

# Quality of tax administration system, governance, and compliance behaviour: Does religion matter?

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## Abstract

Tax revenue is the cornerstone of governments; if tax revenue is deficient, the government requires local and foreign loans to be funded. The present study considers fiscal capacity as an underlying principle that describes "the ability of government to collect revenue from its source (through taxation)". The weak fiscal capacity of emerging economies has gained attention in development economics from researchers, academicians, and policymakers. The findings reveal that the quality of tax administration services indicates a positive and significant association with taxpayers' compliance behaviour in a direct relationship. The similar results were found in moderating religiosity's role. Quality of governance positively and significantly influences taxpayers' compliance behaviour indicate a significance in case of direct relationship and in case of moderating role of religiosity. Moreover, the findings showed that religiosity significantly moderates the relationship between the quality of tax administration services and taxpayers' compliance behaviour. In contrast, insignificant results were shown in the case of quality of governance and compliance behaviour in the presence of religiosity. The present study considered the limiting factors for the assessment of the compliance behaviour of taxpayers. For instance, future studies can add more variables, such as financial position, taxation audit, and the effect of penalties on taxpayers' compliance behaviour. The present study considered the unit of analysis to individuals. The future study can be based only on the salaried persons, AOPs, and companies. AOPs need to investigate individually because approximately 90% of registered businesses are AOPs. Future studies need to consider family-owned businesses because most of the registered businesses were owned and operated by families. They use the transfer pricing concept for tax avoidance.

**Keywords:** Quality of tax administration system, governance, compliance behavior, religiosity, and tax governance.

Tax revenue is the cornerstone of governments; if tax revenue is deficient, the government requires local and foreign loans to be funded. They fulfil their government and other responsibilities by tax revenue. The Government of Pakistan borrowed Rs.198.832 billion from local banks for the 2015-16 financial year and Rs.859.689 billion from foreign borrowings to meet its expenses due to low tax revenues (Finance Division, 2016). Taxes are a critical portion of the income of specific emerging and industrialised economies (Ahmad, 2010). Taxes are the backbone of any country's economy, and it is up to the taxpayers' frame of mind, are willing to pay taxes and how much they can pay (Eshag, 1983). Many taxpayers are not ready to contribute to tax revenue voluntarily in the countries still developing, which raises many problems regarding the collection of taxes on time and authorities to implement tax laws in the country. (Alm, 2012; Vazquez & Rider, 2005). When taxpayers do not want to pay their taxes timely and ignore compliance with tax laws is called an act of noncompliance (Kirchler, 2007). The authorities face problems because of this attitude of noncompliance from the country's taxpayers. By introducing different schemes and incentives for the taxpayers, they try to reduce noncompliance (Eglar, 2001).

For example, in this aspect, 3,388,188 NTN certificates have been issued by FBR, which guarantees that these NTN certificate holders will file their tax returns. In 2015, only 1,010,402 persons filed their income tax return, marginally higher than the past years. However, in Pakistan, Year by year Commission of tax reforms proposed many taxes base reforms to improve compliance. However, the data shows that the graph of direct taxation in the total revenue is still very low. To approach the

individuals who should have to pay the tax and conduct investigations, the Federal Board of Revenue has set up the Broadening Tax Base (BTB) department. (FBR, 2016).

Many studies have been carried out in the world that has tested their hypothesis of the indirect and direct effects of social perceptions, personal norms, and subjective norms that influence taxpayer behaviour to evaluate the behavioural variables correlated with taxpayer behaviour (Bobek, Hageman, & Kelliher, 2013; Christian & Alm, 2014; Dunning, Rosenblatt, Pineiro, & Monest, 2014). BTB (broadening tax base) performs such inquiries to understand the public's noncompliance behaviour to increase tax collections. The study acknowledges that religious organisations can also affect income tax collections. (Bhuiyan, 2017). Numerous studies have been published in developed and developing economies, but only selective studies have been published in Pakistan due to different economic, political, and social limitations.

From 2015 through 2016, industrial contribution to GDP is about 21 percent. Its tax contributions are outstanding, which approximately 76.4 percent. Moreover, it is until business does not contribute to tax revenues. The total number of companies registered with Pakistan's SECP is around 81,465. Only 36 percent of firms file their income tax return, and it's horrible that 70 percent of them file net losses, and the other 30 percent of firms contribute to the corporate sector (Pasha, 2017).

Pakistan's services sector shows tremendous growth over the period with a 59.20 percent contribution to Gross Domestic Production (GDP) during 2015-16. Still, this sector's income and growth do not keep pace with the contribution to tax revenue.

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The service sector currently is the 20.9% of the total tax revenues (Imam, 2014).

Similarly, many studies have been conducted to check noncompliance behaviour on different forums in developing countries. Pakistan's statistics show that taxpayers' behaviour needs to be tremendously investigated to find the reason for their noncompliance with the tax laws. At the same time, tax laws permit different exemptions, incentives, and tax credits in Pakistan. A detailed review must be carried out to find fiscal, psychological, and behavioural variables for individuals who do not comply with tax laws. The current finance bills should be framed in the light of these suggestions (Best, Brockmeyer, Kleven, Spinnewijn, & Waseem, 2015). This research project is a step towards filling this void.

### The Significance of the Study

The weak fiscal capacity of emerging economies has gained attention in development economics from researchers, academicians, and policymakers (Besley & Persson, 2010). Economic growth often emphasises that the state must be prepared to raise its revenue resources using the fiscal resource to provide critical public goods with those lack in developed countries (Tanzi & Zee, 2000). The current study's underlying aim is to determine the variables affecting the taxpayer's compliance in Pakistan. The data collected using a self-administered questionnaire from major cities in Pakistan is followed to achieve the current study survey-based methodology's research objective. The present study considers fiscal capacity as an underlying principle that describes "the ability of government to collect revenue from its source (through taxation)".

By presenting constructive suggestions on behalf of the tax department to the Federal board of revenue, lawmakers, managers, and those responsible for collecting taxes, this study will contribute positively. By adding new provisions, exemptions, and tax credits, Pakistan's finance department does various recent amendments every year. These modifications are made on a committee's suggestions and are not focused on analysis. The Tax Department in Pakistan has never done this kind of research to obtain the public's opinion. This study can also provide tax authorities with some useful knowledge about the behavioural and deterrent factors responsible for tax avoidance.

There are federal and provincial governments, where each country's tax issues are approved, and Pakistan is a federation. The government holds the power to manage high taxes in Pakistan under the control of FBR. However, Provincial governments also have some powers to impose taxes with the parliament's prior approval, such as the federal government collecting GST on goods and the provincial governments collecting services sales tax. FBR is subject to income tax, GST on goods, customs duty, FED, and CVT. Income taxes charged to individuals on their salaries and non-salaried income, such as sole proprietorship, retailer ship, service provider individuals, and manufacturers. The current report focuses on both paid and non-salaried individual taxpayers' compliance acts.

Important amnesty programs, which often represent an attitude of noncompliance, are usually granted to individuals from time to time. Due to their large number and lack of data, individuals are more challenging to track than businesses. Since all individuals with NTN have to be filers, more than 3 million NTN numbers have been released by the FBR. Approximately one million returns have been filled in Pakistan, including companies and associations of individuals. Data has been collected from individuals, salaried and unreported individuals living in different countries to be represented by each province of the country. People gather in big cities from every part of the world, from every province of the country, which is why each province's capital city has been selected.

### Theoretical Framework

A significant number of stakeholders are involved in people's tax compliance behaviour. Economists, accountants, psychologists, and sociologists strive to find why people have noncompliance actions at the government's top. Literature is unable to conclude to date that any single or combination of all the theories is enough or relevant there for the compliance behaviour (Slemrod, 2019). To research the effect of determinants on taxpayer enforcement actions, the current study considered the institutional approach and focused on fiscal strength theory.

The theory of fiscal strength – coined by Charles Tilly (Tilly, 1975, 1990) – is generally believed to represent the nation's fiscal system's growth level. It is also used as a more general measure of state ability and a government's ability to enforce complicated policies (Rogers and Weller, 2013).

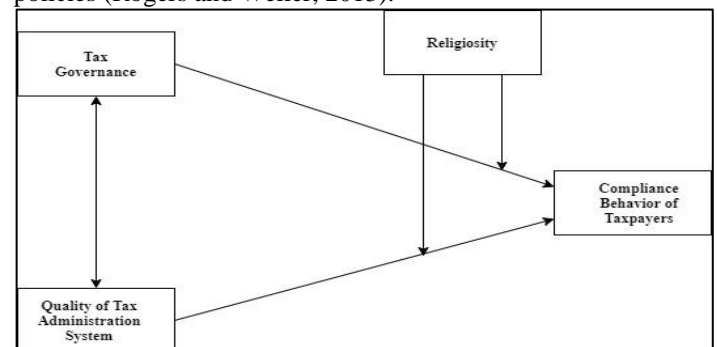


Figure 1: Theoretical Framework

### Data Analysis

The present study used the partial least squares-structural equation (PLS-SEM) modelling using the SmartPLS 3.2.9 version. The PLS-SEM is the most appropriate statistical tool for assessing measurement and structural model (Ringle et al., 2005). The PLS-SEM does not require the normality assumption. Moreover, most of the survey study's dataset does not meet the normal distribution assumption (Chin et al., 2003).

Since the respondents of all the measured constructs are the same individuals or data is from a single source, there is a need to assess the common method bias test (Kock, & Lynn, 2012; Kock, 2015). As per the suggestions (Kock & Lynn, 2012; Kock, 2015), common method bias is assessed using a full collinearity test. All the constructs must be regressed against the single variable's cutoff value of  $VIF \leq 3.3$  for no bias from the single-source data. The findings were reported in table 1, and the results of VIF

The present study considered the items loadings, rho\_A, composite reliability (CR), and average variance extracted (AVE) for the measurement model. Item loadings indicate the significance of individual items towards the observed construct. The cutoff value of item loading in the present study is  $\geq 0.50$ . The rho\_A is being used to assess the reliability of the observed construct. The cutoff value of rho\_A is  $\geq 0.70$  (Dijkstra, & Henseler, 2015). The third factor being used for the assessment of the measurement model is composite reliability. The construct's composite reliability by assessing the internal consistency of items being used to measure the construct. The cutoff value of composite reliability  $\geq 0.7$ . The last factor considered for assessing the measurement model is the average variance extracted (AVE). The AVE is being used to measure the amount of variance captured by the construct in relation to measurement error. The cutoff value of AVE is  $\geq 0.50$  (Hair et al., 2019).

	Loadings	rho_A	CR	AVE
com1	0.765			
com2	0.778			
com3	0.738			
com4	0.733			
com5	0.835			
com6	0.833	0.930	0.926	0.554
com7	0.745			
com8	0.793			
com9	0.814			
com10	0.768			
com11	0.022			
QG1	0.686			
QG2	0.627			
QG3	0.691			
QG4	0.775			
QG5	0.855	0.917	0.923	0.575
QG6	0.824			
QG7	0.793			
QG8	0.812			
QG9	0.730			
TS1	0.739			
TS2	0.735			
TS3	0.822			
TS4	0.811			
TS5	0.805			
TS6	0.768			
TS7	0.789			
TS8	0.801			
TS9	0.782	0.960	0.964	0.625
TS10	0.840			
TS11	0.814			
TS12	0.806			
TS13	0.771			
TS14	0.775			
TS15	0.808			
TS16	0.779			
reg1	0.740			
reg2	0.760			
reg3	0.769			
reg4	0.792	0.881	0.907	0.583
reg5	0.791			
reg6	0.765			
reg7	0.728			

Table 2: *Discriminant Validity (HTMT)*

	1	2	3	4
1 Compliance Behavior				
2 Quality Governance	0.433			
3 Tax Services Quality	0.876	0.315		
4 Religiosity	0.382	0.435	0.639	

### Assessment of Structural Model (Inner model)

The present study reported the standard beta, standard error, t-values, p-values, upper, lower limits, f-square, and variance inflation factor for the proposed relationship among the constructs using bootstrapping 5,000-sample re-sample criteria (Ramayah et al., 2019; Hair et al., 2019). As the previous literature critique, the only p-value is not an appropriate measure to conclude or test the hypothesis's significance (Hahn, & Ang, 2017). The literature suggested that other measures can be effect size, p-value, confidence interval, and variance inflation. The results of hypothesis testing were reported in table 3.

	Stand. Beta	Standard Deviation	T-values	P Values
QG -> CB	0.5288	0.0775	6.8212	<b>0.0000</b>
Reg -> CB	0.2673	0.0731	3.6585	<b>0.0003</b>
TSQ -> CB	0.1299	0.0740	1.7558	<b>0.0792</b>

TS1	
TS10	

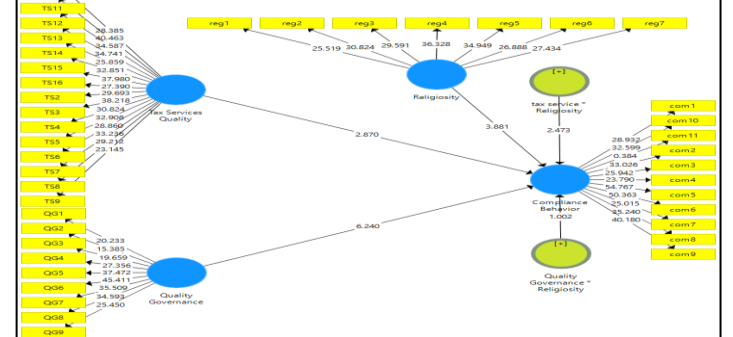


Table 3 shows the testing of the direct hypothesis effect using the standard beta, standard error, t-values, p-values for the variable under observation. Signs and magnitude of hypotheses were compared against the proposed hypotheses to conclude which hypotheses accepted or rejected (Hair et al., 2013). The direct association were tested based on bootstrapping 5000-sample re-sample. The findings have shown that three out of five hypotheses were accepted in case of direct association.

**H3:** Religiosity significantly influence the compliance behaviour of taxpayers.

## Moderation

The present study considers the quality of tax administration, governance towards the compliance behaviour of taxpayers while religiosity is considered as moderating factor. Meanwhile, few studies suggest an indirect relationship or a moderating factor (Vera & Crossan, 2005). However, literature concludes that religiosity is a key factor that influence the compliance behaviour in direct and indirect relationships (Hmieleski & Corbett, 2008; Arshad & Hughes, 2009; Hmieleski, Corbett, & Baron, 2013).

Table 4: *Hypothesis Testing Moderation Effects*

	Stand. Beta	Stand Deviation	T- Values	P- Values	f-sq
QG -> CB	0.4629	0.0742	6.2399	0.0000	0.1823
Reg -> CB	0.2969	0.0765	3.8809	0.0001	0.0761
TSQ -> CB	0.1866	0.0650	2.8697	0.0041	0.0281
TSQ * Reg -> CB	0.1703	0.0689	2.4726	0.0134	0.0306
QG * Reg -> CB	-0.079	0.0797	1.0020	0.3164	0.0059

Note: We use a 95% confidence interval with a bootstrapping of 5,000

Note: \*\*\*p<0.01(t => 2.33), \*\*p<0.05(t =>1.96), \*p<0.1(t =>1.64)

**H4:** Religiosity significantly moderate the relationship between the quality of tax administration and the compliance behaviour of taxpayers

**H5:** Religiosity significantly moderate the relationship between the quality of governance and compliance behaviour of taxpayers

## Discussion

The discussion portion includes the research objectives or research questions defined in chapter one. The findings reported in chapter four how these findings contributed to the underpinning theory and practical implications for policymakers and regulatory authorities. This portion is based on the direction of the relationship in the measured constructs. The first portion is based on the direct relationship between the quality of tax administration, quality of governance, and taxpayers' compliance behaviour. The second portion of discussion is based on the indirect relationship among the variables of how religiosity moderates the relationship between quality of tax administration, quality of governance, and taxpayers' compliance behaviour.

A service is an act or action that is merely intangible and does not result in any possession provided by one party to another (Nurhayat, Halimatusadiah, & Diamonalisa, 2015). Quality of service is an attempt to satisfy customers' expectations and needs and add correctness to complement or boost customer satisfaction. Service quality requires the ordination and streamlining of a system where, without process quality, it cannot be accomplished (Andreas & Savitri, 2015). Tax authorities' provision of timely services and awareness can increase tax enforcement, and confusion about information and services can increase tax avoidance. (Alm, Cherry, Jones, & McKee, 2010). Tax compliance was improved by tax services, such as a hotline or website (Gangl, Torgler, Kirchler, & Hofmann, 2014). There was a positive link between better tax services and tax compliance, and the government could provide taxpayers with better social and economic infrastructure to expand their tax net. Still, the tax imposition was not justified unless the government provided the taxpayer and his family with some benefits (Maiga, 2015).

Studies have shown that quality tax services can enhance the conduct of tax enforcement. Quality services should include

taxpayer education, providing a 24-hour hotline, online tools, facilities, and the availability to taxpayers of tax officials in offices and social services by the tax authorities (Sutrisno, & Dularif, 2020).

The present study's findings significantly contribute to the underpinning fiscal capacity theory by providing empirical findings that the quality of tax administration services significantly influences taxpayers' compliance behaviour. Regulatory authorities and governments want to improve the tax net and broaden the tax base. The quality of tax administration services is a key factor that is considered a priority to improve the tax net or tax base.

Quality of governance means 'negotiation of improved public policy results and agreed governance principles by all stakeholders in an issue, both adopted and regularly assessed by all stakeholders (Bovaird & Löffler, 2003). Public governance is the administration, supply, and distribution of political goods to a country's people (Rotberg & Gisselquist, 2009). The conduct of taxpayers was affected by ethical perception, and public governance was affected by ethical perception. Recent literature suggests that the level of public goods and services has been poor, contributing to taxpayer noncompliance. Public governance can be obtained in a country through a successful taxation framework. Governance problems can have a positive or negative effect on taxpayers' action of compliance (Kiow, Salleh, & Kassim, 2017). Also, the literature states that governance issues and poor tax administration have a negative impact on compliance conduct, especially in developing countries (Umar, Derashid, & Ibrahim, 2016). The taxpayer's behaviour of compliance was influenced by the lack of governance over financial resources. Low public administration led to taxpayers' low motivation and low compliance of taxpayers (Muhrtal & Ogundeji, 2013).

Religious principles and values form the basis of moral decisions and be a central ethical element in noncompliance. To attain compliance behaviour, successful morale may be feasible. Moreover, in a society where the administrative structure is inefficient, a high degree of corruption, a high proportion of bribery, and a tax system are perceived as burdens. They have been recognised as adequate justifications for noncompliance. The literature review indicated that tax avoidance in developed countries is considered one of the potential justifications for an individual's noncompliance actions (Keenan & Dean, 1980). People feel that the tax system is cheated by political, wealthy, and big corporations, and the burden of taxation has moved to them and is unreasonable to pay. Whereas some thought that it was technically incorrect and morally right for noncompliance if the tax system did not care about the money of taxpayers and spent it unlawfully or immorally.

Current literature also notes that religiosity has a significant effect on tax morale as it can be a source of inspiration for taxpayer compliance conduct. The different standards for religious education, activities and membership in religious groups are used to quantify or determine religiosity (Sennur Sezgin et al., 2011).

Likewise, Torgler (2006); Lago-Peñas and Lago-Peñas (2010) studied Positive relationships between tax ethics and beliefs, such as religiosity and national pride. Investment in the country's fiscal capital to pursue tax compliance targets has been shown to contribute significantly to that country's economic development. Likewise, Torgler (2006) and Lago-Peñas and Lago-Peñas (2010) have been identified as constructive associations linking religiosity with the state's tax morale. Besides, the composition of the state institutions through which the government functions and the population structure have substantially contributed to understanding tax enforcement's reasons and behaviours.

### **Contributions of the Study**

The present study contributes to the body of literature in methodological, theoretical, empirical, and contextual grounds that will be discussed in detail in this portion.

The present study considered the fiscal capacity theory as the underpinning theory for assessing taxpayers' compliance behaviour based on the quality of tax administration services, quality of governance, and religiosity is a considered moderating variable. Several studies have been documented in the domain of compliance behaviour, particularly in developed economies. Moreover, limited literature has been documented in developing countries. However, in the case of Pakistan, only limited literature has been documented. The present contributes to fiscal capacity theory by empirically investigating the association between quality of tax administration services, quality of governance, and religiosity's role towards the compliance behaviour of taxpayers. As the critical issue for developing countries is the administration of tax services and quality of governance. Fiscal capacity remains the issue for developed and particularly developing countries; hence, the present study theoretically contributed to the quality of tax administration services. Quality of governance needs to be considered while making new policies. The government of Pakistan needs to consider that state's fiscal capacity is based on the quality of tax administration services, quality of governance, and religiosity play a significant role. Hence, policymakers and regulatory authorities need to consider these factors as a priority. Therefore, the present study contributed to the fiscal capacity theory that quality of tax administration service, quality of governance, and religion are significant for the higher level of taxpayers' compliance behaviour.

The present study contributes to the body of literature by providing the empirical association between the quality of tax administration services, quality of governance, and religion's role in explaining taxpayers' compliance behaviour. Most of the studies previously documented in literature considered the various factors that influence the compliance behaviour of taxpayers. Hence, limited literature has been documented in Pakistan in this domain, and most of them were conceptual and based on outdated techniques. The present study considered the two critical factors based on the literature and considering Pakistan's contextual issues. The present study also considered the role of religion as a moderating factor towards the compliance behaviour of taxpayers.

The present study's findings will facilitate the policymakers, regulatory authorities, and government of Pakistan in how these institutions ensure the compliance behaviour of taxpayers in Pakistan. The findings of the present study facilitate them in understanding the factors affecting the compliance behaviour of taxpayers. The present study empirically documented that the quality of tax administration service, quality of governance, and religiosity significantly influence the compliance behaviour of taxpayers in Pakistan.

Policymakers, regulatory authorities, and the government of Pakistan need to consider the role of quality of tax administration services and quality of governance to improve the compliance behaviour of taxpayers. The underpinning objective of the government is minimising the budget deficit and improving the compliance behaviour of taxpayers to broaden the tax base. To achieve this underpinning objective regulatory authorities, policymakers, and the government of Pakistan need to improve the quality of tax administration services and quality of governance in Pakistan.

### **Conclusion**

The underpinning objective of the present study is to test the role of quality of tax administration services and quality of governance towards taxpayers' compliance in Pakistan. The present proposed the moderating role of religiosity between the quality of tax administration services, quality of governance, and taxpayers' compliance behaviour. To achieve the present study's underpinning objectives, primary data was collected using a questionnaire from the salaried persons, AOPs, and companies. In the case of AOPs, respondents were owners/managers; in the case of the company's managers were considered as true representatives of companies.

After the collection of data, the initial step was data assessment include data coding, screening, and outliers. In the second step reliability and validity of items and constructs were tested, and in the third step, testing of hypotheses was performed based on structural model assessment at 5000-sample-resample bootstrapping.

The present study's findings reveal that the quality of tax administration services indicates a positive and significant association with taxpayers' compliance behaviour at a 90% level of significance in a direct relationship. However, similar results were found in moderating religiosity's role at a 95% level of significance. Quality of governance positively and significantly influences taxpayers' compliance behaviour at a 95% level of significance in case of direct relationship and in case of moderating role of religiosity. Moreover, the findings showed that religiosity significantly moderates the relationship between the quality of tax administration services and taxpayers' compliance behaviour. In contrast, insignificant results were shown in the case of quality of governance and compliance behaviour in the presence of religiosity.

The present study considered the limiting factors for the assessment of the compliance behaviour of taxpayers. For instance, future studies can add more variables, such as financial position, taxation audit, and the effect of penalties on taxpayers' compliance behaviour. The present study considered the unit of

analysis to individuals. However, the future study can be based only on the salaried persons, AOPs, and companies. AOPs need to investigate individually because approximately 90% of registered businesses are AOPs. Future studies need to consider family-owned businesses because most of the registered businesses were owned and operated by families. They use the transfer pricing concept for tax avoidance.

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