

A DISCUSSION OF

A

TAX CULTURE FROM A
SOUTH AFRICAN
PERSPECTIVE

BY

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CHAPTER ONE

1. INTRODUCTION

"No taxation without representation" was the battle cry of the American people against the power of England to tax the American colonies in 1765.

(Interestingly, Zaidi (2002) mentions that in recent tax culture debate in Pakistan this battle cry has been reversed to "No representation without taxation").

This battle cry stood for democracy and freedom and may therefore hint at the key features of the tax culture in the New World.

In view of today's progressive globalization, international coordination and the clash of different cultures and divergent tax systems caused thereby, one would think national "tax culture" to be a fashionable topic of economics and public finance (particularly of taxation). The topic, a discussion of a tax culture from a South African perspective is broached in this dissertation, precisely at the intersection of the disciplines economics, sociology and history.

Recently, the importance of tax cultural consideration has become more obvious, since the necessary reform measures to the tax systems of transformation economies, partly have failed due to their tax cultural incompatibility.

South Africa comes from a past where several factors came together to create a compliance culture that is less than it should be. These factors include:

- The economic marginalisation and consequent lack of knowledge about tax of a large segment of the population.
- The mindset and practices that took hold when circumventing the imposition of international sanctions.
- The historically limited capacity of the tax and customs administrations to challenge tax evasion and highly arguable, or even fanciful, tax planning structures and techniques.

The objective of this dissertation is first to give a brief account on how we define tax culture, using the an embeddedness approach (Compare Granovetter (1985) and Nerre (2001a: 107ff.) considering the history of taxation and by that means explicating national tax cultural diversity.

In the course of continuing globalization two different kinds of disturbances to tax culture may be identified: tax culture shocks and tax culture lags. Both are due to ignorant and/or ethnocentric policy measures. While lags are caused almost inevitably during any transformation or reform process, shocks should be prevented by implementing tax political measures on an international (and national) level in a tax cultural conform way.

A brief overview of a case study of a tax cultural shock- Japan, tax cultural lag – Russia, and a brief characterization of the Austrian political setting and tax system will be reviewed. Thereafter we will look at the tax culture, tax collection and governance in South Africa, tax reform and democratic accountability in Sub-Saharan Africa and the regulating of tax practitioners in South Africa.

We have made progress together, over the first ten years of democracy, in South Africa. Reflecting on **Amarty Sen's** brave formulation of the central intent of economic progress: freedom is the primary aim of development, and also the principal means of achieving it.

The formulation of that intent that goes back 49 years, to the 26th of June 1955: the freedom charter reflects our aspiration for political freedom, freedom from poverty, freedom to transform our society, its culture and values, freedom to explore our capabilities, the freedom that will grant our children choices that our parents did not enjoy.

This is a freedom that opens up opportunities but also imposes disciplines; it is a freedom that creates capabilities, but expects stewardship; it is a freedom that rewards enterprise, but calls for accountability. It is a freedom we have used to build a new society, mould a new culture and create hope and opportunity for future generations.

In South Africa the tax policy over the past decade has been completely reshaped. We have changed from a source based tax system to taxing the global earnings of South African residents. We have begun taxing capital gains, reduced corporate tax rates and made substantial reductions in personal income tax rates, especially for low and middle-income workers.

We have zero rated paraffin, reduced ad valorem excise taxes and introduced a lower tax rate for small businesses. Equally impressive is the change in tax administration. In a short period of time, the South African Revenue Service has overhauled many of its procedures and systems.

We have created an environment that promotes tax compliance. This is almost unique in developing countries. The outcome of these policy changes and administrative reforms is that we have been able to reduce the deficit, increase resources available for spending and give considerable relief to individuals. These factors, including improved tax morality, have had an immeasurably positive impact on the economy.

CHAPTER TWO

2. TAX CULTURE

The term "tax culture" can rarely be found throughout economic literature and appears to be an emotive word (Pausch (1992:8). This character is based mainly on the fact that the average taxpayer would have difficulty in thinking of the exploitation instrument "taxation" as an artistic creation of the human mind).

Accordingly, a brief overview of selected nuances occurring is given in section (2.1.). A synthesis of its different interpretation then leads to our working definition of "tax culture"(2.2.). Subsequently, (2.3.) deals with possible disturbances of tax culture.

2.1. TAX CULTURE IN ECONOMIC LITERATURE

Several groups of economist writing about tax culture can be distinguished. Section (2.1.1.) is a small group of economists which I have classified "classics". On the other hand the transformation economists in (2.1.2).

2.1.1 THE "CLASSICS"

It was more than 70 years ago that Schumpeter used the term "tax culture" in his celebrated article "Economics and Sociology of the Income Tax"(Schumpeter (1929, translation BN): "Okonomie and Sociology der Einkommensteuer), where already its evolutionary character was emphasized: " Like any social

institution every tax outlives the era of its economic and psychological appropriateness.

But as with all other social institutions anything nonconformist in the tax system does not live eternally. Slowly the tide of evolution wears it away" (Schumpeter (1929: 385, translation BN):

Schumpeter assigns the term" tax culture" only to the degree of progressiveness or modernity and to the smartness tax design.

He regards taxation as an "art" (Already in 1868, the German Hugo Eisenhart titled one of his books "The Art of Taxation" (Eisenhart 1868:"Die Kunst der Besteuerung", translationBN), which suggests an understanding of "tax culture" by means of the definition "art creation of cultural goods" (such as sculpture, painting, theatre etc) and distinguishes it from taxation as a mere "craft"(The distinction between "economics as an art" and "economics as a science" can already be attributed to John Stuart Mill)1848).

Consequently, the Schumpeterian understanding of "tax culture" focuses on its creators, the tax economists and tax politicians, who create an artificial thing, a national system of taxation? This meaning seems a little too narrow for the purposes of this work; however, the emphasis of the evolutionary character should enter into the working definition in section 2.2.

A similar position concerning "tax culture" can be found with Armin Spitaler (1954), about whom Alfons Pausch notes that "Spitaler knew that the combination of taxes and culture would seem fairly ambitious and highly

pathetical”(Pausch (1992; 145, translation BN): “Spitaler wubte, dab die Verbindung von Steuer und Kultur Manchen >>reichlich hochgegriffen<< und von>>holem Pathos<<ersheinen mochte”)., and to whom Pausch attributes the invention of the term “tax culture”(Pausch (1992:9) As mentioned above, the term “tax culture” can be found already in Schumpeter (1929). Even four years earlier, in 1925, Franz Merisel used the term of “tax culture”, however, without explaining it, compare Merisel) 1925,1926).

Furthermore, Spitaler postulated the convergence of the tax system of the “civilized nations” (rationalized by Wagner’s Law) and thus followed the Schumpeterian line of thought, however, modified by the above-mentioned postulate.

On account of the contrary empirical experiences this postulate is not included in our subsequent working definition Spitaler distinguishes between “cultivated” and “non-cultivated” tax systems, roughly assigning those attributes to creditor and debtor countries of the fifties, respectively.

Important for a comprehensive definition of tax culture, though, appears Spitaler’s on sight that taxation is influenced by economics, social, cultural, historical, geographical, psychological and further differences prevailing in the individual countries and their societies (Pusch (1992: 9, translation BN):

Alfons Pausch (1992) understands the “tax culture” of a country as being closely connected with the personalities determining the evolution of the tax system.

His understanding also resembles the Schumpeterian viewpoint: “Tax culture is an expression of human spirituality and creativity”(Sometimes the individual allocation to one of the above-mentioned groups was rather complicated, especially in cases where economist holds a political position).

Thus the evolution is being emphasized against its historical background, however, limited to the side of the tax legislation and the tax system design.

2.1.2 TAX CULTURE IN THE TRANSFORMATION CONTEXT

For the better evaluation of the comments of the economists on tax culture in the transformation context, different “origins” of those dealing with tax culture can be identified. First, there is some work coming from the sphere of economics.

Then, there are some aspects coming from politicians and state officials (In any case, it should be emphasized that in Latin America the “cultural tributary”, i.e. “tax culture”, is part of academic discussion. The understanding focuses on voluntary compliance).

This dissertation focuses on the transformation process in Eastern Europe, especially in Russia. Thus, e.g. the Latin American context is not taken into account (In any case, it should be emphasized that in Latin America the “cultural tributary”, i.e. “tax culture”, is part of academic discussion. Its understanding focuses on voluntary compliance and on public methods to increase the propensity to be honest in the taxation process; compare e.g. Cortazar Velarde (2000).

2.1.2.1 THE “ECONOMISTS”

Already in 1997 Michael Camdessus, Managing Director of the IMF, proclaimed in a speech at the Moscow Institute of International Affairs the formation “Taxpaying culture” (Camdessus (1997) His interpretation, as well as that of most economists seems to aim at Schmolders Tax mentality (e.g. Beichelt et al.1969, Strumpel 1969 or Schmolders 1970) to be the

medium-term goal for transformation politics in Russia (The possibility to develop a tax mentality by intention is expressed already with Strumpel (1968:28) who expected, substantial discretion for shaping tax mentality in the long runs).

It should be based on voluntary compliance with transparent tax laws, which should be applied consistently. Thus, Camdessus expresses the current opinion among transformation economist, which limits the understanding of tax culture exclusively to the taxpayers' side (Nevertheless, the formation of the tax paying culture should be accompanied by substantial improvements on behalf of the tax authorities, even though their part is not seen in connection with the prevailing tax culture).

IMF economist led by the recently retired Vito Tanzi (Comp. Tanzi (1999), Tanzi & Tsibouris (2000), and IMF Survey (2000) understand a country's "tax culture" as a certain "tax consciousness" on the part of the taxpayers. In most transformation economies, taxpayer lacks this specific consciousness because of the long-time prevailing planned economy.

Central planners tried to avoid any contact of taxpayers with direct taxes and relied on indirect means of (hidden) taxation, which were not made noticeable to the taxpayers, but rather disguised by the authorities in charge (This behavior contradicts the postulate of transparency of taxation).

The introduction of explicit tax systems was met by "hostility" (Tanzi (1999). of the tax subject. Further, the understanding why one has to pay taxes constitutes a facet of tax culture. (Comp. IMF Survey (2000)

2.2. WORKING DEFINITION OF TAX CULTURE

The concept of tax culture presented here can be explained from its conceptual dismantling in the individual term's "tax" and "culture". From the viewpoint of the "taxes" not only the tax system and the actual tax practice from part of a country's "tax culture", but also the relationship between the authorities and taxpayers accounts for the unique "tax culture" of a country. Moreover, the relations between taxpayers must be considered a very important part of "tax culture", as can be seen from the Swiss case made for transparency.

This behavior contradicts the postulate of transparency of taxation. As regards the tax authorities, the structure of the individual levels' competencies must be taken into account, how are tax revenues to be distributed between local and central bodies? How explicit and precise is the tax law on that account and how consequently are violations sanctioned? Which (rival) interest groups do exist? This incomplete list of questions is a particular important part of national tax culture, especially in transformation economies (Bell (1998), Berkowitz & Li (1999), Blanchard & Shleifer (2000), Shleifer & Treisman (2000).

However, the component of "culture" is far more important: Although there is, according to Geert Hofstede (Compare Hofstede (1983:77), no scientific language to define "culture" (Hermann Pilath (1999a) wrote a critical essay in question), in the course of the work reference is made exclusively to the national culture as such.

In style of the "Shared Mental Models" a la Denzau & North (1994)("Mental models are the internal presentations that individual cognitive system create to interpret the environment"[Denzau & North(1994)] "culture" should be understood as "the collective programming of the mind"(Hofstede 1983, 1991).

Panther calls culture: a learned system of meaning/interpretations (including values) shared by group of actors”(Panther (1999a: 24; 1999b: 165; 2000: 1; translation BN):

It becomes clear that the understanding of “culture” aims at its evolutionary character; the cultural factors are continuously in an ongoing modification process stimulated by external and internal inputs (At this point reference should be made to evolutionary game theory. For an introductory overview see e.g.Holler & Illing (2000, chapter 8). Jones (1995: 274 – 275) points out that “cultures [...] may persist in their current form only while there is no challenge. [...] Gradual modifications take place even in Western societies”). Consequently, culture itself is “a dynamic phenomenon of interaction, not a fixed equipment of the factors (Herrmann-Pillath (1999b: 90; translation BN): Similarly Granovetter (1985: 486) notes that “culture is not a once-for-all influence but an ongoing process”).

The synthesis of the two terms “tax” and “culture” succeeds via the just mentioned evolutionary process: history is the linking or embedding variable. Namely, both subject areas are embedded in the national historical events (in the sense of Granovetter’s “historical embeddedness” (e.g. Granovetter (1985: 486). The general idea of embeddedness can already be found with Schumpeter (1950). Other forms of embeddedness are e.g. structural, cognitive, cultural, political (Zukin & DiMaggio 1990: 14 ff. and Smelser & Swedberg 1994), and regional embeddedness (cf. Nerré 2001a: 107 ff.).

In this regard, already Schumpeter found that “every tax ideal has got its historical, economics and sociological boundaries (Schumpeter (1929: 383, translation BN): In the context of taxation guidelines, Scheer (1996: 156, translation BN) points out unmistakably: “One surely cannot expect that the guidelines for a ‘right’ taxation are independent of time and location.

In this way, the existence or creation of a universal and “objectively good” system of taxation becomes implicitly impossible (An opposing position is taken by e.g. Manfred Rose, who scientifically supervised the introduction of a consumption-oriented income tax in Croatia and holds the opinion that solely economic factors are to be considered for the design of any tax system; cf. e.g. Rose (1998a,b). This is a contradiction to the proclamation of the existence of a gap within economics “between pure fiction and cultural reality” (Groß 1999, translation BN), and as well as to the above mentioned “embeddedness” argument.

Thus, a “tax culture” specific to a particular country emerges coined by tradition of taxation (e.g. an accentuation of [in-] direct taxes) on the one hand, and by the interaction of the actors and the cultural values (Buchanan (1995: 195) states appropriately: “Differences in cultural history must exert behavioral consequences) like “honesty”, “justice” or also “sense of duty” on the other hand.

The latter resembles the by definition taken more narrowly *tax mentality* that consists of the two components of *tax moral* and *tax discipline* and solely aims at the relationship of the taxpayer to the tax state.

Above all, the German Cologne school around Guenter Schmölders and his students treated this subject during the fifties and the sixties comprehensively.

Tretter (1974), who gives the following definition, in this regard gives a pass-able overview:

“Tax mentality includes all attitudes and also all patterns of behavior which the tax-paying citizens hold against (or with?) the tax and the state” (Trett (1974: 39, translation BN):

In general tax *moral* is used as a term connected with a certain “willingness-to-pay taxes”, a feeling of obligation to the state (according to the benefit principle) or the obligation to the general public or community (with tax moral according to the ability-to-pay principle), respectively. Tax *discipline* then reflects the attitudes of the taxpayer in his or her actions.

DEFINITION: TAX CULTURE

A country-specific tax culture is the entirety of all relevant formal and informal institutions connected with the national tax system and its practical execution, which are historically embedded within the country’s culture, including the dependencies and ties caused by their ongoing interaction.

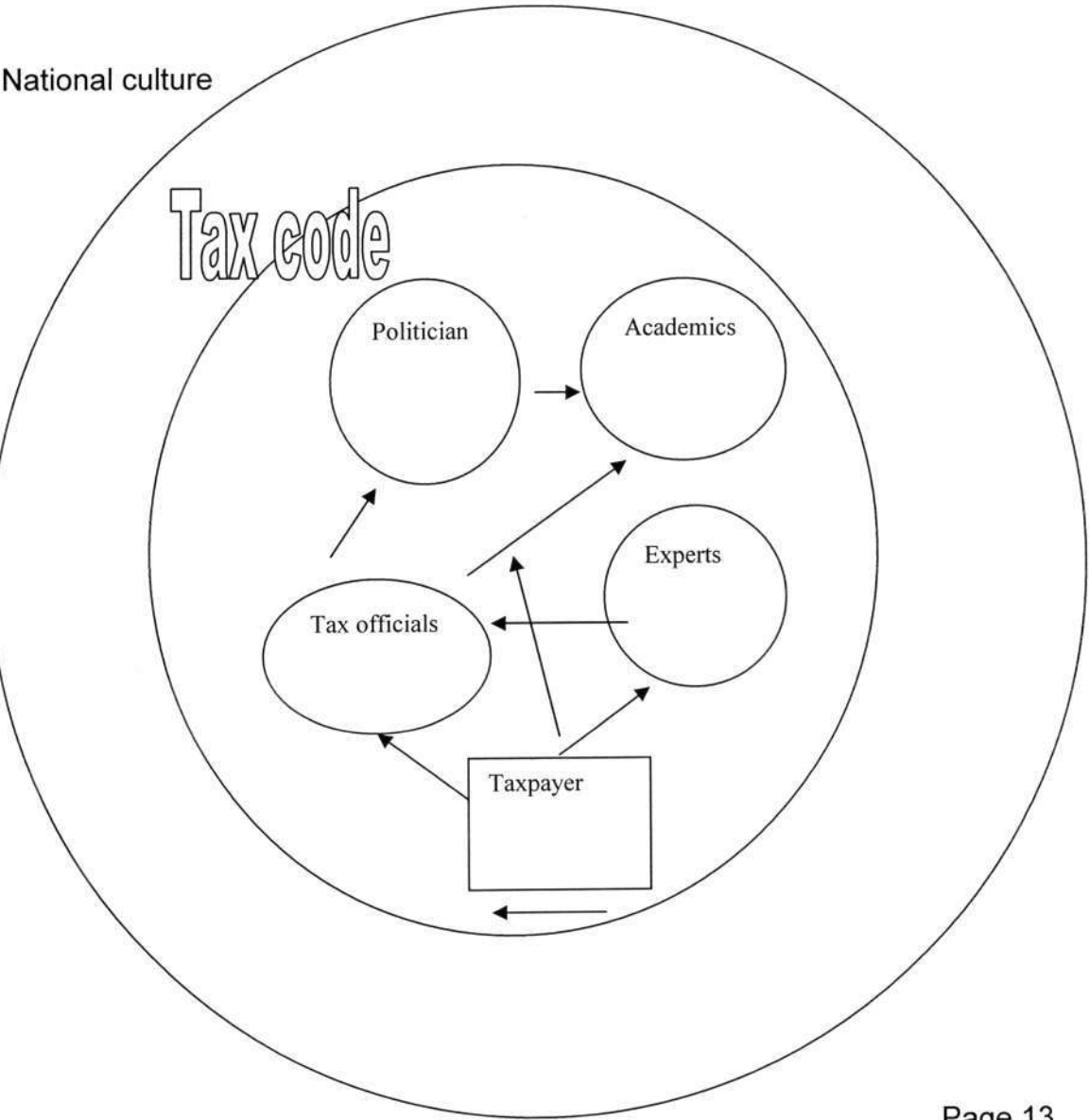
Accordingly, tax culture contains even more than “culture of taxation” and “taxpaying culture”.

A simplified overview which could easily be enhanced by more details is presented in figure one. It shows the embeddedness of the actors into the national culture with its subset of tax culture. Cultural norms and historically developed institutions both determine the tax code.

The latter sets the environment and the constraints, i.e. the rules for the tax game. Players include (among others) taxpayers, politicians, tax officials, expert (e.g. tax advisors), and academics. The arrows indicate interaction between the different groups of players as well as between the members of one and the same group (e.g. academics meet at academic conferences).

By the ongoing interaction, social ties and dependencies are developed over time. I have left out an interaction arrow between academics and taxpayers, because I am not sure about the relationship between both groups (academics tend to model taxpayers far differently than they act in reality, taxpayers seem to know that and thus do not care about propositions academics makes).

Figure1
The Embeddedness of Tax culture



2.3. DISTURBANCES OF TAX CULTURE

From sections one and two one might hopefully be able to imagine what a nation's tax culture is about. The question remains, however, what is the use of this knowledge. From a tax-cultural perspective, the answer lies in occurring abnormalities or disturbances. What tax culture is about is often only realized when changes to the tax system cause more or less serious problems. During transformation processes, e.g., any country's *political* culture is subject more or less dramatic changes. Being a part of political Culture (Strümpel (1969: 28), the tax culture suffers from certain problems, as well. Foreign advisers who might not be tax-culturally conditioned in the same way as the advised country's society often plays the most crucial part. Therefore, institutional conflicts are inevitable during the attempted transfer of a particular tax system into a different "tax culture" following a "big-bang" approach.

In such cases so-called "tax culture shocks" (Compare Nerré (2000, 2001b). are unavoidably caused (section 2.3.1 with smoother "gradualist approaches" or with any attempt of gradual tax reform in general, serious shocks might be avoided. Nevertheless, phenomena might be observed due to adaptation processes which have named "tax culture lags"(section 2.3.2).

2.3.1 TAX CULTURE SHOCKS

The term "culture shock" was coined about 40 years ago by the anthropologist Kalervo Oberg, who published the results of his personal observations of American expatriates in 1960 (Oberg 1960). Following Oberg, other authors placed their emphasis on "*language shock*" (Smalley 1963) or "*role shock*" (Byrnes 1966), but in principle described only facets of the same phenomenon. In

contemporary literature on international management, cross-cultural management or human resource management there can be found a chapter on the theory of culture shocks in almost any textbook(Compare Chaney & Martin (1995), Harris & Moran (1996), Lewis (1996) and Deresky (2000).

There, the negative reactions of individuals to (unexpected) patterns of behavior in a foreign culture are described, resulting in a feeling of insecurity, lack of understanding or uneasiness.

Shocks in the field of tax culture can emerge during an encounter with an unknown or foreign tax culture. A distinction should be made, though: shocks may be observed on the individual or micro level, or on the collective or macro level.

Above all, individual tax culture shocks have become more and more common in the course of today's globalization. They are part of the overall "culture shock" (which is well-known from management literature.) If taxes are to be paid in another country (host country). In the case of a certain "strangeness" of the prevailing local tax culture, where the values reflected possibly differ from those of one's own inherent tax culture, this may well lead to a feeling of unfair processing (One could theoretically think of a positive surprise as well if the individual got the feeling of paying less taxes), helplessness in view of the prevailing tax practice, insecurity etc.

In the case of a shock on the micro level, there are two possibilities to solve it: The individual either returns to his home country (Hirschmann's "costs of exit" in that case must be lower than the costs of remaining in the foreign tax culture), or undergoes a process of adaptation (The duration and the inconveniences of this process depend on different factors, e.g. on the degree of difference between the tax culture of the host country and the individual's home country, on the

individual's cultural adaptability etc), which may lead to a better understanding of the host country's tax culture.

Collective tax culture shocks are to be observed by far more rarely. They are characterized by the fact that both the taxpayers (in their entirety) and the tax administration suffer considerably from them. While the first aspect might be quite obvious (in the sense of massively occurring individual shocks), the second aspect perhaps needs a further explanation. For this purpose, three possible scenarios will be presented:

A certain tax system being forced onto a nation by an external power (One could think of a situation where internal powers enforce a new tax system on a country the course of a malevolent dictator's military putsch).

- (1) in the course of a state of emergency,
- (2) the introduction of a new tax system dictated by donor nations or donor organizations (e.g. the IMF or the World Bank) during transformation processes, and
- (3) the enforcement of a tax system by the central power of a federation.

The effects caused by the situation described in the third case crucially depend on the approach chosen by the authorities. In the case of a so-called "big-leap approach", which consists of sudden and unexpected changes in the existing system of taxation, an event similar to a shock could possibly occur.

In this case, tax administration would be confronted with a great number of new and unknown rules (i.e. tax laws), which can possibly lead to enforcement and implementation problems. With a "gradualist approach", though, all changes are implemented in small steps over a longer period of time.

Thus, it is to be expected that the tax administration and the taxpayers would get accustomed to the new rules little by little.

Therefore, a shock on the macro level cannot occur with the latter approach. Such a situation would be conceivable for example on the EU level. The “central power” (e.g. the European Parliament) would also need a parliamentary and constitutional legitimization in order to be able to enact a “tax reform”.

If that were given, there would not be any argument against a reorganization of the national systems of taxation on the constitutional level. Nevertheless, it would seem to be a violation of the *national* objectives (Concerning constitutional economic issues compare e.g. Kirsch (1997: chapter 4) if no veto right had been provided in the constitution of the *federation*. Thus, even though there could not arise any conflict because of the democratic line of legitimization, indeed a collective tax culture shock in the broadest sense (so-called secondary tax culture shock) might be caused if an affected country could not influence the new tax design significantly (on the EU level, however, a veto right is provided Keen (1993:16). In that case, problems could for example arise due to log Rolling activities as well).

In that case, taxpayers and national tax authorities see themselves confronted with unknown taxes and tax laws possibly contradicting their own national/cultural values. The second scenario mentioned above takes account of the fact that the most crucial part in transformation processes is often played by foreign advisers who are not tax-culturally conditioned in the same way as the advised country's society.

Western industrialized countries often offer foreign aid to so-called developing countries only on the condition that the prevailing financial systems (including the

tax system) be reformed according to the aiding countries' ideals (Russia might serve as an example (for a so-called "tax developing country") in this case, compare Nerré (2001d, e). E.g. in 1996, 1997, and 1998, the IMF was only willing to provide further funds if tax revenues would increase significantly in the nearest future (thus, in this example there is no direct patronage concerning the tax system); comp. Franklin (1997: 137) and Shleifer & Treisman (2000: 148, 176). The IMF demand led to very brutal methods of tax collection in Russia (by elite soldiers), which did not seem very stimulating for Russia's emerging tax culture, cf. Berger (1998).

Therefore, institutional conflicts are inevitable during the attempted transfer of a particular tax system (or only of a particular tax!) into a different "tax culture", especially when following a "big-bang" approach. The results of such ethnocentric measures are even lower compliance rates and lower working moral of tax officials than before.

A perfect example for a shock on the macro level is the first case described above: changes in the national tax system are made against the will of the voters and without democratic legitimization. The tax administration sees itself confronted with new, obscure and above all unwanted changes in the system of taxation and taxation practice. Moreover, the administration is possibly put under pressure by the controlling forces that would like to observe the intended "success" as soon as possible.

In connection with this one scenario's might be imagined: the violent occupation of one country by another one in the course of belligerent activities (See Nerré (2000) for a case study of the events in Japan in the aftermaths of WW II).

A tax culture shock on the macro level as well as one on the micro level causes a feeling of insecurity concerning the new rules of taxation, of dissatisfaction, of being insulted and similar feelings, equally found with the mass of the taxpayers as well as the tax administration.

Furthermore, the tax moral and the tax discipline in the country is to be expected to decline, the tax resistance on behalf of the taxpayers, on the contrary, to rise.

Also, from the part of the tax administration a decline in working moral will occur because the tax officials see themselves confronted with new tax laws and an external pressures for success.

The course of the shock and its long-term effects depend on the methods chosen (In the case of a hostile occupation a big-leap approach has to be expected) as well as on the duration and the degree of strictness of the enforced patronage. Should the latter be of continuous nature and of a high degree, a laborious and painful adaptation process will be triggered, which can probably lead to a slow modification of the prevailing tax culture of the patronized country. In the case of a short-termed patronage of relatively tax character, soon reforms and /or adaptations to the well known tax culture might be expected (This resembles the situation in evolutionary game theory, where a mutant (here: the occupier) enters a (foreign) population and plays a formerly unknown strategy.

If the mutant leaves the population again after a certain time (either exit or death), the continued existence of his strategy (here: the "strange" tax system) depend on the question, whether its fitness outperforms that of the old-established players' strategies or not), as could be observed e.g. in Japan after World War II.

2.3.2 TAX CULTURE LAGS

Even if by using a gradualist approach to tax reform, tax culture shocks may be avoided. Troubles in the sphere of taxation are inevitable in the majority of tax reform projects. One has to keep in mind that a tax reform means to change one part of a nation's tax culture first: namely, the tax code, i.e. the formal institution of law.

The remaining parts of the tax culture stay unchanged for the time being, they lag behind in the tax culture's evolution. Thus, a phenomenon might occur which I have named "tax culture lag" (Sociologists use the expressions "culture lag" and "cultural lag" synonymously. In earlier contributions they have used the term tax cultural lag, but to relate the lag phenomena more closely and more obviously to the concept of tax culture shocks I have decided to use the expression "tax culture lag" from now on).

It has been borrowed from the concept of culture lag which was developed by the economist Thorstein Veblen (1899) and the American sociologist William F. Ogburn (1922) (While Veblen published his "Theory of the Leisure Class" already in 1899, Ogburn coined the expression of "cultural lag" only in 1914, when holding a chair in economics and sociology at Reed College. In 1915 the theory was improved until in 1922 his "Social Change" was published. The accusation of stealing the theory from Veblen is strictly rejected by Ogburn: "I have been accused of taking the theory from Thorstein Veblen [...but] I am quite sure [...] I had never read him on this point"; comp. Ogburn (1957: 168, 1964: 87).

While Veblen analyzed the process of economic evolution in the framework of cultural evolution, Ogburn looked at social evolution in the context of cultural evolution.

Just like the concept of culture *shock* can be found in almost any textbook of international management, the phenomenon of "culture *lag*" is part of most contemporary textbooks of sociology (Brinkman & Brinkman (1997: 609).

"The cultural lag approach has been one of the master concepts of modern social analysis. [...] The concept of culture lag, which Veblen used to analyse social processes, has been widely used by American sociologists to account for both social change and social processes"(Davis (1968: 304 f.).

Ogburn offers the following definition for culture lag phenomena: "A cultural lag occurs when one of two parts of culture which are correlated changes before or in greater degree than the other part does, thereby causing less adjustment between the two parts than existed previously" (Ogburn (1957: 167, 1964: 86).

The 1922 definition in his "Social Change" is even more comprehensive especially for the transfer of the concept to the field of tax culture: "The various parts of modern culture are not changing at the same rate, some parts are changing much more rapidly than others; and that since there is a correlation and interdependence of parts, a rapid change in one part of our culture requires readjustments through other changes in the various correlated parts of culture Where one part of culture changes first, through some discovery or invention there frequently is a delay in the changes occasioned in the dependent part of culture.

The extent of this lag will vary according to the nature of the cultural material, but may exist for a considerable number of years, during which time there may be said to be a maladjustment" (Ogburn (1922: 200). He explains culture lag with the maladjustment between the development of the automobile and the highways in America. While in 1910 both parts were functioning properly together (cars were slow, highways were narrow) the development of stronger motors enabled

speeds of 60, 70 and even 80 mph – but only in theory. *In praxi*, the narrow and curvy streets just did not allow to go at that speed they lagged behind and slowed down traffic's development. It took the government some time to adjust the highways' quality to the new innovations in the automobile sector and thus to enable car owners to extract maximum utility from their cars (in terms of speed); see Ogburn (1957/1964).

The time of maladjustment or imbalance within a culture is marked by social unrest and adjustment problems in society.

This is exactly what can be observed in the sphere of tax culture during transformation or reform processes (Martinez-Vazquez & Wallace (2000: 12): "Reforming a tax code is a difficult and complex procedure, and it requires support and compatibility with other laws and institutions in the system").

In chapter three of the different elements of a national tax culture like the tax code, the tax authorities, tax experts, or the taxpayers have been identified. Tax culture lags may occur similar to cultural lag effects when the different elements of a nation's tax culture develop at different speeds, i.e. if for some reason the relationship between some parts is no longer in cultural/evolutionary equilibrium. This might be due to, e.g., a democratically legitimized tax reform. First, tax authorities will have to cope with the new guidelines and tax laws. Then, it is taxpayers who have to adjust their behavior to the latest changes in the tax law. During this period of multi-level adjustment tax-cultural distortions are inevitable especially in the case of a prevailing (tax) cultural conservation or inertia.

On the hand of the tax officials decrease in working moral might be expected, followed by a decrease in tax moral on the part of the taxpayers.

In Western societies most tax reforms consist of marginal changes to the tax system online e.g. broadening some tax base, changing some tax rate by a percentage point, and so forth.

In those cases, tax culture lags are neither very obvious nor serious, even though they appear, however. E.g., the introduction of the possibility to deduct some sort of expenses from personal income tax liability will change taxpayers' behavior in the medium term. Getting used to it takes some time of adjustment, as well with taxpayers as with taxmen.

More serious are tax culture lags in the case of far reaching tax reform measures as can be observed in many transformation economies. There, grave tax culture lags occurred (See Nerré (2001d, e). Far reaching tax reforms take place in Western societies as well, but are by far rarer than gradual reforms).

Some-times people had to get accustomed to the reality of democracy, i.e. that having democratic rights means to have obligations, too.

The most important one is especially in the case of scarcity in public funds paying taxes to finance the democratic institutions and keep the state in a position to fulfill its task of supplying certain public goods to its citizens appropriately.

Thus, the gains from democratization and transformation can only be achieved in the long run if people obey and comply with the tax law. But, in fact, the majority of the people were of the opinion that they had never paid taxes before (due to hidden methods of taxation e.g. in socialist countries). Changing the "programming of the mind" in transformation economies will take strong punctational efforts (Comp. Cortázar Velarde (2000) and MinTax RF (2000).

and above all a long time. During the time of adjustment to the new (tax) reality the tax systems in these countries will generally not yield the necessary amount of revenue.

Thus, changing a tax code without taking into consideration its embeddedness in the national tax culture might cause serious revenue problems and frustration of the actors, which might initiate a vicious cycle of non-compliance: on the one hand, the economic and political situation may not put the governments of transition countries into a position to fulfill their tasks satisfactorily. On the other hand, taxpayers do therefore not feel the moral obligation to fulfill their part of the institutional contract between the state and its citizens. Accordingly, as taxpayers receive public assistance only on an insignificant level, they think it legitimate to delay payments or entirely evade taxes.

It has to be emphasized that it might be hard to distinguish the negative effects of a tax culture lag from those caused by a tax culture shock. It is of importance to note, though, that lags can hardly be avoided, even if a gradualist approach has been chosen as a method of reforms.

2.4. CONCLUDING REMARKS

Hopefully, the theory of tax culture will be able to belittle the above-mentioned gap between pure theoretical economic fiction and cultural reality, particularly in the sphere of taxation. Furthermore, tax political recommendation can be derived from it, especially in the context of transformation.

CHAPTER THREE

3. CASE STUDIES OF TAX CULTURE LAG

3.1. THE CASE OF RUSSIA

The Russian case study undertaken by Nerre, Birger(2001d), (At present, the case study is not yet finished conclusively) presented is twofold: Its first part briefly analyses the history, development and *status quo* of Russian tax culture (3.1.1), whereas the second part takes a look at recent tax reform measures undertaken in the Russian Federation (3.1.2).

3.1.1. RUSSIAN TAX CULTURE

At this point, a presentation of all historical or technical details of the Russian tax culture is not strived for. Further details can be found in my "Steuerreformen and Steuerkultur in Rußland" .

While in 1805 one could still observe an approximate balance between revenues from direct and indirect taxation (Cf. Wagner (1910: 472), already in 1855 indirect taxes amounted to a share of 72 per cent of total tax revenue (Compare Vilkov (1929: 301).

This tendency to a dominance of indirect taxes has persisted through the whole Soviet period (Compare e.g. Holzman (1958) and is still prevailing in the Russian Federation. Within the sphere of indirect taxes the tax on alcoholic beverages has played a strikingly dominant role in the history of Russian taxation since the 17 th century. Wagner (1910: 476) even called it "the pillar of Russia's public finances" (Translation and emphasis added: BN).

In the 1980s, the revenue share of taxes on alcoholic beverages was still approx. 20 per cent (Compare Lopez-Claros & Alexashenko (1998: 4, Note 4).

It dropped significantly after the 1985 anti-alcohol campaign of the Gorbachev government.

Even more important was a further heritage from Soviet taxation, namely the complete lack of transparency (Martinez-Vazquez & Wallace (2000: 11): “the population at large was neither aware of taxes nor had any perceptions of tax burdens”) on the one hand and the weak tax administration system(See Highfield & Baer (2000) for a discussion of reform measures for the Russian tax administration) on the other hand.

Under the socialist regime in Russia “collection” of “taxes” took place mainly on the “enterprise”-level (with approximately 98 per cent of the Soviet enterprises being state-owned). As the state had played „the role of both taxpayer and tax collector“ (Lopez-Claros & Alexashenko (1998: 12) in the enterprise sector for over 70 years, the taxation of enterprises to a large degree was very arbitrary. Firms had to transfer between zero and one hundred per cent of their “revenues” to the state budget (Lopez-Claros & Alexashenko (1998: 12).

As a result, the payment of taxes was an unpredictable variable in the management process. Rapidly changing tax laws and frequent tax concessions have conserved this circumstance in the last decade. Accordingly, a huge volume of tax arrears can be observed in the Russian Federation, which amounted to 5.5 per cent of GDP in 1996. Their development was additionally fostered by the so-called “30/70-rule” which allowed certain firms to use a fixed amount of 30 per cent of their revenues for wage and salary payments, regardless if in doing so they could not fulfill their tax obligations (Vgl. Lopez-Claros & Alexashenko (1998: 8 und 19).

Dealing with the arrears' settlement, the widespread practice of paying “in kind”

(i.e. by transferring goods to the state instead of cash) has evolved in post Soviet-Russia. The tax authorities are offered, e.g., a shipment of shoes, which are intentionally overvalued (up to twice the market price) by bribed tax officials.

By that means, tax arrears are illegally “settled” by corrupt measures. Interestingly, from a tax cultural viewpoint, paying taxes „in kind“ has always been an important part of Russian taxation practice (Compare e.g. Holzman (1955: 82 ff. and 1958: 104 ff.).

Until 1923 peasants in Russia were taxed exclusively by transfer, in kind”. Even in Soviet times, they had to deliver agricultural goods to the state at a price below producer costs as one part of their tax duties. Accordingly, setting tax arrears “in kind” is a tax culturally conform method of payment to the Russian people.

Concerning personal income taxes, Russians tax culture shows a clear tendency according to the dominance of indirect taxation in the Russian history of taxation: PIT has not been an important means of raising revenue. Initially, a PIT had been exclusively levied on land owners. In 1820, though, the income tax had been abolished until its reintroduction in the 1920ies (Holzman (1958:100) dates the PIT's introduction back to 1920, Hedtkamp (1959/60) deviates from this point of view/name 1920 as the year of reintroduction).

In 1925, the function and intention of personal income taxation was redefined. From then on, the rate scheme of the PIT was designed to be a fierce weapon of class conflict. Ordinary workers and salaried employees were favored by tax rates ranging from 5.5 % to 13 per cent (According to Holzman (1958: 102), about 98 per cent of the subjects to income tax fall in the category of workers and

salaried employees. A significant portion of those 98 per cent were taxed at 13 per cent. Landowners and proletarians, on the contrary, were subject to discriminating tax rates of up to 65 per cent in 1943 (Holzman (1958: 102). However, revenues from PIT have constantly been less than ten per cent of total revenues.

Struggles between different layers of government (especially between federal and regional budgets) have been caused by the fact that they share a significant proportion of tax revenues, particularly those from VAT and profit taxes (Compare Treisman (2000a: 5).

The concrete distribution of the shares is set annually by budgetary laws (See Treisman (2000a: 6), but the property rights on those taxes mentioned above are practically not enforceable in the way prescribed by the law. Regions have tried to secure their own financial needs at the costs of those of the central budget by holding back collected taxes which belong to the central budget. Additionally, it seems to be common practice that "in return for bribes, regional governments offer to protect enterprises against central tax collectors". Treisman (2000a,b) and Berkowitz & Li (1999) assume that this struggle of competences has been a key factor explaining the accumulation of tax arrears in the Russian Federation.

In any case, the impossibility to enforce property rights (tax rights) granted by the law seems to be an important element of Russian tax culture.

At first glance, another very special feature of Russian tax culture seems to be the Federal Tax Police Service (*Federal'naya sluzhba nalogovoi politsei*), which was established in July 1993 to intensify tax collection and increase overall tax revenue. On second thoughts, though, one comes across well-established similar organizations in Italy (*Guardia di Finanza*) and The Netherlands (*FIOD*).

But still, the Russian tax police and especially its methods of task fulfillment (armed raids on firms and private homes) are definitely something special. Just recently, the range of activities of the tax police has been reduced significantly, though: it may not hold tax audits from now on.

Just recently, a reformed and simplified tax code has been passed by the *Duma*. It aims at the mitigation of the above-mentioned problems prevailing in the RF. Already during the process of drafting the new tax code for Russia, severe problems concerning the sphere of tax culture arose. Accordingly, tax cultural lags and/or tax culture shocks could be observed.

3.2 TAX REFORM MEASURES IN THE TRANSFORMATION PROCESS

After the breakdown of the socialist regime, sufficiency of tax revenue became a central problem of public economics, while at the same time the revenue itself dropped significantly, in part due to the massive privatization of formerly state-owned enterprises. Additionally, just like the willingness to pay taxes (tax compliance), the enforcement of the complex and chaotic Russian tax code was fairly weak in the times of *perestroika*.

The way to a comprehensive tax reform in Russia has been hard and rocky. Several draft tax codes have been presented to the *Duma*, at least one of them the Shatalov draft influenced by international experts, others being coined by interest groups, Russian-specific needs and practices. From 1991 on, the law on "The Basic Principles of Taxation" (subject to numerous amendments, though) had served as a deficient substitute for a completely new and comprehensive tax code. "The resulting tax system gave Russia a reputation as one of the worst

examples of tax reform in transition“ and “created a taxpayer culture of mistrust of government and non-compliance that endures”.

Finally, after the *Duma* had passed the first part of the new tax code in 1998 (effective by January 1, 1999, significantly amended in July, 1999), the second part (chapters 21-24) was approved in 2000 and became effective by January 1, 2001. At present, there are approximately 40 various taxes in the Russian Federation, among them a VAT, a profit tax, a unified social tax, certain excise taxes (e.g. on alcohol, tobacco, oil and petrol), a personal income tax and regional sales taxes.

The VAT has a regular rate of 20% and a reduced one of 10% for foodstuff and goods for children. In the tradition of the long-time dominance of indirect taxation in Russia, a VAT certainly is a tax-culturally conform to Russian circumstances, as well as regional sales taxes (up to five per cent), which share the tax base with the VAT. Equally conform are the excise taxes, even though most taxpayers are not aware of paying them.

Problems will most probably arise, however, in the context of the profit tax, which is applied to all firms at a uniform rate of 35 per cent. As mentioned above, tax collection on the enterprise level used to be the rule in Soviet times but on a very arbitrary basis. During the transformation process, frequent tax concessions instead of consequent punishments for not fulfilling one's tax obligations have created a hostile environment of mistrust and opposition especially in the sphere of enterprise taxation.

Thus, taxing the enterprise sector might be the most difficult and the most crucial part of the ongoing reform processes.

The unified social tax is subject to a regressive taxation schedule ranging from 35.6 % to 2 % (when the overall wage sum approaches infinity). Given the catastrophe of the breakdown of the Russian pension system (inherited from the Soviet union) in the cause of accelerating inflation in the 1990ies which could and can be observed by everyone living in Russia, social taxes are most probably causing that special feeling of being robbed by the state. Without knowing any solution to this dilemma, tax authorities should definitely be aware of the problems caused by the current solution.

The personal income tax is levied on the majority of income sources at a flat rate of 13 per cent. Exemptions from that practice include income from certain sources (esp. dividends and royalties) and the income of foreigners living in the Russian Federation (regardless of its source). Despite the fact that most Russians should be used to paying income taxes amounting to about 13 per cent of their incomes, compliance levels are considerably low. As far as I see it, the relationship of the individuals to the state has changed dramatically.

During Soviet times, the state seemed to care for its citizens by providing public goods and by heavily subsidizing the necessary private goods, like foodstuff and clothing.

Thus, a perception of the benefit principle (in the sense of a *do between* taxpayers and the state) seems to be deeply and subconsciously rooted in Russian tax culture. During the transformation process, the economic and political situation did not put the Russian state into a position to fulfill its tasks satisfactorily.

Taxpayers do not feel the moral obligation to fulfill their part of the institutional contract between the state and its citizens as long as the state does not fulfill its part in a proper way.

Accordingly, as they do only receive public assistance on an insignificant level, taxpayers think it legitimate to delay payments or entirely evade taxes. Therefore, Russian authorities face a vicious circle: without having an adequate amount of financial resources they cannot provide a proper level of public goods, but without providing them, tax revenues will be insufficient from the government's point of view. This argumentation seems to be valid in the context of enterprise taxation as well.

3.3. CASE STUDY: TAX CULTURE SHOCK IN JAPAN

3.3.1. THE JAPANESE TAX CULTURE

In the following section both constitutional elements of the Japanese tax culture shall be examined: the specific cultural features and the historical development of the tax system.

3.3.1.1. CULTURAL CIRCUMSTANCES AND HISTORICAL DEVELOPMENT OF JAPAN

Japanese society is very different from the Western ones with regard to culture values. Every Westerner who has contact with Japanese people will state that they are 'somewhat different'. The roots for this difference can be found in the Japanese culture, which is deeply embedded in history. The most important, empirically well founded explanations of national culture are those of Geert Hofstede. He found four dimensions along which nationally divergent cultural patterns might be ranked in comparison: individualism, collectivism, power distances, uncertainty avoidance, and masculinity vs. femininity. According to his empirical findings, Japan ranks as a collectivist, masculine, uncertainty avoidant and medium power distant country.

Historically, the Tokugawa era (1603 – 1867) plays an important role in explaining some Japanese cultural features. The emergence of the Japanese's high degree of hierarchical thought may be dated back to those times when the rulers successfully installed a system of social ranking in the form of a strictly hierarchical class structure.

Furthermore, Confucianism with its values benevolence, propriety, wisdom, obedience, and the five wu lun was imported to aid the structuring of the society according to social classes, showing even more rigidity with regard to seniority in Japan than in China. Not only as a method to conserve the status quo, the system was introduced. This control mechanism means house or household and may be called family principle as well. It is assigned a far higher importance to than kinship. The "house" consists of a house head and many limbs. In fact, the house is a concept of frame, not of attribute. Japanese social life and organizational practice as well, are making it a network concept, where one large house consists of a large number of smaller houses.

Thus, i.e. became dominant in the context of economic action as well (zaibatsu). Assuming the (HARMONY) within the group was the major task for any group leader.

In the 19th century, the Tokugawa feudalism, which had the nation sealed off from the rest of the world by certain strict laws, became weaker as its leaders, the samurai, degenerated more and more. This development culminated in the Meiji Restoration in 1868. The feudal power of the shogunates was abolished by the return to direct governance by the emperor, which had been Japan's traditional political system. Shintoism, with the emperor as the central point, was instituted as the state religion. Remarkably, the restoration was undertaken by the elite, i.e. the governing circles.

They preached that individualism and individual freedom were a contradiction to Japanese tradition and virtues. The Meiji leaders manifested their power through a well-equipped army; national defense became one of the most important political (and budgetary) issues, which was emphasized by the political slogan "Fokoku Kyoker", meaning "a wealthy land and a strong army". In order to create a social climate of self-sacrifice for the state and dedication to it, the Meiji ideology proclaimed the uniting aim to catch up with the West.

Another special feature of the Japanese culture, which seems to be decisive in the Japanese tax culture as well, is the 'face' concept, which emerged from the wu lun and the concept of i.e. during the Meiji period. From the Japanese standpoint it is of major importance to keep one's face because otherwise through any form of behavior deviating from the norm a loss of social capital is inescapable. In fact, social capital is the deciding factor for one's relative position and status in society.

As private capital was sluggish to pick up industrialization, the government was forced to initiate the Japanese industrialization. Wakon-yosai (Japanese spirit and Western knowledge) the extensive adaptation of Western Technology (the so-called copy cat strategy) led to immense technological progress in the Nippon economy. Finally, in 1880, the Meiji leaders decided for several reasons to sell the majority of the government owned enterprises to wealthy and influential families at a marginal price. Subsequently, these families were able to use their advantage to form huge financial and industrial conglomerates based on the concept of organization, the zaibatsu.

In the early 20th century, social unrest and high labor fluctuation marked Japan. Thus when Japan was hit by the world wide economic crisis in the late 1920's it suffered very hard.

To overcome these problems, lifetime employment and the seniority payment system were introduced as strategic tools to gain control of both the unrest and the fluctuation.

3.4. THE DEVELOPMENT OF THE JAPANESE TAX SYSTEM 1887 – 1945 A SHORT OUTLINE

The initial point for the inauguration of a “modern” tax system in Japan can be dated back to the year 1887. In the aftermath of the Meiji Restoration (s.a.) the national government succeeded in establishing an income tax with progressive rate ranging from one to three per cent. In the beginning, it was only of minor importance with regard to its share of the total tax revenues (in 1888 approx. 1.5 per cent with approx. 12,000 taxpayers). The lion’s share of total revenue until 1908 was collected by the land tax (53.8 per cent in 1888), followed by indirect taxes (above all the liquor tax and the Tabasco tax).

In 1940 an overall tax reform was carried out in order to raise the funds necessary for financing the war activities. The former tax system, based mainly on indirect taxes, was redesigned as one being based on direct taxation. Additionally, the former single income tax was split up into a personal income tax and a business income tax. During World War II, taxes as such fell behind government bonds as a source of wartime finances.

The main stages of the development of the Japanese tax system are summarized in Table 1.

TABLE 1

TIME BOARD OF THE EVOLUTION OF THE JAPANESE TAX SYSTEM UP TO THE SHOUP MISSION

1887	Introduction of the income tax (revenue in 1888 approx. 1,5%).
1899	Introduction of the scheduler income tax, corporate income taxation and withholding tax on capital gains.
Up to 1908	Land tax is the most important tax
1908 - 1935	Indirect taxes (mainly on alcohol and tobacco) are the most important taxes
1935	Income tax becomes the most important revenue source
1940	Ax reform due to rising need for wartime finances for WWII <ul style="list-style-type: none"> • Direct taxes are placed at the center of the tax system • Income tax is split up into an individual and a business income tax(18% flat rate)
1946 - 47	Extraordinary tax program
1949 - 50	Shoup Mission

According to the collectivist character of the Japanese society, the longing to have a harmonic distribution of the tax burden (which is embodied in the wa or harmony concept) can be noticed throughout the whole development of the tax system. Even nowadays, the taxpayer's personal situation is taken into account when calculating his income tax debt.

Thus, from a Western point of view, the enforcement of the tax laws in Japan was very poor. Until November 1947, not a single case of tax fraud was made public, with the tax debtor being sentenced or fined.

“Punishment for tax evasion was contrary to the Japanese philosophy of justice” (Shavell 1948a: 139) and “contrary to Japanese ethics” (Shavell 1948b: 140). Instead of this the “face” institution operated as a control mechanism: Making a bad impression on tax authorities by failing to pay the right amount of taxes led to high loss of social capital.

3.5. THE TAX CULTURE SHOCK AFTER WW II

After the pre-war reform of 1940 had already caused sharp changes in the Japanese tax system. Japan was hit by a tax culture shock on the macro level in the aftermath of World War II.

The first reform was triggered by the occupying forces in 1946 in the course of the so-called “extraordinary tax program “. First of all, brief overview on the after war events in Japan shall be given to achieve a embeddedness within the historical context.

3.5.1. THE POLITICAL EVENTS AND ECONOMIC SITUATION AFTER THE WAR

On August 15, 1945, Japan surrendered to the Allied Forces and agreed to the Potsdam Declaration. The signing of the capitulation documents followed aboard the American warship “USS Missouri” in Tokyo Bay on September 2, 1945. During the war, Japan had lost more than 1,850.000 people, one third of them had died in air strikes in Japan itself, 40 per cent of the Japanese municipal areas and 2,25 million buildings were destroyed.

The occupying troops under General MacArthur, which stayed in Japan until April 28, 1952, had two major aims for Japan: demilitarization and democratization.

Due to the anti-monopoly law of 1947 a formal destruction of the zaibatsu was inevitable, but the informal bonds between the former zaibatsu members could in fact not be destroyed that easily. In the same year the new constitution ("Mac Arthur's Constitution"), which had been drawn up at the instigation of the Americans, was inaugurated. It replaced the old constitution of the Meiji Restoration of 1889. Under the surveillance of the occupiers the conception of sovereignty of the people was embodied in the constitution, which guaranteed the basic rights to every citizen explicitly and in a perfectly clear way.

3.5.2. THE EXTRAORDINARY TAX PROGRAM OF 1946

The legislative authorities had shown an inexhaustible perseverance to keep the taxation at its status quo (true to Canard's principle "Old taxes are good taxes") despite Japanese academic circles vehemently calling for taxation programs for some decades. But in 1946 the Allied Forces put pressure on a fast tax reform. The great scope and the rapidity of the changes to come were probably unique in (economic history).

In the course of the so-called "extraordinary tax program" and the accompanying measures the Japanese tax system was turned inside out completely from September 1946, to March 1947. The program was based mainly on the suggestions of Leo Cherne and his assistance Charles J Siegel, who were obligated by the War Ministry to guide a tax reform conform with the American occupants' aims of demilitarization and democratization in May, 1946.

They were confronted with the following three main problems:

1. The prevailing tax system fell short of its financial function and made up only for 11,3 per cent of national income and 31,1 per cent of government expenditure in 1946.
2. Furthermore, the tax system was only insufficiently grounded on ability to pay principles, which became apparent especially with respect to the (to Western eyes) extremely arbitrary levy and enforcement of the personal income tax.
3. Japan's tax system was inflexible with regard to the rapid economic changes, most important of all the accelerating hyperinflation.

3.5.2.1. MEASURES AND ACCOMPANYING MEASURES OF THE EXTRAORDINARY TAX PROGRAM

The extraordinary tax program consisted mainly of two components: a capital levy on wealth and war indemnity taxes. It was designed to reduce the Japanese domestic debt (government war bonds), to raise funds for the immense after war expenses and to achieve a correction/redistribution of wealth in Japan. In particular, the program was supported by the following measures to achieve higher tax productivity, slow down inflation, and to distribute the taxation burden more equitably:

1. higher and more progressive personal income taxes with few exemption (and thus broad coverage) and a shift to a "pay as you go" basis with self assessment,
2. higher excess profits and corporate taxes, which did now allow for an adjustment of depreciations to the hyper inflationary tendencies, and
3. an increase in the number and the rates of sales and excise taxes, connected with the introduction of turnover tax (cascade tax) with a tax rate of one per cent.

The Japanese capital levy aimed above all at the wealthiest two or three per cent of the Japanese society, first and foremost the owners of the old zaibatsu. About 43,5 billion Yen were raised which exceeded the overall tax revenue of the fiscal year 1946 – 1947 by about 20 per cent and equaled about 9 per cent of the total privately owned property according to data from March, 1946. Nevertheless, the non-fiscal intention of the levy was emphasized. Moreover, the capital levy was explained by moral and social political reasons, namely to aid the establishment of democratic institution in Japan.

The war indemnity tax consisted of a partial repudiation of government bonds being issued during the war. To avoid the stigma of repudiation in the narrower sense, a 100 per cent tax on bonds was levied directly at source. Thus, about 90 billion Yen could be raised. In order to keep the dispossession in line with the wa-concept, minor exemption were granted to small savers.

Finally, on December 1, 1947, the “non war sufferer special tax” was introduced. It consisted of a house tax and a personal tax aimed at those properties had not been damaged or destroyed during the war. The rates were nominally high (300 per cent of the rent value of houses), but were justifiable in real term

3.6. CONCLUDING REMARKS

Even though I have not finished my Japanese case study yet, it has become apparent that the transfer of American tax ideals to Japan caused a tax culture shock on the macro level. However, some particular aspects still remain to be analyzed in more detail. After that, a statement on the Shoup Report will have to be made: Was it rather an instrument to mitigate the shock induced by the extraordinary tax program of 1946? Nevertheless, the incidents in Japan in the aftermath of World War II seem to be a classic example of a collective tax culture shock.

CHAPTER FOUR

4. AUSTRIAN ECONOMICS: A CASE STUDY OF THE BIG 1896 TAX REFORMS

4.1. INTRODUCTION

In old Europe, things took a bit longer and of course were a bit different: “No (over) taxation without evasion” could have been the catch-phrase for the Austrian tax culture in the 19 th century. The multinational subjects loathed the fiscalism of the monarchy, but it took the shift from absolute to constitutional monarchy and more than three decades of failed reform attempts to bring change: The reform of the direct taxes in 1896 is considered one of the greatest and most comprehensive tax reforms in the history of Austria.

Before analyzing the influence of the country’s tax culture on the tax reform (and vice versa!), we shall first give a brief account on the characterization of the political setting, the tax system and previous attempts to reshape the direct taxes. Subsequently, we shall sketch out some key elements of the Austrian tax culture at the end of the 19 th century and test them against an extended tax evasion model.

Based on its results we shall argue that the success of the reform was substantially owed to the fact that it implicitly took tax-cultural aspects into consideration and that it attempted to change those elements of the Austrian tax culture, which had had detrimental effects on the amount of taxes the state collected.

4.2. THE POLITICAL SETTING AND THE AUSTRIAN SYSTEM OF DIRECT TAXES

In 1867 the Habsburg monarchy was divided into the double monarchy Austria-Hungary. Both parts formed a union and only defense and foreign policy were still common policies. Austria had its own constitution, administration and legislation and, as a corollary, its own tax competence. Political power was divided between the parliament, which consisted of two chambers, and the monarch.

The Austrian state was organized in three levels, the federal government, the states and the local communities, which all had their own budgets and certain tax competences. The ongoing attempts of the Habsburg Monarchy to be a major player on the stage of European politics led to continuing financing problems of the budget. Consequently, the state's fiscal interest had always been the main impetus behind the design and reform of the tax system. At the beginning of the 19th century the monarchy-introduced taxes on business profits (1812), ground rents (1817), and house rents (1820).

In 1849 this system of profits taxes was supplemented by the so-called "income tax", which in fact was much more a tax on business profits, labor income and interest yields. The main source of income for the states and communities were surcharges mostly on the direct taxes. This system virtually remained intact until the fundamental tax reform of 1896. All previous reform attempts were partial or complete failures; the introduction of a personal income tax in particular never succeeded even though it had been on the reform agenda since 1863. One of the main reasons for this was the fact that owing to the continual budget deficits the reform suggestions always aimed at getting higher tax revenues and consequently encountered fierce

opposition from the taxpayers, public opinion and parliament, which feared a higher tax burden.

4.3. PARTICULAR FEATURES OF THE AUSTRIAN TAX CULTURE

The particular features of the contemporary Austrian tax culture were a predominance of the fiscal interest of the state, comparatively high tax rates, exemptions from the tax base and tax authorities abusing a high degree of discretion. There was a general consensus that the tax burden was too high and distributed unequally. Consequently, people deeply distrusted the tax policies of the government. Not only was tax evasion widespread and socially accepted but even partially supported by the tax authorities.

4.3.1. THE RESULT OF GOVERNMENT ACTION: HIGH TAX BURDEN, HIGH TAXES RATES AND TAX EXEMPTIONS

Throughout the contemporary economic literature, the tax burden of the Austrians was considered as being extraordinarily high and pressing in absolute terms as well as in comparison to other European countries such as, for example, Prussia. Especially the high rates of the direct taxes were seen as detrimental. On top of the tax rates set by the Austrian federal government came the surcharges of the states and communities, which roughly doubled the burden of direct taxes. MYRBACH spoke of the “well-known Austrian tax screw which normally was only ever tightened [...]”, and MENGER stated that the overall tax burden was by far higher than LEROY-BEAULIEU’s “proportion exorbitant”, i.e. a tax burden of more than 12–14% of income. According to MENGER, the level of the direct tax rates in Austria sounded “unbelievable” to foreigners. The government itself regarded the business taxes as extraordinarily high. WIESER, who called the direct taxes “irrational”

because of their unequal distribution and the "crass level" of the tax rates compared the per capita burden of the direct taxes of Austria and Prussia around the turn of the century and came to the conclusion that it was roughly 50% higher in Austria. The unequal distribution of the direct taxes was acknowledged even by high-ranking civil servants dealing with the reform.

To ease the tax burden, the state granted exemptions from the tax base. The taxes on houses were cushioned by a 12 year exemption for new building projects. The tax on interest yields left the greatest part of the capital de-facto tax-free. Also, certain businesses were not obliged to pay taxes or got arbitrary tax reductions. The tax base of the ground tax was based not on the actual ground rent but on the average ground rent fixed in the land register in 1869, therefore the relevant tax base was usually much lower than the actual tax base.

4.3.2. THE TAX AUTHORITIES: BUREAUCRATIC INEFFICIENCY AND ARBITRARINESS

The tax authorities' prosecution of tax evasion was deficient, as tax penalty laws were incomplete, lax and hardly effective. SIEGHART spoke of an extensive freedom from prosecution and meager results of the criminal justice in finance matters. Moreover, the tax authorities, in view of the unbearable tax burden, were often even reluctant to enforce the laws in existence against tax evaders.

According to MYRBACH, the tax authorities went as far as accepting even obvious tax evasion and only initiated prosecution if a whole source of taxable revenue was not declared. He identified a collaboration between tax authorities and taxpayer: "[...] no one, including the tax inspector, thought of putting the true and complete 'taxable income' into the forms." Instead, the tax base was reduced to make the final tax amount bearable.

The fixing of the tax base was at the discretion of the tax authorities.

The business tax law was so undetermined that the tax authorities had much room for discretion and abuse. They were virtually free to determine the tax sum a business had to pay. Formally, their discretion was limited by the existence of different tax classes. As there were no fixed criteria for the inclusion of a business in one class or another, however, the authorities assigned tax classes arbitrarily. Even worse, the taxpayer could not take legal action against these decisions as the administrative court refused to act on complaints.

The amount of tax to be paid by a business therefore depended ultimately on the attitude and career aspirations of the tax inspector in charge. Arbitrary behavior of the tax authorities can also be found regarding the tax on houses: BEER recognized regional differences in the tax authorities' efforts both to find out the current rent and to prosecute the evasion of the original house-interest tax.

4.4. THE TAXPAYERS: TAX MORALE AND TAX EVASION

High marginal tax rates and arbitrary behavior of the tax authorities made the taxpayers distrust the tax state and caused high tax evasion. The latter was a “[...] normal phenomenon of Austrian tax life [...]”. Indeed, the high rates led to the *custom of reducing the tax base when income was declared*. GROSS confirmed that tax fraud was not only seen as being “permitted” but as “a matter of course”. This view was shared by AUSPITZ, who said it was the high rates that “[...] dug the grave for the Austrian tax morale [...]”. WIESER and BEER saw indications that a relevant amount of the taxable income was not declared, and finance minister BRESTEL is quoted with the *bon mot* that every Austrian finance minister should be happy to get half of the tax receipts the taxpayers owe him.⁶¹ Unsurprisingly, finance minister STEINBACH called the tax on businesses “[...] the cradle of the tax lie”, i.e. the Austrian government

themselves acknowledged that the high taxes on businesses led to tax evasion. WIESER claimed that there was a “pact” between the taxpayers, who openly evaded taxes, and the legislator, who willy-nilly accepted this behavior.

4.5. TESTING SOME MODEL HYPOTHESES AGAINST THE AUSTRIAN EMPIRICAL EVIDENCE

4.5.1. AN EXTENDED TAX EVASION MODEL

First evidence from a modified tax evasion model gives a partial explanation for low compliance rates in 19th century Austria. The maximization of expected utility leads to the condition, that an individual taxpayer will only report his full income if the sum (or better: the perceived share) of public goods received and the product of fine rate and catch probability is larger than one less a tax-cultural parameter:

$$(1) \quad m s + p f > 1 - \theta \quad D$$

$$\theta \quad C$$

m is a government multiplier that shows according to which proportion the tax returns are transferred into a public good supplied by the government. s stands for the perceived share of public good received by the individual, p is the probability of audit, and f the fine rate if caught cheating on the authorities. Let C_i denote a function that assigns a number θ to any relative compliance level D/Y (declared tax base to real tax base) where θ takes a positive sign for tax cultures where compliance is the norm and people suffer a psychological loss in expected income because of undisclosed taxes, whereas θ has a negative sign for those tax cultures where evasion is the norm rather than the exception and taxpayers suffer a loss because of “excessive” tax payments. The first derivative of C_i with respect to D_i will be greater than zero in compliance-oriented societies and less than zero in evasion-oriented tax cultures

leading to an additional psychological profit to the individual if he underreports the tax base. p and s are defined in a range between 0 and 1, the fine rate and the multiplier can theoretically even exceed 1. Evidence about the value of the multiplier in 19th century Austria does not really suggest a multiplier greater than one.

The most important public good, which absorbed a great share of the tax revenues, was national security. Anecdotal evidence suggests, though, that administration was highly ineffective and thus a multiplier smaller than one. Concerning the share of public good received by the individual taxpayer, the old documents show no evidence at all. Given the high levels of tax evasion one might assume that the taxpayers were not satisfied with their share of public goods received. That would suggest a value of far smaller than one for s .

The product ms would therefore have a value below 1. Low penalty rates and a low probability of audit and enforcement are stylized facts prevailing in 19th century Austria, see above. Thus, the product pf is very small, and only slightly bigger than zero. Accordingly, the sum ($ms + pf$) is most probably even less than one. From the evidence in the literature under revision that has been cited and explained above, we can surely conclude, that Austria's tax culture at those times was highly evasion-oriented. In our model that would mean a negative sign for $i? D$, making it even harder to satisfy

? C

inequality (1). As we have seen from the evidence reported above, the prediction of our model under those circumstances, that nobody would pay his tax dues to the full amount, holds for the Austrian tax cultural environment at the end of the 19th century quite well. In a next step we want to analyze the amount of taxes evaded more thoroughly. Therefore, the concept of legitimacy of tax policy is introduced.

4.5.2 TAX RATES AND LEGITIMACY

A government faces N policy issues connected with the taxation process. $N-1$ of those issues are all matters determined by the tax-cultural evolution. The N th issue the authorities have to deal with is the tax rate. According to LEROY-BEAULIEU (1883), the tax rates should not exceed some 12 to 14 per cent of total income. In other words, there existed an informal rule, that the actual tax rate must not exceed a certain maximum or critical tax rate t^* . If for some reason the government was to raise the tax rate above the critical level, its policy would lose its legitimacy. Obviously this was exactly the case before the great Austrian tax reform.

We now introduce a legitimacy concept expanding the standard tax evasion model. Legitimacy consists of at least four determining dimensions: (a) reciprocity what does a taxpayer get for his money, (b) loyalty how does a taxpayer feel about the state and its policies, (c) simplicity how understandable and predictable is the tax system, and (d) fairness how is a taxpayer treated in comparison to other taxpayers. Formally speaking, a tax policy and here especially: a tax rate is completely legitimate ($L = 1$), if the Euclidean distance between the policy vector here: the tax rate chosen by the government and the policy vector desired by the taxpayer is zero. With rising distance, legitimacy vanishes and approaches zero:

As long as the actual tax rate lies below the critical tax rate we will assume legitimacy to be one. Then, legitimacy starts to erode according to the difference in the tax rates and a certain weighting parameter b , that values the importance of the specific tax rate in comparison to the other elements of the policy vector, e.g. other tax rates, enforcement probabilities etc. (the term $1/b + t^*$ is exactly that value of t , where $(t - t^*) b = 1$).

Thus, if t is fixed at a rate equal to or higher than $1/b + t^*$, legitimacy of the government's policy is zero. By introducing dissonance costs to the model, legitimacy and tax compliance can be linked – including some tax-cultural parameters. Dissonance costs DC will appear in the individual's calculation if he violates a (tax-cultural) norm, that is if he deviates from generally accepted and supported compliance patterns. With $G \in [0, 1]$ we introduce a parameter showing the importance of tax compliance in a specific tax-cultural setting, and by $g \in [0, 1]$ we denote an individual's propensity to suffer from cognitive dissonances.

Further, let y denotes the total income of the individual and t denotes the fraction of evaded income. Dissonance costs thus may be expressed as

$$(3) DC = GgtyL.$$

Thus, if G , g or the current legitimacy of government's policy are zero, an individual will not suffer psychologically from deviating from his due tax debts. For the risk-neutral individual expected punishment from tax evasion activities will be determined by the probability of audit p and a certain fine F , that has been modeled with constant marginal punishment

$$(4) F = (at)(ty) \text{ (with } a \gg 0)$$

$$(5) E(P) = pF = p(at^2y).$$

The expected costs of evasion $E(C)$ equal the sum of expected punishment $E(P)$ and dissonance costs DC :

$$(6) E(C) = ty(pat + GgL)$$

The occurring costs have to be weighted against the expected utility from evasion if not caught

$$(7) E(U) = (1-p)ty$$

The individual's optimization taking cognitive dissonances into account thus becomes

$$(8) \max_t [(1-p)t - pat - GgL]$$

The solution to (8) is

$$(9) GgL \geq 2p(1-p)t \quad (1)$$

From this it becomes clear that a decreasing legitimacy will lead to an increase in tax evasion. Inserting the legitimacy values from (2) into the optimal rate of tax evasion (9) we get the following solutions:

- (a) $0 \leq t \leq 1$ and $p \geq \frac{GgL}{2t}$
- (b) $GgL \geq 2p(1-p)t$ ($L = 1$) and $t = \frac{GgL}{2p(1-p)}$ [?]
- (10) $t = \frac{GgL}{2p(1-p)}$ ($L = 1$) and $t = \frac{GgL}{2p(1-p)}$ [?]
- (d) $GgL \geq 2p(1-p)t$ ($L = 0$) and $t = \frac{GgL}{2p(1-p)}$ [?]
- (e) $t = 1$ [?]

From our observation we can conclude, that t was neither 0 nor 1, which leaves three cases to be reviewed: 10b, 10c, and 10d. If we consider LEROY-BEAULIEU's statement that the tax rates should not exceed some 12 to 14 per cent of total income we can assume that this informal rule has been violated in Austria, excluding 10b from our possible results (because legitimacy was significantly below one).

The remaining two equations differ by the legitimacy value. As for Austria, we cannot answer for sure if legitimacy was zero or slightly above zero.

So we can only conclude that Austria was somewhere between the values derived in 10c and 10d. (11) $t = 2p$)) $b = (t/p)t^* ? gG(1?? (1? Austria? 2p? p)t (1?)$
Given this situation any tax reform attempt would have had to tackle the low legitimacy of tax rates (and tax policy in general) to lower tax evasion significantly. That was exactly how the fathers of the big 1896 reform proceeded, as will be described in detail in the subsequent section.

4.6. THE BIG TAX REFORMS 1896

The proposal for the general reform of the direct taxes was brought into the parliamentary process in 1892, was finally accepted in 1896 and came into effect in 1898. The reform combined a general overhaul of the existing direct taxes with the introduction of a personal income tax. The latter was the heart and cornerstone of the reform; it paved the way to taxation according to the ability to pay principle. The reform proposal was worked out by EUGEN VON BÖHM-BAWERK and ROBERT MEYER, both eminent representatives of the Austrian School and leading civil servants in the Ministry of Finance.

4.7. AIMS OF THE REFORMS

The first aim of the reform was to shape the tax system according to a general principle of justice: the ability to pay. The superimposition of the personal income tax on the old profits taxes made a taxation of the tax subject's complete income and thus according to their ability to pay possible. In contrast, the previously uneven distribution of the tax burden had been due to the unconnected taxation of different tax objects. While all previous reform attempts focused on fiscalism

and taxed the citizens according to COLBERT'S "goose-principle", the *clou* of this reform was the federal government's codified relinquishment of the collection of higher tax receipts.

This scheme of federal tax restraint had the astonishing time horizon of 12 years. Any extra receipts were to be used to lower both the tax on businesses and the taxes on houses and ground by a considerable amount. The rest of the extra revenues were to be transferred to the states to improve their financial situation. In return for these transfers, the states agreed not to introduce surcharges on the personal income tax.

This agreement prevented that the relatively low tax rates of the new personal income tax fixed by the federal government were spoiled through surcharges imposed by the states. The general tendency to achieve lower tax rates went hand in hand with a broadening of the tax base: For the first time every income regardless of its source was declared taxable income.

The reformers knew, though, that good tax laws alone were not enough, their application in practice was crucial. Therefore they abolished the purely administrative procedure of tax collection and initiated a system of commissions in which the taxpayers could participate. The power to tax, which until then had been solely in the hands of the tax bureaucracy, was now divided between the bureaucracy and the commissions.

The aim was to reduce the discretion of the tax authorities especially regarding the collection of the taxes on businesses, and to bridge the gap between the tax authorities and the taxpayer through active cooperation of both. That way, the alienation of the taxpayer from the tax state was at least partly reduced. To reduce tax evasion tax penalty laws were tightened, but at the same time the

rights of the taxpayer were improved. While tax evasion was penalized with the threefold to ninefold of the evaded sum, taxpayers accused of tax evasion now had the right to be heard by the tax authorities and to defend themselves.

They could also appeal to the tax authorities of the state and afterwards to the administrative court. The greater severity of the penalties aimed at giving an incentive against tax evasion, and the improved rights of the citizens were to attenuate the distrust against the tax state.

All mentioned aims can be seen as suitable measures to improve the prerequisite for a better tax morale of the people and for changing the tax culture of the country.

4.8. THE CONSEQUENCES OF THE REFORM

We interpret the fiscal success of the reform, especially in the long run, as evidence for its favorable effect on the tax morale.⁹⁷ During the 15 years after the tax reform the direct taxes grew at an average annual rate of 3.4%, whereas within the 15 years before the reform they grew at an average annual rate of 1.9%. Despite the reductions of some of the tax rates the tax revenues grew at a much higher pace.

The personal income tax rose at an average annual rate of 7.2% until 1913, i.e. it nearly tripled. Its share of the direct taxes grew from 14% in 1898 to 24% in 1913. ROBERT MEYER noticed an improvement of the tax morale and linked it to the common conviction that the personal income tax was a fair one. He also pointed out that the commissions had a favorable influence on the tax morale. However, as various Austrian economists predicted, the change towards a lower tax evasion rate was very slow.

Sources of income with a low probability of being discovered were still not declared and the tax evasion penalties did only tardily bring the hoped-for deterrence.

Nonetheless, the number of registered taxpayers rose from 2.8% of the population in 1898 to 5.4% in 1912, indicating a rising acceptance of the tax. In terms of our model the government ultimately succeeded in reducing the tax evasion rate (?). Because the reform was regarded as making the tax system fairer, improving the taxpayers' participation and their legal rights as well as containing the bureaucratic arbitrariness, it was psychologically more difficult to evade taxes i.e. (g) rose. For the same reasons, a rising importance of tax compliance (G) slowly developed. The tightening of the tax penalty laws and its stricter enforcement resulted in an (albeit small) rise of the probability of audit (p), which had previously been about zero.

4.9. CONCLUSION

We interpret the big tax reform of 1896 as a successful attempt to initiate a change of key elements of the Austrian tax culture. The architects of the reform, the well-known economists BÖHM-BAWERK and MEYER, tamed the detrimental effects of key elements of the Austrian tax culture: Fiscalism, high tax rates, bureaucratic arbitrariness, unequal distribution of the high tax burden, distrust of the taxpayers and the socially accepted high tax evasion.

They managed to cut through this Gordian tax knot with their reform and thereby paved the way for a long run change of the Austrian tax system and tax culture. The empirical evidence confirms the theoretical results of our tax evasion model: Greater fairness of the tax system, a more efficient tax administration and more rights for the taxpayers as well as a higher audit probability resulted in a higher legitimacy of the tax policy and ultimately in a lower tax evasion rate.

Although it is rather difficult to draw generally applicable conclusions for actual tax reforms, the 1896 reform had certain features that could be helpful for Nowadays' reforms, too: The reform was designed by leading civil servants who were experienced in practical tax problems as well as in economic theory. The reformers at least implicitly identified key elements of the Austrian tax culture and their measures aimed at improving the legitimacy of taxation. As the tax culture changes only slowly their focus rightly was the expected long-run effect of the Reform.

Therefore they were prepared to accept sacrifices in the short run to harvest when the fruits were ripe. Nowadays politicians aiming at being reelected do not seem to have a sufficiently long time horizon to wait for the possible long-run gains of a change in the tax culture.

CHAPTER FIVE

5. CULTURE, TAX COLLECTION AND GOVERNANCE IN South Africa

5.1. INTRODUCTION

WHY do South Africans pay tax?

Can taxpayers behavior tell us anything about the way we are and how we should be governed?

To many lay people and specialists, the answer is obvious and not very interesting. We pay because we have to pay. If tax payments increase, either because more citizens pay or because taxpayers pay more of what the law says, that is because the authorities have become better at forcing citizens to pay. In this view, the implications of tax collection for governance are straightforward: whether taxes are collected or not depends on whether the relevant authority is efficient enough to ensure that they are collected.

Efficient collection depends on effective coercion since people will not pay voluntarily. Translated into a general point about governance, that shows that we obey the rules when the government does its job and ensures that the systems are in place to force us to comply.

All of this sounds less like analysis than common sense. And that perhaps explains why trying to understand the dramatic increase in collections by the South African Revenue Service (SARS). Can be a frustrating business: few practitioners or analysts are willing to look beyond the common sense story, that SARS has become technically better at doing its job and that its ability to force people to pay has increased.

Why should that be a problem?

Because, if we look at the issue a little more closely, there is no reason why SARS's performance should be seen as commonplace. Not only is it at variance with the widespread assumption that compliance is declining in post-apartheid South Africa; improvements in revenue raising are unusual internationally, so this is not a case of a South African government agency catching up with world trends. Nor is there any evidence that the tax collection technologies, which SARS is employing, are available only to it if it doing better than others with the same technologies, then something other than better machinery is at play.

SARS's performance is currently the object of research at the Center for Policy Studies because it holds important lessons for our understanding of how state find the money they need to pay for their functions, and, more generally, of the elements of effective government. If we want to understand why this is so, we

must begin by noting that the conventional approach to tax collection described here is in sharp contrast to the way in which the South African policy debate tends to view compliance with public obligations in other spheres of life.

On issues such as payment of municipal service charges or obedience to the requirement that drivers take out a new form of license, to name but two, there is a lively public debate which assumes that the reasons why people comply or refuse to do are more complicated than the tax explanations suggest. Indeed, far from assuming that the desire not to comply is normal, many of the most vocal and articulate commentators take precisely the contrary view to that which is used to describe tax behavior they denounce the lack of morality and sense of civic obligation of those who do not comply.

These two views, both regarded as common sense by many participants in the debate, are based on contrasting assumptions of human social behavior.

The 'common sense' view on tax assumes that people will evade their tax obligations if they can. Implicit here is the assumption that self-interest dictates non-compliance, whether or not we like the political system in which we live and those who govern it and so tax collection is simply a matter of ensuring that we cannot evade our duty.

Those who frequently complain of declining standards of civic virtue assume that non-compliance is a form of deviant behavior that it sets us apart from others elsewhere. Behind this must lie the assumption that people tend to obey society's rules – presumably whether or not they are forced to obey. Here, if you like, humans become instinctive compliers, in the tax view they are instinctive non-compliers.

Citizen attitudes to compliance are hold implications well beyond the tax question. Even before our first universal franchise election in 1994 it became clear that ensuring that citizens comply with their public obligations would be one of the key challenges facing democratic government.

Predictably, perhaps, that expectation has been vindicated the post-1994 government has found that ensuring citizen compliance with obligations is among its more difficult tasks. In that context, the story of SARS's enhanced performance is a crucial subject of study in a context in which we are repeatedly told that levels of compliance are low, tax is one in which they are clearly increasing.

Why this should be so is therefore a crucial question for researchers or practitioners who want to derive lessons for more effective governance. It is also worth noting that tax behavior would be an important issue even if

SARS had not proved so clear an exception to the rule of post-apartheid government. The capacity to tax is one of the key indicators of a state's ability to govern⁸⁸. Recent analyses have also suggested that the extent to which states

rely on taxes may also decide what sorts of states they are, since those who rely on collecting from their citizens are likely to be more responsive to those they govern than states which largely rely on rents from commodities such as oil or minerals or on foreign aid.

Also, like other states in the global South, South Africa faces a significant challenge to reduce poverty not only does tax provide resources which would allow the government to do this; tax collection can in itself reduce inequalities by enabling the state to redistribute wealth through the tax system. For all these reasons, SARS's enhanced performance is crucial to our understanding of the prospects of South Africa's post-1994 democracy. And the question of why citizens or companies have been more inclined to meet their obligations is crucial to understanding SARS's successes and drawing the appropriate lessons from them.

5.2. TAX COMPLIANCE: AN ALTERNATIVE VIEW

One of the reasons why the conventional view of tax collection seems so self-evident may be that many of its proponents assume that the only alternative is the other position presented here, one which portrays 'normal' tax-payers as enthusiastic compliers. In reality, neither is appropriate.

The argument that tax collection is not purely a matter of coercion and that, therefore, more is required to ensure compliance than the use of efficient coercive strategies by taxing authorities is routinely misunderstood. Those who

insist that tax collection is simply a matter of management technique note that SARS has indeed enhanced its technical tax collection capacity through a variety of measures.

They note too that enhanced tax collection follows the introduction of these measures. Logic would dictate that it is the measures, not some mysterious change in the attitudes of taxpayers, which has caused the change. Similarly, they might note that there is no evidence that tax payers have any reason to feel happier better about paying now than they did before SARS performance began improving indeed, what evidence we have suggests that SARS can be the subject of severe hostility from the tax practitioners or consultants on whom many affluent people rely to complete their tax returns and who have denounced the methods SAS uses to collect revenue.

So if enthusiasm for tax paying has not increased, and vigorous enforcement has, the explanation seems obvious. Both of these arguments implicitly create a false dichotomy. Either, they imply, we assume that tax is paid by reluctant citizens who must be efficiently coerced - or we are obliged to propose some version of the diligent citizen assumed by those who complain of deficient civic morality.

If, therefore, we cannot find evidence of people paying tax voluntarily because they feel they are contributing to a state with which they identify or a government program which they support, we must assume that people have been coerced into paying and that the compliance decision depends purely on a cost-benefit calculation in which the costs of punishment are weighed against the benefits of escaping tax.

This excludes the possibility that the decision to pay may stem not from enthusiastic endorsement of the state but because payers are embedded in a set

of rules, values and relationships, which create a culture, which makes the decision to, pay taxes far more likely. If those elements are present, a technically efficient tax authority may be able to use the routines and attitudes, which underpin that culture to enhance collections. Efficiency may matter but only if a culture conducive to payment already exists. If that culture does not exist among taxpayers, then technical efficiency measures may have no effect. And it is also

possible that, if increased technical efficiency is not based on an accurate Understanding of the culture among taxpayers, it may have no effect or it may reduce the effectiveness of tax collection.

5.2.1 THE MORAL ECONOMY OF SHAME

The argument is perhaps best introduced by examining a SARS tactic, which forms a significant element in its strategy the public embarrassment of individuals. People in public positions, we are told, are prosecuted for alleged tax misdemeanors amid much publicity because SARS believes that this will shame others into avoiding similar ignominy.

This is routinely presented as a technically competent enforcement strategy because it sends a signal to recalcitrance that they will be apprehended, altering the cost-benefit calculation in favor of the tax collector. But that is not all that is happening, since SARS insists that 'embarrassment', not simply the application of the law, is a goal of the strategy. This raises an obvious question: why, if tax compliance is purely a matter of coercion, should anyone found not to have complied be embarrassed; there is surely no embarrassment in being found to have done something which everyone else does if they can. To insist that a suspected tax non-payer can be embarrassed is to assume that there is a culture, which would make this behavior appear shameful.

This is by no means automatic, since there are societies in which non-payment is not a cause of shame. Where there is a culture, which makes exposure of non-payment a source of shame, a form of technical efficiency, which relies on shaming offenders, may be extremely effective. This argument has been made elsewhere.

It is supported by, for example, subsequent interviews with tax practitioners, some of whom fiercely criticize SARS and are clearly at best skeptical about the post-apartheid order, but who insist also that morality dictates that citizens should pay tax.

The example just cited illustrates an important aspect of taxpayer behavior which it may have nothing at all to do with enthusiasm for the state or its governing party. One important analysis of tax collection in South Africa and Brazil argues that compliance here may have originally been inspired by political loyalty but that the behavior may survive even after its cause has passed into history. In this view white South Africans were happy to pay for a state which protected them against a majority they perceived as threatening; this creates a set of habits which become, as it were, ingrained, so much so that they might survive the downfall of the state which inspired the habit and its replacement by one which many of the compliers may view with suspicion.

This theory remains speculative. But its accuracy may be relatively unimportant to the argument made here because the insistence that tax paying depends on an underpinning culture does not depend on the claim that it stemmed originally from loyalty to a political order. It may well be that understandings derived from more complicated forces than identification with a system of government are instrumental in creating that culture.

5.2.2. PEOPLE LIKE US: CULTURAL EFFICIENCIES

Before discussing this issue, it may be important to note that 'technical efficiency' is a less unambiguous term than many analyses assume. What, for example, are we to make of the observation by a tax practitioner that SARS is to be taken seriously because 'you are no longer dealing with the old-style civil servant with his flask of tea and sandwiches now the SARS people wear three piece suits and have worked for major accounting firms'?

The point, of course, is that nothing is being said, at least directly, about the competence of the new type of tax collector we learn only that they have some cultural similarities with the tax practitioners, which their predecessors lacked. This raises an important point about understandings of technical competence. It may well be that the practitioner is attempting to convey, in a culturally coded way, that the new consultants are indeed more technically competent than their predecessors because people who work for large firms and dress accordingly are likely to be better able to extract resources from people skilled in tax avoidance.

But the comment may also reveal the degree to which technical competence may simply be a code for cultural compatibility the practitioner does not, on the surface, say anything about competence: he stresses, rather, the degree to which the cultural fit between him and the SARS employee has increased But the statement may also mean both that the new breed of tax official is both more competent and culturally closer to tax practitioners.

Part of SARS's strategy is premised on the understanding that effective tax collection requires a far greater understanding of the workings of particular sectors of industry than the tax collection agency has hitherto been able to achieve.

Implicit in this is the notion that competence is not simply a matter of forensic accounting technique it requires knowledge of how specific industries and those who work in them operate. The divide between technical competence and cultural understanding becomes blurred since the latter is an important component of the former: one of the elements of technical competence is an understanding of the culture of the companies and individuals from whom compliance is sought.

Equally important is the network of rules and understandings, which underpin tax behavior. The first point, which seems apposite here, is that participation in the market economy may create appropriate conditions for certain types of compliance to become seen as routine. Clearly, the argument here is not that there is any necessary connection between the existence of formal markets and tax compliance. Brazilian taxpayers that are said to see the seeking of exemptions as a more appropriate response to tax assessments than payment also operate in a market economy. However, the point here is that market activity is not simply the exchange of goods and services by private owners. It is, as Douglass North among others has shown, embedded in rules, understandings and routines. And, while North's work is instructive precisely because it points us to the reality that these differ between market economies, it may well be that there are characteristics of market activity which make a culture of compliance more likely.

That SARS has achieved its greatest efficiency gains with companies rather than individuals may, therefore, not be solely attributable to the reality that, given the relative size of firms and individuals' assets, companies are likely to be more cost-effective sources of revenue than people. It may also be related to the likelihood that the tax decision-making process is rather different in companies. They are far more rule-bound than individuals because they are composed of and engage with a variety of groups of people whose rights can be protected only

by ensuring that the activity is bound by rules. Firms and this point would obviously be emphasized the larger and more complex the company are forced to establish sets of rules to govern their internal workings and to engage with government agencies in a variety of rule-bound interactions (on import permits, tariffs, health and safety regulations and the like). It seems likely that this form of behavior creates patterns in which tax compliance is a more 'normal' option than evasion.

To elaborate. SARS has used payrolls as a key source of information to secure greater compliance. But companies who seek to evade tax cannot do so by falsifying payrolls without jeopardizing their labor relations. Similarly, companies which misrepresent profits are negatively affecting shareholders and investors as well as the tax authorities both these constituencies may have as immediate an interest as the revenue gatherer in accurate record keeping and may in some cases have greater direct capacity to enforce it.

Market activity forces companies into a variety of relationships, which rely on the sort of obedience to rules of disclosure, which make tax compliance easier to enforce. Individuals, even if they live in a rule-bound society, do not face the same pressures to disclose information and therefore have greater leeway to evade obligations. To this should be added the reality that firms, like large non-profit organizations, find it more difficult to evade obligations simply because

more people are required to participate in the act and there is an obvious possibility that one or more of them will refuse to co-operate. This ensures that organizations are more likely sources of compliance than individuals. As noted earlier, this does not mean that the factors discussed here mandate compliance – corporate scandals in the United States show that shareholders and workers can indeed be misled while in sub-Saharan Africa it is not

uncommon for large organizations, including some which are publicly owned, to evade their fiscal obligations.

But it does create conditions for behavior, which makes compliance an easier option than its alternative; while in different environments, ranging from the informal through to that in which individuals decide whether or not to comply, the reverse may be the case.

Similarly, we may find that individuals are more likely to be locked into a culture conducive to tax-paying the more habituated they are to particular forms of administrative routine more specifically, if they are used to interacting with the state through a set of rules which are seen to have two key characteristics: that they are not arbitrary and that there is a reasonable expectation that compliance will yield benefits – the extension of rights (such as a license to drive a vehicle) and entitlements (a pension or a subsidies place at a state school). It may also be that engagement with the state tends towards compliance if it is assumed,

Over a fairly long period, to be capable of implementing its own rules. North points towards this when he stresses the role of institutions, or ‘the rules of the game in a society’ in shaping economic behavior. It seems plausible that individuals who are used to acting within rules which make compliance with public obligations more routine would be more open to altering their behavior in response to changes in the efficiency of the tax authority.

Thus, the difference between white and black citizens under apartheid may have been not only that whites identified with the government and blacks did not. It may also relate to different experiences of government and its enforcement of rules.

Apartheid did not only create a racial hierarchy in access to power and privilege it also created a state which often behaved very differently towards white and black citizens. To black South Africans, the state often acted arbitrarily and appeared largely as an alien force. To whites, despite distortions prompted by the fact that intra-white tensions during the system's heyday ensured that Afrikaans-speakers enjoyed preferences which English-speakers did not, the state was experienced as a set of rules which could plausibly be said to underpin mutual rights and obligations between the state and its citizens. Within limits, participation in the state could hold out a realistic expectation that obeying the rules, and complying with the required administrative procedures, could bring benefits.

This may be more likely to inculcate a rule-bound form of behavior, which tends towards compliance. It must be stressed, at the risk of laboring the point, that this does not mean that we can be confident of predicting the compliance behavior of individuals and groups from their immersion in rule-bound administration which they experience as relatively benign. This argument does not posit a direct and necessary correlation between the two. Rather, the point is that engagement of this sort with government may create a context in which enhanced technical efficiency by the tax authority can yield significant improvements in tax collection performance.

Two important points must be made about these assertions. First, the argument made here about the legacy of the past differs significantly from the argument that people comply if they identify with the state.

Rather, the point is that they are more likely to do so if they are immersed in the rule-bound procedures of the state in ways which make these rules seem like legitimate forms of regulation (even when they are resented) rather than the

whims of an alien power. This is important not only as a scholastic point since it alters fundamentally our notion of what to look for if we want to establish whether a particular tax culture exists. Rather than seeking taxpayers that share a sense of political community with the state, we look, if we want to establish a proclivity

for meeting fiscal obligations, for those who are sufficiently immersed in the state's rule-bound institutions in ways, which prompt them to assume that the rules are indeed implemented in the manner intended.

The question of political likes and dislikes, or even of the stated motives for compliance, become irrelevant. The real test is whether the people from whom compliance is required are used to dealing with the state in ways, which would make complying, to them, the most plausible response with obligations.

The second is that a sudden rupture did not end apartheid the constitutional settlement of 1993 was the culmination of a lengthy period of reform apartheid, which began in the mid-1970s. As a result, black South Africans' experience of the state during this period was far more complex than the preceding analysis suggested because individuals and collectives experienced arbitrary and rule-bound state behavior at the same time.

On the collective level, the same group of people might, in the 1980s, be engaged in the highly rule-bound activity of registering their trade union within a process which ensured that compliance with legal obligations would guarantee bargaining rights, at the same time as they experienced arbitrary and entirely oppressive police behavior in response to resistance activity. And individuals might be participating in the rule-bound and mutually obligating process of

applying for a title deed for a home (after black property rights in the cities were conceded in the mid-1980s) while experiencing arbitrary police or official behavior in other contexts.

The degree to which this has produced a culture of compliance is an important area for study: if the claim of one SARS official that black taxpayers behave much as white ones do is accurate, then there may have been sufficient incorporation of black people into state institutions to ensure a shared culture of compliance. It is possible too that current experiences of institutions, companies and the state, state are sufficient to compensate for history that black tax payers now experience a relationship with the rules of the state which tends towards compliance.

This begs an obvious question how did the rule bound nature of the state arise?

The argument advanced here, to a degree, turns on its head the assertion made earlier, that the tax relationship may determine the nature of the state.

While this position does not insist that the nature of the state determines the tax relationship, it certainly suggests that it may have an important impact. But, if the tax behavior does not determine the nature of the state, then what does? The

answer may be beyond this paper. Suffice it to say that this argument does support Brautigam's assertion that, where states have a colonial past, that experience is vital to an understanding of the nature and capacity of the state now. More specifically, it may be that countries who look back on a form of colonialism in which there was a significant settler presence in the colonized society may inherit forms of state more conducive to tax compliance because

rules and procedures designed for people who enjoyed rights in the metropolitan country might be expected to be more open to rule-bound administration in which the state met obligations to citizens rather than merely exerting arbitrary power over them.

These questions deserve further inquiry. However, far more important for those concerned with developing better governance understandings and practices than the genesis of cultures of compliance is the assertion that they matter and that, without them, technical efficiency may have little effect in ensuring compliance. It is common cause that SARS's efficiencies have had far more impact among companies than individuals and in the formal economy than in its informal equivalent. While part of the explanation lies in strategic choice SARS targeted the formal sector as a result of a fairly obvious cost-benefit analysis and it does claim modest successes in the informal sector among taxi operators, it may well be that collecting revenues from people engaged in informal economic activity may prove a far greater challenge not simply because of logistical constraints but because the culture of compliance, which operates in the rule-bound interaction between the formal sector and the state, is absent among informal businesses and those who operate them.

5.2.3. STRATEGIC IMPLICATIONS

What are the implications of this analysis for tax collection in particular, governance in general?

This dissertation has argued that technical efficiency can only be effective if it is underpinned by a culture favorable to compliance and that this culture needs to be underpinned by rules, values and routines if it is to influence behavior. This implies an approach to tax collection different from that, which simply relies on more effective means of coercion. It suggests that revenue collection will be

enhanced if the tax collection authority is able to devise rules, which capitalize on that advantage. This requires 'reading the culture' which underpins tax behavior effectively enough to know what will influence behavior and what will not.

SARS's success thus far clearly rests on its accurate reading of the interventions which would be likely to induce compliance one clear example is the use of public embarrassment techniques, another is the recruitment of officials with a history of working in private accounting firms, who share common understandings with the people from whom they are collecting tax: these have obviously enhanced effectiveness.

Clearly, continued effectiveness will depend on the preservation of the culture and the routines and daily procedures, which underpin it. While these cultures may take years to establish themselves, and may be ingrained enough to be fairly robust in the face of tax collection methods of which tax payers disapprove and which therefore might violate the senses of fairness which makes effective revenue raising possible, SARS and other tax authorities may be most effective when they are able to see the complex system which makes relatively easy compliance possible as an asset and ensure, within the limits imposed by the need to ensure compliance, that their strategies do not threaten the underpinnings of compliance.

One way of illustrating this is to examine the role of tax practitioners. As noted elsewhere they would seem to be obstacles to effective collection since their task is to advise clients on how best to avoid paying tax. Thus the Minister of Finance, while not necessarily referring directly to practitioners, expressed an important aspect of the official attitude when he complained that 'tax is avoided by aggressive tax planning, while purportedly adhering to the letter of the law.' However, it may well be that the practitioners play a crucial role in enhancing the

efficiency of tax collection, for it is they who communicate SARS's intentions to their clients. If it is accepted that effective collection depends on sending messages to tax payers through the set of routines which underpins the tax-paying culture, then the practitioners are crucial conduits of the message they must be if they are to do their jobs. Even when they are trying to conceive ways of beating the system, then, they are also essential cogs in its working.

If official intentions to regulate practitioners are implemented, regulation will need to be framed in ways which ensure that this function is retained if it not, a vital element of effectiveness may be compromised. It is also conceivable that overly aggressive enforcement methods could be counter-productive if they were to appear to violate some of the cultural underpinnings of compliance by appearing arbitrary and capricious. And it is important to stress the degree to which formality is an important ally of a tax collection agency since engagement in formal economic activity tends to incorporate people into the institutional framework which tends towards compliance.

These points are not new to SARS senior leadership who seem very well aware that they are engaged in an activity in which understanding and using the behavior patterns of tax payers and the assumptions which underpin them are a crucial ingredient of success. As noted above, SARS strategies reflect this and their success is clearly partly attributable to it. But it is open to serious question whether this point is widely accepted in government. Often, compliance is assumed to be the natural mode of citizen behavior and policies, which rest crucially on it, are therefore not based on a thorough attempt to understand the institutions and understandings, which might tend towards or away from

compliance. The assumption that citizens will simply respond to a government decision requiring compliance is repeatedly shown to be flawed. Current examples are the switch to new forms of driver license or the registering of domestic workers with the Unemployment Insurance Fund.

Ensuring compliance, will, SARS's experience shows, require a far deeper understanding of the behaviors, rules and norms which prompt people to tend towards compliance or towards ignoring particular expressions of public authority. SARS's performance shows too that developing this knowledge is a continuing process, which will be required well after a measure requiring compliance has been implemented.

5.2.4. THE INFORMAL CONUNDRUM

The second implication has been noted several times here but requires repetition: incorporating informal economic actors into the rule-bound relationship which produces the possibility of tax compliance may prove far more complex than some in SARS seem to believe since the issue is not simply cost, but also that informal activity is governed by a different set of institutions and understandings to its formal counterpart. This sharply limits the applicability of the SARS experience in countries in sub-Saharan Africa and elsewhere in the

South where formal economic activity is limited and in those agencies and departments of the South African state which are required to deal with the millions of citizens engaged in informal activity.

The challenge seems daunting since what is required is the creation of a culture of compliance, not the ability to make use of an existing culture, and cultures are not created quickly or easily.

But it is one of the key arguments of this analysis that the culture tending towards compliance on which SARS currently relies in its dealings with formal economic activity was also created it is not an innate feature of human social activity.

Given that, there is no reason why such a culture should not be established once again among people who now operate outside the formal rules, even if success is likely to be neither easy nor rapid. And it also seems to follow from this analysis that a starting point will need to be a painstaking and lengthy attempt to understand the ideologies and institutions which underpin informal activity. While it seems axiomatic that the elements of a culture of compliance will be less evident, the strategic exercise would depend on trying to identify elements of informal economic and political culture which might tend towards a compliance-oriented culture and ways in which they might be strengthened at the expense of the understandings and institutions which obstruct it.

Progress may be slow and much preliminary work may be needed before greater understanding can produce sustained gains in much wider and more permanent compliance. The message for other parts of the government are much the same. The first step on the way to progress is an acknowledgement that many citizens do not work and live within the same set of rules as the people who draft policy. Not only do their rules need to be understood, but also as in tax collection, ways need to be found of capitalizing on rules and beliefs which open the way to compliance while seeking strategies to weaken those which do not. And the key to this is a much closer link between government and people engaged in informal activity.

Three elements seem required to operate parallel to each other the deepening of representative democracy so that public representatives develop deeper links with citizens engaged in informal economic activity and thus a greater understanding of the institutions and understandings of informal economic

actors; a concerted attempt by government agencies to gather reliable data on this before framing policy and continually as they seek to implement it, and research studies which seek to illumine these patterns over a more protracted period and without being encumbered by the need to produce short-term reports – complex social dynamics are not quickly understood.

None of this would make for the speedy government decisions, which some analysts see as the precondition of effective government. But where people

Underpin their economic activity with a set of rules, values and behaviors which are obstructions to effective government, a hasty approach which does not stop to listen and observe carefully the beliefs and deeds which will decide whether or not a policy succeeds is a sure route to rapid failure.

The history of tax collection perhaps also its present in some cases suggests that people outside the cultural circle, which underpins compliance, can be incorporated into it. But the process is likely to be difficult and lengthy, underpinned by a style of government more geared to trying to understand and learn from activity at the informal grassroots than has thus far been evident.

CHAPTER SIX

6. TAX REFORM AND DEMOCRATIC ACCOUNTABILITY IN SUB-SAHARAN AFRICA

6.1. INTRODUCTION

Can improved revenue collection and tax policies provide for more democratically accountable government?

The theoretical literature, mainly derived from a Western political setting, has concluded that political considerations are important in shaping tax policies and their implementation. In the context of Africa, however, little is known about the actors involved in determining tax policies, the institutional channels applied, the conflicts arising, and the outcomes arrived upon (Fjeldstad *et al.* 2000).

In sub-Saharan Africa this question has gained a new urgency as many countries in the region are currently facing two interrelated challenges:

Under pressure from the international finance institutions many countries are currently reforming their tax systems to extract more revenue from their citizens as aid transfers are in rapid decline. Second, a great majority of Africa's nations

have in the early 1990s moved towards pluralist systems of rule. If Western experiences hold true, democratization will have profound implications for taxation: in democratizing environments it will be necessary to build institutional capacity and political legitimacy in order to generate revenues from citizens; confiscator or coercive forms of revenue extraction are considered incompatible

with the long-term process of democratic consolidation. But, does the relationship between taxation and accountability apply to contemporary state-society relations in sub-Saharan Africa?

In order to assess whether the tax reforms have provided a 'governance bonus' in terms of greater responsiveness in state-society relations, we focus on three interrelated issues affecting the relationship between taxation and accountability.

First, we consider the *internal accountability* of the tax system and ask whether the tax-reforms have resulted in a system of taxation with greater reach, higher level of efficiency and transparency.

Second, we ask whether the tax reforms have created closer links between African governments and their citizens and thereby increased *democratic accountability*.

Third, we discuss to what extent and in what ways *external accountability* relations between African governments and international donors affect domestic accountability relations. The empirical discussion is illustrated by the tax reforms currently undertaken in Uganda, Tanzania and Zambia. Like many other countries in sub-Saharan Africa, in the early 1980s these three countries faced fiscal crises as the main revenue base export taxes declined or collapsed.

Tax reforms were implemented as part of the economic restructuring agreements with the International Finance Institutions (IFIs). The creation of semi-autonomous revenue authorities, elimination of export taxes, simplification of import tax brackets, and implementation of Value Added Tax (VAT) as a replacement of sales taxes were central components of the reform processes. In

all three countries, these reforms resulted at least initially in increases in the ratios of tax revenue to GDP, administrative improvements and a marginal widening of the tax-base. However, the tax reforms have only to a limited degree resulted in closer links between government and citizens and so far. One reason is that the tax reforms have not to any great extent focussed on the forms of taxation most profoundly affecting the relationship between governments and citizen's direct taxes.

Large sectors of the economy, most notably agriculture and the informal sector, remain outside the tax system. As a result, a 'tax culture' seems to be lacking in all three countries.

Nevertheless, with respect to formal sector business our analysis does suggest that, in the longer term, there may be a connection between tax-reforms and accountability in a sub-Saharan African setting as commercial businesses are beginning to use their associations to interact with.

6.2. THE LINKS BETWEEN TAXATION AND ACCOUNTABILITY

Generally, *accountability relations* seek to assure that a person/institution entrusted with a particular task:

- a) carries out the given mandate, and
- b) does so in a way that is in accordance with the norms and rules applicable to this activity.

It thus involves at least two parties, the one who has been entrusted with something that gives rise to the accountability obligation, and the principal who gave the mandate in the first place, or an agent delegated this authority.

Democratic accountability is a special case where the principal is “the people” and the parties owing accountability are those entrusted with political power. A situation characterized by democratic accountability can be defined as a situation where

1. Political power-holders carry out their mandate and exercise their powers in a way that is *transparent*, in the sense that it enables other institutions and the public to see what is actually done, and assess whether it is in accordance with the mandate and the relevant norms and rules;

2. Power-holders are *answerable* in the sense of being obliged to provide reasons for their decisions in public (which also implies an element of *responsiveness*);

3. There are *institutional checks or control mechanisms* in place to prevent abuse of power and ensure that corrective measures are taken in cases where the mandate is contravened or rules are violated.

Democratic accountability requires in addition institutional mechanisms through which ‘the people’ can punish (remove) officials who do not meet the standards, and influence laws and policy decisions.

Taxation is believed to promote these qualities in public officials and institutions because this is necessary in order to make the population accept their tax obligations.

If governments are perceived as accountable, more people will pay their taxes “voluntarily”, which lowers the need for coercion and generally reduces the costs of tax-collection.

Conversely, if people do not see their governments as accountable, there is an increased likelihood that state demands for (new or higher) taxes will be met with protest and violence that is costly and might even jeopardize the position of those in power.

The starting point for an emerging new literature on the interconnections between taxation and democracy in the developing world is the acknowledgement that bargaining over tax policies and the budget is the primary way in which different state and societal goals can be reconciled in a democracy (Moore 1998).

This finding is based on European historical experiences where over the past two centuries taxation and disputes over the use of revenues stimulated the development of greater citizen rights with democratic institutions enforcing greater transparency in expenditures.

History provides numerous examples of democratic concessions granted in order to broaden the tax-base, and of tax-payment being used as an explicit condition for citizens to qualify as a voter or candidate for office. This illustrates both a demand from taxpayers that if they are to contribute they should also have a say in how the money is used, and an acknowledgement from governments of the validity of this claim whether for pragmatic reasons or on grounds of reasonableness (Tilly 1992, Brautigam 1991).

The link between taxation and accountability is typically illustrated by the battle cry from the American colonies' fight for independence from Britain "no taxation without representation".

Because taxpayers were consulted about the revenue raising system compliance in tax collection became quasi-voluntary (Levi 1988) thus, reducing collection costs. Furthermore, the fact that rulers and the more wealthy and influential sections of society bargained over the sources and uses of revenue helped generate a consensus over national policy issues.

Finally taxpayer status became a valid basis for claiming political influence. Thus, the notion that politics determine the formulation and implementation of tax policies is firmly established in European and, more generally, Western scholarship (Brennan and Buchanan, 1980; Levi, 1988; Steinmo, 1993).

6.3. TAXATION AND DEMOCRACY IN SUB-SAHARAN AFRICA

Why should it be expected that a greater fiscal dependence of African governments on tax revenues could lead to greater accountability of states to their citizens-taxpayers?

In most developed countries, issues of taxation rank high on the agendas of political parties, parliaments and governments. Taxation issues are far less prominent public issues in developing countries. Taxpayers in developing countries rarely mobilize politically. The main reason is that only a minority of citizens form part of the tax-net through payment of direct taxes to the state. In the post-colonial period, direct forms of taxation have been limited in sub-Saharan Africa due to problems of information, taxable incomes, infrastructure and political sensitivity. By the time of independence, direct taxation was perceived as illegitimate and often the first thing a new independent government did was to eliminate direct taxes (hut taxes) imposed by the colonial governments. Constrained by political concerns, nationalist leaders relied instead on revenues paid by enclave mining interests or commodity exports and excise duties.

In the case of Africa, it is often noted that aid and aid dependency has thwarted the development of tax-accountability relations. Moore (1998) challenges the linkage between democracy and revenue mobilization in what he refers to as the 'fourth world', or developing countries, due to the strong presence of external forces and forms of capital. According to this perspective, the more states depend on unearned income the less accountable they will be towards their citizens. Moore argues that the more a state earns its income through the operation of a bureaucratic apparatus for tax collection, the more the state needs to enter into reciprocal arrangements with citizens about provisions of services and representation in exchange for tax contributions.

Thus, when state incomes are derived from aid and economic rent, minimal attempts will be made to raise revenue from direct forms of taxation and, as a result, effective democratic governance will be undermined. The argument raised by Moore is important because it points to the exceedingly important role played by external forces in post-colonial Africa.

Based on World Bank data, showing that in low income countries tax revenue as percentage of GDP has declined by almost 3 percent between the 1970s to the 1990s, Brautigam (2002) argues that the failure of revenue-raising seems most acute in countries that receive large amounts of aid. With significant unearned incomes, arguably, African states may in the last decade have faced more organized and effective pressures for accountability and transparency from the international donor community than from their own citizens and parliaments (Brautigam 1999).

In the late 1980s, after a series of external shocks, most African countries faced deep fiscal crises due to, among other factors, adverse terms of trade.

The cases of Uganda and Zambia are illustrative. In Uganda the main revenue source basically collapsed with the demise of the International Coffee Agreement in the 1980s and the subsequent fall in coffee prices. In Zambia, the dramatic decline in world market prices on copper reduced government revenue by half between 1975 and 1980.

Since the late 1980s, a great number of sub-Saharan Africa's countries have received substantial amounts of aid aimed at stimulating economic policy reform. In most cases, the structural adjustment agreements entered into with the IFIs have included tax reforms. Increasingly, however, it was realized that the fiscal crisis was also a crisis of *governance* as the central state apparatuses in most countries of the region were plagued by political and institutional weaknesses that undermined their abilities to promote economic development, and collect revenue to sustain state activities.

From the early 1990s onwards, both the multilateral and bilateral aid agencies began to emphasize 'good governance' in their aid programs. Aid has come with a series of 'dual conditionalities', and a relatively united body of multi- and bilateral donors have come to see political and economic governance as interconnected (World Bank 1998). From a donor perspective, where good (accountable) government is high on the agenda, to strengthen the domestic tax-base has become a major issue in order to weaken the dependence on foreign aid and to make governments more accountable.

In terms of tax-reforms, the emphasis on transparency and autonomy of the tax administration and the focus on widening of the tax, net indicate that aid policies in the 1990s have been founded on an implicit connection between taxation and accountability, based on West European history. The notion that improved taxation, through administrative reform and greater reach, can create

responsiveness and democratic accountability has guided much of the aid policies on tax reforms in the 1990s. The question is whether it is possible to establish democratic accountability mechanisms by external pressure.

6.4. TAX AND ACCOUNTABILITY IN UGANDA, ZAMBIA AND TANZANIA

To rephrase, our main concern in this paper is whether tax reforms have led to increased democratic accountability in the form of greater responsiveness of states to citizen, taxpayer demands. We emphasize that the expected relationship between taxation and accountability is mainly relevant for certain forms of taxation: the revenue sources that are highly 'visible' or 'felt' and thus directly link citizens to the state.

These are primarily direct taxes (corporate and personal taxes). Where indirect taxes are relatively visible and 'felt' by large sections of the populations, such taxes may give rise to demands for something in return and say in how the money is spent. Value Added Tax (VAT) illustrates this: While referred to as an indirect tax, it is intended to be broad in reach and is often highly political because it is felt by a great number of citizens.

In order to establish whether the implied relationship between taxation and accountability holds with regard to tax reforms currently carried out on the African continent, we need to establish whether tax reforms have lead to greater reach, higher levels of efficiency and transparency. In other words, we need to assess whether *internal accountability mechanisms* have been strengthened.

Strengthening internal accountability is important in order to achieve the broader goal of increasing *democratic accountability* between the government and the taxpaying voters.

Lastly, *external accountability mechanisms* between governments and donors (multilateral and bilateral) play a crucial role in initiating and driving the reforms by creating incentives structures and placing conditions on the recipient governments. External accountability relations between the governments and international donors may therefore affect domestic accountability relations.

6.4.1. THREE FORMS OF ACCOUNTABILITY

There are three forms of accountability:

1. With regard to the *internal accountability* of the tax system, we ask to what extent the reforms have succeeded in creating more efficient and trustworthy tax systems transparent systems capable of ensuring that tax money is not embezzled, and that those who should pay tax do in fact pay.

2. We also ask whether the conditions are in place for taxation to have a positive effect on *democratic accountability*. Have reforms changed the nature of the tax system to the extent that taxes are being 'felt' by a majority of the population? And, if so, has this triggered a response in the form of demands for greater accountability by the citizens? Do we find evidence of governments more willing to justify their decisions in public, and be constrained by institutions representing the public will?

3. Has *external accountability* aimed at strengthening domestic accountability? structures through tax reforms succeeded, or has external accountability relations in fact hampered the development of domestic structures for democratic accountability?

6.4.2. THE INTERNAL ACCOUNTABILITY DIMENSION OF TAX REFORMS

If the tax collection apparatus is inefficient, incompetent and corrupt, this is a strong disincentive for potential taxpayers. As part of the economic restructuring process, the international donor community has emphasized administrative reforms through the establishment of independent revenue authorities. Inspired by the executive agency model, currently eight countries mainly in east and southern Africa have established semi-autonomous revenue authorities.

The new revenue authorities were perceived to have a positive effect on accountability relations: By placing the responsibility for revenue collection outside the civil service, the aim was to 'bypass' deficiencies in existing state institutions through higher salaries and more flexible procedures for hiring and firing employees.

In addition, the executive agency model was regarded as an effective mechanism to limit direct political intervention in day to day operations. The new executive revenue agencies established in Uganda (1991), Zambia (1994) and Tanzania (1996) should be regarded as semi-autonomous, as the employees are still public servants. The challenge facing the revenue authorities in all three cases was to increase the contribution of locally raised revenue to the domestic

budget from the very low levels prevailing in the 1980s and 1990s. It was also necessary to restructure taxes away from export taxes to a tax system that could facilitate private sector/export promoted growth. In all countries export taxes acted as a major disincentive for the agricultural sector and they were abolished in the early stages of reform.

6.4.3. IMPROVED REACH THROUGH A WIDENING OF THE TAX NET?

The tax base was narrow in all three countries prior to the reforms. Success in widening it would be an important indicator of their success from an accountability perspective. The record in all three countries is strikingly similar: the reforms so far have focused on increasing collection through improving the compliance of existing and known taxpayers.

According to a recent evaluation study by the British Department of International Development (DFID) of tax reforms in a number of sub-Saharan African countries the failure to tax the informal sector and agriculture, and the continued tendency of granting tax exemptions to powerful businesses individuals with close political connections provide the main reasons why collection appears to have stagnated at a relatively low level (DFID 2001). Echoing this finding, tax reforms in Uganda, Tanzania and Zambia appear to have worked within a largely static tax policy framework. In all three countries, increases in revenue are largely due to enhanced collection compliance. In the case of Uganda, the growth in the number of taxpayers does not reflect the rather broad and rapid economic growth recorded in recent years.

To illustrate: Since 1998 the Uganda Revenue Authority (URA) has been instructed to implement a Presumptive Income Tax on informal sector enterprises with low turnover under IMF conditionality. However, the process has been met with little enthusiasm in the URA, as the collection is not regarded as cost-effective.

In addition taxing the informal sector is regarded as politically sensitive and the reform has been met with little enthusiasm in political circles and the press (Gray, Karuga and Ssemogerere 2001 Anene and Garyio 2000, Therkildsen 2002). Similarly, the accounts from Tanzania Revenue Authority (TRA) indicate

that more than 70 per cent of taxes collected are consumption taxes. The regional distribution also points to a relatively limited tax net: close to 80 per cent of revenues come from the region of Dar es Salaam (Temu and Due 2000, Luoga 2001). In Zambia both the agricultural sector and the non-agricultural informal sector, which account for almost the entire labor force, remain outside the tax net. Recent tax reforms have sought to bring Zambian street vendors and Asian traders into the tax net.

However, as the Minister of Finance has continued to grant significant exemption to corporations and individual businessmen with political connections, most people perceive the attempts to tax parts of the informal economy as largely unfair. These concerns were illustrated in the 2001 election campaign as a number of party programs referred to unfair tax policies as a major concern (Gray, Shera and Condy 2001, Aarnes and Taylor 2002, Rakner and Svåsand 2002).

A common trend noted in all three countries is an apparent lack of ability and/or political willingness to apply the tax law with full force to informal operators perceived to be electoral important. The way VAT has been introduced helps explain the failure to widen the population base of the tax system. A uniform VAT (with major exemptions) has replaced business turnover taxes and sales tax in all three countries. However, as food commodities are zero-rated and most agricultural inputs are exempted, VAT has not included many new groups into the tax net. The experiences with VAT in Zambia may serve as an illustration: With 11.000 registered VAT suppliers, of which 5.000 are active, a large part of the economy, and the bulk of the rural economy, largely fall outside the VAT net. Thus, the tax reforms have so far only to a limited extent involved the forms of revenue considered to affect state-citizen relations.

6.4.4. ASSESSING THE DEMOCRATIC ACCOUNTABILITY EFFECT

In the case of *democratic accountability* the principal is “the people” and the parties owing accountability are those entrusted with political power, in the case of taxation primarily the executive government, the legislative and the revenue authorities. For taxation to have a positive effect on democratic accountability, we need to assess whether the reforms have changed the nature of the tax system to the extent that taxes are being ‘felt’ by a majority of the population. If so, has this triggered a response in the form of demands for greater accountability by the citizens?

Do we find evidence of governments more willing to justify their decisions in public, and be constrained by institutions representing the public will?

6.4.5. EXTERNAL ACCOUNTABILITY

With aid increasingly being conditional and with tax reform part of the conditionality agenda, aid and taxation *may* be positively related. But is this so?

Has *external accountability* aimed at strengthening domestic accountability structures through tax reforms succeeded, or has external accountability relations in fact hampered the development of domestic structures for democratic accountability?

There are as we have seen - indications that it may not be so easy to introduce democratic accountability through externally imposed tax reforms.

The tax reforms carried out in Tanzania, Uganda and Zambia have to a large extent been formulated and imposed by the international donor community. In all three countries, the IMF has maintained a lead role in advising governments on

major issues of design of tax policies. To meet the targets set by the IMF and Ministry of Finance, the revenue authorities have focussed on increasing collection and compliance from existing taxpayers rather than attempting the more complicated task of widening the tax base. The long-term process of building wide tax nets and cultures of voluntary compliance requires different and more time-consuming practices. According to the evaluation by DFID in 2001 some countries have concentrated exclusively on increased compliance by known (existing) tax payers at the expense of widening the tax net in order to meet IMF demands (DFID 2001: 52).

These processes are also politically more sensitive, as the resistance to taxing agriculture in Uganda and Zambia indicates. In the case of Uganda Therkildsen (2002: 28) argues that donors, and the Ugandan Ministry of Finance, by pushing for high revenue targets, have undermined the Uganda Revenue Authority's credibility in the eyes of the public, as the targets have been unrealistically high.

6.5. CONCLUDING REMARKS

In the above we have questioned whether recent tax reforms have contributed to the goal of increasing state accountability to citizens-taxpayers in sub-Saharan Africa. The theoretical literature, mainly derived from a Western political setting, concludes that domestically derived revenues will spark demands for citizens' participation and contribute to democratic accountability in state-society relations.

In the context of Africa, so far little is actually known about the relationship between taxation and democracy. Some aspects of Africa's history and political institutions may indicate that the European experiences may not hold for sub-Saharan Africa. One claim presented is that the authority and legitimacy of existing African governments derive principally from the fact that they are liberators and not from their governance practices.

For as long as this situation endures, the linkage between taxation, accountability and legitimacy will be muted (Friedman and Hlope 2002). More generally, it may be argued that in the context of African neo-patrimonial politics it is difficult to predict whether state-society representatives will really imitate the model of western democracies.

There are, however, a number of reasons why we may expect the taxation-accountability link to become more prevalent in sub-Saharan Africa. As part of the economic restructuring processes, many African countries have embarked on the process of replacing the import and export taxes that used to be a major source of income with levies that bear more directly on individual citizens and enterprises. In a situation of decreasing aid transfers, many countries are currently reforming their tax systems in order to derive more revenue from their citizens as aid transfers are in rapid decline. At the same time, a great majority of Africa's nations have in the early 1990s moved towards pluralist systems of rule. However, for taxation to enhance democratic accountability to the extent that states become more responsive to citizens' demands, taxes must first of all be broad based. At a minimum, the economic and political elites must be covered by the tax net.

Taxation-accountability linkages are products of consistent, long-term political, institutional and cultural processes. As a result, it may not be surprising that the tax reforms in Tanzania, Uganda and Zambia so far only to a limited degree have contributed to increasing state accountability to citizens/tax payers. It is however, worrying that donor insistence that states meet short and medium targets for increasing revenue collections appears to militate against accountability to citizens. In some instances, arbitrary, coercive treatment of taxpayers by revenue officials have been motivated by the need to meet donor imposed revenue targets.

Nevertheless, our analysis does find evidence that there may be a more positive connection, in the longer term, between donor imposed targets and accountability. Commercial businesses are beginning to use their associations to interact with government and revenue authorities over tax collection procedures. While there can be no doubt that this mobilization is motivated by businesses' desire to reduce tax payments, the fact that these issues are being treated through formal, public organizations, rather than through bribery and public deals. This may have positive consequences for legality, legitimacy and accountability in environments where taxpayers currently have few or no legal rights.

CHAPTER SEVEN

7. REGULATING TAX PRACTITIONER

7.1. INTRODUCTION

South Africa comes from a past where several factors came together to create compliance culture that is less than it should be.

These factors include: -

- a). The economic marginalisation and consequent lack of knowledge about tax of a large segment of the population.
- b). The mindset and practices that took when circumventing the imposition of international sanctions.
- c). The historically limited capacity of the tax and customs administration to challenge tax evasion and highly arguable, or even fanciful, tax planning structures and techniques.

SARS is engaged in a number of initiatives aimed at improving the compliance culture and reducing the tax gap in South Africa. As far as tax practitioners are concerned a significant problem for both SARS and taxpayers is that no minimum standard in respect of qualifications or experience is required for tax practitioners and that not all tax practitioners are subject to a code of professional conduct.

In view of these issues the Budget Review 2002 stated that; " Many individual and business taxpayers receive advice and assistance from tax consultants and advisors. Although the final responsibility for the content of a tax return legally rests with the taxpayer, the return is completed on the advice of the tax consultant or advisor, who bears limited responsibility for the advice given.

In order to promote better compliance and ensure that taxpayers receive advice consistent with the tax legislation, SARS will initiate discussion on the regulation of tax consultants and advisors in South Africa, with appropriate sanctions in the event of non-compliance with tax legislation.”

A brief overview of the following issues will be discussed.

- The Customs accredited client scheme,
- The spectrum of possible regulation of tax practitioners,
- The regulatory system in place in three foreign jurisdictions, and
- A possible model for regulation in the South African context.

7.2. CUSTOMS ACCREDITED CLIENT SCHEME

The accredited client scheme was introduced into the Customs and Excise Act, 91 of 1964, by way of section 65E. This scheme is open to enterprises involved in Customs transactions (import, export, warehouse and movement of cargo)

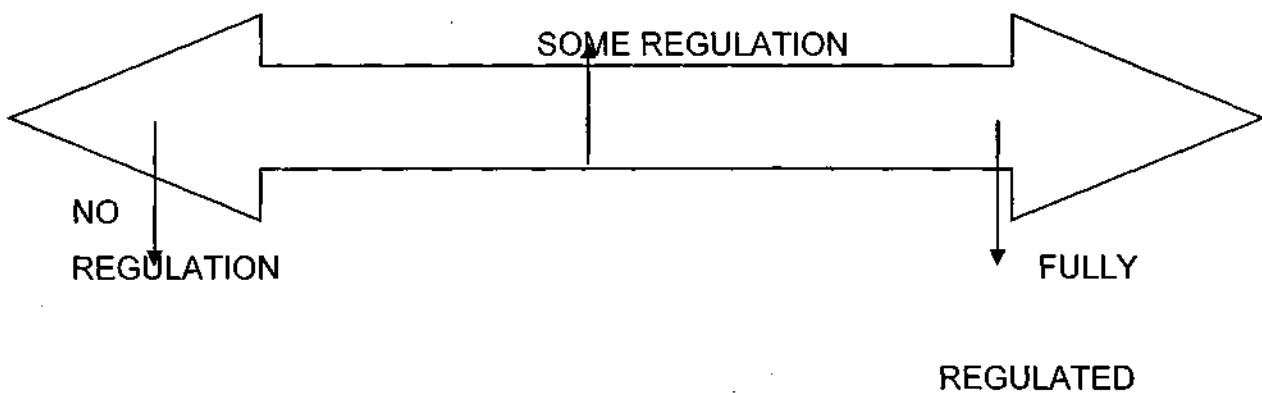
which are capable of instituting and maintaining high quality internal operational processes and computer systems in order to comply with the Customs laws and procedures. Clients whose internal controls meet a certain standard, whose records of compliance over the five years preceding accreditation is acceptable to SARS and whose computer systems are capable of operating within a paperless environment can enter into an agreement with SARS and be recognized as an accredited client.

The primary benefits to the client are simplified procedures, paperless environment and less human intervention (border passage, removal of goods in bond). On the other hand, an employer or Vat vendor may choose to utilize a paperless means of filing a tax return (e-filing) and no sophisticated computer system is required by the taxpayer for this purpose.

The service provider rendering the e-filing service does indeed need such a system to enter into an agreement with SARS. In this context it is the service provider for tax purposes that can be equated to the accredited client for Customs purpose.

7.3. SPECTRUM OF POSSIBLE REGULATION

Before considering the international example it may be appropriate to briefly consider the spectrum of possible regulation.



The two poles labeled “no regulation” and “fully regulated” are extremes and it is doubtful whether ant tax jurisdiction can be regarded to have no regulation, in the widest possible sense, or on the other hand to be fully regulated.

Although South Africa does not regulate tax practitioners in the sense of a code of conduct or a qualification requirement, certain provisions of the tax legislation may be applied in respect of tax practitioners acting on behalf of taxpayers. Section 104 (Offences and penalties) and Section 105A (Reporting of unprofessional conduct) of the Income Tax Act, 58 of 1962.

Admittedly the second example is premised on the offender belonging to a professional association, body or board.

Towards the “no regulation” end spectrum market forces are the only mechanism to ensure tax practitioner competence, in that taxpayers wishing to obtain sound tax advice will normally engage a professional person specializing in tax. This is the position in jurisdiction such as the UK and Ireland, where apart from attorneys, accountants and other professional bodies there is a specific tax profession. The Chartered Institute of Taxation in the UK (CIOT) and the Irish Institute of Taxation in Ireland. Members of these bodies are required to demonstrate a certain degree of competence by way of examination or dissertation before being allowed to utilize their professional body’s designation.

At the other end of the spectrum, no tax authority has full regulatory over tax practitioners. Where there is a higher degree of regulation, the regulatory body is often an independent government body separate from the tax practitioner and their qualification requirements, as in the USA.

7.4. INTERNATIONAL EXAMPLES

7.4.1. AUSTRALIA

- **Registration of Tax Agents**

The registration of tax agents is provided for in Part VIIA of the Income Tax Assessment Act 1936(ITAA36) and Part 9 of the Income Tax Regulations. A person must be registered as a tax agent to charge a fee for preparing or lodging income tax returns and objections, or for transacting business on behalf of a taxpayer in income tax matters.

If a person charges a fee for these services whilst not registered as a tax agent that person will be committing an offence under section 251L of the ITAA36 and face a fine, upon conviction, of up to 200 penalty units (\$22,000). It is also an Offence, under section 251O of the ITAA36, to represent oneself as a tax agent or to advertise that tax returns can be prepared and to attend to income tax matters unless registered a tax agent. The penalty for breaching section 251O is a maximum fine of 10 penalty units (\$1,100).

These offences do not apply to a solicitor or counsel in certain situations where they are acting in the course of their profession. In order to practice as a tax agent a person must be registered with the Tax Agent's Board in the appropriate State. If a person intends to practice through a company or partnership that entity must be registered as the tax agent.

7.4.2. MALAYSIA

- **Registration of Tax Agents**

Section 153 of the Malaysian Income Tax Act provides for Tax Agents. Subsection 1 states that " No person holding himself out as a tax agent, a tax consultant or a tax adviser (or under any other like description) shall be permitted to act in Malaysia on behalf of any person for any of the purposes of this Act unless he is a tax agent as defined in this section."

A proviso to the above states, "nothing in this subsection shall be construed as restricting an advocate in the lawful practice of his profession."

For the purposes of the Act, "tax agent" means:

- (a). A professional accountant authorized by or under any written law to be an auditor of companies;
- (b). Any other professional accountant approved by the Minister; or

(c). Any other person approved by the Minister on the recommendation of the Director General.

In order to register as a tax agent, a fee as prescribed from time to time in the Gazette must be paid. Registration is valid for a period of 24 months after which such registration must be renewed.

7.4.3. THE UNITED STATES OF AMERICA

- **Practice before the IRS**

Publication 947 – Practice before the IRS – discusses who can represent a taxpayer before the IRS. This publication seeks to address representation of a taxpayer after filing rather than regulating who can complete a tax return.

Practice before the IRS can cover all matters relating to any of the following:

- Communicating with the IRS for a taxpayer regarding the taxpayer's right, privileges, or liabilities under law and regulation administered by the IRS.
- Representing a taxpayer at conferences, hearings, or meetings with the IRS.
- Preparing and filing necessary documents with the IRS for a taxpayer.

Just preparing a tax return, furnishing information at the request of the IRS, or appearing as a witness for the taxpayer is not practice before the IRS. These acts can be performed by anyone to the extent provided by the regulation governing practice before the IRS.

- **ENROLLED AGENTS**

The Director of Practice can grant enrolment to practice before the IRS to an applicant who demonstrates special competence in tax matters by passing a written examination administered by the IRS. Enrolment can also be granted to an applicant who qualifies because of the past service and technical experience in the IRS. Additionally, an applicant must not have engaged in any conduct that would justify suspension or disbarment from practice before the IRS.

An enrolment card will be issued to each individual whose application is approved. The individual is enrolled until expiration date shown in the enrolment card. To continue practicing beyond the expiration date, the individual must request renewal of the enrolment

7.5. A POSSIBLE MODEL FOR SOUTH AFRICA

The model conceived for discussion purposes is based on the formation of an Association of Tax Practitioners. This Association would have its own legal persona and would be run by the stakeholders themselves.

SARS would be an important stakeholder but would not be the regulator. Self-regulation would enhance the credibility of the Association to all parties concerned, viz. the taxpayers making use of tax practitioners, SARS in working with tax practitioners and amongst tax practitioners themselves.

7.5.1. LEGISLATIVE BACKING

In order to provide the impetus for the formation of the Association of Tax Practitioners, a legislative provision along the following lines is proposed.

“With effect from 1 January 2004 any-

- (a). person rendering tax-related services for reward, other than to or on behalf of a single employer; or
- (b). employee of a person, who is employed solely or mainly in rendering tax-related services to or on behalf of that person or any connected person, other than under the direct supervision of a member of the Association of Tax Practitioners entitled to full practice; who is not registered as a member in the appropriate membership category of the Association of Tax Practitioners shall be guilty of an offence and liable on conviction to a fine to imprisonment for a period not exceeding two years.”

The provision would:

- Provide a window period for the establishment of the Association of Tax Practitioners and a transition period for the change to the new arrangement.
- Identify persons rendering tax-related services to clients for reward as being persons that should be subject to a code of professional conduct.
- Identify employees whose employment is solely or mainly for the purpose of rendering tax related services as being persons that should be subject to a code of professional conduct, unless they render these services under the direct supervision of a registered tax practitioner entitled to full practice. An example of an affected employee would be a tax manager for a group of companies.

The provision would not:

- Require employees working under the direct supervision of a registered tax practitioner entitled to full practice to register as tax practitioners. An example of an unaffected employee would be a tax consultant in public practice reporting to a registered tax practitioner entitled to full practice.
- Require an employee responsible for the tax affairs of a company, a close corporation or a trust to register as a tax practitioner where this is not the sole or main employment of the employee. An example of an unaffected employee would be the financial director of a private company whose tax-related services to the company form only a small portion of the services he/she provides to the company.

An issue that has been left open for discussion is the definition of “tax-related services.” An example of a possible exclusion from this definition would be a legal practitioner’s representation of a taxpayer in course of litigation. In as far as the constitutionality of this provision is concerned it should be noted that section 22 of the Constitution provides that,

“The practice of a trade, occupation or profession may be regulated by law.”

Furthermore the self-regulatory environment proposed is comparable to or less intrusive than that of other professions in South Africa and that of the tax professions in other open and democratic societies.

7.5.2. OBJECTS OF THE ASSOCIATION

The following objects of the Association are proposed:

(a). To promote the common interest of tax practitioners throughout the Republic of South Africa by means other than the carrying on by the Association of any trading or other profit-making activities, or the participation by the Association in any business, profession or occupation carried on by any of its members, or the provision to any of its members of financial assistance or of any premises or continuous services or facilities required by its members for the purpose of carrying on any business, profession or occupation;

(b). To advance the theory and practice of taxation in all its aspects;

(c). To insist upon a high standard of professional behavior on the part of members of the Association and to preserve and maintain the integrity and status of the profession, to take any steps which may be thought necessary to stop or prevent dishonorable conduct and practices by members, for this purpose to hold enquiries into the conduct of members and to take disciplinary action against members, including the termination of their membership and their expulsion from the Association;

(d). To consider and pass comment on actual or impending legislation in the Republic of South Africa affecting the profession or otherwise and to apply for,

for, or promote any Act of Parliament or other legislative enactment desirable for the betterment or enhancement of the profession;

(e). To provide for research into taxation and kindred matters and to provide members with information on developments in professional thought and methods both inside and outside the Republic of South Africa;

(f). To provide opportunities for an exchange of views among members;

(g). To implement steps to enable the profession as far as is practicable to speak with one voice on matters of national or international importance affecting the profession;

(h). To co-operate at all times with SARS and the National Treasury;

(i). To apply for membership of and to co-operate with national and international bodies representing the interest of the profession;

(j). To provide courses, seminars or other presentation for members of the Association, members of other professions and interested members of the public, and to exchange reasonable fees to persons attending such courses;

(k). To publish from time to time lists of members of the Association;

(l). To provide for the amicable settlement or adjustment of professional disputes, including disputes between members of the public which relate directly or indirectly to tax practitioners;

(m). To prescribe the qualification and /or experience to be obtained by any person wishing to become a member;

(n). Generally to do and undertake and advise on all matters which may be expedient and in the interests of members of the Association and the general public in relation to matters of concern to the profession;

(o). Generally to do such other things as may be incidental or conducive to the attaining of the above objects.

7.5.3. COMPOSITION OF THE BOARD

The affairs of the Association should be managed by a representation Board drawn from members of the Association who are resident in the Republic together with one representative each nominated by SARS and the National Treasury.

7.5.4. MEMBERSHIP

In addition to any absentee or honorary membership that the Association may wish to grant, two main categories of membership are proposed:

1. **Members entitled to limited practice.** A member entitled to limited practice is effectively limited to returns preparation and associated functions. Such a member may only represent the taxpayer concerning the year or period covered by the return that he/she prepared. A member entitled to limited

practice is only permitted to represent taxpayers in respect of an application for extension, deferred payment arrangement, query, audit or objection in

relation to a return he/she is preparing or prepared and is not permitted to represent taxpayers in respect of any other tax matter.

2. Members entitled to full practice. A member entitled to full practice may provide the full spectrum of tax related services and is not limited to return preparation and associated functions.

7.5.5. QUALIFICATION FOR ADMISSION TO MEMBERSHIP

Qualification for admission to the Association shall be proof to the satisfaction of the Board of one of the following:

1. That the applicant has passed the examination, where applicable, and has the practical experience, prescribed by the board; or
2. If the application is for admission as an associate member, that the applicant has passed the examination prescribed by the Board for this purpose, where applicable, has the practical experience prescribed by the Board and is a member in good standing of a body recognized by the Board for this purpose. Issues for discussion are the extent to which an associate member should be required to meet the academic and experience requirements set out below, as well as the bodies to be recognized.

7.5.6. MEMBERS ENTITLED TO LIMITED PRACTICAL: EXAMINATIONS AND PRACTICAL EXPERIENCE

1. MINIMUM ACADEMIC REQUIREMENTS

- (a). where the applicant is only to prepare and file the tax returns of individuals who are not directors of companies and who earn a taxable income of less than

that at which the maximum marginal rate applies, there are no academic requirements.

(b). Where the applicant is to prepare and file tax returns of any other person, the applicant must have passed at a South African university, technikon or approved equivalent:

- (i). At least one course in accounting, e.g. Accounting I; and
- (ii). At least one course in South African taxation.

2. MINIMUM EXPERIENCE REQUIREMENTS

(a). Applicants requiring no academic qualification must demonstrate that they have completed 2000 hours of relevant South African tax work in the preceding five years.

(b). Applicants requiring at least one course in accounting and at least one course in South African taxation must demonstrate that they have completed 1200 hours of relevant South African tax work in the preceding three years.

3. RELEVANT SOUTH AFRICAN TAX WORK

Relevant South African tax work includes:

- (a). Completing and submitting of any tax return of an individual or any other tax return as permitted respectively;
- (b). Responding to queries of a routine nature, e.g. a request for a schedule of bad debts, raised by SARS regarding any tax administered by SARS; and
- (c). Drafting objections to tax assessments of an administrative nature, e.g. arising out of arithmetic errors.

7.5.7. PUNISHABLE OFFENCES

- (a). In respect of a member entitled to limited practice, performing the following:
- Representing a client in matters other than those pertaining to the preparation and submission of tax returns, applicants for extension, deferred payment arrangements, queries, audits, or objections;
 - Representing a client concerning a tax liability for a year or period covered by a return not prepared by him/her; or
 - Signing of any tax returns, any request for the extension of time in respect of the submission of any tax return or any deferred payment arrangement on behalf of a client without the express written consent of that client on each occasion.
- (b). Conducting himself/herself with gross negligence in connection with any work performed by his/her in his/her profession or employment;
- (c). Performing the following without due diligence:
- Preparing or assisting in the preparing, approving, and submission of tax returns, affidavits, and other documents relating to tax matters;
 - Determining the reasonability of oral or written representation made to him/her by clients relating to tax matters; or
 - Determining the correctness of oral or written representation made by him/her to clients relating to tax matters;
- (d). Unreasonably delaying the prompt disposition of any matter before SARS;
- (e). Knowingly giving false or misleading information in connection with tax matters participating in such activity;
- (f). directly or indirectly attempting to influence the official action of Sars

employees by the use of threats, false accusations, duress, or coercion, or by offering gifts, favors, or any special inducements;

(g). Using abusive language, make false accusation and statements knowing the to be false, circulating or publishing malicious or libelous matter, or engaging in any contemptuous conduct in connection with practice before SARS;

(h). Giving false opinion knowingly, recklessly, or through gross incompetence; or following a pattern of providing incompetent opinions inquisitions arising under the tax laws;

(i). Directly or indirectly paying a person, other than a fellow member, a commission or giving such person monetary or other consideration, as remuneration for bringing the member work, or for inducing other persons to give work to the member;

(j). Accepting directly or indirectly any commission, brokerage or other remuneration in respect of professional or commercial business referred to others as an incident to his/her service to any client, except with the knowledge and consent of that client;

(k). Improperly obtaining or attempting to obtain work;

(l). Soliciting or advertising or canvassing in the Republic (or in any territory outside the Republic designated by the Board from time to time) in any manner not permitted by the Rules or Code of Professional Conduct prescribed by the Board from time to time;

(m). Willfully refusing or failing to perform or conform with any of the provisions of the by-laws which it is his/her duty to do;

(n). Committing a breach of any Rule or Code of Professional Conduct prescribed by the Board or, after having been previously warned by the Board or any committee appointed by it, continuing to commit a breach of such Rules or Code of Professional Conduct;

(o). Unlawfully failing to account for, or unreasonably delaying an accounting of any money or property received for or on behalf of a client or any other person when upon to do so;

(p). Conducting himself/herself in a manner which, in the opinion of the Disciplinary Committee, is discreditable, dishonorable, dishonest, irregular or unworthy or which is derogatory to the Association, or tends to bring the profession of tax practitioners into disrepute;

(q). Without reasonable cause fails to resign from a professional appointment when requested by the client to do so;

(r). Fails to answer or deal with appropriately within a reasonable time any correspondence or other communication from the Association or any other person which requires a reply or a response;

(s). Fails to comply within a reasonable time with an order, requirement or request from the Association; or

(t). Fails after demand to pay any subscription or any fee, levy or other charge payable to the Association.

7.5.8. CANCELLATION OF MEMBERSHIP

(a). The board shall cancel the membership of any member who subsequent to his/her admission to membership is:

- Removed from an office of trust on account of misconduct; or
- Convicted of theft, fraud, forgery, or uttering a forged document or perjury and sentenced in respect thereof to imprisonment without the option of a fine or to a fine of an amount to be determined by the Board from time to time and published by the board for the information the members.

(b). The Disciplinary Committee may in its discretion order the cancellation of the membership of any member who is found guilty of committing a punishable offence.

(c). The disciplinary Committee may in its discretion order the cancellation of the membership of any member whose estate is provisionally or finally sequestrated or who enters into an arrangement with his/her creditors subsequent to his/her admission to membership.

(d). A person whose membership has been cancelled may apply for his/her re-admission as a member after the expiry of a period of 10 years reckoned from the date of such cancellation, provided however that the Board may, on the recommendation of the Disciplinary Committee, reduce this period in any particular case where it considers that it would be just and equitable to do so.

(e). The Board shall report any cancellation of membership to members and may report such cancellation to whomsoever else it considers appropriate, in whatever manner it considers appropriate.

7.5.9. CODE OF PROFESSIONAL CONDUCT

In addition to the Association's by-laws, it may be expected that the Association will also set a code of professional conduct dealing with aspects such as:

- Objectives, integrity and objectivity
- Conflicts of interest
- Professional Competence
- Confidentiality
- Fees for Professional Services
- Client's monies
- Recruiting

7.6. CONCLUDING REMARKS

The proposed regulations would modify existing standards of practice. In particular, the proposed regulations would revise standards for opinions rendered by tax practitioners regarding tax shelter transactions. These opinions give prospective investors an assurance that the purported tax benefit of a shelter is likely to be sustained if challenged by SARS and may be offered in an effort to provide a potential investor comfort that penalties will not be imposed if the transaction is successfully challenged.

The new rules would strengthen the standards regarding factual due diligence and legal analysis. In particular, they would help ensure that practitioners analyze and address carefully whether a particular transaction has a legitimate business reason and is not being done solely for the tax benefits, and that they consider and analyze all potentially relevant judicial doctrines and anti-abuse rulings.

CHAPTER EIGHT

8. CONCLUDING REMARKS

8.1. THE CONCEPT OF A TAX CULTURE

Both economic scientists and politicians have disregarded the concept of a country-specific national tax culture for a long time. When using the expression in public discussion, a useful and understandable definition has not been strived for. For further research I propose that a national tax culture should comprehensively be defined as the entirety of all interacting formal and informal institutions connected with the national tax system and its practical execution, which are historically embedded within the country's culture, including the dependencies and ties caused by their ongoing interaction.

From this working definition it becomes evident that to understand a specific country's tax

culture requires a lot of research effort, because a lot of actors and institutions have to be studied as well as the procedures and processes when they interact.

Good policy advice should not disregard the national tax-cultural constraints. Thus, the prevention of collective tax culture shocks should become a *normative* criterion for a "good" international and national tax policy. Furthermore, one should be aware that during transformation processes the appearance of tax culture lags is almost inevitable.

But still, the degree of the negative effects caused by the lag effects will vary with the extent of tax-cultural conformity of the new and reformed tax measures. Hopefully, the theory of tax culture will be able to belittle the above-mentioned gap between pure theoretical economic fiction and cultural reality, particularly in the sphere of taxation. Furthermore, tax political recommendations can be derived from it, especially in the context of transformation processes.

8.2. TAX REFORMS AND DEMOCRATIC ACCOUNTABILITY IN SUB-SAHARAN AFRICA

In this section we have questioned whether recent tax reforms have contributed to the goal of increasing state accountability to citizens-taxpayers in sub-Saharan Africa. The theoretical literature, mainly derived from a Western political setting, concludes that domestically derived revenues will spark demands for citizens' participation and contribute to democratic accountability in state-society relations.

In the context of Africa, so far little is actually known about the relationship between taxation and democracy. Some aspects of Africa's history and political institutions may indicate that the European experiences may not hold for sub-Saharan Africa.

One claim presented is that the authority and legitimacy of existing African governments derive principally from the fact that they are liberators and not from their governance practices. For as long as this situation endures, the linkage between taxation, accountability and legitimacy will be muted (Friedman and Hlope 2002).

More generally, it may be argued that in the context of African neo-patrimonial politics it is difficult to predict whether state-society representatives will really imitate the model of western democracies.

There are, however, a number of reasons why we may expect the taxation-accountability link to become more prevalent in sub-Saharan Africa. As part of the economic restructuring processes, many African countries have embarked on the process of replacing the import and export taxes that used to be a major source of income with levies that bear more directly on individual citizens and enterprises.

In a situation of decreasing aid transfers, many countries are currently reforming their tax systems in order to derive more revenue from their citizens as aid transfers are in rapid decline. At the same time, a great majority of Africa's nations have in the early 1990s moved towards pluralist systems of rule.

However, for taxation to enhance democratic accountability to the extent that states become more responsive to citizens' demands, taxes must first of all be broad based. At a minimum, the economic and political elites must be covered by the tax net.

Taxation accountability linkages are products of consistent, long-term political, institutional and cultural processes. As a result, it may not be surprising that the tax reforms in Tanzania, Uganda and Zambia so far only to a limited degree have contributed to increasing state accountability to citizens/tax payers.

It is however, worrying that donor insistence that states meet short and medium targets for increasing revenue collections appears to militate against accountability to citizens. In some instances, arbitrary, coercive treatment of taxpayers by revenue officials have been motivated by the need to meet donor imposed revenue targets.

Nevertheless, our analysis does find evidence that there may be a more positive connection, in the longer term, between this donor imposed targets

and accountability. Commercial businesses are beginning to use their associations to interact with government and revenue authorities over tax collection procedures.

While there can be no doubt that this mobilization is motivated by businesses' desire to reduce tax payments, the fact that these issues are being treated through formal, public organizations, rather than through bribery and public deals.

This may have positive consequences for legality, legitimacy and accountability in environments where taxpayers currently have few or no legal rights.

8.3. CULTURE, TAX COLLECTION AND GOVERNANCE IN SOUTH AFRICA

Incorporating informal economic actors into the rule-bound relationship which produces the possibility of tax compliance may prove far more complex than some in SARS seem to believe since the issue is not simply cost, but also that informal activity is governed by a different set of institutions and understandings to its formal counterpart.

This sharply limits the applicability of the SARS experience in countries in sub-Saharan Africa and elsewhere in the South where formal economic activity is limited and in those agencies and departments of the South African state which are required to deal with the millions of citizens engaged in informal activity.

The challenge seems daunting since what is required is the creation of a culture of compliance, not the ability to make use of an existing culture, and cultures are not created quickly or easily. But it is one of the key arguments of this analysis

that the culture tending towards compliance on which SARS currently relies in its dealings with formal economic activity was also created it is not an innate feature of human social activity.

Given that, there is no reason why such a culture should not be established once again among people who now operate outside the formal rules, even if success is likely to be neither easy nor rapid.

And it also seems to follow from this analysis that a starting point will need to be a painstaking and lengthy attempt to understand the ideologies and institutions which underpin informal activity. While it seems axiomatic that the elements of a culture of compliance will be less evident, the strategic exercise would depend on trying to identify elements of informal economic and political culture which might tend towards a compliance oriented culture and ways in which they might be strengthened at the expense of the understandings and institutions which obstruct it.

Progress may be slow and much preliminary work may be needed before greater understanding can produce sustained gains in much wider and more permanent compliance.

The message for other parts of the government are much the same. The first step on the way to progress is an acknowledgement that many citizens do not work and live within the same set of rules as the people who draft policy. Not only do their rules need to be understood, but also as in tax collection, ways need to be found of capitalizing on rules and beliefs which open the way to compliance while seeking strategies to weaken those which do not. And the key to this is a much closer link between government and people engaged in informal activity.

Three elements seem required to operate parallel to each other the deepening of representative democracy so those public representatives develop deeper links with citizen engaged in informal economic activity and thus a greater understanding of the institutions and understandings of informal economic actors; a concerted attempt by government agencies to gather reliable data on this before framing policy and continually as they seek to implement it, and research studies which seek to illumine these patterns over a more protracted period and without being encumbered by the need to produce short-term reports complex social dynamics are not quickly understood.

None of this would make for the speedy government decisions, which some analysts see as the precondition of effective government. But where people underpin their economic activity with a set of rules, values and behaviors which are obstructions to effective government, a hasty approach which does not stop to listen and observe carefully the beliefs and deeds which will decide whether or not a policy succeeds is a sure route to rapid failure.

The history of tax collection perhaps also its present in some cases suggests that people outside the cultural circle, which underpins compliance, can be incorporated into it. But the process is likely to be difficult and lengthy, underpinned by a style of government more geared to trying to understand and learn from activity at the informal grassroots than has thus far been evident.

CHAPTER NINE

9. REFERENCES

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