

Impact of Taxation on Financial Services Business Location Decisions in Pakistan

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Abstract: The problem, what is the good tax system? Has been pointed out many times in past. While much optimal taxation research focuses on economic effects of taxation, and the purpose of this study is to add a new dimension by investigating the relationship between tax system variables and certain other variables of location decision making,. These relations are tested using the data from financial service providers functioning especially in sindh. The results show that taxation burden (cost of compliance, certainty of interpretation of tax laws, and exemptions/deductions) are positively concerned with the financial services business location decisions, or in other words we can form a statement in the light of empirical results that institutions are not looking mostly tax factor but they are only trying to avail the Business opportunities.

Key words: Taxation, financial services, location decision, location variables

INTRODUCTION

Research Domain:

Pakistan moves towards becoming a smart country and the regional development of economy becomes critical. Because according to the statement of Professor Rosabeth Moss Kanter from Harvard that:

“in the future, success will come to those companies, large and small, that can meet global standards and tap into global networks. And it will come to those cities, states, and regions that do the best job of linking businesses that operate within them to the global community (Kanter, 1995)”

The most important issue emerges from the research of Kanter, that the factors that contributes to the success of globally competitive companies is the relationship between industry partners and regional governments in developing sustainable economic growth and stability. Industry location decision making is highly complex. It involves multifaceted characteristics including tangible and intangible elements that are often very difficult to measure and evaluate (Hayter, 1997). The perfectly informed, rational and optimizing ‘economic man’, often assumed in so much economic analysis is rarely seen in practice; instead, organizations appear to act with imperfect knowledge and often in pursuit of non material ends (Smith, 1971). The notions of optimal decisions, minimizing costs and maximizing profits are in this sense, theoretical abstraction. Organizations are dense economic, cultural and political institutions that are not highly transparent and no individual is likely to possess complete knowledge (Barrow, 1998).

Regional governments need to understand location decision-making criteria of firms. Regional government quests are to meet economic, social and political objectives and to understand how to develop and provide an environment, which offers a best-fit to deliver the maximum incentive for desired industries (Cheshire, 1999). To assists in meeting the objectives of both industry and regional government entities there is a proved knowledge gap in the area of location decision-making process which this thesis seeks to address.

Research Objectives:

Traditional studies in the area of industrial location decisions have mainly focused on the manufacturing sector (Barrow, 1998). Manufacturing industries are generally strongly sensitive to raw material supplies, transport infrastructure, low and medium labor requirements and to fairly substantial land, infrastructure and capital needs (Hayter, 1997). However the newly emerging financial institutes/ financial service providers also faces the same but the issue which I am raising in my research is the issue of Taxation before selecting a particular location. There are so many variations of factors related to location decision making that require special understanding with respect to financial services business. Thus this study focus on examining the

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location decision making process of financial services business. Indication from the neoclassical economists that location factors have significantly impacted on industry location decisions (Friedrich, 1929, Hotelling, 1929, Isard, 1956, Smith, 1966). Numerous studies have examined the relative significance of various factors in the process of business location decisions, but literature is scarce concerning with those factors which specifically with the ware house and distribution industry. For business in general, taxes tend to be rated as less important than considerations such as access to transportation, distance to market, the education and skill level of potential employees, and even general quality of life in the region. Unlike other location factors, however, tax policy is the one variable that state legislatures can directly improve upon, particularly with respect to neighboring jurisdictions; for this reason legislative bodies are often called upon to re-examine tax policy.

Literature has indicated that there is a connection between organizational structure of firms and their location decision making (Hamilton, 1974, Laulajainen & Stafford, 1995, McDermott & Taylor, 1982, Schmenner, 1982, Townroe, 1971). Firstly, firm seeks a business location to meet their spatial strategies (Rees, 1974). Claimed different location strategies of firms are manifestations of ongoing internal structural change. Secondly when it comes to the actual process of making a location decision (such as deciding what information is needed, where to obtain this information, how extensive the evaluation process should be and who should be involved in the decision process.), is always determined by the experience, capability and organizational structure of the firms (Schmenner, 1982, Townroe, 1969). This study seeks to identify the impact level of taxation on financial services business location decisions through examining the inter relationships between the determinants of decision making process.

This research will examine the recent trends in Pakistan Taxation and their effects on city firms. Also this research will focus exclusively on tax issues and not on any other issues which could alter the competitive landscape between different providers of financial services in Pakistan. And it is important to note that any disproportionate level of taxation on a Financial Institution is not borne by the institution itself—as with all corporate entities, institutions don't bear the ultimate tax liability, people do. Accordingly, the stakeholders in the financial services sector—customers, suppliers, employees and shareholders—ultimately bear any disproportionate level of taxation.

Accordingly a disproportionate level of tax is a cost imposed on one or more of the above groups, which ultimately leads to some level of economic distortion and sub-optimal behavior resulting in consumers and businesses:

- Not getting the financial products they need (i.e. under-investing in financial services by financial service providers and discouraging consumption by consumers and businesses)
- Purchasing the financial products they need but at a higher than market price (a potential problem for individuals and small businesses who do not have unrestricted access to non-Pakistani financial service providers); or
- Purchasing the financial products they need from non-Pakistani suppliers who do not bear a disproportionate level of taxation.

The brief states that the study should focus on the following issues:

- Headline corporate tax rates and their translation into actual effective tax rates;
- Other forms of taxation which add to a company's overall tax spend;
- The relative complexity and lack of certainty of CBR and implementation;
- The impact of taxation on both the real cost of operations and strategic decisions on company location;
- The extent to which actual, planned or possible changes in business or business segment location are/might be driven by relative corporate tax considerations;
- The impact of the Pakistan personal tax regime and its implementation on the recruitment/retention of domiciled and non-domiciled senior staff;
- An overall assessment of which corporate or personal tax regimes exercise the greatest influence on business location and overall Pakistan competitiveness

Studies on location decision making by individual firms can be traced from (Weber, 1909) the theory considers only inputs from a range of materials sources and normally directs output to a single point market. The new direction is towards a more comprehensive business networking approach. It reflects industry and work force shifts under the advance of new technologies. To understand how firms make location decisions, it is necessary to review how the major theories have been constructed and developed. Then after Weber many researchers work in that aspect.

Cathy, April 2004) choosing a strategic location for business operations has always been of critical interest to industry and commerce. The old economy heavily depends on neoclassical economic theory to provide a set of guiding principles, and focused on proximity to material resources, transport and markets. However many argue that the new information economy must be viewed through the prism of different paradigm. This thesis critically examines the implications of the new economy for location decision making process of key industries. And the research concludes the four determinants of the decision process are all interrelated. In particular the organizational structure of firms was seen to play a predominant role in the location decision making process. The research outcomes have implications for further development of theory, as well as related industry decision making and government policy making. The research out come will improve understanding of the location decision of key industries, and contribute to increased knowledge in the area of further theory development.

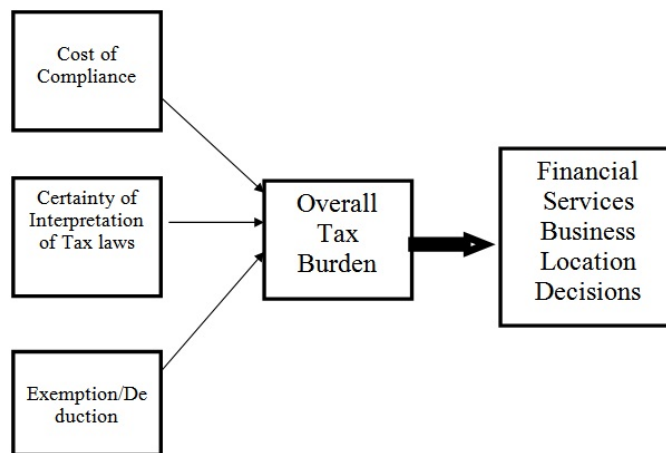
Dammon, Spalt, & Zhang, 2004) used the arbitrage arguments in this paper to drive the results on the optimal location of asset holdings. The arbitrage approach involves making a risk-preserving change in the location of asset holding to determine whether the after tax-return on the investor's portfolio can be improved. This paper examines the Inter temporal portfolio problem for an investor with the opportunity to invest in both a taxable and tax-deferred savings account and published in 2004. The Results indicate that investors have a strong preference for locating taxable bonds in the tax-deferred retirement account and locating equity in the taxable account. This preference reflects the higher tax burden on taxable bonds relative to equity. When investors can borrow without restrictions in their taxable accounts, it is optimal for them to invest their entire retirement account wealth in taxable bonds and either borrow or lend in the taxable account to achieve an optimal overall portfolio mix

Snyder, 2005) discuss the stochastic models for facility location. In the light of this paper the common objective in stochastic programming is to optimize the mean out come of the system; e.g. minimize expected cost or maximize expected profit. The paper reviews the literature on stochastic and robust facility location models. The intent is to illustrate both the rich variety of approaches for optimization under uncertainty that have appeared in the literature and their application to facility location problems for the industries (plants) in USA. A wide variety of approaches has been proposed; this paper discusses at least a dozen such measures. Many of these approaches have modeling, analytical, and computational advantages over the traditional objectives. We have explored these alternative measures with the intention of providing a foundation for researchers doing work in this and related fields.

Badri, 2007) collects the data from the 205 detailed industrial location factor and use the reliability analysis for checking the cronbock alpha and than use factor analysis for to check the factor loadings and suggests that; no previously published research have developed a comprehensive set of critical factors to the industrial location decisions that span the literature. His research describes a study that again produces an instrument which identifies a set of fourteen critical factors of industrial location that have been synthesized from an extensive literature search. The results concerning the measures developed in this study are encouraging but a great deal of further research remains to be done. Replications of the empirical work reported here are needed to corroborate these results. Studies are needed that involve more modern-emerging items. The authors hope that this study will provide impetus for further research aimed at gaining a better understanding of the process of industrial location.

Research Methodology:

The main purpose of this study is to identify the "Impact of Taxation on Financial Services Business Location Decision in Pakistan". Through examining the relationship between Taxation and decision making process. This means research will start with an exploratory quantitative study the broad context, in which these location decisions occur. For this purpose we are designing and testing a questionnaire, and this was followed by a quantitative survey undertaken with the sample of firms (financial service Providers) to examine and test the relationship between different determinants of decision making process. In this connection to address the research questions, a quantitative methodology is employed. This comprises the use of questionnaire to those responsible personals of the financial organizations who are involved in the decision making regarding the selection of location for the new business or expanding of their existing business. Most of the researchers concentrate on the mixed methodology (Qualitative as well as Quantitative). For the method of decision-making research approach was proposed by Carroll and Johnson (1990). They suggested that to achieve all the goals of research, multiple methods in the same study or project should be considered. And the factors we are using to evaluate the tax regime is as follows:



Definitions of Financial services providers/Data sources

The Public Sector/private Sector Commercial Banks:

The banks incorporated in Pakistan of shares/capital controlled by the government units are referred to public sector banks. And the banks incorporated in Pakistan of shares/capital controlled by private sector are referred to as private sector banks. And these are the scheduled banks in Pakistan who are mainly involved in the activities of deposits mobilization through a branch network; extending credit, mostly concentrated in short term collateralized lending such as trade financing and overdraft, together with a range of financial services provided to the clients. With the liberalization of banking rules and laws, commercial banks are now increasingly being allowed to undertake related activities short of investment banking or underwriting, portfolio investment, securities market operations, specialized financing, and related services.

Foreign Banks:

The branches of banks incorporated abroad are termed as foreign banks.

Development Financial Institutions:

The economic development of any country depends on the extent to which its financial system efficiently and effectively mobilizes and allocates resources. There are a number of banks and financial institutions that perform this function; one of them is the development bank. Development banks are the unique financial institutions that perform the special task of fostering the development of a nation, generally not undertaken by other banks. Development banks are the financial agencies that provide medium and long-term financial assistance and act as catalytic agents in promoting balanced development of the country. They are engaged in promotion and development of industry, agriculture, and other key sectors. They also provide development services that can add in the accelerated growth of an economy.

Investment Banks:

The banks which assist the business houses and governmental bodies to raise money through the sale of stocks and bonds for usually long-term purpose these banks perform the usual function of raising deposits of idle money from the public and finance the business houses and other bodies.

National Investment Trust:

It is a joint stock company; the main objective of the trust is the mobilization of savings of the people through the sale of its units and to invest the funds so rose in shares and debentures of sound and productive enterprises in the interest of unit-holders. Thus it not only helps in the consolidation of the savings but goes a long way in meeting the growing financial needs of corporate sector. NIT is only open-ended mutual fund in the Pakistan and has grown steadily since its inception. Its performance over the years proved that NIT is not only the sound and profitable medium of investment for small investors but it has immensely contributed to economic development of Pakistan.

Micro Finance Institutions:

Micro financing or financing small and medium enterprise is a new concept in Pakistan. However, institutions providing short-term finance to this sector have been established in public and private sector both.

Exploratory Analysis:

Taxes burden as a location factor contains one of ten tax variables: (1) difference in tax rate from expected and actual effective, (2) cost of compliance, (3) certainty in implementation of Tax rules, (4) burden of tax on real cost of operations, (5) burden of tax on strategic decisions of the company, (6) level of changes in business location with respect to tax consideration, (7) tax regime and recruitment/retention of the staff, (8) personal assessment about tax regime, (9) priorities about tax free zones, (10) consciousness about tax exemptions.

Financial services business location decisions which also measure with the response received from the sample selected with the help of questionnaire and contains eight questions/variables.

4.1 Diagnostic Tests:

$$LD = \alpha + \beta_1 TBLF_8 + \beta_2 TBLF_9 + \beta_3 TBLF_{10} + \beta_4 TBLF_{11} + \beta_5 TBLF_{12} + \beta_6 TBLF_{13} + \beta_7 TBLF_{14} + \beta_8 TBLF_{15} + \beta_9 TBLF_{16} + \beta_{10} TBLF_{17} + \mu$$

A quantitative technique “Regression analysis” was used to test the inter relationship between the variables of LD (Location Decisions) and TBLF (Taxation Burden as Location Factor) after using the Factor analysis of Location Decisions.

Taxes burden as business location factor and financial services business location decisions.

Dependent Variable: Financial Services Business Location Decisions

Parameter	B	t	Sig:
Intercept	-5.753	-11.57	.000
TBLF8	-.052	-.794	.431
TBLF9	.006	.075	.941
TBLF10	.073	1.479	.146
TBLF11	.338	4.367	.000
TBLF12	.489	6.661	.000
TBLF13	.182	2.953	.005
TBLF14	-.207	-2.531	.015
TBLF15	.062	2.355	.023
TBLF16	-.028	-1.103	.276
TBLF17	-.061	-.78	.438
Adjusted R ²	.925		
R ²	.939		
Computed using α	.05		
Significance	.000		

1. Extensive information process is positively related to financial services business location decisions.
2. More the criteria were used for selecting the location is positively related to financial services business location decisions.
3. More the significant role of personals been in decision process is positively related to financial services business location decisions.

Limitations:

It is common in the empirical research; first of all there are some omitted financial institutes in the data sources because of last years economic down fall especially in the stock exchanges of Pakistan. An other issue is the relatively small sample size because of the number of available institute in the jurisdiction. This research was conducted and applicable to interpret in the province of sindh of Pakistan because in comparing the tax structures of other province it is different because when we are talking about NWFP or Baluchistan governments are offering the tax free zones there in the backward areas. Limitations aside, the paucity of research in this important area continues to suggest a need for further investigation, the impetus of which is driving this study.

Suggestions for the Further Research:

This study will definitely add to the optimal taxation structure by examining the impact of taxation on different aspects of the business and society. The ultimate results of this study lend themselves to many other future research issues and projects. Say suppose it would be interesting to repeat this analysis as a study within the country or cross country research focusing on differences between provincial taxes and differences in cross country tax rate/system respectively.

Conclusion:

After the detailed literature review and analysis of data the empirical results suggests greater the value of R² greater the explanatory power of regression equation and it also shows the proportion of the variance of the dependent variable about its mean that is explained by the independent, or predictor, variables. And the same is happening in the empirical results which shows that overall model is fit, and some variables have –ve relationship with the dependent variable but the major concern is with the

- TBLF9 How much level of cost of compliance incurr in managing or paying the taxes on specific locations/locations
- TBLF10 How much certainty is there in the FBR rules and implementation of those rules
- TBLF17 Before making decision about business locations how much concious you would be about the tax exemptions

TBLF9 and TBLF10 are positively related with location decisions and TBLF17 is negatively related with location decision, which states (with referrence to empirical results) that neither the organizations/financial service providers think about the cost of compliance nor they are worried about the rules and policies of FBR and even though they avoiding from the areas where the exemptions and deductions are a lot because they are only looking for business oppertunities.

APPENDIX Introduction of Variables

Variables	Components by Literature	
	1	2
How long has your company been established	LD1	
What is the ownership of your company	LD2	
Where are your company,s headquarter	LD3	
What was approximate assets value of your company last year	LD4	
what was the approximate revenue of your company for last year	LD5	
What are the proportions of your company,s market courage	LD6	
What was the primary purpose for your company locating in this specific area	LD7	
How much tax rate is different from expected and actual effective at your selected/proposed business locations		TBLF8
How much level of cost of compliance incurr in managing or paying the taxes on specific locations/locations		TBLF9
How much certainty is there in the FBR rules and implementation of those rules		TBLF10
How much burden of taxation is on real cost of operations		TBLF11
How much burden of taxation is on the strategic decisions of company (especially in case of selecting locations		TBLF12
To what extent you think that actual, planned or possible changes in business or business location might be driven by relative tax onsiderations		TBLF13
Impact of total tax regime on recruitment/retention on domiciled, non domiciled staff		TBLF14
How much your personal assesment of tax regime exercises the influence on business location		TBLF15
How much your priorities will be especially for location decisions in the tax free zone		TBLF16
Before making decision about business locations how much concious you would be about the tax exemptions		TBLF17

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