

## **Tax Rate and Tax Compliance Behavior: Insights from Ibn Khaldun's Theory of Taxation and Deterrence Theory**

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### ***ABSTRACT***

Many previous studies have been adopting various classic and modern economic theories in predicting tax compliance behavior. An outstanding and original theory from Islamic perspective, Ibn Khaldun's Theory of Taxation was found in his outstanding work of *Muqaddimah* in early 19<sup>th</sup> century. The grand Economic Deterrence Theory was introduced by Allingham and Sandmo in 1972. This theory has been extensively tested and used until today. However, there are little empirical studies using Ibn Khaldun's Theory of Taxation. This study aims to compare and contrast the similarities, differences and the current phenomena of both theories. The main assumption under these theories outlined that an increased in tax rate will result in tax revenue to be reduced. This study is expected to contribute to theoretical comprehension in taxpayers' compliance behavior by using Khaldunian Theory and Deterrence Theory.

*Keywords: Tax Rate, Tax Compliance, Ibn Khaldun's Theory of Taxation and Deterrence Theory.*

### **INTRODUCTION**

Taxation is one of the economic tools that the government employs to regulate the economy. Income tax continued to be a vital component in driving tax revenue collection and becomes the main contributor to the country's revenue. The major objectives of implementing tax policies are to encourage economic growth through the granting of fiscal incentives and to finance various development programs. In managing fiscal policy, it is important for the government to have an efficient and well-designed tax system as well as to ensure the revenue collected is redistributed properly. This will also contribute towards enhancing the nation's competitiveness particularly by providing a conducive business environment and ensuring convenience to taxpayers thus improving their willingness to pay taxes. High compliance among taxpayers is an important element in determining the total national tax revenue (IRBM, 2016). Even though Self-Assessment System (SAS) has been implemented for almost 15 years ago in Malaysia, the compliance rate is still unsatisfactory whereby only 15.24% compliance rate among individual taxpayers in 2018 (IRBM, 2018).

Tax compliance is still remaining the major issue all over the world as long as tax exists. Substantial amounts of tax compliance research have been undertaken by scholars in establishing the relationship between economic and non-economic factors on tax compliance behaviour. Economics factors such as tax rate, level of income, audit probabilities, tax audit, tax benefits, penalties, fines and perception of government spending and non-economics factors such as attitudes toward taxes, personal norms, social norms and perceived fairness of tax system have been investigated by scholars locally and internationally. Therefore, theories will be referred to in explaining these relationships. A theory and research are closely related as theory generally used to explain and predict phenomena. As theory should ideally guide research, Udo-akang, (2012) emphasized that “a theory and research are interrelated and are dependent one another to make sense of a phenomenon” (p. 91). Many previous studies have been adopting various classic and modern economic theories in predicting and explaining the relationship between economic and non-economic factors and tax compliance behavior.

This study is adopting two economic theories which are Ibn Khaldun’s Theory of Taxation and Economic Deterrence Theory. An outstanding and original theory from Islamic perspective, Ibn Khaldun’s Theory of Taxation was found in his outstanding work of *Muqaddimah* in early 19<sup>th</sup> century. A book ‘the *Muqaddimah*’ was translated from Arabic to English version by Franz Rosenthal in 1958. The book covers various topics which are based on Ibn Khaldun’s economic thinking including the theory of value, the price system, the law of demand and supply, division of labor, production, distribution and consumption of wealth, money, capital formation and growth, domestic and international trade, population, public finance, taxation and government expenditure.

The grand Economic Deterrence Theory was introduced by Allingham and Sandmo in 1972. They asserted that the decision of taxpayers to evade or not to evade taxes is a rational choice in regards of risk and uncertainty. It would also be of interest to see a discussion of tax evasion within the framework of optimal taxation theory. This theory assumes of course that there is no evasion whatever. They concluded that in promoting an efficient allocation of resources, taxes should be levied primarily on commodities that are inelastic in demand or supply. This theory has been extensively tested and used until today.

This study aims to compare and contrast the similarities, differences and the current phenomena of both theories. The main assumption under these theories outlined that an increased in tax rate will result in tax revenue to be reduced. This study is expected to contribute to theoretical comprehension in taxpayers’ compliance behavior by using Khaldunian Theory and Deterrence Theory.

## **BACKGROUND OF IBN KHALDUN**

The full name of Ibn Khaldun was Abd al-Rahman ibn Muhammad ibn Muhammad ibn Khaldun. He was born in Tunisia on 1 Ramadan 732 H (27 May, 1332 AD) and died in Cairo, Egypt on 26 Ramadan 808 H (16 March, 1406 AD). The book written by Ibn Khaldun, the *Muqaddimah*, also known as Prolegomena, is a sublime and intellectual achievement which defined the historical realities of social and intellectual progress of society. The book was written in the year 1377AD concerning economic theories, four centuries earlier than An Inquiry into the Nature and Causes of the Wealth of Nations, which the first published in 1776 M by Adam Smith. Discussion on the relationship between division of labor, specialization and wealth creation which lead to prosperity of a nation also included in the

book. Ibn Khaldun has also contributed to the Western model known as the *Laffer curve* in depicting the relationship between the rates of taxes and the amount of tax revenue.

## **IBN KHALDUN'S THEORY OF TAXATION**

In the history of economics development, Ibn Khaldun has been considered as the forerunner of Islamic economics with his significant discovery on tax rate as written in his book *Muqaddimah*.

He proposed that with high tax rates, it could shrink the tax base because they reduce the economic activity (Islahi, 2006). The core of Ibn Khaldun's Theory of Taxation exposed that:

*"to lower as much as possible the amounts of individual imposts levied upon persons capable of undertaking cultural enterprises. In this manner, such persons will be psychologically disposed to undertake them, because they can be confident of making a profit from them"*.

According to the above opinion, people's determination and incentives to work are psychologically affected by low tax liability. Eventually, they will be confident to pay tax from business profit obtained. Therefore, one way to spur economic activities is by reducing as much as possible the tax imposed on individuals (Jaafar & Ismail, 2017).

Ibn Khaldun has further explained that:

*"At the beginning of a dynasty, taxation yields a large revenue from small assessment. At the end of a dynasty, taxation yields a small revenue from large assessment. The reason for this is that when the dynasty follows the way of the religion, it imposes only such taxes as are stipulated by the religious law, such as charity taxes, the land tax, and the poll tax. They mean small assessments, because, as everyone knows the charity tax on property is low. The same applies on charity tax on grain and cattle, and also to the poll tax, the land tax and all other taxes required by the religious law. They have fixed limits that cannot be overstepped" (II: 89).*

He also described the advantages of low taxes:

*"When the tax assessments and imposts upon the subjects are low, the latter have energy and desire to do things. Cultural enterprises grow and increase, because the low taxes bring satisfaction. When the cultural enterprises grow, the number of individual imposts and assessments counts. In consequence, the tax revenue, which is the sum total (of the individual assessments), increases" (II: 89-90).*

From the above explanations, it has proven that if tax rate is low, tax revenue could be yielded in a large amount. With a low tax rate, there is a guarantee that it will maximize tax revenues. On the other hand, if the tax rate is high, only a small portion of tax revenue could be collected. It will rather be showing diminishing revenue after a certain stage. Because higher tax rates discourage work effort and encourage tax avoidance and even tax evasion, the tax base will shrink as the rates increase. Therefore, an increase in a tax rate causes a less than proportional increase in tax revenue. It is very obvious that at a tax rate of zero percent, the government would collect no tax revenues, no matter how large the tax base. Likewise, at a

tax rate of hundred percent, the government would also collect no tax revenues because no one would willingly work for an after-tax gain of zero (Islahi, 2006).

Taxes and government expenditures determine the strength or weakness of the dynasty at various stages in its development. That is the reason why Ibn Khaldun pays much attention to the analysis of taxes. Ibn Khaldun has analyzed the effect of government expenditure on the economy in much details as high-spending countries need high finance. Ibn Khaldun saw opulence as an obstruction to achieve sovereignty (Islahi, 2006). Opulence will also lead a nation to sink in the luxury of the gains achieved. The second opinion of the theory assumed that with high government spending, tax revenue collection would be low (Islahi, 2015; Samad et al., 2016; Jaafar & Ismail, 2017). When government spends on luxury, the tax rate will begin to increase (Jaafar & Ismail, 2017). Government spending is becoming another important variable in explaining the tax compliance behavior (Palil, M.R., A.Hamid, M. & Hanafiah, 2013). They assumed that taxpayers tend to evade tax if they perceive that the government spends tax money lavishly and unwisely. This is consistent with the Ibn Khaldun's opinion on government spending. Thus, this study adopted Ibnu Khaldun's Theory of Taxation in further evaluating and explaining the relationship between tax rate and government spending on tax compliance behavior.

It is interesting to note that tax rate must be determined based on religious prescription (Jaafar & Ismail, 2017). Government spending must be based on order of priority in Maqasid Shariah. While presenting his ideas on taxation, Ibn Khaldun emphasised various principles that must be observed to have a sound taxation policy, such as equity and efficiency, justice and neutrality, ability to pay, economy, benefit and convenience principles. In imposition of taxes justice and ability to pay must be observed. Ibn Khaldun is especially against any discrimination in imposition of taxes. In addition to excessive and oppressive rate of taxation, injustice and discrimination results in decline in tax revenue.

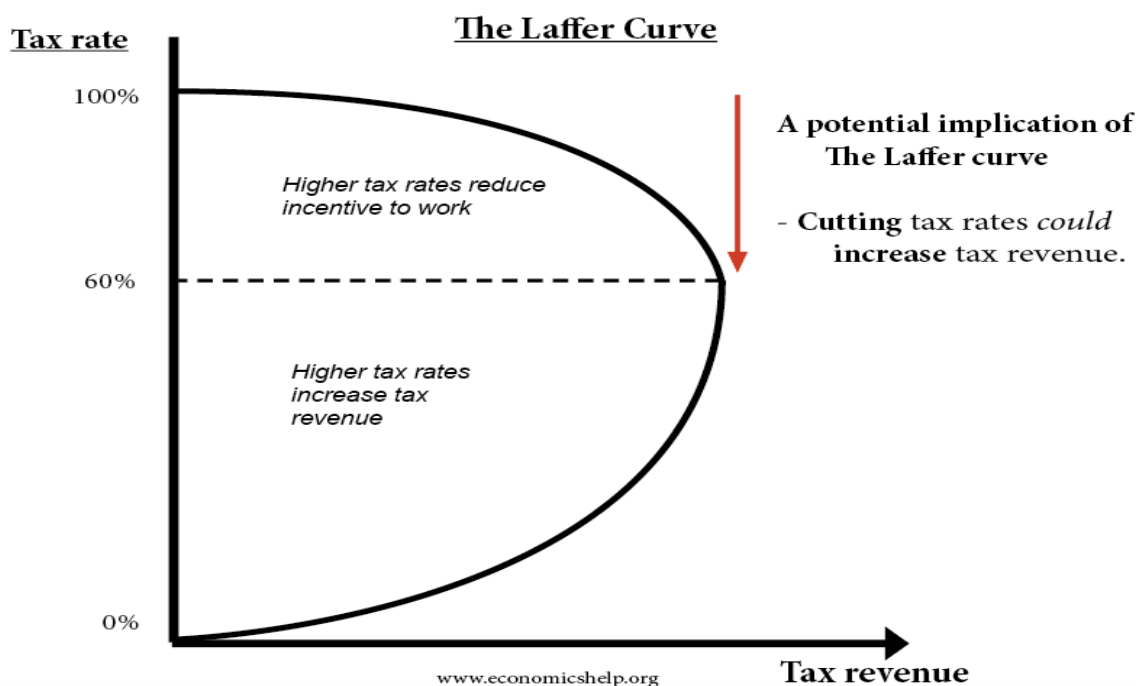
## **RELATIONSHIP BETWEEN TAX RATE AND TAX COMPLIANCE BEHAVIOR**

There are little empirical studies using Ibn Khaldun's Theory of Taxation after the book of Muqaddimah has been published in year 1958. Early study has been done by Islahi in 2006 which was focusing on taxation. Recently, researchers have shown an increased interest in adopting Khaldunian Theory of Taxation in their empirical studies (Mahmood Al-Leheabi, Mustafa Bahjat, & Ahmadi Ramchahi, 2013; Islahi, 2015; Samad et al., 2016; Jaafar & Ismail, 2017).

In 2015, Islahi found that if tax rate is low, tax revenue could be yielded in a large amount. The higher the tax rate, the less tax revenue will be collected (Jaafar & Ismail, 2017). High tax rate will have a negative impact on people's work motivation as they will lose incentive to work.

A study by Annuar et. all, (2018) on corporate tax rate and tax revenue, has gained attention of applying the Ibn Khaldun tax theory. In the study on the impact of the reduction of the corporate tax rate on corporate tax revenue (Annuar et all, 2018). The study adopts the theory of taxation by Ibn Khaldun, depicted as the Laffer curve. The Laffer curve, based on the economic theory developed by Arthur Laffer, depicts the relationship between the rates of taxes and the amount of tax revenue accruing to the government in a given economy. The curve is designed to depict two extreme ends when the level of tax revenue for the

government will be zero. These are when the tax rates are 0 and 100 per cent. Therefore, the government must find an appropriate tax rate at which the level of tax revenue is at its maximum. This is called the optimal tax rate. Corporate tax rate has a dual effect on corporate tax revenue over the study period. It shows an inverted U-shape relationship between the corporate tax rate and corporate tax revenue and reveals that the optimal tax rate is 25.5156 per cent. This result is in line with propositions in Ibn Khaldun's theory of taxation and the idea in the Laffer curve discussed above.



Source: Arthur B.Laffer, 2004

They found that there is a positive relationship between corporate tax rate and corporate tax revenue. The determination of the optimal corporate tax rate show that the policy of gradual reduction in the corporate tax rate had a positive impact on the economic growth of Malaysia. (Annur et al., 2018).

## DETERRENCE THEORY

The Deterrence Theory acknowledged that when tax rate is rising then tax evasion will be reduced (Allingham & Sandmo, 1972). They asserted that the decision of taxpayers to evade or not to evade taxes is a rational choice in regards of risk and uncertainty. In other words, the decision is made by examining the expected cost and benefit. The underlying principles of Deterrence Theory outlined that if the probability of detection and punishments are high, then criminal will be deterred from committing crimes (Mohd Hanefah, 2007). The first is based on the theoretical insight that the probability of detection (the frequency of audits) and the penalty for evasion are policy substitutes. If one wishes to achieve a given degree of deterrence, this may be achieved by high probabilities and low penalties or by low probabilities and high penalties (Sandmo, 2004). The probability of detection and tax penalty were found negatively significant while tax rate was positively significant in relation to income tax evasion. Recent studies have shown mixed findings whereby few studies reported positive relationship between tax rate and tax evasion (Alkhatib, Abdul-Jabbar, &

Marimuthu, 2018) while some studies revealed negative relationship which is consistent with the underlying principle of Deterrence Theory.

## **CONCLUSION**

Both theories have shown a same direction in explaining the relationship between tax rate and tax compliance behavior. The first opinion under Ibn Khaldun's Theory of Taxation is with a low tax rate, tax would be paid voluntarily and happily. It revealed that taxpayers will easily comply with tax obligation if the tax is imposed at minimum rate. Consequently, tax revenue collection could be further increased. With the higher the tax rate, the less tax revenue could be collected. This assumption is consistent with grand Economic Deterrence Theory. It discovered that the theory founded by Ibn Khaldun is still relevant and practical until today. Economic philosophy discussed by Ibn Khaldun is holistic as it comprises justice, commitment, cooperation, moderation and equality. Tax rate cannot be changed or increased to fulfill certain needs. In determining tax rate and government spending, Ibn Khaldun's Theory of Taxation was found based on Maqasid Shariah. He posited that social justice as the best method in collecting and distributing tax revenue.

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