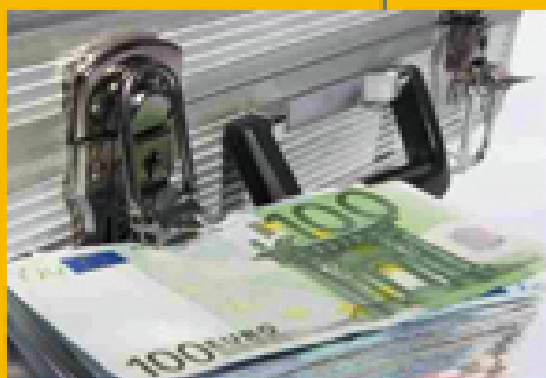


TAX EVASION, TRUST, AND STATE CAPACITIES

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Introduction

Many recently democratized countries in Central and Eastern Europe, having escaped from communist rule and planned economies, face pressing problems related to the notions of tax evasion, trust and state capacities. The chapters of the present volume all address in one way or another the problems transition countries have with tax collection, particularly in the realm of personal income taxes, and how these problems relate to state capacities as well as political and general trust.¹

The three key notions in the title of this volume point to some important issues modern states and, even more, state builders are faced with: norm compliance, tax morale, the level of generalized and political trust in society, and of course the capacities of states and governments to fulfil their basic functions. The organization of revenue collection and the use of revenue form a central aspect of every state-building process. State-building in general and particularly in post-communist societies has to do with the building up of the state's ability to pursue and realize policies and goals. It consists of creating and reinforcing the core state capacities, be they extractive, coercive, integrative, decision-making or political. The capacity to produce and use state revenue is among the most basic capacities. If it is poorly working, "bad governance" is likely to be the result. State capacities

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are mutually reinforcing each other. If the power to extract revenues remains weak, the performance of the other capacities is likely to decrease. On the other hand, a state that relies too much on coercion in order to assure compliance will probably produce resistance or exit strategies in the society, and thus weaken state-society relations. Distrust and tax evasion are likely answers to coercion.

States need revenues. Only through these revenues can they offer services for citizens and provide security. One could speak of an exchange model: states offer public goods in exchange for support through supply of extraction. The interesting question here relates to the conditions under which citizens agree to supply extractions demanded by the State (see Levi 1999). Most of the authors of contributions in this volume focus on the central question in the realm of tax morale: why do people pay taxes, why do they comply? Is it because they fear repression? Is it because they trust each other? Or is it because the tax burden is reasonable and the tax system transparent? Is it because they believe State officials to be efficient? Or the other way around: Do they avoid taxes because tax laws are too complicated or because the state institutions are inefficient? And to what extent and under which conditions can states rely on voluntary compliance or risk to face resistance to extraction? Obviously questions concerning tax morale have to consider capacities on both sides, extraction capacities as well as the capacity to resist such extraction, the quality of institutions of taxation, the expected benefits and trustworthy state officials as well as the structure of trust in society. The question why people comply implies always also the question why do people trust or distrust each other or institutions.

Obviously to extract resources efficiently, a government must be able to mobilize cooperation. One way to explain compliance through cooperation is to point to social capital. Tax compliance could be explained first of all by social capital as Robert Putnam (2000, 347) does in his analysis of American community. It seems that in states where citizens view other people as basically honest, tax compliance is higher than in low-social-capital states. Compliance implies generalized trust, the expectation of reciprocity, the sharing of basic values with regard to reliable and honest behavior. One has no good reasons to cheat, i.e. not to pay taxes if others are behaving honestly and government programs are working the way

they should. On the other hand, the discussion also points to the importance of the efficiency of state institutions. Compliance is contingent on the fact that other people can be trusted to comply, but evidence seems to show that it is also and even more dependent on the efficiency of institutions, particularly the legal system (for this discussion see for example the contributions of Uslaner and Easter in this volume, and Rothstein 2001). Certain types of state capacity such as political capacity can be measured by the level of voluntary tax compliance (see Easter in this volume). High levels of voluntary tax compliance seem to correlate with democratic regimes, the impartiality of state enforcement and high level of trust.

Impartial enforcement by a legitimate state is crucial, since it not only increases the social reach of the legal system but also contributes to the reproduction and the increase of generalized trust, which is also precisely what political and legal institutions need in order to run efficiently and to facilitate third-party enforcement. Third-party enforcement alone without generalized trust would certainly not work (see Reiser 1999). The availability and symbolic presence of efficient third-party enforcement, which implies confidence in the institutions and government officials, constitute the background of daily interactions in business, in politics, or in the relations between state officials and citizens where it affects also tax morale, voluntary tax compliance.

The debate about the relationship among compliance, trust and state capacities points also to the difference between strong and weak states. Strong states are not necessarily states with high compliance. States can be strong with regard to specific capacities, for instance coercion and repression, without “producing” voluntary compliance, a phenomenon to be observed in many transition countries, particularly also in semi-authoritarian states like Russia, and, of course in authoritarian regimes such as China. This also means that they are weak with regard to their *political* capacity to rely on voluntary compliance (a point stressed also by Easter in this volume, see also Fukuyama 2004: 26 f.). And usually they are also weak with regard to their *administrative* capacity, the capacity to enforce tax laws. Extraction rates depend on this capacity and typically, as noted by Fukuyama (2004), extraction rates are higher in richer countries. On the other hand, in a democratic context states are precisely strong

because they rely on the rule of law and on inclusive political structures. Where participation is possible and where people can observe the efficiency of rule of law based state actions and get “returns” in form of efficient policies, compliance and trust are more likely to be reproduced than in a country where society and the State are separated from each other like strangers, as is the case for example in Russia or in some countries in South-Eastern Europe. It seems to be a truism, but only legitimate states are strong in the sense that their governments have the capacity to enlist voluntary compliance. Democracy, the protection of civil and human rights, federalism or performing welfare state are features shaping the identity of a national community, its values, and determine certainly the radius of trust in society.

One cannot speak about tax collection or tax evasion without speaking about the state’s accountability towards society, its responsiveness. Reciprocity is what citizens are expecting also in the relations between them and the state. Citizens are entitled to demand a return of revenue for paying taxes. Compliance is likely to increase if taxes are considered as being exchanged against public goods. There is plenty of evidence that the quality of government determines the tax moral of citizens. The same is also true for state responsiveness which should increase in a democratic state where governments depend on their citizens for income. As we may add here, citizens in Swiss cantons with more direct democratic rights avoid fewer taxes (see the discussion in the contribution of Feld and Frey and Weck-Hannemann and Pommerehne 1989). Citizens are more likely to comply if they have the right to vote on tax issues and governments are also more likely to be trusted in this case. Such mechanisms are a part of trust-building institutions. The state being considered as a part of the community and not as the hostile other or “they” can reasonably expect to secure tax compliance. This is also true about governance, about citizen participation in the management of the rules of the game.

In some regions of Eastern Europe such experiences were never made: here “cultures of distrust” imply also a “culture of tax evasion”. All the more it is interesting to put the focus on the differences between tax compliance and state capacities in Western and Eastern Europe, as is the purpose of this volume. Obviously tax

collection and tax moral tell us a lot about how states, particularly states in Eastern and Central Europe are functioning, about their responsiveness and accountability, good and bad governance, and about particular state- society relations. Individual rights cannot be protected without the power to tax and spend.

Tax reform, simplifying tax systems is an efficient way to increase state capacity. Many countries in Central and Eastern Europe have in the last decade radically simplified their tax system by introducing a flat tax system. Evidence shows, that wherever taxes have been simplified for example by introducing a flat tax, tax compliance has increased. This is also the case of a high tax-rate country like Poland where a flat-rate income tax of 18% is planned for 2009 (see Economist "Survey of Poland," 13.5.06, see for tax reforms also Owsiak in this volume). Fewer people seek to avoid taxes if it becomes easier to administer and easier to comply with (see Economist 14.4.05 "The case for flat taxes"). But this is only part of the story, since other factors have to be taken into account, particularly in transformation countries, such as institutional performance with regard to the production of public goods or the accountability of government.

On the other hand the negative financial consequences to be expected from bad governance in the area of tax regulation or from tax evasion need not necessarily be a problem for certain strong resource-based states, where the state elites have the ability to appropriate revenues and finance state activities without relying essentially on taxes. Evidence shows here that resource rich states suffer from under-development of their extractive institutions (see Tompson 2005). In Russia for example this would also mean that the increasing state control over resources undermines political accountability. The state's autonomy increases with regard to its constituency but at what price? The demand for "no taxation without representation" being based on citizen consent would be perverted in the sense of "no representation without taxation". Democratic governance and control of taxation authorities expected to work in rule of law societies would become very difficult (see Levi 1999 and Scholz in this volume). Indeed when rulers can finance their activities without having to tax the ruled, cooperation and negotiation between rulers and the taxed are not really necessary, since the constraints imposed on the rulers by parliaments for example are minimal.

Such cases may be extreme but they point to the importance of democratic governance, of accountability and, of course, of cooperation between the rulers and the taxed. Most of the authors in this volume are precisely interested in the analysis of the structure of cooperation between extraction authorities and citizens. They all underline the importance of democratic governance, efficient state and legal structures and, therefore, also of trust in the explanation of tax compliance.

The present volume is essentially focusing on tax moral in the changing political and economic contexts of Central and Eastern Europe. A series of chapters focuses on specific experiences, namely those of Romania, the Czech Republic, Hungary, Croatia, Poland, Armenia, Russia, and Armenia. Huge differences between countries of the former Soviet-Union and central European countries being now (or which will be soon) members of the EU cannot only be seen on the level of democratic governance, of state capacities and the structures of trust, but obviously also with regard to tax morale. Benno Torgler in this volume shows to what extent there is significantly higher tax morale in Central/Eastern European (CEE) economies than in Former Soviet Union countries.

The volume starts with three mostly theoretical chapters assessing the problems from western experiences. The contributions on the United-States (Scholz) and on Switzerland (Feld and Frey) are contrasting the experiences in Central and Eastern Europe. At the same time they present also theoretical models on the collective action problems involved in the extraction process (Scholz) or apply a contractarian perspective (Scholz) or a psychological contract model (Feld and Frey) to their cases. The most general view is offered by Eric Uslaner explaining tax moral world wide, based on data from the World Value Survey and empirical studies in Romania. According to Uslaner tax compliance seems to be essentially based on citizen evaluation of how well the entire government works. Political trust in institutions has positive effects on tax morale, whereas corruption and a context of inequality have negative effects on tax compliance. Governments can affect tax compliance through trust building policies (benefits).

Regional overviews on Central and Eastern Europe are presented by Benno Torgler and Stanislaw Owsiak. Torgler's study points not

only to considerable differences between Central and Eastern European countries, it underlines also the importance of institutional arrangements such as fiscal and political decentralisation or more direct democratic governance for the stabilisation of tax compliance. At the same time the reference to the Swiss case represents a link to the study of Feld and Frey who show to what extent in Switzerland high tax morale is influenced by direct democracy, particularly the fiscal referendum. According to these authors taxes in Switzerland are being paid as prices in “exchange” for the supply of goods and services by the State. A culture of cooperation, federalism, direct democracy, accountability, rule of law, and a culture of trust: These are the factors explaining a high tax morale rather unique in Europe. Quite a contrast to some of Central and Eastern European countries, where the lack of such factors often paired with a high tax burden explains also widespread tax evasion strategies. According to Stanislaw Owsiak tax system reforms, which should also be considered in the context of EU membership, are supposed to improve taxation capacities of the state and therefore also tax compliance.

This volume contains also six country studies focussing on tax evasion in Central and Eastern Europe. The study on Russia stays a bit apart from the other countries of Central and Eastern Europe. With the exception of Armenia, all case studies are on tax evasion in consolidated democracies, which are or will be members of the EU. Russia is a different case, not so much because it is the only semi-authoritarian political system presented in this volume, but because Russia is being set by its new power elites on an unprecedented modernisation path driving into the direction of a resource based “petro-state” controlling the economy and society on a large scale. The extraction potential build up in this country by the central State, be it in the area of direct control of resources, or indirectly by controlling the business elites of big enterprises, or in the field of enforcement of tax laws, is impressive. It’s about building up state capacities without democratic governance. Gerald Easter’s study on State Reformation in Russia presents interesting aspects of this still ongoing process of strengthening of State Capacities which are also focussing on increasing tax compliance in society. Putin’s reforms in the field of tax reforms, for example the above mentioned introduction of a flat-tax, seem to be very successful in the sense of

increasing tax compliance. But they have also increased considerably the repressive potential of the State – the case of Khodorkovsky is only one example – this in a context of a power structure which respects neither citizen rights nor the very idea of “justice as impartiality.” Sure, Russia may have now quite an efficient tax system, but this has nothing to do with democracy, on the contrary it is the state that controls to what extent it should be “accountable.” And the actual developments concerning increasing state control over resources say a lot about who wants to get rid of accountability.

If in Russia state capacities have been increased, Janky’s study of Hungary reminds us that the opposite may also be the case, i.e. extractive and administrative state capacities may remain weak, despite or precisely because of the democratic context of tax reforms. Janky points out that the groups most expected to support broader civic morale have benefited the most from the state’s lack of enforcement capabilities, leading to tax policies that have accepted and legitimized practices generally associated with tax evasion. It remains to be seen to what extent ongoing tax reforms will increase compliance and overcome a system widely perceived as unfair.

Ott’s study on Croatia is again an analysis of a successful strengthening of state capacities and improving of the relationship between State and Economy. Ott shows how, through intelligent institutional redesign with state agencies being more accountable and efficient, with reforms of the tax system and with the emergence of a new socio-cultural context, tax evasion and the informal sector could be declined. The author shows in this context also that the strengthening of an accountable state helped to build up political trust towards trustworthy state officials.

The study on Romania by Gabriel Badescu points in the same direction. Although Romania can still be considered as a low trust country which has made a lot of progress with improving tax morale through tax reforms and strengthening of extractive state capacities. The author shows that democracy has, with regard to taxation, also the meaning of increasing knowledge about alternative regimes of taxation and their likely outcomes. On the other hand improving trust implies more positive perception of state efficiency for example in fighting against corruption, which is according to Badescu one of the main determinants of tax compliance. The quote “the less tax

dollars a government has, the less damage it does" (see Badescu in this volume) makes sense, but only in a context of bad governance. A democratic culture and more accountability change also the way people look at government and taxation.

Still one shouldn't be too optimistic about rapid changes of attitude with regard to tax evasion. David Tumanyan's study on Armenia shows how difficult it is to bring this country out of a negative cycle of bad governance – corruption – tax evasion – distrust. But also in more advanced countries like Hungary or the Czech Republic, now being members of EU!, the road to accountable states with governments able and willing to improve their political and administrative capacities is still long. With this regard the methodology presented in the study of Hanousek and Palda about the "Evolution of Tax Evasion in the Czech Republic" tries to predict the level of tax evasion in the next decade on the basis of 'transition' probabilities, namely from not evading to evading taxes and vice versa. It could help to answer the question how and to what extent governments can influence tax morale.

Conclusion

The chapters in this volume certainly underline that the experiences with tax evasion and its link to trust and state capacities are very much diverse. While it is hard to disagree with Scholz's (this volume) conclusion that there is a "growing consensus about transparency and accountability in linking institutions in the tax system with high tax morale," even he argues that the link between institutions and tax morale is of a complex nature. While it might be tempting to conclude from the Swiss experience (see Feld and Frey in this volume) that more citizen participation and better "service" from the tax-man will lead to increase tax-morale, introducing tax reforms along these lines may not work in all contexts. More precisely, more than one observer of the Swiss tax system has voiced his or her surprise at how willing Swiss voters are in raising taxes on themselves.

Hence, research may have to focus much more on how particular tax systems and arrangements “coevolve” (see Scholz in this volume) with the jibing attitudes and behaviors of citizens.

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