

# Tax Knowledge & Tax Compliance Management



## Tax Knowledge and Tax Compliance: Some Observations

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### Abstract

The article argues that tax knowledge is sine qua non for tax compliance. Among all other factors that influence tax compliance behavior, tax knowledge is not less important. Tax statute is very difficult to understand because of its complexities caused inter alia by frequent changes of the taxing provisions. While this is true for all the tax administrations around the world, this is more pertinent for developing countries like Bangladesh. This is imperative that Bangladesh income tax administration takes appropriate strategies to remove the knowledge gap among the taxpayers. Tax knowledge gap creates a distance between taxpayer and tax authority and generates apathy for compliance. If Bangladesh income tax administration becomes successful in disseminating proper knowledge among the taxpayers, the present poor plight of compliance should be improved to a remarkable extent. The article is a theoretical analysis of the existing literatures available so far.

**Keywords:** Tax, Knowledge, Literacy, Compliance, Complexity, Bangladesh.

### Part I: Introduction

Taxes remain vital to state building, funding public expenditures and infrastructure, redistribution of wealth, and generating a 'fiscal social contract' between states and citizens (Forstater, 2018). So ensuring tax compliance and collecting the much needed revenue by the tax administrations remains a formidable challenge for them. This is particularly true for developing countries. While the developed countries have been able to collect tax revenue to a satisfactory level, developing countries have not been able to do so. They are still struggling with tax compliance problem. However, despite plethora of research with tax compliance, it is still a puzzle why taxpayers comply and do not. As Alm et al (1992) notes, 'In recent years economists have devoted increasing attention to the study of individual tax evasion. Despite these efforts. Our understanding of the reasons behind individual tax compliance behavior remains limited. In fact, the puzzle of tax compliance is that most people continue to pay their taxes.' Theories have been profuse and researchers are in a race to develop theories and models to solve the tax compliance puzzle. Factors that affect tax compliance are various and they vary from country to country and individual to individual (Kirchler, 2007, cited by Barbuta Misu, 2011).

Economic deterrent theory argues that taxpayers comply because of fear of detection through audit and

punishment (Allingham and Sandmo, 1972 and Alm et al, 1992). This theory posits on command and control type regulation where stick is used to ensure compliance to law. The theory was first presented by Professor Gary S Becker. According to Becker (1968) punishment and sometimes severe punishment must be rendered for crimes like robbery, murder including tax evasion. Becker calls tax evasion as white collar crime. Later Allingham and Sandmo (1972) developed the theory and through study reached the same decision that tax decision is a decision under uncertainty. It is a gambling on the part of the taxpayer whether to declare income or not. If the cost of detection, audit and penalty appears to outweigh the benefit of evading tax, then taxpayer would not be encouraged to go for evasion and vice versa. Again Alm et al (1992) examined the theory and reached the same conclusion like Becker and Allingham and Sandmo. The theory has been criticized for not being able to address the tax compliance problem in its totality. One important factor that contributes to the tax compliance behavior is taxpayer's tax knowledge. Set apart the seminal theories of tax compliance, researchers are of the view that tax knowledge improves tax compliance. Tax knowledge is essential particularly for the success of self-assessment system (SAS) against the backdrop of developing country like Bangladesh. The purpose of this article is to argue that since Bangladesh introduced universal SAS in 2008, it is imperative that the National Board of Revenue (NBR) takes necessary and effective initiatives to educate the taxpayers with a view to reducing the tax knowledge gap. The article is arranged as follows. While part I gives in introduction, part II tries to present a short literature review in the field of research with tax knowledge. Part III discusses some of the causes of tax knowledge gap. Part IV makes some suggestions to improve tax knowledge. Finally part V makes some concluding remarks. The article is a theoretical analysis of the existing literature available in the field.

## Part II: Literature Review

Research and empirical studies produced mixed results regarding the impact of tax knowledge on tax compliance behaviour. For example Erickson and Fallan (1996) found that tax knowledge has positive impact on tax compliance. Cvrlje (2015) on the other hand found weak correlation between tax compliance and tax knowledge. Kirchler (2007) notes

inter alia that among the factors that shape taxpayer compliance behaviour knowledge of tax law remains vital. Hofmann et al (2008) argues that tax knowledge is essential to positively influence tax compliance behaviour. Fauziati et al (2016) state that tax knowledge is essential and it is the citizen's comprehension of the tax policy regarding imposition of taxes. Tax knowledge is imperative in a voluntary compliance tax system, especially in determining the exact tax liability for the SMEs (Fauziati et al, Adam et al, 2012, Palil, 2015; Saad et al., 2013). Tax knowledge is essential in a tax system with self-assessment system (Newman et al, 2018, Loo, 2016; Loo et al., 2014). Kasippilai and Jabbar (2013) finds through empirical studies with SMEs in Malaysia that proper tax knowledge increases the rate of tax compliance. Ninety seven percent of the compliant SMEs in Malaysia possessed sound tax knowledge. Newman et al (2018) quoted Harris (2013) who found through empirical studies with the SMEs of the UK that the SMEs in the UK possessed tax knowledge and were aware of their tax liabilities. Mckerchar and Hansford (2015) conducted a study with small business small taxpayers of Australia and found that lack of tax knowledge might encourage tax non-compliance either intentionally or unintentionally. It was found that small business tax payers in Australia did not possess requisite tax knowledge. Hasseldine et al (2009) conducted a study on tax knowledge sharing among the revenue department of the UK, the accounting firms and the corporate taxpayers. They found that in terms of knowledge sharing there is no competition among these institutions. Rather there is a relationship of mutual dependency that enables them to implement the taxing legislations and share the knowledge for the purpose. Poor knowledge can evoke distrust and negative attitudes towards tax, whereas good tax knowledge correlates with positive attitudes towards tax (Niemirowski et al., 2002). According to Shaharuddin, Palil, Ramli, and Maelah (2012) lower tax compliance is the result of lack of knowledge of the tax system. Niemirowski, Wearing, Baldwin, Leonard & Mobbs, (2002) found through empirical studies that poor knowledge regarding the tax system generates distrust. Kirchler (2007) argues that trust in the tax authority and voluntary compliance combine inter alia propitious social representations like basic understanding of tax laws. Damajanti & Karim (2017) cited Tarjo and Kusumawati (2006) who found in Indonesia that 69.9 percent of individual

taxpayers did not know the applicable tax rate, and 78.6 percent did not know the changes in income tax laws, and 57.1 percent did not have the ability to calculate taxes. Witono (2008) cited by Damajanti and Karim (2017) conducted research with individual and corporate taxpayers in Malaysia regarding the impact of knowledge on taxpayer's compliance behavior with tax justice intervening variables. They found that tax knowledge had remarkable effect on tax compliance. But tax knowledge did not exhibit significant effect on tax justice as an intervening variable. Maseko (2014) conducted a study with the SME in Zimbabwe about the impact of tax knowledge on tax compliance. He found inter alia that tax advisers were of the view that despite good personal tax knowledge the SMEs sought tax consultation because they either did not have time to prepare returns or their knowledge is not up-to-date. However, most of the SMEs were found to have difficulties in comprehending income tax and the VAT laws. Interpretation of taxing statutes were thought to be daunting challenge for the taxpayers. Maseko (2014) also found that the level of education of taxpayers remains an important factor that influences the knowledge of the tax payer regarding tax requirements, particularly about registration and filing requirements. Bornman and Wasserman (2018) argue that tax literacy is vital in digital economy. Palil and Mustapa (2011) categorised tax knowledge into seven sub-categories namely; taxpayers' responsibilities and rights, knowledge about employment income, dividend and interest, personal relief, child relief, rebates and awareness on offence, penalty and fine (Cited by Bornmann and Wasserman, 2018). Wassermann and Bornman (2018) put forward a conceptual framework of tax literacy that encompasses three elements like tax awareness, contextual knowledge, skills and resources, and informed decision making. Awareness refers to situations where taxpayers can recognize factors that influences a decision and can comprehend the results of such decision. Contextual knowledge on the other hand refers to legal and procedural knowledge. Decision making process is an interaction of mind and context and interaction between awareness and tax knowledge (Bornman and Wassermann, 2018). Tax knowledge is crucial to face the challenges of digital economy. Bornman and Wassermann, (2018) argue, '...there are unique tax knowledge challenges in the digital economy. In order to be a tax literate person,

one needs to be aware of these challenges to be able to make informed decisions with regards to your tax obligations. Taxpayers and tax authorities alike should take note of the risk areas identified to devise strategies for dealing with tax issues in the digital economy.'

### Part III: Causes of Tax knowledge Gap

Lack of tax knowledge might be caused by several factors. For example tax law and tax system complexity causes knowledge gap. Complexity has long been associated with tax system (Milliron, 1985). Milliron (1985) argues, "Complexity represents but one strand in a web of interrelated factors and propositions influencing compliant tax reporting in a democratic society. Nevertheless, it has been singled out as a factor affecting compliance and a study of its effect thereon can be viewed as one step in an ongoing program of study of noncompliance." There has been several findings whether tax complexity influences on tax compliance. For example Song and Yarborough (1978) dismissed the importance of complexity on tax compliance. Mckercher (2003) on the other hand found through empirical study with Australian individual taxpayers that where the taxpayers have intention to comply but complexity deterred them to comply with the expected level. A less complex tax system would also encourage tax compliance (Cox & Eger, 2006; Richardson, 2006). According to Shaharuddin, Palil, Ramli, and Maelah (2012) lower tax compliance is the result of lack of knowledge of the tax system. Bird (2014) argues that simplicity should not be pursued at the expense of other more important elements that make the tax system efficient and effective. However, his findings revealed that presumptive taxation in Bangladesh seem quite appropriate and in line with best practices. He argues that permanent use of presumptive taxes, regardless of the size and turnover of the business concerned has serious adverse effects on the overall system. His opinion is based on the background of the fact that tax collection in Bangladesh still stands at 9%. There are other studies on the topic like Dean, Keenan and Kenney (1980), Internal Revenue Service (1976). Tax complexity however, can be of several dimension. For our purpose we focus on tax law complexity. Tax law complexity affects compliance and deprives taxpayers from taking benefits and incentives (Hill, 2013). Tax laws are complex not only in Bangladesh, but all over

the world. For example, the US tax law, the IRS tax code is very much complex and it runs currently 78000 pages. Besides there are frequent changes in the taxing statutes. For a layman taxpayer it is next to impossible to keep track of the frequent changes. Batrancea and Nichita (2012) note, 'One of the factors which generate non-compliance behavior is the complexity and opacity of tax law. Apart from savvy taxpayers who manage to reduce their tax burden because they understand the law very well, many other taxpayers fail to comply because they understand the law very little. This is due to the fact that tax legislation is often unclear and creates many difficulties in interpreting it.' Tax law complexity is considered as the genesis of tax avoidance and because of tax law complexity taxpayers hire tax professionals to deal with tax matters (Olaoye, 2017). Tax laws in Bangladesh are perceived to be complex (Akhand, 2012). Taxpayers in Bangladesh also think that tax law of Bangladesh is complex and it should be simplified (RIRA, 2003). So there is no denial of the fact that tax law complexity discourages tax compliance and creates knowledge gap.

Inadequacy of information is another cause of tax knowledge gap. If the taxpayers do not receive tax information from the tax authority or there is paucity of information then taxpayer's knowledge of the tax issues is seriously affected. OECD (2005) narrates, 'Taxpayers are entitled to have up-to-date information on the operation of the tax system and the way in which their tax is assessed. They are also entitled to be informed of their rights, including their rights of appeal. All taxpayers can expect that the information provided to them should reflect the complexity of the tax situation, thereby enabling them to understand better their tax affairs. The authorities may use a variety of means to fulfil this obligation: information pamphlets, taxpayers' charters, the telephone oral statements, video guides, etc. Providing tax information to the taxpayers is related to the service orientation of the tax department. Service oriented tax administration is proposed by various tax compliance theories. For example, the responsive regulatory theory, the multifaceted approach and slippery slope framework of tax compliance all suggest service orientation as a promoting strategy to improve voluntary tax compliance (Gangl et al, 2013). In Bangladesh the tax department realizes the truth that taxpayers are not happy with the availability of tax information (RIRA, 2005). So tax administrations

are taking appropriate measures to provide necessary information to the taxpayers. But more efforts should be taken to improve the service. So it is evident that if tax information are not readily available to the taxpayers they might feel discouraged to fill up the tax return and comply. Taxpayer complain about taxpayer service all over the world. For example in Bangladesh taxpayers expressed dissatisfaction regarding taxpayer service. NBR conducted a taxpayer perception survey through RIRA in 2003 where the report inter alia found that taxpayer service in Bangladesh is not at its expected level. Regarding taxpayer service the RIRA report said, 'In conclusion, respondents were strongly of the view that they don't like the service they are receiving.' Some suggestions were made in the report for visible and rapid improvements in service that can be achieved through clearer forms with better instructions, easier to understand publications, more publications, better use of the media, more taxpayer consultation centers, significantly more training for tax officials, better working conditions for tax officials, better pay. Regarding taxpayer service in the USA it is observed that despite improvement in taxpayer's service delivery, it is still very poor. One reason of poor taxpayer service is identified as budget constraint. Olsen (2019) states, 'There is no doubt that budget constraints have limited the IRS's taxpayer service capacity, but the IRS should not blame Congress for a lack of taxpayer services funding when it is itself proposing to shift funding away from taxpayer services. What's more, budget constraints can't be used as an all-purpose excuse for mediocrity. The Taxpayer First Act directs the IRS to develop a comprehensive customer service strategy within one year.' Though evidence cannot be presented, anecdotal evidence shows that tax department in Bangladesh also faces budget constraint while trying to deliver effective taxpayer service.

Motivational posture seems to play a vital role in shaping taxpayer compliance behavior. Motivational posture theory postulates that when the revenue department does not treat the taxpayer in a respectful and well manner, they seem to create a relationship gap with the department and do not consequently defer to the authority (Braithwaite, 2003). Braithwaite (2003) identified five motivational as important against the backdrop of taxation compliance: (i) commitment, (ii) capitulation, (iii) resistance, (iv) disengagement, and (v) game playing. The two postures that reflect

an overall positive orientation to authority are commitment and capitulation. In contrast to these postures of deference, are three postures of defiance, namely resistance, disengagement, and game playing. Last three postures exhibit the defiance attitude of the taxpayer to show resistance towards the policies and regulations of the tax department. So due to motivational posture if the taxpayers shuns away the tax department, she will not be encouraged to gain appropriate knowledge of tax laws and regulations necessary for voluntary compliance.

## Part IV: Some Suggestions to Facilitate Tax Knowledge

There are several ways to improve taxpayer's tax knowledge as well as several elements of tax knowledge. For example Bornman and Ramutumbu (2019) states, 'Three elements of tax knowledge were identified, namely, general, procedural and legal tax knowledge. General tax knowledge relates to a need to have a fiscal awareness; procedural tax knowledge refers to understanding tax compliance procedures; and legal tax knowledge pertains to a need to understand regulations.' On the other hand Bornman and Wasserman (2018) notes, 'Empirical findings has shown that taxpayer knowledge is a factor influencing tax compliance and accordingly, taxpayer education is generally one of the key approaches adopted by tax authorities to improve taxpayer compliance. The concept of 'tax literacy' is however proposed to be a wider concept than tax knowledge alone and needs further investigation in the context of its role in taxpayer compliance.' Cvrlje (2015) states inter alia, '...tax literacy maybe defined as follows: a person is considered functionally tax literate if he/she can independently read and understand tax reports, can engage independently in various tax calculations and is aware of possible tax risks in its financial environment.'

Tax education is vital to facilitate tax knowledge and tax resistance. If the academic institutions in the country starts early taxation curriculum in the schools and colleges, that would create tax awareness and to some extent tax culture. Tax education also discourages tax revolt and incites patriotism among the taxpayers. In most of the countries where self-assessment systems are in operation, taxpayer education programs have been introduced. Countries like the UK, the USA, and Canada introduced tax education programs (Palil,

2010). One way of disseminating tax education is educational institutions.

However, tax education should be crafted in such a way that it does not become a daunting challenge for the students to receive tax education. For example, to comprehend the tax law in Britain, it was estimated that at least 13 years of education are required; reading age in the U.S. was calculated to be 12.5 years of schooling, whereas in Australia estimations rose to 17 years. Most people do not have more than 9 to 10 years of school education (Lewis, 1982). Chan et al. (2012) argues that while educated taxpayers may be aware of the avenues of noncompliance, their potentially better understanding of the tax system and their high degree of moral development creates a more favorable taxpayer attitude and consequently better compliance. Level of education affects tax knowledge (Cuccia, 2013). Iyoke (2016) found through studies in Nigeria that level of education has an influence on tax knowledge. There are of course contesting views regarding the impact of level of education on tax knowledge. Newman et al (2018) cited Atawadi (2012), Bird (2014), Baru (2016), Nellen (2014) and Medley (2015) who concluded that level of education is not of any effect on the tax compliance behavior of the SMEs in the UK, Ghana and some other countries.

To increase tax knowledge of the taxpayers it is sometimes suggested that introduction of self-assessment system can remove knowledge gap. Yahaya et al (2018) note, 'Self-assessment system encourages voluntary compliance. This is a system that allows taxpayers to compute their tax liabilities. In order for the taxpayers to make accurate payment of tax returns, they are to declare their true business income for the relevant year of assessment. However, tax complexities in tax assessment procedures cannot be accomplished except for proper knowledge on how to accomplish it.' Also, Pillai (2010) argues that the purpose of self-assessment system is to educate taxpayers and to make them aware of their tax liabilities. Self-assessment system is very popular among the tax administrations around the world. It is one of the most effective means of collecting revenue (Yahaya et al, 2018). In fact self-assessment requires taxpayer's appropriate knowledge of tax laws and regulations. Because SAS system puts the liability of determining tax liability on the taxpayers. So for the sake of accuracy in dealing with tax issues, it is imperative for the taxpayers to acquire

knowledge beforehand. Damajanti (2017) states, 'Self-assessment system can work well if the people have appropriate knowledge of tax regulations. The taxpayer's knowledge shows the understanding of the taxpayer in applying the tax rules particularly on income tax.' For a successful SAS, taxpayer education is imperative. Without proper knowledge of the rules and regulations, taxpayers might not be able to take advantage of the system. On the other hand, the tax department should take appropriate measures to educate the taxpayers. This is particularly applicable for individual taxpayers who sometimes find it difficult to deal with the rules. Okello (2014) argues, 'Taxpayers are more likely to comply voluntarily when the tax administration: (1) adopts a service-oriented attitude toward taxpayers, and educates and assists them in meeting their obligations; (2) creates strong deterrents to non-compliance through effective audit programs and consistent use of penalties; and (3) is transparent and seen by the public to be honest, fair, and even-handed in its administration of the tax laws. Experience shows that voluntary compliance is best achieved through a system of self-assessment.'

However, as mentioned earlier, tax knowledge can be vital to ensure tax compliance in Bangladesh. So it is worth to mention briefly what Bangladesh can do to enhance tax knowledge and tax literacy of taxpayers of Bangladesh. OECD suggested some methods to increase tax literacy. The main avenues of tax literacy, as per OECD are printing and disseminating brochures and leaflets containing important information, arranging television talk shows, holding taxpayers day, establishing tax friendly clubs and tax advisory council, tax information centers, publishing cartoon books, early tax curriculum in education, arranging tax quiz competitions and town hall talks. Bangladesh income tax administration is aware of the importance of tax knowledge and taxpayer service. So NBR has taken some commendable steps to educate taxpayers. For example to render better taxpayer service NBR started organizing income tax fair from 2010. This is a unique event in Bangladesh organized every year with huge success. Besides, income tax department has set up taxpayer service center in every taxes zone to provide necessary information to the taxpayers. Tax issues are being discussed in TV talk shows on regular basis. Experience shows that TV shows and taxpayer day produce more positive result than leaflets and brochures (Waris, 2013). That was the experience

of Rwanda. The NBR can follow Rwandan example of tax literacy programme. Regarding Rwandan tax literacy programme Cvrlje (2105) comments, 'One of the very successful examples of good tax literacy promotion, in which many public and private institutions were engaged, is tax literacy campaign introduced in Rwanda. The Rwandan Revenue Authority (RRA) launched its tax literacy campaign in 1998 and it lasted till 2011. The process of promoting tax literacy in Rwanda was conducted in three stages during three periods of time; 1998-2002; 2003-2006 and 2006-2011. According to the statistics, Rwandan citizens generally had a low financial literacy levels as well as low levels of tax literacy. However, due to this campaign, their results significantly improved.'

Under the circumstances, taking into strong consideration of the good practices of other countries, with a view to improve the current poor plight of tax compliance in Bangladesh, the NBR should strive to promote and improve tax literacy with a view to reducing knowledge gap about taxation issues. With that end in view the NBR can start a national survey program to gauge the level of tax knowledge and tax literacy of the taxpayers. The survey result would guide the NBR to craft appropriate tax literacy programs. Besides NBR can think of imparting tax education in the young age and for that putting tax education within curriculums in schools, especially high schools and universities.

## Part V: Conclusion

Direct tax administration in Bangladesh is characterized by low level of tax compliance and narrow tax base. Tax non-compliance is generally dealt with by traditional hammer and sized method that reflects the economic deterrence model of tax compliance as discussed at the very outset. But this is time that NBR should explore other means along with the traditional deterrence method of combatting tax non-compliance. Ahmed (2016) suggests that to tackle the problem of tax compliance, Bangladesh should adopt a holistic approach that combines the 'one size one method' approach blending all the existing theories and models of tax compliance available so far. Reducing tax knowledge gap and increasing tax literacy can be one of the ways that can contribute to the effective management of tax compliance problem in Bangladesh. Although tax knowledge is found to be vital in ensuring tax compliance, no research has

been carried out so far in Bangladesh on the topic. This article is a theoretical analysis of the existing literature about the impact of tax knowledge on tax compliance. Further empirical research is necessary to establish the fact that tax knowledge substantially improves tax compliance. It is to be noted that some researcher like Weisbach (2011) argues whether tax knowledge is socially desirable or not. It is observed that there are varying studies regarding the influence of tax knowledge on tax compliance behavior. Weisbeach (2011) states, 'It turns on the interaction of at least three hard to observe factors: taxpayer expectations, the type of tax, and the quality of the tax. Notwithstanding the complexity of the inquiry, it will be central to a number of policy questions.' However, despite varying results regarding the impact of tax knowledge on tax compliance behaviour, tax knowledge remains one of the important factors that affects tax compliance. Taxation issues and taxing legislations are very complicated in nature. Even tax experts very often grapple with intricate tax rules. So for a layman taxpayer, it is more complicated and difficult issue to handle without necessary knowledge. Anecdotal and empirical evidences support the truth.



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