likely to relate to certain demographics. However, unlike other financial literacy measures, it appears that peoples' tax confidence is more aligned to their actual understanding.

Keywords: financial literacy, tax literacy, financial capability, confidence

¹ University of Southern Queensland.

² Department of Accounting, Finance and Economics, Griffith Business School, Griffith University.

³ Department of Accounting, Finance and Economics, Griffith Business School, Griffith University.
Email: toni.chardon@usq.edu.au, telephone: +61 7 4631 5514.

1. INTRODUCTION

The recent decade has been challenging for investors. They have been faced with an economic climate where investors have had their savings eroded due to factors such as the global financial crisis, poor investment returns, heightened market intervention and reregulation (Bateman et al., 2012). It is evident that many investors were not fully aware of the risks being taken or in some cases were misled by targeted marketing. Such examples highlight the importance of financial literacy as a critical issue for governments and consumers alike. Similar to other jurisdictions, the Australian Government has focused on financial literacy of its citizens. In 2004, the Australian Government provided funding to establish the Consumer and Financial Literacy Taskforce and in 2011, as a result of initial research from this taskforce, the Government launched the National Financial Literacy Strategy (ASIC, 2011b). It was suggested that improving financial skills and providing education was central to overall economic prosperity and that low levels of financial literacy act as a barrier to meaningful participation in the financial system (Commonwealth Department of Treasury, 2006).

It has been argued that financial deregulation and an increase in the availability of financial products, has led to a 'complex market for consumers' (Worthington, 2006, p. 59). Additionally, as a result of shrinking workforces, an ageing population, and increased longevity, there is a global trend in western countries toward self-funded retirement (Kelly, 2003). For example, in the last thirty years in Australia, there has been a dramatic increase in Australia's retirement savings, driven by the compulsory superannuation system. It is estimated that there is more than \$2 trillion invested through Australia's retirement system (APRA, 2015), making it approximately the fourth largest pool of privately held retirement savings. However, it appears that many Australians have a low level of understanding of the system (Worthington, 2008). Given the importance of self-funded retirement, these trends are worrying and exacerbated by survey evidence measuring adult financial literacy in Australia, which suggests that there are certain at-risk groups which have low levels of financial literacy particularly in relation to financial products and superannuation (retirement savings) (Worthington, 2008). For example, the Australian and New Zealand Banking Group Ltd (ANZ) surveys of adult financial literacy in Australia have consistently reported people find superannuation aspects more difficult than basic banking (ANZ, 2005; 2008; 2015).

Internationally, the concept of financial literacy has been broadened to 'financial capability' as a more appropriate term when describing a person's abilities or skills in relation to financial matters (Hogarth, 2002). This is also demonstrated in the most recent ANZ surveys of adult financial literacy in Australia acknowledging that financial literacy 'is a complex combination of a person's skills, knowledge, attitudes and ultimately their behaviours in relation to money' (ANZ, 2011; 2015). Internationally, the notion of financial capability is seen as important also. For example, in Canada it has been stated it is important for Canadians to:

develop their skills and confidence to be aware of financial opportunities, to know where to go for help, to make informed choices and to take effective action to improve their financial well-being (Government of Canada, 2006, p. 1).

Studies have demonstrated that increased experience can increase confidence, although accuracy will not necessarily improve with this increased confidence in the absence of systematic feedback (Ryback, 1967). Estes and Hosseini (1988) found, in a survey of shareholders, security analysts, institutional investors and business persons, that females have significantly lower confidence than their male counterparts. This is important as extremely low levels of confidence can affect, even stop, investment decision making. Such low confidence can mean that opportunities with positive expected values can be missed. Although, those who are too (or over) confident can partake in reckless behaviour and incur avoidable losses (Estes & Hosseini, 1988). It appears that even expertise in the area does not stop someone being over-confident, as some studies have found that experts can be prone to over-confidence (Lambert, Bessière & N'Goala, 2012; Russo & Schoemaker, 1992).

In terms of knowledge areas, Blue and Brimble (2014) argue for a broader framework that incorporates enabling factors and content tailored to the circumstances of the participants. Furthermore, Chardon (2011) argues that financial capability needs to include an understanding of taxation and superannuation (taxation of retirement savings). This is because the tax system can have different applications depending upon the type of investment, and the government can use the tax system to deliver policies (Government of Canada, 2006, pp. 9, 17).

Chardon et al. reported tax literacy scores of Australians indicating that 19 per cent of Australians had tax literacy scores classified as either 'poor' or 'low' (Chardon, Freudenberg & Brimble, 2016). Also, it was found that demographic groups with low financial literacy were also likely to have lower levels of tax literacy, identifying the links between these two components. More recently, Mihaylov et al. (2015) found that literacy in terms of self-managed superannuation fund (SMSF) regulation is likely to be significantly higher for those trustees of compliant SMSFs compared to non-compliant ones. Consequently, it may be that higher levels of tax literacy may lead to improved compliance behaviour. However, this study did not find any significant difference in compliance knowledge and over-confidence for trustees of SMSFs (Mihaylov et al., 2015, p. 754).

This article examines Australian taxpayers' confidence in understanding basic tax and superannuation (retirement savings) concepts which has not been addressed in the literature to date. We find that there is likely to be lower tax confidence with females, younger age groups and those on lower incomes. We also find that lower confidence in relation to taxation and superannuation issues is likely to be found in those with less participation in the paid workforce (that is, 'full-time students' or those 'not in paid work') and those with lower education levels.

The remainder of the article is structured as follows. The next section provides a broad summary of the tension between the concepts of financial literacy, financial capability and tax literacy. The important issue of confidence is detailed, followed by the research methodology and the demographics of the participants. Analysis of the results, recommendations and future research directions are then outlined before the conclusion.

2. FINANCIAL LITERACY

Financial literacy has been defined as the ability to make informed judgements and effective decisions regarding the use and management of money (ANZ, 2015; Financial Literacy Foundation, 2007). The importance of financial literacy lies in the potential financial difficulty arising from poor financial decision making as acknowledged by the Organisation for Economic Co-operation and Development (OECD) in the context of the global financial crisis:

the lack of understanding of households on financial issues and, in particular, on credit and investment, has also a major role. As a result, individuals have accepted (sometimes unknowingly) to support more financial risk than what they could afford (OECD, 2009, p. 4).

More recently, Lusardi and Mitchell argue that ‘if the effects of financial literacy on financial behaviour can be taken as causal, the costs of financial ignorance are substantial (Lusardi & Mitchell, 2013, p. 30). The Australian Government has also acknowledged the importance of financial literacy at a population level and launched the National Financial Literacy Strategy (ASIC, 2011b) as a result of research which suggested that improving financial skills was central to overall economic prosperity and that low levels of financial literacy act as a barrier to participation in the financial system (Commonwealth Department of Treasury, 2006).

In Australia, the Australia and New Zealand Banking Group Limited (ANZ) has funded a national ‘Survey of Adult Financial Literacy in Australia’ on a number of occasions (2003, 2005, 2008, 2011 and 2014) and the results remain the most widely cited measures of financial literacy in Australia (ANZ, 2003; 2005; 2008; 2011; 2015). The 2003, 2005 and 2008 surveys were underpinned by a financial literacy framework largely based on principles established in the United Kingdom (UK) by the Adult Financial Literacy Advisory Group (Financial Services Authority, 2004; Kempson, Collard & Moore, 2006). The two most recent surveys incorporated factors such as: knowledge, skills, attitudes, behaviours and personal circumstances rather than focusing merely on knowledge and understanding (ANZ, 2011; 2015). It has been consistently found that Australians are broadly financially literate, but that certain groups have particular challenges, and certain financial skills, services and products were not as well understood or utilised by these groups (ANZ, 2008, p. 1). It has been found that lower levels of financial literacy were more likely to be found in the following groups: those with lower levels of education; those not working, or in unskilled work; those with lower incomes (<\$20 000); those with lower savings levels (<\$5000); females, single people and those at both the younger and older extremes of the age profile (ANZ, 2005; 2008; 2011; 2015). These demographic findings have remained broadly consistent in all of the surveys. Further, it has been reported that all population groups found superannuation (retirement) issues more difficult than basic banking (ANZ, 2005, p. 2; 2008, p. 6).

Ramsay and Capuano found that improved financial literacy means that people are more likely to be realistic and proactive in relation to their financial position (Ramsay & Capuano, 2011, p. 40). Such increased financial literacy can be linked to improved savings and thereby achievement of financial goals (Ramsay & Capuano, 2011, p. 40).

3. FINANCIAL CAPABILITY

The notion of financial literacy has expanded over the last decades, with other definitions put forward, such as, ‘people being informed and confident decision makers in all aspects of their budgeting, spending and saving’ (Worthington, 2006, p. 62). Internationally, ‘financial capability’ is a more accepted term and is defined by Kempson, Collard and Moore (2006, p. 44) as incorporating ‘financial knowledge, skills and attitudes’ and by Leskinen and Raijas (2006, p. 13) as ‘consisting of an individual’s personal characteristics influenced by various factors in his/her micro and macro environment’. Overall, financial capability is defined as ‘the ability to make informed judgements and to take effective decisions regarding the use and management of money’ within a framework that comprises knowledge, skills and attitudes (Kempson, Collard & Moore, 2006, p. 44).

These other descriptions imply that a financially literate person will behave in a certain way, make better decisions and have certain attitudes and characteristics. These elements, and the definitions presented above, all describe a set of behaviours or skills rather than mere knowledge about a subject. Lusardi and Mitchell (2013, p. 43) argue that there is a link between financial knowledge and behaviour, as their research found that ‘both instrumental variables and experimental approaches suggest that financial literacy does play a role in influencing financial decision making, and the causality goes from knowledge to behaviour’.

‘Financial capability’ is considered a more appropriate term when describing a person’s abilities or skills in relation to financial matters (Blue & Brimble, 2014; Hogarth, 2002; Vyvyan & Brimble, 2006) as manifested in the recent focus in the ANZ surveys on building confidence, positive attitudes and beliefs, and self-efficacy. Confidence is seen as a critical component of financial capability as it underpins one’s ability to implement acquired financial knowledge, inform effective financial decisions and drive awareness in relation to one’s limits and thus the propensity to seek financial advice (Blue & Brimble, 2014).

4. TAX LITERACY

To date the understanding and attitudes towards taxation have largely been absent in financial literacy studies. This is despite the fact that taxation is something which impacts on each individual or business and thereby influences their overall financial position. Furthermore, for many investments (such as for share and rental property investments) the purported tax advantages are often used as incentives or sales tactics; particularly for risky investment scams (Financial Literacy Foundation, 2007, p. 24). Also, the tax system can be used to deliver government policy agendas, such as retirement contributions, tax benefits for children, income supplements for pensioners and incentives to encourage savings (Government of Canada, 2006, pp. 9, 13, 17). For example, it has been reported that through a Canadian community service to help low income people prepare their tax returns, that these people were either not aware or did not know how to access government benefits to which they were entitled (Government of Canada, 2006, p. 6). Consequently, it is argued that tax is an important part of financial literacy and capability. Indeed, the OECD’s ‘Core Competencies Framework on Financial Literacy for Youth’ includes an understanding of tax in terms

of its effect on prices, making price calculations and broadly understanding how tax can impact on individuals, households and society (OECD/INFE, 2015).

A survey by the Financial Literacy Foundation explored Australians' attitudes and behaviours to money and found that, given that peoples' self-assessed ability to protect income was overstated, they may be at risk of being caught by investment scams (Financial Literacy Foundation, 2007, p. 24). These investment scams can use purported tax savings as part of their marketing. Also, taxation can influence a person's financial position in terms of meeting tax liabilities on time, preparing tax returns accurately, claiming all available entitlements and communicating effectively with one's financial or tax advisors. It was for these reasons that Chardon (2011) argued that taxation and superannuation must be seriously considered as important components of financial capability.

In terms of tax literacy, Chardon et al. (2016) reported the general level of tax literacy in Australia through a tax literacy score (TLS) of the Australians surveyed. These results indicated that 81 per cent of Australians had a TLS at the 'basic' or 'higher' level. This in turn means that 19 per cent of Australians have a TLS classified as either 'poor' or 'low'. However, when taking the mean TLS as a percentage of the maximum score, it was found that the mean score falls at 52 per cent of the maximum score. In comparison, the 2008 and 2015 ANZ surveys found that the mean financial literacy score (FLS), as a percentage of the maximum score, was 71.3 per cent (ANZ, 2008; 2015). This means that while Australians are broadly tax literate they are less literate when it comes to specific tax and superannuation issues compared to broader financial issues. Furthermore, it was found that there are particular sections of the community which are at risk of low tax and superannuation literacy. However, these reported findings did not include the broader understanding of financial capability in terms of Australians' confidence in their tax understanding. This broader understanding of confidence is important because research in relation to tax compliance has suggested that personal taxpayers are not necessarily confident in the accuracy of their returns even when they used an agent (McKerchar, 2002).

Overall, it can be appreciated that the notion of financial literacy has grown in importance, with studies demonstrating low levels of literacy, especially in certain segments of the population. Furthermore, evidence suggests that financial literacy should be broadened to include ones' capability as well as tax literacy.

5. PRIOR RESEARCH—FINANCIAL CAPABILITY AND CONFIDENCE

In 2006 the Financial Literacy Foundation conducted a telephone survey of 7500 Australians aimed at complementing existing surveys (such as the ANZ survey) and focused 'more on participants' self-assessed ability and confidence versus their understanding, attitudes and behaviours about money' (Financial Literacy Foundation, 2007, p. 1). The discussion in this section focuses on some of the findings in relation to confidence in the context of tax and superannuation.

While self-assessed confidence to invest was relatively high, the survey found that only 34 per cent of adults would actually consider both risk and return when investing, and only a small proportion would consider reputation (6 per cent) and diversification (5 per cent) (Financial Literacy Foundation, 2007, p. 10). Consequently there was a gap between the self-assessed confidence to invest and the indicators of actual

confidence or ability. The survey also found that 46 per cent of participants currently invested in either shares or managed funds and 18 per cent were currently paying off an investment property (Financial Literacy Foundation, 2007, p. 10). We note that the tax treatment of these investment products differs which can influence an investor's after-tax returns and therefore an individual's cash flow position and overall wealth. This highlights the relevance of tax literacy to investment decisions.

In relation to protecting money, Australians reported a high level of confidence in their ability to recognise a scam or investment scheme (above 80 per cent) (Financial Literacy Foundation, 2007, p. 24). However, as the skills required to recognise a scam were considered to be the same as for investing, fewer people actually recognised key aspects of scams and schemes (such as risk and return and understanding financial language) and went ahead with investments despite a lack of confidence or ability. Consequently, peoples' self-assessed ability to protect income was overstated and they may be at risk of being caught by these investment scams (Financial Literacy Foundation, 2007, p. 24). Purported tax advantages are often used as incentives or sales tactics for many investments (such as for share and rental property investments) and particularly for risky investment scams. The findings from this research appear to indicate a general lack of understanding of fundamental aspects that should be considered when investing. These findings are supported by the findings of the ANZ surveys in relation to risky investments. This gives weight to the argument that there needs to be more research on which aspects of taxation consumers lack confidence, knowledge and understanding. With such an understanding, it could be possible to optimise consumers' investment decision making and to mitigate the risk of consumers being caught by investment scams.

In relation to obtaining information and advice, the survey found that 68% of people had used or were likely to use accountants or tax agents to obtain information or advice (Financial Literacy Foundation, 2007, p. 27). Further, the most common reason for seeking information or advice was for assistance in completing a tax return. Although participants were highly confident in their ability to get information and deal with financial service providers (greater than 80 per cent), only 64 per cent said they had an ability to understand financial language (Financial Literacy Foundation, 2007, p. 27). One of the overall findings of the survey was that peoples' attitudes and beliefs about money can adversely affect their actual financial literacy (Financial Literacy Foundation, 2007, pp. 48–49). The Foundation recommended that where peoples' actual ability is lacking, effort should be focussed on building confidence and competence (Financial Literacy Foundation, 2007, pp. 48–49). This is important because extremely low levels of confidence can affect, even stop, investment decisions. Such low confidence can mean that opportunities with positive expected values can be missed (Estes & Hosseini, 1988).

It has been argued that one of the problems with financial literacy education is that even those who are financially literate can make poor financial decisions (Willis, 2011). While this assertion itself is not disputed, it nevertheless provides support for the argument that taking a holistic approach to the elements of financial literacy is important. Given that research demonstrates increased confidence is more likely to lead to consumers seeking advice and assistance, this means that programs focusing on improving confidence may help those who are already financially literate to make better financial decisions. These findings support the argument that confidence is an important aspect of an overall financial literacy model.

Ali et al. (2014, p. 346) found that in a survey of Australian high school students that they were over-confident in terms of budgets and calculations compared to their actual skills. Such misalignment is seen as important because such over-confidence may mean they do not seek further assistance or information when they should.

This concept of confidence (or self-efficacy) as an important aspect of overall financial literacy has been explored in international financial literacy and behavioural economics research. A study which explored financial literacy, financial confidence and expectations of inflation, found that people with low financial literacy also have less confidence and shorter-term financial planning goals (de Bruin et al., 2010). De Bruin et al. (2010, p. 399) argue that those with less financial confidence may not feel they have the ability to make complex financial decisions and that confidence is an important aspect for increasing financial literacy. Van Rooij, Lusardi and Alessie (2012) also found that those with more confidence in their financial knowledge have a higher propensity to plan for the financial future. In terms of confidence and its importance when measuring financial literacy (or when determining where there might be problems with financial literacy), it has been argued that ‘self-reported confidence often has independent predictive power for financial outcomes relative to more objective test-based measures of financial literacy’ (Hastings, Madrian & Skimmyhorn, 2012, p. 13). Lusardi and Mitchell (2009) have also argued there is a strong correlation between self-assessed and objective measures of financial literacy. Kempson et al. (2006) asserted that a financial literacy model which takes into account (a) knowledge and understanding; (b) skills; and (c) confidence and attitudes are the three key elements that determine behaviour.

There has also been research which considers the potential gaps between knowledge and confidence (both under and over-confidence). Lusardi and Mitchell argue that ‘consumer overconfidence regarding their financial knowledge may be a deterrent to seeking out professional advice, thus widening the “knowledge gap”’ (Lusardi & Mitchell, 2006, p. 7). Research has demonstrated that financial literacy tends to improve with increased confidence and under-confidence has a significant negative impact on overall net worth (van Rooij, Lusardi & Alessie, 2012). The literature indicates that confidence can be a predictive indicator of financial literacy. Also over-confidence can potentially lead to poor planning and lower propensity to seek advice. It has also been argued by Gallery et al. that a:

mismatch between self-assessed financial knowledge and actual understanding of more advanced investment matters potentially leads to over-confidence in investment decision-making that could result in undesirable long-term financial outcomes (2011, p. 298).

Consequently, financial literacy is not just about knowledge and understanding of complex areas, it is also about increasing confidence, understanding when to seek advice, and being able to communicate effectively with one’s advisor. Widdowson and Hailwood agree:

[T]he final result (of financial literacy) is not to create financial experts; it is more important to equip individuals with sufficient knowledge to make sense of financial activities, seek out appropriate information, feel able to ask relevant questions, and be able to understand and interpret the information that they subsequently acquire (2007, p. 46).

It is argued that research about self-reported confidence as it relates to specific tax and superannuation aspects will provide additional insights and understanding about financial literacy and capability. A more thorough understanding of confidence levels may assist in identifying specific financial areas which need to be focused on or improved. To date, no study internationally has explored the extent to which there are asymmetries between peoples' perceived confidence in understanding taxation concepts and their actual levels of understanding. As highlighted in the literature, within the financial literacy context, asymmetries often exist between confidence and ability, which then can influence levels of financial literacy. The study which sought to address this is detailed in the next section.

6. RESEARCH METHODOLOGY

In order to explore levels of confidence and knowledge in relation to taxation and superannuation, a survey was conducted wherein tax confidence and tax literacy scores for each survey participant were developed.

The survey was conducted via an online platform (Qualtrics) with web-link invitations sent to participants via email or advertised on radio and Facebook. The sample was derived through convenience or 'snowball' sampling until a desired number of responses was achieved. Convenience sampling occurs where there is not a systematic approach to recruiting participants and participants are not specifically chosen by the researcher because of some particular characteristic (Beidernikl & Kerschbaumer, 2007). Although this means that a specific response rate cannot be calculated (as a finite population has not been identified), a completion rate is able to be determined for those who began the survey. Although there is a potential for sample bias in non-probability sampling and an argument that online surveys will only be representative of the portion of the population that have access to the internet (Roberts, 2007), there is now work which argues that these limitations of internet usage are 'rapidly diminishing, particularly in western countries' (Roberts, 2007, p. 22).

The final version of the survey contained 65 questions including ten demographic questions (the complete survey is available on request). Apart from the initial demographic questions, the survey questions fell into one of three broad categories: confidence questions, knowledge questions and attitudinal questions. Note that the confidence questions were asked in the first part of the survey prior to specific tax knowledge questions to try to obtain the most accurate measure of participants' confidence. The first category contained questions about confidence in understanding the meaning of some tax and investment terms. The second category of knowledge questions incorporated theoretical and practical questions around basic concepts. The development of the questions used to deliver a tax literacy score (TLS) is reported elsewhere (Chardon, Freudenberg & Brimble, 2016). The overall results of the TLS are reported in Appendix 1.

6.1 Participants

Table 1 details the descriptive information of the survey sample. The sample demonstrates the survey to have a higher proportion of females (68.9 per cent) to males (31.1 per cent). To provide an idea of the representativeness of the data to the broader Australian community comparisons are made to Australian Bureau of

Statistics (ABS) data. The ABS data indicates that there are slightly more females than males in the adult population, the survey sample is higher again for females, than the population as a whole (ABS, 2012a). This higher proportion of females to males should be taken into account when interpreting the findings of the survey.

In terms of employment hours, Table 1 demonstrates 74.5 per cent of the sample size as either in full-time or part-time/casual work. While this appears to be a large portion of the sample, it is consistent with ABS statistics which show 88.4 per cent of persons aged 15 and over in either full-time or part-time work (ABS, 2012a).

Data was also collected on categories of income activities with the vast majority of participants (82.1 per cent) identifying as employees. The education level of participants was also gathered. As can be seen, 65.8 per cent of the sample have either under-graduate or post-graduate qualifications. ABS data reports that as of May 2012, the proportion of the adult population (aged 15 to 64 years) with a non-school qualification was 59 per cent (ABS, 2012b). While these results are quite close, it may be concluded that the sample is slightly biased toward the more educated. Based on other surveys of adult financial literacy both in Australia and overseas, this would tend to indicate that levels of tax literacy might be overstated in the final results (given that financial literacy tends to be lowest in those with lower general education levels).

Table 1: Demographics of Participants

		N	Percentage
Gender	Male	188	31.1%
	Female	416	68.9%
Age Bracket	18–29	190	31.5%
	30–44	231	38.2%
	45–54	118	19.5%
	Over 55	65	10.8%
Employment Hours	Full-time paid work	333	55.1%
	Part-time or Casual paid work	117	19.4%
	Full-time student	75	12.4%
	Full-time student working > 15 hours per week	58	9.6%
	Other (including retired)	21	3.5%
Employment Category	Working for an employer	496	82.1%
	Self-employed/Contractor/Small business operator	34	5.6%
	Other	10	1.7%
	I am not in paid work	64	10.6%
Education Level	Secondary (Year 10 or less)	18	3%
	Secondary (to Year 12)	89	14.7%
	Trade, Apprenticeship or other TAFE	97	16.1%
	Undergraduate degree (Bachelor)	164	27.2%
	Postgraduate degree (Masters, Doctorate, professional qualification)	233	38.6%
	Other (coded system missing)	3	0.5%
Total Income	\$0–\$20 000	113	18.7%

		N	Percentage
	\$20 000–\$49 000	140	23.2%
	\$50 000–\$100 000	255	42.2%
	\$100 000–\$150 000	55	9.1%
	> \$150 000	20	3.3%
	Prefer not to say (coded system missing)	21	3.5%
Financial Experience	Yes	112	18.5%
	No	492	81.5%

Note: This table demonstrates descriptive information for the variables that were used in the below statistical analysis. Some variables had more categories in the original survey, however due to low numbers in some categories some had to be recoded in order for valid analysis to occur.

The final piece of demographic information gathered was in relation to whether or not the participant had any previous financial experience. This was defined as the participant having worked as an accountant, financial planner, investment advisor or in the superannuation or finance fields. It can be seen that 18.5 per cent of survey participants identified as having previous financial experience. This means that the vast majority (81.5 per cent) of participants would be regarded as having no specific financial experience. This information was gathered for two reasons. First, evidence suggests that even some consumers with financial experience may have less than the required basic tax knowledge. Also, it was included in order to ensure there was not a sample bias towards those with financial knowledge or previous experience. It was decided that given the small numbers, this category would not be explored further in the analysis.

7. RESULTS

It is important to remember that although building confidence might be a goal of financial literacy, research has suggested that there is often a gap between people's self-assessed level of confidence and their actual skills or knowledge in particular financial areas (Financial Literacy Foundation, 2007). The following presents findings in relation to overall confidence scores. This is followed by an analysis of those specific tax and superannuation concepts where self-assessed confidence did not align with actual understanding.

7.1 Analysis of overall confidence scores

This section will highlight whether there are particular demographics that have particularly low or high confidence and whether or not there are any statistical relationships between particular demographics and confidence. To provide a sense of how representative this is to the broader Australian population comparisons are made with the national 2007 Financial Literacy Foundation research which focused on confidence in terms of particular financial concepts. Following this, confidence is compared to actual knowledge results. Finally, an analysis of the results which compare the overall Tax Literacy Score (TLS) and overall confidence is presented. The conclusions for this section focus on addressing whether there is a link between perceived confidence in understanding taxation-related concepts and actual levels of understanding.

Table 2 presents the overall summary of confidence scores by demographic. The table demonstrates the aggregate confidence scores for those questions in the survey that asked how confident participants were in understanding basic tax and superannuation concepts. Column 3 demonstrates the raw mean of all confidence questions (on a 5 point scale where 1 is 'very confident' and 5 is 'no idea') for each dependant variable. Thus participants whose mean confidence is closer to 1 are more confident and those whose mean confidence is closer to 5 are less confident. Columns 4 through 8 show the number and percentage of participants in the categories of overall confidence. It can be seen that the mean confidence of the sample was 2.43—somewhere between 'Slightly Confident' and 'Neutral'. It should be noted that for the purpose of this study, the Likert confidence scales outlined above have been analysed with both parametric and non-parametric tests. Acknowledging the contention between ordinalist and intervalist views in relation to Likert scales, it is submitted this mixed approach provides a richer analysis of the results.⁴

7.1.1 Gender

Initial analysis as presented in Table 2 demonstrates that the mean confidence of 'males' is slightly higher (mean score 2.26) than that of females (mean score 2.51). Interestingly, of those who were categorised as either 'uncertain' or having 'no idea', only 29 per cent were 'male' compared with 19 per cent female. This finding is consistent with the literature which has found that overall, males are more confident in their abilities to understand financial concepts than females (Financial Literacy Foundation, 2007).

A Pearson chi-squared test⁵ showed a relationship between overall confidence category and gender (χ^2 (3, $N = 604$) = 11.56, $p = .009$). Further, the independent samples t -test conducted showed a significant relationship (at 1 per cent) males are more confident than females ($t(602) = -2.994$, $p = .003$). This is consistent with the overall findings in relation to confidence in the Financial Literacy Foundation research which concluded that females were more confident in relation to everyday financial matters (such as budgeting and saving) but less confident in relation to more complex matters such as investing and retirement planning (Financial Literacy Foundation, 2008, p. 4).

In terms of overall tax literacy, it appears that this slightly higher confidence for males is also reflected in a higher understanding of the tax and superannuation issues because males have been found to have overall higher tax literacy than females (Chardon, Freudenberg & Brimble, 2016).

⁴ It has been argued that it is 'perfectly appropriate to summarise the ratings generated from Likert scales using means and standard deviations, and it is perfectly appropriate to use parametric techniques like Analysis of Variance to analyse Likert scales' (Carifio & Perla, 2008, p.1151).

⁵ Note that in this section, for the purpose of all chi-squared testing and cross tabulation analysis, the categories 'Uncertain' and 'No Idea' were grouped together to form one category.

Table 2: Confidence Scores Aggregate

		Raw Mean	Very Confident (1)	Slightly Confident (2)	Neutral (3)	Uncertain (4)	No Idea (5)	
Gender	Male	2.26	56 29.8%	66 35.1%	40 21.3%	26 13.8%	0 0%	100%
	Female	2.51	82 19.7%	136 32.7%	134 32.2%	57 13.7%	7 1.6%	100%
		2.43						604
Age Bracket	18–29	2.71	37 19.5%	45 23.7%	60 31.6%	45 23.7%	3 1.6%	100%
	30–44	2.44	51 22.1%	75 32.5%	72 31.1%	30 13%	3 1.3%	100%
	45–54	2.25	28 23.7%	50 42.4%	33 27.9%	6 5%	1 0.8%	100%
	Over 55	1.94	22 33.8%	32 49.2%	9 13.8%	2 3%	0 0%	100%
		2.43						604
Employment Hours	Full-time paid work	2.29	85 25.5%	123 36.9%	90 27%	33 9.9%	2 0.6%	100%
	Part-time or Casual paid work	2.40	29 24.8%	38 32.5%	36 30.8%	13 11.1%	1 0.9%	100%
	Other (including retired)	2.33	4 19%	8 38.1%	6 28.6%	3 14.3%	0 0%	100%
	Full-time student	2.92	12 16%	12 16%	27 36%	23 30.7%	1 1.3%	100%
	Full-time student working > 15 hours per week	2.76	8 13.8%	21 36.2%	15 25.9%	11 19%	3 5.2%	100%
		2.43						604
Employment Category	Working for an employer	2.42	111 22.3%	175 35.2%	142 28.6%	62 12.5%	6 1.2%	100%
	Self- employed/Contr actor/Small business operator	1.90	15 44.1%	11 32.3%	6 17.6%	2 5.9%	0 0%	100%

		Raw Mean	Very Confident (1)	Slightly Confident (2)	Neutral (3)	Uncertain (4)	No Idea (5)	
	Other	3.0	2 20%	1 10%	4 40%	2 20%	1 10%	100%
	I am not in paid work	2.75	10 15.6%	15 23.4%	22 34.3%	17 26.6%	0 0%	100%
		2.43						604
Education Level	Secondary (Year 10 or less)	2.50	2 11.1%	9 50%	4 22.2%	3 16.7%	0 0.0%	100%
	Secondary (to Year 12)	2.67	15 16.9%	26 29.2%	30 33.7%	17 19.1%	1 1.1%	100%
	Trade, Apprenticeship or other TAFE	2.50	20 20.6%	32 33%	29 29.9%	15 15.5%	1 1%	100%
	Undergraduate degree (Bachelor)	2.53	31 18.9%	53 32.3%	52 31.7%	27 16.5%	1 0.6%	100%
	Postgraduate degree (Masters, Doctorate, professional qualification)	2.26	70 30%	79 33.9%	59 25.3%	21 9%	4 1.7%	100%
		2.43						601
Total Income	\$0–\$20 000	2.68	22 19.5%	32 28.3%	30 26.5%	28 24.8%	1 0.01%	100%
	\$20 000–\$49 000	2.64	27 19.3%	33 23.6%	54 38.6%	22 15.7%	4 2.8%	100%
	\$50 000–\$100 000	2.40	52 20.4%	98 38.4%	75 29.4%	28 11%	2 0.01%	100%
	\$100 000–\$150 000	1.95	20 36.4%	26 47.3%	7 12.7%	2 3.6%	0 0%	100%
	> \$150 000	1.65	10 50%	8 40%	1 5%	1 5%	0 0%	100%
		2.43						583

Notes: Column 3 demonstrates the raw mean of all confidence questions (on a 5 point scale) for each dependant variable. Columns 4 through 8 show the number and percentage of participants in binned categories of overall confidence. Each participant's individual confidence score was binned according to the category closest to that score. For example, a participant with an overall score of 2.6 would be categorised as 'Neutral'. This means that participant numbers in each category will not compute to the actual raw mean.

7.1.2 Age

From Table 2 it can also be seen that those participants in the '18–29' age category had the lowest overall confidence (mean score 2.71) and those in the 'Over 55' category had the highest overall confidence score (mean score 1.94). Overall, confidence in understanding tax and superannuation concepts gradually increases with age. This is partly in line with the Financial Literacy Foundation research which found that confidence in ability was lowest in the '18–29' age bracket (Financial Literacy Foundation, 2007). Further, in all confidence/ability questions posed in the Financial Literacy Foundation's research, confidence generally increased with age up until the '55–64' age bracket. In almost all questions, confidence was then slightly lower in the 'over 64' age bracket.

A Pearson chi-squared test showed a significant relationship between overall confidence category and age ($\chi^2 (9, N = 604) = 49.87, p = .000$). For mean confidence and the four age groups, the ANOVA⁶ result ($F(3,600) = 13.15, p = .000$) also showed a significant explanatory relationship (at 1 per cent) with confidence increasing with age. However, the result did not show homogeneity of variance ($p = .001$) therefore analysis of the results should be read with some caution.

Table 3 demonstrates that the largest mean difference is between those in the 'Over 55' year's category and those in the '18–29' category. Here the mean difference is almost one full category (0.78100). The results also show that generally mean difference in confidence increases with age.

Table 3: Confidence Score—Age (Comparison of Mean Variances)

	18–29	30–44	45–54	Over 55
18–29		0.27492**	0.46072***	0.78100***
30–44	-0.27492**		0.18580*	0.50608***
45–54	-0.46072***	-0.18580*		0.32028**
Over 55	-0.78100***	-0.50608***	-0.32028**	

Notes: * = statistically significant at 10 per cent, ** = statistically significant at 5 per cent,

*** = statistically significant at 1 per cent where the test is a one-way ANOVA and the LSD results have been reported.

Therefore, it is argued that generally confidence in understanding tax and superannuation issues is likely to increase as age increases and is likely to be lowest in those aged '18–29' years. This result is in line with the Finance Literacy Foundation research which also found that confidence in financial matters was lowest in those aged '18–29'.

7.1.3 Employment hours

From the summary in Table 2 it can be seen that the category with the lowest overall confidence was 'Full-time students' (mean score 2.92). Those with the highest overall

⁶ Here, the test is a one-way ANOVA where the LSD results have been reported in each of the tables of comparison of mean variance.

confidence were those in 'Full-time paid work' (mean score 2.29) with respondents in either 'Full-time paid work' or 'Part-time/Casual paid work' more confident than both 'Full-time student' categories. These results are interesting because they appear to indicate that confidence in understanding basic tax and superannuation issues does not begin to increase until there is some exposure to paid work. This provides some support for the argument that people must deal with a complex system for the first time when they commence paid work despite having little basic tax or superannuation skills taught in the primary and secondary education systems (Chardon, Freudenberg & Brimble, 2016). Unfortunately, the Financial Literacy Foundation research referred to earlier did not separately explore their results by employment hours. This can be contrasted to the Ali et al. findings that did not find a significant difference for high school students in relation to their financial literacy (as opposed to tax literacy) and whether or not the student had part-time work (Ali et al., 2014).

A Pearson chi-squared test showed a relationship between overall confidence category and employment hours (significant at 1 per cent) (χ^2 (2, N = 604) = 38.40, p = .000). This relationship is supported through the ANOVA result (F (4,599) = 8.57, p = .000). Table 4 demonstrates there is a significant difference in mean confidence between those in 'Full-time paid work', 'Part-time/Casual paid work' and both categories of 'Full-time student' (working and non-working). The largest (and most significant) difference is between 'Full-time students' and those in 'Full-time paid work'. However, those in 'Part-time/Casual paid work' are still likely to be more confident. While comparative data in the Financial Literacy Foundation survey cannot be used here, it is worth noting that these results are in line with the earlier results in relation to overall TLS where it was found that those in 'Full-time paid work' were more likely to have a higher TLS than those 'Full-time students' (Chardon, Freudenberg & Brimble, 2016).

Table 4: Confidence Score—Employment Hours (Comparison of Mean Variances)

	Full-time paid work	Part-time or Casual	Other (including retired)	Full-time student	Full-time student working > 15 hours per week
Full-time paid work		-0.11329	-0.04247	-0.62723***	-0.46653***
Part-time or Casual	0.11329		0.07082	-0.51394***	-0.35324**
Other (including retired)	0.04247	-0.07082		-0.58476**	-0.42406*
Full-time student	0.62723***	0.51394***	0.58476**		0.16071
Full-time student working > 15 hours per week	0.46653***	0.35324**	0.42406*	-0.16071	

Notes: * = statistically significant at 10 per cent, ** = statistically significant at 5 per cent,

*** = statistically significant at 1 per cent where the test is a one-way ANOVA and the LSD results have been reported.

7.1.4 Employment category

From Table 2 it can be seen that those ‘Not in paid work’ and in the ‘Other’ categories had the lowest overall confidence (mean scores 2.75 and 3.0 respectively). Those who identified as ‘Self-employed’ were the most confident (mean score 1.9) followed by those who identified as ‘Working for an employer’ (mean score 2.42). Interestingly nearly half (42.3 per cent) of those who were ‘Working for an employer’ scored in the categories ‘Neutral’, ‘Uncertain’ or ‘No idea’ confidence categories.

A Pearson chi-squared test showed a significant relationship between overall confidence category and employment category (χ^2 (19, $N = 604$) = 24.65, $p = .003$). Therefore, while there is a relationship between employment category and confidence category, this is less significant than it was for employment hours where $p = .003$.

In relation to overall mean confidence, this relationship (significant at 1 per cent) is supported through the ANOVA result ($F(3,600) = 7.19$, $p = .000$). Table 5 presents the mean differences between employment categories and confidence and their statistical significance. The results show the largest mean difference is between those in the ‘Self-employed’ category and those in the ‘Other’ and ‘Not in paid work’ categories. Table 5 also demonstrates a relationship between those ‘Not in paid work’ and those ‘Working for an employer’, although the mean difference here is less than it was when compared to the ‘Self-employed’ category. This may indicate that it is not just being self-employed that is likely to lead to increased confidence. Instead it is the connection (in some form) to the paid working environment that is likely to lead to increased confidence. While comparison to the Financial Literacy Foundation research of confidence in overall financial matters is not possible, these results in relation to confidence in tax and superannuation appear to be in line with the results of overall tax literacy where it was found that those ‘Working for an employer’ or ‘Self-employed’ were more likely to have a higher TLS (Chardon, Freudenberg & Brimble, 2016).

Table 5: Confidence Score—Employment Category (Comparison of Mean Variances)

	Working for an employer	Self- employed/Contractor/Small business operator	Other	I am not in paid work
Working for an employer		-0.52192**	-0.57892*	-0.33673**
Self- employed/Contractor/Small business operator	0.52192**		1.10084***	0.85865***
Other	0.57892*	1.10084***		0.24219
I am not in paid work	0.33673**	0.85865***	-0.24219	

Notes: * = statistically significant at 10 per cent, ** = statistically significant at 5 per cent,

*** = statistically significant at 1 per cent where the test is a one-way ANOVA and the LSD results have been reported.

7.1.5 Education

From Table 2 it can be seen that those with ‘Postgraduate’ education had the highest overall confidence (mean score 2.26). Those with ‘Secondary (to Year 12)’ as their highest level of education had the lowest overall confidence (mean score 2.67). Apart from those with ‘Secondary (Year 10 or less)’ having marginally higher levels of confidence than those with ‘Secondary (to Year 12)’, the other results are consistent with the financial literacy research which suggests that those with lower levels of education are more likely to have lower levels of financial literacy.

A Pearson chi-squared test reported less significance difference than was found in all other demographics (χ^2 (12, $N = 601$) = 18.69, $p = .096$). In relation to the mean confidence, a relationship was found and is supported through the ANOVA result ($F(4,596) = 3.77$, $p = .005$). Table 6 demonstrates the largest and most significant mean difference was between those with ‘Postgraduate’ education and those with ‘Secondary (to Year 12)’ education. The Financial Literacy Foundation research into financial literacy confidence did not report findings in relation to education, so no comparison is possible. However, it should be noted that a significant relationship was not found between those with ‘Postgraduate’ education and those with ‘Secondary (Year 10 or less)’, this may have been due to lower numbers in the ‘Secondary (Year 10 or less)’ category.

Table 6: Confidence Score—Education (Comparison of Mean Variances)

	Secondary (Year 10 or less)	Secondary (to Year 12)	Trade, Apprentices hip or other TAFE	Undergraduate degree (Bachelor)	Postgraduate degree (Masters, Doctorate, professional qualification)
Secondary (Year 10 or less)		-0.16618	0.00618	-0.02652	0.24370
Secondary (to Year 12)	0.16618		0.17235	0.13966	0.40987***
Trade, Apprenticeship or other TAFE	-0.00618	-0.17235		-0.03270	0.23752**
Undergraduate degree (Bachelor)	0.02652	-0.13966	0.03270		0.27022**
Postgraduate degree (Masters, Doctorate, professional qualification)	-0.24370	- 0.40987***	-0.23752**	-0.27022**	

Notes:

* = statistically significant at 10 per cent, ** = statistically significant at 5 per cent,

*** = statistically significant at 1 per cent where the test is a one-way ANOVA and the LSD results have been reported.

7.1.6 Income

Table 2 demonstrates that generally confidence in tax and superannuation concepts increases as total income increases. Those with the lowest overall confidence were in the '\$0–\$20 000' category (mean score 2.68). This is in line with the Financial Literacy Foundation research which reported that in almost all categories tested, confidence increased as income increased (Financial Literacy Foundation, 2007, pp. 77–83). A Pearson chi-squared test demonstrates a relationship between overall confidence category and total income category (χ^2 (12, $N = 583$) = 54.49, $p = .000$). The ANOVA result did not show homogeneity of variance ($p = .001$) therefore analysis of the results following should be read with caution. Notwithstanding this, the ANOVA result was $F(4,578) = 10.92$, $p = .000$.

Table 7 demonstrates the relationship is largest and strongly significant when comparing those with incomes in the category '\$0–\$20 000' and those in the 'greater than \$150 000' category.

Table 7: Confidence Score—Total Income (Comparison of Mean Variances)

	\$0–\$20 000	\$20 000–\$49 000	\$50 000–\$100 000	\$100 000–\$150 000	> \$150 000
\$0–\$20 000		0.04403	0.28135**	0.73656***	1.03688***
\$20 000–\$49 000	-0.04403		0.23732**	0.69253***	0.99286***
\$50 000–\$100 000	-0.28135**	-0.23732**		0.45521**	0.75553**
\$100 000–\$150 000	-0.73656**	-0.69253***	-0.45521**		0.30332
> \$150 000	-1.03688***	-0.99286***	-0.75553**	-0.30032	

Notes: * = statistically significant at 10 per cent, ** = statistically significant at 5 per cent, *** = statistically significant at 1 per cent where the test is a one-way ANOVA and the LSD results have been reported.

7.1.7 Conclusions in relation to overall confidence

The preceding section presented the findings and statistical analysis of the survey results in relation to overall confidence in tax and superannuation issues. Broadly, the findings were consistent with the Financial Literacy Foundation research, which found that lower confidence is more likely to be found in females, younger age groups and those on lower incomes. This survey also found that lower confidence in relation to taxation and superannuation issues is likely to be found in those with less participation in the paid workforce (that is, 'Full-time students' or those 'Not in paid work') and those with lower education levels.

The following section explores the survey findings in relation to confidence in specific areas of taxation and superannuation and whether or not confidence was reflected in actual understanding for those specific concepts.

7.1.8 *Confidence versus actual understandings of specific questions*

Table 8 presents comparisons of confidence scores for specific questions and the percentage of correct responses for the corresponding knowledge question. Only those questions where there was a specific correlating confidence question have been reported. It can be seen that there was a disparity between confidence and actual scores in relation to taxable income. Here overall confidence in relation to 'Understanding the meaning of taxable income' was relatively high (1.49 is between 'Very confident' and 'Confident'). However, for both related knowledge questions, the percentage score correct was around 50 per cent. This indicates there is some disparity between confidence and actual understanding in relation to taxable income.

Conversely, the table demonstrates that confidence in 'Understanding the meaning of marginal rates of tax' was relatively low (2.70 being close to 'Neutral'), yet the understandings for the corresponding knowledge questions were well above 50 per cent. This may indicate that participants perceive marginal tax rates to be a more complex area and therefore assessed confidence as lower than for taxable income.

It can also be seen that confidence in 'Understanding the meaning of deductions' was relatively high (1.82 being close to 'Confident'), however there were some particularly low scores in relation to applying the effect of deductions and classifying particular items of expense as either deductible or non-deductible. For example, participants performed quite poorly (43.5 per cent correct) when asked to calculate the actual cost of a deductible item after taking into account the tax saving.

In relation to understanding tax offsets, a low mean confidence (2.75) results for the question, 'Confidence in understanding the meaning of offsets'. This translated to a poor result in the knowledge question. Participants were asked to identify the actual dollar effect of claiming a tax offset (that is, the fact that an offset is a dollar for dollar amount rather than a reduction of taxable income). The correct response rate was only 45.4 per cent.

Table 8: Confidence Compared to Actual Understanding of Taxation Concepts

	Confidence mean (1) Very confident (5) No idea	Number correct % total participants	Number not answered
Confidence in understanding the meaning of taxable income	1.49		
Applying the meaning of taxable income		316 52.3%	0
Calculating taxable income		302 50%*	0
Confidence in understanding the meaning of assessable income	2.30		
Calculating assessable income		321 53.1%	0
Confidence in understanding the meaning of marginal rates of tax	2.70		
Calculating tax payable using marginal rates of tax		432 71.5%	19 n/a
Applying marginal tax rates to an extra \$1 of income		448 74.2%	19 n/a
Confidence in understanding the meaning of deductions	1.82		
Applying the effect of deductions		263 43.5%*	29 n/a
Determine deductibility of transaction			
Travel – home—work		474 78.5%	50 n/a
Travel – separate places employment		302 50%*	50 n/a
Clothing – retail worker		153 25.3%*	50 n/a
Clothing – corporate uniform		498 82.5%	50 n/a
Lunch – whilst at work		534 88.4%	50 n/a
Lunch – at offsite meeting		175 29%*	50 n/a
Newspaper – owns minimum shares		Y 220 36.4% N 199 32.9%	50 n/a
Interest – loan on investment property		394 65.2%	50 n/a
Medical expenses out of pocket		256 42.4%*	50 n/a
Confidence in understanding the meaning of offsets	2.75		
Applying the effect of offsets		274 45.4%*	29 n/a
Classify spouse rebate – offset/deduction		342 56.6%	33 n/a
Classify rental interest – offset/deduction		315 52.2%	33 n/a

	Confidence mean (1) Very confident (5) No idea	Number correct % total participants	Number not answered
Classify super co-contribution – offset/deduction		138 22.8%*	33 n/a
Classify work clothing – offset/deduction		500 82.8%	33 n/a
Classify education tax refund – offset/deduction		190 31.5%*	33 n/a
Classify travel expenses – offset/deduction		474 78.5%	33 n/a
Confidence in understanding the meaning of Medicare levy	2.00		
Understanding the rate of Medicare levy		281 46.5%*	62 n/a
Understanding how the Medicare levy is calculated		282 46.7%*	62 n/a
Confidence in understanding which medical tax offsets I am entitled to	3.12		
Awareness of ability to claim medical tax offsets		319 52.8%	62 n/a
Understanding the threshold for medical tax offset		147 24.3%*	285 n/a***

Notes:

This table compares confidence in understanding particular taxation concepts against actual scores for knowledge questions.

Column 2 demonstrates the mean confidence score for the corresponding question described in Column 1.

Columns 3 and 4 demonstrate the number and percentage of correct responses for each of the questions that counted toward the overall tax literacy score as well as the number of participants that did not answer that question.

* Number of Correct Responses < 50%

** Two marks available for this question

***Flow-on question; some participants not asked

In relation to the Medicare levy, ‘Confidence in understanding the meaning of Medicare levy’ was relatively high (mean of 2.0 is ‘Confident’). However, this translated to only 46.5 per cent of participants correctly identifying the rate of the Medicare levy as 1.5 per cent. This is interesting given that the rate of Medicare levy had largely remained unchanged for eighteen years at the time of the survey.

The literature identified that when there are disparities between confidence and knowledge or when there are particularly low levels of confidence, this can lead to poor financial decisions, lower propensity to plan ahead and less likelihood to seek advice. Here, the results indicate there may be disparities between confidence and knowledge in relation to taxable income, marginal rates of tax, deductions and the Medicare levy. Also, there may be concerns about the level of understanding and confidence in relation to tax offsets. Here, the results demonstrated generally both low confidence and low knowledge.

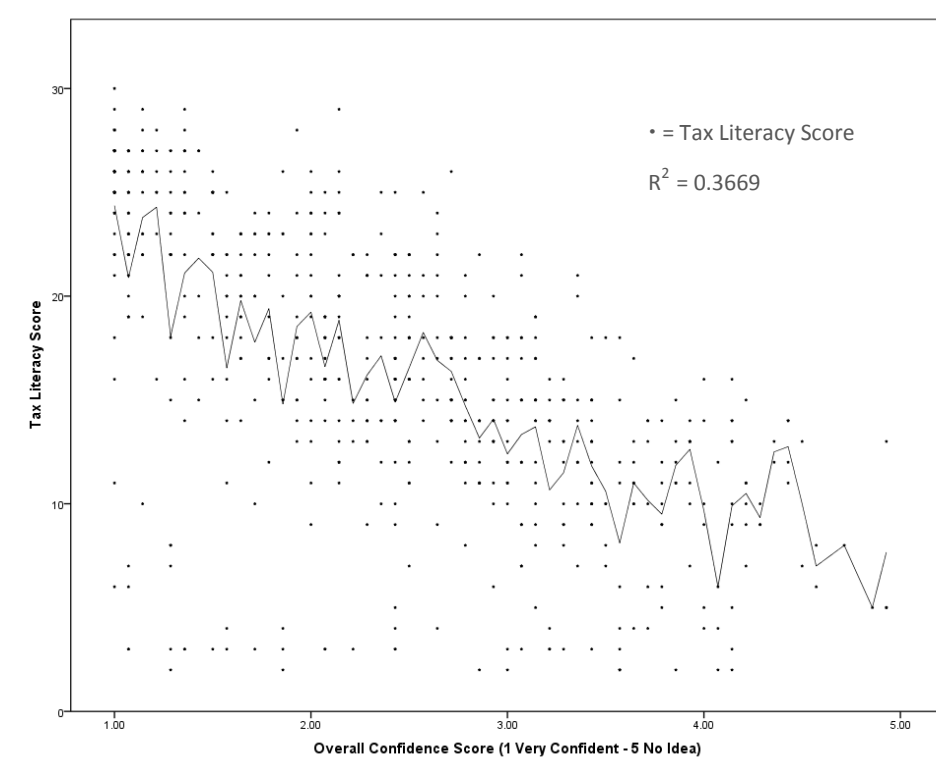
7.1.9 Analysis of overall confidence versus overall tax literacy

The following section presents data which compares overall confidence and overall tax literacy in order to determine whether there is evidence of a link between confidence and actual understanding.

Figure 1 presents overall TLS as it relates to overall confidence. The regression results showed a significant linear relationship between TLS and overall confidence: ($F(1, 602) = 348.74, p < .001$) with $r^2 = .366$. Thus, approximately 36 per cent of the variance in TLS can be explained through knowing a participants' overall confidence. Broadly, it can be seen that as confidence decreases (towards 5), TLS also decreases. This finding is important because it supports assertions made in other financial literacy research which state that increasing confidence in financial matters may have an impact on a person's overall financial literacy. These results indicate that in the context of tax and superannuation, increasing confidence is likely to be related to the knowledge and understanding components of financial literacy.

From Figure 1 it can also be seen that there are very few instances where a participant scored highly in terms of their TLS, but had lower confidence. There were a very small number of participants who had very high confidence (between 1 and 2) and lower TLS. These two findings are unusual and suggest that over-confidence is not common in relation to tax and superannuation issues. This is quite in contrast to previous research where it has generally been found that over-confidence particularly in relation to basic financial concepts and some investment decisions is quite prevalent (Bateman et al., 2012; Financial Literacy Foundation, 2007; Gallery & Gallery, 2010; Gallery et al., 2011). There has been some suggestion in previous research that there may be more over-confidence in advanced investment decision making (Gallery et al., 2011), although as has been stated previously there is no prior research specifically in relation to tax to which these findings can be compared.

Figure 1: Tax Literacy Score and Overall Confidence Scatterplot



In order to explore this relationship between confidence and TLS further, participants were categorised as being either over-confident or under-confident and further analysis by demographic was performed. This over-confidence or under-confidence was determined with reference to each participant's TLS as a percentage of the 31 tax questions asked in comparison to their overall confidence score as a percentage of the five confidence questions asked. It can be seen in Table 9 that in general, a larger percentage of participants were under-confident (60.4 per cent). That is, a larger percentage of participants had a higher TLS percentage when compared to their confidence percentage. Interestingly, it appears that males were slightly less over-confident than females, although further analysis did not find a statistical relationship here. For age, we can see there was some over-confidence in the two older age brackets when compared to the total over-confidence percentage of 39.6 per cent. This is an interesting finding, which is supported by the Pearson chi-squared result of: $\chi^2 (3, N = 604) = 14.33, p = .000$, revealing a significant relationship between under/over-confidence and age.

Table 9: Over-confidence and Under-confidence By Demographic

		Total	Over-confident	Under-confident	
Gender	Male	188	72 38.3%	116 61.7%	100%
	Female	416	167 40.1%	249 59.8%	100%
			239 39.6%	365 60.4%	604
Age bracket**	18–29	190	67 35.3%	123 64.7%	100%
	30–44	231	79 34.2%	152 65.8%	100%
	45–54	118	58 49.2%	60 50.8%	100%
	Over 55	65	35 53.8%	30 46.2%	100%
			239 39.6%	365 60.4%	604
Employment hours	Full-time paid work	333	127 38.1%	206 61.9%	100%
	Part-time or Casual paid work	117	47 40.2%	70 59.8%	100%
	Other (including retired)	21	9 42.9%	12 57.1%	100%
	Full-time student	75	29 38.7%	46 61.3%	100%
	Full-time student working > 15 hours per week	58	27 46.6%	31 53.4%	100%
			239 39.6%	365 60.4%	604
Employment category	Working for an employer	496	197 39.7%	299 60.3%	100%
	Self-employed/Contractor/Small business operator	34	14 41.2%	20 58.8%	100%

		Total	Over-confident	Under-confident	
Other		10	3 30%	7 70%	100%
I am not in paid work		64	25 39.1%	39 60.9%	100%
			239 39.6%	365 60.4%	604
Education level	Secondary (Year 10 or less)	18	9 50%	9 50%	100%
	Secondary (to Year 12)	89	36 40.4%	53 59.6%	100%
	Trade, Apprenticeship or other TAFE	97	40 41.2%	57 58.8%	100%
	Undergraduate degree (Bachelor)	164	60 36.6%	104 63.4%	100%
	Postgraduate degree (Masters, Doctorate, professional qualification)	233	91 39.1%	142 60.9%	100%
			239 39.6%	365 60.4%	604
Total income	\$0–\$20 000	113	43 38.1%	70 61.9%	100%
	\$20 000–\$49 000	140	58 41.4%	82 58.6%	100%
	\$50 000–\$100 000	255	104 40.8%	151 59.2%	100%
	\$100 000–\$150 000	55	21 38.2%	34 61.8%	100%
	> \$150 000	20	5 25%	15 75%	100%
			239 39.6%	365 60.4%	604

Notes:

* = statistically significant at 10 per cent, ** = statistically significant at 5 per cent,

*** = statistically significant at 1 per cent where the test is a Pearson chi-squared.

In relation to ‘Employment hours’ category, the ‘Full-time students working > 15 hours per week’ were more over-confident (46.6 per cent) than the overall levels (39.6 per cent). In relation to education, those in the ‘Secondary (Year 10 or less)’ category were more over-confident (50 per cent) than the overall levels (39.6 per cent). For income, those in the ‘> \$150 000’ category were less over-confident (25 per cent) than the overall levels (39.6 per cent). The earlier results found that there was a correlation with both overall TLS and confidence particularly in relation to connection to work, education and income. Reading those results with these results in relation to over-confidence, it may be argued that where there is increased connection with work, increased education and increased income, confidence in tax and superannuation is less likely to be overstated. This may be due to an awareness of tax and superannuation being more complex than other financial concepts for these demographics. Another (or part of the) reason could also be that people are aware of

the penalties for incorrect reporting of tax matters, and therefore are more cognitive of their actual knowledge.

7.2 Overall findings

The literature identifies that confidence in understanding financial issues is an important aspect of financial literacy and that there is often a gap between confidence and actual understanding. Furthermore, the literature indicated that improving confidence had the potential to improve financial literacy as well as ensuring people were more likely to plan ahead, avoid poor financial decisions and seek appropriate advice.

The survey measured self-assessed confidence in understanding a range of tax and superannuation issues, which aligned with knowledge questions posed. Firstly, in relation to overall confidence in general, the findings were that lower confidence in tax and superannuation issues is more likely to be found in females, younger age groups and those on lower incomes. These findings were consistent with the Financial Literacy Foundation research in relation to financial confidence. However, we find additional evidence that lower confidence in relation to taxation and superannuation issues is likely to be found in those with less participation in the paid workforce (such as full-time students or those not in paid work) and those with lower education levels. This can be compared to the Ali et al. (2014) findings that did not find a significant difference for high school students in relation to their financial literacy (as opposed to tax literacy) and whether or not the student had part-time work.

Secondly, in relation to whether there was a link between confidence and overall tax literacy score, the results showed a statistical relationship between participants' overall TLS and confidence. Generally, participants were largely under-confident and there were almost no instances of low self-assessed confidence and high TLS. It is suggested that this finding may be explained by the fact that tax issues are different to other financial matters because there is the potential for penalties to apply if tax matters are overlooked or are incorrect, whereas the consequences in other financial areas may not be seen as severe (or seen as 'penalties'). In this way the deterrent effect of penalties for incorrect reporting of tax matters may lead to greater alignment between tax literacy and tax confidence. The results also demonstrated that there were relationships with overall self-assessed confidence in relation to all demographics, but particularly in relation to age, employment hours and income. In relation to links between confidence and understanding for particular concepts, it was found that there were disparities for particular concepts including: taxable income, deductions, offsets and Medicare levy.

8. RECOMMENDATIONS

Prior literature suggests that building confidence in relation to financial matters can influence the degree to which people seek assistance with financial decisions, make better financial decisions and overcome attitudes or beliefs that prevent proactive steps being taken (Financial Literacy Foundation, 2007; Lusardi & Mitchell, 2006). Based on this and the findings of this research we make four recommendations. Firstly, it is recommended that those designing, implementing and evaluating financial literacy education programs recognise that confidence is generally lower in relation to tax and superannuation issues compared to other areas of financial literacy. This means that

programs should use appropriate instruction design methodologies to build confidence and motivation to act as well as provide knowledge/literacy. For example, in Canada the St Christopher House in Toronto provides assistance in the preparation of tax returns for clients as part of its financial problem solving (Government of Canada, 2006, p. 15). Also, it appears that there is no substitute for hands-on experience in terms of learning how to manage one's finances, including tax obligations.

Second, we suggest that financial literacy education should be tailored rather than generic, with specific programs targeted to those with low confidence, especially youth, women and those entering the workforce for the first time. These programs may be designed by government agencies, financial service and tax advice agencies, revenue authorities or not-for-profit agencies.

Extending this idea, we also suggest that employers consider developing tax literacy as part of the induction processes for new staff and particularly those employees who are young/new employees and those returning to work after a period of absence.

Finally, we suggest that professional advisers (tax agents, accountants and financial planners) utilise their expertise to enhance the confidence and knowledge of clients as a part of the professional client relationship (in other words empower them). Indeed, we would extend this to suggest such professionals may have the capacity to participate in community education programs as part of their broader professional service to the community. This is especially the case if there is a link between improved literacy and compliance behaviour (Mihaylov et al., 2015, p. 754).

If these recommendations are implemented and disparities between confidence and actual understandings are decreased, this may increase the degree to which people seek out assistance with financial decisions, make better financial decisions and overcome attitudes or beliefs that prevent proactive steps being taken. Furthermore, we believe that these findings could be used by professional bodies (particularly accounting, tax and financial planning entities) in providing relevant information to their members regarding the likelihood of under and over-confidence in relation to specific tax and superannuation issues (such as taxable income, deductions, offsets, Medicare levy and superannuation). Given the literature suggests there may be a decreased likelihood of seeking advice where there are disparities in confidence and actual understandings, these results could provide important opportunities for advice providers to value add to the services provided and/or identify new areas to provide client education.

9. LIMITATIONS AND FUTURE RESEARCH

The study has a number of limitations that should be considered when evaluating the findings of the research. The conclusions drawn from the survey conducted are limited by the sample size and the characteristics of those participants in the survey. Also, it is not certain to what extent these Australian findings could be generalised to other jurisdictions. Further research in other jurisdictions could analyse tax literacy and tax confidence as part of the financial capability model.

The findings appear to support the argument that there appears to be a link between confidence and improved financial (or tax) literacy. Consequently, further research could explore and/or measure the impact of improved confidence on financial (or tax)

literacy (or vice-a-versa). It also provides the opportunity for future research to test methods for increasing confidence and the extent to which this leads to increased confidence and subsequently increased wealth.

Future research could also investigate the relationship between age, tax literacy and confidence. Also, future research could explore why those with lower educational levels appear to be 'over-confident' when it comes to their tax literacy. Another research project in the future, could consider to what extent advisors assist or see value in increased tax literacy and tax confidence of their clients. This could include the notions of 'empowerment' with professional relationships (Hunt, Brimble & Freudenberg, 2011).

Further research could consider the notion of how low tax literacy could result in 'financial exclusion', particularly in terms of the lack of access to government benefits and services that are increasingly being delivered through the tax system.

Research could be conducted to consider the tax literacy and confidence of small and medium enterprise owners, as it appears that they have unique characteristics compared to the population in general. Future research could explore whether higher levels of tax literacy are associated with more tax compliant as compared to tax non-compliant behaviour. Also, research could explore the deterrent effect of penalties for incorrect tax reporting with the alignment between tax literacy and tax confidence.

10. CONCLUSION

In an increasingly complex world, the need for improved financial literacy has been advocated by governments around the world. This financial literacy extends beyond just knowing how to do calculations, but is now seen as including financial capability which includes notions of confidence and ability to put knowledge into action. Also, given the way that the tax system can influence investment returns, it has been argued that financial literacy needs to include aspects of tax and retirement savings. This is particularly important given governments are using the tax system to encourage certain behaviours, especially retirement funding, and that tax can influence investment returns.

This article reviewed the literature in terms of financial literacy, and its relationship with financial capability and tax literacy. The importance of confidence as part of financial capability and the tax system was also considered. It was argued that it is important to understand peoples' confidence and how it relates to their tax literacy.

We reported on measures of Australians' confidence in terms of tax, and compared this to their tax literacy. The study revealed lower tax confidence was more likely to be found in females, younger age groups and those on lower incomes. This survey also found that lower confidence in relation to taxation and superannuation issues was likely to be found in those with less participation in the paid workforce (that is, 'Full-time students' or those 'Not in paid work') and those with lower education levels.

It was also found that in terms of the relationship between tax confidence and tax literacy that, unlike other financial literacy indicators, generally there is a lack of 'over-confidence' when it comes to tax literacy.

Given the growing prominence of confidence as part of a more comprehensive understanding of financial capability, the findings of this study suggest that Australians are largely under-confident in estimating their tax literacy. However, it is important that Australians become more tax confident and tax literate, as this should aid them in making better and more accurate financial decisions, be more likely to plan ahead and seek advice when needed. Such improved decision making has the potential to have positive impacts for themselves, and the economy as a whole. As it has been stated, ‘without financial understanding, knowledge, and confidence, individuals may be at risk of financial exclusion’ (Government of Canada, 2006, p. 6), and this ‘financial exclusion’ includes the lack of access to government benefits and services that are increasingly being delivered through the tax system. It is argued that confidence towards the tax system is an important part of a person’s overall financial capability.

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12. APPENDIX 1

Table 10: Tax Literacy Survey Correct Response Rates By Question

Question	Number correct	% Total participants	Number not answered
Calculating taxable income	302	50%*	0
Calculating assessable income.	321	53.1%	0
Calculating tax payable using marginal rates of tax	432	71.5%	19 n/a
Applying marginal tax rates to an extra \$1 of income	448	74.2%	19 n/a
Applying the effect of deductions	263	43.5%*	29 n/a
Determine deductibility of transaction			
Travel home–work	474	78.5%	50 n/a
Travel – separate places employment	302	50%*	50 n/a
Clothing – retail worker	153	25.3%*	50 n/a
Clothing – corporate uniform	498	82.5%	50 n/a
Lunch – whilst at work	534	88.4%	50 n/a
Lunch – at offsite meeting	175	29%*	50 n/a
Newspaper – owns minimum shares	Y 220 N 199	36.4% 32.9%	50 n/a
Interest – loan on investment property	39	65.2%	50 n/a
Medical expenses out of pocket	256	42.4%*	50 n/a
Applying the effect of offsets	274	45.4%*	29 n/a
Classify spouse rebate – offset/deduction	342	56.6%	33 n/a
Classify rental interest – offset/deduction	315	52.2%	33 n/a
Classify super co-contribution – offset/deduction	138	22.8%*	33 n/a
Classify work clothing – offset/deduction	500	82.8%	33 n/a
Classify education tax refund – offset/deduction	190	31.5%*	33 n/a
Classify travel expenses – offset/deduction	474	78.5%	33 n/a
Knowledge of current rate of compulsory employer superannuation	344	57%	62 n/a
Awareness of superannuation being taxed at a lower rate than other investments	346	57.3%	62 n/a
Understanding tax on capital gains (taxed at marginal rates with 50% discount sometimes applying)**	169 tax rate 160 50% discount	28% * 26.5%*	61 n/a
Understanding the meaning of negative gearing	327	54.1%	61 n/a
Understanding the rate of Medicare levy	281	46.5%*	62 n/a
Understanding how the Medicare levy is calculated	282	46.7%*	62 n/a
Awareness of ability to claim medical tax offsets	319	52.8%	62 n/a
Understanding the threshold for medical tax offset	147	24.3%*	285 n/a***

Notes: This table shows the number and percentage of correct responses for each of the questions that counted toward the overall tax literacy score. The total number of questions counted toward the score was 31.

* Number of Correct Responses < 50 per cent.

** Two marks available for this question.

*** Flow-on question, so some participants not asked.

Tax policy challenges in an era of political transition: The case of Egypt

Mahmoud M Abdellatif¹ and Binh Tran-Nam²

Abstract

Tax policy is normally formulated and implemented during politically stable periods. The collapse of the Soviet Union and Eastern bloc countries in the early 1990s have allowed researchers to study tax policy reform in transition economies with changing political and economic systems. This article aims to examine tax policy challenges in Egypt as a result of the revolution in 2011. Egypt has been chosen because of its importance in the Arab world and its interesting tax reform, including a rationalisation of tax incentives. It is found that Egypt has adopted a combination of counter-cyclical government expenditure policy and pro-cyclical tax policy in an era of political transition. This combination is interesting as it is well known that developed countries tend to employ counter-cyclical fiscal policy whereas developing countries tend to utilise pro-cyclical policy. It is proposed that the Egyptian government should consider modernising its tax administration and enhancing its anti-tax avoidance activities as an alternative to increasing tax rates in pursuing its pro-cyclical tax policy.

Keywords: Tax policy, Political transition, Business cycle, Economic efficiency, Equity

¹ Corresponding author, Assistant Professor, Department of Finance and Economics, College of Business and Economics, Qatar University, Doha, Qatar, email: m.abdellatif@qu.edu.qa.

² Professor, School of Taxation and Business Law, UNSW Australia, Sydney, Australia and Asia Graduate Centre, RMIT University, Vietnam.

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1. INTRODUCTION

Theoretical and empirical studies of tax policy design and implementation are typically concerned with countries, mainly developed countries, having stable political and economic regimes. The collapse of the Soviet Union and the Eastern bloc countries in the early 1990s has allowed tax researchers to study tax policy reforms in the context of simultaneous political and economic transition (see, for example, Martinez-Vazquez & McNab, 2000). However, in some formerly central planned countries such as China and Vietnam, tax reforms have taken place within politically stable but economically evolving regimes. Twenty years after the dissolution of the Soviet Union, the Arab Spring has offered an interesting opportunity to examine tax policy in a reversal situation, that is, within a relatively stable economic system during political transition.

Taking advantage of this opportunity, this article intends to examine tax policy challenges in Egypt since the 2011 civil revolution. Egypt is chosen as a case study for three primary reasons. First, it is the most populous country in the Arab bloc with a significant cultural and political influence in North Africa, the Middle East and the Islamic world (Coleman, 2015). Second, it has, until recently, experienced three decades of reasonable political stability under the regime of former President Mubarak from 1981 to 2011 (Dahi, 2012). Third, Egypt has recently undertaken interesting tax reform measures, including a comprehensive rationalisation of tax incentives (see, for example, Abdellatif & Tran-Nam, 2016). It is thus insightful to consider such reforms in the context of Egypt's political transition.

Before proceeding further, it seems helpful to briefly review the recent political transition in Egypt. At the beginning of 2011, a number of Arab countries, such as Egypt and Tunisia, witnessed uprisings against long established political regimes. The young people were engines of the protests revealing their dissatisfaction of government policies, including lack of political freedom, cronyism, corruption and poverty (Khandelwal & Roitman, 2013). Because of problems of nepotism and ignorance, young people in those countries faced difficulties with finding jobs which have in turn created socio-economic tensions. In fact, income inequality has popularly been perceived to be one of the root causes of the revolution in Egypt (Kandil, 2011, p. 7).³

Young educated people in Egypt started using social media to express their disappointment of the regime and to call for changes. This motivated them to go out protesting, which resulted in the collapse of the Mubarak's regime and establishment of an interim government charged with implementing political changes to create a more democratic country. Another wave of political changes taking place in June 2013 led to new political regimes. Thus, since 2011, Egypt has suffered from political instability and the political transition process has been facing critical challenges (IMF, 2013a). Those challenges have mainly resulted from an inherited corrupted regime, resistance to changes from the previous regime by the business sector and interest groups, all of which have exacerbated political instability and prolonged the transition period.

³ Surprisingly, this perception was not supported by an analysis of Egyptian household survey data; see Verme et al., 2014 at 1.

The economic problems have also been exacerbated because of political changes, manifesting in rising unemployment rates since 2011 compared with the previous situation. Private investment has declined sharply and many businesses have been liquidated (Katulis, 2012). Economic slowdown has also been accompanied by a significant increase in the budget deficit as a result of increasing government expenditures while the tax revenue did not increase at the same rate to meet the additional spending (Morisse, 2013). Accordingly, the Egyptian economy was moving towards a new cycle of slowdown.

The increasing level of budget deficit and the reduction in economic growth rates as a result of declining economic activities during political transition raise the following research question, ‘what is the appropriate tax policy for socio-economic changes during political transition in Egypt?’ In order to answer this question, the present article will attempt to (i) review the scholarly works related to tax policy and business cycles, and the criteria of good tax policy, (ii) examine the Egyptian policy prior and post political changes, (iii) assess Egypt’s tax policy during political changes in terms of its relation with business cycle and norms for a good tax system, and (iv) provide specific policy recommendations to design appropriate tax policy during political changes.

The remainder of this article is structured as follows. Section 2 briefly reviews the literature that discusses the criteria of good tax policy and impact of political changes/transition on tax policy. Section 3 employs both theoretical and simple statistical analyses to examine the nature of tax policy and political changes in Egypt. In Section 4, the null hypothesis that ‘counter-cyclical tax policy is appropriate during political transition’⁴ is tested through assessing the relationship between tax policy and business cycle on the one hand and assessing the tax policy practices from the perspectives of good tax policy criteria on the other. Section 5 concludes.

2. LITERATURE REVIEW

2.1 An overview of tax policy

Tax policy has gained more importance, particularly in developing countries, since the early 1990s. This is mainly because many developing countries have launched their economic stabilisation and transition programs under the direction of international institutions, specifically the International Monetary Fund (IMF) and World Bank (Martinez–Vazquez & McNab, 2000). These programs often employ tax policy as a core element to tackle fiscal imbalance and accelerate economic growth rates. Accordingly, the majority of developing countries have carried out specific tax reform programs in order to achieve a number of objectives. In so doing, tax reform programs vary from one country to another because of differences among countries in terms of socioeconomic factors resulting in different tax reform approaches being employed (Thrisk, 1997).

Tax policy in developing countries faces a number of critical challenges, namely, (i) macroeconomic stabilisation, (ii) globalisation, (iii) economic development

⁴ The research question leads directly to the null hypothesis, which is based on the Keynesian approach which calls for counter-cyclical tax policy for macroeconomic stabilisation.

stimulation, and (iv) modernisation of tax administration (Vermeend et al., 2008). In an era of political changes, policymakers tend to be mostly concerned with economic stabilisation and economic growth. These two issues will be further considered below.

2.2 Tax policy and macroeconomic stabilisation

Macroeconomic stabilisation programs mainly focus on tackling a number of economy-wide issues, particularly unemployment, inflation and budget deficit. Tax policy, among other economic policies, is employed to overcome those issues (Montiel & Servén, 2006). However, a strong link can be easily identified between tax policy and budget deficits. In this regard, tax policy is being used to increase tax revenue through various techniques such as introducing new taxes, increasing tax rates, broadening tax bases, and changing the tax mix (Listokin, 2012).

Many developing countries had restructured their tax systems to increase tax revenue relative to GDP. This process resulted in changes in the tax mix through moving from easy to tax and collect into hard to tax and collect (Aizenman & Jinjarak, 2009). Consequently, foreign trade taxes have declined, especially as a percentage of total tax revenue, while Value Added Tax (VAT) and excise taxes have become more important (Keen & Simone, 2004). At the same time, income tax has been simplified and the marginal tax rates have been reduced. Those measures have led to significant results with regard to increasing tax revenues and consequently curbing budget deficits. Nevertheless, the ratios of total tax revenue to GDP in developing countries are still low in comparison with those of developed countries (Bird, 2008).

Tax policy and economic stabilisation in the short term reflected in the business cycle has been examined by several researchers including Talvi, Ernesto and Carlos (2005), Barro and Redlick (2011), and Vegh and Vuletin (2015). Those scholars carried out studies to identify the characteristics of tax policy in developed and developing countries. They found that fiscal policy, including tax policy, is counter-cyclical in developed countries and pro-cyclical in developing countries. Vegh and Vuletin (2015) developed a model for tax rate changes in 62 developing countries during 1960 to 2009 as a proxy of tax policy changes and they found that tax policy and government spending are both pro-cyclical. Accordingly they concluded that tax policy is pro-cyclical in developing countries.

2.3 Tax policy and economic development

Policymakers often use various tax policy means in order to encourage capital accumulation and consequently investment. This includes granting generous tax reliefs to domestic and foreign investors through various forms of tax incentives such as tax holidays, investment tax credits, reduced tax rates and special economic zones (Vann & Holland, 1998). However, the majority of developing countries tend to rely heavily on two types of tax incentives, namely, tax holidays and special economic zones. Nevertheless, many developing countries have recently come to the realisation that tax incentives are just one of the many determinants of investment including political stability, infrastructure, legal system, (OECD, 2007). As a result, many developing countries have either rationalised or abolished tax incentives (Bird, 2008). However, rationalisation or elimination of

tax incentives may not always be the optimal solution. Tax policymakers must find a proper way to assess the costs and benefits arising from tax incentives.

2.4 Criteria for assessing tax policy and political transition

Under the normative approach, researchers often use a small number of criteria to assess overall tax policy (Wagner, 1985). The monumental and seminal work of Adam Smith forms the core of current assessment criteria, which are equity, efficiency, certainty and flexibility (Coutinho, 2001). In an early study, Sneed (1965, p. 568) identified seven criteria for assessing income tax policy: (i) revenue adequacy, (ii) practicality, (iii) equity, (iv) stability, (v) reduced economic inequality, (vi) free market compatibility, and (vii) political order.

The efficiency of a tax system means that the tax system must achieve the desired objectives without creating unnecessary economic distortions. A distortion is said to occur when a tax system affects investment decisions, which in turn means that the tax system encourages some investments while discouraging others. In this respect Gravelle (1994, p. 29) defined efficiency as ‘minimizing distortions in the allocation of resources caused by taxes and on using the tax system to correct failures of private markets to allocate resources efficiently’. This concept draws attention to the role of the tax system in allocating resources (affecting the investor’s investment decision) and dealing with market failure issues (Sneed, 1965, p. 586). This also means the appropriate tax policy is important in fostering economic growth and increasing employment. These conditions help to identify the proper policy tools during an economic slowdown resulted from political changes.

In an era of political transition, the efficiency of a tax system is concerned with its ability to encourage private sector investments. Political instability negatively affects investment decisions, so policymakers need to design some measures within the tax system to mitigate the impact of political risks and to encourage investments. In this context, Carmignani (2003) examined the relationship between political stability and economy through assessing the impact of political stability on monetary and fiscal policies, and economic growth in general. He found that political instability negatively affects budget deficits and economic growth because of the uncertainty which affect the behaviour of economic agents.

The government is concerned with increasing public expenditures as a means to restore economic stability because of the increasing social needs. Increasing government expenditure requires an equivalent increase in government revenue through raising collected tax revenues or government borrowings. Increasing tax revenues poses a number of issues which are related to the adequacy of the tax system. In this context, a number of researchers, such as Mutascu et al. (2011) and Bohn (2003), have examined the impact of political stability on tax system in terms of tax revenue. They found a positive correlation between political stability and tax revenue collected in the long run.

An important criterion for assessing tax system is equity, which can be classified into ‘horizontal equity’ and ‘vertical equity’. Horizontal equity occurs when taxpayers with the same income bear the same tax burden. On the other hand, vertical equity refers to when taxpayers have more income they should pay more

income tax in both absolute and proportional terms.⁵ Vertical equity interpreted in this way implies progressive tax rate schedules under which the average tax rate rises as income increases (Chen, 2012). In this respect, the equity criterion can be used to impose higher tax rates on higher income groups as a tool to redistribute income. In the presence of political instability in Egypt, a progressive income tax system may be used to redistribute income from the rich to the poor to achieve greater equality.⁶

3. TAX POLICY AND ECONOMIC CHALLENGES DURING POLITICAL TRANSITION IN EGYPT

3.1 Economic challenges during political transition

3.1.1 Income inequality dilemma

The Egyptian revolt in 2011 provoked many researchers to investigate the factors leading to political uprisings. For example, Khalil (2011) examined the reasons behind the 25 January 2011 revolution and concluded that social inequality and lack of democracy were the main reasons for revolt. Other scholars have attributed the uprisings to the economic situation and social injustices (see, for example, Dahi, 2012). Dali (2012) reviewed the political development in Egypt from 1952 to 2011 and its economic consequences. The economic system developed after the 1952 revolution was known as the ‘authoritarian populist’ system under which the government was concerned to achieve social justice through a number of means such as: (i) implementing land agrarian to support peasants, (ii) employing workforce in urban communities in government and public sector, and (iii) giving the professionals the opportunity to be senior bureaucrats. So, regardless of the lack of democracy, the households’ needs were looked after. However, at the beginning of 1970s, the government started a new economic policy which was known as ‘economic openness policy’ to replace the authoritarian populist regime (Assaad et al., 2016).

New economic policies were adopted at the time to encourage foreign direct investment (FDI) as a tool to stimulate economic growth, which led to a diminished role of the middle income class and increasing role of businessmen in the community. Such a situation was further exacerbated after implementation of the structural adjustment program in the early 1990s, which was recommended by the IMF (Ansani & Daniele, 2012). The structural reform focused on three areas, namely, (i) deregulation, (ii) liberalisation, and (iii) privatisation. This has led to

⁵ Vertical equity is derived from Adam Smith’s principle of equity. It means those taxpayers who have a higher income have greater ability to pay and therefore should pay higher taxes. Adam Smith (1776, Book V, Part II) himself favoured proportional tax rates (‘The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities’). Over time, there is now a widely (but not universally) held view that those with a higher income not only should pay more taxes, but should pay a higher fraction of their income in taxes; see, for example, Stiglitz (2000, p. 470). The authors subscribe to the latter interpretation of vertical equity.

⁶ As discussed in the introductory section, important reasons for the Egyptian revolution on 25 January 2011 include income inequality and a lack of justice (Kandil, 2011, p.7). Thus, relatively more progressive government spending and income taxation may help to relieve inequality, or at least the perception of it.

the shrinking role of the government and an increasing role of the private sector in the economy. As a result of a lack of transparency and accountability, privatisation increased the level of corruption and income concentration.

As summarised in Table 1, growth rates of real GDP and real GDP per capita in Egypt have generally decreased over time, especially during the period just before the revolution. Table 1 also shows that the growth rate of GDP per capita has been considerably lower than that of GDP.

Table 1: Average Annual Growth Rates of GDP and GDP per Capita, Egypt

	1961–2010	1995–2011	2008–2011
Average annual GDP growth rates (%)	5.1	5	3.8
Average annual GDP per capita growth rate (%)	3	2.9	2

Source: Ansani & Daniele, 2012.

The income inequality issue addresses the capability of tax policymakers in dealing with the equity criterion within the Egyptian tax system. Hlasny and Verme (2013) conducted a study to measure the top income in order to identify the level of inequality based on three household income and expenditure surveys in Egypt using a number of different measures. They concluded that there is insufficient evidence about rising income inequality. Accordingly, policymakers should focus on stimulating economic growth to stabilise the economy and to create more jobs for unemployed people (Hlasny & Verme, 2013, p. 30). This study sheds light on the importance of increasing GDP growth rates as a tool to tackle a number of economic issues, particularly unemployment.

In a study of inequality in the southern Mediterranean region, including Egypt, El-laithy (2012, p. 7) found that the average loss in the Human Development Index (HDI) due to income inequality in Egypt is more than 25 per cent. This indicates there is scope for the tax system (income taxation) to reduce the level of income inequality in Egypt.

3.1.2 Stimulating economic growth

A critical consequence of political transition is slower economic growth and increasing unemployment rate because of the higher risk adherent to political instability (Ansani & Daniele, 2012, p. 2). In this context, Carmignani (2003) carried out an empirical study to assess the impact of political instability on economics through assessing its impact on growth, and fiscal and monetary policy. He found that political instability affects the degree of uncertainty of potential economic policies which in turn negatively impacts economic growth. This situation has been evident in Egypt since the start of political transition. The GDP growth rate went

down sharply from 5.1 per cent in 2009 to 2010 to 1.9 per cent in 2010 to 2011. Table 2 illustrates Egypt's GDP growth rates of real GDP from 2002 to 2014.

Table 2: Real GDP Growth Rate, Egypt, 2002 to 2014

Year	Real GDP growth rate (%)
2002–03	3.1
2003–04	4.2
2004–05	4.6
2005–06	6.9
2006–07	7.1
2007–08	7.2
2008–09	4.7
2009–10	5.1
2010–11	1.9
2011–12	2.2
2012–13	2.1
2013–14	2.1

Source: Central Bank of Egypt

The above table shows that the economy has been experiencing economic slowdown since the early 2010s. Another aspect related to economic consequences of political instability is unemployment level. Political changes have a negative impact on unemployment because it contracts the production level and consumption, the availability of new jobs is not sufficient to absorb new entrants to the labour market. Also many businesses were shutting down causing a further increase in the unemployment level. Consequently the unemployment rate rose during 2011 to 2014 in comparison with previous periods. This is summarised in Table 3.

Table 3: Labour Force (mil people) and Unemployment Rate (%), Egypt, 2000 to 2014

Year	Total labour force	Total employment	Total unemployment*	Unemployment rate (%)
2000–01	19.3	17.6	1.8	9.2
2001–02	19.9	17.9	2	10.2
2002–03	20.4	18.1	2.2	11
2003–04	20.9	18.7	2.2	10.3
2004–05	21.8	19.3	2.5	11.2
2005–06	22.9	20.4	2.5	10.6
2006–07	23.9	21.7	2.1	8.9
2007–08	24.7	22.5	2.1	8.7
2008–09	25.4	23.0	2.38	9.4
2009–10	26.2	23.8	2.35	9
2010–11	26.5	23.3	3.2	12.0
2011–12	27.0	23.6	3.4	12.7
2012–13	27.2	23.6	3.6	13.3
2013–14	27.6	23.9	3.7	13.3

Source: Central Bank of Egypt.

Political transition also impacts on private investment, which has declined sharply since the revolution. For example, FDI has significantly declined since 2011 to date as shown in Table 4.

Table 4: FDI Flow and Stock (in current million US\$), Egypt, 2009 to 2014

	2009	2010	2011	2012	2013	2014
FDI inward flow	6712	6386	-483	2798	4192	4783
FDI outward flow	571	1176	626	211	301	253
FDI inward stock	66 709	73 095	72 612	75 410	83 114	87 882
FDI outward stock	4273	5448	6074	6285	6586	6839

Source: United Nations Conference and Trade and Development (UNCTAD), 2016.

The above table shows that the FDI inward flow was negative in 2011 but improved in 2012 and subsequent years.

Egypt's situation during political transition indicates that tax policymaker face challenges from three economic aspects, namely, (i) stimulating economic growth, (ii) minimising unemployment rates, and (iii) stimulating private investment.

3.1.3 Budget deficit issue

Because of significant problems inherited from the previous political regime in terms of increasing poverty level and social injustice, the expectations of the majority of Egyptian people were culminated in terms of increasing salaries and better living standards. Such demands had manifested in the increasing number of protests and workers' strikes. Therefore, various interim governments that came to power were looking for ways to minimise the level of dissatisfaction through increasing government expenditures on wages and other social needs. Table 5 depicts the growth rates of government expenditure from 2001 to 2014.

Table 5: Government Expenditure (current million EGP), Egypt, 2001 to 2014

Year	Government expenditure	Growth rate (%)
2001–02	115 542	
2002–03	127 320	10.2
2003–04	145 988	14.7
2004–05	161 611	10.7
2005–06	207 811	28.6
2006–07	222 029	6.8
2007–08	282 290	27.1
2008–09	351 500	24.5
2009–10	365 987	4.1
2010–11	401 866	9.8
2011–12	470 992	17.2
2012–13	588 188	24.9
2013–14	701 514	19.2

Source: Central Bank of Egypt.

Since the revolution, government expenditure growth rates increased from 9.8 per cent in 2010 to 2011 to 17.2 per cent in 2011 to 2012 and then again to 24.9 per cent in 2012 to 2013. At the same time, government revenue has not increased at the same rate, as illustrated in Table 6.

Table 6: Government Revenue (current million EGP), Egypt, 2001 to 2014

Year	Total Revenue		Tax Revenue		Other Revenue	
	Amount	Growth rate (%)	Amount	Growth rate (%)	Amount	Growth rate (%)
2001–02	78 318		50 801		23 252	
2002–03	89 146	13.8	55 736	9.7	30 120	29.5
2003–04	101 881	14.3	67 147	20.5	29 683	-1.5
2004–05	110 864	8.8	75 759	12.8	32 252	8.7
2005–06	151 266	36.4	97 779	29.1	51 108	58.5
2006–07	180 215	19.1	114 326	16.9	62 003	21.3
2007–08	221 404	22.9	137 195	20.0	82 746	33.5
2008–09	282 505	27.6	163 222	19.0	11 1299	34.5
2009–10	268 114	-5.1	170 494	4.5	93 288	-16.2
2010–11	265 286	-1.1	192 072	12.7	70 927	-24.0
2011–12	303 622	14.5	207 410	8.0	86 109	21.4
2012–13	350 322	15.4	251 118	21.1	93 996	9.2
2013–14	456 788	30.4	260 289	3.7	100 643	7.1

Source: Central Bank of Egypt.

Table 6 shows that the government revenue increased in 2011 to 2012 and 2012 to 2013. However, government revenue growth rates were lower than the corresponding growth rates of government expenditure shown in Table 5. Consequently, budget deficits have increased not only in absolute values but also as a percentage of GDP (see Table 7 below).

Table 7: Budget Deficits as a Percentage of GDP, Egypt, 2001 to 2014

Year	Percentage
2001–02	9.8
2002–03	9.1
2003–04	9.1
2004–05	9.4
2005–06	9.2
2006–07	5.7
2007–08	6.8
2008–09	6.6
2009–10	8.1
2010–11	10.0
2011–12	10.9
2012–13	13.6
2013–14	12.3

Source: Central Bank of Egypt.

The above table shows that the budget deficit as a percentage of GDP in 2008 to 2009 was 6.6 per cent and it has been increasing steadily although it slightly declined to 12.3 per cent in the fiscal year 2013–14. Recently the IMF commented on the fiscal situation in Egypt as a result of high budget deficits and increasing level of finance. It stated that ‘countries with high levels of deficit and debt and large gross financing needs (including Egypt, Jordan, Morocco, and Pakistan) are exposed to shocks and swings in market sentiment and thus must take early decisive steps to safeguard against adverse debt dynamics and bolster credibility’ (IMF, 2013b).

The Egyptian government tends to rely heavily on domestic sources for funding budget deficits and this has a crowding out effect on private investments. With regard to tax policy, increasing budget deficit is related to the criterion of revenues adequacy, which will be used to assess the tax policies implemented since the 2011 revolt.

3.2 Tax policy in Egypt prior to 2011

In 1991, the Egyptian government, with the cooperation of international financial institutions, launched an economic stabilisation program. Accordingly, a new tax policy was needed to meet the program's requirements, which included minimising the severe budget deficit. A new sales tax was introduced by the *General Sales Tax Law No. 11 of 1991 (GSTL 1991)*. The revenue impact of this tax was considerable because the budget deficit to GDP ratio decreased substantially from 17.2 per cent in 1990–91 to 5.2 per cent in 1991 to 1992 and to 1.9 per cent in 2000 to 2001 (Abdellatif, 2011).

Also, in 1993, a significant amendment to the *Income Tax Law No. 157 of 1981 (ITL 1981)* was introduced. This amendment was known as the *Unified Income Tax (Global Income Tax) No. 187 of 1993* (Gersovitz et al., 1993). The fiscal imbalance was the main concern of tax policymakers, while the economic development objectives (for example, economic growth) were not addressed well in the 1990s tax policy (OECD, 2010).

Since the beginning of the new millennium, the Egyptian tax system has faced many new challenges relating to globalisation and the achievement of the millennium development agenda (United Nations, 2007). These objectives include accelerating economic growth, integrating national economy with the world economy, and achieving high rates of human development.

Because the tax legislation was outdated, it led to many economic distortions and constrained economic development. As a result, a new tax policy was launched in July 2004 (OECD, 2010). This policy focused on accelerating economic growth by encouraging private investment, broadening the tax base and modernising the tax administration. In order to achieve these objectives, a new income tax law was ratified in June 2005, the *Income Tax Law No. 91 of 2005 (ITL 2005)*. It repealed the *ITL 1981* and its amendments, and introduced new provisions in an attempt to cope with international taxation norms. Moreover, it also reduced the tax rates for both individuals (a progressive rate structure with a top rate of 20 per cent for individuals) and corporations (a flat rate of 20 per cent for corporations), and eliminated all tax incentives and development fees (OECD, 2007, p. 45–46).

Such tax policy was maintained until 2010 after which the political situation led to a number of tax reforms focusing on increasing tax revenue collection. Because of the increasing level of political unrest, the budget deficit has increased significantly (as discussed above), thus the government has been concerned with increasing tax revenue to control budget deficit blowouts. Since 2011, the government has introduced a number of tax reforms which are further elaborated in the following section.

3.3 Tax policy during political transition

The increasing social demands since the start of the political uprising has led to increasing government expenditures on social goods such as health and education. Such increases have not been accompanied by a similar increase in the government revenue which has forced the government to increase borrowing from banks through issuing treasury bills. This has consequently increased the amounts of interest payments (Shetta & Kamaly, 2014). The situation has manifested in the

rising ratio of budget deficit to GDP as shown in Table 7. Furthermore, a recent report by the IMF identified that the gross financing needs as a percentage of GDP for Egypt in 2013 and 2014 were 42.8 per cent and 39.9 per cent respectively.

Egypt has carried out a number of amendments to tax legislation because of the revenue need pressures. These include:

1. amendments to the *GSTL No. 11 of 1991* by *Law No. 4 of 2011* which includes, for example, waiving the surcharge tax on late filers of sales tax returns
2. amendments to the *GSTL No. 11 of 1991* by *Law No. 49 of 2011* which includes, for example, increasing the excise tax on tobacco
3. issuance of *Law No. 11 of 2012* which grants specific discount rates to taxpayers for paying their tax debts. The discounts range from 10 per cent to 25 per cent until the end of 2012, in order to encourage taxpayers to pay their tax debts and consequently increase the amount of tax revenue
4. issuance of *Presidential Decree No. 101 of 2012* which includes various amendments to a number of provisions in the *ITL No. 91 of 2005*. However such law was inactive until the issuance of *Law No. 13 of 2013*.
5. issuance of *Presidential Decree No. 102 of 2012* which amended *GSTL No. 11 of 1991*. This amendment includes increasing the tax rates on a number of goods and services.
6. *Law No. 13 of 2013* amends a number of provisions of *ITL 91 of 2005* which include:
 - a. adding a new tax bracket to individual income tax rates (annual income above EGP 250 000 will now be subject to 25 per cent tax rate instead of 20 per cent)
 - b. increasing the top marginal tax rate of legal entities other than individuals to 25 per cent instead of 20 per cent
 - c. imposing withholding tax on interest payments derived from treasury bills at 20 per cent and interest payments derived from government bonds at 32 per cent
 - d. introducing stricter measures to combat tax avoidance and tax evasion.

It is obvious that the amendments introduced by *Law No 13 of 2013* aimed to increase the tax revenues derived from individuals and legal persons. Nevertheless, these amendments also address a number of issues relating to equity and efficiency as discussed in the next section.

4. ASSESSING TAX POLICY DURING POLITICAL TRANSITION

4.1 Tax policy and business cycle

Discussions of economic challenges after the 25 January 2011 Revolution in Egypt have shown that there are a number of challenges facing the government, namely, (i) declining GDP growth rate, (ii) rising unemployment rate, and (iii) growing budget deficit. The first and the second macroeconomic issues require economic policy, particularly fiscal policy, to be employed in order to stimulate the economy. So government expenditure increase, as recommended by the Keynesian policy, is an important economic tool. A 1 per cent increase in government expenditure can, in principle, raise GDP by more than 1 per cent because of the government expenditure multiplier (Mankiw, 2007, p. 294).⁷

The second tool of fiscal policy to deal with economic downturn is tax rate cut in order to reduce the tax burden on business, which consequently promotes GDP growth, and lowers unemployment. This is referred to as 'expansionary tax policy' which is often prescribed under the Keynesian approach during economic downturn. Note that expansionary tax policy during economic downturn is an example of a counter-cyclical fiscal policy.

As mentioned previously, many scholars have identified that developing countries tend to use pro-cyclical fiscal policies which correlate positively with economic cycle. Increasing government expenditure during political changes is a counter-cyclical fiscal policy which is supposed to have a positive impact on the Egyptian economy during economic slowdown. In contrast, increasing tax rates as a means to raise tax revenue and curb the budget deficit, as discussed in Section 3.3, is a pro-cyclical fiscal policy. This tends to have a negative impact on private investments and, consequently, GDP growth rates and unemployment rates, especially after taking the tax multiplier effect into account. So, while Egypt's government expenditure policy has been counter-cyclical, its tax policy has been pro-cyclical during political changes. Therefore the null hypothesis is rejected and we accept the alternative hypothesis that Egypt has adopted a pro-cyclical tax policy during political transition.

4.2 Tax policy and economic efficiency

Since the 1990s, income tax reforms in Egypt have focused on creating a more efficient tax system mainly through cutting tax rates of individuals and corporations. This trend has been demonstrated clearly in the tax reform in 2005, in which the government implemented a lower tax rate schedule with a broader base tax system. The tax rate reduction in 2005 was significant since the top marginal tax rate for individuals decreased from 40 per cent to 20 per cent. Furthermore, the development fees imposed at 2 per cent were abolished. Such an approach is consistent with supply side taxation. It is argued that such a reform has improved a country's competitiveness and the efficiency of its tax system (OECD, 2010). Nevertheless, Egypt has not used the marginal effective tax rate to assess

⁷ The impact of government expenditure increase on GDP is indicated by government expenditure multiplier which measures how much GDP increases in response to an increase in government expenditure. In a simple macroeconomic model it is calculated by $\Delta Y / \Delta G = 1 / (1 - MPC)$ where ΔY refers to the change in GDP, ΔG to the change in government expenditure and MPC is the marginal propensity to consume.

the possible impact of raising tax rates on investments (OECD 2010). The current situation of increasing the marginal tax rate on individuals and legal persons from 20 per cent to 25 per cent can create economic distortions and contradicts the experiences of many developed countries which have adopted tax cut to stimulate the economy and create economic growth (Mankiw, 2007). Thus an increase in tax rates will have a negative impact on both investment and unemployment.

Tax revenue figures of fiscal years from 2010 to 2013 (Table 8 below) show that the private sector share of tax revenue has declined over the years. More specifically, the combined income tax revenue share of companies and individuals decreased from 60 per cent in 2010 to 2011 to only 46 per cent in 2012 to 2013. In more recent years, these combined shares were 49, 50 and 46 per cent in 2010 to 2011, 2011 to 2012 and 2012 to 2013 respectively. The decline of tax revenue derived from private investment is consistent with the decline in GDP growth rates because of political instability. So increasing the tax rate will negatively affect private investment and the economic growth rates, taking into account the impact of tax multiplier on economic activities.

In summary, a tax rate increase contradicts the economic efficiency principle and will have a negative impact on economic growth, private investment and employment. The increase in the growth rates of tax revenue to total revenues in 2013 to 2014 (see Table 6) appears to be attributable to the imposition of withholding tax on the interest payments on government treasury bills and government bonds which accounted for 7 per cent of income tax revenue in 2013 to 2014. Furthermore, it is known that the bulk of tax revenue is generated from government institutions, mainly through Egyptian General Authority Petroleum Cooperation, Suez Canal Authority and Central Bank of Egypt.

To have an efficient tax system, tax policymakers should focus on consumption tax, as occurred with the amendment to the *GSTL 1991*. Recently, the Egyptian parliament ratified the *Value Added Tax Law No. 67 of 2016* which abolished the *GSTL 1991*. The main reason for such tax reform is to increase tax revenue. It can also be claimed that such a reform is consistent to some extent with the criterion of economic efficiency, which tends to call for tax base broadening and a uniform tax rate.⁸

⁸ In terms of direct taxation, a broader tax base with uniform tax rate contributes to greater tax neutrality and increased economy-wide productivity (Freebairn, 2005). In terms of indirect taxation, the Ramsey optimal rule suggests that consumption tax should be imposed at a higher rate on more inelastic goods (Mankiw et al., 2009). This is impossible to do in practice since every commodity has a different elasticity for every consumer. Further, inelastic goods are more likely to be consumed by low-income households.

Table 8: Breakdown of Income Tax Revenue (million EGP), Egypt, 2001 to 2013

Year	Total income tax revenue	EGPC [*]		SCA ^{**}		CBE ^{***}		Other		Individuals	
		Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
2001-02	19 624	3562	18	3406	17	841	4	5.276	27	6539	33
2002-03	20 842	2564	12	4188	20	514	2	6.857	33	6719	32
2003-04	27 280	4771	17	6514	24	317	1	7.518	28	8160	30
2004-05	31 571	4030	13	7343	23	212	1	10.671	34	9315	30
2005-06	48 268	23 620	49	7321	15	0	0	7.946	16	9381	19
2006-07	58 535	25 380	43	9144	16	0	0	14.291	24	9720	17
2007-08	67 059	29 268	44	10 268	15	0	0	16.028	24	11 495	17
2008-09	79 073	34 135	43	10 391	13	0	0	20.263	26	14 284	18
2009-10	76 618	32 181	42	9443	12	0	0	18.591	24	16 403	21
2010-11	89 593	34 308	38	10 900	12	0	0	25.330	28	19 055	21
2011-12	91 245	34 075	37	11 800	13	0	0	23.674	26	21 696	24
2012-13	117 762	45 816	39	12 150	10	8 290	7	25.275	21	26 231	22

Source: Central Bank of Egypt.

Notes: * EGPC - Egyptian General Petroleum Cooperation

**SCA - Suez Canal Authority

***CBE - Central Bank of Egypt.

4.3 Tax policy and revenue adequacy

Revenue adequacy refers to the capability of the tax system to generate sufficient revenue to finance government expenditures. Assessing the tax policy in Egypt in terms of revenue adequacy reveals that the tax revenue has increased in fiscal years 2011 to 2012 and 2013 to 2014 as shown in Table 9 below.

Table 9: Tax Revenue as Share of Total Government Revenue, Egypt, 2001 to 2014

Year	Total revenue	Tax revenue	Tax revenue/Total revenue (%)
2001–02	78 318	50 801	65
2002–03	89 146	55 736	63
2003–04	101 881	67 147	66
2004–05	110 864	75 759	68
2005–06	151 266	97 779	65
2006–07	180 215	114 326	63
2007–08	221 404	137 195	62
2008–09	282 505	163 222	58
2009–10	268 114	170 494	64
2010–11	265 286	192 072	72
2011–12	303 622	207 410	68
2012–13	350 322	251 118	72
2013–14	456 788	260 289	57

Source: Central Bank of Egypt.

Such increase in tax revenue share is attributable to the following:

1. imposition of withholding tax on interest income derived from treasury bills and government bonds (see Table 8)
2. introduction of tax incentives in a form of specific discount rate for paying tax debts
3. increase in the sales tax rates on a number of goods and services.

The increase of tax revenue is evidence that the tax policy during the political instability focused on increasing tax revenue to meet increasing trend of government expenditure. However, the gap between government expenditure and government revenue has still remained high, and the budget deficit accounted for 13 per cent of GDP in 2012 to 2013. Consequently, the government should find another means to increase its revenues such as through improving enforcement measures and modernisation of tax administration. These measures entail fighting tax evasion and closing tax avoidance loopholes to increase the share of tax revenue to GDP above 14 per cent, as reported by the IMF (2013b).

4.4 Tax policy and equality

Achieving income equality and minimising social injustice were the main objectives of the 2011 revolution to which the tax system can significantly contribute and achieve through creating a tax system characterised by equity. Nevertheless, achieving equity implies the introduction of a progressive tax system which was almost abolished under Income Tax Law of 2005. This policy objective also contradicts the efficiency criterion. The interim government has increased the tax rates on individuals and other legal entities because of revenue needs, rather than concern for equality. However, this increase has a contracting impact on the economy and it negatively affects the economic growth in the short run. Accordingly, it is recommended that the government pursue the equity issue as a long term goal which can be achieved after restoring political stability.

5. SUMMARY AND RECOMMENDATIONS

This article has examined the challenges facing tax policymakers in Egypt since 2011 as a result of political changes which have led to economic slowdown. It reviews the fiscal policy in developed and developing countries during economic downturn and it is found that fiscal policy is counter-cyclical in developed countries and pro-cyclical in developing countries. Further, political changes and related economic consequences require assessing tax policy in terms of benchmarking criteria for a good tax system, including revenue adequacy, economic efficiency and stability, and equity.

An analysis of Egypt's tax law and budgetary data demonstrates that, in response to political changes, economic slowdown and increasing public expectations, Egypt has implemented a combination of expansionary (counter-cyclical) government spending policy and contractionary (pro-cyclical) tax policy. In particular, pro-cyclical or contractionary tax policy has been achieved mainly through increasing the tax rates on income and a number of goods and services, and a rationalisation of tax incentives.

The assessment of the implementation of tax policy in Egypt since 2011 has revealed several areas where improvements are feasible. First, the current tax policy practice has largely contradicted the criterion of economic efficiency since it ignores the current situation of economic stagnation and uncertainties related to the future of political instability which affect domestic investment in general and FDI in particular. Furthermore, the unemployment issue requires specific tax policy which encourages new business activities in order to lower the unemployment level.

Second, in terms of revenue adequacy, it is evident that various amendments of tax legislation have been steadily introduced in order to curb budget deficits. Thus, the government should pay more attention to the modernisation of tax administration and setting strengthened measures to curb tax evasion. This is because in raising tax revenue it is preferable to improve the efficiency of tax administration rather than to increase tax rates on income, good and services, which generally has a contractionary impact on the business cycle.

Third, it is extremely difficult at the moment for the Egyptian government to use its tax system to serve conflicting policy objectives: balanced budget, accelerated GDP growth, and reduced income inequality. The policy objectives of internal balance and faster economic growth should perhaps be temporarily delayed until political stability has been achieved via fiscal and social measures aimed at mitigating perceived or actual inequality.

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Developing a sustainable tax base through a financial transaction tax: An analysis of suitability for the New Zealand environment

Simoné Pycke¹, Jagdeep Singh-Ladhar² and Howard Davey³

Abstract

The purpose of this research is to address whether a Financial Transaction Tax (FTT) should be implemented in New Zealand in order to address the effect of an ageing population on the New Zealand tax revenue base. This paper considers the wider theoretical literature on the implementation of a FTT. In considering the literature it draws out the main arguments for and against the imposition of a FTT. This paper identifies that New Zealand has an imminent issue with needing to adapt the tax revenue base because of the impact of its ageing population. The advantages and disadvantages of a FTT are considered in the New Zealand context. The key advantages are that a FTT can generate increased revenue and reduce speculative behaviour in financial markets. The disadvantages identified in the literature are that there are limited means to accurately predict the actual revenue generated by a FTT, or the potential negative effects on market trading within a country. There is also concern that a FTT needs to be applied on a regional or wider global basis for a FTT to be effective. In the New Zealand context further research could include considering the amount of potential revenue that can be generated by a FTT, assessing the potential effect of a FTT on the government-funded superannuation saving scheme, KiwiSaver, and whether the imposition of a FTT would be more effective on a regional scale across Australia and New Zealand. This paper provides an initial explorative study of the potential for a FTT to be implemented in New Zealand and areas for future research.

Key words: Financial Transaction Tax, Tax base, Tax policy, Tobin tax, KiwiSaver, New Zealand

¹ PwC Hamilton, EY.

² Assistant Lecturer, Waikato Management School, University of Waikato, Hamilton, New Zealand:
Corresponding Author – ladhar@aikato.ac.nz.

³ Professor of Professional Accounting, University of Waikato, Hamilton, New Zealand.

1. INTRODUCTION AND BACKGROUND

1.1 Introduction

The purpose of this paper is to consider whether a Financial Transaction Tax (FTT) should be implemented in New Zealand. This is an exploratory paper that will review the relevant literature on the implementation of a FTT in New Zealand. The literature review will first consider the information relevant to the problem of an ageing population and related issues. The second part will focus on the literature relating to the implementation of a FTT, its associated tax revenue raising benefits, criticisms and implementation considerations. This research will provide a platform for the consideration of whether implementing a FTT could be a feasible means of extending the New Zealand tax base primarily to provide the funding necessary to support the ageing New Zealand population.

This paper is divided into five sections. The first section provides the background to the context of the research. The second section describes the method chosen for the study. The third section uses literature to identify and discuss issues regarding ageing population in the OECD nations, with a specific regard to New Zealand. It also uses literature from a wide variety of sources covering FTT, its current global status, its advantages, criticisms and implementation considerations. The fourth section focuses on whether New Zealand may have a potentially strong reason for the implementation of this tax. This paper will finish with a short conclusion on why New Zealand holds a sound position on an explorative level for the implementation of this tax to aid the funding of its ageing population. This paper is explorative in nature and as such specific legislation and regulation and implementation issues, including numerical taxation percentages, should be considered for future research.

1.2 Background

The demographic change occurring as larger proportions of the populations move into retirement is causing global concern. The concern is related to the perceived lack of social infrastructure available to support an increased number of retirees.⁴ An increase in the size of the retiring population highlights a double problem caused by decreasing income tax revenue and increased retirement expenditure. There has been some recognition of the future implications of these trends in academic research as well as public debate, with government agencies and economic development units suggesting that new methods of revenue generation is important. These trends will be discussed in the literature review in Section 3.

New Zealand has one of the highest proportion of retirees among OECD countries. The New Zealand government provides various health and social welfare infrastructure to support retirees. Given the potential for increased costs associated with a larger number of retirees in the future, this explorative research paper will consider whether New Zealand should consider the implementation of a FTT to mitigate some of the fiscal pressure. There are limited resources on the topic of a FTT

⁴ James Obben and Monique Waayer, 'New Zealand's Old-Age Pension Scheme and Household Saving' (2011) 38(9) *International Journal of Social Economics* 767; David E Bloom, David Canning, Günther Fink and Jocelyn E Finlay, 'The Effect of Social Security Reform on Male Retirement in High and Middle Income Countries' (Working Paper No. 48, Program on the Global Demography of Aging, 2009).

in the New Zealand context, and as such this paper provides a platform for future research into the more specific considerations of implementation.

2. RESEARCH DESIGN

This paper uses an exploratory research design; it will define a FTT and the specific characteristics that are associated with it; it will help formulate the problem more precisely for future investigation; and lastly also establishes a basis for future research. As such, a literature review that covers the initial exploration of this topic within the New Zealand and overseas contexts will be undertaken. The public nature of FTT discussion provides this paper with the opportunity to use a mixture of expert, non-expert and opinion literature. These sources contain a mixture of both quantitative and qualitative research information, and as such the authors benefit from prior, informed and heavily-resourced information. Future research into this topic could adopt a more empirical approach.

3. LITERATURE REVIEW

This literature review considers the aging population problem from both global and New Zealand perspectives. It highlights why an ageing population is of economic concern to current and future taxpayers. The literature review will provide the context for the next section of this paper, which will consider the advantages and disadvantages of a FTT. The latter is undertaken in order to assess whether a FTT may be a practical means of revenue generation for governments in order to support ageing populations and the associated fiscal pressures.

3.1 Ageing population demographics

Population ageing has long term fiscal and structural impacts.⁵ Reports by the United Nations and OECD confirm declining fertility, lifestyle choices and improved healthcare have resulted in a noticeable demographic shift upwards in the global mean population age.⁶ The extent of the demographic changes may be underestimated.⁷ New Zealand is also experiencing large upward shifts in the structural and numerical age of its population.⁸ The change in New Zealand is primarily driven by declining birth rates, improvements in life expectancy and the fact that ‘baby-boomers’ born between 1946 and 1965 are retiring. These findings are supported by the United Nations reports on changing global demographics and lower fertility rates.⁹ It is

⁵ Natalie Jackson, ‘The Demographic Forces Shaping New Zealand’s Future. What Population Ageing [Really] Means’ (Working Paper No 1, University of Waikato: National Institute of Demographic and Economic Analysis, 2011)

<<http://researchcommons.waikato.ac.nz/bitstream/handle/10289/6539/NIDEA%20Working%20Paper%20No%201.pdf?sequence=1>>; Susan M St John, Claire Dale and Toni Ashton, ‘A New Approach to Funding the Costs of New Zealand’s Ageing Population’ (2012) *New Zealand Population Review* 55.

⁶ United Nations, ‘World Population Prospects: The 2010 Revision. United Nations, Department of Economic and Social Affairs’ (Population Division, Population Estimates Section; 2010); Organisation for Economic Co-operation and Development, ‘Pensions at a Glance 2011: Retirement-Income Systems in OECD and G20 Countries’ (OECD, 2011).

⁷ David E Bloom, Axel Boersch-Supan, Patrick McGee and Atsushi Seike, ‘Population Aging: Facts, Challenges, and Responses’ (2011) 41(1) *Benefits and Compensation International* 22.

⁸ Jackson, above n 5.

⁹ United Nations, above n 6.

estimated that between 2010 and 2060 people aged 65 will increase from 13 per cent to 26 per cent of the population and the percentage of the population aged over 80 will triple.¹⁰ Increased life expectancy also means that a larger group of people will be in retirement for longer periods. Fewer people will be entering the workforce but will have to carry the burden of funding more retirees. This is a fundamental demographic shift.

3.2 Economic implications of demographic ageing

As the population ages there will be higher demands for pensions, healthcare, and elder-orientated goods and services.¹¹ The structural impact of the shifting proportion of young to old will have an increasing impact on the amount of tax received by governments. For countries such as New Zealand, with a policy of collecting taxes over a broad base in order to keep taxation rates low, the contributions of the workforce to tax revenue are currently greater than other sources of taxation revenue. The problem with the ageing population in New Zealand is that it will lead to proportionately less taxpayers contributing to the tax base as more people retire from the workforce.¹²

The effect of population ageing is a focus of New Zealand government policy. In 2013 the New Zealand Treasury commissioned a working paper on the fiscal impact of population ageing. The purpose of the study was to examine the financial and social consequences for ageing populations. It built upon an earlier Treasury-commissioned report published in 2002 that identified specific economic issues that would arise for New Zealand with its ageing population. The earlier 2002 Treasury report focused on the economic impact of retirement and superannuation.¹³ The 2013 Treasury report found factors such as health, education and finances are relevant to the retirement age, however, the most influential factor in the decision to retire was around certainty of retirement income. The 2013 Treasury report findings recognised that as these ageing New Zealanders approach retirement, not only do they become reliant on support such as New Zealand Superannuation (NZS), but also on second and third tier benefits such as accommodation supplements and medical aid. The most significant implication for countries is on the collection of taxes as retirees leave the labour force reducing primarily direct but also indirect tax revenue collection. The 2013 Treasury Report notes that indirect tax revenue will fluctuate based on 'the changing pattern of expenditure over the life cycle'.¹⁴ In the New Zealand context indirect taxes include consumption taxes, such as Goods and Services Tax (GST). This means that the problem of an ageing population is twofold. There is an increased demand on services to support an ageing population, while at the same time there is reduced taxation revenue from the retired population.

¹⁰ Omar A Aziz, Christopher Ball, John Creedy and Jesse Eedrah, 'The Distributional Impact of Population Ageing In New Zealand' (2015) 49(3) *New Zealand Economic Papers* 207, DOI: 10.1080/00779954.2014.890023.

¹¹ Obben and Waayer, above n 4.

¹² Christopher Ball and John Creedy, 'Population Ageing and the Growth of Income and Consumption Tax Revenue' (Working Paper 13/09, New Zealand Treasury, April 2013) <<http://www.treasury.govt.nz/publications/research-policy/wp/2013/13-09/twp13-09.pdf>>.

¹³ John Stephenson and Grant Scobie, 'The Economics of Population Ageing' (Working Paper 02/05, New Zealand Treasury, March 2002) <<http://www.treasury.govt.nz/publications/research-policy/wp/2002/02-05/twp02-05.pdf>>.

¹⁴ Ibid, 3.

The next section will consider the specific impact of retirees on the collection of taxes in New Zealand by examining the New Zealand tax base model.

3.3 Effect of an ageing population on tax base

The New Zealand tax base is reliant upon the collection of taxes from three major sources: personal income, company income and GST.¹⁵

One notable change in recent years is that the proportion of revenue from individual income tax has decreased while the proportion of revenue from GST and company income tax has increased. Between the years ended June 2010 and June 2013, individual income tax reduced from 48 per cent to 39 per cent of total revenue, while company income tax increased from 13 per cent to 16 per cent of total revenue, and GST from 24 per cent to 32 per cent. This switch in tax revenue is partially attributable to the increase in the GST rate from 12.5 per cent to 15 per cent and reductions to individual income tax rates from 1 October 2010.

New Zealand has the sixth lowest GST rate at 15 per cent among OECD countries, however, proportionally the collection of GST as a consumption tax is the highest in the OECD.¹⁶ The high amount of GST collected reflects New Zealand's GST broad base, which has been extended in 2016 to include supply of digital services.¹⁷ On the other hand the contribution of individual income tax remains the main source of revenue in the New Zealand tax base. The change in New Zealand demographics means that in the future 'it is plausible to foresee changes in the tax base for income taxes'.¹⁸

3.4 Private retirement savings and other funding solutions

Funding solutions to the problems of an increasing number of retirees has typically focused on superannuation funding. New Zealand has a universal tax-funded state pension scheme called the New Zealand Superannuation (NZS) available by right to all residents over 65 years of age.¹⁹ NZS payments do not depend on prior earnings of an individual and are paid at a flat rate to all who are entitled to receive it.²⁰ In 2007 the New Zealand government introduced an opt-out workplace-based superannuation savings scheme called KiwiSaver.²¹ The purpose of the scheme is to encourage saving for retirement.²² KiwiSaver is funded by contributions from the government, employers and employees. As a result of KiwiSaver many New Zealand retirees will have access to the accumulated private retirement funds. However due to the

¹⁵ New Zealand Inland Revenue Department, 'Briefing for the Incoming Minister of Revenue—2014: The New Zealand Tax System and How it Compares Internationally' (Inland Revenue Department, 2014) 11 <<http://www.ird.govt.nz/resources/8/d/8d8ea8f9-53fe-4934-87c5-9094338af754/bim-2014.pdf>>.

¹⁶ OECD, above n 6.

¹⁷ *Goods and Services Tax Act 1985* s°14 specifies exempt supplies. From 2016 digital supplies of services will not also be subject to GST. Previously this had been one area that was not covered. However, this extension does not include the supply of goods online which would bring in a greater amount of GST.

¹⁸ Stephenson, above n 13, 14.

¹⁹ Ministry of Social Development, 'New Zealand Superannuation' (New Zealand Government) <<http://www.workandincome.govt.nz/products/a-z-benefits/nz-superannuation.html>>.

²⁰ Ibid.

²¹ *KiwiSaver Act 2006* (NZ).

²² Ibid, s°3.

relatively recent introduction of the scheme only modest returns will be available for several decades. This means that retirees will still have to rely principally on government support.

3.5 FTT as a solution to an aging population

For the purposes of this literature review, a FTT will be considered as a tax levied on the wholesale capital market secondary transactions.²³ The concept of FTT was developed by John Maynard Keynes in 1936 and James Tobin in 1972, and was considered a tax that would have both the benefit of raising taxation revenue, as well as reducing the negative externalities of the transactions they were imposed upon.²⁴ Tobin specifically considered a tax on international foreign exchange transactions and stated that it would be a ‘soft’ control on a system which as a result would deliver great benefit. Tobin continued to advocate for a ‘uniform worldwide tax on spot transactions across currencies’ which he observed was rediscovered by different groups from time to time.²⁵

Broadly there are two factors in support of a ‘Tobin’ tax. The first is the concept of supporting international agencies as argued in Tobin’s original concept advocated in 1972 at the Eliot Janeway Lectures. The second is recognition of the power of revenue generation as reviewed by Tobin in 1996.²⁶ Critics of Tobin’s approach have argued that currency-based transactions will be moved offshore to avoid the tax and make it less effective.²⁷ However, the need for a Tobin-type tax on international currency exchange is linked to concerns about international finance. These concerns have only increased in light of the Global Financial Crisis (GFC) and continuing concerns about the need to put ‘sand in the wheels of international finance’.²⁸ The potential revenue estimate from a global FTT of 0.05 per cent is US\$500 billion per annum.²⁹ In theory, the imposition of FTT would also see financial institutions contribute to the societies in which they operate. The concerns about international finance relate mainly to speculative behaviour and its potentially detrimental effect on global economies.³⁰ A quantitative country-specific study has also confirmed the link between currency fluctuations and a lack of control over currency-related

²³ Ross P Buckley, ‘Introducing a 0.05% Financial Transactions Tax as an Instrument of Global Justice and Market Efficiency’ (2014) 4(1) *Asian Journal of International Law* 153, DOI: 10.1017/S2044251313000271.

²⁴ John M Keynes, *The General Theory of Employment, Interest and Money* (Cambridge University Press, 1936); James Tobin, *The New Economics One Decade Older. Eliot Janeway Lectures 1972* (Princeton University Press, 1974).

²⁵ James Tobin, ‘A Currency Transactions Tax, Why and How’ (1996) 7 *Open Economies Review* 493, 493

²⁶ *Ibid*, 497.

²⁷ Nissanke, M ‘Revenue Potential of the Currency Transaction Tax for Development Finance: A Critical Appraisal’ (WIDER Discussion Paper No. 2003/81, World Institute for Development Economics, 2003).

²⁸ Barry Eichengreen, James Tobin, and Charles Wyplosz ‘Two Cases for Sand in the Wheels of International Finance’ (1996) 105(428) *The Economic Journal* 162, 162.

²⁹ Stephan Schulmeister, ‘Boom-Bust Cycles and Trading Practices in Asset Markets, the Real Economy and the Effects of a Financial Transactions Tax’ (2010) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1705628>.

³⁰ Rameshwar Tandon and Mohd. Shariq, ‘Global Capital Flows and Payment Imbalances’ in Ambar Nath Ghosh and K Asim Karmakar, (eds) *Analytical Issues in Trade, Development and Finance: Essays in Honour of Biswajit Chatterjee* (Springer India, 2014).

transactions.³¹ Another counter currency speculation option includes maintaining a low interest rate to remove incentives for speculators.³² The literature has responded to the Tobin tax proposal over time so that in its current context, post GFC, the anti-speculation aspects of a Tobin-type tax are the most important. It can be argued that in a similar manner a FTT would be a tax that can also reduce speculative behaviour in capital market transactions.

3.6 Factors influencing a FTT in Europe

While the section above considered the broader context of a FTT by focusing on the Tobin tax example, this section will review the implementation efforts of a FTT in the European Union. The European Commission has considered the implementation of a FTT and published documents relating to the implementation on its public website.³³ The European Commission has extensively emphasised the importance of renewing the economic and social contract between financial institutions and the society in which they operate and whom they serve.³⁴ In 2010 a Special Communication was released by the European Commission proposing the implementation of a FTT.³⁵ It conceded that regulatory reforms are essential to stabilise the financial sector, which benefitted from government support through the GFC, and it should 'make a fair contribution in return'.³⁶ FTT is also referred to as the 'Robin Hood tax', which will allow governments to take from the financial institutions and give it to the poor through welfare benefits and support.³⁷ The original proposal put forward on 28 September 2011 was not carried through because of lack of support.³⁸ On 22 January 2013 the Council of the European Union approved the adoption of a FTT for those states who wanted to continue with a FTT proposal on cooperative grounds.³⁹ The legality of this decision was challenged by the United Kingdom.⁴⁰ However, the process for establishing the tax, rather than the tax per se was challenged. With the United Kingdom exiting the European Union it is assumed that the challenge to the process for establishing a FTT will be mitigated.

³¹ Shakill Hassan, 'Speculative Capital Flows, Exchange Rate Volatility and Monetary Policy: South African Experience' (2015) *Contemporary Issues in Development Economics* 136.

³² Ibid.

³³ European Commission, 'Taxation and Customs Union', <http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.html>.

³⁴ Ibid.

³⁵ European Commission, 'Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee of The Regions Taxation of The Financial Sector {Sec(2010) 1166}' (European Commission, 2010).

³⁶ Ibid, 3.

³⁷ Buckley, R. (2011), 'Don't laugh this tax could fix the world', *The Conversation*, <http://theconversation.com/dont-laugh-this-tax-could-fix-the-world-772>. RHTO Robin Hood Tax Organisation, *How it works* <<http://www.robinhoodtax.org/how-it-works> on 26/11/2014>.

³⁸ European Commission, 'Financial Transaction Tax: Making The Financial Sector Pay Its Fair Share'. (Press Release, 28 September 2011) <http://europa.eu/rapid/press-release_IP-11-1085_en.htm?locale=en>.

³⁹ Council of the European Union, 'Financial transaction tax: Council Agrees to Enhanced Cooperation.' (Press Release, 22 January 2013) <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/134949.pdf>.

⁴⁰ *United Kingdom of Great Britain and Northern Ireland v Council of the European Union* (Case C-209/13) 2013 European Court of Justice.

3.7 Capital markets

Moderating the impact of capital markets in global finance is a feature of the Tobin tax discussed above. In terms of a FTT, the financial markets has also been considered in the literature. Tobin tax on currency, securities transaction taxes and FTTs are at times used interchangeably in the literature on taxing capital market transactions.⁴¹ The difference between each tax is its design and implementation. Each category of tax is linked through the concept that the financial transactions are taxed in some manner which affects trading activity and raises revenue. Technological improvements have increased financial transaction volumes and changed how transactions are implemented.⁴² Complex algorithms, high-frequency trading and computer-generated activity have enabled financial transactions on a large scale. These technologies are a primary factor facilitating large volumes of trades and algorithmic or computer-driven trading accounts.⁴³ These technologies work on predetermined rules to deliver specific outcomes and therefore are not driven by any underlying economic incentive other than short-term gains.⁴⁴ An ever-increasing proportion of market trades are short-term and technically driven by instruments such as derivatives, stocks, bonds and foreign exchange currencies. However, despite large trading volumes the true economic value of the capital markets has come under criticism.⁴⁵ Darvas and von Weizsäcker propose that the intentions of traders and institutes are unclear, and their actions leave to question whether the financial transactions are grounded in sound incentives and deliver economic efficiency, or whether they are merely measures entrenched in short-termism.⁴⁶

4. IS A FTT APPROPRIATE FOR NEW ZEALAND?

4.1 The New Zealand capital markets

The previous sections have identified that New Zealand has an issue with supporting its future ageing population. The existing government schemes to address this issue include encouraging individuals to save for their retirement through government-funded schemes. However, the sections above also identified that New Zealand faces a twofold problem with an ageing population because there is both an increased demand for social services and a decrease in tax revenue from income earners as they retire. Hence the possibility of introducing a FTT is one that should be considered particularly with the potential of a FTT to raise greater amounts of tax revenue. As a FTT is a tax on the financial transactions of an economy associated with shares, bonds

⁴¹ Karl Habermeier and Andrei A Kirilenko, 'Securities Transaction Taxes and Financial Markets' (2003) 50(1) *IMF Economic Review* 165.

⁴² Harald Hau, 'The Role of Transaction Costs for Financial Volatility: Evidence From the Paris Bourse' (2006) 4(4) *Journal of the European Economic Association* 862.

⁴³ Tom C W Lin, 'The New Financial Industry' (2014) 65 *Alabama Law Review* 567
<<http://ssrn.com/abstract=2417988>>.

⁴⁴ Frank J Fabozzi, Sergio M Focardi and Caroline Jonas, 'High-Frequency Trading: Methodologies and Market Impact' (2011) 19(7) *Revenue Futures Markets* 9.

⁴⁵ Stephan Schulmeister, Margit Schratzenstaller, Oliver Picek, 'A General Financial Transaction Tax: Motives, Revenues, Feasibility and Effects' (Austrian Institute of Economic Research, 2008)
<http://www.wifo.ac.at/jart/prj3/wifo/resources/person_dokument/person_dokument.jart?publikationsid=31819&mime_type=application/pdf>.

⁴⁶ Zsolt Darvas and Jakob von Weizsäcker, 'Financial-Transaction Tax: Small is Beautiful', (2011) 33(3) *Society and Economy* 449, DOI: 10.1556/SocEc.33.2011.3.2.

and derivatives; the need to evaluate the current position of New Zealand's capital market is relevant. The New Zealand Stock Exchange (NZX) is a listed company that builds and operates capital, risk and commodity markets in New Zealand. In June 2016 it had a total of 177 listed instruments and a combined market capitalisation of \$118 billion.⁴⁷ There are many other transactions and organisations that could be captured by a FTT including banks, investment firms and hedge funds operators. The size of the market and the potential revenue that can be raised is beyond the explorative scope of this study. However, other than its ability to raise revenues, the literature reveals various other advantages and disadvantages associated with FTT.

4.2 Advantages

A practical benefit in the implementation of a FTT is that the collection cost is generally low due to the electronic nature of the transactions. The United Kingdom's collection of various stamp duties provides an example of the cost effectiveness of collecting FTT.⁴⁸ According to the United Kingdom's Revenue and Customs in 2008 to 2009 the average collection cost for United Kingdom stamp duties was approximately 0.21 pence per pound raised, whereas the average collection cost for all taxes in the United Kingdom was approximately 1.10 pence per pound. Further to this, the collection cost for stamp duty (or similar taxation methods) on share transactions is likely to be substantially lower because stamp duties also include property taxes, which are typically more expensive to collect.⁴⁹ The success of the United Kingdom stamp duty is that it buys legal certainty. Buckley observes that it works in a way that inoculates the geographic relocation of transactions by charging only transferring ownership when it has officially been stamped.⁵⁰ Although it is possible to sell the share to a counterparty abroad and subsequently trade it thereby making it exempt from the United Kingdom stamp duty, the United Kingdom government charges a stamp duty at three times the normal rate, which reduces the likelihood to exit the system.⁵¹ The success of the United Kingdom system illustrates the collection of a FTT can be cost-effective.⁵²

Another advantage of an FTT is that it can limit some of the socially undesirable transactions which increase the systematic risk of the financial system.⁵³ In other words, a FTT can reduce speculative behaviour. For example, financial trades may be speculative with limited consideration of the underlying value of the economic assets on which they are made.⁵⁴ The effect of speculative transactions have a tendency to be negative rather than neutral. Speculative behaviour affected financial markets in

⁴⁷ New Zealand Stock Exchange, *Markets* (16 June 2016) <<https://www.nzx.com/markets/NZSX>>.

⁴⁸ HM Revenue & Customs, 'Meeting Our Challenges. Departmental Autumn Performance Report 2009' <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/228592/7774.pdf>.

⁴⁹ Steve Bond, Mike Hawkins and Alexander Klemm, 'Stamp Duty on Shares and its Effect on Share Prices' (Working Paper WP04/11, Institute for Fiscal Studies, 2004) <<http://www.ifs.org.uk/wps/wp0411.pdf>>.

⁵⁰ Buckley, above n 23.

⁵¹ Buckley, above n 23.

⁵² Stijn Claessens, Michael Keen and Ceyla Pazarbasioglu, 'Financial Sector Taxation: The IMF's Report to the G-20 and Background Material' (International Monetary Fund, 2010).

⁵³ Ross P Buckley and Gill North, 'A Fundamental Re-examination of Efficiency in Capital Markets in Light of the Global Financial Crisis' (2010) 33 *University of New South Wales Law Journal* 714.

⁵⁴ Schulmeister, above n 29.

the years leading up to the GFC in 2008.⁵⁵ A FTT will simplify financial transactions and consequently enable securities regulators to perform their job better and ultimately improve investor confidence. A core lesson from the GFC was that transactions have become overly complex resulting in a lack of understandable disclosures.⁵⁶ As Buckley and Arner observe, investors bought investments that they did not fully understand, with their investment choices based on ratings, the reputation of the investment bank and the advice of accounting firms. Better informed investing is likely to lead to a stronger, more accurately priced financial market and will also likely lead to more long-term investment rather than short-term allocations of funds.⁵⁷

The United Nations has noted an apprehension that the financial sectors of many developed nations have grown too large and consuming too much of a nations' human and financial capital.⁵⁸ The financial services industry has become attractive to the best-educated individuals in countries and, consequently, their abilities are used to trade virtual assets in a financial sector rather than creating tangible assets.⁵⁹ An advantage of a FTT is that it will tend to mitigate the short-term growth in the financial sector and instead may see more focus on the productive capacity of an economy.⁶⁰

4.3 Disadvantages

Despite the advantages as discussed above, the institutionalisation of a FTT has come under great scrutiny. One objection is that the potential impact of a FTT on global financial markets is difficult to quantify. Darvas and Weizsäcker observe that the lack of quantification brings into doubt the claims of increased tax revenue through a FTT.⁶¹ Also, complex transactions that are made up of a series of related, conditional transfers will be charged a FTT a number of times and as a result is likely to dissuade a substantial proportion of financial transactions. For this reason, alternatives such as bank levies or financial activities taxes, which are easier to quantify in a more predictable in terms of raising greater revenue. On the other hand, Darvas and Weizsäcker accept that if a FTT is imposed to reduce speculation then it does have some benefit in reducing short-term speculative trading.

Another drawback of a FTT is the potential to increase the trading costs of transactions in the financial market. The imposition of a FTT increases the cost per

⁵⁵ Gordon Menzies, Ron Bird, Peter Dixon and Maureen Rimmer, 'The Economic Costs of US Stock Mispricing' (2010) 33(4) *Journal of Policy Modelling* 552, DOI:10.1016/j.jpolmod.2010.10.010.

⁵⁶ Ross Buckley and David Arner, *From Crisis To Crisis: The Global Financial System and Regulatory Failure* (Kluwer Law International, 2011).

⁵⁷ Luigi Zingales, 'A Tax on Short-term Debt Would Stabilise the System' *Financial Times* (online), December 17, 2009 <http://faculty.chicagobooth.edu/luigi.zingales/papers/editorials/a_tax_on_short-term_debt_would_stabilize_the_system.pdf>.

⁵⁸ United Nations, 'Report of the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System' (2009) <http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf>.

⁵⁹ Margaret M Blaire, 'Financial Innovation and the Distribution of Wealth and Income' (Research Paper No. 10–22, Vanderbilt University Law School. 2010) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1656451>.

⁶⁰ Dean Baker, *The Benefits of a Financial Transaction Tax* (Center for Economic and Policy Research, 2008)

<<http://cepr.net/publications/reports/the-benefits-of-a-financial-transactions-tax>>.

⁶¹ Darvas and Weizsäcker, above n 46.

transaction and as a result is likely to negatively impact the attractiveness of trading.⁶² Furthermore the reductions in trading volume will also likely result in a reduction in market liquidity; however, the degree of impact remains unclear. Buckley notes that if trading costs and bid-ask spreads are regarded as measures of efficiency, then under that definition a FTT would reduce efficiency.⁶³ However, if the measure of efficiency is so narrowly defined in where it focuses on individual transactions only, and not the allocative efficiency of the market overall, then its measure becomes rather uninformative for policy purposes. For perspective, if one considers the fact that high-frequency transactions cause prices to diverge from the indicative prices based on economic fundamentals, then it would be reasonable to state that the current financial markets are actually allocating resources relatively inefficiently.⁶⁴

It is also worth addressing the link between high-frequency transactions and speculation. High-frequency transactions that utilise speculation to allocate resources have been reported to make markets relatively more crisis-prone.⁶⁵ There is evidence that confirms that crisis damage impacts the long-term growth of financial markets far more than minor enhancements in trading costs⁶⁶. Therefore, although a FTT will marginally increase the cost of transactions, it can also decrease the long-term externalities caused by high-frequency transactions. From this perspective a FTT can actually be a means of long-term welfare enhancement.

As with any new tax regime, a key concern is where the burden of tax will fall. A FTT or the 'Robin Hood tax' is a tax that is supposed to take from the rich financial institutions, and used to provide social support to society. However, it has been argued that the burden of taxation is likely to fall entirely on the consumers who are investors or pensioners and not on the banks.⁶⁷ In response, the counter-argument is that a FTT which targets consumers would require the majority of these short-term trades to be initiated by pension fund managers.⁶⁸ Instead, evidence has shown that the majority of short-term trades are initiated by hedge funds and hedge fund-like proprietary traders working for banks rather than accounts targeted at clients. In this case a FTT would more likely impact the profits of hedge funds and banks rather than investors or pensioners. It appears that the taxation burden is far more likely to impact on the intended financial institutions. It should be noted that the New Zealand KiwiSaver institutional investors are likely to be affected by this tax, and as such it will be important for future research to study how this will affect investor perceptions as well as the profitability of the KiwiSaver scheme. On the other hand, the benefit they receive from more stable and long-term orientated markets will likely provide greater benefit than the imposition of tax.

Another key challenge in introducing a FTT is that there may be a lack of global reciprocity between nations implementing a FTT at a similar time. A problem with introducing new taxes is that institutions and individuals will find it relatively more

⁶² Ibid.

⁶³ Buckley and North, above n 53.

⁶⁴ Menzies et al, above n 55.

⁶⁵ Buckley, above n 23.

⁶⁶ Menzies et al, above n 55.

⁶⁷ Ralitsa Kovacheva, 'Pros and Cons of a European Tax on Financial Sector' *EUinside* (Online) 10 November 2011 <<http://www.euinside.eu/en/news/pros-and-cons-a-european-financial-transaction-tax>>.

⁶⁸ Neil McCulloch and Grazia Pacillo, 'The Tobin Tax: A Review of the Evidence' (Research Report No. 68, Institute of Development Studies, University of Sussex, 2011).

attractive to move their funds overseas to jurisdictions that impose relatively lower taxes.⁶⁹ For example, if a FTT was instituted in only limited jurisdictions, depending on the FTT rate, then traders could view FTT as a disincentive to trade in a particular country. For a FTT to achieve the objectives of raising revenue and reducing speculation it should be applied across major trading jurisdictions to limit incentives to switch trading focus to non-FTT jurisdictions. New Zealand would benefit more from an FTT tax if these other major trading jurisdictions, such as Australia, also implemented a FTT. Nonetheless, just as with the current United Kingdom stamp duty, a FTT does not need to be applied globally. A regional approach may also work effectively.

5. CONCLUSION

Overall, this paper provides an overview of FTT and highlights its value. The paper has also identified that the application of a FTT requires further research. Future research could focus on practical requirements for implementation of the tax within New Zealand. This includes research on the potential impact of a FTT on retirement funds that are held as part of the government-funded retirement KiwiSaver Scheme that operates in New Zealand. It is also recommended that future research is more empirical to ascertain the opinions of members potentially affected by this tax, which should include those working in the financial industry and investors. In terms of revenue gathering there is a need to assess the potential revenue that could be collected from the implementation of a FTT. Without an adequate measurement on the potential benefit of a FTT and a consideration of the potential economic impact on financial markets, the suggestion of immediate implementation of an FTT would be unsubstantiated. A FTT could be a powerful means of revenue generation and it may be effective in reducing speculative behaviour in capital markets. In the New Zealand context it is important to determine ‘why’ a FTT is needed or useful. A FTT could potentially address the concerns of how the government responds to increasing sources of tax revenue as the population ages. A FTT could potentially shift the reliance on tax revenue to another source of tax revenue, namely a FTT. However, if critics of a FTT are correct in suggesting that a FTT is limited in generating extra tax revenue then the other aspects of a FTT in reducing speculation should also be considered. It would be useful to research the implementation of a FTT at a regional level incorporating Australia. Overall this paper has provided a starting point for both the consideration and discussion of this topic and indicators for future research in this area.

⁶⁹ John Creedy and Norman Gemmell, ‘Can Fiscal Drag Pay for the Public Spending Effects of Population Ageing in New Zealand?’ (2014) 48(2) *New Zealand Economic Papers*, 183, DOI: 10.1080/00779954.2013.874394.

Filling the land tax void: New Zealand standpoint

Ranjana Gupta¹

Abstract

This paper investigates land taxation from a New Zealand perspective and examines the principles of economic efficiency and equity behind three common property valuation methods for taxation. The primary question is whether using land value as the base on which to assess property tax remains the most efficient and equitable tax mechanism compared to capital value tax on improvements and annual value tax on estimated income earned from the property. The paper briefly assesses the challenges confronting valuation and the impacts that may arise from a levy of property tax in jurisdictions with different features. While issues exist in the determination of any basis of value, it is asserted however, that there is a need for considering exemption provisions to implement a land value tax in New Zealand, which has a significant potential to compromise the principle of economic efficiency.

Keywords: Land tax, Property tax, Equity, Efficiency, Exemptions

¹ Dr Ranjana Gupta, Senior Lecturer in Taxation, Faculty of Business and Law, Auckland University of Technology.

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1. INTRODUCTION

Whoever hopes a faultless tax to see, hopes what ne'er was, is not, and ne'er shall be. Alexander Pope (1688-1744)

The tax system plays multiple roles. In addition to being a fundamental instrument to raise revenue that finance government expenditure, it also acts as an instrument to achieve the economic and social aims of government, and to redistribute income on a socially acceptable basis.

The New Zealand tax system is generally well-designed and has served the country over decades however, it is not sustainable. The approaches to tax design and governance practices will need to change to meet global competition and technological development. The challenge for New Zealand tax authorities is to reform the legal and administrative environment while broadening the tax base. A narrow tax base is inefficient because there is the tendency to avoid participation in taxed activity, which increases the tax rate on that activity. Therefore, the converse is true: by taxing different activities or new sources of revenue, tax rates can be kept comparatively low.² New Zealand relies heavily on the Goods and Services Tax and income tax.

Land tax, recommended by the Tax Working Group (TWG)³ in 2010 to replace a number of existing taxes, is one of the biggest holes in the New Zealand tax regime. The TWG has indicated their belief that the current tax system is inefficient, stating that changes are needed to enhance efficiency and reduce the barriers to productivity and growth. Unless exemptions are made, a land tax will have an impact on all landowners including non-residents, charities, local authorities, non-state schools, hospitals and others owning land in New Zealand at the time the tax is announced.⁴

A property tax is a proxy for income tax and is based on the assumption that a certain level of property holdings indicate a certain ability to pay taxes on a regular basis.⁵ A property tax, which includes the value of improvements to land as well as land values, is less efficient.⁶ Land tax is a tax levied solely on unimproved value⁷ of the land.⁸

² P Genschel, 'Globalisation and the Transformation of the Tax State' (2005) 13/Supplement S1 *European Review* 53–71.

³ Tax Working Group, 'A Tax System for New Zealand's Future: Report of the Victoria University of Wellington Tax Working Group' (Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, 2010).

⁴ A 1 per cent per annum tax on all non-government land could raise approximately \$4.6 billion annually (rising to \$6.7 billion annually by 2030 with 2 per cent per annum land inflation). A Coleman and A Grimes, 'Fiscal Distributional and Efficiency Impacts of Land and Property Taxes' (2010) 44(2) *New Zealand Economic Papers* 179–199.

⁵ S Kwak and J Mak, 'Political Economy of Property Tax Reform: Hawaii's Experiment with Split-Rate Property Taxation' (2011) 70(1) *American Journal of Economics and Sociology* 4–29. At 4–5, Nobel laureate in economics W Vickrey observed, 'The property tax is, economically speaking, a combination of one of the worst taxes—the part that is assessed on real estate improvements ... and one of the best taxes—the tax on land or site value'.

⁶ Coleman and Grimes, above n 4.

⁷ The term 'unimproved land values' refers to the value of bare land, that is, exclusive of the value of any man-made structures or improvements.

Generally, the taxable value excludes improvements⁹ and personal property located on the land.¹⁰ It is a cost of owning land and taxes an immobile factor.¹¹ Further, it is the concept of elasticity¹² that makes the taxation of land unique amongst other taxes. Land values are the rising element in real estate prices and a land tax may encourage landowners to put their land into the most productive use¹³ and reduce speculation in land and property sales. A land value tax is a fair way of making everybody benefit from community-created increases in land values. While the government did not act on the recommendation to implement a land tax as part of the reforms undertaken in 2010, a land tax targeting foreign buyers of residential real estate is now the government's policy tool for addressing base broadening.¹⁴ This idea is in line with a number of other recent proposals for reforming the income tax system and for solving the current steep increase in land values across Auckland¹⁵ which presents a threat to the country's financial stability.¹⁶

One of the most famous advocates for a tax on land was Henry George, who argued in his 1879 work *Progress and Poverty* that the value of land was largely created by the community's economic activities.¹⁷ Henry George so strongly believed in the strength of land tax that he even suggested all of a government's financing needs could be met by a sole land tax. While the revenue raising ability of the tax is clearly insufficient to replace all other forms of taxation today, it remains an important part of many taxation systems and has attracted much attention in New Zealand.¹⁸ However, it is

⁸ R F Dye and R W England, 'The Principles and Promises of Land Value Taxation' in R F Dye and R W England (eds), *Land Value Taxation: Theory, Evidence, and Practice* (Lincoln Institute of Land Policy, Cambridge, Massachusetts, 2009) 3, at 4.

⁹ The value of man-made structure, for example, residential or commercial buildings.

¹⁰ W J McClucksey and Riël C D Franzsen, *Land Value Taxation: An Applied Analysis* (Ashgate, England, 2005) 115–190.

¹¹ T Dwyer, 'The Taxable Capacity of Australian Land and Resources' (2003) 18 *Australian Tax Forum* 1, 21–68 at 41 '[in] a world that is mobile and labour supply is shrinking in line with demographic decline, an immobile tax base is the only tax base which makes economic sense'.

¹² Due to inelastic supply of land, no adverse side effects arise from tax. Land does not disappear when it is taxed. Elasticity is a measure of the responsiveness of demand and supply of a good or service to an increase or decrease in its price. In economics, the elastic product means that any change in price can result in changes in supply or demand. The inelastic product means that changes in price do not affect to a noticeable degree the supply or demand.

¹³ F E Foldvary, 'The Ultimate Tax Reform: Public Revenue from Land Rent' (2006) *Civil Society Institute Policy Study* (Santa Clara University, CA).

¹⁴ T Watkins, 'PM Hints at Land Tax To Rein In Foreign Speculators', *Business Day* (online), 24 April 2016 <<http://www.stuff.co.nz/business/79271237/PM-hints-at-land-tax-to-rein-in-foreign-speculators>>. 'Land tax could be slapped on foreign buyers, including Kiwis overseas, if new data shows overseas speculators are fuelling the residential property boom, Prime Minister John Key has hinted. Key said the Government was yet to make a call on a land tax but it was an option if foreign property speculation became "a runaway train".'

¹⁵ G Spencer, 'Trends In The New Zealand Housing Market' (Speech delivered to Property Council of New Zealand, 15 October 2013) <<http://www.rbnz.govt.nz/research-and-publications/speeches/2013/speech2013-10-15>>.

¹⁶ OECD, *OECD Economic Surveys: New Zealand 2015* <<https://www.oecd.org/eco/surveys/New-Zealand-2015-overview.pdf>>.

¹⁷ H George, *Progress and Poverty* (Hogarth Press, London, first published 1879, 1953 ed) Chapter 19.

¹⁸ R D Keall, 'New Zealand: Land and Property Taxation' (2000) 59(5) *American Journal of Economics and Sociology* 417. At 422, Keall noted, 'The dismantling of the land tax in New Zealand took place over the course of many decades, often against the general public's preferences and in the context of a poor understanding of the key principles and advantages of the tax'.

questionable whether land tax will generate sufficient revenue which is stable and predictable allowing local authorities to budget for expenditure.

Classical economist Adam Smith developed the principles (maxims) of a ‘good’ tax system back in 1776.¹⁹ These include equality (fairness in the distribution of tax burden), certainty (the tax system should be easy to understand), convenience of payment (the tax system should be easy to comply with) and efficiency (the lowest possible cost of tax collection). He proposed that any ‘good’ tax system would comply with an appropriate mix of each of these principles. The underlying meaning of these four terms forms the backbone of tax policy and subsequent reforms. All nations have tried to apply Adam Smith’s philosophy to their tax laws. However as evolution takes place, laws have to be modified to meet the requirements of the day. Smith’s principles have been expanded by subsequent economists and writers, who have added concepts such as adequacy (raising sufficient revenue), sustainability (the ability to meet changing needs of government)²⁰ and simplicity.²¹

Since taxation generally is understood to be harmful for the economy,²² it is worth discussing the balancing of these core principles for imposing a national land tax in New Zealand, a tax that was abolished in 1992.²³ Repealing the land tax was a progressive move and through the rating system the responsibility for collection of property tax²⁴ was passed onto local government.²⁵ New Zealand does not rely on income from transaction taxes imposed on property and a recurrent tax on property imposed through the rating system addresses this shortfall to some degree.²⁶ However, land tax, levied by national/state government, generally on the unimproved value of land at its highest and best use is viewed as a consolidated revenue tax by economists.²⁷

The objective of the present study is to address the relevance of these core principles regarding the role of the national land tax system to increase recurrent tax revenue from land and to encourage optimal use of land. Specifically, this paper will consider

¹⁹ A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, (University of Chicago Press, first published 1776, 1977 ed), Book V, Chapter II, Part II.

²⁰ Australian Government, *Australia’s Future Taxation System Review (Henry Tax Review)* (Australian Government, Canberra, 2010), 17. The Henry Tax Review emphasised the importance of sustainability, where this is the ability to meet the changing revenue needs of governments, and consistency across tax laws and treatments.

²¹ R H Woellner, S Barkoczy, S Murphy, C Evans and D Pinto, *Australian Taxation Law* (Oxford University Press, 26th ed, 2016). Certainty and convenience is the notion that taxes should be economical to collect and have been labelled by economists as simplicity.

²² A libertarian view. If we accept the reasons why governments tax—to redistribute, to achieve various goals (such as discouraging young people from smoking)—then taxation is good; it is the price we pay for civilisation.

²³ *Land Tax Abolition Act 1990* (NZ) repealed the land tax effective from 31 March 1992. See Part 3.4 below.

²⁴ Land tax is imposed on unimproved values of land whereas property tax is imposed on both improvement values and land values. Refer to Dye and England, above n 8.

²⁵ Local authorities may use land value (unimproved value), capital value (improved value) or annual value (imputed rental from improved land) for setting the rates. Refer to Part 4.4 of this paper for more detail.

²⁶ Property is generally lightly taxed in New Zealand. Refer to Local Government Rating Inquiry, ‘Funding Local Government, Executive Summary’ (2007) (Shand Report) 2.

²⁷ V Mangioni, *Land Tax in Australia: Fiscal Reform of Subnational Government* (Routledge, 2016), 28.

the principles of economy (commonly called efficiency) and equity, to critically assess whether the New Zealand environment would effectively sustain a land tax to fill in a gap in its tax base and encourage investments that better promote economic growth. Compliance with these maxims encourages public acceptance, essential for the effective operation of any tax system and deserves serious consideration by national and local government. The findings of the present study may also shed some light on the role of various property tax bases. This study is important because there is limited attention from New Zealand tax and economics researchers on the role of these principles in the operation of a land tax which inhibits our understanding on how to develop a good property tax system.

The paper proceeds as follows: Section 2 of the paper considers an analysis of implementation of the different methods (annual value, land value and capital value) of property taxation. Section 3 provides a succinct review of the literature relevant to the property tax system in New Zealand and different jurisdictions. Section 4 reviews the effect of the New Zealand environment on the implementation of a land tax. Section 5 discusses relevant exemptions in New Zealand in relation to a land tax. Finally, Section 6 sets out the conclusions emerging from this study and identifies areas for further possible research.

2. THEORY OF COMMON PROPERTY TAX BASE

The desirable aspects of a good tax system are dependent on the method of taxation used to calculate tax liability. In the absence of vacant land sales the value determined and used to assess recurrent property tax in highly urbanised locations is an artificial construct.²⁸ There are different kinds of property tax valuation methods used overseas that must be considered to facilitate the application of national land tax in New Zealand. These include the following: annual rental value, a tax on estimated (not actual) income earned from the property; capital improved value, a tax on the total value of land, buildings and improvements; and land value or site value tax, a one-off tax on the existing wealth in the form of property that only targets landowners. The paper will now critically assess the implementation of the different property valuation methods for taxation, specifically focusing on principles of economy (commonly called efficiency) and equity in the implementation of a land value tax in New Zealand.

2.1 Annual rental value (ARV)

Annual rental value taxation is a tax on estimated (not actual) income earned from the property. Estimates are based on existing or current use of the property and fail to include the future earning potential of the land. This is the value created by the owner of the land. The rationale for using rental value is that tax is paid from income and not from wealth. Assuming land is used at its best and highest use then the present value of all rental income will equal the capital cost of the property. However, this is not always the case in reality.

Rental value becomes less equitable when using hypothetical rent for properties not earning real income. There may be a divergence between assessed actual rental value and market rental valuation. Annual rental value is ideal for commercial or industrial

²⁸ V Mangioni, 'Land Value Taxation and the Valuation of Land in Australia' (2014) 10(2) *Nordic Journal of Surveying and Real Estate Research* 82, 87.

property since property is more likely to be used to its maximum potential and actual rental value is closer to the market rental value. In this instance market rent will be ideal because it will capture the income that could be earned from the property. However, market rental value can also be distorted by annual rental value reductions, market intervention and rental controls to protect low income earners, as implemented in India.²⁹

For efficiency, rental valuation should be valued using real income earned excluding the costs of repairs, insurance and other expenses involved in maintaining the property. This makes it more complicated to value because the expenses differ from owner to owner and would require a costly process of data collection, not to mention increased opportunity of tax avoidance. In situations where property is leased, it would be easier to collate data for tenancy agreements where the tenant is responsible for repairs and maintenance rather than the agreements where owners are required to maintain the property because owners can shift the burden through higher rent.

2.2 Capital improved value (CIV)

Capital improved value is a tax on the total value of land, buildings and improvements.³⁰ Taxation on capital value of property is a fair system because as population grows, so do subdivisions and the council's costs associated with servicing the community. Subdivisions add more value to capital value tax than land value tax. This means that new subdivisions will pay higher taxes because they are responsible for the growth, thereby reducing the burden on other rate payers. Under the capital taxing system, low valued land with high valued buildings such as apartment blocks will be paying similar rates as high valued land. This effectively brings two extreme situations closer together under the capital value taxing compared to the land value taxing. Capital improved value tax is more progressive and assumes that those with higher value buildings have more ability to pay tax. Capital improved valuation also allows local authorities to raise more revenue to fund infrastructure projects and other expenditure.

Considering the theory that tax should match the service provided, there is clearly an inequality in the taxing system when looking at properties with large areas of land. For example, farm land will incur high rates even after deductions. It receives the same services that a small block of rural land receives from the council. Property values differ on a property to property basis since the price people are willing to pay for it depends on many economic and geographic reasons. It is difficult to change the property values to match services but we can regulate services to the property.

Capital improved value taxation has a lower nominal tax rate which makes it politically acceptable and easy to understand by taxpayers. The administrative difficulties with collecting information on improvements can be lessened if there is a good record of sales data on land transfers.

²⁹ W J McCluskey, M E Bell and L J Lim, 'Rental Value Versus Capital Value—Alternate Bases for the Property Tax' in R Bahl, J Martinez-Vazquez and J M Youngman (eds), *Challenging the Conventional Wisdom on Property Tax* (Lincoln Institute of Land Policy, Massachusetts, 2010) 120.

³⁰ In fiscal revenue terms, a 0.5 per cent property tax is approximately equivalent to a 1 per cent land tax. Coleman and Grimes, above n 4.

2.3 Land value (LV)

Land value or site value (SV) tax is a one off tax on the existing wealth in the form of property³¹ and only targets landowners. At the time of sale, a tax decrease will increase the market value of the property, allowing the owner to benefit from a windfall gain. A tax increase will reduce the value of the property causing a loss borne entirely by the landowner. It is a tax on a certain form of wealth; for business it is a tax on capital assets and for private owners it essentially targets savings. Those who do not own land will not be impacted directly by the tax. However, tax shifting opportunities are available for types of properties and industries. For example, business owners can pass on part of the tax burden to customers, suppliers or even employees in the form of reduced benefits or wage cuts. Apartment owners can increase rents. Owner-occupied homes will bear all the costs.

Adam Smith's canon of economy states that 'every tax ought to be so contrived as to take out and keep out of the pockets as little as possible, over and above that which it brings into the public treasury of a state'.³² To satisfy a cost-benefit analysis, the tax system must be able to raise substantial revenue at a relatively low cost.³³ It is said that, '[f]or any given tax, the larger the price elasticities of demand and supply, the larger the change in consumption and production. Therefore, the larger price elasticities of demand and supply are associated with larger deadweight loss'.³⁴

Land tax is a tax levied on the unimproved³⁵ or rental value of land (but there are some variations that include improvements to land). Land tax is a cost of owning land, and taxes an immobile factor.³⁶ In a perfect functioning market with no transaction costs and a fixed supply of land, the full burden of the tax falls on the landowner at the time the tax is levied. This has been mathematically proven; the new market value for a piece of land is reduced by the tax. The purchaser is compensated for all future tax payments through a reduced purchase price for the land.³⁷ Any attempts by the landowner to increase property price will result in lower demand for the land and excess supply of land. Thus, the market price is set by the purchaser rather than on the basis of expenses born by the landowner. The fixed supply of land enables high revenue from low rate.³⁸

³¹ Coleman and Grimes, above n 4.

³² Smith, above n 19.

³³ I Vlassenko, 'Evaluation of the Efficiency and Fairness of British, French and Swedish Property Tax Systems' (2001) 19(5) *Property Management* 384, 386.

³⁴ J P Cohen and C C Coughlin, 'An Introduction to Two-Rate Taxation of Land and Buildings' (2005) 87(3) *Federal Reserve Bank of St Louis Review* 359, 364. Deadweight loss (an excess burden) in economic terms is the measure of inefficiency.

³⁵ The term 'unimproved land values' refers to the value of bare land, that is, exclusive of the value of any man-made structures or improvements.

³⁶ T Dwyer, 'The Taxable Capacity of Australian Land and Resources' (2003) 18 *Australian Tax Forum* 1, 21, 41 '[A] world that is mobile and labour supply is shrinking in line with demographic decline, an immobile tax base is the only tax base which makes economic sense'.

³⁷ W E Oates and R M Schwab, 'The Simple Analytics of Land Value Taxation', in R F Dye and R W England (eds), *Land Value Taxation: Theory, Evidence and Practice* (Lincoln Institute of Land Policy, Massachusetts, 2009) 51, at 71.

³⁸ Tax Working Group, above n 3, 50.

Land value taxation is a conceptually sound method because it is theoretically efficient and neutral.³⁹ Tax on improvements such as capital value taxing could affect a landowner's decision to develop property. Land tax will continue to apply post development and will be a fixed cost to owning land rather than a hindrance to development. The imposition of the tax will still result in a decline in price as consumers are mainly concerned with the out of pocket expense. However, this change in price is exactly proportional to the tax revenue collected with the notable absence of an excess burden on society. It is this feature that makes land tax more efficient and transparent than other forms of taxation, as Adam Smith argued, '[g]round-rents are a still more proper subject of taxation than the rent of houses. A tax on ground-rents would not raise the rents of houses. It would fall altogether upon the owner of the ground-rent, who acts always as a monopolist, and exacts the greatest rent that can be got for the use of his ground'.⁴⁰

Adam Smith's canon of equity states 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'. The significance of this early definition lies in the normative concept that the tax burden should be linked to the respective ability of the taxpayer to make those payments.

The value of land reflects access to public amenities (shopping centres, parks and libraries), income-generating potential of the land and infrastructure (transportation, water systems and sewer systems), and value created by society (economic activity and population growth).⁴¹ Land is only valuable because of the society that surrounds it, as Henry George said, 'It is taking by the community, for the use of the community, of that value which is the creation of the community'.⁴² According to this argument, it is fair that those with high value land should be able to pay more tax because they receive greater benefits generated by the community. Therefore, a land value tax does not tax owner efforts but the unearned value of the land generated by population growth, infrastructure and economic growth.

Land value taxation in heavily built-up urban areas becomes difficult to calculate compared to capital value taxation.⁴³ A residual method of valuation will require the value of improvements to be deducted from the capital value of the land. This approach makes land valuation more subjective compared to capital improved value taxation.⁴⁴ Academics in tax and economics typically use the principles of horizontal and vertical equity to provide a more principled approach to the definition of 'fairness'.⁴⁵

³⁹ T N Tideman, 'A Tax on Land Value Is Neutral' (1982) 35 *National Tax Journal* 1, 109–111.

⁴⁰ Smith, above n 19.

⁴¹ L C Walters, 'Land Value Capture in Policy and Practice' (2013) 10(2) *Journal of Property Tax Assessment & Administration* 5–22.

⁴² H George, above n 17.

⁴³ M E Bell, J H Bowman and J C German, 'The Assessment Requirement for a Separate Tax on Land', in Dye and England, above n 8, 171–194. This lack of simplicity and transparency had been defined as the rationale to the move to CIV in many international jurisdictions.

⁴⁴ R W Bahl, 'Fiscal Decentralisation, Revenue Assignment and the Case for the Property Tax', in M E Bell and J H Bowman, *Property Taxes in South Africa: Challenges in the Post-Apartheid Era* (Lincoln Institute of Land Policy, Massachusetts, 2002) 23–42.

⁴⁵ Vlassenko, above n 33.

Horizontal equity can simply be defined as the equal treatment of equals.⁴⁶ In the context of a land tax, the system is considered to have achieved the horizontal equity principle if two pieces of land with the same value are taxed at the equal amounts. Assuming that the tax is low rate, broadly applicable, with no exemptions, this goal would be satisfied. However, the assessment of horizontal equity extends beyond a mere equality test to judge how the tax fits within the existing taxation system. Given that a land tax extends the tax base only to one type of wealth, while helping to solve the 'ability to pay' problem, it is discriminatory. Wealth may be stored in many forms, and the principle of horizontal equity requires them to be treated alike. The introduction of a land tax only taxes wealth stored in the form of land, and thus cannot be said to be equitable. Such discrimination cannot be justified, and is likely to result in public resistance due to its perceived 'unfairness'. A broader wealth tax, such as a capital gains tax on the real estate market,⁴⁷ may overcome this problem; however, it is beyond the scope of this research paper to set out the implications of capital gains tax in New Zealand.

Vertical equity requires the appropriate differentiation of unequal circumstances.⁴⁸ A tax system is considered fairer when a higher burden is paid by those who are most able to pay. While this principle is desirable in theory, its practical application can be difficult. The justification and definition of who has a better ability to pay is complex and somewhat subjective with the decision generally being made by politicians. It is then reflected in the workings of the tax system through the utilisation of exemptions, reliefs and progressive taxes.

Compliance with horizontal and vertical equity should be synonymous, not alternative. Together they represent the broader principle of equity and essentially represent alternative sides of the same coin.⁴⁹ Without the appropriate differentiation of people (through vertical equity measures), horizontal equity is merely a tool to safeguard against capricious discrimination.⁵⁰ However, public perception of equity can at times make it difficult to implement vertical equity measures. While it is commonly accepted that those who earn more should pay more, it is somewhat less accepted that discrimination on certain policy grounds is tolerable. As a result, politicians are incentivised to engage in behaviour that blurs the objective standards of equity in favour of popular opinion.

It is clear that every tax method has a compliance cost. Therefore, it is difficult to isolate a distinguishing New Zealand perspective and study the suitability of a land value tax in a purely New Zealand context. The in-depth analysis of implementation of the different methods (land value, capital value and annual value) of taxation in different jurisdictions will assist to effectively stack these methods against the criteria of a good tax system. The following section discusses relevant property tax systems in a selected countries; namely, Australia, California (United States of America) and New Zealand.

⁴⁶ R A Musgrave, 'Horizontal Equity, Once More' (1990) 43(2) *National Tax Journal* 113.

⁴⁷ Capital gains tax is only levied when investors sell an asset and on the realized appreciation of the asset.

⁴⁸ Musgrave, above n 46.

⁴⁹ Ibid, 117.

⁵⁰ R A Musgrave, *The Theory of Public Finance* (McGraw Hill, New York, 1959) 160.

3. HISTORY OF PROPERTY TAX IN DIFFERENT JURISDICTIONS

3.1 Australia

Land value taxation is an important source of tax at the state and the local government levels in Australia. State tax is imposed on owners of land used for income producing purposes. The Australian Local Government Association website shows 563 local authorities that rely exclusively on the land value tax as own-source revenue. Australia has a long history of land value taxation which has achieved consistent results.

Table 1: Land value taxation at the state and local government level⁵¹

Australian States/Territories	State tax first introduced	State Government Land Tax	Local Government Council Rates
Australian Capital Territory	1987	Unimproved Value	Unimproved Value
New South Wales	1895	Land Value (replacing unimproved value in 1978)	Land Value
Northern Territory	None	None	Unimproved Capital Value
Queensland	1915	Site Value	Site Value
South Australia	1884	Site Value	Improved Value*
Tasmania	1910	Land Value	Gross Rental Value*
Victoria	1910	Site Value	Improved Value
Western Australia	1907	Site/Unimproved Value	Gross Rental Value*

* The option of assessing council rates on more than one basis across different Local Government Authorities.

The table above, modified from Mangioni,⁵² shows land value is taxed at the State level for all eight territories except Queensland which taxes only the raw value of land, excluding levelling and drainage (merged improvements). Local governments have a choice of methods with the exception of Australian Capital Territory. There is a growing preference for capital value, as evidenced by the high number of councils choosing capital value taxation in South Australia and Victoria. In Tasmania, despite the choice of tax methods, rental value is the preferred method.

The evolution of land taxation in New South Wales provides an insight into the challenges confronting all cities when imposing a land value tax in increasingly urbanised locations. These challenges have resulted in an additional layer of

⁵¹ V Mangioni, above n 28, 86.

⁵² Ibid.

complexity which requires accounting for the added value of improvements in the valuation of land.⁵³

3.2 California, United States of America

Another interesting study is the State of California where the acquisition 'value based' property tax system is used. Taxation is based on the purchase price of property plus a yearly allowance for inflation. Local governments in California had absolute autonomy in land taxation until tax payers began to protest the unprecedented rise in property taxation. Proposition 13 was introduced in 1978 to cap the increase in the property tax at 2 per cent per annum.

3.3 New Zealand

Property tax⁵⁴ has always been the main source of revenue for local authorities in New Zealand. The Local Government Rates Inquiry Panel of 2007⁵⁵ shows property tax accounted for 57.3 per cent of revenue in 1994 and 56.1 per cent in 2006. Statistics New Zealand 2010⁵⁶ showed the reliance of property tax had jumped to 92 per cent of total taxation revenue for local governments. The investigation of property tax over a period shows that local authorities have favoured one method over another.

By 1842, during the early colonisation period in New Zealand, local authorities had the power to make and levy rates. This was fine-tuned by the passing of the *Property Rate Ordinance 1844* to include tax on property and income.⁵⁷ During the first 10 years of colonisation, the annual rental value method was preferred because it was the method used in Britain and ideal given the large areas of undeveloped land in New Zealand.⁵⁸ The *Rating Act 1882* made capital valuation compulsory with a few exceptions. All rural areas adopted capital value rating and urban areas adopted annual rental value. Undeveloped land had no rental value. Farm land improvements added more to annual rental value than capital value and capital valuation was a move towards a common valuation tax basis.⁵⁹ Together, these were the main reasons given for this change.

⁵³ NSW Ombudsman, 'Improving the Quality of land Valuations Issued By The Valuer-General' (October 2005).

⁵⁴ In New Zealand two types of property taxes are charged by local authorities: recurrent taxes on immovable property (rates) and non-recurrent taxes on property (development and financial contributions).

⁵⁵ Local Government Rates Inquiry Panel, *Funding Local Government* (Wellington: Local Government Rates Inquiry, 2007)
<[http://www.dia.govt.nz/Pubforms.nsf/URL/RatesInquiryFullReport.pdf/\\$file/RatesInquiryFullReport.pdf](http://www.dia.govt.nz/Pubforms.nsf/URL/RatesInquiryFullReport.pdf/$file/RatesInquiryFullReport.pdf)>.

⁵⁶ Statistics New Zealand, *Government Finance Statistics (Local Government): Year ended June 2010*
<http://www.stats.govt.nz/browse_for_stats/government_finance/local_government/GovernmentFinanceStatisticsLocalGovernment_HOTPYeJun10/Commentary.aspx>.

⁵⁷ W J McCluskey, A Grimes and J Timmins, 'Property Taxation in New Zealand' (Working paper, Lincoln Institute of Land Policy, 2002)
<http://scholar.google.co.nz/ezproxy.auckland.ac.nz/scholar?q=related:ThY8kpslyp4J:scholar.google.com/&hl=en&as_sdt=0,5>.

⁵⁸ McCluskey et al, above n 29.

⁵⁹ McCluskey and Franzsen, above n 10.

Land value tax was adopted in New Zealand for the first time in 1878.⁶⁰ Public expenditure and immigration contributed to the boom in land value before 1870 and peaked between 1874 and 1878, coming to an abrupt end in 1879.⁶¹ Liberal thinkers believed wealthy landowners had greater taxable ability but a low tax burden compared to the working class who were generating the bulk of government revenue through tariffs. However, when the land values began to fall, the counter argument was that it was unfair to tax a group who was receiving no special benefits and whose growth was important to the growth of the economy. This tax was repealed a year later by the *Property Tax Act 1879* (NZ) which taxed capital value only and then returned to unimproved land value in 1894.⁶² Over the next century, the concept of land value taxation underwent numerous changes in an attempt to create a more equitable system and in the late 19th century a land value tax was a major source of the government's revenue.⁶³ At the same time, the Ross Committee observed that 'tax is no longer necessary or effective as a means of breaking up large land holdings'.⁶⁴ The McCaw Report also noted that the land tax had 'no perceptible redistributive effect' and was 'not an adequate indicator of the taxable capacity provided by wealth'.⁶⁵ Finally, the resulting exemptions and distortions rendered the tax uneconomic and inefficient,⁶⁶ leading to its abolishment in 1992.⁶⁷

Overall, the study of various property tax methods employed by different jurisdictions indicates that there is no universal tax system applicable to all jurisdictions. There are large variations in implementation strategies and resulting successes for land value tax overseas. The effective operation of a tax system is influenced by the legislative framework, environmental factors, social policies, values, beliefs, and the culture of a country. Due to the highly sensitive nature of tax and the environment in which it is implemented, a system which may work well in one country could be a complete disaster in another. Further, land tax has also led to avoidance and evasion, and costly challenges to valuations.⁶⁸ However, following the recommendations of the TWG to the New Zealand Government, the question of whether a land value tax is suitable for

⁶⁰ *Land Tax Act 1878* (NZ) made it compulsory to tax land value. The introduction of this land tax by treasurer John Ballance in 1878 was significant.

⁶¹ P Goldsmith, *We Won, You Lost, Eat That!: A Political History of Tax in New Zealand since 1840* (David Ling, 2008) 83; M King, *The Penguin History of New Zealand* (Penguin Books, 2003) 260–261.

⁶² McCluskey and Franzsen, above n 10; 'Taxation in New Zealand: Report of the Taxation Review Committee' (Government Printer, 1967) (Ross Report) 410.

⁶³ B F Reece, 'The Abolition of Land Tax in New Zealand: Searching for Causes and Policy Lessons' (1993) 10(2) *Australian Tax Forum* 223–244.

⁶⁴ Ross Report, above n 62, 415.

⁶⁵ New Zealand Government, 'Report of the Task Force on Tax Reform' (Government Printer, 1982) (McCaw Report) 230.

⁶⁶ The McCaw Report noted that in 1960, land tax contributed 6 per cent of direct tax revenues. In the same period, the land tax as a percentage of gross domestic product (GDP) fell from 0.9 per cent to 0.2 per cent (at 228).

⁶⁷ *Land Tax Abolition Act 1990* (NZ) repealed the land tax with effect from 31 March 1992. See McCaw Report: 'In 1982, only five per cent of total land value was taxed, agricultural land being explicitly exempted and residential land effectively exempted by the exemption of \$175,000 for all landowners', (at 230).

⁶⁸ G Morgan and S Guthrie, *Tax and Welfare: The Big Kahuna* (Public Interest Publishing, 2011) 91. However, it may be argued that property owners cannot avoid a tax on land by producing less land and land cannot be moved from a high-tax jurisdiction to a low-tax jurisdiction.

the New Zealand context is nonetheless pertinent.⁶⁹ Therefore, the paper will now consider how the New Zealand environment will affect the implementation of a land value tax and its influence on the canons of efficiency and equity.

4. A LAND VALUE TAX: SOME NEW ZEALAND CONSIDERATIONS

This section sets out the factors which must be taken into consideration while implementing a land value tax in New Zealand.

4.1 Lack of tax revenue from property

Cheung observed that a favourable taxation system, immature capital markets, migration patterns and ‘easy credit conditions’ have made rental property an attractive investment option for New Zealanders.⁷⁰ The New Zealand Government under-utilises its ability to levy taxes on property.⁷¹ As mentioned earlier,⁷² local authority rates, which can be based on land, capital or rental values of properties, have been the major source of revenue for local government in New Zealand. Central government, on the other hand, earns only an estimated 5 per cent of its total tax revenue from property. This is well below the OECD average,⁷³ which is not surprising given New Zealand remains one of the last countries within the OECD which does not have a comprehensive capital gains tax (CGT). A partial CGT exists under Subpart CB of the *Income Tax Act 2007* but its application is rather limited. The current bright-line test for residential land (effective from 1 October 2015)⁷⁴ and the residential land withholding tax (RLWT) regime (came into effect from 1 July 2016)⁷⁵ are also designed to remove certain capital gains and bring them within the tax net. In 2008, the revenue from rates was approximately equal to 2 per cent of GDP and was in line with the OECD average; however, the revenue as a percentage of aggregate housing value fell from 2.2 per cent in 1980 to 0.65 per cent in 2008.⁷⁶

The relatively small reliance on property taxation increases pressure on the government to collect equivalent revenue from income/profit and consumption. From an economic point of view, such taxes are detrimental to the efficient operation of the market. An economic analysis of taxes shows a distortion in behaviour which leads to

⁶⁹ A 1 per cent land value tax on all non-government land would raise revenue equivalent to 20 per cent of current income tax revenue. See Coleman and Grimes, above n 4.

⁷⁰ C Cheung, ‘Policies to Rebalance Housing Markets in New Zealand’ (Working Paper No 878, OECD Economics Department, 2011) 20.

⁷¹ Under s°EE 31(3) *Income Tax Act 2007*, from the start of the 2011–2012 income year, no deduction for depreciation can be claimed on most types of buildings, including investment properties. However, prior to the start of the 2011–2012 income year, only a 20per cent loading was added to the depreciation rates for most new assets and did not apply to buildings.

⁷² Refer to Part 3.4 of the paper.

⁷³ P Vial, ‘The Sustainability of the New Zealand Tax Base: Are We at the End of the Road?’ (2009) 15(1)*New Zealand Journal of Taxation Law and Policy* 17, 24.

⁷⁴ Section CB 6A, *Income Tax Act 2007*. Any gain a person derives from disposing of residential land is income of the person if the property is disposed of within 2 years of acquisition, subject to some exceptions/exemptions, for example, land first acquired before 1 October 2015.

⁷⁵ RLWT would apply only to residential land in New Zealand: acquired by an ‘offshore person’ from 1 October 2015; sold after 1 July 2016; and sold within the 2-year bright-line period.

⁷⁶ Cheung, above n 70.

excess burdens on the society.⁷⁷ The resultant 'deadweight' loss does not benefit the consumer, the producer or the government.⁷⁸ Given the inherent inefficiencies of the current tax regime, the introduction of a land tax might be beneficial. A land value tax may be used to reduce the existing reliance on income and consumption taxes and could steer investors to more productive areas of the economy.⁷⁹ Such a shift would enable the tax regime to remain revenue neutral while reducing the excess burden on the society thus achieving a more efficient outcome. Clinton and Davis⁸⁰ proposed a land transfer levy to tax wealth accretions through property. They opined that the main purpose of the tax would be to correct the tax-induced preference for investment in residential property in New Zealand. A 1 per cent tax on all non-government land, using 2006 land values, was estimated to raise \$4.6b annually.⁸¹

4.2 Fall in land prices

It is predicted that the introduction of a land value tax will result in an immediate fall in the value of land.⁸² Coleman and Grimes estimated that the introduction of a 1 per cent land tax will amount to 16.7 per cent decline in the value of land.⁸³ This reduction is equivalent to the present value of the future taxes due. Accordingly, the immediate fall in value largely places the burden of the tax on current landowners. As a result, current landowners are inequitably made to bear an unjust proportion of the tax.

A reduction in value benefits the potential purchasers of land and more people will be able to afford acquisition of their own home. Speculative land purchases will also reduce due to lower land values. A land value tax will reduce the existing high incentives of land investment, one of the main contributors to recent price increases in urban New Zealand. Lack of land value tax results in low holding costs of land. If land value tax is imposed, some investors will be discouraged by the capital requirements necessary to pay a land value tax each year and optimal development,⁸⁴ thus cooling the market and contributing to the affordability of home ownership.

However, while there is a clear government policy to help New Zealanders own their own homes,⁸⁵ if land value tax is adopted, it will come at a high cost to existing landowners. Accordingly, serious policy considerations must be given to the equity

⁷⁷ J R. Hines Jr, 'Excess Burden of Taxation', (Working Paper Series WP 2007-1, Office of Tax Policy Research, Michigan Ross School of Business, 2007).

⁷⁸ R Arnott and R Petrova, *The Property Tax as a Tax on Value: Deadweight Loss* (National Bureau of Economic Research, 2002).

⁷⁹ J Barrett and J Veal, 'Land Taxation: A New Zealand Perspective' (2012) 10(3) *eJournal of Tax Research*, 573, 574.

⁸⁰ C R Alley and M Davies, 'A Land Transfer Levy with Equity as the Key: A Preliminary Examination into an Alternative Regime to Generate Broad-Based Tax Revenue' (2011) 17 *New Zealand Journal of Taxation Law and Policy*, 309, 338.

⁸¹ Coleman and Grimes, above n 4.

⁸² Inland Revenue Department Policy Division and New Zealand Treasury, 'Land Tax' (Background paper for Session 3 of the Victoria University of Wellington, Tax Working Group, September, 2009).

⁸³ Coleman and Grimes, above n 4.

⁸⁴ J Barrett, 'Equity in Local Government Rating' (2007) 13 *New Zealand Journal of Taxation Law and Policy* 4, 625–633.

⁸⁵ In New Zealand there are a number of schemes in place to support low to middle-income earners in buying their first home. Refer to KiwiSaver first home deposit and Welcome Home Loan in general.

concerning the balancing of a benefit in the reduction of land prices, versus the loss to current landowners' investment.

4.3 Single source of wealth

As discussed earlier, the implementation of a land value tax places a significant burden on a single source of wealth. This results in a violation of the horizontal equity principle, which promotes equal treatment of equals. Such discrimination might however be justified on policy grounds, and thus still satisfy vertical equity.⁸⁶

It appears there are compelling policy reasons to discriminate for a tax involving land investment in New Zealand.⁸⁷ The policy to tax land value may be justifiable through the intended distortion of investment behaviour⁸⁸, that is, away from property transactions to investments that better promote economic growth. Investment in property, which is considered tangible and has historically produced substantial capital gains which are exempt from tax, have always been preferred by New Zealanders.⁸⁹ However, the imposition of a land value tax results in substantial burdens on existing owners and decline in land values which will 'punish' investment in land. Such a tax, without exemptions, would be contrary to existing government policies⁹⁰ that promote home ownership and encourage agricultural activities.

4.4 Ease of implementation

To achieve a successful implementation of a tax system, certain infrastructural requirements must be met in advance. In the case of a land value tax, the survey of land parcels and the records of ownership must be accurate to enable determination of the amount of tax payable and the identification of who is responsible for its payment. As discussed earlier, the implementation of a land value tax in developed countries such as Australia has faced considerable challenges for this reason. In South Africa when land tax was implemented, it was found that there were many large parcels of land that had never been surveyed and it was sometimes difficult to identify the legal owner of the land.⁹¹ Similarly, many complexities arose where land was identified as tribal land. Tribal land is generally not owned by a single person or entity as is custom in most developed cultures, but instead held under a less formal, communal ownership regime.

⁸⁶ A Carter and S Matthews, 'How Tax Can Reduce Inequality' (2012) 290/91 (Q1-Q2) *OECD Observer* 53.

⁸⁷ C R Alley and M Davies, 'A Land Transfer Levy with Equity as the Key: A Preliminary Examination into an Alternative Regime to Generate Broad-Based Tax Revenue' (2011) 17 *New Zealand Journal of Taxation Law and Policy* 309, 324.

⁸⁸ Carter and Matthews, above n 86.

⁸⁹ New Zealand does not have a comprehensive capital gains tax. The *Estate Duty Abolition Act 1993* (NZ) s 3 abolished estate duty in respect of deaths occurring on or after 17 December 1992. The *Taxation (Tax Administration and Remedial Matters) Act 2011* (NZ) repealed gift duty effective from 1 October 2011. Also refer to C C Huang and C Elliffe, 'Is New Zealand Smarter than Other Countries or Simply Special?' (2010) 16(3) *New Zealand Journal of Taxation Law and Policy* 269–306.

⁹⁰ Refer to KiwiSaver first home deposit and Welcome Home Loan in general.

⁹¹ M E Bell, J H Bowman and L C Clark, 'Valuing Land for Tax Purposes in Traditional Tribal Areas of South Africa Where There Is No Land Market' (Lincoln Institute of Land Policy, Working Paper WP05MB1, Massachusetts, 2005).

New Zealand, however, has an existing land registry which records essential information in regards to all land in the country.⁹² In creating the registry, nearly all land was surveyed, resulting in the records of parcel boundaries being reasonably accurate. Electronic conveyancing improves the operational efficiency and integrity of New Zealand's land register. The pre-existence of such a registry would allow for the easy operation of a land tax in New Zealand. Both the size and owner of any piece of land is quickly and easily identifiable. Without these infrastructural details, however, the levy of a land value tax would be expensive to administer, reducing its efficiency, and may lack public acceptance due to uncertainties.

In addition, four of the main cities in New Zealand (Auckland, Wellington, Christchurch and Hamilton) all currently and periodically value land for rating purposes.⁹³ Local authorities may use land value (unimproved value), capital value (improved value) or annual value (imputed rental from improved land) for setting the rates.⁹⁴ The valuation provides a capital value and improvements value which makes an excellent framework to support the land valuations for tax purposes.⁹⁵ The TWG suggested that the existing rating system could also be utilised to reduce the cost of collection⁹⁶ and further enhance efficiencies.⁹⁷

Until 1985 land value was the preferred base on which to assess the property tax in New Zealand. However, by 2006 to 2007, capital value had become the tax base for the majority of local authorities.⁹⁸ At present in the four major cities of New Zealand (Auckland,⁹⁹ Wellington, Christchurch and Hamilton) rates are assessed on capital improved value (CIV),¹⁰⁰ while the majority of regional authorities in New Zealand still impose rates on land value.¹⁰¹ Rates are the dominant source of revenue for local government across New Zealand.¹⁰² Local authorities' rates are determined at each local authority level on the basis of local budgetary requirements and include general rates on all property owners or specific rates imposed for a special purpose, for example, infrastructure improvements. Ordinary rates cover council's basic costs; special rates are charged for services provided by council or for special purposes such

⁹² The registry is run by Land Information New Zealand (LINZ), previously known as Land Transfer Office, and records are available for a small fee from <<http://www.linz.govt.nz/survey-titles>>.

⁹³ W J McCluskey, A Grimes, A Aitkin, S Kerr and J Timmins, 'Rating Systems in New Zealand: An Empirical Investigation into Local Choice' (2006) 14(3) *Journal of Real Estate Literature* 381, 389. The *Local Government (Rating) Act 2002* (NZ) provides local authorities with powers to charge rates 'in order to promote the purposes of the [Local Government] Act'.

⁹⁴ *Local Government (Rating) Act 2002* (NZ), s°13. New Zealand government comprises 74 local authorities and 16 regions and there is no state uniform system of property taxation.

⁹⁵ The *Rating Valuations Act 1998* (NZ) provides for methods of land valuation.

⁹⁶ The rating system makes land tax convenient for government and taxpayers as well.

⁹⁷ Tax Working Group, above n 3.

⁹⁸ R C D Franzsen, 'International Experience with Land Value Taxation', in R F Dye and R W England (eds), *Land Value Taxation: Theory, Evidence, and Practice* (Lincoln Institute of Land Policy, Massachusetts, 2009) 27–50, 37.

⁹⁹ Auckland City Council uses single rates system.

¹⁰⁰ McCluskey et al, above n 93.

¹⁰¹ Local Government Rating Inquiry, 'Funding Local Government, Executive Summary' (2007) (Shand Report), Wellington New Zealand.

¹⁰² G Bush, 'Local Government' in R Miller (ed), *New Zealand Government and Politics* (Oxford University Press, 3rd ed, 2003) 161–170. At 164, Bush observes: 'In 2001 rates (excluding user charges) contributed an average of 57 per cent of local authority revenue'.

as water supply, sewerage and drainage. Ordinary rates can vary for different categories of land.¹⁰³

4.5 Māori land

The existence of Māori Authorities is another unique consideration for the implementation of a land tax in New Zealand. Māori Authorities, created in 1939, are trustees administering communally-owned Māori property—often in the form of land following *Treaty of Waitangi* settlements—on behalf of the individual owners.¹⁰⁴ The imposition of a land value tax would adversely affect the negotiated settlements. Māori Authorities would be subject to an inequitable and disproportionate share of the tax burden and the monetary value of their land would also fall. Māori freehold land is underdeveloped relative to general land, even after taking into account differences in land quality and location and could have important equity implications on a land value tax.¹⁰⁵

Māori land is culturally sensitive, possessing *Mana* (spiritual power) with some land being *Tapu* (sacred) and therefore while held by Māori Authorities will never be developed for commercial or residential purposes. This acknowledgement further contributes to an unfair burden of land tax on Māori Authorities. Given the above factors, it is likely the inclusion of land held by Māori Authorities within the taxable land definition will be strongly opposed. If land is valued on the basis of unimproved land value (highest and best use of the land), it will not reflect the fact that some land is culturally sensitive and therefore will not be used in an economic manner. Imposing a tax on an unrealistic value of land, given in settlement of past wrongs and in recognition of the cultural value of land, would be contrary to the underlying principles of the Treaty settlements and would result in an inequitable burden of tax on Māori Authorities. Therefore, it is suggested that an exemption (or other relief) must be used to avoid the inequities of this situation.

4.6 Land use considerations

The introduction of a land value tax has significant implications on the use of land. It is a tax on the unimproved value of the land which makes the tax seem cheaper if the land is put to its highest and best use. Assuming a broadly applicable land value tax covering all land in New Zealand is implemented (with the exception of parcels in government ownership), as discussed below, the effects will be different in urban cities to rural farmland.

A tax on land (including a split rate property tax) can be utilised as a policy tool to encourage denser developments in urban areas.¹⁰⁶ A land value tax removes the disincentive existing on the construction of buildings under a traditional property

¹⁰³ There are four categories of land viz residential, business, farmland and mining.

¹⁰⁴ Inland Revenue Department, 'Māori Authorities' (May 2011) IR 487.

¹⁰⁵ L Tímár, 'Rural Land Use and Land Tenure in New Zealand' (Working Paper 11–13, Motu Economic and Public Policy Research, 2011) 36–37.

¹⁰⁶ H S Banzhaf and N Lavery, 'Can the Land Tax Help Curb Sprawl? Evidence from Growth Patterns in Pennsylvania' (2010) 67 *Journal of Urban Economics* 169. Evidence from Pittsburgh shows this occurring.

tax.¹⁰⁷ A land value tax is said to be neutral with respect to land use which promotes the development of land to its highest and best use.¹⁰⁸ Oates and Schwab's Pittsburgh study suggests that some cities gain the beneficial effects of greater tax neutrality, and land-value taxation alone was not the direct stimulus to the regenerative land uses in Pittsburgh, although it did assist to a lesser degree.¹⁰⁹ Further, their study of effects of Pittsburgh's tax system on housing development suggests that to induce new construction the property owners who redeveloped or renovated buildings on their land were not taxed for the first three years for the additional value from reconstruction.¹¹⁰ The imposition of a land value tax will benefit rapidly expanding cities such as Auckland, where the local council has been investigating areas of sprawl to accommodate the growing number of residents.¹¹¹ Since more intensive use of land may lead to unduly dense development or the destruction of heritage buildings, as well as infrastructural and socio-economic problems, it is suggested that to be effective as an urban planning tool, a land value tax would need to be integrated with other planning mechanisms.¹¹²

However, the rural environment presents substantial hurdles to the implementation of a land value tax in New Zealand. In New Zealand, an estimated 55 per cent of all land is put to agricultural use and the impact of a land value tax will be felt severely by those who rely on the use of agricultural land.¹¹³ The farming and forestry industries in particular rely on substantial land holdings to conduct their business and a land value tax would adversely impact on the value of their land holdings and the cost of operating their business. Such land-intensive activities stand to face an inequitable share of the tax burden and, given the direction of existing policies, would likely result in mitigating measures being implemented.

While a land value tax is an *ad valorem* tax, meaning that the urban areas, on a per hectare rate, will face substantially larger taxes, the land intensive uses in rural areas will result in a higher tax burden on individuals and small companies.¹¹⁴ Considering that the average plot size in suburbia is around 700m², the incidence of tax per owner will be significantly less than farmers who own many hectares of land.¹¹⁵

¹⁰⁷ L C Walters, 'Land Value Capture in Policy and Practice' (2013) 10(2) *Journal of Property Tax Assessment & Administration* 5–22.

¹⁰⁸ W E Oates and R M Schwab, 'The Impact of Urban Land Taxation: The Pittsburgh Experience' (1997) 50(1) *National Tax Journal* 1, 17.

¹⁰⁹ Oates and Schwab, above n 108, 18.

¹¹⁰ W E Oates and R M Schwab, above n 108, 7. Also refer to M Weir and Peters E Lillian, 'Development, Equity and the Graded Tax in the City of Pittsburgh' (1986) 5(2) *Property Tax Journal* 71–84.

¹¹¹ See the Auckland Council Long Term Plan which highlights areas that the Council is investigating as potential sites of future Greenfield developments. The city's growth far outpaces the provision of infill housing through increased density.

¹¹² S C Bourassa, 'The Political Economy of Land Value Taxation', in R F Dye and R W England (eds), *Land Value Taxation: Theory, Evidence, and Practice* (Lincoln Institute of Land Policy, Massachusetts, 2009) 195–210, 196. Denser urban development may have general environmental benefits but it is uncontroversial that heritage buildings should be preserved.

¹¹³ R C D Franzsen, above n 98, 38.

¹¹⁴ V Mangioni, 'Transparency in the Valuation of Land for Land Tax Purposes in New South Wales' (2011) 9(3) *eJournal of Tax Research*

¹¹⁵ Ross Report, above n 62, 291.

Thus the effect of a land value tax is inconsistent with current policy measures that protect farming in recognition of its importance to the New Zealand economy. The farming industry accounts for around 5 per cent of New Zealand's annual GDP. Existing policy measures tend to stipulate special provisions applicable to farming and forestry which in general tends to be more favourable than the standard rules.

The study of unique considerations of a land value tax implementation in New Zealand context shows that there is a clear need for exemption provisions to ensure that the tax system is suitable. The paper will now consider the provision of relevant exemptions.

5. EXEMPTIONS

Special interest groups such as farmers and Māori Authorities are likely to be amongst those that are given relief from the land tax.¹¹⁶ The TWG report noted that land tax imposition could particularly affect certain people, such as farmers, retirees and Māori Authorities.¹¹⁷ Land tax, a tax on unearned increment, would possibly result in negative equity for highly geared properties. While their differentiation may be justifiable on the grounds of vertical equity, it renders the proposed land tax inefficient in its ability to raise large amounts of revenue at a low cost. The TWG's land value tax proposal was a broad-base low-rate tax. The Ross Committee observed the effects on farmers' income of flooding or movements in international commodity prices and their ability to pay land tax.¹¹⁸ These findings are relevant for policy-makers because the impact of the tax could drive some farmers off their land.¹¹⁹ However, if agricultural, Māori Authority and the Department of Conservation land was excluded, considering the remaining land tax base, the tax will be unable to raise the proposed revenue without a substantially higher land value tax being imposed.

For charities,¹²⁰ the special consideration may also be desirable from an equity point of view. Given that charitable organisations and churches are non-profit organisations, through land tax exemption it is important for the government to recognise and take responsibility for the much-needed community and charitable services provided by them.¹²¹ Land does not necessarily generate cash and land tax may create cash flow issues for charities. Socially, there is a need for relief from the payment of land value tax by pensioners and elderly property owners who may experience financial hardship due to the annual tax payments; or tax payments could be deferred and rolled up until they sell or bequeath their property.¹²² The higher rate of a land tax is also unviable

¹¹⁶ Tax Working Group, above n 3, 51. Under ssCB 12 and CB 13 farm land is exempt from income tax in New Zealand.

¹¹⁷ Tax Working Group, above n 3, 51.

¹¹⁸ Ross Report, above n 62, 291.

¹¹⁹ Ibid.

¹²⁰ Land tax pre-1992 exemptions included farming land, sports clubs, local authorities, charities, customary Māori land, hotels, aged peoples' homes and hospitals, historic places. Land used for religious worship, religious education or for charitable purposes are all classed as non-rate able under existing legislation by Local Government New Zealand (LGNZ)

¹²¹ Charities are also exempt from income tax. Refer to *Income Tax Act 2007*, subpart CW.

¹²² Richard W Lindholm, 'Twenty-One Land Value Taxation Questions and Answers' (1972) 31(2) *American Journal of Economics and Sociology* 153. See the different phasing-in options (at 154–155).

as it will increase the fall in land value and will result in further complications by straining the lending market and creating the risk of land abandonment.

It appears that the required exemptions to make land tax suitable for the New Zealand environment restrict the tax base too severely and it is unable to raise the forecast revenues.¹²³ In an attempt to achieve vertical equity, the principle of economic efficiency is sacrificed.¹²⁴ The resulting tax is reminiscent of the land value tax that was abolished in 1992.

6. CONCLUSION

This paper has reviewed the various bases of value on which the property tax is assessed and has carried out a critical analysis of the possible implementation of a land value tax in New Zealand. Property tax is the best way to align the benefits received to the taxes paid, which according to Henry George's concept is captured in the value of the property.¹²⁵ Every property taxation method has a compliance cost and works well in different environments in different jurisdictions. Annual value taxation works well in an environment where renting is predominant because of the subjectivity of rental estimates. Rental values can be artificially manipulated or limited through legislation. Capital value relies solely on sales data but improvements are ongoing with behavioural implications and therefore less efficient. The full burden of the land value tax falls on the landowner at the time the tax is levied because of the inelastic supply of land. The paper demonstrates that none of the property taxation methods simultaneously meets horizontal and vertical equity objectives.

Given the theoretical merits of a land value tax system, it is evident that the unique features of land¹²⁶ amounts to land value taxation as economically the most efficient form of tax. At present rates are the dominant source of revenue for local government across New Zealand. However, the relatively low taxation of properties in New Zealand compared to OECD countries indicates that further revenue collections by national government from properties are beneficial, assuming that the nominal rate of a national land value tax is not the critical concern for taxpayers, who 'may be prepared to endure high nominal rates if they are satisfied with effective tax rates and if they receive acceptable levels of government services in return'.¹²⁷

Beneficially, New Zealand does have the required infrastructural prerequisites needed for the smooth implementation of a land value tax by a national government. Overseas jurisdictions have experienced barriers to implementation where the survey of land and ownership status is unclear. This study shows that in New Zealand, utilisation of the local authorities' existing rates valuation and collection systems would enhance the efficiency of a national land value tax system. The imposition of

Older people or superannuitants tend to own disproportionately expensive properties relative to their incomes.

¹²³ 'Historically, New Zealand has had a land tax but it had been weakened with exemptions and ultimately repealed, so its sustainability may be questionable'. New Zealand Treasury, 'The Role of Tax in Maintaining a Sustainable Fiscal Position New Zealand Treasury' (2013) 4.

¹²⁴ Arnott and Petrova, above n 78.

¹²⁵ H George, above n 17.

¹²⁶ The supply of land is inelastic and finite. Land does not disappear when it is taxed.

¹²⁷ Barrett and Veal, above n 79, 586.

land tax by the national government and collection by the local government will encourage more intensive land use and will result in a higher level of improvements to the land.¹²⁸ However, this study shows that at present in the four major cities of New Zealand capital improved value had become the tax base for local authorities¹²⁹. To impose a national land tax land values need to be determined.

Overall, the New Zealand economic landscape requires unique consideration in the implementation of a land value tax and the use of exemptions to relieve the burden on disadvantaged groups is highly likely. The extent of the required exemptions will severely narrow the tax base resulting in loss of efficiency and may not depress land speculation. The desire to implement an equitable tax would lead to its demise through the reliance on exemptions to increase vertical equity. A land value tax is based on a single source of wealth and violates the principles of horizontal equity as the same level of investments are not treated similarly. Singling out real property owners, particularly farmers,¹³⁰ for special tax treatment would, indeed, appear to constitute a brave political move.¹³¹

The precise form of a land tax and its design, for example, any exemptions, would determine whether the principles of a 'good' tax were met, including its acceptance by most New Zealanders. The valuation process by the government must be both consistently determined and communicable to the taxpayer.¹³² Although the resulting decreases in land values due to a land value tax may increase affordability of home ownership, it should not be achieved at the expense of existing landowners. As the New Zealand Productivity Commission noted, a land tax could have unintended effects on housing markets and housing affordability.¹³³

As this paper has argued, while policy grounds exist for shifting investment behaviour from properties to investment vehicles that promote foundations of economic growth, the unique New Zealand environment is unsuitable for efficient and equitable implementation of land tax. Therefore, while some form of a tax on land investments might be suitable to help achieve greater sustainability for the New Zealand environment, a land value tax may not be the solution.¹³⁴ In addition, a land value tax,

¹²⁸ J K Brueckner, 'A Modern Analysis of the Effects of Site Value Taxation' (1986) 39(1) *National Tax Journal* 49–58.

¹²⁹ McCluskey et al, above n 93.

¹³⁰ The Henry Report noted that most land in lower-value use (including most agricultural land) would not face a land tax liability. Henry K, Harmer J, Piggott J, Ridout H, Smith G, 'Australia's Future Tax System: Report to the Treasurer' (Canberra, Commonwealth of Australia, 2009). Also refer to Tax Working Group, above n 3. The Tax Working Group contemplated farms and forestry land being exempt from a land value tax.

¹³¹ 'Hawaii was able to introduce an LVT because, despite the traditional political power of landowners, they were small in number, whereas 'there were many more people who would gain'. Kwak and Mak, above n 5, 10.

¹³² V Mangioni, 'A Review of the Practices of Valuers in the Assessment of Land Value for Taxation in Australia' (2015) 12(2) *Journal of Property Tax Assessment & Administration* 5, 15.

¹³³ New Zealand Productivity Commission, *Housing Affordability Inquiry* (2012) 101.

¹³⁴ McCluskey and Franzsen, above n 10, 15:

Despite the apparent merits and demerits of a land value tax from a theoretical point of view, the choice of the tax base is more often based on the very specific circumstances faced by the relevant taxing authority. Socio-political views, historic factors, as well as practical realities seem to be the deciding factors.

should it be adopted, will need to apply to all investment housing, not just foreign-owned property.¹³⁵ In the author's opinion, implementation of a land value tax is an impulsive reaction to the Auckland real estate bubble and could lead to an increased risk of significant political influences that would translate to exemptions as previously shown by the abolished land value tax in 1992.

Consequently, this study contributes to a call for further investigation into whether taxing all effective income from capital (real estate market) and stamp duty or transfer tax¹³⁶ payable by the transferee or purchaser at the time of conveyancing¹³⁷ will broaden the New Zealand tax base and therefore overcome the problem of equity and efficiency in the tax system. This points to a promising direction for future research.

¹³⁵ Foreign investors are merely one of the many symptoms of a broader problem of the fiscal privileges enjoyed by landowners.

¹³⁶ The most recent example is Vancouver, British Columbia which just imposed a 15 per cent transfer tax on purchases of real property by foreigners.

¹³⁷ Land Information New Zealand could act as the agent for collecting the transfer tax or stamp duty.

Delineating the fiscal borders of Australia's non-profit tax concessions

Natalie Silver¹, Myles McGregor-Lowndes² and Julie-Anne Tarr³

Abstract

Since the inception of tax exemption and tax deductibility for non-profit entities, Australian governments have made policy choices about where to draw the fiscal border for such concessions. The legislation states that entities entitled to these tax concessions must be 'in Australia', however the meaning of 'in Australia' has been subject to different interpretations over time. Judicial decisions have disrupted the Australian Tax Office's (ATO) longstanding interpretation, resulting in measures to realign these decisions with government policy. Following a lapsed 'in Australia' Bill under one government and a languishing exposure draft by another, the ATO recently announced it would issue a public ruling. We examine the various interpretations of 'in Australia' to understand how the current misalignment between tax law and government policy came to be. Our findings uncover the precarious legal foundations underlying reform.

Keywords: Cross-border charity, deductible gift recipient, income tax exemption, non-profit tax concession, public benefit, public benevolent institution, tax deductibility

¹ Research Fellow, Australian Centre for Philanthropy and Nonprofit Studies, Queensland University of Technology.

² Professor, Australian Centre for Philanthropy and Nonprofit Studies, Queensland University of Technology.

³ Professor, School of Accountancy, Queensland University of Technology.

1. INTRODUCTION

Australia has tightly drawn fiscal boundaries around the non-profit tax concessions of income tax exemption and gift deductibility. This is the result of government policy over the past 50 years, administered by the Australian Tax Office (ATO), concerning the 'in Australia' provisions in the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997).⁴ Under the ITAA 1997, an income tax exempt entity must have 'a physical presence in Australia and, to that extent, incurs its expenditure and pursues its objectives principally in Australia'.⁵ Deductible Gift Recipients (DGRs) have traditionally been subject to a stricter 'in Australia' test. The ITAA 1997 states that DGRs must be 'in Australia',⁶ which has been interpreted by the ATO as requiring that a DGR 'be established, controlled, maintained and operated in Australia' and have 'its benevolent purposes' in Australia.⁷ Two important judicial decisions have disrupted the traditional interpretation of the fiscal border for these charitable tax concessions, resulting in significant policy responses from both the Australian Government and the ATO.

In *Commissioner of Taxation v Word Investments Ltd*⁸ (*Word Investments*) the High Court dismissed the Commissioner's interpretation of an anti-avoidance provision in the ITAA 1997. The provision was motivated by the Government's concern about tax abusive behaviour conducted outside Australia involving untaxed revenue of charitable institutions.⁹ The ATO's submission to the Court that this provision should be interpreted broadly to restrict non-profit entities from transferring funds outside Australia, in accordance with intended policy, was rejected. The majority judgment baldly concluded that:

The Commissioner's contention that the revenue authorities would have great difficulty in monitoring the use of funds generated by a body in Australia and given to another body active overseas is exaggerated.¹⁰

The Court referred the ATO to its ample powers elsewhere to achieve these policy purposes through monitoring and scrutiny, even if it involved greater administrative cost.¹¹

The territorial boundaries of these non-profit tax concessions crumbled further with the decision of a Full Federal Court in *Federal Commissioner of Taxation v The Hunger Project Australia (Hunger Project)*¹². This case involved a business model similar to the one in *Word Investments*, in which tax deductible fundraising revenue was transferred offshore from a Public Benevolent Institution (PBI) to another entity. The Court's blunt but unanimous assessment was that '[t]he Commissioner's

⁴ See ITAA 1997 s 30–15 (gift deductibility), s 50–50 (income tax exemption).

⁵ ITAA 1997 s 50–50(1)(a) (registered charities). See also s 50–55(a) (scientific and educational institutions, hospitals), s 50–70(a) (societies, associations or clubs).

⁶ The 'in Australia' requirements for DGR endorsement are set out in ITAA 1997 s 30–15 under 'Special conditions', which include that 'the fund, authority or institution must be in Australia'.

⁷ ATO, *Income Tax and Fringe Benefits Tax: Public Benevolent Institutions*, TR 2003/5, 4 June 2003 (TR 2003/5), [129].

⁸ (2008) 236 CLR 204.

⁹ Explanatory Memorandum, Taxation Laws Amendment Bill (No 4) 1997 (Cth) [5.24]–[5.25].

¹⁰ *Word Investments* (2008) 236 CLR 204 [72].

¹¹ *Ibid.*

¹² (2014) 221 FCR 302.

submissions based on statutory context are in our opinion at best unpersuasive and at worst misconceived'.¹³

Successive recent governments have consulted widely on amendments designed to address these judicial interpretations of the 'in Australia' provisions for income tax exemption and gift deductibility in the ITAA 1997.¹⁴ The Government's contention has been that the Court's interpretation in *Word Investments* 'was inconsistent with the Commissioner of Taxation's interpretation and with the policy intent underlying the ['in Australia'] special conditions'.¹⁵ While the current government has indicated its intention to deal with the 'in Australia' issue, progress towards legislative amendment has stalled. Meanwhile, the ATO appears to have shifted from its traditional position, effectively reversing its former policy of a more stringent 'in Australia' requirement for DGRs as compared to income tax exempt entities. In doing so, the ATO consulted its Not-for-Profit Advisory Group and, following this consultation, announced that it is drafting a new 'in Australia' public ruling.¹⁶

As a result of these important recent developments, it is timely to review the history and development of the territorial boundaries of the non-profit tax concessions in Australia in terms of policy, law and administration. To provide context, we begin with a description of the geographic boundaries of public benefit in the common law. We then examine the 'in Australia' provisions for income tax exemption and gift deductibility in the early state and federal legislation. This review reveals the changes to the ATO's interpretation of 'in Australia' since the 1960s, culminating in the proposed public ruling on this issue. It also uncovers the shaky legal foundations underlying the Government's proposed legislative reforms. More practically, it highlights the implications different interpretations of the 'in Australia' provisions have had and continue to have on the ability of Australian non-profit organisations operating overseas to obtain tax exempt and DGR status.

¹³ (2014) 221 FCR 302 [40].

¹⁴ Exposure Draft, Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No 1) 2011 (Cth): Tax Exempt Body 'in Australia' Requirements. See also: Treasury (Cth), *'In Australia' Special Conditions for Tax Concession Entities* (4 July 2011) <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2011/In-Australia-Special-Conditions-for-Tax-Concession-Entities>>; Exposure Draft, Tax Laws Amendment (2012 Measures No 4) Bill 2012 (Cth): Tax Exempt Body 'in Australia' Requirements; Treasury (Cth), *Restating and Standardising the Special Conditions for Tax Concession Entities (Including the 'in Australia' Conditions)* (17 April 2012) <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/In-Australia-Special-Conditions-for-Tax-Concession-Entities-Revised>>; Tax Laws Amendment (Special Conditions for Not-for-profit Concessions) Bill 2012 (Cth); Treasury (Cth), *Restating and Centralising the Special Conditions for Tax Concession Entities* (12 March 2014) <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2014/Conditions-for-tax-concession-entities>>.

¹⁵ Commonwealth, *Parliamentary Debates*, House of Representatives, 23 August 2012, 9727–8 (David Bradbury).

¹⁶ ATO, *Completed Matters 2015–16*, Guidance Update—Interpretation of 'in Australia' (14 January 2016) <<https://www.ato.gov.au/General/Consultation/What-we-are-consulting-about/2015-Completed-matters/#G201534>>.

2. GEOGRAPHIC BOUNDARIES OF PUBLIC BENEFIT IN THE COMMON LAW

From the earliest charity cases, common law judges have upheld trusts covering a range of charitable activities and purposes carried out overseas.¹⁷ *Commissioners for Special Purposes of Income Tax v Pemsel (Pemsel)*,¹⁸ the most iconic charity law case, involved a charitable trust established in the United Kingdom to support and advance 'missionary activities among heathen nations'.¹⁹ The English common law of charity has had relatively little difficulty in finding public benefit in charitable objects performed outside the supervising jurisdiction. Issues such as lack of direct or indirect public benefit to the local jurisdiction,²⁰ or the inability of the Attorney-General to supervise such charities in a foreign jurisdiction²¹ have been dismissed. British charity law scholar, Jonathan Garton, notes that Australian judicial authority seems to have gone further than that in England, not requiring any connection with home jurisdiction benefits.²² For example, finding public benefit in the relief of distress in Europe,²³ advancement of education in Germany,²⁴ healthcare in Greece,²⁵ settlement of Jews in Israel,²⁶ and a musical competition in Austria.²⁷ Common law judges have drawn the line, not surprisingly, at purposes 'inimical to the interests of the local community or contrary to local public policy'.²⁸ This broad concept of public benefit developed through the common law of charity has been reflected in Australian charity legislation. The *Charities Act 2013* (Cth) now provides that 'it does not matter whether a [charitable] purpose is directed to something in Australia or overseas'.²⁹ This permissive stance on cross-border activities under Australian charity law has not been similarly adopted in the Australian tax laws applying to the charitable tax concessions of income tax exemption and gift deductibility, to which we now turn.

3. GEOGRAPHIC BOUNDARIES OF THE INCOME TAX EXEMPTION

3.1 Legislative development

The establishment of an income tax regime in Australia reflected the permissive common law approach to charities operating overseas, although over time the income tax laws have become increasingly restrictive. The first comprehensive state income

¹⁷ *Armenian Patriarch of Jerusalem v Sonsino* [2002] EWHC 1304 (Ch). See also G E Dal Pont, *Law of Charity* (LexisNexis Butterworths, 2010) 75–78; Jonathan Garton, *Public Benefit in Charity Law* (Oxford University Press, 2013) 60–73; Miranda Stewart, 'The Boundaries of Charities and Tax' in Matthew Harding, Ann O'Connell and Miranda Stewart (eds), *Not-for-Profit Law: Theoretical and Comparative Perspectives* (Cambridge University Press, 2014) 232, 245.

¹⁸ [1891] AC 531.

¹⁹ *Ibid* 532.

²⁰ *Camille and Henry Dreyfus Foundation Inc v Inland Revenue Commissioners* [1954] Ch 672, 684; *Re Lowin (deceased)* [1967] 2 NSWLR 140.

²¹ *Re Stone (deceased)* (1970) 91 WN (NSW) 704.

²² Garton, above n 17, 71.

²³ *Re Piper (deceased)* [1951] VLR 42.

²⁴ *Estate of Schultz* [1961] SASR 377.

²⁵ *Kytherian Association of Queensland v Sklavos* (1958) 101 CLR 56.

²⁶ *Re Stone (deceased)* (1970) 91 WN (NSW) 704.

²⁷ *Re Lowin (deceased)* [1976] 2 NSWLR 140.

²⁸ *Re Stone (deceased)* (1970) 91 WN (NSW) 704; *Habershon v Vardon* (1851) 64 ER 916.

²⁹ *Charities Act 2013* (Cth) s 12(3).

tax legislation, introduced in South Australia in 1884,³⁰ exempted charitable organisations from income tax. The financial requirements of Australia's participation in World War I necessitated the enactment of the first Commonwealth legislation introducing personal income tax,³¹ the *Income Tax Assessment Act 1915* (ITAA 1915).³² When the Commonwealth levied income tax, the exemptions were largely preserved. The ITAA 1915 provided a tax exemption for 'the income of a religious, scientific, charitable, or public educational institution'.³³ However, the legislation made no specific mention of whether these entities had to be located in Australia or whether their activities or beneficiaries were to be in Australia. This language on tax exemption was replicated in the *Income Tax Assessment Act 1922* (Cth) (ITAA 1922)³⁴ and the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936).³⁵

In 1938, the High Court case of *The University of Birmingham and Epsom College v Federal Commissioner of Taxation*³⁶ established that the income tax exemption provisions in the ITAA 1936 were not limited to Australian organisations carrying on operations in Australia, but extended to organisations operating outside Australia. In that case, the two taxpayers were corporate bodies established in Great Britain for charitable purposes. They carried on no activities in Australia, but derived income from Australia through distributions from a testamentary trust fund. The Commissioner argued that the benefit of the exemption was limited by the ITAA 1936 to such institutions which are 'in Australia', or at least to such institutions which carry on some form of activity or operate in some way in Australia. The Court found that the income tax exemption provisions 'are general and do not in themselves contain any local limitation',³⁷ and that 'the natural reading of the provision is that it extends to all taxpayers, independently of their place of residence or activity, who fall under the description it contains'.³⁸ Apart from this case, the law in relation to income tax exemption for cross-border charitable activities remained undisturbed until the late 1990s when legislative amendments were enacted.

The genesis of the legislative amendments in the late 1990s was a 1987 House of Representatives Standing Committee on Finance and Public Administration (the Committee) investigating tax avoidance through international profit shifting and abuse of the withholding tax provisions. The Committee published three reports from its deliberations, releasing the final report, *Follow the Yellow Brick Road*, in 1991.³⁹ The Committee received evidence from a member of the public that tax exempt charities were making distributions to overseas charitable trusts, which found their way back to the donor through a deposit to the donor's international bank account or international

³⁰ *Taxation Act 1884* (SA); the Commonwealth's income tax provisions in s 23 of the *Income Tax Assessment Act 1936* (Cth) closely followed the State's exemption provision.

³¹ The power to levy taxes is a power concurrent with the States, pursuant to *Australian Constitution* s 51(ii).

³² See Robin Woellner, *Australian Taxation Law* (CCH, 22nd edition, 2012) 8 [1-060].

³³ ITAA 1915 s 11(d).

³⁴ ITAA 1922 s 14(1)(d).

³⁵ ITAA 1936 s 23(e).

³⁶ (1938) 60 CLR 572.

³⁷ Ibid 575 (Latham CJ).

³⁸ Ibid 578–9 (Rich J).

³⁹ See House of Representatives Standing Committee on Finance and Public Administration, Parliament of Australia, *Follow the Yellow Brick Road – The Final Report on an Efficiency Audit of the Australian Taxation Office: International Profit Shifting* (1991).

credit card.⁴⁰ The ATO told the Committee that it had no evidence of significant abuse involving charities, citing extensive inquiries into two overseas charitable bodies that had received significant income from Australian trusts, where no evidence was found that these were anything but genuine gifts.⁴¹ The Taxation Institute of Australia also appeared before the Committee and confirmed that it was not aware of such schemes.⁴² Despite this evidence, in its final report the Committee recommended legislative controls:

The introduction of this measure would signal to those who consider that such tax avoidance arrangements are still effective the clear intention of the Parliament to eradicate the potential for tax avoidance hidden within the guise of donations to overseas charities.⁴³

Following this inquiry and immediately prior to the federal election in November 1995, the ATO drew to the Government's attention certain tax avoidance strategies which enabled wealthy individuals to enjoy lavish lifestyles, while paying little or no tax.⁴⁴ In February 1996, the Treasurer forecast changes to the taxation regime to prevent the abuse of Australian charitable trusts and overseas organisations to disguise benefits provided by family trusts to family members. However, the Government stated:

[T]hese are not techniques which are practised by the overwhelming majority of trusts operated by and for Australians. Trusts provide an appropriate structure to meet a range of legitimate needs as for charities, educational and non-profit organisations, deceased estates, a variety of family purposes, and for solicitors and other professionals. The Government will not interfere with these arrangements. The Government undertakes that the measures it will adopt will ensure that activities not involving tax avoidance are not adversely affected.⁴⁵

On Budget night in 1996, the newly-elected Treasurer announced not only the taxation reform of trusts, but the removal of 'the tax exempt status for certain organisations located overseas, irrespective of whether they are subject to tax in their home country'.⁴⁶ The Treasurer further stated that '[t]he measure will not impact on any entity which is a resident for Australian tax purposes' and the Government would consult widely to 'ensure that *bona fide* charitable organisations are not detrimentally affected'.⁴⁷ This culminated in a 1997 Bill introducing amendments to provisions in the ITAA 1936 concerning the geographic boundaries of income tax exemption for charitable organisations.⁴⁸

⁴⁰ Ibid 51 [4.3].

⁴¹ Ibid 53 [4.9].

⁴² Ibid 53 [4.10].

⁴³ Ibid 54–55 [4.16]–[4.17], Recommendation 15.

⁴⁴ Myles McGregor-Lowndes, 'Does Charity Begin and End at Home for Tax Exemptions?' (1998) 5 *Canberra Law Review* 221, 224.

⁴⁵ Ralph Willis, 'High Wealth Individuals—Taxation of Trusts' (Press Release, No 1, 11 February 1996).

⁴⁶ Peter Costello, 'Election Commitment: Measures to Address Tax Avoidance Through Tax Exempt Entities Distributing Funds Offshore' (Press Release, No 74, 20 August 1996) <<http://www.budget.gov.au/1996-97/pressreleases/budgetp2.pdf>>.

⁴⁷ Ibid.

⁴⁸ Taxation Laws Amendment Bill (No 4) 1997 (Cth).

The *Taxation Laws Amendment Act (No 4) 1997* (Cth) amended s°23(e) of the ITAA 1936 (religious, scientific, charitable and public educational institutions), s°23(ea) (hospitals)⁴⁹, s°23(g) (certain clubs and community organisations), and s°23(j)(ii) (a fund established by will or instrument of trust for public charitable purposes).⁵⁰ These amendments provided that in order to be exempt from income tax, the relevant entity (in the case of charitable institutions and organisations) must have ‘a physical presence in Australia and, to that extent, incurs its expenditure and pursues its objectives principally in Australia’.⁵¹ The entity also had to be ‘an institution to which a gift by a taxpayer is an allowable deduction’, linking income tax exemption to the gift deductibility provisions.⁵² For charitable trusts, the amendments provided that to be income tax exempt the trust ‘incurs ... its expenditure principally in Australia and pursues ... its charitable purpose solely in Australia’. These trusts must also ‘[distribute] solely ... to a charitable fund, foundation or institution which, to the best of the trustee’s knowledge, is located in Australia and [incur] its expenditure principally in Australia and [pursue] its objects solely in Australia’.⁵³ The Explanatory Memorandum gave no reason for the new geographic restrictions on tax exemption, other than potential tax avoidance by charitable trusts.⁵⁴ However, these restrictions were not just confined to charitable trusts—they applied to all charities.⁵⁵

The result of these amendments was to remove income tax exemption for certain organisations located offshore and for those organisations not incurring their expenditure and pursuing their objectives principally in Australia. Until this time there had been no geographic restrictions on the activities of income tax exempt entities. There were limited exceptions to this new ‘in Australia’ provision. These were for institutions specifically prescribed by the income tax assessment regulations to be tax-exempt, which were located outside Australia and exempt from income tax in their resident country, or which had a physical presence in Australia but incurred their expenditure and pursued their objects principally outside Australia.⁵⁶ The Explanatory Memorandum stated that these exceptions were permitted because the process of being prescribed in the tax regulations ‘allow[s] Parliament the opportunity to fully scrutinise the [non-resident] organisation to determine whether it should

⁴⁹ Specifically, the income of a public hospital, or of a hospital which is carried on by a society or association otherwise than for the purposes of profit or gain to the individual members of that society or association.

⁵⁰ Specifically, the income of a society, association or club which is not carried on for the purposes of profit or gain to its individual members and is:

- (i) a friendly society, not being a friendly society dispensary;
- (ii) a society, association or club established for musical purposes, or for the encouragement of music, art, science or literature;
- (iii) a society, association or club established for the encouragement or promotion of a game or sport;
- (iv) a society, association or club established for the encouragement or promotion of animal races; or
- (v) a society, association or club established for community service purposes (not being political purposes or lobbying purposes); ...

⁵¹ *Taxation Laws Amendment Act (No 4) 1997* (Cth) Schedule 5. See ITAA 1936 s 23(e)(i).

⁵² ITAA 1936 s 23(e)(ii). This meant that the institution was listed in the table in ITAA 1936 s 78(4).

⁵³ *Taxation Laws Amendment Act (No 4) 1997* (Cth) Schedule 5.

⁵⁴ Explanatory Memorandum, *Taxation Laws Amendment Bill (No 4) 1997* (Cth) [5.2].

⁵⁵ Parliamentary Library (Cth) *Bills Digest*, No 54 of 1997–98, 3 October 1997
 <http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/bd/BD9798/98bd054>.

⁵⁶ ITAA 1936 s 23(e)(iii), (iv).

receive the benefit of the exemption⁵⁷ and thereby satisfy itself that the institution was not likely to engage in tax avoidance. The Explanatory Memorandum also clarified that distributions received by an institution as a gift or government grant are to be 'disregarded when determining whether an organisation incurs its expenditure and pursues its objectives principally in Australia and, therefore, can be applied overseas without affecting an organisation's income tax exempt status.'⁵⁸

The Explanatory Memorandum briefly addressed the meaning of the phrase 'in Australia',⁵⁹ focusing on the definition of the terms 'physical presence' and 'located', rather than the extent to which expenditure must be incurred and objectives pursued principally in Australia. The Explanatory Memorandum stated that because these terms were not defined in the legislation, their ordinary or everyday meaning should be used.⁶⁰ It also provided a detailed description for each:

In the case of "physical presence" a broad interpretation is to be adopted—all that is required is for an organisation to operate through a division, subdivision or the like in Australia. The structure of the organisation is immaterial as is whether it has its central management and control or principal place of residence in Australia. On the other hand, the term would not apply where an organisation merely operates through an agent based in Australia. A much narrower meaning is intended in relation to the term "located". A mere physical presence will not be sufficient to satisfy this requirement although it will not be necessary for an organisation to be a resident for income tax purposes. A separate centre of operations such as a branch would fall within the meaning of this term.⁶¹

The broad definition of 'physical presence' requires minimal Australian operations, in accordance with its ordinary meaning. The narrower definition of 'located' still does not require that the central operations or control of the entity be in Australia, so long as the entity sets up a branch in Australia, again, in keeping with the everyday meaning of the term. These definitions clearly do not place any limitations on the geographical scope of the Australian entity's operations, activities or beneficiaries and thereby confirm that the meaning of 'in Australia' is to be taken from its ordinary meaning—being physically located in Australia, nothing more. A subsequent Explanatory Memorandum explained the meaning of the term 'principally' in Australia: 'The dictionary meaning of the word "principally" is mainly or chiefly. Accordingly, it is not possible to specify a particular percentage but less than 50 per cent would not be considered to meet the "principally" requirement.'⁶² The ATO later issued a public ruling, which clarified the 'in Australia' requirement in s 50-50(a), consistent with these definitions.⁶³

In 1993, the Joint Committee of Public Accounts recommended that Australia's income tax law be rewritten. This led to the Tax Law Improvement Project, resulting

⁵⁷ Explanatory Memorandum, Taxation Laws Amendment Bill (No 4) 1997 (Cth) [5.40].

⁵⁸ Explanatory Memorandum, Taxation Laws Amendment Bill (No 4) 1997 (Cth) [5.44].

⁵⁹ Explanatory Memorandum, Taxation Laws Amendment Bill (No 4) 1997 (Cth) [5.28]–[5.30].

⁶⁰ Explanatory Memorandum, Taxation Laws Amendment Bill (No 4) 1997 (Cth) [5.28].

⁶¹ Explanatory Memorandum, Taxation Laws Amendment Bill (No 4) 1997 (Cth) [5.29]–[5.30].

⁶² See Explanatory Memorandum, Taxation Laws Amendment Bill (No 3) 1998 (Cth) [3.14].

⁶³ ATO, *Income Tax: Endorsement of Income Tax Exempt Charities*, TR 2000/11, 28 June 2000.

in the ITAA 1997.⁶⁴ The 'in Australia' provisions for income tax exemption were migrated to s 50–50 of the ITAA 1997, with no effective amendments.

3.2 Judicial decisions

The Australian courts dealt with this legislation some time later, with the landmark High Court case, *Word Investments*,⁶⁵ which enshrined the destination of profits test for income tax exemption. The applicant (Word), which operated a series of businesses as a fundraising arm, distributed funds to an Australian charity (Wycliffe) conducting missionary work overseas. Word applied for income tax exemption under the ITAA 1997. This was refused. The Commissioner argued that there were four issues precluding Word from receiving tax exempt status, one of which was that it did not meet the 'in Australia' requirement of s 50–50(a) ITAA 1997 that an entity have a physical presence in Australia and, to that extent, incur its expenditure and pursue its objectives principally in Australia.⁶⁶ While the initial tribunal decision did not consider the 'in Australia' issue,⁶⁷ on appeal the Federal Court addressed this issue and found that Word satisfied the requirements of s 50–50(a). It was conceptualised as being a 'nexus' question. Word passed money to another organisation to achieve its purposes in Australia.⁶⁸ Word had a physical presence in Australia, and the fact that it knew that this other organisation operated outside Australia was not fatal, as s 50–50(a) was not a provision involving an assessment of motive such as that involved in a finding of a charitable nature. On appeal, the Full Court of the Federal Court upheld this narrow view noting that: '[I]f the Parliament desires the place of expenditure of funds by the donee to be analysed before the donor can fall within the section, it can say so'.⁶⁹

The majority of the High Court⁷⁰ confirmed the Full Court decision that Word met the 'in Australia' requirement of ITAA 1997 s 50–50(a) for income tax exemption: it had a physical presence in Australia, incurred its expenditure and pursued its objectives principally in Australia, the decisions to pay were made in Australia, and the payments were made in Australia to Australian organisations.⁷¹ In reaching this conclusion the majority examined Word's role as a giving intermediary, finding:

⁶⁴ See Explanatory Material, Tax Laws Amendment (Transfer of Provisions) Bill 2009 (Cth) [1.2]. The ITAA 1997 will be progressively amended and added to, as instalments of the rewrite are enacted. The parts of the ITAA 1936 which have not been rewritten are adopted directly into the ITAA 1997 by Schedule 1, 52 of the *Income Tax (Consequential Amendments) Act 1997* (Cth).

⁶⁵ (2008) 236 CLR 204.

⁶⁶ The other three issues were: (1) Word's objects were not confined to charitable purposes; (2) Word was an entity which did not engage in any significant charitable activities but rather was established to engage in commercial activities for profit and therefore could not be a charitable institution; and (3) the recipients of Word's profits were not confined, as to the use to which the funds distributed to them could be put.

⁶⁷ *Re Applicant and Federal Commissioner of Taxation; subnom Case 11/2005* [2005] AATA 941 (Administrative Appeals Tribunal, 27 September 2005). Subsequent litigation history: *Commissioner of Taxation (Cth) v Word Investments Ltd* (2006) 64 ATR 483 (Federal Court, Sundberg J, 3 November 2006); *Federal Commissioner of Taxation v Word Investments Ltd* (2007) 164 FCR 194 (Federal Court of Australia, Full Court, 14 November 2007).

⁶⁸ *Commissioner of Taxation (Cth) v Word Investments Ltd* (2006) 64 ATR 483 [52].

⁶⁹ *Federal Commissioner of Taxation v Word Investments Ltd* (2007) 164 FCR 194 [57].

⁷⁰ Gummow, Hayne, Heyson and Crennan JJ.

⁷¹ *Word Investments* (2008) 236 CLR 204 [73].

Section 50–50(a) does not impose a prohibition on distributing to other charitable institutions. Nor does it require the money, when ultimately expended by Wycliffe and the other institutions, to be expended in Australia. Section 50–50(a) could have imposed a requirement of that latter kind, but it did not. It only imposed a requirement that Word incur its expenditure and pursue its objectives principally in Australia—not that Wycliffe and the other institutions do so. No doubt the ultimate benefit to charity which Word causes is effected by Wycliffe indirectly and to some extent outside Australia, not directly and in Australia: but s 50–50(a) draws no distinction between direct and indirect effects.⁷²

The majority concluded that the ‘in Australia’ requirement in s 50–50(a) is confined to ‘the place where the relevant conduct occurs, not to that where the ultimate purpose of that conduct is given effect, or its objective realised, by a donee’s actual use of the money it receives’.⁷³ This conclusion is consistent with a decision of the English Court of Appeal in *Inland Revenue Commissioners v Helen Slater Charitable Trust Ltd*⁷⁴ that charitable objects could be fulfilled by one charity, by applying income to another similar charity, in effect acting as a conduit or intermediary for charitable funds.

In his dissenting opinion, Kirby J found this to be an ‘erroneous reading’ of the ‘in Australia’ requirement for income tax exemption.⁷⁵ While His Honour agreed with the majority that Word had a physical presence in Australia, he believed that the majority took ‘a narrow view of what is involved in Word’s incurring its expenditure and pursuing its objectives *within* Australia’, noting that the majority’s approach ‘sees no difficulty in the fact that the destination of the income that is subject to the tax exemption is (and always was intended to be) principally *outside* Australia’.⁷⁶ Kirby J’s conclusion, that he deemed ‘fatal to Word’s case’, was that in so far as Word pursued any charitable objectives, the fact that it did so principally outside Australia meant that it was not entitled to exemption.⁷⁷

The finding of the majority in *Word Investments* that sending funds abroad through a suitably qualified organisation meets the ‘in Australia’ test under s 50–50(a) of the ITAA 1997 was confirmed in the recent Full Federal Court of Australia decision in *Hunger Project*.⁷⁸ That case turned on the question of whether Hunger Project Australia (HPA), which operated primarily as a fundraising arm for a global network of entities that provided hunger relief in developing countries, qualified as an Australian public benevolent institution (PBI).⁷⁹ The Federal Court determined that HPA was a PBI even though it sent funds to entities overseas. While the Court did not consider the ‘in Australia’ issue, it found that:

⁷² Ibid.

⁷³ Dal Pont, above n 17, 145.

⁷⁴ [1982] Ch 49.

⁷⁵ *Word Investments* (2008) 236 CLR 204 [131].

⁷⁶ (2008) 236 CLR 204 [130].

⁷⁷ (2008) 236 CLR 204 [158].

⁷⁸ (2014) 221 FCR 302.

⁷⁹ PBIs are charities that provide direct services to those in need of benevolent relief, or raise funds for the purpose of providing benevolent relief. See *Australian Charities and Not-for-profits Commission Act 2012* (Cth) s 25–5(5) column 2, item 6.

[t]he ordinary contemporary meaning or understanding of a public benevolent institution is broad enough to encompass an institution, like HPA, which raises funds for provision to associated entities for use in programs for the relief of hunger in the developing world.⁸⁰

By interpreting the meaning of 'in Australia' for income tax exemption such that the ultimate purposes or beneficiaries were not required to be 'in Australia', *Word Investments* and *Hunger Project* are consistent with the ordinary meaning of 'in Australia' as stated in the Explanatory Memorandum introducing the 'in Australia' amendments for income tax exemption.

3.3 Proposed legislative reforms

In the 2009–2010 Budget, the Australian Government announced amendments to the 'in Australia' requirements in div 50 of the ITAA 1997 in response to the *Word Investments* decision 'that charities may be pursuing their objectives *principally* "in Australia" even where they merely pass funds within Australia to another charitable institution that conducts its activities overseas'.⁸¹ This strikes directly at conduit arrangements—what is known as 'auspicing' or 'channelling'—in Australia. The ATO has explained 'channelling' as occurring where:

A deductible gift recipient is approached by an organisation that is seeking to raise funds. The organisation has potential donors but they will not give unless they claim tax deductions for their gifts. The organisation arranges with the deductible gift recipient for the gifts to be made to it. The deductible gift recipient gives gift receipts to the donors. It then passes on the donations substantially to the organisation.⁸²

The Government stated that these amendments to the 'in Australia' provisions would serve to 'reverse the decision that charities and other income tax exempt entities can direct funds to overseas projects outside the current restrictions'.⁸³

After two exposure drafts,⁸⁴ a Bill was proposed to reform the tax laws applying to the geographic boundaries of both income tax exemption and gift deductibility.⁸⁵ While the Bill lapsed when Parliament was dissolved ahead of a federal election, the

⁸⁰ *Hunger Project* (2014) 221 FCR 302, 314 [66]–[67].

⁸¹ See Wayne Swan and Lindsay Tanner, 'Budget Measures 2009–10' (Budget Paper No 2, Australian Government, 12 May 2009) 29 [emphasis added].

⁸² Senate Economics Legislation Committee, Parliament of Australia, *Report on Taxation Laws Amendment Bill (No.8) 1999*, Appendix 3; Letter from ATO to Senator Brian Gibson, 23 November 1999.

⁸³ *Ibid.*

⁸⁴ Exposure Draft, Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No 1) 2011: Tax Exempt Body 'in Australia' Requirements; Treasury (Cth), *'In Australia' Special Conditions for Tax Concession Entities* (4 July 2011) <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2011/In-Australia-Special-Conditions-for-Tax-Concession-Entities>>; Exposure Draft, Tax Laws Amendment (2012 Measures No 4) Bill 2012 (Cth): Tax Exempt Body 'in Australia' Requirements; Treasury (Cth), *Restating and Standardising the Special Conditions for Tax Concession Entities (Including the 'in Australia' Conditions)* (17 April 2012) <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/In-Australia-Special-Conditions-for-Tax-Concession-Entities-Revised>>.

⁸⁵ Tax Laws Amendment (Special Conditions for Not-for-profit Concessions) Bill 2012 (Cth).

incoming government announced it would continue with the 'in Australia' measures,⁸⁶ releasing its own draft Bill with 'in Australia' language for income tax exempt entities and DGRs mirroring the language in the lapsed Bill.⁸⁷

The draft Bill amended s 50–50(a), changing the requirement from incurring expenditure and pursuing objectives principally in Australia, to requiring organisations to '*operate* principally in Australia and pursue [their] *purposes* principally in Australia'.⁸⁸ The Explanatory Materials suggested that this would allow a wider range of circumstances to be considered such as:

where the entity incurs its expenditure; where it undertakes its activities; where the entity's property is located; where the entity is managed from; where the entity is resident or located; where its employees or volunteers are located; and who is directly and indirectly benefiting from its activities.⁸⁹

None of the above indicators is determinative, but a weighing up of all indicators is proposed.⁹⁰ Examples used in the Explanatory Materials show that although an Australian tax-exempt organisation may be centrally controlled and managed from outside Australia, if a certain amount of expenditure, operations and beneficiaries are located in Australia, it could still satisfy the special conditions.⁹¹ None of these considerations are included in the actual words of the draft Bill and a court may well be persuaded to adopt a different interpretation of 'operate', as it is not a legal term. The ordinary sense of the word in the context of the provision may suggest itself to a court called on to determine its meaning. The Macquarie Dictionary gives various meanings of 'operate', including 'to work or run, as a machine does; to keep (a machine, apparatus, factory, industrial system, etc.) working or in operation; to act effectively, exert force or influence',⁹² which may not be as wide as that expressed in the draft Bill.

⁸⁶ Arthur Sinodinos, 'Integrity Restored to Australia's Taxation System' (Media Release, 14 December 2013) item 37 <<http://axs.ministers.treasury.gov.au/files/2013/12/MR008-2013.pdf>>.

⁸⁷ Exposure Draft, Tax and Superannuation Laws Amendment (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions.

⁸⁸ Exposure Draft, Tax and Superannuation Laws Amendment (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions, 10 [31] s 50-50(2) [emphasis added]. Under s 50-51(2), organisations can be exempt from the provisions by being prescribed in the *Income Tax Assessment Regulations 1997*, or if endorsed as a DGR. Prescribed organisations must be: overseas NFP organisations exempt from foreign tax in their resident countries; or be resident in Australia and operate and pursue their objectives principally outside Australia. Prescription is only in exceptional circumstances: where the organisation is providing a broad benefit to the Australian community, and considering the national interest, tax system integrity, any risk the organisation will be used for money laundering or terrorist financing, among other relevant considerations. This power is subject to Parliamentary scrutiny, by way of disallowance. See Explanatory Materials, Exposure Draft: Tax Laws Amendment (2014 Measures No #) Bill 2014 (Cth) [1.98].

⁸⁹ Explanatory Materials, Exposure Draft: Tax Laws Amendment (2014 Measures No #) Bill 2014 (Cth) [1.59].

⁹⁰ Ibid.

⁹¹ Explanatory Materials, Exposure Draft: Tax Laws Amendment (2014 Measures No #) Bill 2014 (Cth) [1.64], example 1.5: Overseas Control.

⁹² *Macquarie Dictionary Online* (9 September 2014) <<https://www-macquariedictionary-com-au.ezp01.library.qut.edu.au/>>.

Further, the funds that an organisation provides to non-exempt organisations are to be taken into account in determining whether the requirements have been met.⁹³ An exempt donor organisation is expected to have a reasonable knowledge of the purpose or cause that it intends the donee organisation to carry out with the funds. However, the donor need only take all those steps that are reasonable to confirm or trace the use of such funds outside Australia.⁹⁴ The Explanatory Materials note that 'if it later transpires that the funds were spent in such a manner that would result in the loss of status of the providing entity, the entity will be able to rely on the reasonable and genuine steps it has taken to demonstrate compliance with the special conditions'.⁹⁵ This specifically redresses the issue in *Word Investments*.⁹⁶

Submissions on the most recent exposure draft closed on 7 April 2014 and the Bill was expected to be before Parliament by early 2015. Although a number of submissions argued that a policy of stifling cross-border charity with greater regulatory controls was not in Australia's best interests, this does not appear to have swayed either of the two main political parties. The proposed legislative reforms have an even greater impact on the tax provisions relating to the geographic boundaries of gift deductibility. We now turn to these provisions.

4. GEOGRAPHIC BOUNDARIES OF GIFT DEDUCTIBILITY

4.1 Legislative development

Gift deductibility first appeared in the Australian legislation after federation in two Victorian statutes, the *Income Tax Act 1907* (Vic) and the *Administration and Probate Duties Act 1907* (Vic), which provided for tax deductions for gifts to certain institutions 'situate within Victoria'.⁹⁷ This geographic restriction was a last minute amendment by the Premier and was not discussed in the parliamentary debate.⁹⁸ While the provision required organisations to be located geographically in Victoria, they were not necessarily prohibited from operating or having beneficiaries outside Victoria. Later legislation was more explicit. The *Administrative and Probate Act 1928* (Vic),⁹⁹ the *Administrative and Probate Act 1953* (Vic),¹⁰⁰ and the *Probate Duty*

⁹³ If an income tax exempt entity provides money to another income tax exempt entity, the receiving entity will itself have met the 'in Australia' special conditions and be operating principally in Australia, or be expressly exempt. Therefore, an entity does not need to take account of the eventual use of these funds by the donee entity.

⁹⁴ Exposure Draft, Tax and Superannuation Laws Amendment (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions, 11 [31] s 50–50 (4A).

⁹⁵ Explanatory Materials, Exposure Draft: Tax Laws Amendment (2014 Measures No #) Bill 2014 (Cth) [1.80].

⁹⁶ See Ian Murray, 'Not-for-Profit Reform: Back to the Future?' (2014) 20(1) *Third Sector Review* 109, 132.

⁹⁷ See *Income Tax Act 1907* (Vic) s 3 and *Administration and Probate Duties Act 1907* (Vic) s 3(2). For a discussion of the parliamentary debates surrounding this legislation, see Ann O'Connell, 'Charitable Treatment? A Short History of Charities in Australia' in John Tiley (ed), *Studies in the History of Tax Law* (Hart, 2012) vol 5.

⁹⁸ Victoria, *Parliamentary Debates*, Legislative Assembly, 19 September 1907, 1277. We are indebted to John Emerson for bringing this point to our attention.

⁹⁹ *Administrative and Probate Act 1928* (Vic) s 160.

¹⁰⁰ *Administrative and Probate Act 1953* (Vic) s 117.

Act 1962 (Vic),¹⁰¹ are now repealed, effectively required philanthropic trust deeds to restrict the trust's location and operations to Victoria in order to be estate tax-effective. To this day, trust deeds established under this regime prohibit making grants to organisations outside the borders of Victoria by their founding documents, despite recommendations for reform by the Industry Commission in 1995.¹⁰²

The ITAA 1915 contained the first federal gift deductibility provision in s 18(h), which provided tax deductibility for gifts over £20 to charitable institutions *in Australia*.¹⁰³

18. In calculating the taxable income of a taxpayer the total income derived by the taxpayer from all sources in Australia shall be taken as a basis, and from it there shall be deducted—(h) gifts exceeding Twenty pounds each to public charitable institutions *in Australia and* contributions exceeding Five pounds in the aggregate in respect of each object of contribution made during the continuance of the present war to any public fund established in any part of the King's Dominions or in any country in alliance with Great Britain for any purpose connected with the present war: Provided that payments shall not be allowable as deductions under this paragraph unless verified to the satisfaction of the Commissioner.¹⁰⁴

Section 18(h) appears to be based on the earlier Victorian provisions requiring that the charitable institution be 'situate within Victoria',¹⁰⁵ indicating a geographic restriction based on the physical location of the institution. As well as providing a deduction for gifts to charitable institutions 'in Australia', s 18(h) of the ITAA 1915 also provided a deduction for contributions over £5 to public funds overseas, specifically connected to the British effort in World War I. The original draft of s 18(h) in the Income Tax Assessment Bill 1915 (Cth) restricted tax deductibility for contributions to public funds connected to the war effort to 'any public fund established in Australia',¹⁰⁶ but it was amended to replace Australia with the King's Dominions and Great Britain's allies in the war.¹⁰⁷ The provision as conceived by the Attorney General did not include a gift deduction for domestic gifts over £20; it only provided a deduction for international contributions. The Senate amended the Bill and returned it to the House with both the domestic gift deduction and the deduction for international contributions, and both were included in the Act.¹⁰⁸ From its inception, it is clear that there have been differences of opinion as to the geographic parameters of gift deductibility in Australia.

¹⁰¹ *Probate Duty Act 1962 (Vic)* s 21.

¹⁰² Industry Commission, 'Charitable Organisations in Australia' (Report No 45, AGPS, 1995) 253–4.

¹⁰³ The original Bill did not include a tax deduction for gifts to charities, but did include tax deductions in respect of contributions to the war. See O'Connell, above n 97, 108.

¹⁰⁴ ITAA 1915 s 18(h) [emphasis added].

¹⁰⁵ O'Connell, above n 97, 108, noting that the £20 threshold for tax deductibility of donations was the same as that set by the Victorian legislation and that the ITAA 1915 was likely only the second Australian income tax legislation to include this provision.

¹⁰⁶ Commonwealth, *Parliamentary Debates*, House of Representatives, 1 September 1915, 2.

¹⁰⁷ *Ibid* (William Hughes).

¹⁰⁸ Commonwealth, *Parliamentary Debates*, House of Representatives, 9 September 1915, 1. For a discussion of political manoeuvring that resulted in the gift deduction provision being included in ITAA 1915, see O'Connell, above n 97, 108–9.

The ITAA 1922 altered the gift deduction provision (s 23(1)(h)), and reduced the gift threshold to £5.¹⁰⁹ Also, given that Word War I had ended, there was no longer a need to reference donations to public funds overseas for purposes connected with the war.¹¹⁰ Instead, the ITAA 1922 specifically included contributions to the Department of Repatriation¹¹¹ and continued to restrict tax deductibility to gifts to public charitable institutions 'in Australia'.¹¹²

A Royal Commission on Taxation was established in 1932 in relation to deductible gifts. It was primarily concerned with the parameters of the concession, including whether it should be restricted to charitable institutions carrying on their functions within the jurisdiction of the taxing authority. In its final report in 1934, the Commission recommended 'that a deduction be allowed for gifts of one pound and upwards made during the year of income ... to charitable institutions ... which carry on their functions within the jurisdiction of the taxing authority'.¹¹³ In this event, 'the Commonwealth would allow deductions to a charitable institution in Australia, and each State would allow donations to similar institutions within the State'.¹¹⁴ This language is consistent with the legislative history that 'in Australia' is referring to the location and operations (or functions) of a charitable institution, but does not extend to its purposes.

This issue was subsequently raised at the Conference of Commonwealth and State Commissioners of Taxation to discuss recommendations of the Royal Commission.¹¹⁵ During the Conference, the question was asked whether the words 'in the state' in the New South Wales gift deductibility provision was intended to cover contributions to 'funds raised in other countries', such as the case of an earthquake in Japan, or whether the fund must be a state fund.¹¹⁶ The Commonwealth Commissioner for Taxation responded that 'the Federal law covered only charitable institutions in

¹⁰⁹ Section 23(1) states:

In calculating the taxable income of a taxpayer the total assessable income derived by the taxpayer from all sources *in Australia* shall be taken as a basis, and from it there shall be deducted—(h) ... (ii) gifts exceeding Five pounds each made, during the year in which the income was derived, to public charitable institutions *in Australia*, if the gifts are verified to the satisfaction of the Commissioner. [Emphasis added].

¹¹⁰ See Explanatory Memorandum, Income Tax Bill 1922 (Cth) 26.

¹¹¹ Known after 1976 as the Department of Veterans' Affairs. The most recent iteration of this defence provision is contained in ITAA 1997 s 30-50, item 5.1.2.

¹¹² Note that para 1.22 of Explanatory Memorandum, Tax Laws Amendment (Special Conditions for Not-for-profit Concessions) Bill 2012 (Cth) states: 'The Explanatory Memorandum to the Bill that became the *Income Tax Assessment Act 1922* notes that the amendment was for the purpose of limiting deductions to those actually incurred in Australia which is interpreted as meaning "decided upon in Australia by the controlling authority, although the actual expenditure might be made outside Australia" and also included expenditure actually made in Australia.' However, this appears to have been taken out of context, as the ITAA 1922 Explanatory Memorandum is referring to the amendment of a different provision, s 23(a), concerning deductions for 'all losses and outgoings ... including commission, discount, travelling expenses, interest and expenses actually incurred in gaining or producing the assessable income'.

¹¹³ Commonwealth, Royal Commission on Taxation, *Third Report* (1934) [618].

¹¹⁴ *Ibid* [617].

¹¹⁵ 'Proceedings and Decisions of Conference' (Conference of Commonwealth and State Commissioners of Taxation to Discuss the Recommendations of the Royal Commission on Taxation, Melbourne, 8 August 1935).

¹¹⁶ *Ibid* 140.

Australia'.¹¹⁷ This limited discussion indicates that donations to a fund located overseas would not be covered by the deduction provisions, but that donations to a fund located in Australia would be. Again, this appears consistent with the existing view that it is the location of the institution receiving the funds that is important, not the final beneficiary of those funds.

The Commission's work resulted in the ITAA 1936, with s 78 containing a list of the types of organisations (not necessarily charities) that would be entitled to tax deductible donations, and specific DGRs, many of which remain today. Section 78(1) stated:

The following shall ... be allowable deductions: (a) Gifts of the value of one pound and upwards made by the taxpayer in the year of income to any of the following funds, authorities or institutions *in Australia*: (i) a public hospital; (ii) a public benevolent institution; (iii) a public fund established and maintained for the purpose of providing money for public hospitals or public benevolent institutions *in Australia*, or for the establishment of such hospitals or institutions, or for the relief of persons *in Australia* who are in necessitous circumstances; (iv) a public authority engaged in research into the causes, prevention or cure of disease in human beings, animals or plants, where the gift is for such research, or a public institution engaged solely in such research; (v) a public university or a public fund for the establishment of a public university; (vi) a residential educational institution affiliated under statutory provisions with a public university, or established by the Commonwealth; and (vii) a public fund established and maintained for providing money for the construction or maintenance of a public memorial relating to the war which commenced on the fourth day of August, One thousand nine hundred and fourteen.¹¹⁸

The Explanatory Memorandum said little about the 'in Australia' provisions.¹¹⁹ Early versions of the Act defined Australia as including Papua New Guinea.¹²⁰ The inclusion of 'in Australia' in s 78(1) as both a general condition for gift deductibility at the outset, as well as an express limitation for certain types of funds, requires an understanding of the legislative drafting underlying these provisions. An example is 'a public fund established and maintained for the relief of persons in Australia who are in necessitous circumstances'.¹²¹ This secondary 'in Australia' reference may at first glance appear duplicative and redundant. However, the application of the principle of statutory interpretation that all words have meaning and effect¹²² suggests that the secondary qualifier refers not to the geographic location of the body, but to some other attribute, such as its beneficiaries. To give a wider meaning to the first instance of the words 'in Australia' to include not only the geographic location of the body but also

¹¹⁷ Ibid 141.

¹¹⁸ ITAA 1936 s 78(1) [emphasis added].

¹¹⁹ The phrase 'in Australia' was only mentioned in the Explanatory Memorandum to the ITAA 1936 to note its inclusion in s 78(1)(iii) for deductions for the relief of persons *in Australia* who are in necessitous circumstances 'to make the intention of the law clear': Explanatory Memorandum, Bill to Consolidate and Amend the Income Tax Assessment Act 1922–1934 (Cth) 81.

¹²⁰ ITAA 1936 s 78(2)(b).

¹²¹ ITAA 1936 s 78(1)(a)(iii).

¹²² Dennis Pearce and Robert Geddes, *Statutory Interpretation in Australia* (LexisNexis Butterworths, 8th ed, 2014) 62.

where it conducts its activities, makes the second instance of the words redundant and infringes the principle of statutory interpretation that all words have meaning and effect.¹²³ A similar interpretative issue involving the phrase 'in Australia' in income tax legislation was presented to the High Court in 1921.¹²⁴ The Court confined the phrase 'in Australia' to the immediate words and not the whole section, preferring 'the natural construction of the words used'.¹²⁵

Confirming this view, a 1961 Canberra Income Tax Circular from the Commissioner of Taxation noted that, in relation to PBIs, 'the words "in Australia" refer to the location of the institution and not to the persons who are to benefit from the institution's activities. If the public benevolent institution itself is in Australia, it is not essential that the granting of assistance is limited to persons in Australia'.¹²⁶ In a later paragraph the Circular stated that '[p]ublic funds providing relief for persons in necessitous circumstances will qualify for approval only if these persons are in Australia'.¹²⁷ This accords with the interpretation of the provisions above, given that necessitous circumstance funds have a secondary 'in Australia' qualification.

During this period there was an emerging global focus on international aid, led by the United Nations in 1959 declaring a 'Development Decade', with many overseas jurisdictions providing tax incentives for private donations to aid organisations. As part of this movement, in 1963 the Freedom from Hunger Campaign was supported by the Australian Government and given gift deductibility status. It raised over \$2 million.¹²⁸ During this time Australian aid organisations lobbied the Government for permanent gift deductibility for activities carried on outside Australia, rather than for one-off appeals. It was not until 1981, however, that the Overseas Aid Gift Deduction Scheme (OAGDS) was legislated through an amendment to s 78 of the ITAA 1936.¹²⁹

In 1967 another memorandum from the First Assistant Commissioner of Taxation was sent to all Deputy Commissioners on the meaning of 'in Australia'.¹³⁰ This memorandum completely reversed the ATO's prior position by baldly stating: 'It is the clear intention of the income tax legislation that deductions should be limited in general to gifts made to organisations which render aid to needy residents of Australia'.¹³¹ The explanation for this about-face was not based on any legal interpretation of s 78 of the ITAA 1936. Instead, the memorandum explained that the comments were based on the ATO's specific approval of the Australian Red Cross Society for PBI status.¹³² The memorandum pointed out that the approval of that

¹²³ Ibid.

¹²⁴ *The Alliance Assurance Company Limited v The Federal Commissioner of Taxation* [1921] 29 CLR 424.

¹²⁵ [1921] 29 CLR 424, 430.

¹²⁶ Commissioner of Taxation, 'Gifts to Public Hospitals, Public Benevolent Institutions, Etc' (Canberra Income Tax Circular Memorandum No 806, 10 November 1961) 7 [26].

¹²⁷ Ibid 9 [36].

¹²⁸ Patrick Kilby, *NGOs and Political Change – A History of the Australian Council for International Development* (ANU Press, 2015) 30, 32, 35.

¹²⁹ Income Tax Law Amendment Bill 1981 (Cth), cl 10.

¹³⁰ First Assistant Commissioner of Taxation, 'Organisations Concerned with Overseas Relief' (J106/82/2 Pt 26, 13 January 1967).

¹³¹ Ibid 1 [2].

¹³² Ibid 1 [4].

organisation was granted because the funds applied outside Australia were insignificant. In doing so, it emphasised that an organisation concerned with the provision of relief overseas 'should not be treated as a PBI in Australia if its benevolent work is carried out mainly overseas'.¹³³ The memorandum then instructed that any organisation that had been awarded PBI status on the basis of the previous 1961 Canberra Income Tax Circular was to be contacted and advised that the status was to be withdrawn apart from where activities were confined to Australia.¹³⁴

In reversing its earlier position, the 1967 memorandum resulted in a far stricter interpretation of 'in Australia' by the ATO, requiring not only that the organisation be physically located in Australia, but also that its activities and beneficiaries must be in Australia. In a 1987 taxation ruling, the Commissioner of Taxation, noting the precedential value of the 1967 memorandum, determined that a PBI whose purpose was to provide financial assistance to people in necessitous circumstances in a country overseas should be denied the ability to receive tax deductible gifts pursuant to s 78 of the ITAA 1936 because its purposes and beneficiaries were located overseas.¹³⁵

The revised, stricter ATO interpretation of 'in Australia' was also adopted by the first monograph on charities and deductible gifts, published by the Taxation Institute of Australia in 1977. In this monograph, Professor Colditz did not reference the 1961 tax circular, but illustrated the effect of s 78(1)(a) claiming, 'a gift to a public hospital in Australia is *prima facie* allowable, a gift to a public hospital catering to the needs of the sick in a nearby country is not'.¹³⁶ The legislative listing of public hospitals at the time did not have a secondary 'in Australia' qualifier. Professor Colditz went on to remark, 'there has been no case or guidance on whether a hospital located in Australia could allocate part of its funds to overseas activities',¹³⁷ and further that it was 'open to considerable doubt' whether there was any scrutiny by the ATO of this practice.¹³⁸

The introduction of the international aid exception to s 78 in 1981, created greater uncertainty about the meaning of 'in Australia' under the ATO's strict interpretation. Specifically, it raised the question of how allowing gift deductibility under the exception, for donations to aid organisations with overseas purposes and beneficiaries could be consistent with the ATO's interpretation that an organisation's purposes and beneficiaries must be in Australia. It was simply not possible for an overseas aid fund maintained for the relief of people in developing countries to be in Australia. The only way to reconcile these conflicting provisions was if 'in Australia' referred to physical location only, which would enable the overseas aid provision to allow a deduction for gifts to funds established in Australia for the purpose of providing relief to people outside Australia.

The international aid exception was not the only inconsistency in s 78 arising from the ATO's strict interpretation of 'in Australia'. With the expansion of s 78 over the years

¹³³ Ibid 2.

¹³⁴ Ibid 2 [10].

¹³⁵ Commissioner of Taxation, *Income Tax: Gifts to Public Benevolent Institutions*, TR 2386, 19 March 1987.

¹³⁶ Bernard Colditz, 'Income Tax Aspects of the Income of Charities and of Gifts to Charities' (Taxation Institute of Australia Research and Education Trust, 1977) 30.

¹³⁷ Ibid.

¹³⁸ Ibid.

reflecting the growth of the charity sector and the perception of its importance,¹³⁹ the number of sub-paragraphs containing express 'in Australia' limitations grew to encompass not only necessitous circumstances funds and public hospital funds, but also public funds providing religious instruction in government schools, Australian disaster relief funds, Australian war memorial funds, public funds for family counselling or family dispute resolution, and marriage guidance funds. The express inclusion of a geographic limitation in these sub-paragraphs appears to make the 'in Australia' general condition at the beginning of s 78 redundant. Like the overseas aid exception, the only way these conflicting 'in Australia' provisions can be reconciled according to the principles of statutory interpretation is if 'in Australia' in the general condition at the beginning of the section refers only to an organisation's physical location, with the specific limitations in the sub-paragraphs extending to an organisation's purposes and beneficiaries.

With the enactment of the ITAA 1997, the listed deductible purposes and organisations were categorised into subject areas placed into div 30.¹⁴⁰ Under div 30, the gift deductibility provisions are extensive and detailed. The 'in Australia' requirement for DGR endorsement is set out in s 30-15 under 'Special Conditions', which states that 'the fund, authority or institution must be *in Australia*'.¹⁴¹ Following its predecessor, div 30 also contains express 'in Australia' limitations for certain categories of funds, including public funds providing religious instruction or ethics in government schools,¹⁴² Australian disaster relief funds,¹⁴³ necessitous circumstances funds,¹⁴⁴ Australian war memorial funds,¹⁴⁵ public funds for family counselling or family dispute resolution,¹⁴⁶ and marriage guidance funds.¹⁴⁷ The result is that the inconsistencies contained in s 78 of the ITAA 1936 arising from the ATO's strict interpretation of 'in Australia' remain today, creating uncertainty both for organisations seeking to engage in cross-border charitable activities and for their donors.

In 2000, the ATO produced a guide, known as GiftPack, for DGRs and donors.¹⁴⁸ Unlike public information documents in the mid-1990s which did not mention the geographic qualification at all,¹⁴⁹ the GiftPack noted that 'in Australia' generally requires 'establishment and operation in Australia, and purposes and beneficiaries in

¹³⁹ O'Connell, above n 97, 118–120, noting in particular the growth in the Australian arts and scientific communities as reflected in the legislation.

¹⁴⁰ Other than s 78A of the ITAA 1936. Div 30 of the ITAA 1997 applies to gifts made in 1997–98 and subsequent years of income. See *Income Tax (Transitional Provisions) Act 1997* (Cth) s 30–1.

¹⁴¹ ITAA 1997 s 30–15 [emphasis added].

¹⁴² ITAA 1997 s 30–25 items 2.1.8, 2.1.9 (religious instruction), item 2.1.9A (ethics).

¹⁴³ ITAA 1997 ss 30–45A, 30–46 and 30–45, item 4.1.5.

¹⁴⁴ ITAA 1997 s 30–45 item 4.1.3.

¹⁴⁵ ITAA 1997 s 30–50 item 5.1.3.

¹⁴⁶ ITAA 1997 s 30–70 item 8.1.2.

¹⁴⁷ ITAA 1997 s 30–70 item 8.1.1.

¹⁴⁸ ATO, *GiftPack: A Taxation Guide for Deductible Gift Recipients and Donors* (NAT 3132-5.2000, 2000) (*GiftPack 2000*).

¹⁴⁹ ATO, 'Information for Public Benevolent Institutions', [ca 1995]; ATO, 'Public Benevolent Institutions' (Sales Tax Bulletin No 5, 1 May 1997).

Australia' apart from certain special bodies such as overseas aid funds or public environmental funds.¹⁵⁰

In 2003 the ATO finalised its public ruling on PBIs, enshrining its strict interpretation of 'in Australia' by writing:

129. To be in Australia a public benevolent institution must be established, controlled, maintained and operated in Australia and its benevolent purposes must be in Australia. Because the purpose of public benevolent institutions is to provide direct relief to persons in need, this will mean that relief will be provided to people located in Australia.

130. However, we accept that where a public benevolent institution conducts an activity outside Australia that is merely incidental to providing relief in Australia, or is insignificant, it will not disqualify the institution from endorsement. For example, if a public benevolent institution provides medical assistance to children in Australia with a particular disability but, to a minor extent, it also brings children from other countries to receive treatment in Australia, it still meets this condition for endorsement.¹⁵¹

The consequence of this public ruling is that donations made directly by Australian taxpayers to an organisation outside Australia are never tax deductible. Donations made to an Australian DGR that uses the gift for its own programs outside Australia are also not tax deductible unless its activities outside Australia are 'merely incidental',¹⁵² fall within the *Hunger Project* circumstances,¹⁵³ or the organisation obtained its DGR status pursuant to one of the four exceptions dispersed throughout div 30.¹⁵⁴ These exceptions are: overseas aid funds;¹⁵⁵ developed country disaster relief funds;¹⁵⁶ public funds on the Register of Environmental Organisations;¹⁵⁷ and DGRs specifically listed by name in the ITAA 1997 under the category of international affairs.¹⁵⁸

Following its public ruling on PBIs in 2003, the ATO's strict view of 'in Australia' requiring geographical residence as well as confining activities and beneficiaries geographically appeared to be entrenched. However, more recently the ATO's position seems to be shifting. Since 2012, the GiftPack's wording has altered, stating that 'for funds, institutions and authorities to be in Australia, they must be established

¹⁵⁰ *GiftPack 2000*, above n 148, 13–14.

¹⁵¹ TR 2003/5, above n 7, [129]–[131]. Note that the recent case of *Hunger Project* (2014) 221 FCR 302, decided that the ATO view about 'direct relief' was incorrect and that fundraising proceeds to be given to others to relieve the poor did satisfy the directness test.

¹⁵² *Ibid* [130]: 'For example, if a [DGR] provides medical assistance to children in Australia with a particular disability but, to a minor extent, it also brings children from other countries to receive treatment in Australia, it still meets this condition'.

¹⁵³ (2014) 221 FCR 302.

¹⁵⁴ For a detailed discussion of these exceptions, see Natalie Silver, Myles McGregor-Lowndes and Julie-Anne Tarr, 'Should Tax Incentives for Charitable Giving Stop at Australia's Borders' (2016) 38 *Sydney Law Review* 85, 96–103.

¹⁵⁵ ITAA 1997 s 30–85.

¹⁵⁶ ITAA 1997 s 30–86.

¹⁵⁷ ITAA 1997 s 30–55.

¹⁵⁸ ITAA 1997 s 30–80.

and operated in Australia'.¹⁵⁹ The GiftPack then lists those 'funds' for which the 'purposes or beneficiaries' must also be in Australia and those for which the purposes and beneficiaries do not have to be in Australia.¹⁶⁰ The ATO's website reflects these changes and goes one step further, stating:

The 'in Australia' condition requires all DGRs to be in Australia. This means that all DGRs must be established and operated in Australia. *The purposes and beneficiaries of a DGR do not have to be in Australia*, unless the DGR is one of the following public funds: a public fund for providing religious instruction in government schools; a Roman Catholic public fund for religious instruction in government schools; a public fund for ethics education in government schools; an Australian disaster relief fund; a necessitous circumstances fund; an Australian war memorial fund; a public fund for family counselling or family dispute resolution; a marriage guidance fund; a public fund for providing money for scholarships.¹⁶¹

The website then lists specific examples clarifying this new position.¹⁶² An example provided for PBIs provides:

An institution is set up in Australia as a charity whose main purpose is for the relief of poverty. The institution is a registered public benevolent institution. The institution's controlling board, its donors, and most of its assets are in Australia ... [A]ll of the money provided by the institution is sent to beneficiaries overseas. The institution is established and operated in Australia. The institution is not required to have its purposes and beneficiaries in Australia. It meets the 'in Australia' condition.

The ATO recently announced its intention to issue a new public ruling on 'in Australia', which is likely to reflect the changes made to its GiftPack and website, relaxing its strict interpretation.¹⁶³ Despite these developments, the Australian Government's reform agenda proposes to restrict the geographic boundaries of the gift deduction even further.

4.2 Proposed legislative reforms

To provide greater clarity to the 'in Australia' provisions in s 30–15 of the ITAA 1997 following the decision in *Word Investments*, the Government's reform agenda contains specific policy imperatives that seek to limit further the ability of Australian organisations and their donors to engage in tax deductible cross-border charitable activities. In doing so, the reform agenda represents an effort to reinstate the stricter

¹⁵⁹ See ATO, *GiftPack: Guide for Deductible Gift Recipients and Donors* (NAT 3132, 2012) (*GiftPack 2012*); and *GiftPack: Guide for Deductible Gift Recipients and Donors* (NAT 3132, 2015) (*GiftPack 2015*).

¹⁶⁰ Emphasis added. GiftPack remains silent on this point for institutions and authorities. See *GiftPack 2012*, above n 159; *GiftPack 2015*, above n 159.

¹⁶¹ ATO, *Can You be Endorsed as a DGR? In Australia Condition* (1 March 2016) <[https://www.ato.gov.au/Non-profit/Getting-started/Endorsement/Deductible-gift-recipient-\(DGR\)-endorsement/Can-you-be-endorsed-as-a-DGR-/#In_Australia](https://www.ato.gov.au/Non-profit/Getting-started/Endorsement/Deductible-gift-recipient-(DGR)-endorsement/Can-you-be-endorsed-as-a-DGR-/#In_Australia)> [emphasis added].

¹⁶² Ibid.

¹⁶³ This is based on the recommendations of the ATO's Not-for-Profit Advisory Group, which met in December 2015 to consider an 'In Australia' discussion paper, to provide greater clarity on the meaning of 'in Australia' in ITAA 1997 divs 30 and 50. See ATO, *Completed Matters*, above n 16.

'in Australia' test for DGRs that was undone by *Word Investments* and *Hunger Project*.

The core principle for income tax exempt entities is applied similarly to DGRs, but with a stricter threshold test.¹⁶⁴ DGRs generally must 'be established in Australia; operate solely in Australia; and pursue their purposes solely in Australia'.¹⁶⁵ According to the Explanatory Memorandum, 'solely in Australia' is to be interpreted as requiring DGRs to be established and operated only in Australia (including control, activities and assets) and to have their purposes and beneficiaries only in Australia. However, overseas activities that are merely incidental to a DGR's purposes in Australia will not be caught. Further, if overseas activities are minor in extent and importance when considered with reference to the operations and pursuit of the organisation's Australian activities, again, it will not be caught. The Explanatory Memorandum states that 'the overall quantum of an entity's overseas expenditure should also be considered by reference to current public expectations about what is considered minor'.¹⁶⁶ This is likely to produce an interesting contest between the tax authorities and the sector about what are 'current public expectations' and how these are to be interpreted. Just as for tax exemption, functioning as a mere conduit DGR for another organisation that operates overseas will not be permitted, and if funds are passed to another organisation that is not a DGR, the funds will be subject to tracing.¹⁶⁷

There are a number of carve outs from these tests which have grown with each exposure draft of the Bill. Organisations that are DGRs under the overseas aid category or are specifically listed in the ITAA 1997 under the international affairs category are exempt from the 'in Australia' special conditions for DGRs.¹⁶⁸ The Explanatory Memorandum gives the reason 'that they nonetheless further Australia's overseas aid objectives and therefore contribute to the broad public benefit of the Australia[n] community'.¹⁶⁹ The Explanatory Memorandum goes on to note that further regulatory measures are already in place for these organisations under the scrutiny of the OAGDS.¹⁷⁰ Entities on the Register of Environmental Organisations can seek the approval of the Environment Minister to be exempt from the 'in Australia' special conditions. They will need to convince the Minister that they have to engage in cross-border activities 'in order to effect change that will be of benefit to the Australian public'.¹⁷¹ The draft Bill also makes provision for exceptions of

¹⁶⁴ Exposure Draft, Tax and Superannuation Laws Amendment (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions, ss 30–15(2), 30–18, 31–10(2)(a).

¹⁶⁵ Exposure Draft, Tax and Superannuation Laws Amendment, (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions, s 30–18(1).

¹⁶⁶ Explanatory Materials, Exposure Draft: Tax Laws Amendment (2014 Measures No #) Bill 2014 (Cth) [1.110], s 30–18(2).

¹⁶⁷ Exposure Draft, Tax and Superannuation, (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions, s 30–18(4).

¹⁶⁸ Exposure Draft, Tax and Superannuation, (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions, s 30–18(5).

¹⁶⁹ Explanatory Materials, Exposure Draft: Tax Laws Amendment (2014 Measures No #) Bill 2014 (Cth), [1.113].

¹⁷⁰ Explanatory Materials, Exposure Draft: Tax Laws Amendment (2014 Measures No #) Bill 2014 (Cth), [1.115].

¹⁷¹ Explanatory Materials, Exposure Draft: Tax Laws Amendment (2014 Measures No #) Bill 2014 (Cth), [1.116].

scholarship, bursary or prize funds,¹⁷² some touring arts organisations¹⁷³ and a new category of medical research institutions that operate outside Australia.¹⁷⁴ Even with these carve outs, the Government's reform agenda, if implemented, will have a significant and lasting effect on the ability of Australian organisations and their donors to engage in tax effective cross-border philanthropy.

5. CONCLUSION

Since its inception, the common law notion of the public who should benefit from charity has not been confined to national borders, pointing to a broad conception of public benefit that supports charitable purposes being carried out overseas. This permissive stance on cross-border activities has been reflected in Australian charity legislation. However, as the legislative history of the tax exemption and gift deductibility provisions reveals, it has not been adopted in the Australian tax laws applying to these charitable tax concessions.

For income tax exempt entities, there were no geographic restrictions on charitable activities until 1997, in response to concerns (largely unfounded) that these entities were being used for tax avoidance purposes. While the 'in Australia' requirement in div 50 of the *ITAA 1997* provides some scope for income tax exempt entities to pursue their objectives outside Australia, its parameters remain uncertain, particularly since the decision in *Word Investments*. What has been clearer, is that the geographic boundaries of income tax exemption have historically been less restrictive than those for gift deductibility.

For gift deductibility, the requirement to be 'in Australia' was introduced in the first federal income tax legislation. While the meaning of 'in Australia' was never clearly stated in the legislation, its origins and early development suggest that the requirement to be 'in Australia' referred to an organisation's physical location only. However, the ATO ultimately adopted a stricter interpretation of 'in Australia', requiring that an organisation have its benevolent purposes in Australia and provide relief to people located in Australia. This interpretation was revealed to be fundamentally flawed based on the operation of the law, resulting in legal inconsistencies that have rendered the 'in Australia' provisions in div 30 incoherent. Remarkably, this flawed interpretation remained unchallenged for almost 50 years, indicating either that the incredible complexity of div 30 made it impossible to decipher, or that there has been resistance to mounting a legal challenge. Either way, the implications of this longstanding interpretation for many Australian organisations with purposes and beneficiaries overseas have been considerable.

It is only recently that the ATO has indicated a shift away from its strict interpretation of 'in Australia' for PBIs, reverting to its pre-1967 position that 'in Australia' requires only that an organisation be established and operated in Australia. This interpretation enables certain organisations with DGR status to have their purposes and beneficiaries

¹⁷² Exposure Draft, Tax and Superannuation Laws Amendment (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions, s 30–18(5).

¹⁷³ Exposure Draft, Tax and Superannuation Laws Amendment (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions, ss 30–18(9), 30–19(2)–(3), 30–305(1).

¹⁷⁴ Exposure Draft, Tax and Superannuation Laws Amendment (2014 Measures No 3) Bill 2014 (Cth): In Australia Special Conditions, s 30–80(1).

overseas. This more relaxed position is reflected in changes to the ATO's taxation guide and website. The ATO has announced it will issue a new public ruling on the meaning of 'in Australia'. This public ruling is likely to further cement the ATO's more permissive approach to cross-border philanthropy, while also redressing the inconsistencies in div 30. Until that happens the ATO's existing public ruling remains valid, albeit inconsistent with its website and taxation guide.

The resulting legal vacuum provides an opportunity for PBIs with purposes and beneficiaries overseas to seek DGR status. A number of law firms have already informed their clients of the ATO's shift in approach and the implications for cross-border charity and philanthropy.¹⁷⁵ As organisations act on this changed position by establishing PBIs for their overseas charitable activities, regulators will need to ensure appropriate oversight and monitoring of these cross-border charitable funds and activities. There are several regulatory measures that can be implemented for charities operating overseas to preserve the integrity of both the tax system and the not-for-profit sector. These range from inquiries during the initial registration process with the Australian Charities and Not-for-profits Commission (ACNC), which is required for charities to access tax concessions from the ATO, through to specific ongoing reporting requirements utilising the ACNC's annual information statement and the introduction of external conduct standards (ECSs) provided for in the *Australian Charities and Not-for-profits Commission Act 2012* (Cth).¹⁷⁶ Ironically, allowing charitable organisations with overseas purposes and beneficiaries to engage in cross-border transactions may result in greater transparency and accountability than has previously been the case, when many organisations resorted to workarounds by sending funds overseas through third party intermediaries.

The opportunity to establish a PBI for overseas charitable activities may also have the effect of making organisations less reliant on the OAGDS, particularly those engaged in 'benevolent relief' abroad.¹⁷⁷ The other 'in Australia' exceptions may also become less attractive for organisations that qualify for PBI status. This raises the question of whether an amendment to the ITAA 1997 is necessary to remove some or all of the categories of exceptions and to clarify the 'in Australia' language in div 30.¹⁷⁸ It

¹⁷⁵ See, for example, email from Mark Fowler, Neumann & Turnour Lawyers, to clients, 'ATO says DGRs can be Active Overseas', 4 March 2016 (on file with authors); John Vaughan-Williams, *Can Public Benevolent Institutions Operate Overseas?* (March 2016) Mills Oakley, <<http://www.millsOakley.com.au/can-public-benevolent-institutions-operate-overseas/>>; Paxton-Hall Lawyers, *Not-for-Profit Bulletin* (March 2016) 1–2, <<http://www.paxton-hall.com.au/Open-Attachment/131/March%202016.pdf>>. See also Krystian Seibert, 'Recent Developments Make it Easier to do International Giving Differently', *Generosity* (online), 7 April 2016 <<http://www.generositymag.com.au/recent-developments-make-it-easier-to-do-international-giving-differently/>>.

¹⁷⁶ See Silver, McGregor-Lowndes and Tarr, above n 154, 117–8, for specific recommendations on establishing an appropriate supervisory framework for monitoring cross-border giving.

¹⁷⁷ Relief organisations have been distinguished from organisations engaged in '[p]revention ... directed at the community at large' by the ACNC in its recent draft interpretation statement on the definition of a PBI. See ACNC, *Commissioner's Interpretation Statement: Public Benevolent Institutions* (Public Exposure Draft, CIS 2016/03) <http://www.acnc.gov.au/ACNC/Contact_us/Pub_consult_comment/Exposure_CIS_PBI/ACNC/Edu/Consultation_CIS_PBI.aspx?hkey=835cebae-55c6-44fc-b564-f3ea652a38ef>. As a result, organisations primarily engaged in community development work overseas will not qualify as PBIs, and those engaged in both relief and development work will likely maintain a separate fund under the OAGDS for their non-PBI 'prevention' activities.

¹⁷⁸ See Silver, McGregor-Lowndes and Tarr, above n 154, 118–9, for specific recommendations.

seems likely that an amendment will be required for div 50 to ensure that the 'in Australia' provisions are consistent for income tax exemption and gift deductibility. That is, 'principally' in Australia in s 50–50(a) will need to be removed so that the 'in Australia' requirement for tax exemption is not stricter than that for DGR status, which has never been the intention. Only a legislative amendment can rectify this inconsistency.

What the Australian Government will now do with its 'in Australia' reform agenda remains uncertain. It may prove extremely difficult for the Government to reverse its course and implement its reform agenda once PBIs with overseas charitable activities obtain DGR status. A critical juncture exists at present for the Government to clarify the law applying to the geographic parameters of income tax exemption and gift deductibility. The question is which path it will take in delineating the fiscal borders of Australia's non-profit tax concessions.

Does selecting a taxpayer for audit violate civil rights—a critical analysis of the Pakistani High Court’s decision?

Najeeb Memon¹ and Christian Lorenz²

Abstract

This paper deals with taxpayers’ selection for tax audit under the Self Assessment Scheme (SAS). Tax administrations across the world are continuously striving to improve the quality of taxpayer selection for audit. Often, the one who gets selected asks, ‘why me?’ Recently, the Lahore High Court (LHC) in Pakistan has held that selection for audit by field officers, being discriminatory, violates the civil rights enshrined in the Constitution of Pakistan, such as equal protection under law for all citizens. This paper reviews international best practices and finds that tax agencies, through collaboration of central and field officers, use both objective and subjective criteria in the selection. Another finding is that tax agencies in various jurisdictions are given leverage to select any taxpayer for audit and the courts there do not hold such selections unconstitutional. A critical analysis of the LHC decision in this paper finds that it suffers from legal and rational fallacies because it has ignored the autonomy given by the superior courts of various jurisdictions for discriminating citizens in taxation if that has a reasonable basis and helps in securing tax objectives such as redistribution of income.

Keywords: Taxpayer audit, Selection quality, Civil rights, Self Assessment Scheme (SAS)

¹ Dr Najeeb Memon has completed a PhD in Taxation from the University of New South Wales, Australia. He works as the Commissioner Inland Revenue, Federal Board of Revenue Government of Pakistan and is also a faculty member at Iqra University, Karachi. Email: memonnajeeb@yahoo.com.

² Dr Christian Lorenz, Centre for Applied Economic Research, Münster, Germany. Email: christian.lorenz@gmx.ch. Opinions and points of view expressed in this article are those of the authors and do not necessarily reflect any official position or policy.

1. INTRODUCTION

Since the introduction of the Self Assessment Scheme (SAS) in income tax, the process of taxpayer selection for audit has been of central importance and received much attention from policy makers in designing tax compliance management.³ Right selections help in detecting evading taxpayers and consequently deter non-compliance. The goal of picking taxpayers for audit is to reward compliant taxpayers instead of punishing the delinquent ones.⁴

Tax administrations have worked rigorously to improve the quality of selection. Most tax administrations in the world have been statutorily given the liberty to select any case for audit.⁵ Under best practices in this regard, the selection is partly based on the objective criteria emanating from data mining by a central office; and partly on some subjective judgment of case officers. This freedom in the selection and collaboration between central and field formations has provided for better responding to the dynamic business world and changes in taxpayers' behaviour.⁶ However, the individual who is selected for audit often asks, 'why me?' and alleges discrimination.⁷

In terms of similar allegations in Pakistan, the Lahore High Court (LHC) has recently held that a taxpayer's selection for audit by a case officer without fixed statutory selection criteria is discriminatory and violates the constitutional right of equality of citizens. The Pakistani Tax Code, detailed in Part 4 of this paper, empowers the central office and case managers to select any taxpayer for audit. For selection by the latter no criteria is provided in the tax code resulting in allegations of discrimination. The LHC has held that in the presence of power resting with the central office to select on the basis of risk parameters, the parallel authority of the case officers to select without statutory criteria violates the right of equality of citizens. Thus, the LHC expects that legislature should also provide objective criteria for selection by case managers. The LHC decision has ignited crucial debate as to whether a tax statute, which empowers the tax agency to pick any case for tax audit on the basis of subjective criteria, violates the basic civil right of equality enshrined in most state constitutions. This paper attempts to examine this issue and to draw guidelines for tax administration regarding selection of cases for audit.

A critical analysis of the LHC decision finds that the LHC, while suggesting fixed criteria for case managers, has erred in treating case managers and the central office as distinct administrative entities. Case managers and head office are two parts of an administrative body called the Federal Board of Revenue (FBR), which is the sole federal tax administration in the country. Both wings have to work in collaboration to identify risk to tax compliance in respect of one taxpayer or a class of taxpayers. The case managers report to the head office hence they are under control of the head office. The LHC therefore cannot segregate their roles in absolute terms. The LHC lacks

³ OECD, 'Compliance Risk Management: Managing and Improving Tax Compliance' (Forum on Tax Administration Compliance Group, Committee on Fiscal Affairs, Centre for Tax Policy and Administration, 2004) 15.

⁴ European Union, 'Compliance Risk Management Guide for Tax Administrations' (Directorate General Taxation and Customs Union, European Union Commission, 2010) 2.

⁵ OECD, 'Compliance Risk Management: Audit Case Selection Systems' (Information Note prepared by Forum on Tax Administration, Centre for Tax Policy and Administration, 2004) 7

⁶ OECD, *Audit Case Selection Systems*, (2004), 27.

⁷ Bonnie Lee, 'Why the IRS Picked You to Audit', *Fox Business* (online) March 22, 2012 <<http://www.foxbusiness.com/features/2012/03/22/why-irs-picked-to-audit.html>>.

legal jurisdiction to interfere in the internal distribution of work in tax administration. Although the division of functions in an organisation is important to prevent concentration of authority in the hands of a few, the nature and function of audit selection is such that both centre and field formations have to share information available at their levels and corroborate in making right selections. Case managers have local information about businesses and head office has data mining facility to generate case wise information from whole country. Nevertheless, the actual performance of an audit is recommended to be done by a separate team of administrators instead of the team which has selected the cases to prevent the misuse of authority.

This paper finds that the LHC has overlooked the latitude provided by the superior courts in tax matters as well as ignored the best international practices in this field. For example, in *M/S Ellahi Cotton Mills v Federation of Pakistan*, the Supreme Court of Pakistan allowed some taxpayers to be taxed under an entirely different tax regime (that is, the Presumptive Tax Regime). The LHC also appears to have also ignored the fact that most tax regimes must be discriminatory in order to secure some of their objectives, such as redistribution of income. Redistribution of income is possible mostly because of progressive taxation which is inherently discriminatory. The above mentioned latitude in tax matters is justified by superior courts on the basis that the public necessity is greater than the private. On the same footing, not giving freedom to tax administration at central office and case manager level to select taxpayers for audit may let some taxpayers get away with evading tax and that would appear even more discriminatory for the compliant taxpayers. This paper, therefore, concludes that a tax administration at both central and local level should be allowed to pick any taxpayer for audit even if that appears slightly discriminatory. Finally, this paper offers some suggestions to optimise selection of taxpayers for audit.

The paper is divided into five parts. Part 2 takes an overview of the audit process in the context of tax objectives and public expectation. Part 3 reviews process of selection for audit under the Self Assessment Scheme (SAS). This part also discusses the link between central and field offices for better quality of selection. Part 4 reviews the sections of old and new Pakistani income tax legislation pertaining to taxpayers' selection for audit. Later, this part offers a critical examination of the LHC decision in the context of relevant Articles of Constitution of Pakistan and judgments of the Apex Court. Part 5 presents recommendations to make the taxpayer selection more objective, transparent and fairer. Part 6 provides a conclusion.

2. TAX AUDIT: OBJECTIVES AND PUBLIC EXPECTATIONS

Historically, income tax was collected through the official assessment system whereby every taxpayer's returned version for each year had to be investigated through examination of their books of accounts. Later, high compliance and administrative costs in official assessments encouraged the government to introduce the SAS for collecting income tax. Under the SAS, every taxpayer was entrusted with the responsibility of assessing their income tax liability by complying with all the provisions of the Tax Code and declaring all activities generating income.⁸ The Tax Office mostly accepts these declarations after reviewing tax returns. However, some

⁸ Nobuaki Usui, *Penetration of the Self Assessment System for Income Tax Half-a-Century's Experience in Post War Japan* (2002) <<http://ideas.repec.org/p/idx/brikps/4599.html> accessed 4 November 2012>.

taxpayers are picked for audit of their tax affairs. Any mistakes by taxpayers under the SAS, whether deliberate or unintentional, when detected in the audit incur various levels of penalties⁹ that are aimed at discouraging non-compliance.

A tax audit is an investigation by tax authorities into the background of tax returns submitted by a taxpayer to ensure accurate filing of returns. The audit is an examination of a person's financial transactions of a person and includes assessment of both business and personal financial matters. An inquiry may be made into assets and expenditures of business and professional entrepreneurs. The extent of inquiry, however, depends on the facts of each case and may be limited to either merely a telephone call to the taxpayer or a more detailed investigation including visiting the taxpayer's premises.¹⁰

Generally the role of audit is to (1) detect individual cases of non-compliance; (2) promote voluntary compliance by increasing the probability of detection and penalties for non-compliant behaviour; (3) provide a good opportunity for tax administrations to educate taxpayers on their legal obligations or book-keeping requirements, thereby improving future compliance; and (4) gather information on the health of the tax system and the evasion techniques applied by taxpayers. More importantly, the audit must deliver in the SAS due to its punitive and enforcement role¹¹ so that a high probability of punishment to evaders is ensured. It is worth referring here to the goal of the Taxpayer Audit Program, as articulated by the Australian Tax Office (ATO) during the introduction of SAS in the Access and Equity Plan for 1991–92/1993–94:

To promote voluntary compliance through a balanced program which is seen by the community at large to be soundly based between taxpayer groups and which, within each group detects and brings to account those who do not pay their correct amount of tax.

The key message that will be sent to the target groups is that enforcement activity is undertaken as an incentive to voluntary compliance, not as a punitive measure. All complying taxpayers should rightfully expect that those who do not comply with their tax obligations do not benefit from that non-compliance.¹²

Right selection of taxpayers for audit in SAS is important for two main reasons. First, better the quality of the selection (right cases are picked up for audit), the higher the probability of detecting evading taxpayers.¹³ Studies show that higher the probability

⁹ Some countries (like Pakistan) do not use penalties for incorrect declarations in SAS returns (see *Income Tax Ordinance, 2001*, available at <<http://www.fbr.gov.pk>>).

¹⁰ Australian Tax Office, *Tax Audits—What are They?* (2012), <<http://www.ato.gov.au/individuals/content.aspx?doc=/content>, accessed 12 October 2012>.

¹¹ John Wickerson, *Managing the Risks to Revenue: A New Model for Evaluating Taxpayers Audit Programs* (PhD Thesis, University of Canberra, 1995) 355.

¹² Ibid 356.

¹³ Kent W Smith and Karyl A Kinsey, 'Understanding Taxpayer Behavior: A Conceptual Framework With Implications for Research', (1987) 21 *Law and Society Review* 4, 639–663. See also Silvia A Madeo, Albert Schepanski and Wilfred C Uecker, 'Modelling Judgments of Taxpayer Compliance' (1987) 62 *Accounting Review* 2, 323–342; Joel Slemrod, Marsha Blumenthal and Charles Christian, 'Taxpayer Response to an Increased Probability of Audit: Evidence From a Controlled Experiment in Minnesota' (2001) 79 *Journal of Public Economics* 3, 455–483.

is of being caught, the lesser are the tax evasive practices.¹⁴ Evading taxes is kind of gambling with the tax authorities. The risk or deterrence of being caught and losing money needs to be higher than the expected gain tax evasion. A study by the State Bank of Pakistan found that the lack of audits was responsible for poor tax collections in the years immediately after the introduction of the SAS in 2003. Further, negative growth of collections on demand occurred after 2003 when audits ceased.¹⁵

Correct selection of audit subjects also optimises resource allocation of the tax administration because every taxpayer indiscriminately cannot be subjected to audit due to resource constraints.¹⁶ Studies show that the greater the specificity in identifying the cases the lesser the number of selected cases.¹⁷

3. REVIEW OF PROCESS AND QUALITY OF SELECTION FOR AUDIT UNDER THE SAS

Although most tax regimes in developed economies have shifted to the SAS for reasons mentioned in Part 2, tax administrations have kept the statutory authority to audit any taxpayer either on the basis of objective criteria or even a hunch. Legislative framework in those countries allows tax administrations to scrutinise the tax affairs of any taxpayer. Thus, tax assessment ultimately remains a statutory prerogative of tax administrations, which perhaps explains why selection of cases for audit has not been challenged before the courts as unconstitutional or unlawful.

However, under the SAS, the process of improving the quality of taxpayer selection for audit has become the most important part of compliance management. The criteria used for selection is usually is not made public perhaps because divulging this information to taxpayers may help them strengthen tax evasion strategies.¹⁸ On the other hand, some tax administrations have recently made the criteria public (like Pakistan, which has revealed at least for 50 per cent of the relevant selection criteria) for the sake of transparency and to improve their tax risk management and thereby ensure voluntary compliance.¹⁹

The selection of cases for audit could be either random or on the basis of some criteria. Studies show that random selection of cases does not produce desired results²⁰ because they are not designed to target those with highest probability of non-compliance. Better quality of selection to ensure optimum compliance, therefore, is

¹⁴ Michael G Allingham and Agnar Sandmo, 'Income Tax Evasion: A Theoretical Analysis' (1972) 1 *Journal of Public Economics*, 323, 330.

¹⁵ State Bank of Pakistan, *Public Finance and Fiscal Policy, Annual Report 2006* <<http://www.sbp.org.pk/reports/annual/arfy06/Chp-4.pdf>> 77.

¹⁶ Wickerson, above n 11, 353, 362; also see Margaret E Cotton, 'Selecting Cases for Audit — Getting It Right' (2007) *Asia Pacific Tax Bulletin*, 13.

¹⁷ Cotton, above n 16.

¹⁸ The Australian Tax Office (ATO) provided details on how it selects cases for audit first time in 2006 (see Michael Jenkins, 'Profit Shifting and ATO's Approach to Risk Profiling' (2007) *Asia Pacific Tax Bulletin*, 65; Office of Auditor General of Manitoba, Canada, 'Audit Findings and Recommendations' (2012), <<http://www.oag.mb.ca/reports/>> 304; also see PricewaterhouseCoopers, 'Korean National Tax Service Issues Guidelines for Selecting Candidates for Tax Audit' (2009) *Worldwide Tax Daily*, 188.

¹⁹ Jeyapalan Kasipillai, 'Malaysia-New Tax Audit Framework' (2009) 56 *Tax Notes International*, 2, 129; PwC, (2009), 188.

²⁰ See Wickerson, above n 11, 360.

generally based on risk management criteria of selection.²¹ The selection criteria could consist of quantitative and qualitative factors.²²

Based on quantitative and qualitative factors, there are three major pre-requisites for effective audit selection,²³ which are determined on the basis of the strike rate²⁴ (that is, proportion of audits and the increase in tax payable).²⁵ Firstly, pre- and post-audit information should be recorded in a well-developed ICT-based management system. Secondly, skilled audit selection teams need to be equipped with ICT, accounting and investigative instincts. Thirdly, the organisational commitment to an effective audit system is imperative. More simply, audit selection includes procedures and judgments to prioritise the work in order to make optimum use of the administrative resources.²⁶

Compliance cannot be ensured by a single action strategy²⁷ and thus the selection process in most developed jurisdictions consists of two levels. In the first level of strategic risk management, electronic data mining and statistical analysis techniques are used to identify the business sectors where there is likelihood of compliance risk.²⁸ This primarily involves a systematic filtering and prioritising exercise. This step of data mining requires well-developed ICT program as well as a reliable and authentic database, along with a team of highly skilled assessors to produce the desired results,²⁹ for example, Japan's national tax comprehensive management, Kohuzei Sougou Kanri, verifies, tabulates and processes data which is uploaded in the system.³⁰ Studies have noted that without support of ICT good case selection remains a difficult task.³¹ In the second level, the use of local knowledge by case officers is necessary, such as information that the car purchased in name of the wife is actually intended for a taxpayer.³²

In the Netherlands large business are selected for audit on an individual basis only.³³ Indeed, in most OECD countries, in terms of selection of large businesses for audit, the involvement of case managers is quite considerable.³⁴ Case reviews by auditors are considered the traditional method by which audit cases are selected, which was especially true during period when there was little or no ICT support available.³⁵ This perhaps explains why in developing countries selection by auditors is a common procedure.

²¹ OECD, 'Strengthening Tax Audit Capabilities: Auditor Workforce Management—Survey Findings and Observations' (Information Note prepared by Forum on Tax Administration, Centre for Tax Policy and Administration, 2006), 24.

²² Wickerson, above n 11, 357.

²³ OECD, above n 3, 5.

²⁴ Wickerson, above n 11, 358.

²⁵ OECD, above n 3, 9.

²⁶ Wickerson, above n 11, 353.

²⁷ OECD, above n 3, 6.

²⁸ Wickerson, above n 11, 354.

²⁹ OECD, above n 3, 10.

³⁰ Tapan K Sarker, 'Improving Tax Compliance in Developing Countries Via Self-Assessment Systems—What Could Bangladesh Learn From Japan' (2003) 9 *Asia Pacific Tax Bulletin*, 6, 173.

³¹ OECD, above n 3, 12.

³² OECD, above n 21, 16. See also, OECD, above n 3, 11.

³³ OECD, above n 21, 16.

³⁴ OECD, above n 21, 16–26.

³⁵ OECD, above n 3, 11.

More broadly, strategic risk management is done in the central offices of tax administration whereas the local selection process is carried out by the field formations. When the central and field offices operate in synchrony, synergy develops and the selection process produces better results. In practice, however, most selections are decentralised.³⁶ Some examples of developed tax jurisdictions follow so as to provide a better understanding of the role of central and field offices of tax administration in selection of cases.

In the US, the Internal Revenue Service (IRS) and Discriminate Function (DIF), which does macroeconomic statistical analysis, operate together to choose cases for audit.³⁷ The US uses highly specialised Centralized Examination Classification Systems (CECS) for macro level analysis.³⁸ Beyond that, the review of selection by states of Florida and Columbia show that personal observations are predominantly used for selection.³⁹

In Canada two tiers of tax administration are involved in the selection of cases. First the central office performs a statistical analysis and then the experienced auditors examine that data and, using local knowledge, select cases for audit.⁴⁰ Local knowledge plays a decisive role in audit selection.⁴¹ France and Japan also use collaboration between central and field offices for selection of cases.⁴² In contrast, the UK selection of cases for audit collectively or independently involves three tiers of tax administration.

New Zealand (NZ) has a Taxpayer Audit Selection System (TASS) whereby some cases are picked on the basis of selected queries. These cases are then exported to individual investigators to further scrutinise the returns. The investigators can also seek help from compliance risk officers (CROs) before making a final selection.⁴³ The individual auditors thus have the key role in selecting cases for audit.⁴⁴ A study based on a review of practices around the world conducted by Hasseldine shows that the NZ tax administration practice of audit selection is among the best in this regard.⁴⁵

Australia also has a variety of tax audits such as specific issue audits or reviews and comprehensive audits. The latter usually follow review audits and data matching based on the electronic system. They also rely on other factors such as errors in the taxpayer's returns, third party information or even suspicion of participation in a cash economy.⁴⁶ The ATO also announces the 'hit list' of areas which could be one reason

³⁶ Wickerson, above n 11, 354.

³⁷ OECD, above n 3, 15.

³⁸ OECD, above n 3, 20.

³⁹ Pappas Group, *What is Florida's Tax Audit Process?* <http://www.pappastax.com/article/business-facing-fdor-sales-tax-audit-will-want-read/>.

⁴⁰ OECD, above n 3, 24.

⁴¹ OECD, above n 3, 27.

⁴² OECD, above n 21, 17.

⁴³ New Zealand Inland Revenue Department, *Case Selection and the Conduct of Audits: Part 4, Performance of Taxpayer Audit* <<http://http://www.oag.govt.nz/2003/inland-revenue/part4.htm>>.

⁴⁴ New Zealand Inland Revenue Department, *What is an Audit?* <<http://www.oag.govt.nz/2003/inland-revenue/part4.htm>>.

⁴⁵ John Hasseldine, *Study Into Best Practices in Tax Administration* (Consultancy Report for National Audit Office, 2007).

⁴⁶ ATO, *How We Check Compliance* (2013) <<http://www.ato.gov.au/General/How-we-check-compliance/>>.

to pick the cases for audit in order to encourage taxpayers to fully comply with the tax code.⁴⁷ This procedure indicates that humans are actively involved in audit activities at the ATO.

Factors evident in the selection criteria of various countries demonstrates that quantitative (financial), qualitative (social and psychological) and other elements⁴⁸ collectively contribute to the selection criteria. Besides the objective indicators, factors used in the criteria also include items which are nothing but subjective judgments such as tips from other taxpayers or even hunches such as seeing something odd in a return.⁴⁹ There is certainly sufficient evidence on record that returns of corporations are often selected by humans instead of computers.⁵⁰

The above detailed review of selection of cases for audit by various tax administrations indicates that it is the tax administration which selects taxpayers for audit. Sometimes the central office selects on the basis of data mining; case managers act on the basis of subjective judgment; or both the central agency and case managers work in synergy. In most jurisdictions there is no fixed criteria provided by statute for the selection of taxpayers for audit which is followed by tax administrations. Indeed, criteria designed by tax administrations at different levels of hierarchy depend upon the latest facts and circumstances revealed by taxpayers. There is also no distinction provided in most tax jurisdictions between central and local offices in terms of their role in the selection of cases because they are part of the one and the same pillar of the state (executive) and that pillar is entrusted with the job of taxpayer selection to make the audit system effective.

The reason for not having fixed criteria is that there is a need for constant review and amendment of criteria. This flexibility enables tax administrations to adapt to the dynamic business world which often capitalise on the latest available tax avoidance and evasive opportunities. As mentioned above, the post-audit information is also very useful in the audit selection process because feedback from earlier audits help in updating selection criteria. This need for updates and amendments of the criteria after each audit exercise shows that they cannot be fixed. On the contrary, the criteria need to be constantly modified in an innovative way and therefore tax administrations should be given the liberty to adjust the criteria as and when required.

Overall the audit selection criteria are flexible in that quantitative and qualitative techniques by both computers and case managers respectively are used. The combination of statistical analysis by computers and intelligent judgment by humans is expected to synergise for good quality selection and to produce the desired results under the SAS.

⁴⁷ Mason Lloyd Accounting Firm (Australia) <<http://www.masonlloyd.com.au/blog?post=%2029>>

⁴⁸ Cotton, n 16, 12.

⁴⁹ AL Gutkin, *How Tax Returns Are Selected for Audit?*
<<https://totseans.com/totse/en/privacy/taxaudit.html>>.

⁵⁰ Ibid.

4. SELECTION PROCESS UNDER THE PAKISTANI TAX CODE

In order to understand the evolution of selection of taxpayer's audit, the legal framework under the repealed ordinance (*Income Tax Ordinance 1979*) and the new ordinance (*Income Tax Ordinance 2001*) is visited in the following sections.

4.1 Repealed ordinance

Under s 59 of the repealed ordinance,⁵¹ non-corporate taxpayers were provided with a self-assessment which was very liberal. The acknowledgment of filing of return was deemed as an assessment order. Only some cases were selected for audit by the central tax authority or its subordinate authorities by any method, which was prescribed by the central office. More simply, the method or scheme of selection was made part of the legal framework of the SAS. This shows that historically the selection, under the statute, was the domain of the central office with no or little role for the case managers.

4.2 New ordinance

The legal framework under the repealed ordinance regarding the selection of cases under SAS has been almost replicated in the new *Income Tax Ordinance 2001* except that now commissioners, who are case managers, can also select a case for audit.

There are two sections in the new Income Tax Ordinance which deal with taxpayer selection for audit. The first is s 177, which empowers the commissioner to call for taxpayer records after communicating the reasons for selection and then conduct the audit.

177. Audit.

(1) The Commissioner may call for any record or documents including books of accounts maintained under this Ordinance or any other law for the time being in force for conducting audit of the income tax affairs of the person and where such record or documents have been kept on electronic data, the person shall allow access to the Commissioner or the officer authorized by the Commissioner for use of machine and software on which such data is kept and the Commissioner or the officer may have access to the required information and data and duly attested hard copies of such information or data for the purpose of investigation and proceedings under this Ordinance in respect of such person or any other person:

⁵¹ **59. Self-assessment.**—(1) Where the return of total income for any income year furnished by the assessee [not being or a company engaged in the business of banking, leasing and modaraba,] under section 55 qualifies for acceptance in accordance with the provisions of a scheme of self assessment made by the Central Board of Revenue for that year or under any instructions or orders issued there under, the [Deputy Commissioner] shall assess, by an order in writing, the total income of the assessee on the basis of such return and determine the tax payable on the basis of such assessment.

[*Explanation.*—For the removal of doubt it is hereby declared that a return of total income furnished under section 55 does not include a return of total income furnished under section 57.]

(1A) Notwithstanding anything contained in sub-section (1), the Central Board of Revenue or any authority subordinate to it, if so authorized by the Central Board of Revenue in this behalf, may, in accordance with a scheme referred to in sub-section (1), select out of returns referred to in that sub-section any cases or classes of cases or persons or classes of persons, howsoever determined, for assessment under section 62, and the [Deputy Commissioner] shall proceed to make the assessment under that section or, if the circumstances so warrant, under section 63, accordingly.

Provided that—

- (a) the Commissioner may, after recording reasons in writing call for record or documents including books of accounts of the taxpayer; and
- (b) the reasons shall be communicated to the taxpayer while calling record or documents including books of accounts of the taxpayer:

Provided further that the Commissioner shall not call for record or documents of the taxpayer after expiry of six years from the end of the tax year to which they relate.

(2) After obtaining the record of a person under sub-section (1) or where necessary record is not maintained, the Commissioner shall conduct an audit of the income tax affairs (including examination of accounts and records, enquiry into expenditure, assets and liabilities) of that person or any other person and may call for such other information and documents as he may deem appropriate.

(3)⁵²

(4)⁵³

(5)⁵⁴

(6) After completion of the audit, the Commissioner may, if considered necessary, after obtaining taxpayer's explanation on all the issues raised in the audit, amend the assessment under sub-section (1) or sub-section (4) of section 122, as the case may be.

(7) The fact that a person has been audited in a year shall not preclude the person from being audited again in the next and following years where there are reasonable grounds for such audits ...

(8) The [Board] may appoint a firm of Chartered Accountants as defined under the *Chartered Accountants Ordinance, 1961* (X of 1961) [or a firm of Cost and Management Accountants as defined under the *Cost and*

⁵² Subsection (3) omitted by the *Finance Act 2010*. The omitted subsection (3) read as follows: '(3) The Board shall keep the criteria confidential'.

⁵³ Subsection (4) omitted by the *Finance Act 2010*. The omitted subsection (4) read as follows:

(4) In addition to the selection referred to in sub-section (2), the Commissioner may also select a person or classes of persons for an audit of the person's income tax affairs having regard to —

- (a) the person's history of compliance or non-compliance with this Ordinance;
- (b) the amount of tax payable by the person;
- (c) the class of business conducted by the person; and
- (d) any other matter which in the opinion of Commissioner is material for determination of correct income.

⁵⁴ Subsection (5) omitted by the *Finance Act 2010*. The omitted subsection (5) read as follows:

(5) After selection of a person or classes of persons for audit under sub-section (2) or (4), the Commissioner shall conduct an audit of the income tax affairs (including examination of accounts and records, enquiry into expenditure, assets and liabilities) of such person or classes of persons.

Management Accountants Act, 1966 (XIV of 1966)], or a firm of Cost and Management Accountants as defined under the *Cost and Management Accountants Act, 1966 (XIV of 1966)* to conduct an audit of the income tax affairs of any person [or classes of persons ...] and the scope of such audit shall be as determined by the [Board] [or the Commissioner] on a case to case basis.

(9) Any person employed by a firm referred to in sub-section (8) may be authorized by the Commissioner, in writing, to exercise the powers in sections 175 and 176 for the purposes of conducting an audit under that sub-section.

(10) Notwithstanding anything contained in sub-sections (2) and (6) where a person fails to produce before the Commissioner or a firm of Chartered Accountants or a firm of Cost and Management Accountants appointed by the Board or the Commissioner under sub-section (8) to conduct an audit, any accounts, documents and records, required to be maintained under section 174 or any other relevant document, electronically kept record, electronic machine or any other evidence that may be required by the Commissioner or the firm of Chartered Accountants or the firm of Cost and Management Accountants for the purpose of audit or determination of income and tax due thereon, the Commissioner may proceed to make best judgment assessment under section 121 of this Ordinance and the assessment treated to have been made on the basis of return or revised return filed by the taxpayer shall be of no legal effect.

The second is s 214(c), which empowers the central office (FBR) to select cases for audit through either random or parametric method. However, the procedure for conducting audit shall be the same as provided in s 177.

214C. Selection for audit by the Board.

(1) The Board may select persons or classes of persons for audit of Income Tax affairs through computer ballot which may be random or parametric as the Board may deem fit.

(2) Audit of Income Tax affairs of persons selected under sub-section (1) shall be conducted as per procedure given in section 177 and all the provisions of the Ordinance, except the first proviso to sub-section (1) of section 177, shall apply accordingly.

(3) For the removal of doubt it is hereby declared that Board shall be deemed always to have had the power to select any persons or classes of persons for audit of Income Tax affairs.

A review of the current legal framework shows that central selection has to be parametric, which means it should be based on reasons. On the other hand, despite the fact that the statute has given some authority to case managers to pick cases for audit, they have yet to disclose the reasons as to why an individual taxpayer has been picked. In contrast to the practice in other countries as discussed in Part 3, case managers in Pakistan cannot act on the basis of mere belief or 'hunch'. Rather, they have to disclose the specific reasons to the taxpayer. In other countries, the method is disclosed and communicated for the sake of transparency and not as a statutory

requirement. This indicates that the authority of selection for audit is comparatively constrained in Pakistan as both central office and case managers have to officially disclose any reasons.

Further, the reasons, which are required to be communicated to taxpayers on their selection, are mostly open to challenge before the courts in terms of whether they are sufficient and reasonable. This statutory requirement in Pakistan has made the criteria for selection relatively inflexible. Hence, tax administration in Pakistan has limited discretion when compared to other countries.

A review of the old and new legal framework therefore shows that there is a tendency in Pakistan to maintain the function of selecting taxpayers for audit with the central office and that case managers are not called to collaborate on the selection. Since case managers historically have on many occasions offered useful insights in terms of individual cases they perhaps should have more say in the selection process. Furthermore, there is no rationality in statutorily splitting the tax administration into two tiers, that is, central office and case managers, because they are actually both part of the same organisation with frequent exchange of officers. Although splitting the tax function may be essential for the prevention of concentration of authority and its misuse, it is not advisable to split the function of selection for audit. By its nature, this process requires close collaboration and sharing of information between centre and field formations to make the right selections. Nevertheless, the audit performance function should be separated from audit selection to prevent concentration of authority.

In a developing country like Pakistan, where making the right selection is already a hard task due to less developed tax administration and a large cash economy, the less discretionary and inflexible selection procedure under the existing legal framework has resulted in protracted litigation and an ineffective audit system. Despite a decade-long and very expensive tax reform process under the auspices of the World Bank, whereby the SAS was introduced, Pakistan still has not been successful in developing an undisputed and effective system for taxpayer selection and audit.

4.3 Does selecting a taxpayer for audit violate civil rights?

Adding to the weakness in the Pakistani legal framework discussed above, the LHC has recently held that the selection by commissioners under s 177 is discriminatory and violates the civil rights of a citizen, which are enshrined under the Constitution of Pakistan.⁵⁵ The court concluded that s 177 is ultra vires and illegal. Furthermore, the LHC offered this verdict under Article 199 of the Constitution of Pakistan which gives High Courts of states/provinces an original jurisdiction to issue an order of mandamus in matters where adequate remedy under the law is not provided.⁵⁶ Consequently, the selection process in Pakistan reverted to the position that prevailed under the repealed ordinance where only the central office under its SAS could select the cases. Whether or not the LHC has examined all the legal and conceptual facets of the subject and considered internationally accepted best practices in this regard before reaching its conclusion is discussed below.

⁵⁵ *M/S Chenone Stores Ltd v Federation and Others in Constitutional Petition No. 393 of 2012 reported as 2012 TAX 109 and 2012 PTD 1815*.

⁵⁶ Article 199, Constitution of Republic of Pakistan <<https://pakistanconstitutionlaw.com/article-199-jurisdiction-of-high-court/>>. Similar jurisdiction also rests with superior courts in other jurisdictions. For example, in Australia s 39B of *Judiciary Act 1903* (Cth) grants the Federal Court of Australia with jurisdiction to order mandamus <http://www.austlii.edu.au/au/legis/cth/consol_act/ja1903112/s39b.html>.

4.3.1 Selection for audit and scope of Article 10A

In *M/S Chenone Stores Ltd*⁵⁷, the LHC held that s 177, which empowers the commissioner to select a taxpayer for audit, violates Articles 10A, 18, 23 and 25. The decision basically raises three questions. First, is s 177 really discriminatory? Second, can a tax statute contain provisions which are discriminatory? Third, can ss 177 and 214(c) be aligned with internationally adapted best practices regarding selection criteria for taxpayer audit? These questions are discussed further below.

The LHC held that a provision of law, which is ex-facie discriminatory, also violates the right to due process (this also covers the right to a fair trial and is enshrined in Article 10A),⁵⁸ because the fundamental rights in the constitution exist in a symbiotic relationship. Therefore violation of one right can cause prejudice to other related rights. The relevant part of the decision is reproduced below.

These skeletal provisions lack check on the exercise of power by the commissioner, who is therefore free to pick and choose any person or taxpayer for audit. The requirement of giving reasons in the first proviso to section 177 (1) does not remedy the inherent flaw. In fact giving reasons reaffirms the targeted approach of the tax regulator. ... Legislative policy of the Ordinance cannot equip the commissioner with naked power to pick and choose according to his whims and wishes. Even though the Commissioner may be the best person in the system to identify a tax default, he cannot enjoy unguided discretion but only exercise discretion which is under a legislative guideline showing structured, uniform and transparent exercise of discretion. Hence these provisions as they stand are ex-facie discriminatory and give an un-checked license to the Commissioner. Any provision of the law that is ex-facie discriminatory also offends the right to 'due process' under Article 10A. Fundamental rights in our constitution have a symbiotic relationship. They are interrelated and mutually support each other. A provision of law that is ex-facie discriminatory and is also being applied discriminatorily cannot pass the text of the due process under Article 10A of the Constitution. Similarly, any such illegal and unconstitutional invasiveness to call for the record for verification is extra burden on the taxpayer and unduly interferes with his business offending Articles 18 and 23 of the Constitution. Hence section 177(1) and its first proviso offend Article 10A, 18, 23 and 25 of the Constitution.⁵⁹

A critical perusal of the court's findings leads to the following conclusions. First, the probing of any taxpayer on the part of the tax agency, in order to ensure that no violation of tax law is committed, in itself may not violate any civil rights in general and the right to a fair trial in particular. More simply, a civil right of equal protection does not make any person immune from a reasonable probe for the purpose of enforcement of a law. For the same reason, the Bill of Taxpayer Rights passed by the US congress does not provide a taxpayer with any right to challenge selection for audit,

⁵⁷ *M/S Chenone Stores Ltd*, above n 55.

⁵⁸ s 10A. [Right to fair trial: For the determination of his civil rights and obligations or in any criminal charge against him a person shall be entitled to a fair trial and due process.].

⁵⁹ *M/S Chenone Stores Ltd*, above n 55 at 30 [32].

which is the prerogative of the IRS.⁶⁰ Similarly, the legal frameworks of the sample countries discussed above also demonstrated that selecting cases is a statutory function of tax agencies across the world. Nevertheless, under certain tax regimes it is a taxpayer's right to know that why they have been selected and the tax agency has to provide the reasons.⁶¹ However, those reasons are not open to challenge in court. Thus, the LHC can be seen to have acted against this basic understanding of the process for case selection. More importantly, it is also widely acknowledged that legislation needs to provide the administration with wide powers for information gathering which is essentially related to the performance of the administration's functions under the law. An audit is a process of verification by obtaining relevant information which cannot be denied to a tax agency.

Second, s 177 does not violate the 'substantive due process' enshrined in Article 10A because the returns filed under the ordinance are deemed as assessed under s 120(1) and statutorily these returns are liable to a possible audit under s 120(1A). All citizens of Pakistan have been given identical treatment under the law. It is incorrect to assume that 'substantive due process' is violated merely because specific criteria for selection by the commissioner have been omitted from s 177. In this regard, the LHC's following remarks also require comment.

It is for the reason that, in the past, section 177 specifically provided a guideline and a criteria for the Commissioner to observe before selecting a person for audit. The under mentioned criteria re-examined on the statute till 27-10-2009:

- (a) The person's history of compliance or non-compliance with this ordinance;
- (b) The amount of tax payable by the person;
- (c) The class of business conducted by the person; and
- (d) Any other matter which is in the opinion of the Commissioner is material for determination of correct income.

Subsection (d) above meant that the Commissioner could add to the list of existing criteria for carrying out selection of the taxpayer for audit.⁶²

The court held that 'the provisions are noticeably silent regarding parameters, guidelines or criteria which can form the basis for triggering the said provisions into the motion'.⁶³

The court's remark that legislative guidelines, like the one present in the form of four criteria in s 177 until October 2009, are mandatory for the completion of the due process is also defective. Providing taxpayers with specific statutory reasons is not compulsory under the best practices for selection in most developed jurisdictions. As stated in Part 2, the dynamic nature of business and changing taxpayer compliance

⁶⁰ See Marvin E Owen, *IRS Audit and Your Bill of Rights* (10 December 2012) <<http://www.meocpa.com/irsaudit.html>>.

⁶¹ See IRS, *Part-4 Examining Process, Internal Revenue Manual* <http://www.irs.gov/irm/part4/irm_04-001-003.html#d0e135>.

⁶² *M/S Chenone Stores Ltd*, above n 55 at [Para 27 on Page 25].

⁶³ *M/S Chenone Stores Ltd*, above n 55 at Para 29 at Page 26.

behaviours demand that criteria for selection should be flexible rather than fixed criteria in the statute. The LHC therefore needs to provide stronger reasoning in order to challenge the mechanism of selection in developed tax jurisdictions.

Consistent with Part 4.2, even without the four criteria, commissioners are required to give reasons, thus the court's insistence on statutory criteria is not logical. Interestingly, s 214(c) also does not contain any specific statutory criteria for selection but that section has not been pronounced unconstitutional by the court, which reflects contradiction within court's own judgment. Put more broadly, the audit selection under s 177 neither causes any unreasonable probes, searches or seizures nor does it cause double jeopardy. Hence it should be seen strictly in terms of 'procedural due process'.⁶⁴ Moreover, in tax matters courts have previously allowed searches for the fair enforcement of tax laws. For example, in respect of sales tax the courts have justified searches of taxpayers without a warrant if the circumstances so demand.⁶⁵

Lastly, the above finding of LHC is inconsistent with the very spirit of taxation which suggests redistribution of income from rich to poor through inequitable and relatively large tax burden on rich as compared to poor sections of population. For example, progressive taxation and varying tax rate regimes for different classes of income are discriminatory but have been held as constitutional by the courts. Even presumptive tax regimes are justified for persons who otherwise escape taxation due to their activities in informal sectors.

4.3.2 Analysis of scope of Articles 18 and 23 and the selection for tax audit

The LHC held that because audit selection, being discriminatory, causes unconstitutional invasiveness which consequently interferes with the taxpayer's business, it therefore violates Articles 18⁶⁶ and 23.⁶⁷ As a result, the taxpayer cannot carry on their business. The relevant part of the court's decision is reproduced below.

A provision of law that is ex-facie discriminatory and is also being applied discriminatorily cannot pass the test of the due process under Article 10A of the Constitution. Similarly, any such illegal and unconstitutional invasiveness to call for the record for verification is extra burden on the taxpayer and unduly interferes with his business offending Articles 18 and 23 of the Constitution.⁶⁸

⁶⁴ The Free Dictionary <<http://legal-dictionary.thefreedictionary.com/Due+Process+of+Law>>.

⁶⁵ *Messrs Food Consults (Pvt.) Ltd. Lahore and another v Collector Excise and Sales Tax Lahore and two others* (2004 PTD 1731).

⁶⁶ **18. Freedom of trade, business or profession:** Subject to such qualifications, if any, as may be prescribed by law, every citizen shall have the right to enter upon any lawful profession or occupation, and to conduct any lawful trade or business:

Provided that nothing in this Article shall prevent:—

- (a) the regulation of any trade or profession by a licensing system; or
- (b) the regulation of trade, commerce or industry in the interest of free competition therein; or
- (c) the carrying on, by the Federal Government or a Provincial Government, or by a corporation controlled by any such Government, of any trade, business, industry or service, to the exclusion, complete or partial, of other persons.

⁶⁷ **23. Provision as to property:** Every citizen shall have the right to acquire, hold and dispose of property in any part of Pakistan, subject to the Constitution and any reasonable restrictions imposed by law in the public interest.

⁶⁸ *M/S Chenone Stores Ltd*, above n 55 at [Para 32 on Page 30].

The court, however, has failed to explain how a civil or a criminal audit started with valid reasons by a statutory agency could cause interference in a business and how a legal inquiry could obstruct a taxpayer carrying on their lawful business or profession. In this case the taxpayer will have been provided with all their rights during the audit process and no prejudice may be caused to them before or even after the conclusion of the audit. The taxpayer also has the right to appeal against the outcome of the audit before various appellate authorities from the Commissioner (Appeals) to the Supreme Court. Further, the court has also failed to appreciate that the SAS puts less of a burden on taxpayers as compared to official assessments which envisage investigating every taxpayer. A tax regime containing the SAS with a few taxpayers selected for audit every year is much less cumbersome than the regime which envisages official assessment of every case every year.

In addition, the LHC's judgment has two conceptual faults. First, even when a provision of law causes interference with taxpayers' businesses the courts have traditionally allowed it for the welfare of the public. This is on the basis of the famous maxim, *Salus populi est suprema lex* ('the welfare of the people is the paramount law') and *Necessitas publica major est quam privata* ('public necessity is greater than private'). In Pakistan, which has a less resourceful tax administration and a poor tax to GDP ratio (that is, less than 10 per cent), the selection of cases, like other investigations under other laws by other agencies, could not be wholly carried out on the basis of rigid statutory criteria. Therefore, as other government agencies operate with the flexible tools, the FBR should also not be stopped from selecting cases for audit because this may result in a loss of public revenue.⁶⁹ This is particularly significant when we consider that the method of selection adapted by the FBR is much less invasive than the practice followed by more developed tax jurisdictions.

Second, under this very principle of public benefit, courts have previously determined that presumptive income taxation (PIT) is lawful when there is a large informal economy and massive tax evasion.⁷⁰ This is despite the fact that PIT treats all persons equally and even charges tax against persons with no income or those who have made a loss. The courts also have held that the power to search without a warrant is lawful under s 40 of the *Sales Tax Act 1990* when carried out with a statement of the grounds of belief by the officer.⁷¹ As stated in Part 3, in the German Tax Code, the basis of assessment of various incomes is set out differently which shows that jurisprudence and best practice on selection of cases gives leverage to taxation and allows it to not observe absolute uniformity.

4.3.3 Analysis of scope of Article 25 and the selection for tax audit

Regarding Article 25 (Equality of citizens), the LHC has held that audit selection by the Commissioner IR under s 177 is discriminatory, as no due process is provided in the law. Thus it violates Article 25 which guarantees equal protection of law for all citizens.⁷²

⁶⁹ *Ch. Muhammad Ishaq Advocate v Cantonment Executive Officer, Chunian, District Kasur* (PLD 2009 Lah. 240).

⁷⁰ *Ellahi Cotton Mills v Federation of Pakistan* (PLD 1997 SC 582).

⁷¹ *Messrs Food Consults (Pvt.) Ltd.*, above n 65.

⁷² **25. Equality of citizens:** (1) All citizens are equal before law and are entitled to equal protection of law.

(2) There shall be no discrimination on the basis of sex.

In its pronouncement the court also failed to take into account two important aspects. First, the Supreme Court of Pakistan has already stated that elements of discrimination in a fiscal statute cannot be pleaded nor can such a statute be struck down on the basis of Article 25 of the Constitution. As a result, there are many examples where various incomes, persons and industrial sectors are taxed differently. For example, income from manufacturing is subject to tax in Pakistan while agricultural income is not. For effective taxation superior courts in India have allowed varying tax regimes for different classes of persons based on reasonable and rational differentiation.⁷³ The Supreme Court also mentioned that progressive taxation taxes citizens differently at varying levels of income for the sake of public welfare and to remove economic disparity.⁷⁴ Thus we can see that the equality of all citizens under Article 25 is violated when citizens are taxed in such a way as to achieve economic equality.

More specifically, in *Anoud Power Generation Ltd v Federation of Pakistan*, the Supreme Court held that different laws can be promulgated to deal with various types of persons albeit subject to a reasonable classification.⁷⁵ In *NWFP Public Service Commission v Muhammad Arif*, the Supreme Court opined that it is also not for courts to demand from the legislature scientific accuracy in the classification adopted. If the classification is relevant to the object of the Act, it must be upheld unless the relevancy is deemed too remote or fanciful. A classification that proceeds on irrelevant considerations, such as differences in race, colour or religion will certainly be rejected by the courts (although no such thing has been pointed out by petitioners in the audit selection process).⁷⁶ More broadly, in *Mir Hashmat v Birendra Kumar Ghosh and Others*, Dacca High Court decided that any reasonable classification, which is not violative of the doctrine of equality, cannot be questioned.⁷⁷

Similarly, in *IA Sherwani v Government of Pakistan* the Supreme Court held that the Constitution itself contemplates passing of different laws for different provinces by their respective legislatures. The doctrine of reasonable classification is founded on the assumption that the state has to perform many activities and deal with a vast number of issues and problems. Therefore it should have the power to make a reasonable classification of persons and things to which different treatment may be accorded. Provided there is a legitimate basis for such difference the state can make laws to attain special objects and administrative authorities may make classifications in pursuance of such laws.⁷⁸

The Indian Supreme Court in *Indian Bombay v Bhanji Munji and Others* held that 'a law applying to one person or one class of persons is constitutional if there is sufficient basis or reason for it'.⁷⁹ The court, in the case of *DS Nakara v Union of India*, further held that:

The fundamental principle is that Article 14 forbids class legislation but permits reasonable classification for the purpose of legislation which

(3) Nothing in this Article shall prevent the State from making any special provision for the protection of women and children.

⁷³ *Kunnathat Thathunni Moopil Nair etc v State of Kerala and another* (AIR 1961 SC 552; 3 SCR 67).

⁷⁴ *Ibid*, at page 96.

⁷⁵ *Anoud Power Generation Ltd v Federation of Pakistan* (PLD 2001 SC 340).

⁷⁶ *Mir Hasmat Ali v Birendra Kumar Ghosh and others* (PLD 1965 Dacca 88).

⁷⁷ See *NWFP Public Service Commission v Muhammad Arif* (2011 SCMR 848).

⁷⁸ *IA Sherwani v Government of Pakistan* (1991 SCMR 104).

⁷⁹ *State of Bombay v Bhanji Munji And Anr* (AIR 1951 SC 41).

classification must satisfy the twin tests of being founded on an intelligible differentia which distinguishes persons or things that are grouped together from those that are left out of the group and that differentia must have a rational nexus to the object sought to be achieved by a statute in question.⁸⁰

While such distinctions may create some martyrs they necessarily have to be accepted for the general welfare of the public.⁸¹

Second, the selection for audit does not cause adverse distinction in terms of a benefit for a group or an individual. Selection or no selection means nothing in monetary terms unless some discrepancy is found in the tax return as a result of the audit. As stated in Part 3, there are no fixed criteria for tax agencies in terms of choosing any case for civil audit or even for investigative audit and nowhere in the developed world is selection for audit considered a violation of civil rights. Even if selection causes apprehension, this should not deprive a tax agency of the role of 'watch dog', ensuring that everyone complies with the SAS which has been introduced in the spirit of reducing compliance costs in official assessments.

Taking away from case managers this selection right would more likely result in non-compliance which ultimately leads to greater inequity. As stated in Part 1, inequity caused by lack of tax enforcement enhances feelings of discrimination among compliant taxpayers. Therefore, consistent with Part 1, it is suggested that in Pakistan taxpayer selection for audit should be carried out through the combined role of central and field officers. Commissioners should utilise the data prepared by FBR along with their local knowledge of individual taxpayers in order to pick the right taxpayers for audit.

However, in order to inculcate transparency it is advisable that 'self-selection' be avoided. Instead, this task may be assigned to Risk Intelligence and Analysis Teams working independently from teams performing audits. Separation of functions between various wings of government agencies improves internal controls and dilutes absolute authority to prevent misuse.⁸²

5. RECOMMENDATIONS

This review of international best practices for taxpayers' selection for audit and critical analysis of the issue of civil rights in the context of taxpayers' selection indicates that absolute uniformity or equality is not recommended for better selection of taxpayers for audit. More simply, the tax administration should not be provided with inflexible criteria in terms of picking cases for audit. Instead, the administration should be given the liberty to pick any taxpayer who is considered to have a high probability of being involved in tax evasion.

In order to ensure that the tax administration does not act arbitrarily or a case manager with too much authority is not biased against any individual taxpayer, the function of selection and carrying out of the audit should be allocated to two separate teams or divisions within the administration. Collaboration between central office and field

⁸⁰ *DS Nakara v Union of India* (AIR 1983 SC 130).

⁸¹ *Sonia Bhatia v State of UP* (1981) 3 SCR 239, 258; AIR 1981 SC 1274, 1284.

⁸² Nick Szabo, *Patterns of Integrity—Separation of Duties* referred by Nick Kochan and Robin Goodyear, "Corruption: The New Corporate Challenge" (2011) Palgrave MacMillan p-164

formation for selection is essential due to the nature of this function which involves the use of taxpayer specific information at both levels. In addition, the processes of selection of cases and performance of audit should be totally transparent in order to develop trust between taxpayers and the tax administration. Further, for any tax administration to operate efficiently and honestly some prerequisites such as sufficient skills, high remuneration, appropriate performance evaluation mechanisms and suitable internal controls are mandatory in general and necessary for the success of SAS in particular.

In terms of making the criteria for taxpayer selection flexible in Pakistan, it is suggested that ss 177 and 214(c) should be accordingly amended. The criteria for selection should not be provided in law and the function of designing criteria should be delegated to the tax administration so that it can be resilient and able to be adjusted each year in accordance with the facts of that year. As noted above and seen in the good practices of developed countries, better selection relies on collaboration between the central office and field formation. Such collaboration ensures the optimum use of centrally prepared data analysis reports with local information.

Moreover, following the well-known anecdote that ‘one size does not fit all’ it is recommended that selection from all categories of taxpayers cannot be carried out using identical criteria. This is because the relevant information for each category is different as are the different tools used in evading taxes. Well-developed ICT systems for obtaining, sorting and manipulating third party information and sector specific criteria are essential.

Finally, the quality of selection and results of any audit should be watched through well-defined benchmarks for the purpose of efficiency and control.

6. CONCLUSION

Under the SAS, the correct selection of cases for audit is an important part of designing tax compliance strategy. Correct selections help catch tax evaders thereby generating the perception that the tax system is fair and no one escapes taxation, which is most satisfying for compliant taxpayers.

Tax administrations have usually been given the liberty via statute to pick any case for audit, mostly due to the demands of the ever changing world of business. New ways of evading taxes need to be tackled with innovative means of detection. Best practice selection is partly based on the objective criteria arising from data analysis by the central office and also on the subjective judgment of case officers. A review of legal frameworks in Canada, Germany, Singapore, New Zealand, Australia and India reveals that liberty is given to tax administrations in those countries in terms of selection of cases for audit. Although the constitutions of those jurisdictions, like that of Pakistan, protect the fundamental right of equality of citizens, the courts have not pronounced such freedom of selection as discriminatory.

Although tax administrations have been improving their systems of selection for audit, allegations of discriminatory treatment do arise. For example, the LHC in Pakistan has held that a taxpayer’s selection for audit by a case officer without fixed statutory criteria is discriminatory and violates the right of equality of all citizens enshrined in the Constitution. With this statement LHC has ignited a crucial debate about whether

tax statute, which empowers the agency to pick any case for audit on the basis of subjective criteria, violates the right of equality and consequently is ultra vires to the Constitution. Despite the fact that the Pakistani Tax Code also empowers both case managers and central office to select any taxpayer, the LHC has held that the power to select on the basis of risk parameters and without fixed statutory criteria violates the right of equality of citizens. The LHC has therefore noted that an objective and fixed criteria must be statutorily designed, otherwise the selection is unconstitutional.

A critical analysis of the LHC decision finds that the court, while suggesting fixed criteria for case managers, has erred in treating case managers and the central office as distinct administrative entities rather than just two parts of the FBR that is the sole federal tax administrator. The case managers report to the head office and are under control of head office. Therefore, this distinction between case managers and head office is poor. Although a division of functions within an organisation is essential for prevention of concentration of authority, the nature and function of selection for audit is such that central and field formations need to corroborate and share information available at their level in order to make right selections. The case managers have local information about businesses and head office has data mining facility to produce information of each business on overall country basis. Nevertheless, carrying out an audit should be assigned to a different team from that which is engaged in the selection so as to curb the misuse of authority.

The LHC, besides ignoring the best international practices, also has completely overlooked the latitude provided in tax matters by superior courts of various jurisdictions. It appears to have disregarded that discrimination in tax matters is allowed by superior courts for a variety of reasons, such as for the sake of securing the objective of redistribution of income through progressive taxation. Several tax regimes understand that a progressive tax rate means treating individuals under different economic circumstances differently in order to achieve redistribution of income. Different tax regimes for different sections of persons are held to be lawful in order to ensure effective taxation across the board and to see that no one escapes taxation, which would create a perception that the tax system is unfair. Such classifications are justified by both legislatures and superior courts on the basis of the principle that the public necessity is greater than the private.

Similarly, not giving the administration liberal power to select taxpayers for audit may enable some taxpayers to get away with evading payment. Treating equals un-equally is in fact more discriminatory. A tax administration should be allowed to pick any taxpayer for audit in terms of overall public benefit even if that appears discriminatory on the surface. This paper also recommends areas for improvement in quality of taxpayer selection for audit.