



Policy Brief

TAX COMPLIANCE, TAX BEHAVIOUR AND TAX MISPERCEPTION: EVIDENCE FROM FAISALABAD

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INTRODUCTION

In the developing economies, tax compliance remains a major challenge to the fiscal sustainability due to narrow tax bases, widespread informality, and weak governance capacity to mobilize domestic revenue (Lompo, 2024). Traders represent an important yet under-researched segment of the tax system. Operating at the intersection of formal regulation and informal markets, their compliance behavior is highly sensitive to the institutional structures, administrative design, and state legitimacy. Specifically, in Pakistan, tax evasion is a significant problem, often exacerbated by the factors like inadequate institutional capacity and misperceptions about legal compliance, lacking tax enforcement laws (Alm & Torgler, 2011). Understanding how traders perceive and respond to taxation is therefore crucial for designing policies that go beyond short-term revenue collection and promote sustained voluntary compliance. The literature suggests that tax compliance cannot be achieved through coercion alone and is strongly influenced by macro-level behavioral and institutional factors, such as taxpayer awareness, perceptions of fairness, administrative simplicity, and trust in state institutions. These non-coercive factors are particularly important in the developing economies where enforcement capacity is uneven and administrative complexity is high (Vu, 2022). The current study aims to examine how institutional, administrative, and behavioral factors jointly shape tax compliance behavior among traders in Faisalabad, and how the perceptions of the traders regarding tax system influence their willingness to comply voluntarily.

LITERATURE REVIEW

The size of the informal economy remains a critical determinant of tax revenue performance. The pre-existing evidence indicates that informality is associated with inflation positively, while it is in negative relationship with the tax burden, supporting the view that governments partially



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substitute tax revenue with seigniorage in economies with weak tax capacity (Mazhar & Méon, 2017). Prior studies also emphasize the role of firm-level ethics and auditing standards in curbing tax evasion. For instance, Benkraiem et al. (2021) demonstrate that ethical corporate behavior is particularly effective in reducing evasion in low-income countries characterized by weak investor protection and low board effectiveness. At the micro level, the literature suggests that complex tax systems and extensive exemptions can facilitate legal tax avoidance, thereby reducing participation in the shadow economy. While such complexity may deter illegal activities, it can also serve as a substitute for illegal tax evasion by enabling lawful avoidance strategies (Neck et al., 2011).

Beyond compliance, tax misperception has broader economic consequences. Tax misperception is increasingly recognized as a critical mechanism that mediates the relationship between tax compliance and its key determinants, including cognitive capacity, tax complexity, and behavioral biases. This perspective is supported by Blaufus et al. (2022), who synthesize extensive evidence on the sources of tax misperception, ranging from heuristic decision-making, salience, and behavioral bias to the institutional features such as system complexity, interdependent taxes, tax uncertainty, and the format in which tax information is presented. Moreover, distorted tax perceptions influence risk-taking behavior, investment choices, real effort, tax planning, consumption patterns, and retirement decisions. At the policy level, concerns about tax rate progressivity are often framed through the lens of the Laffer effect, which suggests that higher tax rates may discourage labor supply (Stentcheva, 2020). While existing studies provide valuable insights into the determinants and consequences of non-compliance, they largely focus on developed economies and general taxpayer populations. There is limited empirical evidence examining how tax misperceptions interact with compliance behavior among traders and small businesses in the developing countries, where tax complexity, limited financial literacy, and institutional trust deficits are more pronounced. This study addresses these gaps by empirically examining tax misperception as a central behavioral channel influencing compliance decisions. It also integrates tax complexity, behavioral perceptions, and social influences within a single framework to explain compliance decisions.

RESEARCH METHODOLOGY

The current study utilized mixed-method approach, combining quantitative and qualitative components to examine the behavioral and institutional factors underlying tax non-compliance. The mixed-method framework was opted to allow for the triangulation of findings, enabling a deeper understanding of not only the measurable factors influencing compliance behavior but also the underlying perceptions and institutional realities forming taxpayer decisions. This research was conducted within the formal tax and business setting of Faisalabad. The qualitative component of



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the study played a central role in capturing traders' lived experiences, perceptions, and behavioral responses to the tax policies, administrative procedures, and enforcement practices.

Primary data were collected through a structured questionnaire with both open- and closed-ended questions from thirty tax consultants/lawyers, 387 traders and 20 tax officials followed by a focus group discussion held with representatives of tax bar, traders and tax officials to obtain in-depth insights. Quantitative data were analyzed using logistic regression and Structural Equation Modelling (SEM). Qualitative data were analyzed using the triangulation method and an inductive thematic approach. The study was based on inductive reasoning, which enabled analytic insights to be developed from the discussions held by the participants. The survey covered multiple areas of Faisalabad, with a primary focus on the eight central bazaars around the Clock Tower, as well as the major roads and markets across the city.

FINDINGS AND DISCUSSION

The findings identify tax complexity as a key obstacle to the compliance, both directly and indirectly through tax misperception. Traders who perceive higher complexity, however, show a greater preference for presumptive or fixed tax regimes. Social influences, captured through spatial lag effects, play a significant role, highlighting the importance of social norms and tax culture. Perceived high tax rates further discourage compliance, whereas recurrent use of banking channels encourages adherence to tax laws. Risk-tolerant traders are more likely to register for income and sales taxes and to accept turnover taxation, emphasizing the role of incentives. Furthermore, Institutional trust strongly influences willingness to participate in turnover-based and presumptive tax systems. Tax salience also affects compliance decisions, emphasizing the relevance of tax rates and policy design. A supportive business environment increases acceptance of turnover taxes. Overall, tax misperceptions substantially contribute to non-compliance, while traders operating in homogeneous environments or under traders' unions tend to exhibit lower levels of misperception. Finally, tax knowledge, cognitive ability, and education significantly improve compliance outcomes, both directly and indirectly by reducing tax misperceptions. The representatives of traders, tax bar and FBR collectively emphasized to reduce tax burden on the existing tax payers by reducing the tax rates and turnover tax rate, particularly for the traders who are offered very low profit margins against very high business volume. They further stressed the policy makers to focus more on expanding the tax net rather than burdening the existing tax payers in the form of high tax rate, frequent issuance of FBR notices, complex tax procedure and cumulative tax burden. They further advised to introduce 1-page tax filing in Urdu language, internal hiring of FBR prosecutors, and digital footprint of the FBR notices to improve tax governance. They prioritized incentives based policy arrangements over the enforcement measures that spread fear.



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CONCLUSION

This study examined the factors driving tax non-compliance among traders and proposed policy-relevant solutions to improve compliance by the triangulation of qualitative and quantitative data. The study concludes that low tax compliance among traders is primarily driven by structural, behavioral, and institutional constraints rather than by enforcement gaps alone. Tax complexity emerges as the most significant barrier, directly discouraging compliance and indirectly through widespread tax misperceptions. The strong preference for the fixed tax regimes among traders who perceive higher complexity stresses the need for simpler, more predictable tax systems.

The findings further highlight the critical role of social norms and peer effects in shaping compliance behavior, emphasizing that tax culture and collective behavior matter alongside individual incentives. High perceived tax rates continue to undermine compliance, while policies promoting transparency, such as mandatory use of banking channels can effectively encourage adherence to tax laws. The positive association between risk tolerance and compliance indicates that incentive-based approaches may be more effective than disciplinary measures in broadening the tax base. Importantly, tax misperceptions remain a major source of non-compliance, while traders operating in homogeneous environments or within trader unions exhibit fewer misperceptions. Overall, the study emphasizes that improving tax compliance requires a holistic approach that combines simplification of tax procedures, strengthening institutional trust, enhancing taxpayer awareness, and a supportive business environment.

POLICY IMPLICATIONS

This study provides critical insights for public policy by identifying key factors that contribute to non-tax compliance among traders. Pakistan is stuck in a vicious circle in which lower tax compliance and lower tax to GDP ratio lead to lower provision of publicly provided goods that weakens institutional trust among the business community. Consequently, this environment of low institutional trust further undermines the tax compliance behavior. This vicious cycle can be dismantled by the incentive-based measures such as lower marginal tax rates, targeted tax credits, and direct benefits such as health insurance for the compliant traders to encourage registration and sustain long-term compliance.

Following policy measures are recommended in order of priority.

1. Tax rate should be dropped significantly, particularly for the traders who fully comply with the tax obligations such as registration with sale tax, integration with POS network, and the



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offering of payment via debit/credit card machines for the customers. Furthermore, turnover tax rate under section 113 should be re-determined after consultation with the stakeholders. Wholesalers of Fast-Moving Consumer Goods should particularly be taken into confidence, as their profit margins are quite low against very high business turnover.

2. Trust-based governance practices are essential for promoting voluntary participation and stabilizing the tax base. Direct benefits such as health insurance, relief on utility bills, VIP treatment at government offices for the tax payers, and recognition certificates should be offered to promote institutional trust, which are essential for voluntary tax compliance. Moreover, corruption in tax matters can be overcome by digital footprint of the notices issued by the FBR officials and by developing a mechanism to evaluate the performance of the FBR prosecutors.
3. Tax authorities should prioritize simplifying tax laws, filing procedures, and documentation requirements to reduce compliance costs and minimize tax misperceptions. As the Federal Board of Revenue (FBR) expands digitalization initiatives such as Point-of-Sale (POS) integration, electronic invoicing, and online return filing, these reforms should be accompanied by simplified, transparent, and user-friendly tax communication to reduce cognitive burdens on traders and small businesses. Moreover, presumptive tax regime can be offered to the small traders based on utility bills, rent and market survey based sale after the consultation with traders. Proper documentation of rental and employee's contracts should be made essential.
4. Tax net should be expanded to reduce burden on existing tax payers.
5. As the findings suggest that incentives are more beneficial than enforcement measures. Therefore, enforcement-driven approaches should be replaced with facilitative compliance models. In this regard, incentives should be offered to the both traders as well as to the customers to use banking channel for the transactions. The study vindicates the recent decisions by the FBR/government such as discriminating between the filers and non-filers on bank transactions/purchase of property to lift tax filing ratio. Therefore, such similar steps are recommended to induce the traders to register with sales tax and to accept turnover or fixed tax based regimes.
6. Proper consultation with the traders and tax bar representatives should take place prior to the implementation of any tax law/scheme/SRO.