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Personal Income: Administrative
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Alternative Methods of Taxing Personal Income: Administrative Issues¹

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Abstract

This paper complements research addressing policy design issues on alternative options of taxing personal income. As there is a paucity of scholarly research that addresses national tax agency management and tax administration issues we rely on published comparative studies from international agencies to outline recent trends in personal income tax and VAT administration. The paper focuses on the parties in the tax environment and specifically highlights the importance of tax compliance research as well as studying the effects of compliance costs. The paper then discusses prior behavioral research on taxpayers' attitudes and preferences within the context of complex tax systems.

Keywords: tax administration; tax compliance; personal taxation; consumption taxes

JEL Descriptors: H20, H24

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1. Introduction

The development and introduction of policy in the area of personal taxation is not an easy task (OECD 2006a; Zee 2005). Likewise, the area of administration is not simple with taxpayer compliance in particular posing a serious challenge for administrators (Bird 2004). It is only comparatively recently that tax administration has received serious attention from scholars and international agencies (e.g., Aaron & Slemrod 2004; Gill 2000; Messere 2003; Tomkins et al. 2001). Considering tax environment issues such as globalization, tax competition, complexity and widespread avoidance at both personal and corporate levels, an increased research focus on tax administration is not before time.

There have of course been many country/region reports on issues of tax policy and administration (some authored by presenters at this conference) as well as volumes dedicated to particular topics (e.g. Alm, Martinez-Vazquez & Wallace 2004). More generally however, it was only with Gill (2000) that a general diagnostic framework was published by the World Bank. Briefly, this framework suggests a preliminary examination to identify the symptoms of a tax agency's weaknesses: (comprising indicators of the nature and scale of operations, indicators of effectiveness and indicators of efficiency). This indicator data can be used to track recent performance of the agency and in comparing actual performance with targets. Preliminary examination highlights functional areas where performance deficiencies are severe and which, consequently, deserve special attention. Using the congruence model that Gill develops, this can then be applied to the revenue agency examining inputs, transformation processes and outputs. Of course this type of evaluation must be adapted to specific countries, given the wide

variation in country circumstances, levels of development of the agency and the nature of problems and their solutions.

The purpose of this paper is to expand on two broad issues that surround the administration of personal and value-added taxes. The first revolves around the interaction between the parties in the tax environment (revenue agency, taxpayers, practitioners) and the internal structures and processes of each party. As some measure of public support is necessary for the efficient functioning of any tax policy, the second broad issue is an outline of prior research on taxpayers' preference and attitudes.

The remainder of this paper is organized as follows. Section two discusses prior research on the administration and compliance issues of personal taxes. The third section describes mirrors this for indirect taxes, with an emphasis on VAT. As tax reforms must have political and public support, the fourth section discusses prior behavioural research on taxpayers' tax system preferences and attitudes. Concluding remarks appear in section five.

2. Personal taxes

2.1 Administration issues

There are several reviews of recent tax administration reforms. Gill (2003, p. 7) states agencies have sought to:- improve the organization and management of revenue administration; strengthen the regulatory and legal framework; broaden the tax base by registering potential taxpayers; facilitate voluntary compliance; improve capacity to process the massive information flows resulting from declarations filed by taxpayers, payment transactions and administrative actions; enhance availability of information

about taxable transactions from third parties; develop risk-analysis capacity; strengthen investigation, audit and enforcement capacity; improve appellate procedures; enhance analytical ability to carry out fiscal studies to assess tax burdens, collection trends, compliance gaps and impact of tax policy changes; and reduce corruption. Clearly the task of managing the key functions of a tax agency is a mammoth task.

Recently, the OECD published a comparative report on tax system design/administration based on a survey of country members (OECD 2004). France and Switzerland require an annual return and are notable for not using a system of withholding. All other countries rely on withholding arrangements with a majority (15 countries) operating a cumulative system that is mainly tax return free over those operating a non-cumulative system (9 countries). One clear trend has been to expand withholding from employment income alone (28 countries) to include forms of investment income such as dividends (22 countries) and interest (21 countries). Several countries have expanded the principle to include extensive information reporting programs.

Aside from those countries using a cumulative/non-cumulative system, several countries now use a reconciliation approach where pre-populated returns are made available to taxpayers (via paper or the internet) for validation. This process is summarised by the OECD (2006b) as shown in Figure 1 which shows that the revenue agency (rather than the taxpayer) provides the initial return documentation based on a wide range of information from third party sources that is relevant at an individual taxpayer level.

[Insert Figure 1 about here]

The stated benefits are essentially in reducing the compliance cost burden for taxpayers, giving taxpayers assurance that they have fully complied, more efficient processing of information and refunds, and reducing the revenue agency's administrative costs. The countries with most experience are the Nordic countries of Denmark, Finland, Norway and Sweden with Denmark commencing its scheme in 1988.

Of course, there are costs in implementation and in operation as there is a need for accurate workplace information. Second, taxpayers are given the opportunity to adjust (i.e. correct) the information provided which in itself will lead to additional costs for the revenue agency. The adjustment rates for these four countries range from Denmark (22%) to Norway and Sweden (both 50%). The OECD (2006b, p.14) notes that there is a risk that revealing all known information to taxpayers might lead to non-compliance, although no country surveyed reported that this was a problem.

The critical success factors of these systems are listed by the OECD (2006b, p.??) as: accurate withholdings at source, high integrity taxpayer identifiers, comprehensive systems of third party reporting to the revenue agency, and a compatible legislative framework.

Some countries have achieved administrative simplification by implementing a policy of removing the need to file tax returns at all. One example is when New Zealand withdrew all employment-related expenses as available deductions in the late 1980s, thus removing the need for many of its taxpayers to file a return at all (although this is now reversing with social policy objectives being incorporated into their tax system). This allows a revenue agency to focus on service delivery to those taxpayers with more complex circumstances such as those running businesses. As a case example, there are

calls for similar personal tax reform in Australia with Evans and Drum (2006) stating that there is overdue reliance on PIT with over ten million taxpayers filing annual returns. More importantly, the Australian PIT is claimed to have both high visibility and impact in the form of compliance costs (discussed below). One obvious issue for consideration however, is the impact of any wholesale switch on the tax profession itself. For instance is an individual's tax return a revenue stream in itself (H&R Block), or a by-product of other accounting services provided to a client? Certainly, as Hite and Hasseldine (2003) show, different types of preparers have different vested interests and consequently exhibit different behaviors.

2.2 Compliance effects

Central to the success of any system of personal taxation is the concept of taxpayer compliance. Research into personal tax compliance is voluminous (Andreoni, Erard & Feinstein 1998) and it is outside the scope of this paper to further review it here. Suffice to say, disciplines such as economics and psychology have theorized analytic and conceptual models of compliance and there has been substantial empirical work on personal tax compliance. Much of this has been conducted in western countries, particularly the U.S. This section describes only factors that are centrally linked to administration.

Tax accountants and preparers play a key role in tax (non)compliance. They may enforce the system by assisting taxpayers to comply with unambiguous items or they may exploit the system through aggressive tax planning. Hite et al (2003) split prior research into three areas. The first area is the group of factors that influence taxpayer demand for

practitioner services such as complexity, desire to save taxes etc. Secondly, there are many individual and environmental factors that affect the propensity of preparers to recommend aggressive positions for their clients (see Roberts 1998 for a review). A key factor here is the existence (or not) of strong sanctions against preparers for promoting avoidance or recommending abusive tax positions. The third area is whether tax returns prepared by practitioners are more/less compliant than those filed by individual taxpayers themselves. Published prior research on this factor is sparse and inconclusive (Erard 1993; Hite and Hasseldine 2003) although tax agencies are increasingly interested in the relationships they have with accounting firms/organizations and how to promote “responsible” behavior.

Associated with the use of preparers is the literature on the costs of personal tax compliance. With several notable exceptions (such as Alm 1988; Slemrod 1989) this literature is largely separate from the taxpayer compliance research discussed above. The compliance costs literature is dominated by large-scale mail surveys which are expensive and time consuming (Sandford 1995). In fact Evans (2003, p. 69) in his analysis of prior studies into operating costs suggests there are only about “a dozen of the studies focused solely on personal income taxes.” Lately, it is common for tax administrators to be lobbied extensively by taxpayer groups and their representatives as well as being held accountable by governments and audit agencies for the level of these costs.

We suggest that much more research can and should be completed using data provided by tax agencies. There are only a couple of studies that have been able to test cause-and-effect relationships using actual taxpayer data and which incorporate practitioners, compliance costs and personal tax compliance (Slemrod, Blumenthal &

Christian 2001; Hasseldine, Hite, James & Toumi 2006). While studies in the laboratory are clearly important (Alm 1991), studies using actual taxpayer data are likely to offer complementary insights and real-world insight to tax administrators.

3. Consumption taxes and VATs

3.1 Administration issues

Owens (2006) notes that while the decision to use a VAT is now commonplace (with the notable OECD member exception of the U.S.) in practice there is considerable diversity in their rates, exemptions and thresholds. An extremely popular course of action has been for countries to introduce a VAT with over 135 now in existence. The International Tax Dialogue had its first global conference on VAT in Rome at which both policy and administration issues were discussed (see www.itdweb.org/vatconference).

Countries adopting VATs nowadays have the benefit of international agencies as well as consultants. Richard Bird (2005) has described the NOSFA principle of “No - One - Size - Fits - All” in relation to design features. There are of course some commonalities. With the passage of time, lessons of “best practice” have been learnt with respect to VAT administration. The Australian Tax Office’s benchmarking exercise reviewed the experiences of other countries and Figure 2 shows important external environment factors, risks and opportunities for administrators, and the ways revenue agencies are responding.

[Insert Figure 2 about here]

3.2 *Compliance issues*

Compliance and compliance costs issues are as salient for VAT as for direct personal taxes. VATs have been described as regressive as the compliance costs tend to fall with more severity on traders with lower turnovers (Evans, Pope & Hasseldine 2001). This has led to many tax administrations introducing special simplified arrangements for compliance, such as cash accounting schemes, options to file and pay less regularly, flat rates of tax on turnover etc. However even with these, they may simply mitigate rather than remove the competitive disadvantage faced by smaller firms, and additionally, there are often issues of low take-up with these initiatives. Thus, design features such as threshold and exemptions clearly affect compliance and compliance costs.

Noncompliance with VAT can be achieved by simply not registering and of course through fraud. In the U.K. the VAT gap, defined as the difference between the 'theoretical' yield and the actual yield is about 13.5%, with a target to reduce this to no more than 11% by 2007-08 (HMRC 2005, p. 54). With the existence of the EU and the availability of credits for VAT paid in other member states, there has been a spate of missing trader intra-community (MTIC) fraud. These are circular sham transactions that rely on the input tax credits to claim very large refunds, but when the time comes for the VAT to be paid to the tax agency, that particular trader is 'missing'. This is thought to be a considerable problem in the U.K. with annual losses of around £2 billion (HMRC 2005, p. 54).

As with personal income taxation, from a compliance viewpoint, both enabling and enforcement techniques are recommended. While audits tend to lead to adversarial relationships between VAT traders and revenue agencies, comparative survey work

suggests that taxpayers believe auditors need to understand business better and that “best practice” includes integration of VAT with other taxes, good compliance management practice, use of IT and automation, simplification of law and administration and staff flexibility (ATO, 2000, p. 59).

Given the limited prior work on VAT compliance costs (Evans 2003), only a few administrations have regular data on compliance costs, attitudes and perceptions and levels of non-compliance. Further, in contrast with research on individual tax evasion, there is very little analytic or empirical research on VAT (non)compliance. This may be due to modeling difficulties, the fact that the U.S. doesn't have a federal consumption tax, or simply the difficulties of obtaining data. Again, there are notable exceptions, such as Adams and Webley (2001), but they are extremely rare. Thus, much more work on VAT compliance needs to be completed.

4. Personal taxpayers' attitudes and preferences

Given that taxes are a certainty and that governments need the revenue, a relevant issue is whether policy-makers can identify which type of tax system will be the most acceptable or perhaps the least egregious. Graetz (1999) stated that public support is a requisite for any tax system. If the system differs dramatically from the public's basic values, then support will be eroded. Public resentment led to the demise of the British poll tax, and public rebellion is currently creating havoc in India where shopkeepers have been closing their doors as a form of protest against a new value-added tax. The tax was passed in an attempt to limit widespread tax evasion and local impediments to trade, yet many local governments still support the old tax regime (Kiplinger 2005).

4.1 *Perceptions of tax burdens*

Numerous studies within the Economics and Public Choice literatures have examined the issue of ‘fiscal illusion’ - the possibility of misperceptions of tax liabilities. A frequent hypothesis (or assertion) here is that voters *under*-estimate their tax liabilities due, for example, to ‘invisible’ taxes or complex tax structures (see Dollery and Worthington, 1996, and Gemmell, Morrissey and Pinar, 1999, for reviews). Consequently, government expenditures might be higher than would be chosen by fully informed voters. Such illusion, if it exists, also has important implications for the design of tax structures because misperceptions can be expected to distort expressed tax preferences. In political economy models of the tax system, such as Hettich and Winer (1984, 1988) for example, politicians design the tax structure to minimise the political costs associated with revenue-raising. Any over- (under-) estimation of tax liabilities will raise (lower) the associated political costs and hence affect tax policy.

Preston and Ridge (1995) and Gemmell, Morrissey and Pinar (2004) used British Social Attitudes Survey (BSAS) data to investigate whether, and to what extent, British taxpayers misperceive their tax liabilities. Preston and Ridge focus on local public spending and taxation and find that state-local government grants are partly responsible for considerable confusion among local taxpayers concerning the true ‘tax prices’ associated with local government provision. With respect to national level taxes, BSAS participants were asked to estimate the tax-cost to themselves of specified increases in income tax and VAT rates, and about their preferences over alternative tax increases to finance public expenditure increases. Gemmell, Morrissey and Pinar (2004) measure misperceptions in tax-cost estimates and considered whether these misperceptions

influence taxpayers' preferences over the alternative tax choices. They show that taxpayers' perceptions of their income tax and VAT liabilities are systematically biased towards *over*-estimation. This is an interesting finding in itself because it challenges the assumption, common in the fiscal illusion literature, that voter-taxpayers tend to underestimate tax liabilities.

Gemmell, Morrissey and Pinar (2004) also find a greater tendency to over-estimate VAT liabilities than income tax liabilities, suggesting that British taxpayers are more aware of income tax costs than of VAT. Assessing the impact on tax preferences, Gemmell, Morrissey and Pinar (2004) found strong empirical support for two hypotheses.

- (1) Preferences are biased away from taxes for which personal liabilities are over-estimated by participants.
- (2) Tax preferences respond negatively to differences in tax bases: the higher an individual's tax base for a particular tax (e.g. income, VAT-liable spending), the less likely is that individual to prefer expenditures to be funded via that tax.

However, tax preferences were also found to be strongly influenced by preferences for redistribution: those more in favour of redistribution preferred the most progressive tax option. Though some altruism with respect to redistribution cannot be ruled out, overall the evidence appears to support the view that preferences over tax structure are dominated by self-interest considerations.

4.2 *Taxpayer attitudes, tax complexity and fairness*

For most countries the income tax system is the most visible, and from a compliance perspective the administrative challenges are unending. In the United States the tax gap is

estimated at \$319 billion, and according to the GAO (Government Accounting Office), the costs of compliance are at least \$107 billion (with some all-inclusive estimates reaching nearly \$600 billion), yet total revenues from the income tax system are just over one trillion dollars. Even if tax administrators ignore public complaints about the tax system, eventually the rising compliance costs and tax gap could disable the income tax system.

The individual income tax system is the dominant source of revenue for the Internal Revenue Service (IRS), and it is the most obtrusive, given taxpayers' annual wrestling match with the tax forms. Two frequently repeated complaints about the tax are its inequity and complexity. Few disagree with the latter. Legislators have been arguing for simplicity since the 1960's, but the system's complexity continues to grow. Hence, the increasing costs of compliance. In our opinion, if complexity is not adequately addressed, then this negative attribute will be the "straw that breaks the camel's back". Even if complexity is contained, the other common complaint, inequity will need to be resolved.

Correcting the system's inequity is problematic, because any unfairness in the tax system could be real, it could be a self-interested response, it could vary with the taxpayer's value judgments, or the inequity could be based on a misconception. For example, in a nationwide attitude survey, Slemrod (2006) found that complexity and unfairness were significantly correlated to taxpayers' belief that the current income tax system should be replaced with a flat tax or perhaps a retail sales tax. Since many of the respondents believed high-income taxpayers would pay more tax under either a flat tax or sales tax system, the author concluded that their conception of progressivity in the current

and alternative systems was misguided. Most experts, he noted, believe a flat tax would have very little progressivity and a sales tax would probably be regressive depending on how such taxes would be devised (e.g., size of an income exemption for the flat tax or whether food, medicine, and small clothing items would be exempt on a sales tax...). The question then becomes whether respondents would prefer the current income tax system over a flat tax or a retail sales tax if the alternative systems were clearly defined and understood in regards to which income level would pay what amount of tax. Interestingly, the results of the study indicate that only 24.5 percent think the government should redistribute from high- to low-income families, and only 28.6% indicated that the government should redistribute from high- to middle-income families. Thus, it is possible that any misconception about the relative progressivity (or lack of it) in those three tax systems is not the salient factor driving the respondents preference to switch to either a flat tax or a retail sales tax. Nearly fifty-three percent favored the flat tax, and 39.4 percent favored the sales tax over the income tax. Nonetheless, the point is well taken. If respondents clearly understood the progressivity level of the current income tax versus proposed flat or sales tax systems, their preferences may have changed. For example, Hite (1997) told a group of potentially aggressive taxpayers (taxpayers who typically have a balance due on their tax returns) about a 1989 statistic showing that approximately three percent of the taxpayers paid nearly one-third of all the tax. (Today the top two percent pay about 41 percent). Compared to a comparable control group, those receiving this information indicated a greater willingness to report hypothetical cash income. Thus, correcting misunderstandings about the tax system could be a promising strategy.

In the 2001 national survey analyzed by Slemrod (2006) 51.5 percent of the respondents indicated that the income tax is very complex, while 48.4 percent indicated it is unfair. One problem with the survey is that equity or inequity of the income tax is not specific as to which aspect of the system is perceived as unfair. Is it only the tax rates with its corresponding level of progressivity, or is it the level and type of deductions, level of income that allows or disallows a tax break, whether some income is taxed and other is exempt, deferred, or taxed at a preferential rate? For some taxpayers the differing tax rates for marital status or who qualifies as a dependent is a dominant source of perceived inequity. The point is that there are many aspects of the current income tax system that could be driving the preference for an alternative system.

4.3 Framing effects

Trying to identify taxpayer preferences has been an illusive task for many researchers. In fact, studies have documented a wide variety of framing effects. Hite and Roberts (1991) found that when respondents were asked their tax rate preferences, the results differed significantly depending on whether subjects were asked to provide their responses in percent or dollars. In addition to that metric effect, McCaffery and Baron (2004) found other framing effects, such as a penalty aversion (preferring a tax rule described as a bonus rather than a penalty) and a status quo effect (preferring the starting point to any change).

Hite, Hasseldine and Fatemi (2005) reported significant framing effects for the way preferences were solicited based on the favorable or unfavorable language used in the survey question. When subjects were asked whether the income tax system is fair, 53

percent disagreed. In contrast, when asked whether the system is unfair, only 44 percent agreed.

Using equivalency framing, another type of framing effect was documented in the Hite et al study (2005). A second group of the subjects was informed that half of the U.S. taxpayers pay 96 percent of the taxes paid. When asked if that is a positive or negative feature, respondents were split with 40.7 percent indicating it is positive, 38.2 percent indicating it is negative and 21.1 percent remaining neutral. In contrast, a different set of taxpayers were informed that half of the U.S. taxpayers pay four percent of all the tax. In this case, 54.5 percent indicated it was a positive feature with only 23.8 percent indicating it was negative.

Given the misconceptions and the shifting preferences based on alternative frames, it is clear that soliciting taxpayer preferences is no easy task, regardless of whether researchers are investigating the income tax, a sales tax, value-added tax, or social security tax. Moreover, McCaffery and Baron (2003) found that respondents were not rational in their responses when asked to design a global tax system with both a payroll and income tax system. Most governments utilize more than one tax system, and it seems rational to analyze the combination of systems. Unfortunately, accurately determining preferences for any one tax system is difficult enough, and this should be the first objective for researchers and administrators.

Aside from framing effects, all research on taxpayer preferences must control for demographic factors such as income level, education, marital status, gender, etc. Furthermore, when McGowan (2000) examined taxpayer preferences for alternative tax systems, he found that preferences were influenced by political party affiliation. Those

identifying themselves as Republicans tended to prefer a flat income tax or a sales tax system over the current income tax system, and this is consistent with data in the Slemrod study (2006). Consistently, Gemmell, Morrissey and Pinar (2003, 2004) found that Labour Party supporters in the UK expressed stronger preferences both for more progressive taxes and for increases, rather than decreases, in tax-financed public expenditure.

Still, with careful framing and with a research method that controls for a myriad of demographic factors, an acceptable tax system (whether its income, value-added, or social security) needs to be one in which the government is trusted. Slemrod (2006) found that trust in the government will do “what is right most of the time” is significantly correlated with belief that the tax system is fair. In addition, Slemrod and Burman (2003) argued that the true center of the tax debate involves the size and scope of the government. In short, in our search for the best tax system, we must consider that the tax system itself is not the only issue. In addition, a closely aligned factor is whether the revenue from that system is handled in a fiduciary manner.

5. Discussion and concluding comments

This paper demonstrates that whether a country shifts reliance between personal income taxation and a consumption tax such as VAT, then many tax administration issues will remain. Specifically “best practice” features, e.g., up-to-date risk management techniques, should desirably be considered for implementation, and attention must be paid to issues of compliance costs and public support for any tax regime as these affect compliance itself and the ultimate viability of the system.

Identifying such “best practice” features would be impossible without international benchmarking and co-operation and collaboration between tax administrations and international agencies. It would appear that good progress is being made in this area on the sharing of policy and administrative insights. However given the paucity of research in some areas (e.g. VAT compliance), there are ample opportunities for further research in the areas outlined in this paper. Grasping these opportunities will require effective national and international linkages among scholars, tax administrations and international agencies. Such investment and insight by these parties is likely to be worthwhile.

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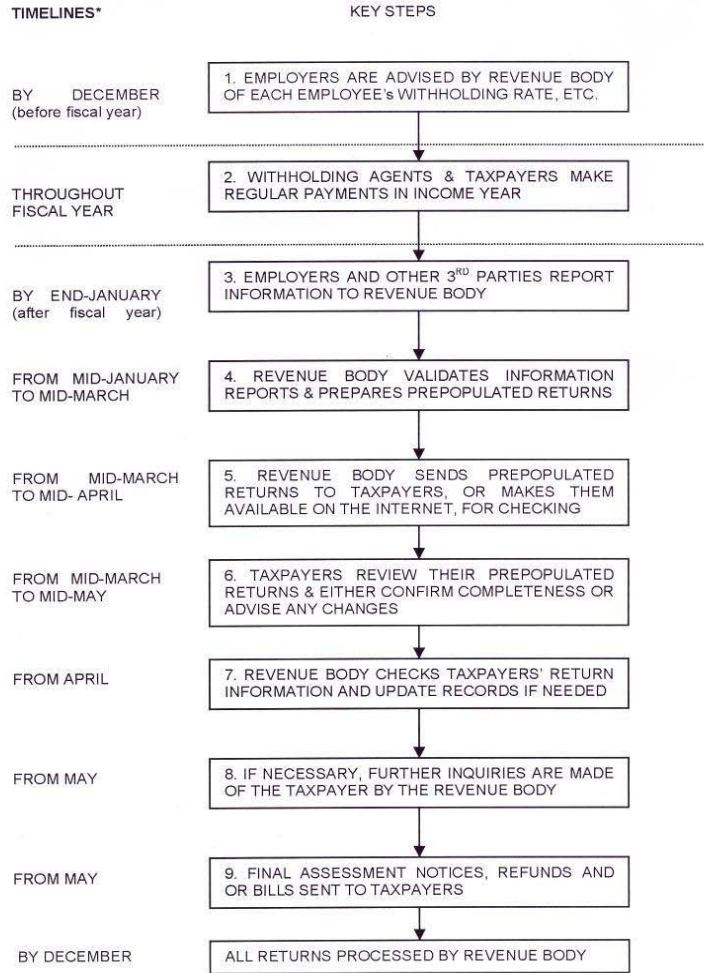
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FIGURE 1
Overview of pre-populated tax return systems used by Nordic region countries
 (NB: The fiscal year is the calendar year in all surveyed countries.)



*TIMELINES MAY VARY SLIGHTLY FROM COUNTRY TO COUNTRY

The Environment

- Legislation becoming more complex
- Global Business
- Global Crime
- E- commerce is increasing
- High turnover of businesses in “sensitive sectors”
- Registrants are increasing
- Fraud is Increasing
- Increase in electronic filing
- GST questions are becoming more complex
- Some governments are scrutinising Public Service efficiency and reducing budgets
- Some Audit offices and the EC are calling for more funding of VAT control, because of fraud
- Increasing volume/ Diversity of economic activity

Risks

- Revenue may be lost as e-commerce becomes more widespread
- Staff may find it difficult to adapt to new approaches and systems and may not use them
- Integration of VAT with other tax work can reduce focus & expertise re VAT and make costs difficult to track.
- Joint-agency approaches to fraud are cumbersome
 - Fraud undetected by the automated risk assessment system could flourish
- Quality of VAT admin. may influence business location & imports

Gaps/ Opportunities

- Need to review compliance policy
- Need to allocate more resources to Compliance
- Some countries may move back to VAT specialisation.
- Need to update law to address commercial practices
- Need good links between export & tax risk systems
 - Need for international solutions on issues such as e-commerce and information sharing
 - Need to investigate systemic VAT crime
 - Need for computer auditing

Tax Administration Capabilities

- Use of risk assessment
- Focus on voluntary compliance
- Increasing Automation
- Integration of VAT admin. with other taxes
- Reducing staff numbers
- Call centres & processing centres being set up
- Field officers increasingly using portable IT
- Hot-desking unsuccessful in UK
- “Streamlined administration”
- Legal data bases introduced
- simplified collection via banks
- Payment by credit card
- Pro-active enforcement
- Centralisation of some resources

FIGURE 2

Overview of VAT Administration Internationally

(Source: Australian Tax Office benchmarking exercise; ATO 2000, p. 62)