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Determination of Tax Literacy: A Systematic Review and Conceptual Framework

Gurpreet Kaur and Shailinder Sekhon***

ABSTRACT

This paper proposes a conceptual framework of tax literacy (basic, advance and functional) in the Indian economy by a systematic literature review. Basic tax literacy is based upon one's understanding of general income tax concepts. Advanced tax literacy is associated with one's ability to apply the tax knowledge for computing tax liabilities. Functional tax literacy is related to the self-filing of Income Tax Returns (ITRs). Thereafter, primary data was collected from taxpayers to test the proposed framework. This study has applied a tax literacy framework and determined the basic, advance and functional tax literacy level of individual tax payers. The proposed framework may assist future research in providing a structured approach for assessing tax literacy as a factor influencing tax compliance. Furthermore, the results of the study are expected to help the government in deciding the future course of action towards effective policy making for taxation.

Keywords: *Basic tax literacy; Advance tax literacy; Functional tax literacy.*

1.0 Introduction

Resources owned by the government of any nation are extensively used for their economic development and for fighting against economic problems like fiscal deficit, recession, and balance of payment of that nation.

**Corresponding author; Assistant Professor; Department of Commerce and Management, Sri Guru Granth Sahib World University, Fatehgarh Sahib, Punjab, India (E-mail: preet.gurpreet1910@gmail.com)*

***Professor, Department of Distance Education, Punjabi University, Patiala, Punjab, India (E-mail: shailinder_sekhon@yahoo.co.in)*

Among these resources, taxes collected by the government are the primary source of their earning. In 2020-2021, direct taxes formed 56.4%, corporate taxes contributed 28.1% and personal income tax made 28.3% of the contribution in the total income of the government (Times of India, 2021). These revenues are utilized by the government for carrying out existing developmental functions to provide decent services to the public. Tax literacy is needed for raising the public (government) revenue to provide decent services to the public. This fact shows that it is very important for individuals to be tax literate so that they can make well-informed decisions regarding their tax matters and are also able to easily comply with the complex tax requirements. Tax Literacy also plays an important role in improved tax compliance. It also amounts to awareness regarding tax issues and complying with these issues properly. In developed nations, tax compliance is a serious matter of concern. Whereas, in developing countries like India, awareness and knowledge regarding tax issues is in itself a matter of concern. Knowledge regarding the income tax system in itself is very difficult for most of the taxpayers, without which, proper compliance is not possible. Thus, for the people in our country, knowledge and awareness about the income tax laws is important from all the aspects of tax compliance.

In India, there is a variation in the income level of individuals which is very evident. More and more income level added the responsibility in terms of tax liability or burden for an individual. An individual has to make several decisions that are related to tax planning. Individuals have to decide how much to spend on tax payments, save, invest, borrow, and how much tax planning to do. To take such decisions effectively and accordingly, an individual must be tax literate. Increased health facilities and education costs have made it necessary for people to plan and invest adequately. An individual must appreciate the need for tax planning, systematic investments in different tax-saving avenues. All these tasks can be accomplished only when an individual is aware of the tax matters which concern him. Thus, there is a need for tax literacy among taxpayers.

The Income Tax Act-1961 of India contains several provisions for various deductions, exemptions, rebates, reliefs, etc. To understand the deductions under different heads of income, deductions from gross total income, various exempted incomes, the maximum permissible deductible amount from the gross total income, rebate under section 87 of the Income Tax Act, an individual must be tax literate. Each of these above-mentioned items offers a range of benefits depending upon the nature of income and level of income. Due to this increased complexity of tax-saving methods, including the extent of deduction limits, individuals find it difficult to take tax planning decisions themselves. If individual taxpayers are aware of their tax matters and understand different tax-saving methods provided by the law, it will be able to improve

their tax compliance behavior certainly. In India, where the tax rules and regulations change and are being constantly revised, a tax illiterate individual does not upgrade himself with such new information. However, it is expected that the citizen must have at least the minimum level of required tax knowledge. However, there is another important issue that needs to be considered. Is ‘what constitutes a basic knowledge in taxation’ sufficient for every citizen? And ‘what constitutes advance knowledge in taxation?’ which is having to update themselves every year. So, the study adds literature on these aspects of tax literacy. Moučková & Leoš (2018) also agreed that currently, there is no uniform methodology of tax literacy measurement and assessment.

Hence, it is to be noted that, to handle the above-mentioned problems, an individual should be tax literate. And, there should be some kind of uniform pattern which should be used to measure the tax literacy level of an individual functioning in the Indian economy. Therefore, the objective of the paper is to develop a conceptual framework for the measurement of the tax literacy. A systematic literature review approach was used to develop the framework. The paper is divided into three sections namely; section first talks about the different concepts of tax literacy, levels of tax literacy across the world, section second proposes the conceptual framework of tax literacy and the third section discusses the outcome of the model.

2.0 Concept of Tax Literacy

Discussions on tax literacy are normally not widespread and the concept is also not discussed much widely nor generally defined or accepted. To some extent, however, the concept of tax literacy has been defined by different researchers which are as follows:

Des, 1989 differentiated the concept of tax literacy and illiteracy in simple terms as, “Those people who have the ability and skills to complete the tax return forms are considered ‘functional tax literate’ and those people who cannot understand and complete the tax return forms can be considered tax illiterate people”. Some other definitions of tax literacy defined by others author include, “Tax literacy can be defined as the ability to fill the tax form and compute the taxable income, calculate tax liability independently.” (Bardai, 1992; Razman & Ariffin, 2000) measured the tax knowledge of respondents in terms of tax filing experiences. Nero & Amrizah(2003) determined the level of tax literacy among the salaried class at three levels; i) very literate; ii) literate; iii) illiterate. “Tax literacy means ‘having the sufficient ability to read, write and understand taxation matters’.” (Latiff *et. al.*, 2005). They measured the tax knowledge of individuals in terms of chargeable income, exemptions, reliefs, rebates and tax credits.

“Tax literacy is the ability to fill in the tax form and calculate the tax liability independently so that a taxpayer should know how to determine tax liability and for calculating tax liability, he should know what constitutes taxable income, deductible deductions, claimable tax reliefs, and rebates.” (Palil, 2005). Loo & Ho (2005) measured the tax knowledge of individuals in terms of chargeable income, exemptions, reliefs, rebates, and tax credits. At the end, they concluded that the respondents were incompetent to work for the Self-Assessment System in the way of filing of returns, calculating tax liability, tax reliefs, and exemptions independently. Coetzee & Oberholzer (2009) measured the tax knowledge of chartered accountants on the theoretical and practical aspects of taxation.

While, below are the statements specified by authors that have defined the concept of tax literacy with some specific context. According to a study made by Madi *et. al.*, (2010), “a person can be considered functionally literate if he/she can read, write and calculate for his/her self-income. On this analogy tax literacy may be defined as follows: a person is considered functionally tax literate if he/she can independently read and understand income statements, can engage independently in various tax calculations, and is aware of possible tax risks in the financial environment.”

Another aspect defines tax literacy as, “an ability to understand important terms such as public finance which include state budget and municipal budgets, incomes and budget expense, taxes, deficit management, and budget policy” (Vybihal, 2011).

Palil & Mustapha (2011) divided 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 of offence, penalty and fine. Warris, 2012 stated that “Tax Literacy is intended firstly, to help provide tax information, secondly not to support any particular type of amount of taxes but simply to explain taxes within a domestic system as well as regional and international system and how does it impact on those being informed. Thirdly, that the information transmitted consists of not just tax revenue but also expenditure” (Warris, 2012). Similarly, Bhushan & Medury, (2013) defined tax literacy as, “the knowledge which an individual possesses to manage the issues concerning personal taxation effectively.” (Bhushan & Medury, 2013) considered the dimensions associated with the concept. Brackin & Toni (2014) argued that taxation concepts should be combated with financial literacy concepts. Hastuti (2014) refers to tax awareness as the ability of taxpayers to each take ownership of their tax calculations, payments and reporting. Kamil (2015) concludes that awareness is that taxpayers “want to pay taxes”; Bahari & Ling (2009) proposed tax knowledge to be the knowledge with regard to the public understanding of tax and some matters relating to the taxation system. It is stated as “Tax

literacy presents one of the financial literacy dimensions which refers to possessing specific tax-oriented financial knowledge and numeracy skills that are required for managing tax calculations” (Cvrlje, 2015). Oladipupo & Obazee (2016: p.2) states that tax knowledge is the level of awareness or the level of sensitivity of taxpayers to tax legislation.

From the view point of essentials required, the concept can be stated as, “Some basics of tax knowledge regarding taxation concepts and some information are necessary to become tax literate to deal effectively with requirements of using Self-Assessment System” (Al-Maghrebi *et al.*, 2016). The taxpayer needs to be tax literate, which means that they must possess adequate knowledge of the various aspects of tax to discharge their tax liability responsibly, precisely, and timely (Hasseldine *et al.*, 2016). “Tax literacy is the name of greater alignment between knowledge and confidence and at times under-confidence, i.e., if a person is confident about his/her tax knowledge, then this is likely to be aligned with the person’s knowledge, or that their knowledge is greater” (Chardon 2017).

Hence, from the above stated definitions it can be concluded that tax literacy is a specialized field of financial literacy. It is the ability or the skills required by the taxpayers which will help them to generate confidence for managing their own tax liabilities. According to Bornman & Wassermann (2018) “Tax literacy is a process of ‘drawing meaning’ from the interaction between tax awareness and contextual knowledge”. The framework illustrates three elements of tax literacy, namely 1) tax awareness, 2) contextual knowledge & skills, and 3) wise decision making. The first element, tax awareness, refers to individuals’ understanding of their role in the fiscal exchange or social contract with the government. The second element proposes procedural as well as a legal component of contextual knowledge and skills. The procedural context allows the consideration of the knowledge and skills required to interact with tax authorities and setting records for tax purposes in order. The legal context refers to an understanding of how the taxpayer is taxed. The third element makes aware of taxpayers’ engagement in fulfilling their tax obligations as a result of the social construction of their awareness and knowledge, based on their perceptions. Additionally, Kaur (2018) conducted a study on tax literacy among taxpayers in the Indian context. The researcher collected data from 60 respondents by administering a questionnaire in the city of Derabassi, Punjab. The study showed that the respondents had proper knowledge of the various tax provisions related to basic tax exemptions, slab rate etc. Bornman & Ramutumbu (2019) proposed a framework of tax knowledge that provides a structured approach for assessing tax knowledge requirements in various contexts as a factor influencing tax compliance. The framework suggests that tax

knowledge is discernible in three categories: (1) General tax knowledge, (2) Procedural tax knowledge and (3) Legal tax knowledge.

From the earlier stated concepts of tax literacy, the researcher has developed the tax literacy concept with a broad idea that needs to be considered to determine the level of tax literacy in an Indian economy. Hence, Tax Literacy is a set of skills and knowledge that allow an individual to understand the taxation principles and concepts which an individual needs to know to make informed decisions regarding the investment in tax-saving products. Here, tax literacy is concerned with the understanding of basic tax concepts, principles, skills, and the ability to understand the available tax-saving products and to make good tax planning choices.

3.0 Research Gaps

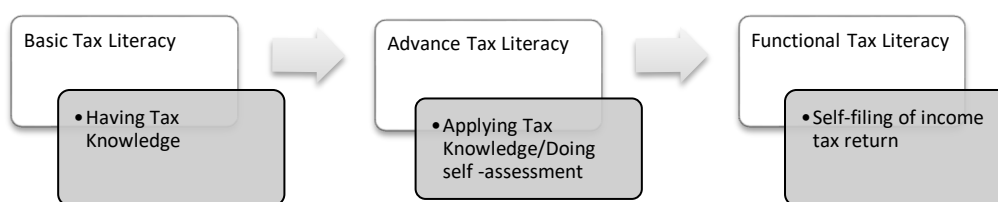
Based on the literature review, some general conclusions have been drawn by the researcher. Most of the studies conducted on tax literacy in foreign countries are related to tax compliance behavior. Few studies have been conducted in an Indian context such as the study conducted by Bhushan & Madury (2013) which has found a low level of tax literacy among the various demographic groups of salaried employees. Hence, more studies are needed to be conducted in an Indian scenario while keeping in mind the tax literacy and tax-saving behavior of an individual taxpayer. Different researchers used different approaches to determine tax literacy across the world. Nero & Madi (2005) classifies the income taxpayers in three groups based on tax literacy namely, very literate, literate, and tax illiterate. Latiff *et al.*, (2005) classifies the income taxpayers in two groups, functionally tax literate and functionally tax illiterate by utilizing the definitions of tax literacy given by the OECD. Chardon (2014) reported the results of an adult survey of tax literacy in Australia and the tax literacy scores classified as either 'poor' or 'low'. Hence, there is a need to determine the levels of tax literacy in terms of basic and advanced criteria.

4.0 Conceptual Framework of Tax Literacy

The objective with this study is to build and apply the conceptual framework of tax literacy. Different researchers used different approaches to determine tax literacy across the world. Here, the important issues that need to be considered are 'What constitutes a basic knowledge in taxation' sufficient for every citizen? And 'what constitutes advance knowledge in taxation?' According to the conceptual framework of tax literacy developed by Bornman, (2018) tax literacy has three concepts in the modern

economy namely; (1) tax awareness, (2) contextual knowledge and skills, and (3) meaning making or informed decision making. By analogy, it can be said that tax literacy comprises three elements. One is basic tax literacy which enables the individual to understand and possess knowledge of basic taxation concepts, second is advanced tax literacy which deals with the knowledge, principles, skills, and ability to apply tax deductions, tax rates, rebates for calculating income tax liability so that an individual may be able to make well- informed decisions. And in relation with this, well-informed decision-making by taxpayers in filing an income tax return independently without taking the help of any tax agent is identified as the third element and known as functional tax literacy. This third element is the end product of the first two elements.

Figure 1: Elements of Tax Literacy



Source: Compiled by author

After reviewing various definitions of tax literacy, it can be said that Tax Literacy comprises three elements: one is Basic Tax Literacy which enables the individual to understand and possess knowledge of taxation concepts which are of basic nature, second is Advance Tax Literacy deals with the knowledge, principles, skills, and ability to apply tax deductions, tax rates, rebates for calculating income tax liability so that an individual may be able to make well- informed decisions. The end product of Advance Tax Literacy is filing an income tax return at its own without taking the help of any tax agent. Third element is identified as Functional Tax Literacy (Figure 1).

After undergoing an in-depth study of available literature related to chronological developments that have taken place with regard to tax literacy, the researcher has conceived the following levels of tax literacy, which defines the scope of the concept of tax literacy for the present study. To explore the level of tax literacy, a conceptual framework has been framed. The in-depth description of the scope of the terms of basic tax literacy, advanced tax literacy, and Functional Tax Literacy is mentioned as follows.

4.1 Basic tax literacy (tax knowledge)

Basic Tax Literacy covers knowledge and understanding of general concepts mentioned below:

- Basic Income Tax concepts and terms
- Role and Responsibilities of a taxpayer
- Rights of a taxpayer
- Incidence of income tax on taxpayers
- Taxable income
- Items of Exempted income
- Heads of income
- Basis of a charge of income tax under each head of income
- Deductions available under each head of income
- Deductions available from Gross Total Income to reduce tax burden

4.2 Advance tax literacy (application of tax knowledge/self-assessment)

Advance tax literacy covers the ability to understand more technical concepts in comparison to basic tax literacy; and to calculate income tax liabilities independently (self-assessment approach) by taking the following steps:

- Determining the Gross Total Income under five heads of income
- Reducing Gross Total Income by applying deductions available under sections 80C to 80U
- Knowing the applicable tax rates on net taxable income
- Calculating the income tax liability before rebates
- Reducing income tax liability by providing rebates/reliefs
- Calculating final tax liability, with surcharge and education cess

4.3 Functional tax literacy (self ITR filing)

Functional tax literacy is the end product of advance tax literacy. Functional tax literacy is expounded to independently filling of income tax return. It is treated as an action-oriented approach under the study. In this context, taxpayers should be familiar with the appeals and litigation proceedings, recent initiatives such as e-assessment (2015) and faceless assessment (2018). With the changing scenario, these aspects add the skills of taxpayers to become functional tax literate.

5.0 Research Methodology

A qualitative approach was used in the study by the means of a thematic search of appropriate literature. Tax Literacy Level was determined with the help of a self-

structured questionnaire. The sampling unit in this study is an individual who falls under the income tax bracket. For the present study, sample size is determined (i.e 384 in total) by applying Cochran's formula for calculating sample size when the population is infinite (Israel, 1992). Data analysis was done by descriptive statistics such as percentage, frequency and averages.

6.0 Results and Findings

Tax literacy has been determined at three levels viz; basic, advance and functional. Basic tax literacy relies on one's understanding regarding income tax concepts. Advanced tax literacy is concerned with one's ability to apply and use tax knowledge for computing income tax liabilities. Whereas, functional tax literacy is expounded to independently (without the help of experts) filling of income tax return.

- As per the results of the study, the basic tax literacy rate is 79% which is not considered to be satisfactory. Hence, it is suggested that the government should educate the taxpayers regarding the basics of taxation through tax literacy campaigning.
- The study reports that the advance tax literacy rate is 68% which implies that the majority of taxpayers are unable to handle all the aspects related to computation of tax liabilities or self-assessment of tax because the taxpayers assume that assessment of tax liability is a complicated task for them. Hence, it is recommended that Income Tax Authorities should simplify the tax computation process or self-assessment process so that individuals can make their assessments themselves. Simplification of tax computation can be done by adopting the following course of action:
 - By attaching the annexure showing all the steps to compute income tax liability.
 - By providing another annexure depicting the further details to determine gross total income, all the available deductions to reduce taxable income.
 - By furnishing a copy of applicable tax rates/tax tables to find out the tax burden of each income level.
- As per the findings of the study, the level of functional tax literacy among respondents is 22% which appears to be very less. And functional tax illiteracy or dependence upon tax agents for ITR filing is 78%. Dependence upon tax expert's services is mainly due to two reasons; (i) lack of time and (ii) lack of confidence among taxpayers. Hence, it is recommended that the Income Tax Department should initiate 'Self ITR Filing Week' to overcome the problem related to time. During this week, taxpayers would be encouraged for self-filing of their ITRs by giving them a token of appreciation. Furthermore, additional tax benefits should be given to those

functional tax literates who make others functional tax literates. Simultaneously, taxpayers' care centers should be opened to build up confidence among taxpayers and to motivate them for self-filing of ITRs.

7.0 Conclusion

Tax literacy is needed for raising the public (government) revenue to provide decent services to the public. Tax Literacy also plays an important role in improved tax compliance. If individual taxpayers are aware of their tax matters and understand different tax-saving methods provided by law, it will certainly be able to improve their tax compliance behavior. On the other hand, tax literate individuals can make informed decisions regarding their tax issues and can make effective use of the tax planning instruments. So, tax literacy helps in improving the state of an economy and contributes to the economic growth and development of the country as well.

The present paper has framed a three-dimensional model to measure the tax literacy in an Indian scenario. The basic tax literacy level is 77% which is not up to the mark. And advance tax literacy is 68%. From the above figures, it can be stated that the majority of taxpayers are unable to handle all the aspects related to the assessment of tax liability because they assume that assessment of tax liability is a complicated task for them. The study reports that only 22% of the sampled respondents are functional tax literates. And the rest of the respondents i.e. 78% are found functionally tax illiterate as they are dependent on tax experts for their ITR filing. The major reason for functional tax illiteracy is lack of confidence, time among individuals and another prominent reason is associated with the behavior of the respondents. In conclusion, we need to move towards increasing our tax literacy. Tax Literacy can be enhanced by launching tax literacy campaigning, educating the taxpayers, making the tax computation process easier and simpler as suggested by the present study.

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