Taxation and Public Finance in Transition and Developing Economies

Edited by Robert W. McGee

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Preface

Much has been written about the economic and political problems of countries that are in the process of changing from centrally planned systems to market systems. Most studies have focused on the economic, legal, political and sociological problems these economies have had to face during the transition period. However, not much has been written about the dramatic changes that have to be made to the accounting and financial system of a transition economy. This book was written to help fill that gap.

Taxation and Public Finance in Transition and Developing Economies is the third in a series to examine accounting and financial system reform in transition economies. The first book used Russia as a case study. The second volume in the series examined some additional aspects of the reform in Russia and also looked at the accounting and financial system reform efforts that are being made in Ukraine, Bosnia & Herzegovina, Armenia, Eastern Europe and Central Asia.

The present volume examines taxation and public finance in transition and developing economies. It is divided into three parts. Part I consists of four general studies on various aspects of tax compliance, corruption, budget efficiency and fiscal policy. Part II includes nine comparative studies of various aspects of public finance. Part III consists of 23 country and regional studies of countries in Europe, Asia, Latin America and Africa.

Florida International University — Robert W. McGee

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PART ONE: GENERAL STUDIES

1

Bureaucracy, Corruption and Tax Compliance

Ahmed Riahi-Belkaoui*

Introduction

Why do individuals resist tax compliance with their tax commitments and why does this situation differ internationally? The question has been extensively researched from the theoretical perspectives of general deterrence theory, economic deterrence models and fiscal psychology (Cuccia 1994). This study takes the view that the actions of governments can best explain the phenomenon of tax compliance internationally. It shows that where governments reduce bureaucracy and increase the control of corruption, tax compliance will be at its highest. It argues for an implicit social contract where the government and/or the state create a tax environment unburdened by the inefficiencies of bureaucracy, and corruption for tax compliance to be effective. This is especially crucial for developing countries where economic development can be drastically hampered by lower public revenues from lack of tax compliance.

The second section of the paper describes the relationship of bureaucracy, corruption, and tax compliance. The third section describes the data. The fourth section presents the regression analysis and discussions, and the fifth section concludes.

Bureaucracy, Corruption and Tax Compliance

Tax compliance has been extensively reviewed (e.g. Andreoni et al. 1998; Jackson and Milliron 1986; Kinsey 1986; Long and Swingen 1991; Cuccia 1994). Three theoretical perspectives are used to explain the degree of tax compliance, namely general deterrence theory, economic deterrence models, and fiscal psychology. What appears from these three theories is that tax noncompliance is deterred by sanctions (e.g. Tittle 1980), and can be modeled

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as a purely economic decision under uncertainty (e.g. Allingham and Sandmo 1972), or can be the result of non-economic factors such as demographics, attitudes, and perceptions or compliance (e.g. Kinsey 1986). But, given the likelihood that cheaters are rarely caught and penalized, and also defy a strict profile description, the three theories and related findings do not provide a definite explanation of why people pay taxes (Alm et al. 1992, p. 22), and over predict noncompliance (Andreoni et al. 1998, p. 855). Tax noncompliance is a pervasive phenomenon in all societies. There is good evidence of a shadow economy, internationally (for a survey, see Cowell 1990, pp. 22–23). The crux of the problem in the shadow economy is the fact that individuals are behaving dishonestly by providing false information. When reviewing the literature on the ethics of tax evasion from various religious perspectives and with a focus on the question of whether tax evasion is unethical if the payments would go to an evil or corrupt state, McGee (1999a) found differences among religions with the surprising result that “the Jewish literature strongly suggests that it would be unethical to evade taxes under the Nazi regime, even though the taxes collected might be used to kill Jews” (McGee 1999a, p. 150). In the case of transition/developing countries like Armenia, McGee (1999b) found that tax evasion is easy because there is no mechanism to collect taxes and there is a widespread feeling that people do not owe anything to the government because the government does not do anything for them.

Basically, it is the distortion of information that can affect the state’s problem of exercising control and authority on the economy (Cowell 1990, p. 40). What would lead citizens to behave more honestly, provide correct information and improve the tax compliance rate? One answer to this question is the role of government in creating an intrinsic motivation to pay taxes, which has sometimes been called “tax morale” (Frey 1994, 1997a, b). Government can try to deter tax noncompliance through a large and strong bureaucracy (Kornhauser 2002). The likely impact of a large bureaucracy is the increase of bureaucratic corruption (Hall and Jones 1997; Bai and Wei 2003; Waller et al. 2000). Both large bureaucracy and bureaucratic corruption are likely to reduce the tendency of individuals in a given state to accept and trust their government in general and comply with the tax burden in particular (Slemrod 2002; Slemrod and Katuscak 2002). The government may elect to control corruption to create conditions more conducive to tax compliance. Accordingly, the hypothesis to be tested in this study is that:

> “Tax compliance is positively related to the level of control of corruption and negatively related to the level of bureaucracy”.

Basically, regardless of the reputation cost and/or the legal punishment tax noncompliance trigger, a citizen might chose to comply with taxes if the level of bureaucracy is low and the level of control of corruption is high. In short, less bureaucracy and corruption trigger higher tax compliance.

Data

The determination of the sample rested on securing the necessary data on the variables of interest specified in the main hypothesis of the paper. A total of 30 developed and developing countries met this test. They are shown in Table 1.

Table 1 List of Countries

Name of country	Tax compliance	Bureaucracy	Control of corruption
Argentina	2.41	15.4	–0.27455
Australia	4.58	23.7	1.60108
Austria	3.60	40.5	1.45711
Brazil	2.14	24.6	0.05762
Canada	3.77	21.5	2.05547
Chile	4.20	22.6	1.02921
Denmark	3.70	37.3	2.12902
Finland	3.53	33.4	2.08459
France	3.86	46.2	1.28239
Germany	3.41	32.6	1.62029
Indonesia	2.53	17.6	–0.79885
Israel	3.69	47.8	1.27669
Italy	1.77	43.8	0.80233
Malaysia	4.34	19.7	0.63342
Mexico	2.46	14.7	–0.27713
Netherlands	3.40	45.9	2.02641
New Zealand	5.00	33.4	2.07494
Norway	3.96	37.2	1.68655
Philippines	1.83	19.1	–0.22809
Poland	2.19	37.5	0.49190
Portugal	2.18	39.0	1.21791
Singapore	5.05	19.8	1.94751
South Africa	2.40	30.4	0.29886
Spain	3.29	32.9	1.21426
Sweden	1.91	41.6	2.08534
Switzerland	4.49	28.3	2.07173
Thailand	3.41	22.7	–0.16479
Turkey	2.07	32.1	–0.34887
U.K.	4.67	36.9	1.70652
U.S.A	4.47	19.9	1.40684

Table 2
The Variables
This table describes the variables collected for the 30 countries included in our study. We present the description and the sources from which each variable is collected.

Variable	Description	Source
1. Tax compliance	"Assessment of the level of tax compliance. Scale from 0 to 6 where higher scores indicate higher compliance. Data is for 1995." (La Porta et al. 1999)	The Global Competitiveness Report 1996 as reported in La Porta et al. (1999)
2. Bureaucracy	Percentage of tax government expenditures over gross domestic product for 1991–1995	World Bank sources
3. Control of corruption	Control of corruption score. Scale from –2.5 to 2.5 where higher scores indicates lower corruption	Kaufman et al. (2002)

Table 2 summarizes all the variables. They are computed as follows:

1. Tax compliance is measured by an assessment of the level of tax compliance that varies from 0 to 6. Higher scores indicate higher compliance (La Porta et al. 1999). The three highest scores are for Singapore (5.25), New Zealand (5.00) and Australia (4.58). The three lowest scores are for Italy (1.77), Philippines (1.83) and Sweden (1.91).
2. Bureaucracy is measured by the percentage of government expenditures over gross domestic product. Higher scores indicate higher bureaucracy. The three highest bureaucracies are for Israel (47.8), France (46.2) and Netherlands (45.9).
3. Corruption is measured by a "control of corruption" score obtained from Kaufman et al. (2002). It measures perceptions of corruption, conventionally defined as the exercise of public power for private gain. The scores are oriented so that higher values correspond to better outcomes, in a scale from –2.5 to 2.5. A higher index indicates lower corruption and higher control of corruption. It may be also understood as the lack of corruption. The three highest scores are for Denmark (2.12), Sweden (2.085) and Finland (2.084). The three lowest scores are for Indonesia (–0.79), Turkey (–0.34) and Argentina (–0.27).

Determinants of Tax Compliance Internationally

Table 3 presents the descriptive statistics for the main variables used in the study, while Table 4 presents the Pearson correlations among the same variables. Table 3 shows that there is a great variation among the countries in the sample for each of the variables included.

Table 3 Descriptive Statistics[a]

Variables	N	Mean	Std. Dev.	Minimum	Maximum
TC	30	3.410	1.010	1.770	5.050
GEGDP	30	29.822	10.505	9.300	47.800
COR	30	0.217	0.906	–0.798	2.129

[a]Variables are defined as follows:
TC: Tax compliance score
GEGDP: Government Expenditures over Gross Domestic Product
COR: Corruption score

Table 4 Pearson Correlation[a]

	TC	GEGDP	COR
TC	1.000	–0.064 (0.736)	0.582 (0.0004)*
GEGDP	–	1.000	0.526 (0.001)*
COR	–	–	1.000

[a]Variables are defined in Table 3
*Significant at 0.01 level

To examine the determinants of tax compliance, the following regression was used:

$$TC_i = \alpha_0 + \alpha_1 GEG_i + \alpha_2 COR_i + U_i$$

Where
TC_i = Tax compliance score for country i (La Porta et al. 1999)
GEG_i = Government expenditures over gross domestic product
COR_i = Control of corruption score for country i (Kaufman et al. 2002)
The results of the regression are presented in three columns of Table 5.

Column 1 of Table 5 presents the result of regressing tax compliance against the control of corruption score. As expected, the impact of control of corruption on tax compliance is positive and significant (t = 3.99, p = 0.01). This is in conformity with our thesis that the control of corruption creates a favorable tax morale, more conducive to tax compliance.

Column 2 of Table 5 presents the result of regressing tax compliance against both the control of corruption and bureaucracy. The impact of control of corruption is still positive and significant (t = 5.53, p = 0.01). The impact of bureaucracy is negative and significant (t = –3.05, p = 0.01). This is in conformity with our thesis that "bloated" bureaucracy creates an unfavorable tax morale, more conducive to noncompliance with taxes.

Column 3 of Table 5 adds the impact of the type of legal system. The legal system is used as a control variable with the added implication that tax compliance will be higher in common law countries. The impact of the legal system is positive and significant (t = 2.62, p = 0.05). The impact of both control of corruption and bureaucracy is similar to the findings in columns 1 and 2. Basically, as expected, tax compliance is positively related to control of corruption and negatively related to the level of bureaucracy, after controlling for the type of legal system.

The results of Table 5 rely on White's adjusted standard error estimates (1980) to deal with heteroscedasticity. The Wald test for joint significance is reported in the table. In addition, there is no evidence of serious multicollinearity among the independent variables. The RESET (regression specification error test), as suggested by Ramsey (1969) and Thursby (1981, 1985), and the Hausman test (1978), as suggested by Wu (1973) and Hausman (1978), were used as specification tests. The results of the RESET test, used to check for omitted variables, incorrect functional form, and nonindependence of regressors, show that the model used in this study is not misspecified (see diagnostic check statistics in Table 5).

Table 5 Determinants of Tax Compliance

Dependent Variable[a]	Tax Compliance TC		
Independent Variable	Model 1	Model 2	Model 3
Intercept	2.699 (11.76)*	3.779 (8.68)*	3.414 (5.99)*
COR	0.672 (3.99)*	0.923 (5.53)*	0.663 (3.73)*
GEGDP	–	–0.046 (–3.05)*	–0.032 (–1.72)***
CL	–	–	0.807 (2.62)**
R^2 adjusted	31.85%	49.89%	56.32%
F	15.95*	15.44*	11.32*
Wald test	0.01	0.01	0.01
Reset F value	0.04	0.05	0.06
Hausman F value	11.23*	11.24*	10.84*

[a]Variables are defined in Table 3. CL= Dummy variable with a value of 1 for common law countries and a value of 0 for civil law countries

*Significant at $\alpha = 0.01$; ** Significant at $\alpha = 0.05$ and *** Significant at $\alpha = 0.10$

Conclusions

This study examines the international differences in tax compliance and relates these differences to selected determinants of tax morale. The findings of the empirical investigation from 30 developed and developing countries indicate that tax compliance is highest in the countries characterized by high control of corruption and low size of bureaucracy. It shows that a powerful deterrent is the creation of a tax morale or climate, where citizens are protected from corruption and "bloated" bureaucracies. This is an important result for the developing countries where the lack of tax compliance and the resulting low revenues can drastically hamper economic development. It is very urgent for the developing countries to reduce both the corruption and the bureaucracy in order to create the type of tax morale conducive to both tax compliance and economic development.

This study is a levels study as opposed to a changes study. One could argue that changes in tax compliance are sensitive to changes in bureaucracy and corruption in addition to the levels of current bureaucracy and corruption. Future research that can secure data on changes on tax compliance could include both forms of the variables, levels and changes, in a replicated study.

This study may also acts as an anchor for examining the myriad of potentially correlated omitted variables in this study. Examples may include: cultural differences regarding tolerance to bureaucracy; cultural differences regarding tolerance to corruption; the relation between the government and the population (democratic versus nondemocratic regimes); differences in tax regimes that impact taxpayer compliance; differences in national wealth that affect compliance; popularity of government with the population, to name only a few. Future research needs to address the relevance of these and other factors to the thesis of this study.

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2

Enlarging the European Union: Taxation and Corruption in the New Member States*

M. Peter van der Hoek

Introduction

It was only 18 years ago that the Berlin Wall fell. Anyone who predicted at the time that the former East Bloc states would join the European Union within 18 years was considered to be a dreamer. However, after decades of communism and Soviet domination the countries in Central and Eastern Europe wanted to return to Europe, as the then Czech president Vaclav Havel put it. The European Union responded promptly and positively by encouraging the former socialist countries' reorientation to the West. As early as 1989 the European Union set up the Phare[1] program to offer financial support to the countries of Central Europe and to help them cope with drastic economic restructuring and political change. The fact that this process started with Poland and Hungary seems quite logical, since they were the first of the former East Bloc countries to distance themselves from their communist past. The German unification in 1990 marked the end of the historic division of Europe resulting from the Yalta negotiations of the allies who defeated Germany in World War II.

In 1991, Poland and Hungary were the first countries to conclude Europe Agreements with the European Union. Again, they were the front-runners in Central and Eastern Europe. The aim of the agreements was to establish a free trade area between the European Union and the associated countries. In 1993, Agreements were also concluded with Bulgaria, the Czech Republic, Romania and Slovakia. Estonia, Latvia and Lithuania fol-

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[1] Phare is the acronym for Poland Hungary Assistance for Reconstruction of the Economy.

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lowed in 1995 and Slovenia in 1996. Next, the associated countries applied for European Union membership.

In 1992, the European Council adopted the now well-known Copenhagen criteria that candidate member countries will have to meet to a sufficient number of benchmarks before accession negotiations can begin. The benchmarks comprise political, economic and administrative criteria. In 1997, the European Council invited five Central and Eastern European countries (Hungary, Poland, Estonia, the Czech Republic and Slovenia) to start accession negotiations. Also, the European Union developed a pre-accession strategy assisting the associated countries to prepare themselves for membership.

By inviting only five countries to open accession negotiations the European Council divided the ten accession countries in Central and Eastern Europe in a first wave (the five above-mentioned countries) and a second wave (Bulgaria, Latvia, Lithuania, Romania, and Slovakia). In 1999, however, the European Union effectively abolished the concept of accessions in two waves by also inviting the other countries to start accession negotiations. As a result, the European Union engaged in simultaneous accession negotiations with all candidate member countries (including the two Mediterranean mini-states, Cyprus and Malta, but excluding Turkey).

In December 2002, the European Council closed negotiations with ten candidate member countries. As a result, they joined the European Union on May 1, 2004, and the European Union's membership increased from 15 to 25 countries. Eight of the new member countries are former East Bloc states including three former soviet republics (the Baltic States: Estonia, Latvia and Lithuania) and five countries in Central and Eastern Europe (Hungary, Poland, Slovenia, Slovakia, and the Czech Republic). The other two countries that joined the European Union are mini-states in the Mediterranean (Cyprus[2] and Malta). Accession negotiations with Bulgaria and Romania continued and resulted in their accession on January 1, 2007. In addition, there are three candidate member countries (Croatia, Macedonia and Turkey). Two of them (Croatia and Turkey) have already begun accession negotiations. Albania and the other former Yugoslav republics that are not yet (candidate) member countries are potential candidate member states.

[2] Since Turkey occupied the north of the island in 1974, Cyprus is divided in Turkish Cypriot and Greek Cypriot communities. The Turkish Republic of Northern Cyprus is only recognized by Turkey. Officially, Cyprus joined the European Union as one country. Effectively, however, only the Greek Cypriot community joined.

Accession and Economic Conditions

The accession of the former East Bloc countries has progressed surprisingly fast. It seems questionable, therefore, whether they were ready for European Union membership in all respects. The Treaty on European Union says in Article 49 that “any European State which respects the principles set out in Article 6(1) may apply to become a member of the Union.” Article 6(1) states that “the Union is founded on the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law, principles which are common to the Member States.” The Copenhagen European Council has made the principles set out in Article 6(1) of the Treaty on European Union more concrete. These so-called Copenhagen criteria comprise a political criterion, an economic criterion, and the ability to take on the *acquis communautaire*:

1. Stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities.
2. The existence of a functioning market economy, as well as the ability to cope with competitive pressures and market forces within the European Union.
3. The ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

The answer to the question whether candidate member states meet these criteria is political in nature and, thus, open to political interpretation. The impression has been raised that political pressure to keep the enlargement process going has prevailed in a number of cases and that in fact not all new member states sufficiently meet the Copenhagen criteria. The level of economic development is generally still very low (and the unemployment rate very high), while the administrative capacity is often still very limited. The political criterion—democracy, the rule of law, human rights, etc.—together with geopolitical considerations seem to have settled the matter in a number of cases. The new member states in Central and Eastern Europe have little experience with a market system and the decision-making processes in Brussels. However, the European Union’s eastern enlargement is a fascinating adventure that undoubtedly will lead to more stability in Europe and a reduction of the risk of wars within the area to zero. That was precisely the main driving force behind the creation of the European Union’s predecessors in the 1950s.

Approximately half of the new member states still cope with budget deficits that exceed 3% of GDP (the Maastricht criterion). Figure 1 shows the budget deficits in the period 1991–2007 in the three regions that the European Bank for Reconstruction and Development (EBRD) discerns: Central and Eastern Europe and the Baltic States, South Eastern Europe, and the

Commonwealth of Independent States.[3] In the first years after the collapse of the Soviet Union budget deficits increased to high levels. The highest level was reached in the Commonwealth of Independent States, it was somewhat less high in South Eastern Europe and the relatively lowest level was reached in Central and Eastern Europe and the Baltic States. From the mid-1990s, deficits came more and more under control. Notably, from 2000 a kind of role reversal emerged. Deficits are now at the highest level in Central and Eastern Europe and the Baltic States and at the lowest level in the Commonwealth of Independent. However, the average deficit in the Commonwealth of Independent States is heavily influenced by the large surpluses in oil-rich countries like Russia (8.1% in 2005) and Kazakhstan (5.3% in 2005). The differences among individual countries are also large in Central and Eastern Europe and the Baltic States, where general government balances in 2005 varied from a surplus of 2.3% of GDP in Estonia to a deficit of 7.8% in Hungary, while estimates for 2006 and 2007 do not fundamentally change the picture.

Table 1 Cumulative Inflows of Foreign Direct Investments Per Capita (US$), 1989–2006

New member states		
1.	Czech Republic	5,512
2.	Estonia	5,098
3.	Hungary	4,545
4.	Slovakia	3,194
5.	Latvia	2,203
6.	Poland	2,123
7.	Lithuania	1,669
8.	Bulgaria	1,575
9.	Slovenia	1,333
10.	Romania	1,110
Candidate member states		
1.	Croatia	3,177
2.	Macedonia	814

Source: EBRD

There are also considerable differences in attractiveness of the new member states for foreign investors. Table 1 displays the cumulative inflows of foreign direct investments since the fall of the Berlin Wall in each of the new member states in Central and Eastern Europe and the Baltic States as

[3] Central and Eastern Europe: Czech Republic, Hungary, Poland, Slovakia and Slovenia.
South Eastern Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia.
Baltic States: Estonia, Latvia and Lithuania.
Commonwealth of Independent States: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

well as in the candidate member countries in South Eastern Europe. Given the differences in population size the table does not contain the total amounts of foreign direct investments, but rather the amounts per capita. Obviously, the Czech Republic is the foreign investors' darling. Notable is the second place of Estonia. As a former soviet republic its starting position was considerably weaker than those of the other countries of the former East Bloc. Contrary to Poland's image in the popular press and with the public at large this country has attracted a mediocre amount of foreign direct investments in the period 1989–2006. Also notable is that Croatia scores relatively high with an amount of foreign direct investments that matches Slovakia's, which is number four on the ranking list of foreign direct investments in the new member states. On average, Central and Eastern Europe and the Baltic States have attracted $3,030 per capita in the period 1989–2006, which is nearly two times as much as South East Europe's average ($1,658).

Tax Capacity and Tax Effort

Since most countries in the region cope with continued budget deficits, as Fig. 1 illustrates, the question arises as to how these countries can tackle their deficit problems. In principle, governments have a choice between two strategies: increasing revenues or cutting expenditure. It goes without saying that a combination of both strategies is also possible. The question arises on what basis a government can make a choice. In other words, at what point should the emphasis be placed on cutting expenditure rather than raising revenues?

Answering this question involves evaluating a country's tax capacity and tax effort. *Tax capacity* is defined as the ability of a government to raise tax revenues based on structural factors including the level of economic development, the number of "tax handles" available, and the ability of the population to pay taxes (Chelliah 1971, p. 293). *Tax effort* is defined as a measure of how well a country is using its taxable capacity, that is tax effort is the ratio of actual tax revenues to taxable capacity (Bahl 1971, p. 582). Indices of tax effort provide a tool for measuring differences between countries in how effectively they are using their potential tax bases. These indices may indicate the appropriate policy for dealing with budget deficits. For example, countries with a high tax effort index may need to look at reducing expenditure rather than raising taxes (Stotsky and WoldeMariam 1997).

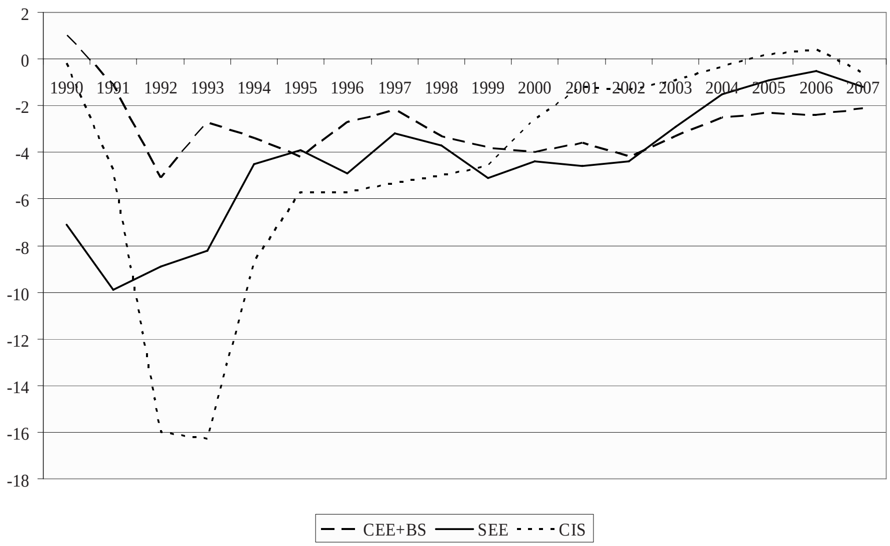

Fig. 1 General government balances (in % of GDP), 1991–2007. Estimates for 2006 and 2007. *Source*: EBRD

Figure 2 shows general government revenue as a percentage of GDP over the period 1996–2004 in the three regions, while it includes as benchmarks the USA and the EU-15 (the European Union of 15 member states as it existed before May 1, 2004). In Central and Eastern Europe and the Baltic States, the tax burden is comparable to that of the EU-15 and, thus, well above the level of the USA. In the mid-1990s, South Eastern Europe's tax burden was well below the level of the EU-15 and even lower than the level of the USA, but it increased in the late 1990s. From the turn of the century tax levels in Central and Eastern Europe and the Baltic States and South Eastern Europe are on average within the range of European Union countries, which is roughly 30–55% of GDP (van der Hoek 2003, p. 22). Though large differences exist across individual countries, only one of the new member states has a tax/GDP ratio below this range. The total tax level in Lithuania amounted to 27.4% in 2004, but it was somewhat higher in previous years. Slovenia's tax/GDP ratio amounted to 45.4% in 2004, which was the highest of the accession countries in Central and Eastern Europe and the Baltic States. In two other accession countries (Hungary and Slovakia) the tax burden in 2004 was also over 40% (nearly 45%). In particular in the period 1997–2000 the total tax level of Slovakia was considerably higher than in 2004.

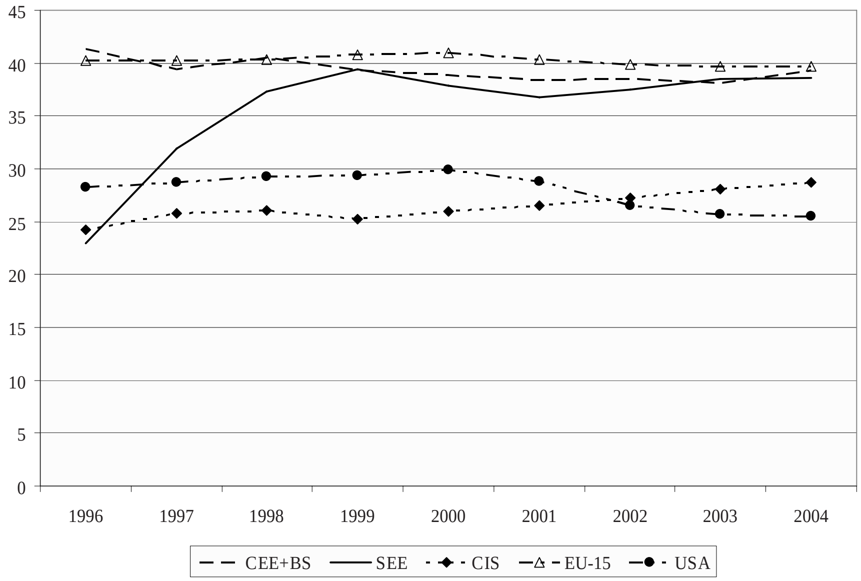

Fig. 2 General government revenue (in % of GDP), 1996–2004. *Source*: EBRD and OECD

In the Commonwealth of Independent States the situation with regard to the tax burden is the reverse. As can be expected, these countries face the greatest taxation problems. They have been under communist rule for over sixty years. The state financed itself through state-owned companies rather than taxation, so the countries in this region have little experience with taxation and markets. No wonder that they are the only of the three regions where the total tax level is clearly below the range of tax burdens in the member states of the European Union. Until the early 2000s it was even lower than the level of the USA. In 2004, five of the Newly Independent States had a tax/GDP ratio that fell within the range of European Union countries (Uzbekistan with 32.3%, Moldova with 34.7%, Ukraine with 35.6%, Russia with 38.6% and Belarus with 46.2%).

Approaches to Tax Capacity

It seems relevant to know how well the new European Union member states are utilizing their tax capacity. Musgrave (2000) identifies three factors that determine a country's taxable capacity:

- The stage of development, often measured by per capita income.

- The existence and extent of “tax handles.”
- Efficacy of tax administration.

Each of these factors contributes either to a country’s potential taxable base (for example the greater the level of economic development the higher the income tax base) or contributes to the accessibility to that tax base by the government. For example, an economy with a sizable and established manufacturing sector has more easily identifiable and accessible taxpayers than an economy that is largely agricultural or comprised of many small traders. A well-developed manufacturing sector points to the existence of a “tax handle.”

A simple measure of tax effort across countries might compare countries’ tax/GDP ratios, but such comparisons would ignore differences in tax capacity across countries. Countries differ with respect to their economic situations, for example per capita income, economic structure, resources, and other factors. These differences must be accounted for when measuring tax effort. Another approach, therefore, is using regression analysis across countries to predict a country’s tax/GDP ratio (Bahl 1971; Chelliah 1971; Stotsky and WoldeMariam 1997; Tait et al. 1979; Tanzi 1968, 1992).

A tax effort index can be developed as the ratio of actual tax share to the predicted tax share. An index of 1 means the country’s tax effort is at the “expected” level, given the structural factors of that country. In other words, the country is using its taxable capacity at a level consistent with the average of the other countries in the sample. By comparing tax effort across similar countries, it may be possible to identify countries that have the potential to increase tax revenues through increased tax effort. Alternatively, countries may be identified where tax effort is already relatively high and it would be more obvious to closely examine the expenditure side of the budget in order to reduce the budget deficit.

Table 2 Deviation of Actual Tax Share from Predicted, as a Percentage of Predicted, 1992–2000

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Albania	–4.7	17.2	15.4	14.8	–12.2	–10.6	3.3	0.4	12.0
Bulgaria	–3.5	–19.1	–8.9	–15.8	–	–6.9	–1.4	–10.1	–13.4
Croatia	–	–	21.0	22.8	21.6	17.7	25.7	10.6	7.9
Czech Republic	–	11.0	8.6	7.7	5.4	–2.0	–4.4	–2.0	–
Hungary	4.4	9.1	2.3	10.4	5.6	1.9	1.0	–	–
Macedonia	–	–	–	–	–4.1	–7.0	–10.6	–8.7	–
Poland	–3.1	3.6	–2.3	–4.2	–6.1	–8.3	–11.6	–14.7	–16.6
Romania	8.8	5.1	–5.9	–3.5	–9.8	–14.6	–15.7	–10.1	–14.9
Slovakia	–	–	–5.3	3.7	2.1	–5.9	–9.2	–14.3	–
Slovenia	–	11.6	9.7	8.0	5.5	3.7	4.0	6.2	1.7

Source: Mertens (2003, p. 548)

A study by Mertens (2003) uses a regression approach covering the period 1992–2000 and including data for ten countries in Central and Eastern Europe and South Eastern Europe: Albania, Bulgaria, Croatia, the Czech Republic, Hungary, Macedonia, Poland, Romania, the Slovak Republic, and Slovenia. Notably, this sample does not include all new European Union member countries. Rather, it comprises seven new member states, two candidate member countries (Croatia and Macedonia) and one potential candidate member state (Albania). A very interesting dimension of this study is that it presents a ranking based on each country's deviation between its actual and predicted tax/GDP ratio. Table 2 summarizes the results. The value of –14.9% for Romania in 2000 means that the country's actual revenue share was 14.9% lower than that predicted by the model. To my knowledge there are no comparable data available for the "old" member states of the European Union. To obtain them would require a separate research study because they will have to be calculated on the basis of a regression analysis.

The results of the Mertens study suggest that in several Central and Eastern European and South Eastern European countries—especially Bulgaria, Poland, Romania and Slovakia—deficit reduction is possible through increasing tax effort. The European Commission may use this kind of information to assess to what extent these countries prepare themselves for membership of Economic and Monetary Union. As the new member states have to accept the principles of Economic and Monetary Union, they will have to meet the Maastricht criteria regarding inflation, real interest rates, budget deficits, public debt and exchange rate stability. Contrary to the "old" member states, the new member countries do not have the latitude to opt out of Economic and Monetary Union. The European Commission may use the data pertaining to tax effort in particular in relation to the Stability and Growth Pact's budget deficit criterion.

Future Research

The study cited above (Mertens 2003) points out some possible avenues for further research. Countries in Central and Eastern Europe and South Eastern Europe have had myriad tax law changes as well as major tax reform efforts during the 1990s. Reviewing these events may shed light on what is happening with tax effort in Central and Eastern Europe and South Eastern Europe. For example, Slovenia and Croatia consistently have tax effort indices above one, while both have positive deviations from predicted tax shares for each year. These two countries have many factors in common, including a steady approach to tax reform. Slovenia introduced a new income tax law in 1994, a new tax administration law in 1997, and the VAT in 1999. Croatia began in

1993 creating its tax service, introduced income taxes in 1994 and the VAT in 1998. Because tax administration is an important component of tax effort, further examination of these relationships is warranted.

However, there is another factor that warrants further examination: corruption. Though it is a phenomenon that is not easy to study, data are available about perceived corruption levels in a large and growing number of countries. Transparency International, a Berlin based institution, publishes an annual Corruption Perceptions Index for a growing number of countries. The scores range between 10 (highly clean) and 0 (highly corrupt) and relate to perceptions of the degree of corruption as seen by business people and risk analysts. Respondents expressed their perceptions in surveys assessing a country's performance. At least three surveys are required for a country to be included in the Corruption Perceptions Index. Therefore, in its 2006 index Transparency International could include only 163 of the more than 200 sovereign nations.

Table 3 Corruption Perceptions Index, 1996–2006

		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
1.	Finland	9.1	9.5	9.6	9.8	10.0	9.9	9.7	9.7	9.7	9.6	9.6
9.	Australia	8.6	8.9	8.7	8.1	8.3	8.5	8.6	8.8	8.8	8.8	8.7
11.	UK	8.4	8.2	8.7	7.2	8.7	8.3	8.7	8.7	8.6	8.6	8.6
16.	Germany	8.3	8.2	7.9	6.2	7.6	7.4	7.3	7.7	8.2	8.2	8.0
20.	USA	7.7	7.6	7.5	7.5	7.8	7.6	7.7	7.5	7.5	7.6	7.3
24.	Estonia	–	–	5.7	5.7	5.7	5.6	5.6	5.5	6.0	6.4	6.7
28.	Slovenia	–	–	–	6.0	5.5	5.2	6.0	5.9	6.0	6.1	6.4
41.	Hungary	4.9	5.2	5.0	5.2	5.2	5.3	4.9	4.8	4.8	5.0	5.2
45.	Italy	3.4	5.0	4.6	4.7	4.6	5.5	5.2	5.3	4.8	5.0	4.9
46.	Czech Rep.	5.4	5.2	4.8	4.6	4.3	3.9	3.7	3.9	4.2	4.3	4.8
	Lithuania	–	–	–	3.8	4.1	4.8	4.8	4.7	4.6	4.8	4.8
54.	Greece	5.0	5.4	4.9	4.9	4.9	4.2	4.2	4.3	4.3	4.3	4.4
49.	Latvia	–	–	2.7	3.4	3.4	3.4	3.7	3.8	4.0	4.2	4.7
	Slovakia	–	–	3.9	3.7	3.5	3.7	3.7	3.7	4.0	4.3	4.7
57.	Bulgaria	–	–	2.9	3.3	3.5	3.9	4.0	3.9	4.1	4.0	4.0
61.	Poland	5.6	5.1	4.6	4.2	4.1	4.1	4.0	3.6	3.5	3.4	3.7
69.	Croatia	–	–	–	2.7	3.7	3.9	3.8	3.7	3.5	3.4	3.4
84.	Romania	–	3.4	3.0	3.3	2.9	2.8	2.6	2.8	2.9	3.0	3.1
105.	Macedonia	–	–	–	3.3	–	–	–	2.3	2.7	2.7	2.7
111.	Albania	–	–	–	2.3	–	–	2.5	2.5	2.5	2.4	2.6
121.	Russia	2.6	2.3	2.4	2.4	2.1	2.3	2.7	2.7	2.8	2.4	2.5
163.	Haiti	–	–	–	–	–		2.2	1.5	1.5	1.8	1.8

Source: Transparency International

Table 3 shows the amount of perceived corruption over time in selected countries. In 2006, Finland was perceived as the cleanest country and Haiti as the most corrupt. Table 3 includes new European Union member states (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia) as well as two candidate member countries (Croatia and Macedonia). In addition, it includes Russia, several large western countries (Australia, Germany, UK and USA), the two most corrupt "old" European Union member states (Greece and Italy) and a potential candidate member state (Albania).

Politicians pay lip service to the fight against corruption, but they fail to clamp down on corruption to break the vicious circle of poverty and graft. Corruption seems a self-sustaining phenomenon, since anti-corruption measures tend to be adopted where they are needed least: in countries that do not have particularly serious corruption problems (Steves and Rousso 2003, p. 28). Transition countries with low levels of administrative corruption have been more likely to adopt intensive anti-corruption programs than countries with high levels of administrative corruption.

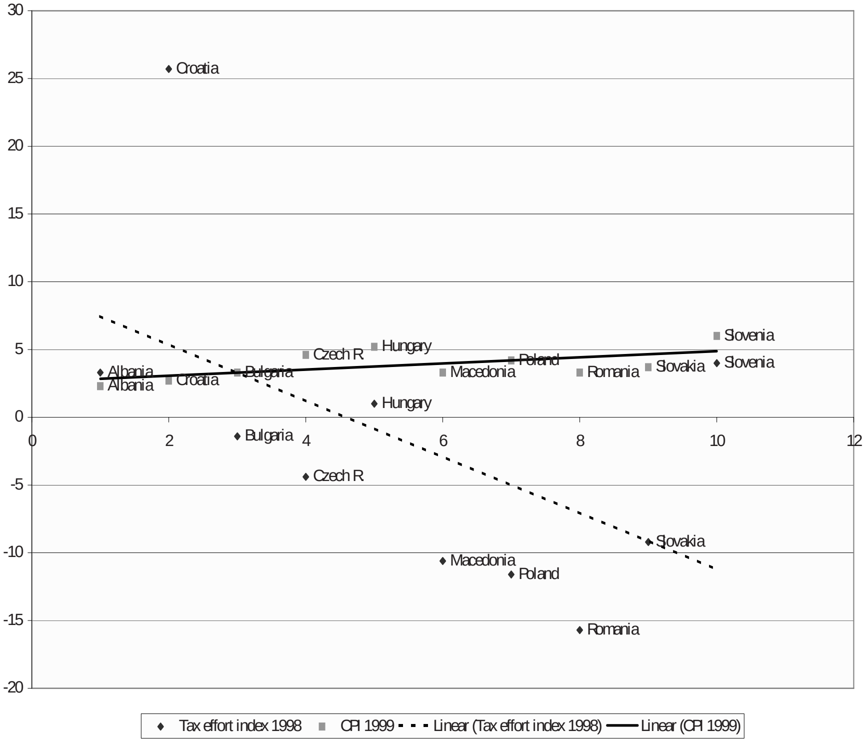

Fig. 3 Corruption perceptions index and tax effort, 1998/1999. *Source*: Transparency International and Mertens (2003)

The low scores for countries in Central and Eastern Europe, the Baltic States and South Eastern Europe—with Estonia and Slovenia as notable exceptions—indicate that doing business in these countries is not only subject to normal business risks, but also to additional risks resulting from corruption. As a result, businesses face additional uncertainties. Particularly worrying is that the amount of perceived corruption does not diminish over time in half of the new member countries. Rather, it remains more or less stable (Bulgaria, the Czech Republic, Hungary and Romania) or even grows (Poland). It seems plausible that a negative relationship exists between corruption and economic development in general. Corruption creates additional risks for businesses and disturbs market signals hampering economic growth. More in particular, negative relationships seem plausible between corruption and tax effort on the one hand and corruption and foreign direct investments on the other hand. Corrupt tax inspectors fill their private pockets rather than the public purse, while corrupt officials make foreign direct investments more risky.

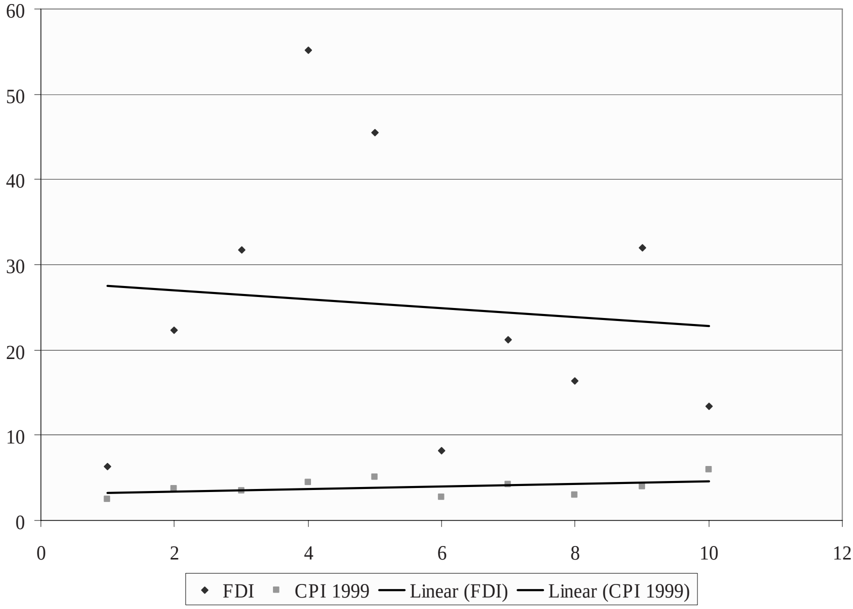

Fig. 4 Corruption perceptions index and foreign direct investments, 1989–2006. *Source*: Transparency International and EBRD

However plausible these hypotheses are, I have found only very weak empirical evidence supporting the hypotheses of negative relationships between corruption and tax effort and between corruption and foreign direct investments. Figure 3 displays how the data pertaining to the Corruption Perceptions Index and tax effort were related in 1998/1999. This figure suggests there is no relationship at all. Figure 4 shows how the averages of the data pertaining to the Corruption Perceptions Index in the period 1996–2006 relate to the average foreign direct investments data in the period 1989–2006. This figure suggests there might be some weak relationship between the two variables. Therefore, it seems worth doing more research in this area in future to unravel a possible relationship between foreign direct investments and the extent of corruption.

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3

No Taxation with or without Representation: Completing the Revolutionary Break with Feudalist Practices

Tibor R. Machan*

Introduction

Taxation is a vestige of feudalism and monarchy. It persists because of the mistaken belief that government is somehow entitled to a portion of our labor or assets. This chapter challenges that belief from a philosophical perspective and offers a different viewpoint.

Taxes are bad. It's not just taxation "without representation" that is destructive and unjust. It's taxes, period.

The American Revolution constituted a principled rejection of monarchy and feudalism. It established that individual human beings, not rulers or government, are sovereign; that individuals have rights to "life, liberty, and the pursuit of happiness"; that government exists only to safeguard, not routinely violate, these rights.

But the revolution is not complete.

A Feudal Vestige

Through most of history, governments—usually monarchies headed by kings, emperors, pharaohs and sundry other tyrants—legally owned everything under their rule, including the people. We are all children of God. So the king, as God's surrogate, was routinely, though not uniformly, thought to be justified in taking the same stance as God toward us here on earth. In those regimes the population was regarded as subjects, not citizens. They were treated as the

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underlings, subject to the will of the ruler. To the extent that they were allowed to go about their business, it was by sufferance, not by right.

In these social systems the institution of taxation was a cruel method of outright subjugation, perpetrated by rulers upon their subjects. Because the rulers owned everything, subjects living on the land had to pay for this privilege. When they transformed nature into something useful for human life, the fruits of that work belonged to the king. In such a context, taxation made sense—what is produced is collected as taxes, with the people allowed to keep enough to keep working for the king. These subjects thus enjoyed no legal right to the land they worked; no legal right to their own labor; no legal protection of the basic rights of individuals.[1]

Gradually this absolute power began to be checked and contained, as the idea spread that people in government are human beings after all, not gods or divinely anointed surrogates. It dawned on many that the rulers had no (divine) right to rule anyone other than themselves. Indeed, between the eleventh and the eighteenth centuries, the idea began to gain headway that every human individual possesses a basic, natural right to his life, liberty and property. Anyone wanting to gain the benefit of another's work or other assets would have to ask for it. Sovereignty lay with individuals, not the state.

But though we in the U.S.A. no longer believe in feudalism and the divine right of kings, many of the features of monarchies gained a life of their own even after monarchies were abolished or at least relegated to ceremonial status. Taxation is one such relic, a particularly corrosive one. It persists as a legacy of feudal "rent" taking, with rationales that continue to regard citizens as serfs.

The American Revolution affirmed that kings and such possess no such divine rights and that the individual is sovereign. But the Founding Fathers didn't finish the job. Instead of transforming public finance from a coercive to a voluntary system, the framers left taxation intact, albeit with the proviso that there at least be representation along with it. Those who love government more than individual rights have exploited this anomaly to expand the state. It is not surprising. Whenever one compromises a principle, the compromise eventually threatens to devour the principle altogether. (This is why ethics counsels us against even little white lies—it corrupts character, and makes it easier to tell the next lie.) Sadly, there remain many apologists for continuing one of the feudal era's worst practices. Instead of finding a just, humane way to fund legal services, these denizens of government and universities struggle to convince us that when government steals our wealth, it has a right to it.

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[1] There are today some political theorists and legal scholars who are intent on reintroducing just this rationale for taxation, claiming that individual rights are grants from the government, not based on human nature, having no pre-political foundation. See, for example, Stephen Holmes and Cass Sunstein, *The Cost of Rights, Why Liberty Depends on Taxes* (New York: W. W. Norton, 1999), and Liam Murphy and Thomas Nagel, *The Myth of Ownership* (New York: Oxford University Press, 2002).

If there was ever one who stated unambiguously the neo-feudal case for the institution of taxation, it was August Comte, the father of modern sociology and an avid champion of socialism. Defending a secular version of divine right, Comte argued that everything we have belongs

> to Humanity…. Positivism never admits anything but duties, of all to all. For its social point of view cannot tolerate the notion of right, constantly based on individualism. We are born loaded with obligations of every kind, to our predecessors, to our successors, to our contemporaries. Later they only grow or accumulate before we can return any service. On what human foundation then could rest the idea of right, which in reason should imply some previous efficiency? Whatever may be our efforts, the longest life well employed will never enable us to pay back but an imperceptible part of what we have received. And yet it would only be after a complete return that we should be justly authorized to require reciprocity for the new services. All human rights then are as absurd as they are immoral. [To live for others], the definitive formula of human morality, gives a direct sanction exclusively to our instincts of benevolence, the common source of happiness and duty. [Man must serve] Humanity, whose we are entirely.[2]

It is this view more than any other which now is invoked to support the belief that taxation is just: that from birth to death everyone is obligated to pay with some portion of his life for whatever benefits of society he may enjoy. On this view, we are in bondage from the start, with no question about whether we have voluntarily assumed our debts.

With or Without Representation

If the American Founders had accepted the notions of those intellectuals who enthusiastically endorse the institution of taxation in even its most abusive manifestations, there would be no United States of America, the bastion of individual liberty in the world. There would be no glimmer of hope of extending its ideas to further regions of human life. But more than two centuries ago, the leaders of this country had the revolutionary courage to call for more liberty for its citizens than those in other countries had. This call has by now been seriously eclipsed by the call of the most prominent of our

[2] August Comte, *The Catechism of Positive Religion* (Clifton, NJ: Augustus M. Kelley Publ., 1973), pp. 212–230.

current intellectuals and leaders. These leaders do not even see the point of mentioning, let alone expanding, the protection of individual liberty.

Of course, calling for liberty didn't always suffice, which is why slavery had to be abolished, for example, and why there is so much more work to be done along lines laid out in the Declaration of Independence. But all in all, despite certain compromises and failures, the call for more individual liberty has been one of the cornerstones of America's uniqueness. One thing the Founders failed to do—I am not sure whether they even considered it—was match the system of financing the government to their new idea about the relationship between citizen and that institution. It was clear to them that, properly understood, government is hired by the people and is not their ruler. But that also means that government does not own the products of the people's labor and enterprise.

The Founders didn't abolish taxation as they should have. But they did try to ensure that taxation is never imposed without full and proper representation in government. They believed this would guard against any eager-beaver tax and spend policy. It was the famous pre-Revolutionary patriot James Otis who said, "Taxation without representation is tyranny," and it became one of the revolution's rallying cries. By now, however, the American tax system does not even adhere to this less overarching power-curbing principle. Today the tax policies of the United States of American are more bloated and tyrannical than those of George III, against whose government the Founders waged their revolutionary war.

The idea of no taxation without representation has been nearly forgotten. Today, throughout the country, people who cannot vote on tax measures affecting them are nonetheless taxed more and more—in hotels, restaurants, airports, stores, business of all kinds. Government even taxes members of future generations, ones certainly not represented in Congress. Some taxes are imposed directly by regulatory agencies, without approval from Congress (and of course, many of the regulations of these agencies are expensive to comply with and constitute a kind of de facto tax). What is far worse, but to be expected, given the logic of such processes, is that instead of confining taxation to financing the only proper function of government, "to secure [our] rights," taxation is now used to fund virtually every kind of project the human imagination can conceive and the supporters of which can be favored by politicians.

The public has been persuaded to believe that taxes are absolutely necessary. So they have taken their eyes off their own money to the extent that they don't bat an eyelash over this abomination. You will notice, if you travel about, that only in America does the sales tax get added to the prices and wages being charged in trade. In other countries, which are much more closely linked to various monarchical eras, no such separation is in evidence. That is because in America, for a while, it was at least important to keep in mind that government is seizing our wealth, that it is ours and doesn't automatically belong to it. But even that little gesture is in danger of disappearing, what with so many hidden taxes on the books in our time.

Were we at all loyal to the letter, let alone the spirit, of the revolutionary idea of the Founders, we would long ago have switched from taxation to some truly voluntary means of funding government. With a return to the limited role government was to have played in our lives, this would be no idle dream—scholars and other thinkers have conceived of such voluntary systems and found them promising.[3] But instead of working to complete the Founders' revolution, politicians and their intellectual apologists have driven us further and further from it. All we have left of the spirit of the American Revolution is a little bit of rhetoric. And that is all that will remain—perhaps even vanish in time—unless the ideas and ideals of the Founders are recovered.

In fact, taxes have no place in a free society. In such a society one has inalienable rights—rights that can never be justly violated—to life, liberty and the pursuit of happiness, among other rights. And if that's true, some other means must be found to pay for legal services. For free adult human beings, government can only be a hired agent, even if a powerful one (something like a bodyguard or an arbitration agency). Its services, however, must be provided not by imposing them on citizens—i.e., the feudal and despotic approach—but on a voluntary basis, for a reasonable charge. That is the only way to prevent the legal authorities from exercising arbitrary power. Otherwise, like organized criminals, government will become not a hired agent but an extortionist and paternalistic bully, lording over us. In a democratic context this is mitigated a bit by the fact that some measure of collective consent is sought from the citizenry. But as the American experience shows, this helter-skelter check and balance is hardly adequate to constrain the power of government. If taxes were abolished, our governors could be held more accountable and their power could be limited.

Alas, the idea of a tax-free society is too radical to even be considered by those who set the terms of mainstream public policy discussions, so few will consider the alternative. The bulk still accept some version of the perverse view that government owns everything and that no one ought to challenge what it decrees should be done with its property.

An Extortion Racket

But isn't it the case that, to quote Justice Oliver Wendell Holmes, Jr., "Taxation is the price we pay for civilization?" It has a nice ring to it, but it's

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[3] See, for example, Tibor R. Machan, "Dissolving the Problem of Public Goods: Financing Government Without Coercive Measures," in T. R. Machan, ed., *The Libertarian Reader* (Lanham, MD: Rowman & Littlefield, 1982), pp. 201–208, and Ayn Rand, "Government Financing in a Free Society," in E. S. Phelps, ed., *Economic Justice* (Baltimore: Penguin Books, 1973), pp. 363–367.

a ruse. It was asserted by a man who had no sympathy at all for limited government.

"And what is the state but a servant and a convenience for a large number of people, just like the electric light and the plumbing system? And wouldn't it be preposterous to claim that men must exist for their plumbing, not the plumbing for the men?" asks one character in Ayn Rand's first novel, *We The Living*.[4] What folks don't seem to understand is that a truly just society is a place where people can live without having to suffer denial of their basic humanity. Being human is a matter of making moral choices about one's own life, which is why we need freedom; to be oppressed by others is to directly thwart that moral decision-making. That is why slavery was such a vicious institution, an assault on human dignity. That is why any kind of coercion must be banned. People require, for their flourishing, to be free. When our freedom is impeded, even just a little bit, our humanity is under assault.

The fact that for most of human history people lived under oppression doesn't undermine the moral point I am making here. Throughout history there has also been theft, rape, robbery, murder, assault and all kinds of related evils; yet no one would seriously argue that these are just part of the price we pay for civilization. It is clear-cut enough that these practices are evil.

Yet what is taxation but the coercive imposition of an ongoing, heavy burden on persons without their consent? It is the same type of thing that burglars, robbers, embezzlers and all others do when they confiscate wealth from its rightful owners. These criminals, too, believe that they, not the rightful owners, ought to decide how the loot should be deployed. They do not necessarily devote all the loot to personal comforts, either—they may well spend it on projects that benefit others or some worthy cause. There is no telling ahead of time where the loot will go. What we know for certain is that those who do the looting want to determine this themselves.[5]

But, didn't "we" enter into a social compact that resulted in the tax system we have? No, not if we indeed possess inalienable rights to life and liberty. No contract can obligate contracting parties to forfeit anyone's rights. I certainly may not contract that you lose your rights. A contract may only be entered into voluntarily—unwilling third parties may not be conscripted into it. If, as in the case of the United States, a society is grounded on inalienable individual rights, the only way government can come about is through the

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[4] (New York: Signet, 1996), p. 72. Perhaps "servant" is misleading—more on the order of a hired professional, like a dentist or attorney. Government is an organization for the purpose of rights protection, as medicine is for health protection or education is for advancement of knowledge. All are to benefit human beings who employ their professionals.

[5] The theory that people will tolerate considerable taxation before they revolt is supported by ordinary psychology. They will do the same with out and out burglary, for a while, after which they will stop producing unless it is stopped. It is no argument in support of taxation that many do not take to the streets about it—often it simply doesn't pay to protest wrong-doings.

"consent of the governed." And while this concept had been understood too loosely, even by the American Founders, its meaning is clear: you and I must consent to be governed.[6]

In a sense, of course, we do thus consent if we remain within the legal jurisdiction of a just government; but only to the extent that its governance is in fact just. It is the just powers only of government that we can sanction, and taxation isn't one of the just powers of government. To be properly funded, some other means—but in any case a voluntary means—must be found. But since this is a very novel idea—about as novel even in the United States as free markets are in the former Soviet bloc countries or freedom of religion in Iran—studies on to how to do so are in short supply. (And most universities are tax-funded, so they aren't too likely to encourage alternative ways of funding government!)

Sure, there are police and judicial services that make living free from violent intrusion more likely. These services cost something. But civilized life requires that we pay and obtain these services only if we choose to do so. We should, if we want, be free to try doing without the services and suffer the consequences. In practice, most of us would not try to live without cops, courts, and the military, all of which make working, owning property, and trade feasible and convenient. But we can arrange to obtain these services without using force. We don't need to be subjected to extortion and coercion in order to be defended from extortion and coercion; that's how the mob operates.

Like all extortion, taxation is difficult to fight. Furthermore, in the case of taxation the very people on whom we rely to combat criminal extortion are the enthusiastic extortionists themselves. They are the judges, politicians, police officers, all kinds of agents of various levels of government—all part of the system the Founders of the American Republic had called upon "to secure these rights." Those in government and their supporters who defend its supreme role in society often believe, sincerely, that their coercive institution is necessary, performing a function much like that of parents or guardians in relation to children.

They may start by saying, "Well, we must have such extractions so as to provide citizens with the police, the military and the courts." But they never end there. Once they have gotten millions of us to say, "Oh, yes, those things are vital, so you go ahead and use coercion to get them," the next step is to say, "Well, now that we have the authority to use coercion, why not use it for all kinds of lovely purposes in addition to providing security from others?" And the scope of the state then grows and grows and grows, as does its size, the moral argument against these having been compromised. These folks are

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[6] We do not, however, need to consent to others defending themselves from aggressors; so a constitution that consists primarily of policies that protect individual rights does not require universal consent, on the consent needed to provide it with sufficient power to oppose crime. See, for more along these lines, Randy E. Barnett, *Restoring the Lost Constitution: The Presumption of Liberty* (Princeton, NJ: Princeton University Press, 2004).

convinced that what they provide for us is so vital that there is no need to stoop to requesting permission to provide it, so long as some sizable portion of the citizenry—via some kind of democratic process (but one wherein many third parties have been coerced)—is willing to go along. Never mind whether consent to take the fruits of their labor and other resources from them has been obtained from all those who are to be benefited and from whom payment is coercively extracted, on penalty of fine or imprisonment.

Sure, those bent on perpetrating this scam want us to believe something else, namely, that they just want us to be less selfish and to help other people more. Yet this assumes that while all us mere citizens are inept at knowing how we could help others, folks in government are experts at this task and more virtuous than the rest of us to boot. Surely this has no historical basis to it. There is far more waste and pork, even outright mendacity, in government than anything private citizens could cook up. So even from the point of view of helping people, it is best to leave the money with those whose it is in the first place. They'll do just fine in distributing portions of it to those who are in dire straits or just need some help to carry on with worthy tasks that may not get sufficient backing from the marketplace.[7]

But extortionists never get enough. Government officials have even claimed that tips should be taxed because they are a form of income. But income is payment for services rendered. If you do not pay the income of those who work in restaurants—for example, if you walk out without paying for your dinner—you are subject to prosecution. If you don't pay for the furniture delivered to your home, you can be sued. If your barber does not receive the payment you owe for the hair cut he or she provides, again you are in trouble with the law.

But now ask yourself—as per the suggestion of Jackson R. Wheeler—what happens if you don't pay a tip? Nothing much, other than getting some people angry at you. But angry or not, no legal action can be taken at you. Your sin is not failure to pay for service rendered, but to provide a customary gift to those who rendered the service beyond the call of duty. An almost automatic gift but a gift just the same. Gifts are not taxable, certainly not as income. Yet in California, for example, restaurants must add 8% of their income to the income they earn, as an estimate of the tips received. It is ridiculous but not surprising. The government wants whatever it can get.

The opposite view, laid out first by John Locke, is that each of us comes into the world free and independent and as adults we then take up various tasks, including certain responsibilities toward others, as a matter of our free choice. But no one has any claim to our effort or the products of our effort prior to our having made a free decision about the matter. So, just as Jimmy Carter lusted in his heart, I "cheat" on my taxes in my heart. Unlike Carter, though, I don't think I'm sinning. It is only because the consequences

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[7] For a fuller discussion of these points, see Tibor R. Machan, *Generosity: Virtue in Civil Society* (Washington, DC: Cato Institute, 1989).

of refusing to pay what the government claims I must pay would be so devastating, do I continue to pay.

If taxation were indeed morally mandatory—if whenever we gain some benefit from someone in trade we would really owe money to the state—then every time we were the beneficiaries of the generosity of friends when, for example, we travel, we would be committing theft. Escaping the costs of a hotel, car rental, or anything else would amount to nothing less than an immoral act of theft, inasmuch as we also escape payment of taxes thereby. Yet of course, no one in his or her right mind considers it immoral to accept the generosity of friends. Nor does anyone believe that we are cheating the rental car company or the hotel chain by failing to use their services.

Those who try to justify taxation often claim that everyone owes taxes to the government because, well, the money is the government's in the first place. We do not really own our wealth. It's government that owns it and lets us have a bit out of generosity.[8] But if this were so, we should all be naturally guilt-ridden when we fail to act in ways that produces taxes for government. And, of course, all those professional tax-escape helpers, who show us how to hide our wealth effectively and thereby escape the extortion perpetrated by governments, would be aiding and abetting crimes rather than performing a valuable and peaceful service.

Taxation prevails because we have yet to fully grasp the implication of individual rights and of rejecting the idea of the divine rights of kings and bureaucrats.

Immoral or Impractical?

In 1957 Ayn Rand published *Atlas Shrugged*, a riveting novel in which the most productive people—who create wealth but who are being devoured by exorbitant government regulation and taxation—decide to go on strike and teach the country a lesson. The result is that the country goes belly up. At the end of the novel it seems that these productive folks will be able return and be allowed to produce without all this state regimentation, the best way in which they and their fellows could possible interact.

In 2000 Joel B. Slemrod, a University of Michigan professor of business economics, edited a book entitled *Does Atlas Shrug*?[9] Slemrod considers the question of what exactly are the economic consequences of high taxation on the rich?

The answer arrived at, after 15 eminent scholars have conducted their more or less technical economic analysis, is that, "All in all, these studies do not suggest anything like the complete withdrawal of productive energies

[8] Op. cit., Murphy and Nagel, *The Myth of Ownership*.
[9] Joel B. Slemrod, *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (Cambridge, MA: Harvard University Press, 2000).

that Ayn Rand warned of." But, adds the editor in his introductory essay, "Nevertheless, the tax system clearly induces people to rearrange their affairs and change their behavior, and these changes are evidence of an unseen but real cost of levying taxes."

As Frederick Bastiat taught us,[10] it is difficult to assess the impact of taxation because this impact is indeed most often unseen. Thus it cannot be measured by the standards of empirical economic science (nor depicted effectively on television). That is one reason the editor notes that the evidence is "mixed on the question of how, and how much, today's Atlases shrug." The ones that are shrugging totally may, of course, not be providing any evidence at all to be analyzed. They are simply not there.

Of course how people react to having some of their wealth taken from them by force, extortion and intimidation will vary. Some will work harder, some will continue as is, writing it all off as just the price of being left in peace (albeit with fewer resources to conduct their enterprises than would have been available without the taxation), while others will withdraw or even take up arms.

Yet looking at the matter solely with respect to how people will behave in response to taxes does not do the topic justice. For one thing, Ayn Rand wasn't making an economic forecast. Hers was at most a prediction in the if-then mode: "If all the producers realize how badly they are being treated, then they would likely withdraw." Actually, it was more a dramatization of moral advice, as portrayed in the high-level meetings between John Galt and various captains of industry: "If you productive folks know what is good for you, you will not tolerate being ripped off by those who do it to you left and right, throughout history. Withdraw and see how they come running to you then." The venue is fiction, of course, and Rand in her lifetime did not ever believe that life in the U.S. had become so oppressive that the producers were warranted in withdrawing en masse from economic activity. But she certainly always believed that businessmen should not give "the sanction of the victim" to their own destroyers; that they should, rather, proudly assert their moral right to their honestly produced wealth.

You may think this is advice is selfish, and, indeed, Rand intended it as such. But is this really objectionable? Is it not a counsel of "selfishness" when we tell battered wives to leave their brutal husbands? Or when we advise someone to care for his or her health, family, and other ingredients of a decent life? Selfishness—unless it is the perverse type that involves using others against their will—is not bad at all. It is the virtue of prudence, a virtue we need to exercise if we are to live well.

Atlas Shrugged is a novel and a romantic one at that. It is not intended to be a naturalistic portrayal of the consequences when bad things happen to

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[10] Frederick Bastiat, "What Is Seen and What Is Not Seen," in *Selected Essays on Political Economy*, George B. de Huszar, ed. (Irvington-on-Hudson, NY: Foundation for Economic Education, 1995), pp. 1–50.

good people. It is, rather, a work of imagination involving moral principles—framed, yes, in black and white terms, just as all clear moral advice should be, even when the actual situations we must contend with are complicated or murky.

Morality, like all disciplines, seeks abstract principles and then implores those who would apply these principles to do so with intelligence and integrity. This is also what engineers seek to do with the principles of engineering and mathematics. Even when an engineering solution is less than perfect given the constraints of a messy situation, it will not be any solution at all if it ignores the absolute fact that two plus two equals four, that gravity exerts a certain force, that a piece of tape can provide only a certain amount of adhesion.

The empirical approach cannot tell us how much taxation is proper—or whether any at all is.

Imagine if that were the method by which someone went about assessing the merits of kidnapping, rape, murder, suicide, adultery, lying, cheating, and other evils humans can perpetrate. What if, upon rigorous economic analysis, it turned out that women who've been raped eventually became wealthier, more skilled at their work and even, perhaps, more self-confident, in comparison to women who haven't been? Would that warrant changing our assessment of rape or the law against rape? Or what if kidnapped children developed a stronger sense of adventure and courage, in general, following their experience? Would this suffice to render kidnapping a moral good? Or what if burglaries, at times, induce the victims to go out and work harder to recover the losses? Do we then laud burglary as aiding and abetting the Protestant work ethic?

No one can tell for sure what people will do in the face of adversities that do not incapacitate them. We are different, all of us, in many respects, even while we are the same in others. When the American Founders observed that all men are created equal, they made clear that this equality pertains to the inalienable rights to life, liberty and the pursuit of happiness that all equally possess in virtue of common humanity. But once these rights are secure, how things will turn out cannot be predicted. On the whole, of course, one would expect that a system of just principles would foster a better life for those governed by them. But in particular cases and times this may not be so, even if it is over the long haul.

Once this is recognized, the entire way of discussing tax cuts has to be revised. For example, let us assume that there is no way to make sure that the wealth citizens retain will be spent in a way that stimulates economic growth. Sure, that is one of the justifications George W. Bush and his economists put forth in order to make their tax-cut plans jive with mainstream thinking. Such thinking, you may recall, cites how your money and mine can advance various macro-economic or public policy objectives, such as reducing unemployment, bolstering stock values, increasing investments and all the rest. The assumption seems to be that the country is some kind of huge conglomerate and government's economists are its managers, entrusted with making the enterprise economically viable. Of course, that's a misguided way to view government, and all kinds of disappointments must flow from such thinking.

One problem with expecting tax cuts to stimulate the economy is that people who are "generously allowed" to keep more of their own wealth may not choose to dispose of it productively, at least not as determined by macro-economic standards. After all, just because more wealth enables us to invest and spur employment, it doesn't mean that we will all actually do so. Accordingly, those who are skeptical about the stimulus potential of Bush type tax cuts can easily appear credible—who knows what people will do with more money in their pockets? Sure, they may spend a good deal of it. But that is by no means certain.

If, however, George W. Bush had a clearer understanding of the very words he kept using as he defended his plans to cut taxes—namely, that the money taken from us is ours and when returned via tax cuts, it is returned to those to whom it already belongs—he would also have recognized that we might not dispose of it as he and his advisors would prefer. After all, when you own something fair and square, you are the one who gets to decide what to do with it. No one should harbor expectations that you will do their bidding. The bottom line is that tax cuts should occur not because they will stimulate the economy or do other fine macro things but because the money is ours by right. If that were the explicit reason Bush and his team gave for tax cuts, the liberal democrats couldn't fuss about whether it will or will not lead to various macro-economic objectives. It is none of their business anyway.

Despite the inconclusiveness of Slemrod's study, there is no reason to be inconclusive about the relevant moral principles here. It is wrong to tolerate thievery and extortion.

Robbery Versus Charity

Some folks view opposition to taxation as per se greedy, stingy, and uncharitable, a proof of ungenerous nature. Why would one wish to hold on so obsessively to what one has earned—or, indeed, inherited or been given or maybe just found (say in the ground, as when one discovers oil by accident)—if one understands how much others could benefit from a portion of one's wealth?

But, in fact, taxation deprives taxpayers of the opportunity to be supportive of various good causes. When a person gains wealth by whatever honest means, there is more he can do with it than buy goodies to be piled up in his home or estate. Sure, we do spend our resources on food, clothing, gadgets around the house, vacations, and similar consumption goods and services. Why not? We are human beings who live in a world with many chances for self-development and self-enhancement. A trip to Paris, four years in college, a dependable health insurance policy, a nice birthday meal at a fancy restaurant—spending one's wealth on such things can be a good idea, indeed. Life is to be lived—and we ought to strive to thrive living it. No need for apologies here at all, however much some people want to make one feel guilty for this. They forget, usually, that others who might be in greater need desire to escape their lot so they, too, can one day obtain just such things for themselves and their loved ones.

But the ability to obtain such goods and services is not the sole benefit of wealth. A great deal of one's wealth enables one to decide, in line with one's own best judgment, who else or what else should be supported with what one owns. Taxation, by contrast, confiscates from the owners a substantial portion of what they own so that others may decide where the wealth will go and what good works (if any) it will do. Thus taxation denies the taxpayers' fitness to be a good judge of worthy recipients of the taxpayer's generosity.

At the same time, of course, the government itself often proves inept or corrupt in how it spends the money it steals. Public officials themselves freely complain of this. The paradox is that the complaints divert attention from the immorality of the very process that makes possible all the corruption and bungling.

Politicians love talking about abuses of government power, just as they love talking about government waste. It makes it seem that there is no problem with the plain use of such power or the spending of funds, only with the abuses and waste! It is true that we don't want the Internal Revenue Service to feel it can behave with any degree of arbitrariness, trampling taxpayers underfoot, and simply get away with it. But if we focus too much on how really brutal the IRS can be when left unchecked, we may forget that even when it is "kind and gentle," the agency is doing something wrong. Innocent men and women should not have money extorted from them, no matter how important the cause! And the IRS is the arm of such extortion. A friendly mugger is still a mugger. And even if he gives some of the cash he stole to charity.

Escaping the Vicious Cycle

Many features of monarchies gained a life of their own even after monarchies were abolished or at least diminished to ceremonial status. Taxation is one such feature. It could and should eventually be replaced with a system of fees for service rendered. In the U.S. there is implicit awareness of this when it is argued that ultimately taxes are paid voluntarily. This notion is a fiction, but one required by the logic of the inalienability of individual rights to life, liberty and the pursuit of happiness, the idea of which still exerts a certain persistent tug on America's political conscience.

Some of the language surrounding President George W. Bush's proposal to cut taxes also implicitly acknowledged that taxation in a free society is an anomaly. For example, as just noted, Bush has told us as candidate and as president that it is we who own our income and other assets, not the government. This observation may simply be a way to irk liberal democrats, who tend to treat all wealth as belonging to the government. But whether Bush knew it or not, to admit that our assets belong to us implies that taxation is a form of immoral taking—or theft or extortion or robbery. Unless the sums the government takes from us are given to it by willing citizens, there is no way to disguise the fact that the taking is a violation of our right to property, hence immoral.

How would voluntary funding of government work? It would involve, mainly, attaching a surcharge to all contracts drawn up among citizens, contracts that require the force of law for their backing—including courts, police, and military, all of which serve the purpose of keeping the peace, including securing a civilized adjudication of contractual disputes. One would still be free to enter agreements apart from contracts, via a hand shake or a promise. But the millions of corporations doing business cannot afford such informality, so they would enter into contractual relationships and need to pay for the service governments provide to back these up.[11]

I don't have a comprehensive blueprint for the transition to a tax-free society. It may be too soon to draw one up: the size and purview of government must first be drastically reduced. But I am confident that if the idea were not dismissed so readily by those eager to tax fellow citizens for projects of their own, human beings could put their minds to the task profitably enough and find a way to eliminate the scourge of taxation. As a truly free society were more closely approached, the task would become both more exigent and more viable. Taxes could be eliminated in phases as new and voluntary methods of funding government were brought on line.

The call for abolishing taxation is just a further step in the direction of living up to the promise of the American revolution. Ultimately, taxes need to be replaced with a form of payment for government services that is uncompromisingly consistent with the principle of "the consent of the governed." Barring such a development, all we can do is press the point: reduce taxes, privatize services, and through this make us all more free.

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[11] Op. cit., Machan, "Dissolving," and Rand, "Government Financing."

4

Enhancing Efficiency of Government Budget and Fiscal Policy

Robert W. McGee and Yeomin Yoon*

Introduction

The usual way to look at efficiency in connection with government budget and fiscal policy is that more is better. It is better to be efficient than inefficient and the goal should be to find ways to improve efficiency with each passing year. That is the mindset of businessmen and it is a good way to look at things—if you are running a business. But government is not quite like a business. Businesses provide goods and services that consumers want. If they don't do a good job of it, they go bankrupt. Consumers have choices and they vote with their dollars, Euros or won to purchase goods and services of whoever will give them the quality they want at the lowest price.

But government does not run that way. Governments, although they can become temporarily bankrupt, never go away if they provide services that no one wants. If anything, such governments just raise taxes to cover their cost of operations. Government is more like a monopoly than a competitive business. Although there is some competition between governments, the basic structure of government is monopoly. Taxpayers have little choice but to pay for the services of whatever government they live under. If particular taxpayers do not like the services their government provides, the most they can do is move to another jurisdiction. If they cannot or will not move, they must be content with the services of the government they have. They cannot hire a different government that provides better services.

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The Case for Efficiency

Since governments possess most of the attributes of monopoly—lack of competition, higher cost and lower quality than would exist under competitive conditions—one of the few options that government bureaucrats and policy makers have is to try to make their government work more efficiently. Several techniques have been tried in the past, some more successful than others. The next few pages will explore some of these options.

Efficiency in government can be classified into several categories. On the budget side, governments can find ways to spend money more efficiently. From the perspective of political philosophy, the threshold question to ask is—What should government do? We will not address that question in this paper, since it would take us too far afield of the main topic, which is efficiency in budget and fiscal policy. But it is an important question to ask, because one must determine which services governments should provide before determining the size and content of the budget. Once the proper functions of government have been decided, the next step is to determine the best and least expensive way to provide those services.

The other way to look at efficiency is to examine fiscal policy with the goal of making the collection of taxes more efficient. Some taxes have historically proven to be more efficient than others. Some taxes are easier to collect than others. Some taxes result in less distortion to the economy than others. Some taxes have proven to be counterproductive. Governments should examine their fiscal policy, taking these factors into account. There is no need to continue to make the mistakes that governments in the past have made in this regard. Past experience should be the guide when it comes to formulating fiscal policy. Unfortunately, many governments continue to make the same mistakes because they fail to learn from the mistakes of the past.

To summarize, there are two basic avenues that can be taken to increase efficiency in budget and fiscal policy, the spending side and the revenue-raising side. These two approaches are not mutually exclusive. They can be, and should be used in tandem. Both are important.

The Privatization Option

Once it has been decided which services government should provide, the next step is to determine how those services should be provided. When making this decision, it is important not to fall prey to perhaps the most popular *non sequitur* of all—something needs to be done, therefore the government needs to do it. Just because it appears that something needs to be done, it does not follow logically that government should do it. There are at least four options from which to choose when it has been determined that there is a need for some service. Government provision of the service is only one option.

Another option is to have the function performed by the private, profit-making sector. The third option is to have the nonprofit sector do it. The last option is to do nothing at all. This option may not seem like a very desirable option, but it is an option nonetheless. Not everything that needs to be done should be done. Since the amount of resources available is insufficient to allocate to meet all the needs of every individual and group, some things that need to be done must remain undone.

The point is that government is not the only solution. However, once it is decided that government involvement is necessary in a particular case, it does not follow that some government must actually provide the service. Government can hire someone in the private sector—either profit or non-profit—to perform the task.

The evidence is clear that the private sector can provide just about any service more efficiently and at a lower cost than government. One reason for this structural advantage is because of the profit motive. If a business does not cut costs ruthlessly and focus its attention on consumer wants, it will soon go out of business. Governments do not work under those constraints. If some government does not provide quality service at a reasonable price, there is nowhere its constituents can go. There is no alternative service provider because government, practically by definition, is a monopolist. Where there is little or no incentive to increase quality or reduce cost, quality will tend not to be improved and costs will tend not to be reduced.

There are ample real world examples to prove this point. The collapse of the Soviet Union in the late 1980s is partly attributable to the massive misallocation of resources that necessarily results when there is no price system to make allocations efficient. Ludwig von Mises (1881–1973), an Austrian economist, predicted as far back as the 1920s that the Soviet Union would collapse because of this inefficiency (1923, 1928, 1935).

But the collapse of the Soviet Union is not the only example that could be given to illustrate what can happen when budget allocations are not made efficiently. The privatization movement, which started in the 1970s in the UK and the USA, provides hundreds, if not thousands of examples to illustrate the benefits of privatization, if it is done transparently without collusion. The Privatization Center [www.rppi.org/privatization/index.shtml and www.privatization.org] has a rich trove of publications to document how costs can be cut for practically any services provided by government.

By hiring private sector firms to perform tasks that would otherwise be provided by government it is possible to inject competition and the profit motive into areas where this incentive structure would otherwise be absent. Hiring private firms to provide government services allows the price system to operate to allocate resources in the most efficient manner. In the absence of the price system it is impossible to rationally and efficiently allocate resources. Thus, it is necessary to find a way to create an environment in which the price system can be allowed to function. Privatization does exactly that.

One of the classic books on privatization was written by Bennett and Johnson (1981). Their book, titled *Better Government at Half the Price: Private Production of Public Services,* documents hundreds of cases where government services can be provided by the private sector at greatly reduced cost, often with remarkable increases in efficiency as well. Robert Poole (1980) and Randall Fitzgerald (1988) have also written classic books on the topic of privatization. Here are some examples of cost savings that can be had if government hires private sector firms to perform a service rather than allowing government employees to do it.

Table 1
Cost Reductions and Efficiency Increasesas a Result of Privatization

Service provided	Cost saving
Asphalt overlay construction (Goodman 1985)	96%
Grass maintenance (Goodman 1985)	40%
Janitorial services (Goodman 1985)	73%
Municipal solid waste disposal (Savas 1982)	61–71%
Prison administration (Segal 2002)	69%
Refuse collection (Goodman 1985)	42%
School food services (Segal 2002)	28%
Street cleaning—121 cities in Los Angeles county (Goodman 1985)	43%
Street maintenance (Goodman 1985)	37%
Traffic signal maintenance (Goodman 1985)	56%
Waste collection (Stevens 1992)	22–30%
Waste water treatment (Segal 2002)	35%

It takes 68% more federal government employees to remove 21% as much railroad track as private sector employees over the same period of time and under similar conditions (Fitzgerald). The U.S. Department of Defense has achieved cost savings through outsourcing tasks that were formerly performed by government employees. Table 2 summarizes cost savings in selected areas.

Table 2
Selected Cost Savings from Outsourcing
U.S. Department of Defense

Service provided	Cost savings
Supply/logistics	15–38%
Housing maintenance	17–42%
Visual information services	61%
Base operations support	42–46%
Aircraft maintenance	42–66%
Vehicle ops and maintenance	48%

Source: Segal (2002).

Quality also tends to improve when government tasks are turned over to the private sector. In the case of emergency medical and fire services, for example, private providers react faster and are better equipped. Such increased efficiencies save lives.

Some defense functions have been privatized. Some of the governmental functions that have been successfully privatized include:

Airplane maintenance
Bill collection
City management
Criminal justice
Data processing
Day care
Delivery services
Education
Electricity
Emergency ambulance service
Fire protection
Garbage and solid waste
Grounds-keeping
Health care
Leisure and recreational services
Mental health services
Payroll accounting
Pension management
Police
Prisons
Public works
Road construction and maintenance
Sewage treatment
Ship maintenance
Social security
Social services
Toll collection
Transit systems
Weather forecasting

Privatizing Social Security

Social security is an excellent example of a governmental function that can benefit by being privatized. Many governments in developed countries as well as countries in Eastern Europe and the former Soviet Union are facing a crisis in their government pension system. The birth rate has declined, so fewer people are putting money into the social security system. Medical advances have made it possible for people to live longer, which places a further strain on the system, since people will be drawing money out of the system for more years. Also, in some countries, people have been retiring earlier. As a result, fewer people are putting money into the system and more people are taking money out of the system for a longer period of time. This phenomenon has been described as a demographic nightmare (Ferrara and Tanner 1998a, p. 129).

Numerous studies have discussed the benefits of privatizing social security (Aaron et al. 1989; Crane 1997; Ferrara 1980, 1985; Ferrara and Tanner 1998b). Rather than paying into some government's dubious trust fund (not all governments have a trust fund set up for social security. Some use a pay-as-you-go method), workers would pay into a private investment trust that they would actually be able to claim as property when they retire. Since it is their property, their heirs would be able to inherit.

Such is not the case with social security in the United States and in many other countries. When someone dies, there is no asset to inherit. Payments stop when the recipient is no longer living. Thus, one of the benefits of a privatized system is that a massive pool of funds would accumulate. This fund would be available for investment, thus leading to a stock market boom. Interest rates would drop, making it easier to finance a home. Those who placed money into the system for a number of years would be able to retire as millionaires (Tanner 1996b). According to Martin Feldstein of Harvard University, "the combination of the improved labor market incentives and the higher real return on savings has a net present value gain of more than $15 trillion, an amount equivalent to 3% for each future year's GDP forever" (cited in Tanner 1979).

Rather than being mere transfer payments, as they are today, a privatized system would result in a ready pool of wealth that people can draw on when they retire. Monthly retirement checks could be two or three times more than what would be paid under a governmentally run system. Such a reform would be of special benefit to the poor, since poor people receive a higher percentage of their total income from social security than do middle class and rich people (Gokhale 2001; Tanner 1996a).

Women would stand to benefit disproportionately from social security privatization. Under present U.S. rules, benefits are cut by as much as half when the spouse (usually the husband) dies. One study found that this partial cut-off throws one widow out of five into poverty (Shirley and Spiegler 1998). This would change under a privatized system, since the widow would retain the assets that were placed into the fund.

Some countries have started to privatize their social security systems, with some success. As the pool of capital builds, it is invested in projects, leading to economic growth. Poor countries that previously could not attract sufficient foreign capital are now exporting capital to other countries. The prospects for continued capital growth and the expansion of employment and a higher standard of living are very real prospects.

Chile was the first country to privatize its social security system, in 1981. Ninety-five percent of all workers are now covered under the private system (Pinera 1996). The compound annual rate of return has been more than 11% (Rodriguez 1999). Pension benefits in the private system are now 50–100% higher, adjusted for inflation, than they were in the state-run system. Chile's growth rate jumped from its historic 3% annual rate to a rate that has averaged 7% over the 12 years prior to the Rodriguez study. The savings rate jumped to 25% of GDP and the unemployment rate dropped to about 5% (Pinera 1998). Argentina, Peru, Colombia, Bolivia, Mexico and El Salvador have also privatized their social security systems (Ferrara 1997).

The Cato Institute [www.cato.org] has published a number of studies that investigate various aspects of social security privatization in the United States and other countries. It has a Social Security Benefit Calculator on its website. Table 3 compares the benefits that would be received under a private system to the benefits projected to be received under the present government system. The results are shown in Table 3.

Table 3
Comparison of Social Security Benefits
Private System vs. Government System in the United States

Recipient	Estimated annual benefits				Estimated asset accumulation	
	Annual salary $	Private system $	Govt. system $	Ratio of pvt/govt. system	Private system $	Govt. system $
Male, age 25	35,000	52,236	19,794	2.64	548,546	0
Female, age 25	35,000	50,021	19,794	2.53	600,746	0
Male, age 25	40,000	59,011	21,816	2.70	619,694	0
Female, age 25	40,000	56,389	21,816	2.58	677,229	0
Male, age 25	60,000	83,596	26,963	3.10	877,872	0
Female, age 25	60,000	79,015	26,963	2.93	948,979	0
Male, age 25	100,000	116,320	32,182	3.61	1,221,518	0
Female, age 25	100,000	108,775	32,182	3.38	1,306,388	0

Source: www.socialsecurity.org

Table 3 makes a number of assumptions. Retirement age is assumed to be 67, which is the projected retirement age for most people presently paying into the U.S. government plan. Dollar amounts are in constant 2004 dollars. Contributions into the private plan are estimated to be 6.2% of earnings, up to the Social Security limit, which changes every year. Under present rules, employees and employers each pay more than 7% of salary into the social security system. Thus, the private plan would be less costly, since less than half as much money is put into the private plan (6.2% vs. 14+%). Additional assumptions are explained by Tanner (2004).

Women in the United States live an average of 7 years longer than men. This difference is reflected in the privatized system but not in the government system. For example, a male who starts contributing into the private or government social security system at age 25 and who earns $35,000 a year, with annual cost of living increases can expect to receive $19,794 under the government program or $52,236 under a privatized system. In other words, the private system will pay $2.64 for every $1 paid by the government program. A woman who is the same age and who earns the same salary can expect to receive the same $19,794 annually under the government system. Also, and what the figures in Table 3 do not show, is that she will receive this amount for 7 years longer than the male, which means she will receive an additional $138,558 over her lifetime. Under a privatized plan she would receive $50,021 a year for the rest of her life, which means she would receive $2,215 less per year than her male counterpart, but she would be receiving her $50,021 for an additional 7 years, which amounts to an extra $350,147.

Another point to be made is the difference in asset accumulation that would occur in a privatized system. Under the government system, no assets would accumulate, so if a worker dies before retirement, the heirs get nothing, whereas under a privatized system, the heirs of the male worker discussed above would receive $548,548. The heirs of the female worker discussed above would receive $600,746.

These numbers jump dramatically for individuals who start putting money into the system at an earlier age or who earn more than the $35,000 given in the first case. For example, if the annual salary were $40,000, a male retiring at age 67 would receive $59,011 annually under a privatized system, compared to $21,816 under the government system, or $2.70 under the private system for each $1 under the government system. A female would receive the same $21,816 under the government system, compared to $56,389 under a privatized system. So she would receive $2622 a year less than her male counterpart, but she would receive the $56,389 for an average of 7 years longer than a male, or an extra $394,723. Thus, it can be concluded that a privatized system would benefit both males and females, but would benefit females more than men, since females would receive more in total benefits.

As can be seen from Table 3, it is quite possible that employees can retire as millionaires under the private system. A male who starts contributing into the private system at age 25 and who earns $70,000 can expect to retire at 67 with $1,000,893 in asset accumulation. A female who earns the same amount can expect her assets to be worth $1,077,002 at retirement.

The big question is how do we get from here (the present system) to there (a private system)? What would happen to those who now (or soon to be) on the system if the system went private? Various proposals have been made. For example, young people could elect to set aside a portion of their present social security payments in a private fund and the remainder of their social security taxes could continue to be used by those presently (or soon to be) drawing benefits. That way, those presently (or soon to be) drawing benefits would continue to do so.

One rather alarming proposal would be for the government to invest the funds in the capital markets. If this were done, the government would become the largest shareholder in most American businesses, and would be able to influence corporate policy. In all likelihood, corporate decisions would be made for political rather than economic reasons (Ostaszewski 1997). Perhaps there would be restrictions on the types of company that the funds could be invested in. Such a possibility is not far-fetched, judging from what has taken place in the state public employee pension funds (Tanner 1996c). Of course one could also point out that if the government were the largest shareholder in all or most American corporations, it would, in effect, own or at least control the means of production, which means the American economy would become socialist, an economic system that has proven to be structurally inferior to the market system.

One problem with partial privatization is that young workers would still be forced to pay for other peoples' benefits. Thus, it is unfair to young workers who have to pay into a system that they cannot draw from. Another solution that has been proposed is to sell federal land and use the proceeds to fully fund the present system. The federal government owns more than 50% of some western states, and owns substantial assets in every state. If these assets were sold, some estimates conclude that there would be enough money to fully fund the system for those who are presently on the system and for those who will retire within a few years.

The Case Against Efficiency

> "…government has proved incompetent at solving social problems. Virtually every success we have scored has been achieved by nonprofits." (Drucker 1991)

The evidence that the private sector can perform many functions better and cheaper than government is overwhelming. Thus, it does not make sense, from an economic point of view, to allow government to do much of anything directly. It is almost always better to have the service performed by the private sector. If government involvement is deemed to be necessary, for some reason, the more efficient approach is for the service to be contracted out to the private sector and paid for by government. One cannot make a case against efficiency if one is discussing the spending side of government.

However, a case can be made for creating inefficiencies on the tax collection side of government. Government has no resources of its own. Whatever resources it has it must first take from someone in the private sector. Since the private sector has proven to be more efficient than the government sector, the more resources that are shifted from the private sector to the government sector, the more overall welfare declines. If one is interested in increasing total utility, the way to go about achieving the goal is not to give government more resources but rather to give it less.

Governments have a tendency to expand over time. If one looks at the relative and absolute size of most governments today and compares them to the relative and absolute size they had a few decades ago, one would find that government has increased in size, regardless of the measurement technique used. One study points out that government spending in the United States relative to Gross National Product (GNP) has risen from 10% during World War I to nearly 40% during the 1990s. At the federal level, the government went from taking $1 out of every $12 earned in 1890 to $1 out of every $3 earned in 1990 (Perry).

If the transfer of resources from the more productive private sector to the less efficient government sector is to be minimized, methods must be found to make the transfers more difficult. Several techniques have been advocated over the years.

One approach that has been advocated is to require the government to balance its budget. This approach would prohibit government from borrowing money for current spending. The problem with this proposal is that it does not guarantee that government expenditures will be restrained. There are two ways to balance the budget. One may either reduce spending or increase taxes. Having a balanced budget requirement without a rule that would make it difficult to increase taxes would not be a very effective restraint on government spending.

The argument could be made that balancing the budget over the business cycle would be better than balancing it annually, the reasoning being that fiscal policy should be used as a tool to stimulate economic growth. Keynes (1936) and various Keynesians (Hansen 1953) and post-Keynesians have advocated this approach. There are several problems with this view. For one, fiscal policy has been historically ineffective, at best, and counter-productive at worst in smoothing out the business cycle.

It takes the legislature many months to agree that spending should be increased or decreased and many more months before their decision has any effect on the economy. By the time the new government spending pattern injects itself into the economy, the economy is in a different phase of the business cycle. If the legislature starts debating how spending should be increased to stimulate a weak economy, for example, it will take several months to agree on the specifics and another several months before the increased spending has the desired effect. By the time the new spending permeates the economy, it could be out of the recession and moving toward a boom. Having government artificially stimulate spending could cause the boom to expand even further, which causes the business cycle to fluctuate more than would be the case if the government did nothing.

Another problem with using fiscal policy as a tool to smooth out the business cycle is that much, if not all of the additional spending is little more than a shifting of existing spending rather than the creation of new spending. If government obtains the extra money by borrowing, it shifts funds from the private sector to the public sector. The gross quantity of funds remains the same. If the government prints money to finance the boom, the increase in the quantity of money dilutes the purchasing power of the money that is in the private sector at the same time it is pumping money into increased government spending. The total value of goods and services remains about the same, so spending is merely shifted, not increased, in terms of purchasing power. If government finances its additional spending by raising taxes, it merely takes money out of private hands and puts it into public hands. The total amount of money in circulation remains the same. There is merely redistribution from the more efficient private sector to the less efficient government sector. Hazlitt (1959, 1960), Hutt (1963) and Terborgh (1968), among others have pointed this out. Yet the perception persists that government stimulation of the economy can smooth out the business cycle.

Of course, one may point out that the whole argument about balancing the budget over the business cycle is a mere theoretical argument anyway, since governments the world over have been unable to balance their budgets. Almost all governments at the national level run continuous budget deficits every year, whether the economy is in a recession or a boom. Government officials seem incapable of balancing their budgets in the absence of constitutional constraints. The fact that most state governments in the United States are able to balance their budgets every year is mostly because their state constitutions have provisions that require a balanced budget. Without such a constitutional rule the legislature is usually incapable of exercising the needed restraint to achieve a balanced budget.

Requiring a balanced budget, coupled with rules that make it more difficult to increase taxes, would be a more effective way to prevent resources from being shifted from the more efficient private sector to the less efficient government sector. One way to make it difficult to raise taxes would be to require more than a simple majority of the legislature to vote in favor of any tax increase. If a 2/3rds or 3/4th requirement were needed to increase taxes it would be more difficult to increase taxes than if a simple majority vote were all that was needed. Having such a supermajority requirement has proven to be somewhat effective in the U.S. states that have adopted this rule.

The evidence is clear that having a supermajority requirement decreases the rate of government growth. Between 1980 and 1996, the state tax burden as a percentage of personal income rose five times as fast in states that did not have a supermajority requirement than in states that did have such a requirement. Between 1990 and early 1998 the top tax rate increased in ten states. In all ten states where the top rate was raised, there was no supermajority requirement. During this same time period, the top tax rate was reduced in three of the 13 states that do have a supermajority requirement (Stansel 1998).

In Arizona, taxes had been raised eight times in the nine years before its supermajority requirement was enacted into law in 1992. Between then and early 1998, Arizona reduced taxes five years in a row (Stansel 1998).

The rate of government growth at the federal level would also likely be reduced if a supermajority requirement were in place. Four out of five federal tax increases would not have passed if a two-thirds vote were needed for passage (Perry n.d.). The four largest tax increases between 1980 and 1998 [1982, 1983, 1990 and 1993] would not have passed if the two-thirds supermajority requirement would have been in place (Cato 1999).

The argument has been made that occasional tax increases are necessary to reduce the deficit. But a closer analysis shows that such is not the case. The history of the last few decades is that when Congress increases taxes, it increased spending by even more. In recent years, Congress has increased spending by $1.59 for each $1 increase in taxes (Perry, n.d.). The evidence is clear that the way to balance the budget or reduce the deficit is to reduce spending, not increase taxes.

Another technique that could be used to restrain government's taxing tendencies would be to make taxes more visible. If taxpayers can see what they are actually paying for government services, they will be more sensitive to having a portion of their income taken from them. One way to make taxpayers more aware of the cost of government would be to abolish the rule that allows employers to withhold a portion of an employee's salary for taxes. Many jurisdictions require employers to withhold a portion of an employee's salary from the paycheck. Such a policy is good, from a government's perspective, because it makes it easier to collect larger sums of money than would otherwise be the case. It is an efficient way to collect taxes.

However, efficiency may not be a good thing if increased efficiency in collecting taxes results in making it easier to transfer resources from the more efficient private sector to the less efficient government sector. If taxpayers had to write out a check to the government every month instead of having a portion of their income taken from them before they get to see it and touch it, people would have a better feel for what government costs. It would cause them to think harder about how much government really costs and whether they want to continue to maintain that level of government spending (Schmidt 2002).

A similar technique would be to replace the value added tax (VAT) with a retail consumption tax. One criticism that has been made of the VAT is that it can be administratively burdensome. The tax is assessed at each level of production, subject to tax credits (Organization for Economic Cooperation and Development 1988). In some jurisdictions, where the VAT is complicated, it has been jokingly referred to as an accountant's full employment act because it takes so many accountants to administer it. One advantage of replacing the VAT with a retail consumption tax is that it would only need to be collected once, at the end of the process. Another advantage is that the full cost of the tax would become more visible.

One criticism of the VAT is that the people who ultimately pay it cannot always see that they are paying it. It is included in the cost of whatever product they are buying, in many cases. With a retail consumption tax, consumers are better able to see how much the tax is, especially if the tax is added on to the price at the cash register rather than hidden in the price tag. This technique would make the tax more visible, and thus would increase resistance to increasing it.

Taxing sales rather than income may also have a positive effect on the savings rate. If people are not taxed until they buy something, there may be more of a tendency to save rather than consume. If savings increase relative to income, the supply of funds available for investment will increase, which will lead to lower interest rates, lower cost of capital, and more investment, which will increase economic growth and create jobs.

Another suggestion that has been made would be to allow the taxpayers themselves to choose where their tax money is spent. Podolsky (2002), Murray (2004) and McGee (2004) have suggested that taxpayers be given a list of possible destinations for their tax money as part of the tax forms that they must complete every year (in the USA). They could then check off which government functions they want their tax money to support. In the Podolsky suggestion, taxpayers would insert percentages in the spaces provided, based on the percentage of taxes paid that would be allocated to the various budget items.

Such an option would add a level of administrative burden to the already burdensome tax administration system. However, if one defines efficiency based on the relationship between taxes collected and the destination of the proceeds, implementation of such a proposal would greatly increase the efficiency of the system. Taxpayers in California would no longer be forced to pay to construct a bridge in Florida. Taxpayers in Texas would no longer be forced to pay for a sports stadium in New York. In all likelihood, the most wasteful government programs would no longer be funded because they would no longer have any support.

Such programs currently receive support only because of the special interests that advocate spending for these projects. If taxpayers were allowed to allocate how their tax money is spent, the power of special interests would be greatly reduced, because they would no longer be able to lobby the legislature to fund their pet projects. Another benefit of such an approach would be that politicians would have much less incentive to pander to the various special interests by promising to increase spending for their projects because such decisions would be totally out of their control. Rather than trying to buy off potential voters with their own tax money, politicians would have to find other ways to convince voters to vote for them rather than their opponent. Implementing such a proposal would have far reaching effects on the whole structure of political debate.

Concluding Comments

When one talks about efficiency in government budget and fiscal policy, it is really necessary to talk about two aspects of the issue. From the spending side, one must strive for efficiency. Ways must be found to cut costs so that government revenues can stretch farther. But from the collection side, efficiency should not necessarily be the goal. Collecting taxes should be made more difficult rather than less if the goal is to increase overall economic welfare. The easier it is to transfer resources from the more efficient private sector to the less efficient government sector, the more overall welfare will be decreased. In other words, efficiency and welfare can be increased by making it more difficult to shift resources from the private sector to the government sector. Economic efficiency and overall welfare will be maximized only if the amount of resources that are left in the private sector is maximized. Making it easy to shift resources to the government sector will defeat the goal, not make it easier to achieve, since funds are being transferred from the more efficient private sector to the less efficient government sector.

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PART TWO: COMPARATIVE STUDIES

5

A Comparative Study of Indirect Taxes in Transition Economies and the European Union

Robert W. McGee

Introduction

There is often a great deal of resistance to increasing individual income taxes because taxpayers can see the money being taken out of their pockets. Furthermore, the taxpayers being fleeced vote and politicians hesitate to increase taxes on the masses, since the result might be losing their elected office. There is less resistance to corporate tax increases because corporations don't vote and there is a widespread perception on the part of the masses that corporations have some moral duty to pay taxes. There is also a certain amount of envy involved, since corporations are perceived as being rich and therefore more able to pay taxes.

Indirect taxes are easier to raise because the people don't see them as easily. There is less resistance where taxes are not seen. There is a certain immorality involved in hiding taxes from those who pay them. People have a right to know what they are being forced to pay and indirect taxes make it more difficult, or even impossible, to know how much the government is taking at the individual level.

This study compares value added tax (VAT) rates in various transition economies, then compares VAT rates in transition and European Union countries to determine which group pays higher VAT rates.

Background

The value added tax (VAT) suffers from the same major deficiency as most other forms of taxation in that it is coercive. It involves the taking of property without the owner's consent. But if one believes that some forms of takings are better than others, one might ask whether the VAT is a viable alternative to the income tax. For years, some commentators have been calling for the

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replacement of the income tax with some form of VAT because the income tax discourages production and encourages consumption and leisure, whereas the VAT encourages thrift and enterprise (Weidenbaum and Christian 1989). Certainly, if this is so, it is a form of taxation that should be of interest to an emerging democracy, where economic growth is especially important.[1] In recent years, some commentators in the USA have advocated a VAT not as a replacement for the income tax but as a supplement, because they think that raising more funds via an income tax is not feasible (Organisation for Economic Cooperation and Development 1988, p. 32).[2] According to one view, "...consumption taxes alone cannot achieve the ability to pay principle and accordingly could not entirely replace an income tax." (McLure 1975, p. 175) But, as has been discussed elsewhere (McGee 1998), the ability to pay principle is not a legitimate principle of taxation.

In a sense, they are right. If income tax rates are raised beyond a certain point, it will trigger a reaction among taxpayers and some politicians might get voted out of office in the next election. It would be easier to raise revenue if, instead of raising income tax rates, a form of value added tax were used to make up the difference. The reason for this solution is that the value added tax is a hidden form of taxation, in the sense that the people who ultimately pay[3] it do not know precisely what they are paying. In a sense, then, the VAT is an unethical way to raise revenue because the tax is hidden. From an ethical standpoint, visible taxes are to be preferred to hidden taxes (McGee 1993, 1996, 1997). The fact that it is hidden makes it easier for the government to raise the tax without the knowledge of the taxpayers, so there is little resistance to increasing the tax. At least one study has pointed out that governments have not been able to resist raising the tax rate once a VAT is in place, which might account for the fact that those OECD countries that have a VAT also have much higher tax ratios than those that do not have one (Bannock 1986).

In a sense, then, the VAT is a dishonest way to raise revenue because of the lack of full disclosure. The U.S. government[4] is putting increasing pressure on publicly traded corporations to have full disclosure on their financial statements. The Federal Trade Commission pressures banks to fully

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[1] A subtle issue is involved here, whether the tax system should encourage or discourage certain kinds of activity. Those who favor the VAT over the income tax often do so because they think that government should encourage savings over consumption. But is the influencing of taxpayer behavior a legitimate function of government? If government is the servant and taxpayers the masters, should a servant really care what the master does with his own money?

[2] For a study that considers the relative merits of a VAT as an additional revenue source by comparing it to an income surtax on individuals and corporations, see *Effects of Adopting a Value-Added Tax* (Washington: Congressional Budget Office, February, 1992).

[3] The question of who ultimately pays a VAT or other consumption tax is a major one, and economists cannot agree on who ultimately pays the tax. For a discussion of this point, see Raboy and Massa (1989).

[4] Specifically, the Securities and Exchange Commission and Congress.

disclose loan charges. The Food and Drug Administration pressures companies to disclose the content of the cans of food they produce. Yet when some government makes use of a value added tax, there seems to be no need for any disclosure. The amount of the tax is hidden, in the sense that the ultimate payer does not know how much the tax is. The blame for the tax may even be shifted onto the corporations that sell the products. When consumers see that corporations charge high prices for their products, they may blame the corporations, when in fact a large portion of the purchase price is attributable to the VAT.

Another drawback of the VAT is the high bureaucratic cost of administration (Japanese Consumption Tax 1991). On the government's side, it would take thousands of bureaucrats to administer it. And for the businesses that have to pay it, it would take many hours of valuable time to keep the appropriate records and file the proper tax returns.[5] If there were no VAT, these many thousands of individuals could spend their time creating wealth instead of shuffling papers.[6]

But the same argument could be made for abolishing the income tax, which has become increasingly complex with each passing year (Hultberg 1997). All other things being equal, a simple and easily administered VAT might be preferred to a complex, obscure and burdensome income tax. So simplicity, clarity and administrative burden are issues that must be considered regardless of which form of taxation is chosen.

One advantage of the VAT is that an enormous amount of revenue can be raised while keeping rates relatively low, compared to income tax rates. That is because the tax base for a VAT is much wider. The VAT tax base consists basically of the economy's total output of goods and services, plus imports minus exports (Weidenbaum and Christian, p. 4). So a 3.5% VAT could raise as much as a 34% corporate income tax, and a 16% VAT could raise as much as an individual income tax that is assessed at the U.S. rates of 15% and 28%.[7] But the revenue-raising aspect of a VAT is a double-edged sword. Those who advocate low taxes see the VAT as a threat because the VAT makes it easy for the government to raise revenue—to take wealth out of the private sector. "Conservatives fear that instituting a VAT or a retail sales tax would be as risky as turning over the wine cellar key to an alcoholic." (McLure 1987, p. 176).

Computing the correct tax might prove to be a problem. Basically, the tax is assessed on the value added, the difference between the value of the

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[5] In England, small businesses complained about the complexity of the British VAT. Their complaints subsided somewhat when the VAT tax forms were simplified (Prest 1980).

[6] And where the VAT is used as a supplement to the income tax rather than as a replacement, two sets of bureaucrats and private sector accountants would be required, one to administer the VAT and another to administer the income tax requirements.

[7] Weidenbaum and Christian. These comparisons are based on the tax system in the USA in 1987.

product as it comes in the door and the value as it goes out. But in practice, the computation would not be that simple. Certain items would probably be exempt, such as food.[8] And policymakers will be tempted to assess different rates for different products and services, so there would be classification problems.[9] And there would be pressure to exempt governmental units and nonprofit organizations, or perhaps to charge them lower rates. Producers who are engaged in both exempt and taxable activities would have to resort to apportionment, which could get quite complicated (Prest 1980, p. 26).

Proponents of a VAT contend that the VAT offers several additional advantages over other forms of taxation. For example, they say that it is "neutral" because it is levied at a uniform rate over the whole consumption base.[10] Thus, the method of production chosen is not affected by the tax system and producers can shift to more profitable methods of production without affecting their tax burden. There is no penalty for being efficient with a VAT, whereas with an income tax, companies that are more efficient, and that therefore have a higher profit, get hit with a higher income tax. And a VAT does not subsidize waste, whereas an income tax does, in the sense that costs are deductible and reduce the amount of income upon which the income tax is assessed. But a study of several countries has concluded that, in practice, the VAT is far from neutral in most cases (Bannock 1986, p. 8).

Those who oppose the VAT give several reasons. For one, it is viewed as regressive, in the sense that those least able to pay will wind up paying a higher percentage of their income in VAT taxes than those who are in the higher income brackets.[11] Some relief could be granted to these groups by exempting certain items, like food and medicine, but doing so would make the system more complicated and difficult to administer. The adverse effect on economic growth must also be considered. One econometric study predicted that the U.S. economy would grow 1% more slowly for each 1% VAT and

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[8] The author found a very easy way to evade the VAT at a McDonald's in Paris. A VAT is charged on food that is consumed on the premises but not on food that is taken away. All one need do to evade the VAT is to declare that you are taking the food away at the time of purchase, then change your mind and sit down at a table after you have the food in-hand. Enforcement would require the hamburger police to be stationed at every McDonald's.

[9] Is an antidandruff shampoo, for example, a medicine, and therefore exempt, or a cosmetic, and therefore taxable. French tax officials engaged in an extensive debate over this issue, as is pointed out in Weidenbaum and Christian, p. 5.

[10] In fact, it is not neutral, but it is not easy to predict where distortion will occur. The tax is paid by producers, but may be passed on to consumers in the form of higher prices. If it cannot be passed on, then profit margins suffer, shareholders must be content with a lower return on investment, and employment expands less rapidly. And a VAT may adversely affect some lines of business more than others. Any tax also has an adverse effect on economic growth, so it cannot truly be said that a VAT is neutral.

[11] This view takes for granted that the ability to pay principle is to be preferred over the cost-benefit principle, which is questionable, at best. For a critique of the ability to pay principle from an ethical perspective, see McGee (1998).

inflation would be one and a half to two percentage points higher during the initial adjustment period (Weidenbaum and Christian 1989, p. 10).[12]

A study of European VAT systems found that the VAT is regressive in another way as well. The cost of compliance and administration fall more heavily on small firms than on large ones (Bannock 1986, pp. 24–25). This point should be of special interest to emerging democracies, since most economic growth is expected to come from small enterprises rather than large ones. A VAT could choke off growth before it starts in the case of many small businesses.

Mitchell (2005) lists a number of problems with the VAT. His basic arguments are that it expands government, slows economic growth and destroys jobs. There is also evidence to suggest that adopting a VAT can cause total taxes on profits to increase, which is just the opposite of what VAT proponents suggest. It is almost certain that the total tax burden will increase. He cites several studies to support his argument that increases in government spending have an adverse effect on economic growth.

Mitchell also argues that a VAT would impose a heavy administrative burden on businesses and taxpayers. He also explodes a series of myths about the VAT, such as the belief that imposing a VAT would increase savings by reducing the over-taxation of savings and investment; the belief that a VAT would have a favorable effect on the balance of trade; that the VAT is a simple tax with low compliance costs.

Another factor that must be considered, especially in an emerging economy, is collection. As is true of an income tax, the VAT will likely be collected only in the formal sector of the economy. Evasion will be widespread in the informal sector. This very fact will encourage enterprises to do their business informally rather than join the formal sector.

Comparisons

Transition economies have been adopting the value-added tax as a supplement to the income tax as a means of raising additional revenue. Some transition economies adopted a VAT in order to gain admission to the European Union, since having a VAT is a requirement for EU membership. That is bad news, in a way, since countries that have a VAT tend to have higher tax burdens than countries that do not have a VAT. Also, as the burden of taxes increases, the private sector has fewer funds available for saving and investment, which has a negative effect on economic growth. Having a VAT causes more resources to be shifted from the more efficient private sector to the less efficient government sector.

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[12] The study they cite is Prakken (1987).

Table 1 lists the VAT rates in various transition countries.

Table 1
VAT Rates in Transition Economies

Rank	Country	
1	Vietnam	10
2	Kazakhstan	14
3	Mongolia	15
4	Bosnia & Herzegovina	17
4	China	17
4	Montenegro	17
7	Azerbaijan	18
7	Belarus	18
7	Estonia	18
7	Georgia	18
7	Latvia	18
7	Lithuania	18
7	Macedonia	18
7	Russia	18
7	Serbia	18
16	Czech Republic	19
16	Romania	19
16	Slovakia	19
19	Albania	20
19	Armenia	20
19	Bulgaria	20
19	Hungary	20
19	Kyrgyzistan	20
19	Moldova	20
19	Slovenia	20
19	Tajikistan	20
19	Turkmenistan	20
19	Ukraine	20
19	Uzbekistan	20
30	Croatia	22
30	Poland	22
	Average	18.5

Sources: Anderson and Andelman (2007); International Tax Dialog (2005); KPMG (2007)

Vietnam is far ahead in first place with a rate of just 10%. The most popular rates are 18% and 20%. The highest rate among transition economies is 22%, shared by Croatia and Poland.

While comparing VAT rates in transition economies provides some insights about the relative levels of taxation, to obtain a more complete picture one must compare the VAT rates in transition economies to those in some segment of the more economically developed world. The European Union was chosen, since EU countries tend to be more economically developed than countries in many other parts of the world.

Table 2 lists VAT rates for transition and EU countries and ranks them from lowest to highest rates. In some cases, a country is both a transition economy and a member of the EU. In those cases, the country is listed only as a transition country.

Table 2
VAT Rates
A Comparison of Transition and EU Countries

Country	TE	EU
Vietnam	10	
Kazakhstan	14	
Cyprus		15
Luxembourg		15
Mongolia	15	
Spain		16
Bosnia & Herzegovina	17	
China	17	
Montenegro	17	
UK		17.5
Azerbaijan	18	
Belarus	18	
Estonia	18	
Georgia	18	
Latvia	18	
Lithuania	18	
Macedonia	18	
Malta		18
Russia	18	
Serbia	18	
Czech Republic	19	
Germany		19
Greece		19
Netherlands		19
Romania	19	
Slovakia	19	
France		19.6
Albania	20	
Armenia	20	
Austria		20
Bulgaria	20	
Hungary	20	
Italy		20
Kyrgyzistan	20	
Moldova	20	
Slovenia	20	
Tajikistan	20	
Turkmenistan	20	

Ukraine	20	
Uzbekistan	20	
Belgium		21
Ireland		21
Portugal		21
Croatia	22	
Finland		22
Poland	22	
Denmark		25
Sweden		25
Average	18.5	19.6

Sources: Anderson and Andelman (2007); International Tax Dialog (2005); KPMG (2007)

VAT rates in the transition economy sample averaged 18.5%, compared to 19.6% for European Union countries. A Wilcoxon test found the differences between the VAT rates in transition economies and the European Union to be insignificant ($p \leq 0.2358$).

Concluding Comments

There are several ethical problems with the value added tax. The main ethical problem, which is shared by just about every form of public finance other than lotteries and user fees, is coercion. In order to collect the tax it is first necessary to take property that rightfully belongs to others. In the case of the VAT, there are other ethical problems as well. For example, the tax is hidden. Those who ultimately pay the tax are not fully aware that they are paying or what they are paying. It is impossible to accurately trace the amount of the tax that is paid by the ultimate consumer or at each stage of production. Worse yet, there is no attempt at disclosure on the part of the government. Hidden taxes are unethical forms of public finance and the VAT is a hidden form of tax.

From a utilitarian ethical point of view, the tax is unethical because it is inefficient. Utilitarian ethics includes the premise that what is efficient is ethical and what is inefficient is unethical (Posner 1998, pp. 284–285). This view may be correct or incorrect, but it violates utilitarian ethics in any event.

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6

Tax Administration Costs in Transition Economies and the OECD: A Comparative Study

Robert W. McGee

Introduction

Paying taxes is a cost of doing business. The looters (or public servants, depending on your perspective) must be paid and tax proceeds must be distributed to various groups and individuals, both worthy and unworthy. But tax expense includes more than just the amount of taxes that must be paid. Before taxes can be paid, a determination must be made as to how much is owed. That involves paying the salaries of accountants, bookkeepers and clerks and perhaps an occasional law firm.

This study examines the level of tax administration burden, not from a monetary perspective but rather from the perspective of annual hours required to comply with the tax laws. Comparisons are made of the tax administration burden of 29 transition economies. A comparison is then made of the tax administration burden in transition economies and OECD countries.

Multinational companies look at a number of factors when trying to determine where to invest and establish new locations. Some of the most important factors include business climate, trade policy, fiscal policy, freedom from government, monetary policy, investment restrictions, financial freedom, property rights, corruption and labor restrictions. The *Index of Economic Freedom* (2007) compiles data on all of these factors annually for more than 160 countries. The present study is more modest in scope. It looks only at the burden of tax administration, which is one of the most important factors multinationals consider when determining where to invest their resources.

Tax systems that are overly burdensome can be a deterrent to setting up shop. Tax compliance headaches can be avoided by choosing jurisdictions that are not overly burdensome. An example from the author's own experience illustrates the point.

Early in my career I worked in the tax department of a U.S.-based multinational corporation. One day the president asked my boss, the director of

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taxation, where the company should build a warehouse. Several states were mentioned as possible locations, including Pennsylvania. My boss immediately crossed Pennsylvania off the list of possible states, not because taxes were higher in Pennsylvania than in other states but because he did not want to fill out a Pennsylvania corporate tax return. He had filled out Pennsylvania corporate tax returns in his former job and he did not want to do it again if he didn't have to because of the overly burdensome nature of Pennsylvania corporate tax returns in those days. So he chose another state and gave the president some plausible reason for his choice. It was probably a breach of the principal-agent relationship to choose to avoid Pennsylvania just because he didn't want to fill out a Pennsylvania corporate income tax form, but that's reality. The more burdensome tax compliance is, the less likely companies are to set up shop. The administrative cost in terms of salaries is an important factor, but it is not the only factor, as illustrated from the above example.

One way to measure the hassle factor empirically is to estimate the number of hours it takes to comply with the tax law of a particular jurisdiction. That is what the present study attempts to do.

Companies in 90% of the countries surveyed in the PricewaterhouseCoopers—World Bank study listed tax administration as one of the top five obstacles to doing business (PWC–WB 2006: 5). The main factors they mentioned that contribute to this burden were:

- the large number of business taxes to pay;
- lengthy and complex tax administration;
- complex tax legislation; and
- high tax rates.

While corporate tax rates are an important factor to consider when determining where to do business, the PWC–WB (2006) study showed that corporate taxes in the 175 countries surveyed account for just 36% of the total tax rate, 11% of the total tax payments and 25% of compliance time. Compliance with other taxes takes much more than half of total tax administrative resources.

Review of the Literature

The U.S. Internal Revenue Service hired the consulting firm of Arthur D. Little, Inc. during the 1980s to ask taxpayers how much time it took them to gather the necessary information and fill out their individual income tax returns. That initial study has been repeated several times since and the results are incorporated into various IRS instruction booklets, which give estimates regarding the amount of time it should take to gather information and prepare various tax forms. The Arthur D. Little model was later refined by the Internal

Revenue Service and the U.S. Treasury Department, which evolved into the Individual Taxpayer Burden Model (ITBM).

The ITBM has been discussed in numerous places. DeLuca et al. (2003) discussed the challenges in developing a small business taxpayer burden model. Lerman and Lee (2003) discuss it in conjunction with the alternative minimum tax. In their paper at note 10 they state that "Under the A.D. Little methodology, the aggregate AMT burden for Form 6251 filers would be calculated as 28.4 million hours." That translates into having 14,200 people working full-time just to complete one minor IRS form, if we assume an average of 2,000 working hours per year.

Guyton et al. (2005) studied the effects of tax software and paid tax preparers on compliance costs.

The federal government of the United States has published compliance statistics from time to time. In 2003 the U.S. Treasury Department published an ITBM user guide. In 2005 it started estimating the time and out-of-pocket costs of complying with the federal tax system separately. The data in Tables 1a & 1b were taken from the Federal Register, July 8, 2005 (Vol. 70, No. 130, pp. 39550-39555); August 3, 2006 (Vol. 71, No. 149, pp. 44075–44080); August 31, 2007 (Vol. 72, No. 169, pp. 50459–50465 [wais.access.gpo.gov] and Keating (2007).

Table 1a
Tax Burden for Individual Taxpayers
Who Filed Form 1040

	No. returns (millions)	Avg all preparation methods	
		Hours	Cost ($)
2003 tax year			
All taxpayers filing Form 1040, 1040A and 1040EZ	130.2	23.3	179
Subcategories			
Form 1040	88.2	30.5	242
Form 1040A	23.3	9.1	62
Form 1040EZ	18.7	7.2	29
Self-employed	35.6	53.9	410
2004 tax year			
All taxpayers filing Form 1040, 1040A and 1040EZ		25.4	185
Subcategories			
Form 1040		32.5	242
Forms 1040A and 1040EZ		9.8	62
Self-employed		55.8	408

2005 tax year		
All taxpayers filing Form 1040, 1040A and 1040EZ	23.8	204
Subcategories		
Form 1040	30.1	267
Forms 1040A and 1040EZ	11.0	74
Self-employed	57.0	420
2006 tax year		
All taxpayers filing Form 1040, 1040A and 1040EZ	26.5	207
Subcategories		
Form 1040	34.0	268
Forms 1040A and 1040EZ	10.2	75
Self-employed	58.1	444

Table 1b
Tax Burden for Individual Taxpayers
Who Filed Form 1040

	2003	2004	2005	2006
Hours				
All taxpayers	23.3	25.4	23.8	26.5
Self-employed	53.9	55.8	57.0	58.1
Cost ($)				
All taxpayers	179	185	204	207
Self-employed	410	408	420	444

Tables 1a and 1b show that it took individuals in the United States more than 3 billion hours to prepare their federal income tax returns for the 2003 tax year at an out-of-pocket cost of $23.4 billion. If the average number of hours worked in a year is 2,000, that translates into 1,516,830 people employed full-time just to complete federal tax returns. These figures do not include the time and cost of preparing state income tax returns and various other kinds of tax returns. Also excluded are the compliance costs of preparing corporate, partnership, excise and estate and gift tax returns and the federal and state levels.

As Table 1b shows, the costs of compliance since 2003 have gone up, both in terms of hours and monetary costs. For fiscal year 2006 individual and business taxpayers in the USA had to spend 6.65 billion hours complying with the tax laws, which is the equivalent of 3.2 million employees working 40 hours a week. Individual taxpayers alone had to spend 3.18 billion hours to comply. The Tax Foundation estimates that the average total wage compensation is $23.75 per hour. At that rate, individual tax compliance costs would be $75.5 billion in terms of labor hours (Keating 2007).

Individuals spent $26.5 billion for tax software, tax preparers and other out-of-pocket costs. Add that to the $75.5 billion in labor hours and the result is $102 billion a year in tax compliance costs, just for individuals (Keating 2007).

A number of studies have examined various aspects of the tax compliance burden in the United States. Arena et al. (2002) discussed measurement issues. Guyton et al. (2003) and Holtzblatt (2004) looked at the cost of complying with the U.S. individual income tax. Guyton et al. (2004) did research on the small business compliance burden. Evans (2003) reviewed the various studies that have been made on measuring tax operating costs.

A search of various databases plus the internet was unable to uncover any studies of tax compliance and administrative costs that focused specifically on transition economies. That does not mean that no such studies exist. It means only that any studies that do exist are either not listed in the major databases or are not in the English language. Luckily, one source was found that had data for transition economies, although the study did not focus specifically on transition economies.

Methodology

In recent years PricewaterhouseCoopers and The World Bank have been conducting joint studies on tax administration burden. The present study uses the data they gathered between April and July, 2006 for 29 transition economies and OECD countries. Their study examined tax administration burdens for standard, modest-sized companies in 175 countries PWC–WB, 2006).

Findings

Table 2 shows the number of hours needed to comply with the tax laws annually for each transition economy. Columns are provided for the total and for three separate categories—profit tax, labor tax and consumption tax. On average it took 437 hours to comply with the administrative requirements of tax laws. But companies in some countries took substantially more time than average to comply.

Table 2
Annual Hours Needed to Comply with Tax Laws
Transition Economies

Country	Total hours	Profit tax	Labor tax	Consumption tax
Albania	240	120	96	24
Armenia	1120	160	480	480
Azerbaijan	1000	250	150	600
Belarus	1188	960	180	48
Bosnia	100	25	40	35
Bulgaria	616	40	288	288
China	872	200	288	384
Croatia	196	60	96	40
Czech Republic	930	150	420	360
Estonia	104	20	36	48
Georgia	423	144	67	212
Hungary	304	16	192	96
Kazakhstan	156	60	64	32
Kyrgyz Republic	204	60	72	72
Latvia	320	32	192	96
Lithuania	162	28	76	58
Macedonia	96	30	36	30
Moldova	250	100	100	50
Mongolia	204	60	72	72
Montenegro	208	16	96	96
Poland	175	50	100	25
Romania	198	42	96	60
Russia	256	64	96	96
Serbia	168	48	60	60
Slovak Republic	344	80	120	144
Slovenia	272	80	96	96
Tajikistan	224	80	48	96
Ukraine	2185	425	800	960
Uzbekistan	152	32	48	72
Average	437	118	155	163
Percentage of total	100.0	27.0	35.5	37.3

One interesting finding is the percent of total tax compliance burden by category. The burden to comply with profit tax laws was the lowest of the three categories, at 27%. The compliance burden was substantially higher for both labor tax laws and consumption tax laws.

Table 3 ranks the transition economies from least hours to most hours. Ten of the 29 transition economies took less than 100 hours a year to comply with the tax laws. Four of the ten—Macedonia, Bosnia, Serbia and

Croatia—are former Yugoslav republics. The other former Yugoslav republics included in the study—Montenegro and Slovenia—took between 208 and 272 hours to comply. Five of the six former Yugoslav republics ranked in the top half and 4 of them ranked in the top 10.

At the other end of the spectrum is the group that took the most hours to comply. Six of the 10 countries having the highest compliance burden—Latvia, Georgia, Azerbaijan, Armenia, Belarus and Ukraine—are former Soviet Republics. The four countries with the highest compliance burden are all former Soviet republics.

Table 3
Ranking of Transition Economies from Least Hours to Most Hours
Annual Hours Needed to Comply with Tax Laws

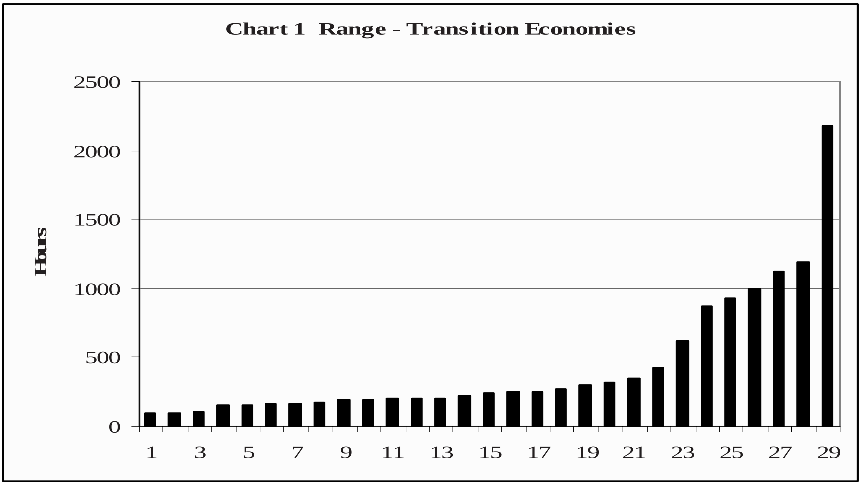
Rank	Country	Hours	Percentage of average
1	Macedonia	96	22.0
2	Bosnia	100	22.9
3	Estonia	104	23.8
4	Uzbekistan	152	34.8
5	Kazakhstan	156	35.7
6	Lithuania	162	37.1
7	Serbia	168	38.4
8	Poland	175	40.0
9	Croatia	196	44.9
10	Romania	198	45.3
11	Kyrgyz Republic	204	46.7
11	Mongolia	204	46.7
13	Montenegro	208	47.6
14	Tajikistan	224	51.3
15	Albania	240	54.9
16	Moldova	250	57.2
17	Russia	256	58.6
18	Slovenia	272	62.2
19	Hungary	304	69.6
20	Latvia	320	73.2
21	Slovak Republic	344	78.7
22	Georgia	423	96.8
23	Bulgaria	616	141.0
24	China	872	199.5
25	Czech Republic	930	212.8
26	Azerbaijan	1000	228.8
27	Armenia	1120	256.3
28	Belarus	1188	271.9
29	Ukraine	2185	500.0
	Average	437	

Table 3 also shows the compliance burden as a percentage of the average burden for the 29 transition economies included in the study. Three countries—Macedonia, Bosnia and Estonia—had compliance burdens that were less than 30% of average. Five countries—the Czech Republic, Azerbaijan, Armenia, Belarus and Ukraine—had compliance burdens that were more than 200% of average. China was not far behind, with a compliance burden that was 199.5% of average.

Another interesting finding was the relative distribution of the scores. Twenty-two of the 29 countries (75.9%) had compliance burdens that were below the average for the group. Seven countries (24.1%) had above-average scores. Thus, the distribution is skewed. A few countries with relatively high scores caused the average to be higher than would otherwise be the case.

A modest size Ukrainian company takes 2185 hours to handle tax administration. That's the equivalent of one full-time person or perhaps a bit more just to comply with tax laws. It is also five times the average number of hours required for a transition economy. Macedonian accountants, on the other hand, take an average of just 96 hours to comply, or just over two weeks per year. Stated in statistical terms, it takes Ukrainian companies 22.8 times as many hours to comply with tax laws as it does for Macedonian companies of the same size. This wide divergence in time requirements might lead one to conclude that there is something wrong with the Ukrainian tax system. Perhaps Ukraine would be better off adopting the Macedonian tax system.

Chart 1 shows the range of scores for transition economies.



It is obvious from looking at the chart that Ukraine is far out of step with the other transition countries. A glance at the chart quickly reveals that only seven countries require more than 500 hours to comply with the tax laws in their country.

Comparison with OECD Countries

While comparing the various transition countries to each other yields valuable information, that is not the end of the story. It is also important to compare them to the more developed market economies to see how well they are doing compared to some benchmark. Using developed market economies as a benchmark provides this comparison. OECD member countries are used as a surrogate for developed market economies, since all OECD countries fit this description to a certain extent, with the possible exception of some recent membership additions from Eastern and Central Europe.

Table 4 shows the scores for the OECD countries. Four transition countries—the Czech Republic, Hungary, Poland and the Slovak Republic—are also OECD members. Those four countries were omitted from Table 4 to prevent overlap in the comparison of OECD and transition economies. No data was provided for Luxembourg, so it could not be included in this study.

Table 4
Ranking of OECD Countries
Annual Hours Needed to Comply with Tax Laws

Rank	Country	Hours	Percentage of average
1	Switzerland	68	31.1
2	New Zealand	70	32.0
3	Ireland	76	34.7
4	Norway	87	39.7
5	Germany	105	47.9
5	UK	105	47.9
7	Australia	107	48.9
8	Canada	119	54.3
9	Sweden	122	55.7
10	France	128	58.4
11	Denmark	135	61.6
12	Iceland	140	63.9
13	Belgium	160	73.1
14	Greece	204	93.2
15	Netherlands	250	114.2
16	Turkey	254	116.0
17	Finland	264	120.5
18	Austria	272	124.2
19	Korea	290	132.4
20	USA	325	148.4
21	Portugal	328	149.8
22	Japan	350	159.8
23	Italy	360	164.4
24	Mexico	552	252.1
25	Spain	602	274.9
Average		219	

Switzerland has the lowest burden (68), followed closely by New Zealand (70) and Ireland (76). Thirteen of the 25 OECD countries listed in the table take less than 200 hours a year to comply with the tax laws. Only Spain and Mexico have compliance times that are more than 200% of average. Fourteen (56%) of the 25 OECD countries have a compliance time that is below the average for the group. Thus, the results are not as skewed for the OECD sample as they were for the transition economy sample.

Chart 2 shows the range of scores for the OECD countries. As can be seen, the scores for Mexico and Spain soar far above the rest.

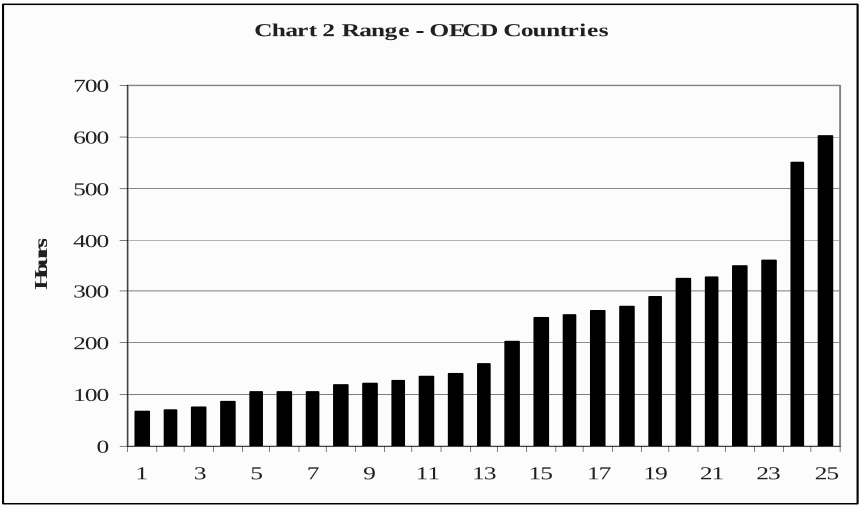


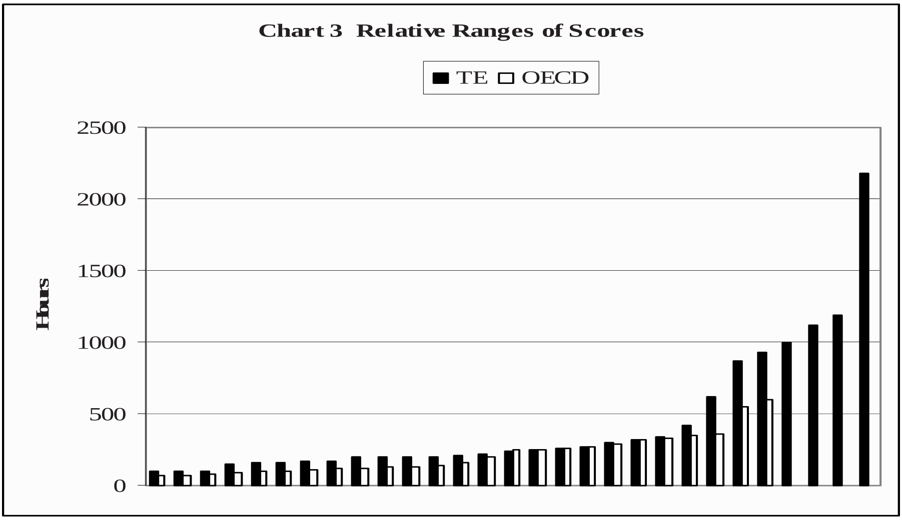
Table 5 combines the two sets of data. As can be seen, four OECD countries have the lowest number of hours and 7 transition economies have the highest number of hours. OECD countries average 219 hours to comply with the tax law, compared to 437 hours for transition economies, or about twice as long. If the hours were translated into the number of 40-h work weeks, it would take the average company in a transition economy 10.9 weeks a year to comply with tax rules, compared to 5.5 weeks for a company that is a member of the OECD. A Wilcoxon test found this difference to be significant ($p <= 0.05202$).

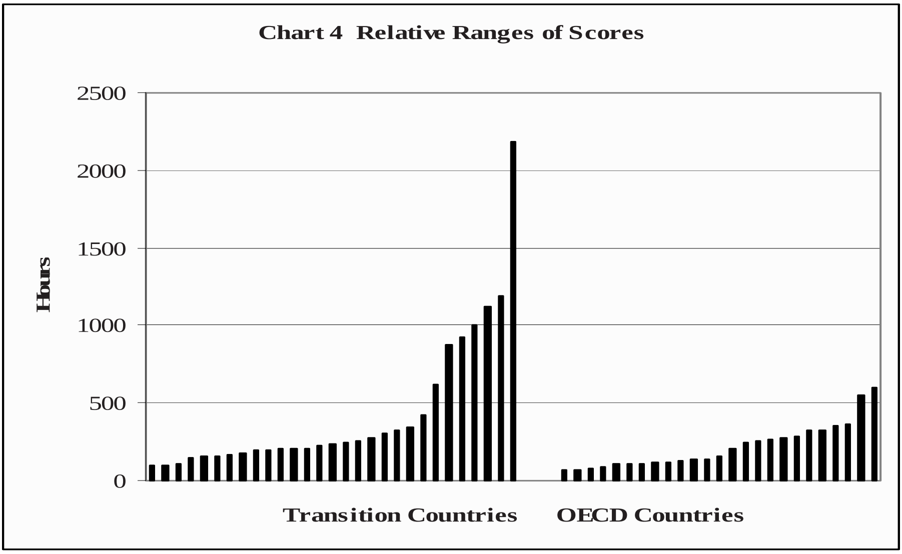
Table 5
Ranking & Comparison of Transition and OECD Countries

Rank	Country	TE	OECD
	Switzerland		68
	New Zealand		70
	Ireland		76
	Norway		87
	Macedonia	96	
	Bosnia	100	

Estonia	104	
Germany		105
UK		105
Australia		107
Canada		119
Sweden		122
France		128
Denmark		135
Iceland		140
Uzbekistan	152	
Kazakhstan	156	
Belgium		160
Lithuania	162	
Serbia	168	
Poland	175	
Croatia	196	
Romania	198	
Greece		204
Kyrgyz Republic	204	
Mongolia	204	
Montenegro	208	
Tajikistan	224	
Albania	240	
Moldova	250	
Netherlands		250
Turkey		254
Russia	256	
Finland		264
Austria		272
Slovenia	272	
Korea		290
Hungary	304	
Latvia	320	
USA		325
Portugal		328
Slovak Republic	344	
Japan		350
Italy		360
Georgia	423	
Mexico		552
Spain		602
Bulgaria	616	
China	872	
Czech Republic	930	
Azerbaijan	1000	
Armenia	1120	
Belarus	1188	
Ukraine	2185	
Average	437	219

Charts 3 and 4 show the relative ranges for transition countries and OECD countries.





The charts clearly show that it takes more time for countries in transition to comply with the tax laws of their country.

Concluding Comments

Countries that are in transition from central planning to a market economy face a number of obstacles. They need foreign investment to help make the transition and to foster economic growth but they must compete for capital with every other country in the world. It has become easier in recent years for capital to cross borders, which is both good news and bad news for transition economies. It is good news because it is now possible for capital to flow into their countries. But it is also bad news because domestic investors are now freer to export their capital to other countries if the investment climate in those countries is more hospitable.

In order to compete for international and even domestic capital, countries must try to foster a friendly investment environment. Factors that make a country look attractive to investors include low tax rates and low administrative burden. The results of the present study indicate that transition economies are not competitive in the area of administrative tax burden. That will need to change if they want to take maximum advantage of the reduced capital barriers that have resulted as part of the increase in globalization.

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7

A Comparative Study of Tax Misery and Tax Happiness in Transition Economies and the European Union

Robert W. McGee

Introduction

Each May, Forbes magazine publishes a study on tax misery. The Forbes Tax Misery Index is a proxy for evaluating whether tax policy attracts or repels capital and talent. It is computed by adding the top marginal tax rate for the corporate income tax, individual income tax, wealth tax, employer's and employee's social security tax and value added tax (VAT). The higher the total, the more the misery. Some taxes are omitted, such as the real and personal property tax and excise taxes. The 2007 Index was used for this study. Fifty-six countries are ranked. The present study examines the data for the transition countries from Eastern and Central Europe and the former Soviet Union that were included in the Forbes study, plus China. Comparisons are then made with European Union countries to determine which set of countries has to endure the most tax misery.

Tax Misery

The Tax Misery Index is computed by adding the top marginal rates for the following taxes: corporate income tax, personal income tax, wealth taxes, the employer's portion of social security taxes, the employee's share of the social security tax and the value added or sales tax. The Forbes 2007 survey included a total of 56 countries, of which 14 could be considered transition economies.

Some of my collectivist friends have criticized the concept of measuring tax misery, arguing that one must also take into consideration the services that governments provide to their citizens. Their arguments might be worthy of some consideration if we were talking about countries that provide services like good health care and large pensions to their citizenry. However,

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none of the countries included in the category of transition economies provides much of any kind of services at present.

Even the more developed market economies of the European Union have inadequate pensions, in the sense that they are not enough to live on. The health care systems in some EU countries also leave a lot to be desired. In some EU countries, patients must wait more than six months for elective surgery. During a conversation I had with someone who lived in England I was told that it took her five months to get an MRI test and another 18 months to get the results. After ranting and raving about the evils of the relatively free market United States, a country she has never visited, she proudly declared that she was a socialist, as though that were something to brag about. Apparently she thinks that a government provided health care service that takes 23 months to get results for a simple MRI test is somehow superior to a fee based system where the results are available in a day or two.

The point is that government delivered services often leave a lot to be desired. There is overwhelming evidence to show that the private sector can do just about anything more efficiently than government (Bennett and Johnson 1981; Fitzgerald 1988; Gilroy 2006, 2007). That being the case, one might argue that calculating the extent of tax misery might be just the starting point and that these scores should be increased by some factor to show the extent of the inefficiencies that the citizenry must endure because their government insists on providing services that could be performed more efficiently in the private sector. However, we will leave those calculations for another day. The purpose of the present study is simpler. We will just calculate the extent of tax misery in selected countries and make some comparisons.

Table 1 shows the scores and rankings for the transition economies.

Table 1
Misery Index
Rankings and Scores
Transition Economies

Country	Rank within transition economies	Rank overall [out of 56]	Misery index score
China	1	3	152.0
Hungary	2	9	130.5
Poland	3	11	128.0
Slovenia	4	16	122.2
Romania	5	22	111.0
Ukraine	6	24	110.0
	Median score		107.1
Slovakia	7	29	106.9
Czech Republic	8	31	103.5
Estonia	9	36	95.9
Latvia	10	37	91.1
Lithuania	11	38	91.0
Bulgaria	12	40	90.5
Russia	13	49	81.0
Georgia	14	53	58.0

China has by far the worst score (152.0), which is more than two times the score for Georgia (58.0), the country with the lowest score. The Chinese press took the news quite badly and tried to defend its high score by making excuses and arguing that the country is engaged in the process of tax reform (Fangchao 2007). But the fact remains that taxes are higher in China than in any other transition economy. China's score ranked third among all countries, surpassed only by France and Belgium.

The French also complained about how the Forbes study seemed to show them in a bad light. Although the French score was right at the top in terms of misery, one French commentator argued that France was engaged in reforming its tax system. He also pointed out that the French get more for their money than do residents of New York City (Favre 2007).

It is interesting to note that none of the countries ranked 2 through 5—Hungary, Poland, Slovenia and Romania—are former Soviet republics. Slovenia, which was part of the former Yugoslavia, was not even part of the Soviet orbit. Five of the eight countries that had scores below the median (less than average tax misery) are former Soviet republics. Three of those former Soviet republics—Estonia, Latvia and Lithuania—are now part of the European Union.

One might interpret these results as evidence of a backlash against Soviet-style communism. The three Baltic states of Estonia, Latvia and Lithuania were among the first to secede from the Soviet Union and currently they do not allow the state to take as much in taxes as do the countries that were in the Soviet orbit.

Chart 1 illustrates the relative scores for the transition economies.

Chart 1 Tax Misery Rankings & Scores

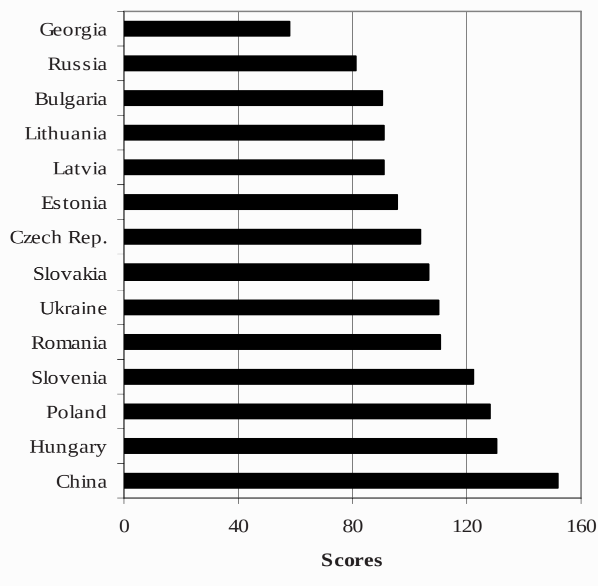


Table 2 provides a breakdown into the various tax categories.

Table 2
Misery Index
Tax Rates
Transition Economies

Rank	Country	Corp IT	Ind. IT	WT	SS Em'er	SS Em'ee	VAT	Misery index score
1	China	25	45	0	44.5	20.5	17	152.0
2	Hungary	20	40	0	33.5	17	20	130.5
3	Poland	19	40	0	20	27	22	128.0
4	Slovenia	23	41	0	16.1	22.1	20	122.2
5	Romania	16	16	0	43	17	19	111.0
6	Ukraine	25	15	0	50	0	20	110.0
7	Slovakia	19	19	0	36.5	13.4	19	106.9
8	Czech Republic	22	15	0	35	12.5	19	103.5
9	Estonia	21	21	0	33.3	2.6	18	95.9
10	Latvia	15	25	0	24.1	9	18	91.1
11	Lithuania	15	24	0	31	3	18	91.0
12	Bulgaria	10	24	0	24	12.5	20	90.5
13	Russia	24	13	0	26	0	18	81.0
14	Georgia	15	12	0	13	0	18	58.0

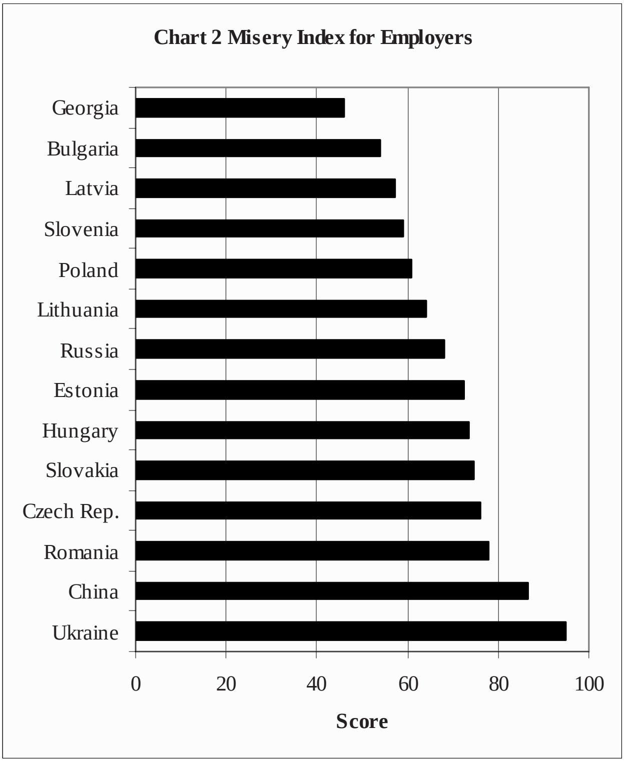
Another measure of tax misery is the total tax that employers must pay. Table 3 uses the Forbes data to compute relative corporate tax misery by adding the top tax rates for the corporate income tax, the employer portion of social security taxes and the VAT. The totals and ranks are given in Table 3.

Table 3
Misery Index for Employers
Tax Rates in Transition Economies

Rank	Country	Corp IT	SS Em'er	VAT	Employer misery index
1	Ukraine	25	50	20	95
2	China	25	44.5	17	86.5
3	Romania	16	43	19	78
4	Czech Republic	22	35	19	76
5	Slovakia	19	36.5	19	74.5
6	Hungary	20	33.5	20	73.5
7	Estonia	21	33.3	18	72.3
8	Russia	24	26	18	68
9	Lithuania	15	31	18	64
10	Poland	19	20	22	61
11	Slovenia	23	16.1	20	59.1
12	Latvia	15	24.1	18	57.1
13	Bulgaria	10	24	20	54
14	Georgia	15	13	18	46

In the area of corporate tax burden, Ukraine surpasses China as the worst place for corporations to set up shop. Romania, the Czech Republic, Slovakia and Hungary are also among the least corporate friendly countries. Georgia is the most corporate friendly country among the transition group, followed by Bulgaria, Latvia, Slovenia and Poland. Russia and Estonia are in the middle of the group.

Chart 2 illustrates the relative scores.



Tax Happiness

Another way to look at tax misery is to examine the size of the slice of the pie that government taxes away from employees. Potential ex-pats who are considering a move to a foreign country often rate the tax bite as one of the most important factors in decided whether to take or decline a foreign assignment.

For those employees who are allowed to keep a large portion of the fruits of their labor, one might just as easily call it tax happiness. Table 4 shows the percentage of salary that employees get to keep after income taxes and the employee portion of social security taxes are deducted. The figures assume the employee is married with two dependent children and earns a salary of €50,000.

Table 4
Employee Tax Happiness
€50,000 Income Level
Married, Two Dependent Children

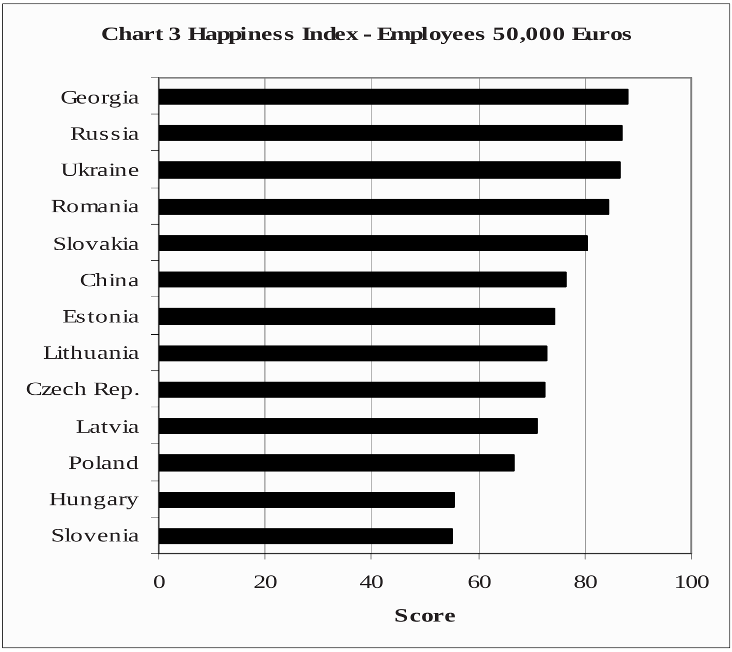
Rank	Country	Gross salary	Employee SS	Income tax	Net to employee	% Net
1	Slovenia	50,000	11,050	11,323	27,627	55.00
2	Hungary	50,000	4,608	17,760	27,632	55.26
3	Poland	50,000	8,138	8,484	33,378	66.76
4	Latvia	50,000	2,573	11,834	35,593	71.19
5	Czech Republic	50,000	6,250	7,500	36,250	72.50
6	Lithuania	50,000	1,500	12,000	36,500	73.00
7	Estonia	50,000	1,500	11,327	37,173	74.35
8	China	50,000	1,096	10,634	38,270	76.54
9	Slovakia	50,000	1,736	8,033	40,231	80.46
10	Romania	50,000	380	7,381	42,239	84.48
11	Ukraine	50,000	246	6,468	43,286	86.57
12	Russia	50,000	0	6,500	43,500	87.00
13	Georgia	50,000	0	6,000	44,000	88.00

Slovenia is the least desirable place to work among the transition countries, at least from the perspective of tax bite. People who work there get to keep just 55% of what they earn. The people who work in Hungary aren't much better off, being able to keep just 55.26% of what they earn.

Polish workers get to keep a full 11% more than Hungarians, 66.76% compared to 55.26%. But that's still not great news, considering the Christian Bible suggests tithing just 10% to the state or, stated differently, keeping 90% of what one earns.

The best places to work, from a tax perspective, are Georgia, Russia and Ukraine, all three of which are former Soviet republics. Romania and Slovakia also allow their workers to keep more than 80% of what they earn.

Chart 3 illustrates the relative scores.



The tax bite may change as income increases. Many countries have adopted a graduated income tax, which takes a higher percentage of income as the income level increases. The graduated income tax has been criticized on a number of counts. It seems unfair to tax the most productive members of society more than less productive people (McGee 1998a, b). It violates equal treatment for all citizens, since some are forced to pay more than others. It also reduces incentives and causes the economy to operate less efficiently (Blum and Kalven 1953). It also exacerbates envy, something governments should never do (deJouvenel 1952). Karl Marx advocated a graduated income tax system as a means of destroying market economies (Marx Engels 1848).

Some economists (Hall and Rabushka 1985) have recommended a flat tax as the solution to these problems and some transition economies have taken this advice. However, in spite of all these criticisms a number of transition economies have decided to adopt a graduated tax rate system anyway and some modern economists continue to suggest some form of graduated income tax (McCaffery 2002).

While it is clear that a flat tax is fairer (or less unfair) to the most productive citizens, the analysis can be pushed a step farther. If the private sector can do just about anything more efficiently than the government, and the evidence is overwhelming that this is the case, then it seems that the best alternative is not a flat tax but rather no tax. The more tax money that is sucked out of the economy, the less efficiently it operates, since it is sucked from the more productive private sector and transferred to the much less productive government sector. Therefore, countries that are really serious about economic growth should work toward minimizing taxes, since governments that drain less taxes from the citizenry are less parasitic.

Table 5 shows the percent of gross pay that employees earning €100,000 are allowed to take home. In some cases the percentage workers are allowed to keep is less at the €100,000 level than it was at the €50,000 level because of the graduated income tax. But in other cases the percentage is unchanged, since some countries have adopted the flat tax.

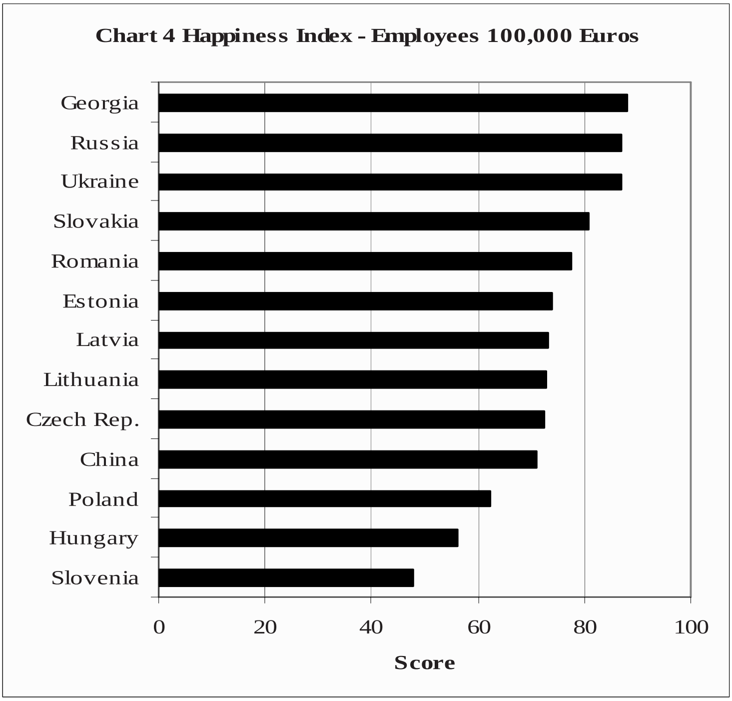
Table 5
Employee Tax Happiness
€100,000 Income Level
Married, Two Dependent Children

Rank	Country	Gross salary	Employee SS	Income tax	Net to employee	% Net
1	Slovenia	100,000	22,100	29,947	47,953	47.95
2	Hungary	100,000	7,108	36,760	56,132	56.13
3	Poland	100,000	13,509	24,214	62,277	62.28
4	China	100,000	1,096	27,725	71,179	71.18
5	Czech Republic	100,000	12,500	15,000	72,500	72.50
6	Lithuania	100,000	3,000	24,000	73,000	73.00
7	Latvia	100,000	2,573	24,334	73,093	73.09
8	Estonia	100,000	3,000	22,967	74,033	74.03
9	Romania	100,000	7,620	14,781	77,599	77.60
10	Slovakia	100,000	1,736	17,533	80,731	80.73
11	Ukraine	100,000	246	12,968	86,786	86.79
12	Russia	100,000	0	13,000	87,000	87.00
13	Georgia	100,000	0	12,000	88,000	88.00

Slovenia ranks first, meaning its workers are the most miserable, with a take-home pay of less than 50% of earnings. All the other transition economies allow their most productive citizens to keep more than half of what they earn.

Russia and Ukraine do the best job, with take-home pay averaging about 87% of gross earnings. Slovakia is only a bit behind, with net earnings of 80.73% of gross.

Chart 4 illustrates the relative scores.



A Comparison with the European Union

Although much can be learned by comparing tax misery among transition economies, the analysis can be taken a step farther by comparing them to some other group of countries. The group of countries chosen for comparison in this study consists of European Union countries. EU countries that are also transition countries are excluded from the EU group.

Table 6 lists the tax misery scores for EU members and transition economies. Where a country is both an EU member and a transition country, the country is listed in the transition category.

Table 6
Tax Misery Scores
Comparison of Transition and EU Countries

Country	Transition	EU
France		166.8
Belgium		156.4
China	152.0	
Sweden		150.4
Italy		148.0
Austria		144.4
Finland		131.0
Hungary	130.5	
Greece		128.9
Poland	128.0	
Spain		127.5
Portugal		124.3
Slovenia	122.2	
Netherlands		121.2
Germany (Berlin)		120.5
Denmark		118.0
Romania	111.0	
Ukraine	110.0	
United Kingdom		109.3
Luxembourg		107.2
Slovakia	106.9	
Czech Republic	103.5	
Estonia	95.9	
Latvia	91.1	
Lithuania	91.0	
Ireland		91.0
Bulgaria	90.5	
Russia	81.0	
Cyprus		73.3
Malta		73.0
Georgia	58.0	
Average	105.1	123.0

The average tax misery score for transition countries is 105.1; for EU countries it is 123.0. A Wilcoxon test determined that the average scores were significantly different at the 10% level ($p <= 0.06786$). Thus, the average transition economy has significantly less tax misery than the average EU country that is not also a transition economy.

Chart 5 shows the relative scores graphically.

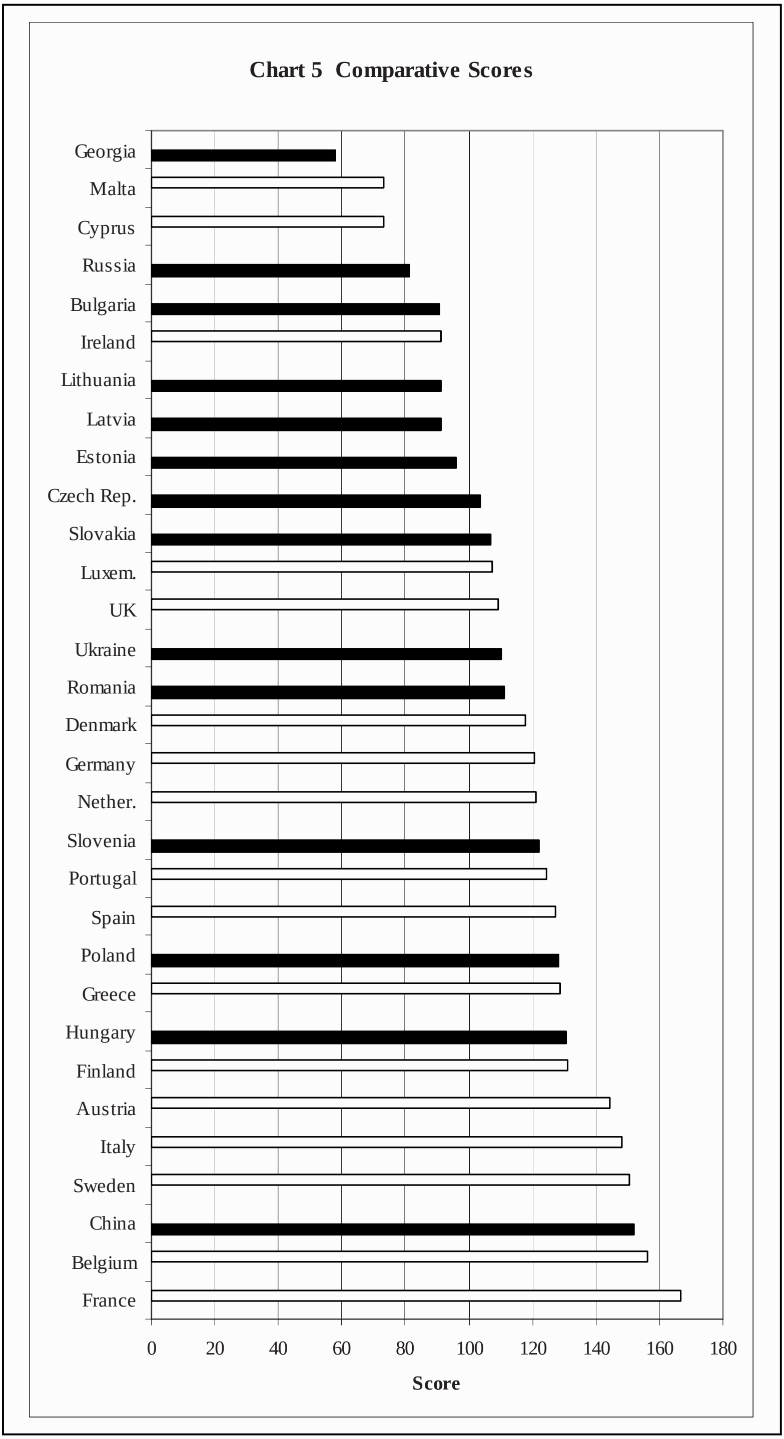


Chart 5 Comparative Scores
Georgia
Malta
Cyprus
Russia
Bulgaria
Ireland
Lithuania
Latvia
Estonia
Czech Rep.
Slovakia
Luxem.
UK
Ukraine
Romania
Denmark
Germany
Nether.
Slovenia
Portugal
Spain
Poland
Greece
Hungary
Finland
Austria
Italy
Sweden
China
Belgium
France
0
20
40
60
80
100
120
140
160
180
Score

Concluding Comments

The Forbes *Tax Misery Index* makes it possible to compare the relative tax burden of transition economies. The present study found that some transition economies have a significantly heavier tax burden than other countries, but that the average tax burden for a transition economy is significantly less than the average tax burden for EU countries that are not transition economies.

This finding has policy implications. The EU countries and transition countries that have relatively high tax burdens will find it difficult to compete for investment. Transition countries generally have lower wage rates and lower production costs than countries in the EU. That, coupled with lower taxes, make investment in transition countries appear to be relatively attractive. If high tax misery countries want to compete for international investment they need to reduce the tax burden they impose on the corporations that set up shop in their countries.

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8

Fiscal Freedom in Transition Economies and the OECD: A Comparative Study

Robert W. McGee

Introduction

Each year the Heritage Foundation and The Wall Street Journal publish the *Index of Economic Freedom*. This major study compiles economic data on more than 150 countries. The compilers divide the data into ten categories, ranging from business freedom to labor freedom. One of the ten categories is fiscal freedom.

The variables for fiscal freedom include individual income and corporate income taxation and tax revenues as a percentage of GDP. These three variables are weighted equally. The range for each variable is 0–100. Table 1 shows the extent of fiscal freedom for the transition economies that were included in the study. The figures are for the 2007 study. The perfect score is 100. The scoring of fiscal freedom is computed using a quadratic cost function where each component is converted to a 100-point scale, using the following equation:

$$FF_{ij} = 100–200(Component_{ij})^2$$

where FF_{ij} represents fiscal freedom in country i for component j and $Component_{ij}$ represents the raw percentage value, which is between 0 and 1, in country i for component j.

The present study analyzes the scores and compares them between countries and between years for 28 transition countries. A comparison is also made with OECD countries to determine how well or how poorly transition economies are doing in the total scheme of things.

Fiscal Freedom

Fiscal freedom is important for several reasons. Since the private sector can do just about anything more efficiently than the government sector (Bennett and Johnson 1981; Crane 1997; Fitzgerald 1988; Goodman 1985; Pinera

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1996; Poole 1980; Rodriguez 1999; Savas 1982; Segal 2002; Shirley and Spiegler 1998; Stevens 1992; Tanner 1979, 1998), the more that the private sector is permitted to do, the less there is for the relatively inefficient government sector to do. Thus, countries with a high degree of fiscal freedom are more efficient than are countries with a lesser degree of fiscal freedom, all other things being equal. Efficient economies have a higher rate of economic growth because of this relative efficiency, all other things being equal.

There is also the question of property rights. Taxation is the forced taking of property. There is nothing voluntary about it. The fact that some group of elected representatives might determine the amount to be taken and which groups or individuals will be the targets of the tax police does not change the fundamental nature of taxation.

Table 1
Fiscal Freedom 2007
Transition Economies

Country	Indiv. income tax rate	Corp. tax rate	Total tax revenue % GDP	Score income tax rate	Score corp. tax rate	Score total tax rev.	Fiscal freedom score
Albania	20	20	21.7	92.0	92.0	90.6	91.5
Armenia	20	20	15.3	92.0	92.0	95.3	93.1
Azerbaijan	35	22	14.4	75.5	90.3	95.9	87.2
Belarus	30	24	18.6	82.0	88.5	93.1	87.9
Bosnia	10	30	22.4	98.0	82.0	90.0	90.0
Bulgaria	24	15	22.3	88.5	95.5	90.1	91.3
China	45	33	15.1	59.5	78.2	95.4	77.7
Croatia	45	20	24.2	59.5	92.0	88.3	79.9
Czech Republic	32	24	37.6	79.5	88.5	71.7	79.9
Estonia	23	0	31.9	89.4	100.0	79.6	89.7
Georgia	12	20	18.2	97.1	92.0	93.4	94.2
Hungary	38	16	37.7	71.1	94.9	71.6	79.2
Kazakhstan	20	30	23.6	92.0	82.0	88.9	87.6
Kyrgyz Republic	10	10	23.1	98.0	98.0	89.3	95.1
Latvia	25	15	27.5	87.5	95.5	84.9	89.3
Lithuania	27	15	19.8	85.4	95.5	92.2	91.0
Macedonia	18	15	30.8	93.5	95.5	81.0	90.0
Moldova	18	15	29.8	93.5	95.5	82.2	90.4
Mongolia	30	30	32.3	82.0	82.0	79.1	81.0
Poland	40	19	34.3	68.0	92.8	76.5	79.1
Romania	16	16	27.1	94.9	94.9	85.3	91.7
Russia	13	24	36.1	96.6	88.5	73.9	86.3
Slovakia	19	19	18	92.8	92.8	93.5	93.0
Slovenia	50	25	37.6	50.0	87.5	71.7	69.7
Tajikistan	13	25	15.2	96.6	87.5	95.4	93.2
Turkmenistan	10	20	18.3	98.0	92.0	93.3	94.4
Ukraine	13	25	29.1	96.6	87.5	83.1	89.1
Uzbekistan	29	12	22.7	83.2	97.1	89.7	90.0
Average							87.6

Another important factor to consider is the interrelationship between fiscal freedom and the ability to attract investment capital. Countries that are hostile to foreign or domestic investors and creditors will find it difficult to attract capital. High tax rates and high levels of government spending make a country less attractive as a place for investment. This fact is especially important for transition and developing economies, since they are in need of capital to spur economic growth.

Table 1 shows the individual components of the fiscal freedom scores for all 28 transition economies for 2007. It also shows the final fiscal freedom scores.

Table 2 ranks the transition economies from most to least fiscal freedom for 2007.

The Kyrgyz Republic has the best score (95.1), followed closely by Turkmenistan (94.4), Georgia (94.2), Tajikistan (93.2), Armenia (93.1), and Slovakia (93.0).

Slovenia (69.7) had the worst score, far worse than China (77.7), which came in at second place. Next came Poland (79.1) and Hungary (79.2),

Table 2
Ranking of Fiscal Freedom 2007
Transition Economies

Rank	Country	Fiscal freedom score
1	Kyrgyz Republic	95.1
2	Turkmenistan	94.4
3	Georgia	94.2
4	Tajikistan	93.2
5	Armenia	93.1
6	Slovakia	93.0
7	Romania	91.7
8	Albania	91.5
9	Bulgaria	91.3
10	Lithuania	91.0
11	Moldova	90.4
12	Macedonia	90.0
13	Bosnia & Herzegovina	90.0
14	Uzbekistan	90.0
15	Estonia	89.7
16	Latvia	89.3
17	Ukraine	89.1
18	Belarus	87.9
19	Kazakhstan	87.6
20	Azerbaijan	87.2
21	Russia	86.3
22	Mongolia	81.0
23	Czech Republic	79.9
24	Croatia	79.9
25	Hungary	79.2
26	Poland	79.1
27	China	77.7
28	Slovenia	69.7

both recent entrants into the European Union, followed by Croatia (79.9), the Czech Republic (79.9), Mongolia (81.0) and Russia (86.3).

Chart 1 shows the range of fiscal freedom scores for 2007.

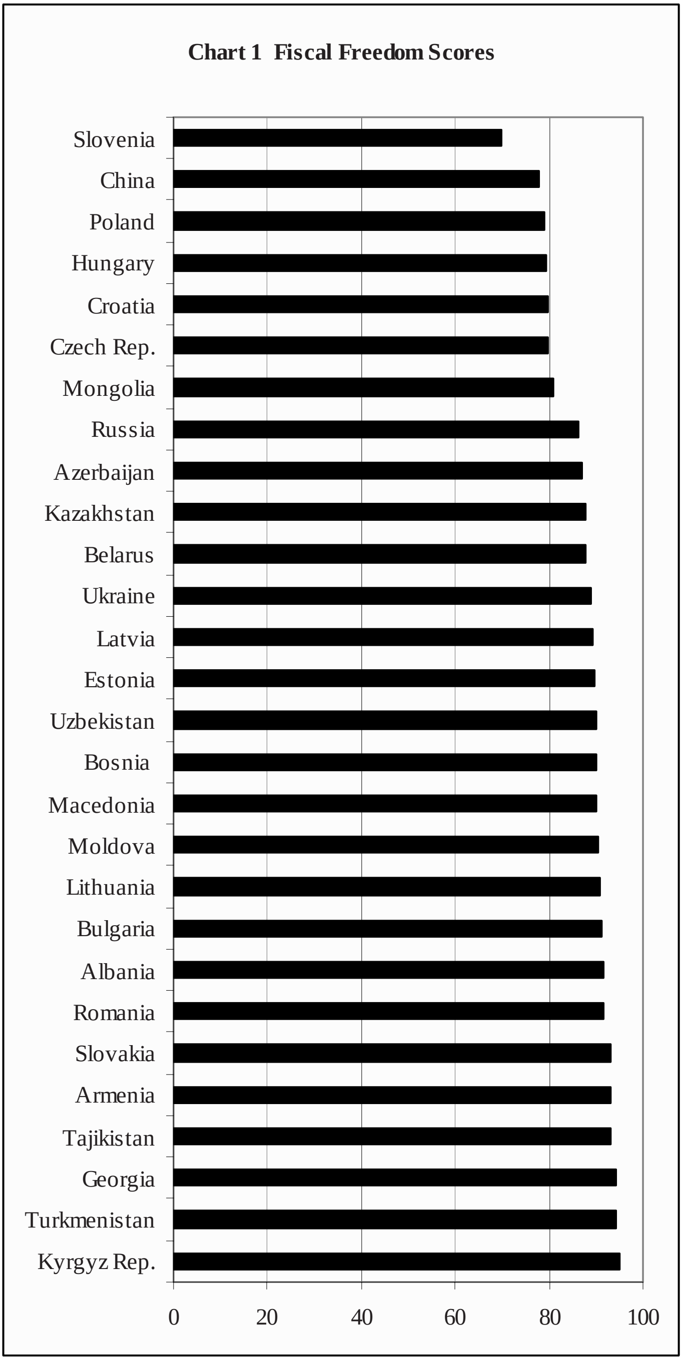


Table 3 shows the trend of fiscal freedom scores for the odd years, starting with 1995.

Table 3
Trend of Fiscal Freedom Scores

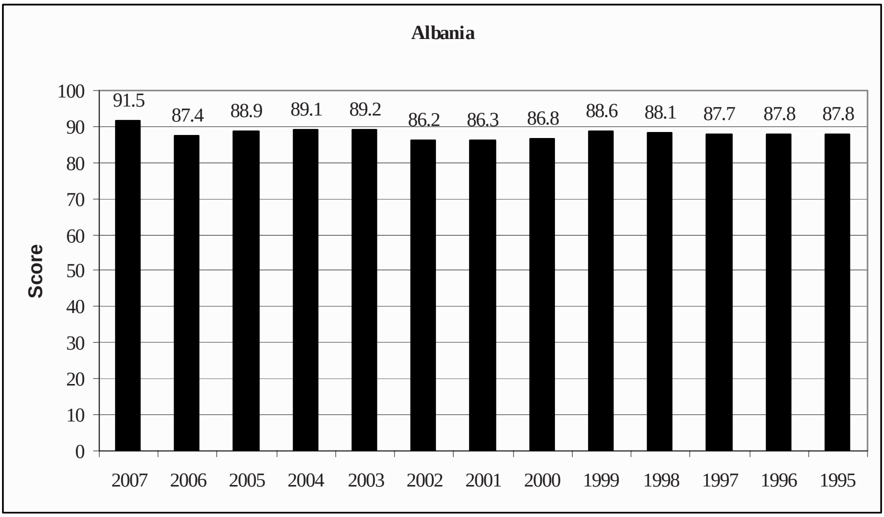
Country	2007	2005	2003	2001	1999	1997	1995
Albania	91.5	88.9	89.2	86.3	88.6	87.7	87.8
Armenia	93.1	93.2	92.6	87.9	86.9	87.1	
Azerbaijan	87.2	86.1	85.6	81.2	81.0	69.8	
Belarus	87.9	84.2	76.8	77.3	61.5	56.9	59.5
Bosnia	90.0	90.8	77.4	78.0	78.8		
Bulgaria	91.3	86.9	81.6	72.1	78.7	65.9	64.0
China	77.7	78.6	77.9	80.3	80.3	80.3	80.4
Croatia	79.9	72.9	85.1	77.9	78.9	82.9	
Czech Republic	79.9	78.8	78.1	78.4	72.8	69.1	64.5
Estonia	89.7	88.6	86.9	86.4	81.9	81.0	88.0
Georgia	94.2	93.3	93.7	93.9	94.2	92.0	
Hungary	79.2	78.6	77.0	77.1	75.0	69.6	64.5
Kazakhstan	87.6	88.4	85.3	86.1	82.5		
Kyrgyz Republic	95.1	90.0	84.4	79.1	81.8		
Latvia	89.3	89.1	85.5	83.6	84.8	85.3	
Lithuania	91.0	88.5	85.9	80.6	81.6	83.7	
Macedonia	90.0	89.1	86.8				
Moldova	90.4	89.7	87.6	69.6	72.3	72.7	47.1
Mongolia	81.0	82.4	74.5	76.3	75.8	74.7	65.0
Poland	79.1	78.9	77.1	74.2	68.8	66.3	67.3
Romania	91.7	80.1	79.4	71.7	61.5	61.1	57.9
Russia	86.3	94.3	93.7	83.1	82.8	85.1	83.7
Slovakia	93.0	87.9	78.4	72.9	68.7	66.4	57.7
Slovenia	69.7	70.4	68.7	68.5	68.3	67.6	
Tajikistan	93.2	89.8	82.7	72.0	71.8		
Turkmenistan	94.4	92.3	92.5	89.7	71.6		
Ukraine	89.1	88.7	78.1	75.9	75.3	74.1	45.2
Uzbekistan	90.0	87.0	83.4	70.2	66.3		

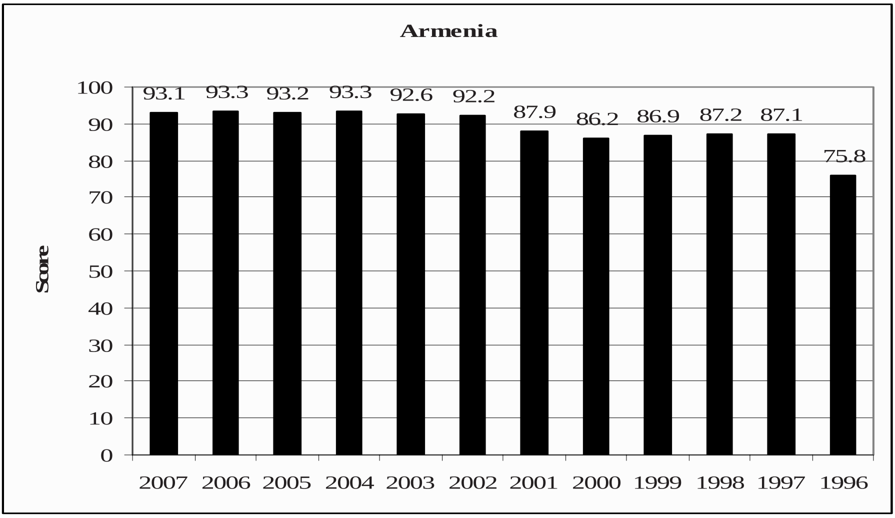
As can be seen from Table 3, some countries are doing better than others. Some are getting better over time while others are not.

The charts below illustrate the trends graphically for each transition country.

Albania has been consistently strong on fiscal freedom, starting with a score of 87.8 in 1995. Its score for 2007 is the highest score it has had. Part of the reason for the high scores is because Albania has relatively low tax rates. The top tax rate is 20% and the government reduced the flat corporate tax rate by 3% in January, 2006. Overall tax revenue as a percent of GDP is 21.7%.

Armenia has made rapid progress in the area of fiscal freedom, starting with a low score of 75.8 in 1996, the first year it was included in the *Index of Economic Freedom*, jumping to 87.1 in 1997 and gradually rising to more than 90% for each of the six most recent years.

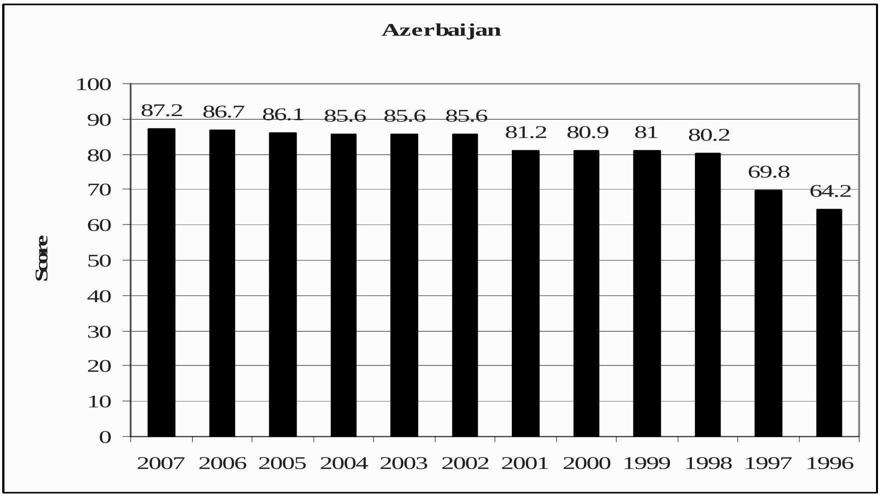


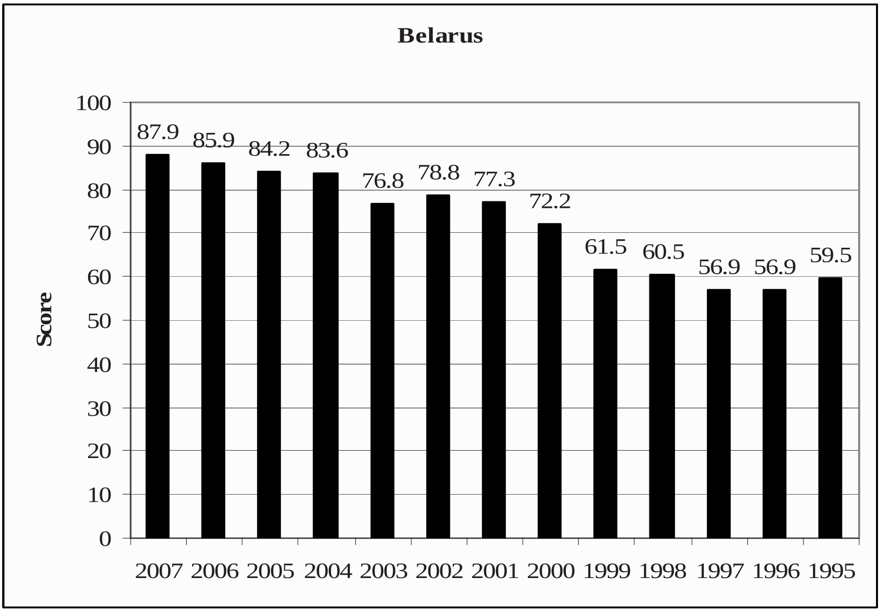


The reason for the good scores is relatively low tax rates. The top individual and corporate rate are both 20%. Tax revenue as a percent of GDP is 15.3%.

Azerbaijan has made good progress on fiscal freedom, starting with a low of 64.2 in 1996 and climbing to the mid-80s. Progress has leveled off in recent years and has not been quite as good as its Armenian and Georgian neighbors. Its top individual income tax rate is 35%. As of January, 2006 its top corporate tax rate is 22%. Tax revenue as a percent of GDP is 14.4%.

Belarus has made good progress on fiscal freedom, starting with a low score of 59.5 in 1995 and climbing to 87.9 in the most recent year. The biggest jump in score occurred in 2000, when it went from 61.5 to 72.2.

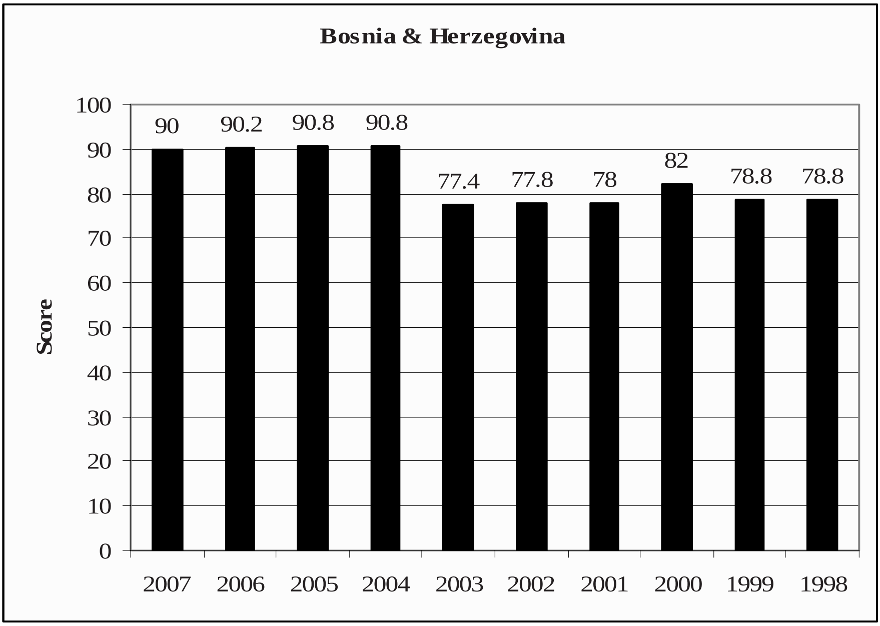


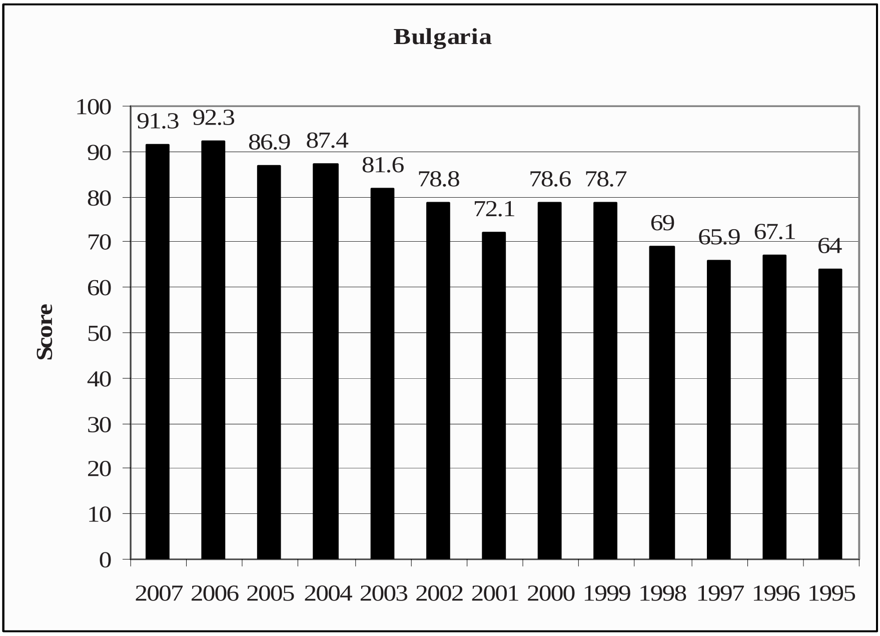


Its top individual income tax rate is 30% and the top corporate tax rate is 24%. Tax revenue as a percent of GDP is 18.6%.

The small Balkan state of Bosnia & Herzegovina started with a relatively good score of 78.8 in 1998, then fluctuated for a few years before jumping above 90% in 2004. It score has hovered around 90% ever since then.

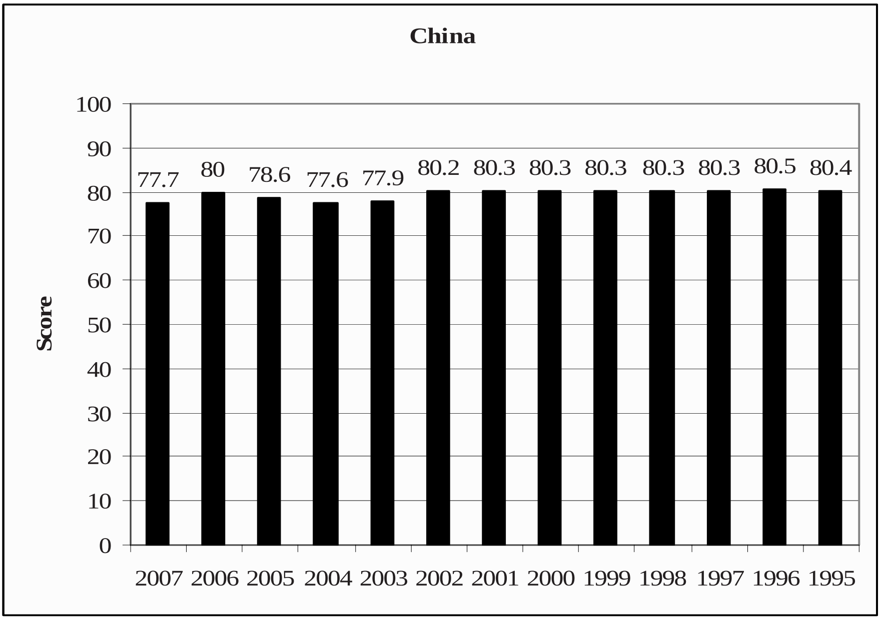
Its top individual income tax rate is 10%. The top corporate tax rate is 30%. Tax revenue as a percent of GDP is 22.4%.





Bulgaria has experienced a strong upward trend in fiscal freedom, with some fluctuations. It had a relatively poor score of 64 in 1995 and hovered in the 60s until 1999, when its score jumped to 78.7. Its score dropped to 72.1 in 2001, then rose into the low 90s.

Its top individual income tax rate is 24%. The top corporate tax rate is a flat 15%. Tax revenue as a percent of GDP is 22.3%.



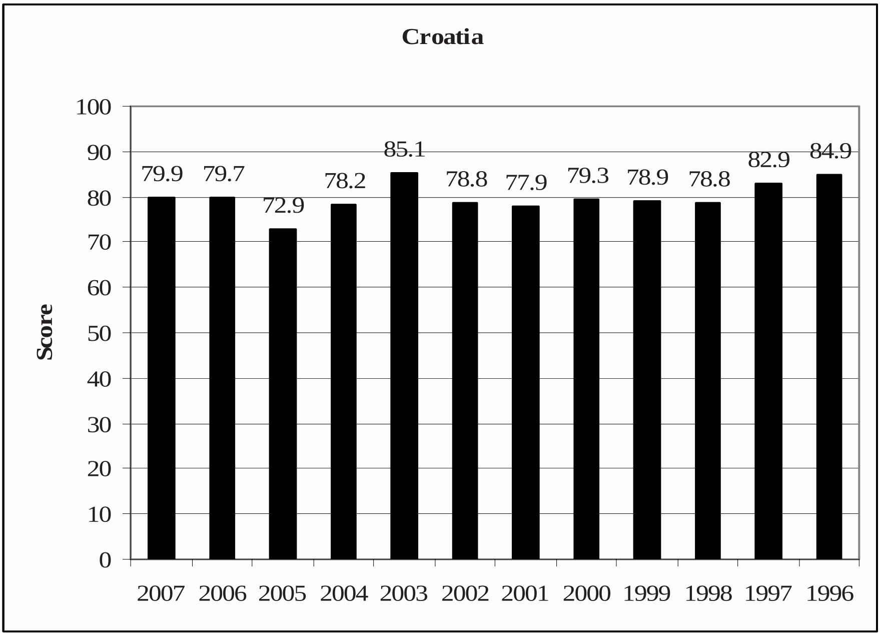
China started with a relatively high score of 80.4 in 1995 but has not made any progress since then. In fact, its score for every year since then has been lower, with the exception of 1996, when its score rose by a paltry one-tenth of a percentage point.

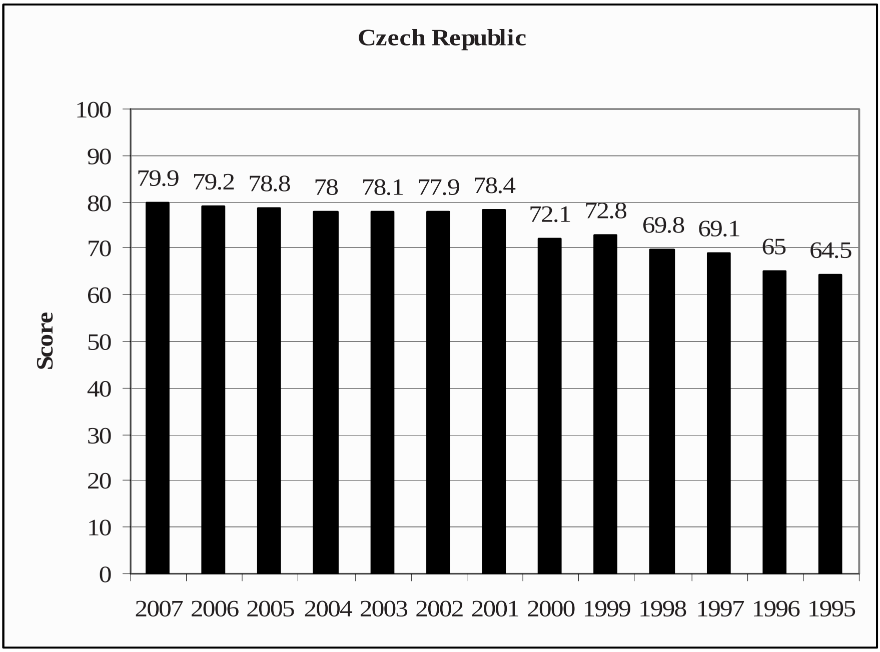
The reason for the relatively poor performance is its high tax rates. The top individual income tax rate is 45%. The top corporate tax rate is 33%. The good news is that the percent of tax revenue to GDP is a relatively low 15.1%.

Croatia's performance in the area of fiscal freedom has been disappointing. It started with a relatively high score of 84.9 in 1996 but its score has been lower than that practically every year since then, with the exception of 2003, when its score was 85.1. For most years its scores hovered in the 70s.

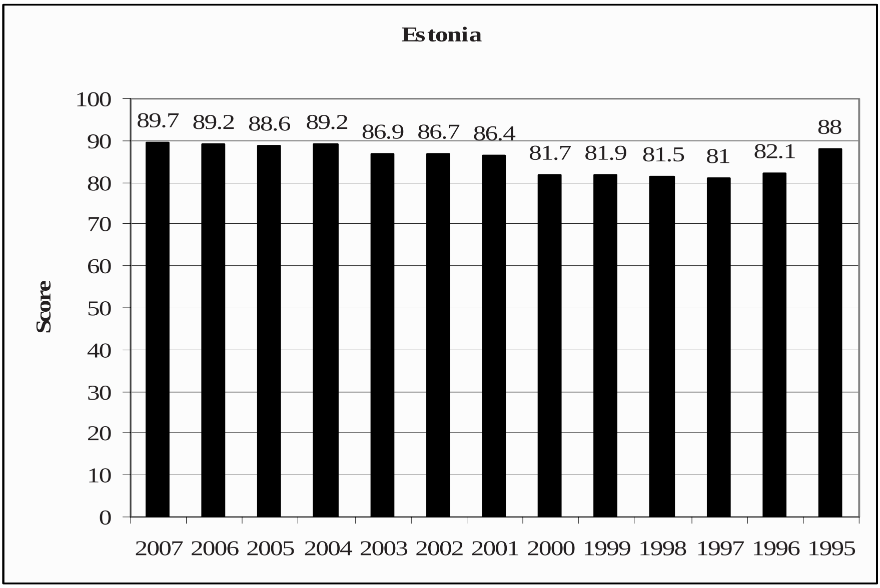
Part of the problem is its relatively high individual income tax rate, which is 45%. However, its corporate income tax rate is relatively low, at 20%. Tax revenue as a percent of GDP is 24.2%.

The Czech Republic started with a relatively low score and made some improvement for a few years before leveling off in the high 70s, where its score has remained for the last 7 years. Part of the problem is its individual income tax rate which is 32%. The corporate tax rate is somewhat lower at 24%. Tax revenue as a percent of GDP is a relatively high 37.6%.

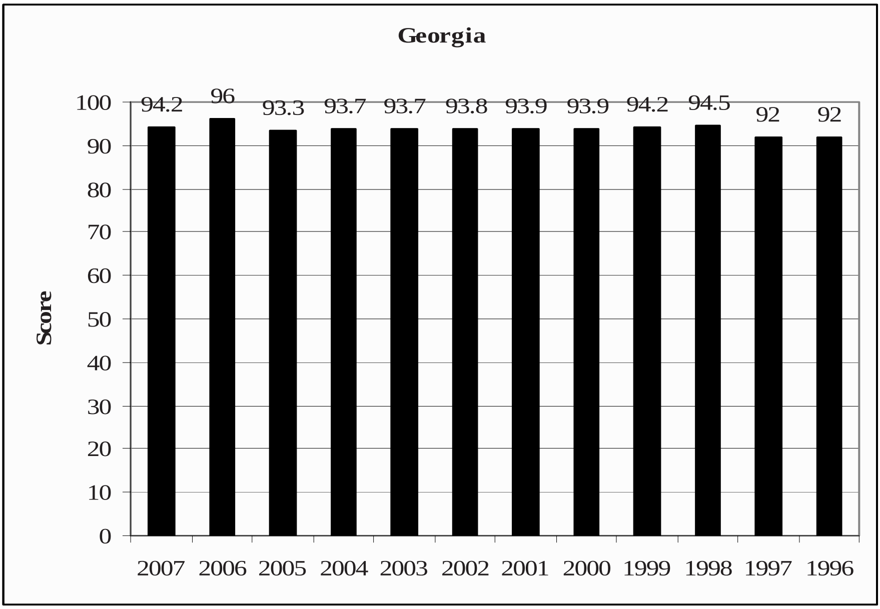




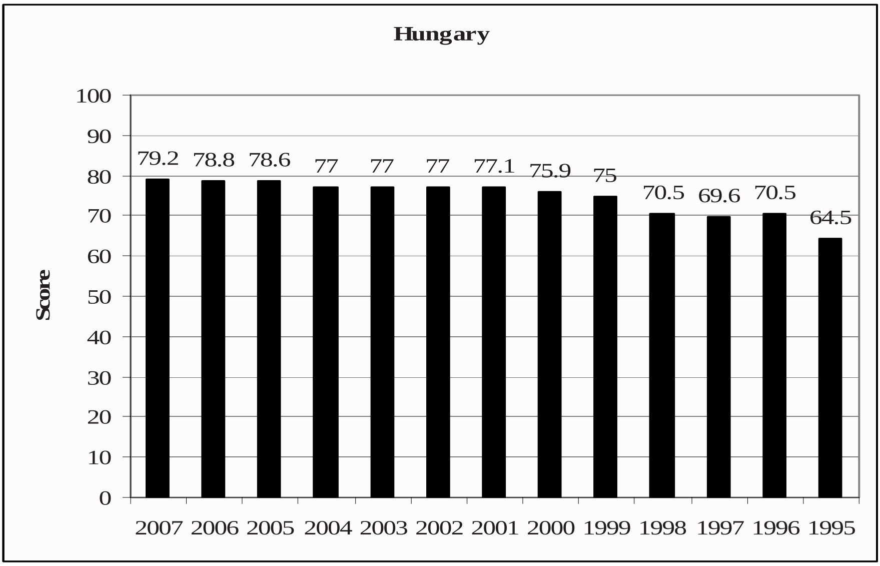
Estonia's initial score was quite high, at 88, but its performance since then has been disappointing. It did not surpass that score until 2003. Its score has hovered in the mid to high 80s for the past 7 years but it has been unable to break into the 90s.

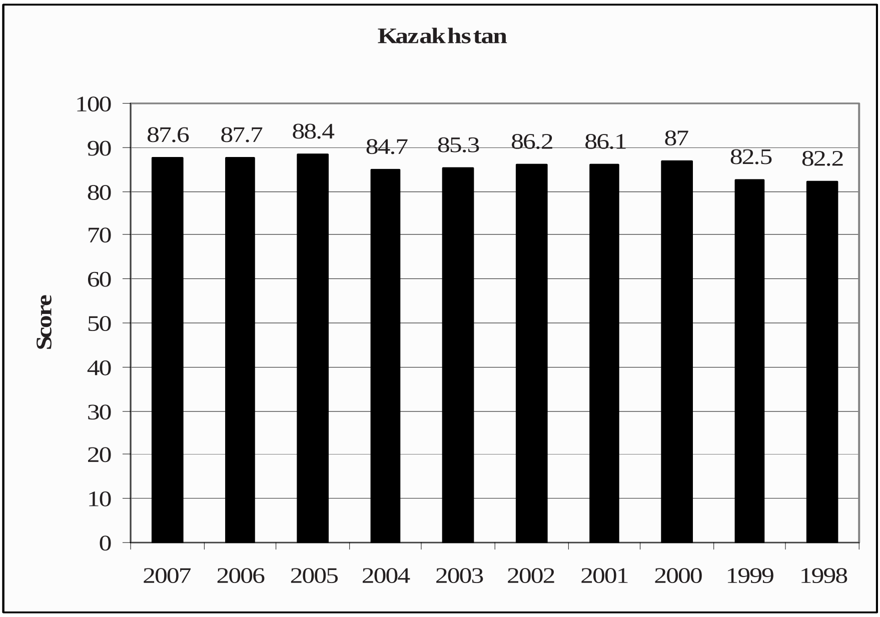


It has a flat individual income tax rate of 23%, which is scheduled to drop to 20% by 2009. Estonia does not tax corporate profits unless they are distributed. Distributed profits are taxed at 23%. Tax revenue as a percent of GDP is 31.9%.



Georgia's score has been quite high from the start and has remained high. For most years it has ranked near the top in terms of fiscal freedom. The reason for the high ranking is its relatively low tax rates. Its individual income tax rate is a flat 12%. The top corporate rate is 20%. Tax revenue as a percent of GDP is 18.2%.



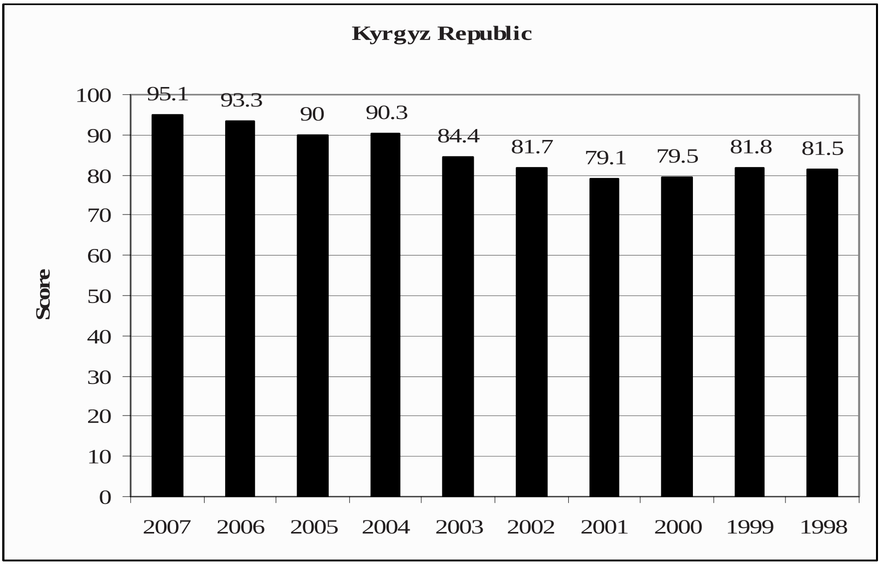


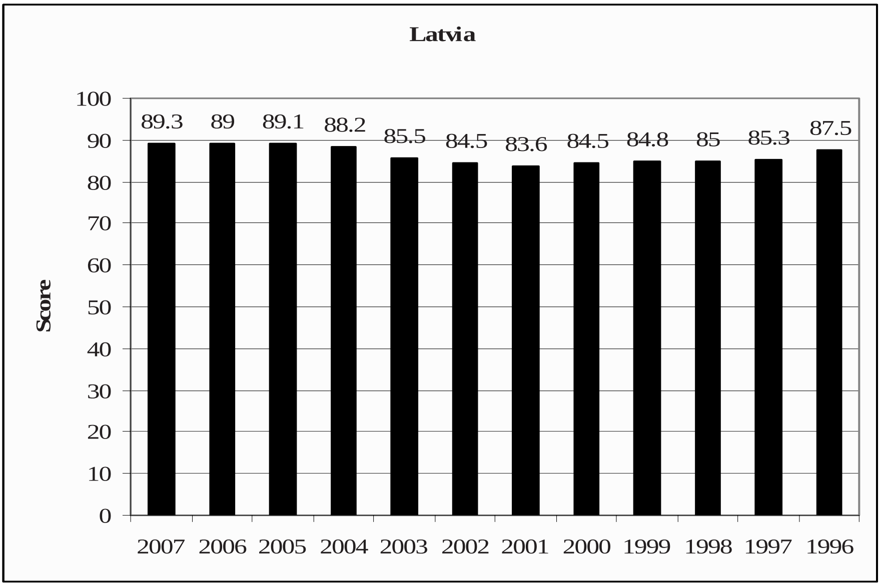
Hungary started from a relatively low score of 64.5 and has been on an upward trend ever since. It has not yet been able to crack the 80% barrier but that may happen in the next few years.

Its individual income tax rate is rather high at 38% but the corporate tax rate is a more comfortable 16%. Tax revenue as a percentage of GDP is a rather high 37.7%.

Kazakhstan started at a relatively good 82.2% and has improved slowly since 1998, the first year it was included in the *Index of Economic Freedom* study. Its top score so far is 87.7, which it achieved in 2006.

Its top individual income tax rate is 20%. The top corporate rate is 30%. Tax revenue as a percent of GDP is 23.6%.

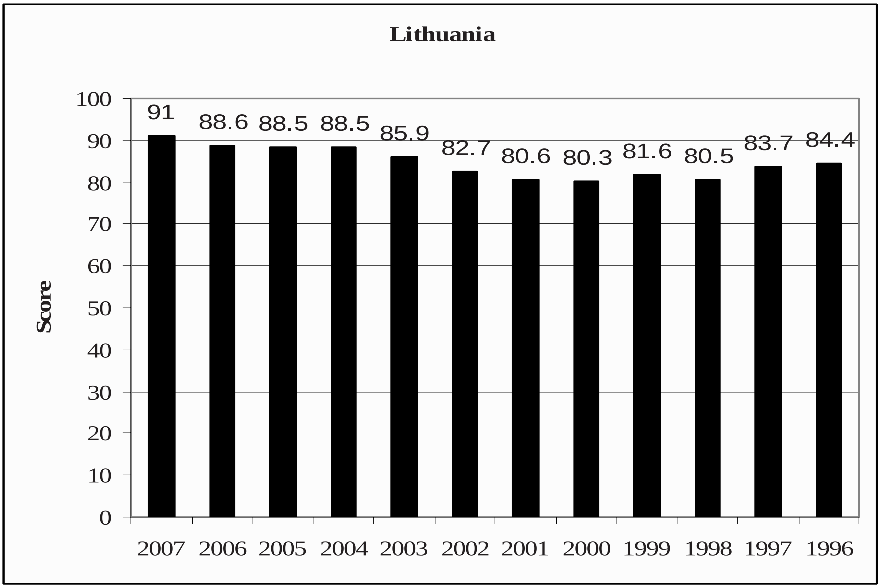




The Kyrgyz Republic had a score of 81.5 in 1998, the first year it was included in the study. Its score then went up slightly, then dropped before starting its upward climb to the mid-90s. It implemented tax reductions in 2006, with both the individual and corporate income tax rate dropping from 20% to a flat 10%. Tax revenue as a percent of GDP is 23.1%.

Latvia started off well with an initial score of 87.5 in 1996, then began a series of declines. It did not surpass its 1996 score until 2004. It is now close to breaking the 90% barrier.

The individual income tax is a flat 25%. The corporate rate is 15%. Tax revenue as a percent of GDP is 27.5.

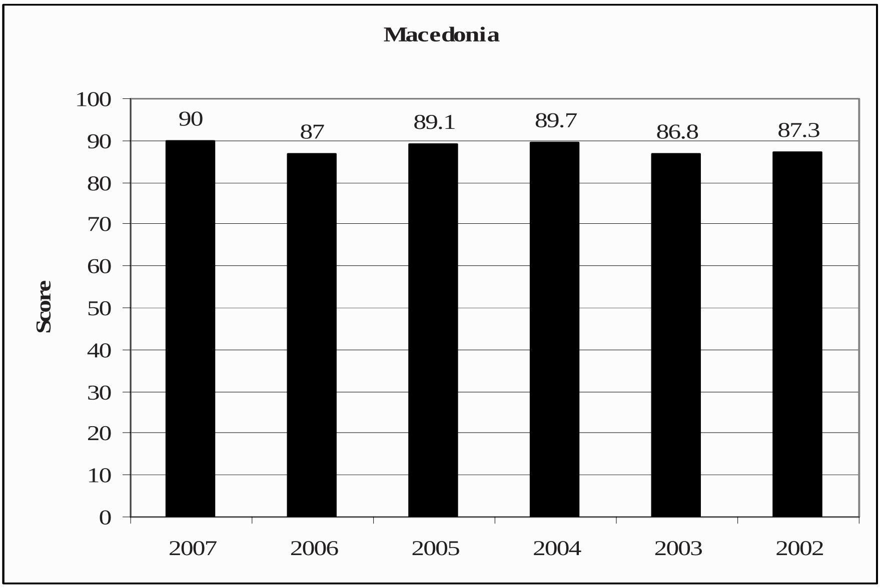


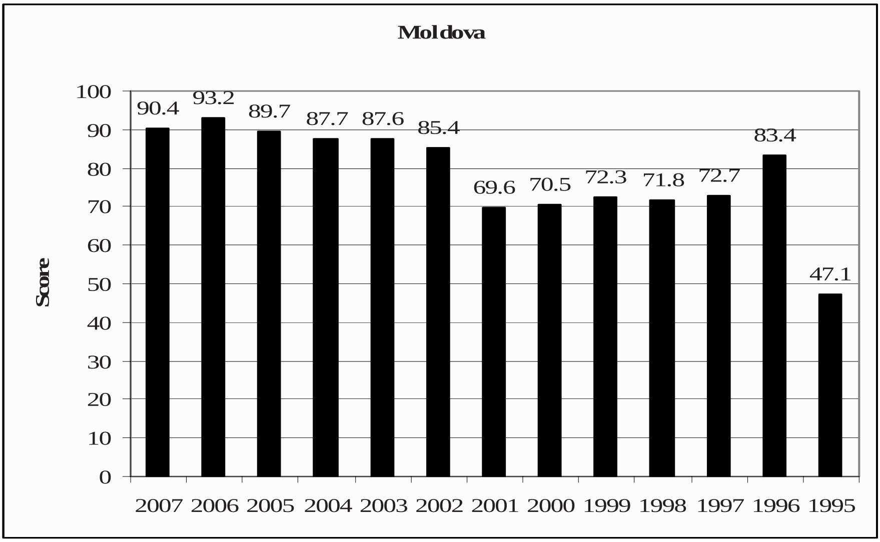
Lithuania started off with a relatively good score of 84.4 in 1996, then experienced a series of declining scores. It did not surpass its 1996 score until 2003. It broke the 90% barrier in 2007.

Its individual income tax rate is a flat 27% and is scheduled to drop to 24% in January, 2008. The corporate tax rate is 15%. Tax revenue as a percent of GDP is 19.8%.

The former Yugoslav republic of Macedonia was not included in the *Index of Economic Freedom* study until 2002. Its initial score was a relatively healthy 87.3. It has since fluctuated and reached a high of 90 in 2007.

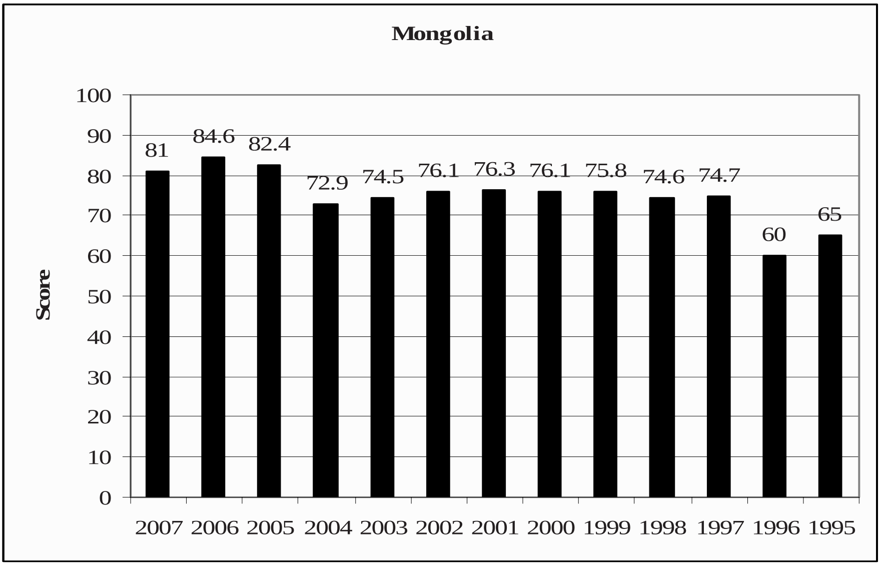
Its top individual and corporate income tax rates are 18% and 15%, respectively. Tax revenue as a percent of GDP is a relatively high 30.8%.





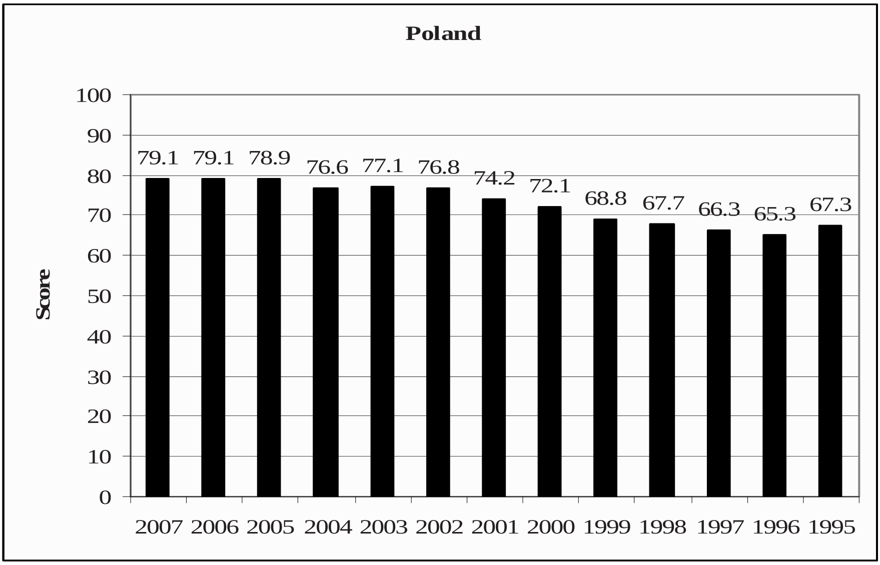
Moldova, which used to be part of Romania before becoming part of the Soviet Union, started with a very weak score of 47.1, then jumped the following year to 83.4. It then dropped more than 10 points, to 72.7, coasted downward for the next few years before jumping again, this time to 85.4%. It has been on an upward trend ever since, breaking the 90% barrier for the first time in 2006.

The top individual income tax rate is 18%. The top corporate tax rate is 15%. Tax revenue as a percentage of GDP is 29.8%.



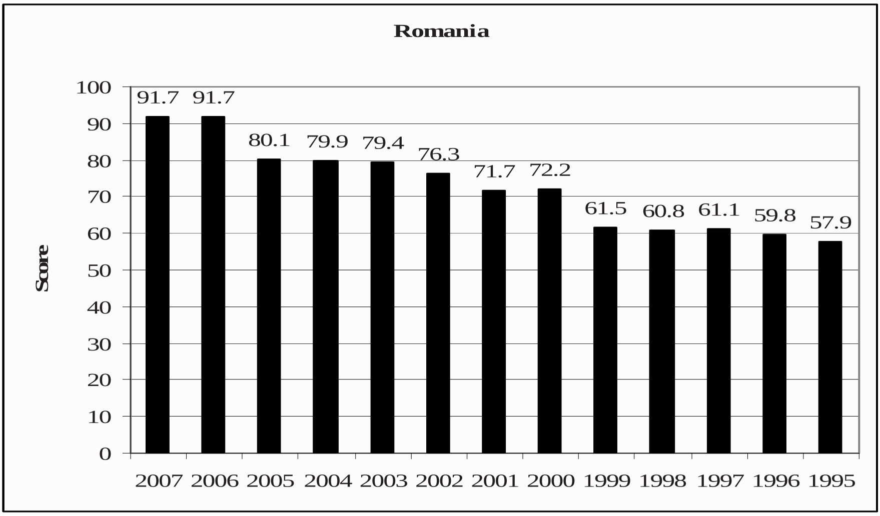
Mongolia was never officially part of the Soviet Union but was heavily influenced by it. Its initial score was a weak 65%. It dropped five points, to 60, the following year, then jumped by nearly 15 points. Its scores fluctuated for much of the next decade before seemingly breaking out of the rut in 2005 to break the 80% barrier for the first time. Its most recent score is in the low 80s.

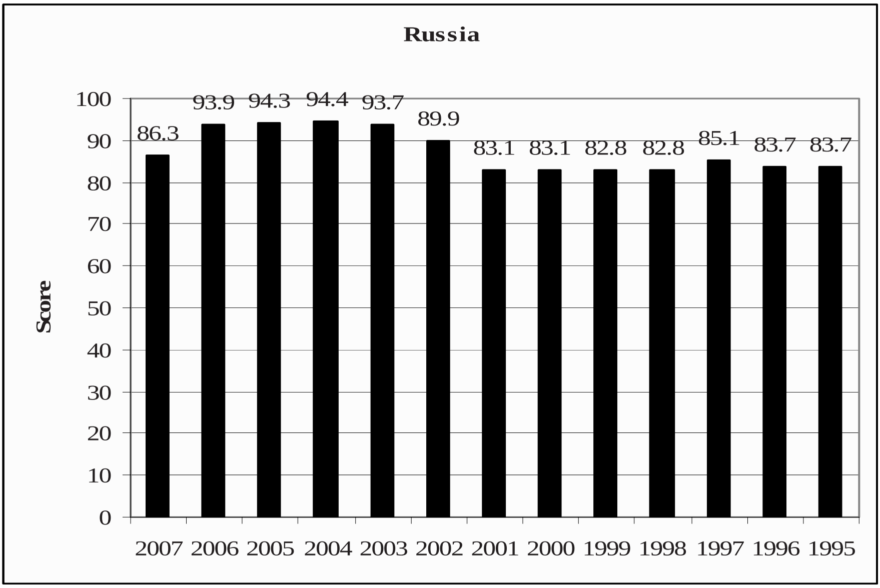
The top individual and corporate tax rates are 30%. Tax revenue as a percent of GDP is a relatively high 32.3%.



Poland started off with a score of 67.3, then dropped for a few years before starting its slow upward trend. It has been in the mid-to high 70s for the last half decade but has not yet broken the 80% barrier.

Its top individual income tax rate is one of the highest for transition economies, at 40%. Its corporate income tax rate is more reasonable at 19%. Tax revenue as a percentage of GDP is a relatively high 34.3%.





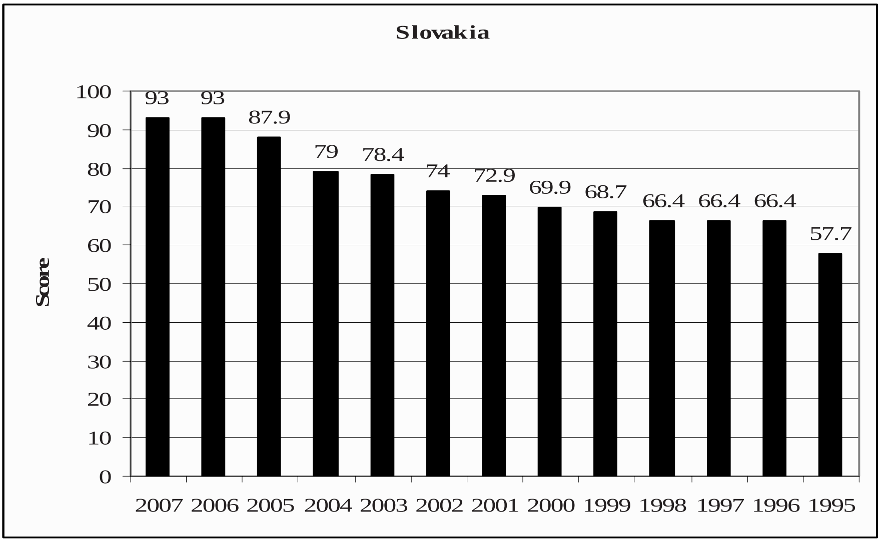
Romania started with a relatively low score of 57.9 and has been climbing ever since. Its score in 2000 jumped by more than 10 points, to 72.2 and has risen practically every year since. It broke the 90% barrier in 2006.

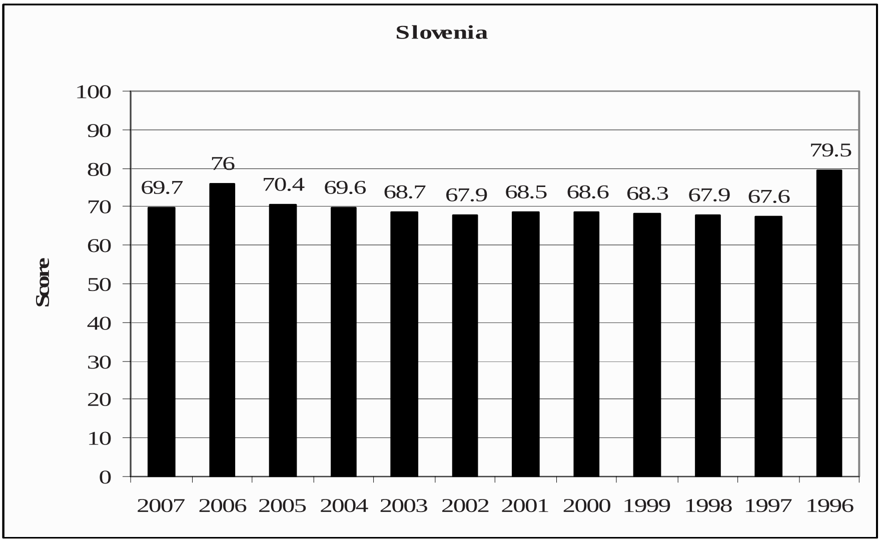
The individual and corporate income tax rates are both a flat 16%. Tax revenue as a percentage of GDP is 27.1%.

Russia's scores started off in the mid-80s and stayed there for seven years before jumping to the high 80s, then to the mid-90s. In 2007 its score dropped significantly, to 86.3%.

Its individual income tax is a flat 13%. Its top corporate tax rate is 24%. Tax revenue as a percentage of GDP is a relatively high 36.1%.

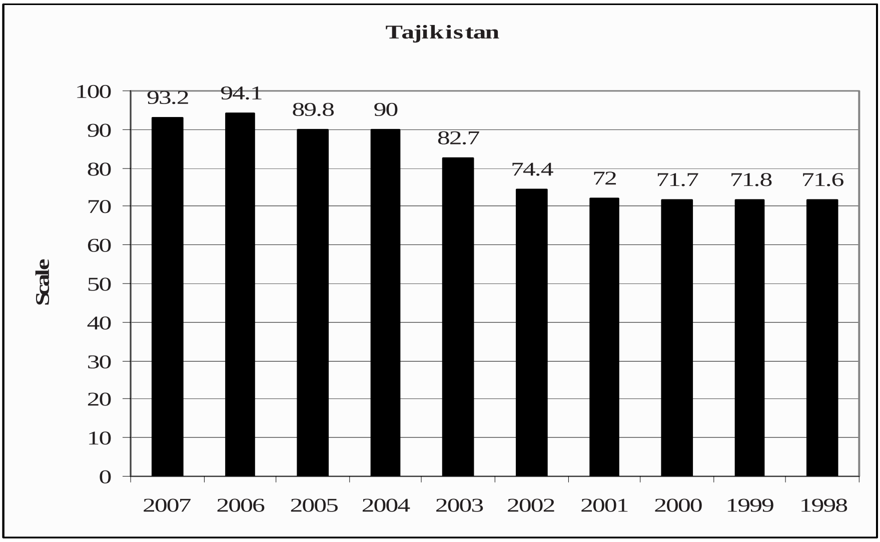
Slovakia's initial score was a weak 57.7 but it has maintained or improved its score each year since then. It broke the 90% barrier in 2006. The individual and corporate income tax rates are both a flat 19%. Tax revenue as a percentage of GDP is 18%.



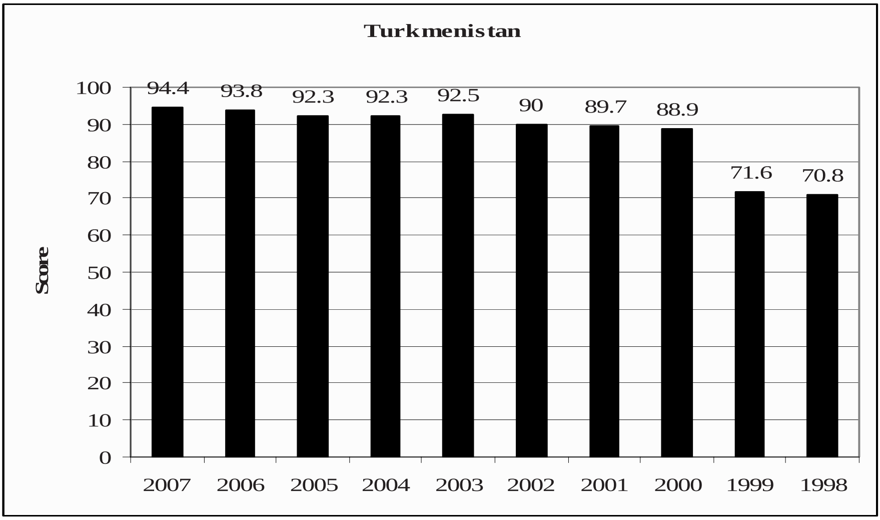


Slovenia started off with a relatively high score of 79.5, which dropped significantly to 67.6 the following year. Its scores have remained more or less flat since then. It has not been able to surpass its initial score in the following 11 years.

Part of its problem is its relatively high individual income tax rate, which is 50%. The top corporate rate is a much lower 25%. Tax revenue as a percentage of GDP is a relatively high 37.6%.

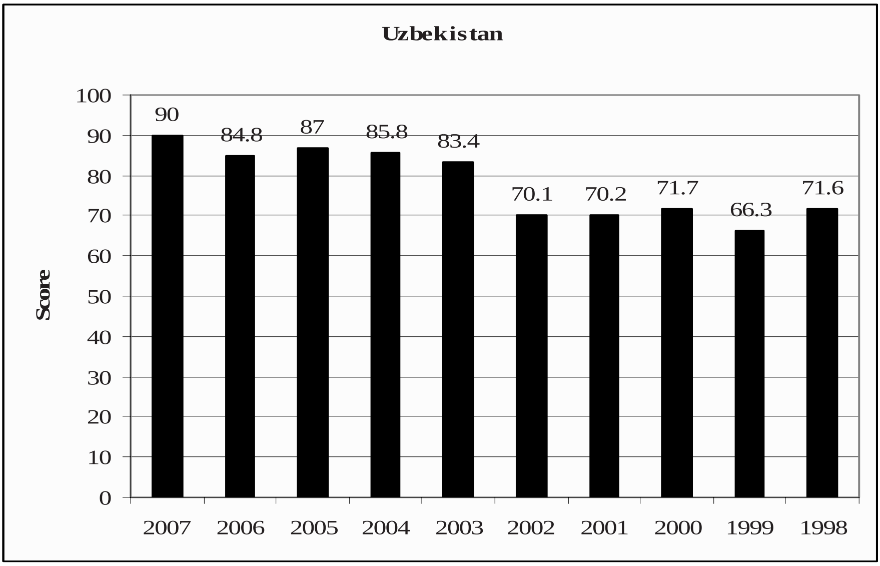


Tajikistan started with a modest score in the low 70s, which rose slightly at first, then took a big jump, to 82.7, in 2003. The last 2 years have seen scores in the 90s.



The top individual income tax and corporate income tax rates are 13% and 25%, respectively. Tax revenue as a percentage of GDP is a relatively low 15.2%.

Turkmenistan had a modest 70.8 initial score, which jumped to 88.9 two years later. Its score ahs been in the high 80s to mid-90s ever since. Its top individual income tax rate is 10%. The top corporate tax rate is 20%. Tax revenue as a percent of GDP is 18.3%.



Ukraine's initial score was a weak 45.2, which dropped even lower the following year before taking a jump of more than 33 points in 1997. Its scores remained in the mid to high 70s for the next 7 years before jumping another 10 points, to 88.7. It has been in the high 80s or low 90s for the last 3 years.

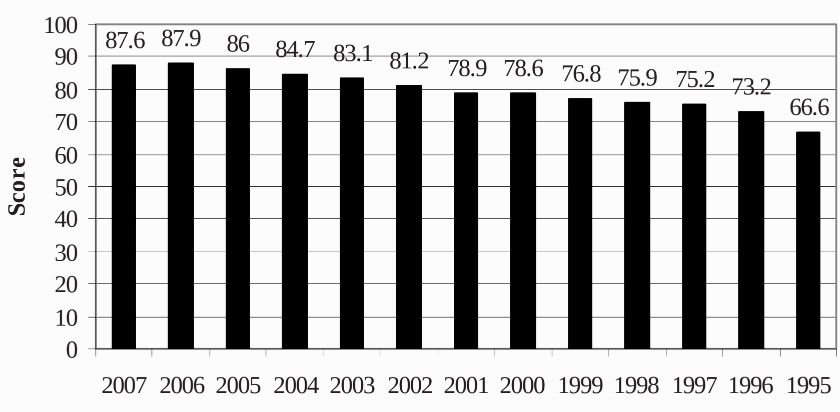
Its top individual income tax rate is a flat 13%. Its top corporate tax rate is 25%. Tax revenue as a percentage of GDP is 29.1%.

Uzbekistan started off with a moderate score in the low 70s, then dropped to 66.3 before climbing back into the low 70s in 2000, where it remained until 2003, when its score jumped to 83.4. It broke the 90% barrier in 2007.

The top individual income tax rate is 29%. The top corporate tax rate is 12%. Tax revenue as a percentage of GDP is 22.7%.

Chart 2 shows the trend for all transition economies as a whole, from 1995 to 2007. Some transition economies were not included in the earlier years, so not all years contain data for all 28 transition economies included in the present study.

Chart 2 Average Scores - Transition Economies



The trend has been positive, starting at a low point of 66.6 in 1995 and reaching a high point of 87.9 in 2006. The average score got better in every year except 2007. Hopefully, the upward trend will continue, since having a good fiscal freedom score makes it easier to attract capital, which is a key factor in economic growth.

Comparison with OECD Countries

While comparing the various transition countries to each other yields valuable information, that is not the end of the story. It is also important to compare them to the more developed market economies to see how well they are doing compared to some benchmark. Using developed market economies as a benchmark provides this comparison. OECD member countries are used as a surrogate for developed market economies, since all OECD countries fit this description.

Table 4 shows the fiscal freedom scores for the OECD countries for 2007, 2000 and 1995. Four transition countries—the Czech Republic, Hungary, Poland and the Slovak Republic—are also OECD members. Those four countries were omitted from Table 4 to prevent overlap in the comparison of OECD and transition economies. Some countries were not included in the *1995 Index of Economic Freedom* study, which explains why some countries do not have scores for 1995.

Table 4
Fiscal Freedom 2007, 2000 and 1995
OECD Countries

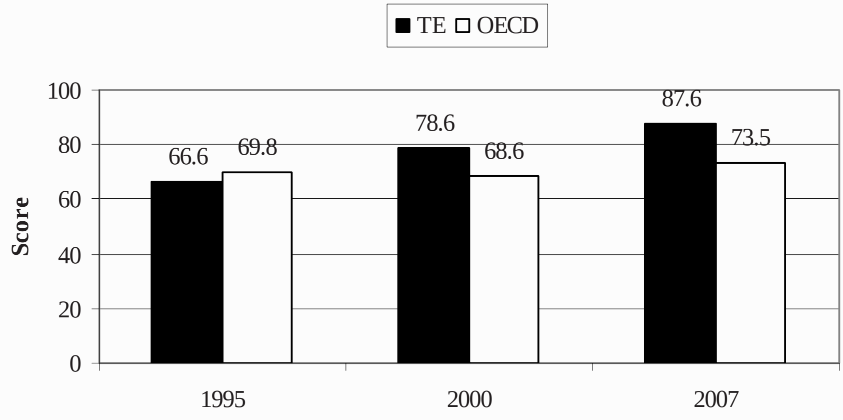
Country	2007		2000		1995	
	Rank	Score	Rank	Score	Rank	Score
Mexico	1	88.1	2	82.1	1	81.6
Canada	2	83.9	19	60.0	3	76.1
Iceland	3	82.4	7	76.5		
Ireland	4	81.1	10	73.7	11	66.1
Korea	5	81.0	3	81.2	4	75.5
Japan	6	80.6	4	80.1	10	69.1
Portugal	7	79.6	11	73.6	8	73.7
USA	8	79.4	8	75.9	2	76.6
Turkey	8	79.4	5	78.2	14	63.0
Switzerland	10	78.6	1	87.1		
Australia	11	75.4	13	70.6	9	73.1
Luxembourg	11	75.4	15	67.6		
Finland	11	75.4	21	57.9		
UK	14	74.6	9	75.0	6	74.2
Greece	15	74.5	14	68.1	5	75.0
Germany	16	74.3	20	59.0	17	55.5
New Zealand	17	74.2	6	77.2		
Spain	18	70.1	16	63.9	13	63.5
Italy	19	68.5	17	63.8	16	62.4
Austria	20	66.9	18	62.8	12	64.2
Norway	21	66.1	12	71.5		
Netherlands	22	65.8	23	56.1		
France	23	64.2	22	56.7	7	73.8
Belgium	24	62.2	25	55.4		
Denmark	25	55.2	26	53.5		
Sweden	26	53.6	23	56.1	15	62.7
Average		73.5		68.6		69.8

Mexico ranked first among OECD countries for 2007 and it ranks consistently high for the 3 years reflected in Table 4. It always ranked either 1 or 2. Canada ranked 2nd in 2007 and also ranked highly in 1995 but did not rank nearly as well in 2000. Iceland, Ireland and Korea rounded out the top five.

Sweden, Denmark, Belgium, France, the Netherlands and Norway all ranked below 20 for the most current year examined. Most of them also ranked below 20 for all years examined. The average for all OECD countries declined slightly from 1995 to 2000, falling from 69.8 to 68.6, then rose to 73.5 in 2007.

Chart 3 shows how the scores for transition economies and OECD countries compare for the 3 years.

Chart 3 Comparison of Fiscal Freedom Scores



The average for the transition economies was lower than the OECD average in 1995 but surpassed the OECD average by 1990 and continued to climb in 2007. Wilcoxon tests found the difference in scores to be insignificant for 1995 ($p <= 0.4627$) but highly significant for 2000 ($p <= 0.0006354$) and 2007 ($p <= 2.729e–07$). If one were to be cynical, one might conclude that, rather than having the developed market economies send experts to give advice to the leaders in transition economies, perhaps the transition economies might consider sending experts to provide advice to the average OECD country.

Another way to compare transition and OECD countries is by the percentage of tax revenues to GDP. The higher the percentage of tax revenue to GDP, the less fiscal freedom taxpayers have. Table 5 provides the statistics for 2007. Again, the four transition countries that are also OECD members are listed in the transition category.

Table 5
Tax Revenue as a Percentage of GDP
Transition and OECD Countries 2007

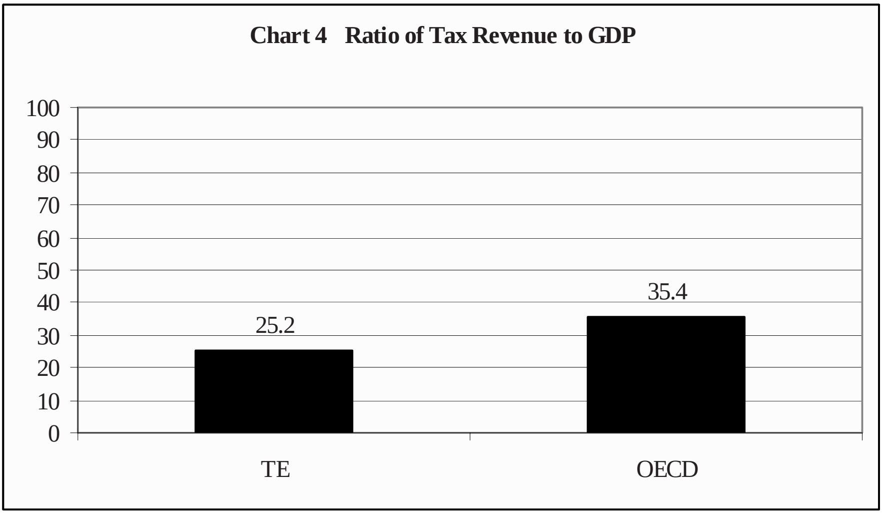
Rank	Country	TE	OECD
	Mexico		10.1
	Azerbaijan	14.4	
	China	15.1	
	Tajikistan	15.2	
	Armenia	15.3	
	Slovakia	18.0	
	Georgia	18.2	
	Turkmenistan	18.3	
	Belarus	18.6	
	Lithuania	19.8	
	Albania	21.7	
	Bulgaria	22.3	
	Bosnia & Herzegovina	22.4	
	Uzbekistan	22.7	
	Kyrgyzistan	23.1	
	Portugal		23.2
	Kazakhstan	23.6	
	Australia		24.1
	Croatia	24.2	
	Korea		24.6
	Japan		25.3
	USA		25.4
	Romania	27.1	
	Latvia	27.5	
	Ukraine	29.1	
	Switzerland		29.4
	Moldova	29.8	
	Ireland		30.2
	Macedonia	30.8	
	Turkey		31.1
	Estonia	31.9	
	Mongolia	32.3	
	Canada		33.0
	Poland	34.3	
	Germany		34.6
	Spain		35.1
	New Zealand		35.4
	UK		36.1
	Russia	36.1	
	Greece		37.2
	Czech Republic	37.6	
	Slovenia	37.6	
	Hungary	37.7	
	Netherlands		39.3
	Luxembourg		40.6

Iceland		41.9
Italy		42.2
Austria		42.9
France		43.7
Finland		44.3
Norway		44.9
Belgium		45.6
Denmark		49.6
Sweden		50.7
Average	25.2	35.4

Source: Index of Economic Freedom 2007

A quick look reveals that the transition economy countries tend to be clustered at the lower end whereas the OECD countries tend to gravitate toward the upper end, although there are some exceptions. The country with the lowest ratio of tax revenue to GDP is Mexico, which is an OECD country. Mexico seems to be an outlier with a percentage of 10.1. The next highest OECD country is Portugal, at 23.2. Sweden has the highest score, at 50.7%. The average score for transition countries is 25.2, compared to 35.4 for OECD countries. The averages are significantly different at the 1% level ($p <= 9.817e{-}05$).

Chart 4 shows the ratio of tax revenue to GDP for the transition and OECD countries. As can be seen, the percentage taken in OECD countries is much larger.



By all measures it seems that transition countries have more fiscal freedom than do the more developed market economies. Furthermore, the extent of tax freedom is increasing over time. Hopefully, this trend will continue, although there may be some backsliding or even reversals as the transition economies try to emulate the bloated welfare states in Western Europe.

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9

Trends in the Ethics of Tax Evasion: An Empirical Study of Ten Transition Economies*

Robert W. McGee

Introduction

Tolerance for tax evasion varies widely by country and culture. Crowe (1944) examined 500 years of theological and philosophical literature and found that three basic positions on the ethics of tax evasion had evolved over the centuries. Philosophers and theologians had argued that tax evasion was (1) never justifiable, (2) always justifiable, or (3) sometimes justifiable. Those who thought tax evasion could sometimes be justified on ethical grounds generally thought that it could be justified in cases where government was corrupt or where the tax system was perceived as being unfair. Inability to pay was also an argument that often appeared in the literature. Some philosophers who discussed just war theory argued that individuals have no ethical duty to support a government that is engaged in an unjust war (Pennock 1998).

Some religious literature takes the position that tax evasion is never, or almost never justified. The religious literature of the Jewish (Cohn 1998; Tamari 1998), Baha'i (DeMoville 1998) and Mormon (Smith and Kimball 1998) faiths believes that it is against God's law to evade taxes. Some secular philosophers, on the other hand, were unable to find any justification for taxation (Block 1989, 1993).

A few studies have asked specific questions about the ethics of tax evasion to groups in Argentina (McGee and Rossi 2006), Guatemala (McGee and Lingle 2005), Bosnia (McGee et al. 2006a), Slovakia (McGee and Tusan 2006), Hubei, China (McGee and Guo 2006), Guangzhou, China (McGee and Noronha 2007), Beijing, China (McGee and Yuhua 2006), Hong Kong (McGee and Butt 2006; McGee and Ho 2006), Macau (McGee et al. 2006b) and Thailand (McGee 2006). Those surveys consisted of a series of statements that generally began with "Tax evasion is ethical if …."

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Respondents were asked to place a number from 1 to 7 in the space provided to indicate the extent of their agreement or disagreement with each statement.

One thing that is obvious when one compares the human beliefs and values survey data (Inglehart et al. 2004) to the data from the various McGee studies is that the McGee study scores are higher than the Inglehart et al. scores, meaning that there is more tolerance for tax evasion in the McGee studies. One possible explanation is that the methodologies were different. In the Inglehart et al. study participants were asked the questions by an interviewer face to face. This approach might cause participants to say that they are more opposed to tax evasion than would be the case if the survey were conducted anonymously. The surveys in the McGee studies were anonymous.

The scales in the two studies were also different. The scale in the Inglehart study was from 1 to 10 whereas in the McGee studies it was 1 to 7. However, even with the differences in scales it is obvious that participants were less opposed to tax evasion in the McGee studies.

Methodology

The Human Beliefs and Values Surveys (Inglehart et al. 2004) collected responses to scores of questions from 200,000 people in 81 societies representing 85% of the world's population. The interviews were face to face, which introduces a bias, since people might have different answers to some questions if they could answer anonymously. The data used in the present study was collected between 1989 and 2001.

The Human Beliefs and Values survey included the following question [F116] in its survey:

> Please tell me for each of the following statements whether you think it can always be justified, never be justified, or something in between: Cheating on taxes if you have a chance.

Participants responded on a ten-point scale where one (1) represented "never justifiable" and ten (10) represented "always justifiable." The present paper examines, compares and contrasts the responses that were given by participants in the transition economies that were included in those surveys. In order to be included in the study, data on tax evasion attitudes had to be collected in at least two surveys more than five years apart. Unfortunately, the interviewers did not ask the reasons why respondents thought tax evasion was ethical or unethical, so it is not possible to determine the reasoning process behind the responses. Wilcoxon tests were performed to determine whether the differences between the earlier and more recent surveys were significant.

Transition Economy Opinion

The survey data for ten transition economies were examined and compared to determine whether tax evasion became more acceptable or less acceptable over time. One might think that tax evasion would become less acceptable over time if one compares the views of the sample population shortly after the fall of the Berlin Wall to a more recent period. Under communism, people had little or no respect for government and presumably they felt little or no duty to respect the laws or government property. Under a market economy there is more respect for the rule of law which, presumably, includes less tolerance for tax evasion.

But on the other hand, under communism people looked to and depended on the government for everything. In many cases there was a feeling of patriotism and a sense of duty to the government, which might lead one to conclude that tax evasion would be frowned upon, although in many cases there were no direct taxes to pay.

One aim of the present study is to determine which of these two conflicting views is dominant. However, it should be pointed out that the view people have of tax evasion might not always closely correspond with their actions. There is widespread tax evasion in most transition economies, so even if some sample from a transition economy indicates that they strongly oppose tax evasion theoretically, it does not necessarily follow that they do not engage in tax evasion, given the opportunity.

The results are given below.

Table 1 shows the results for the Bulgarian sample. The sample size for the 1990 survey was 1009; for the 1999 survey the sample size was 946. In each sample, more than 50% thought tax evasion was never justifiable. In the 1990 sample, for instance, 57.4% thought tax evasion was never justifiable. Worded differently, one might say that 42.6% thought tax evasion was justifiable in certain circumstances. A small percentage of the sample (4.6%) thought tax evasion was always justifiable. The average score was 2.598, indicating that, in general, there was strong opposition to tax evasion.

In the 1999 sample, opposition to tax evasion was even stronger. More than two-thirds of respondents (66.9%) thought tax evasion was never justifiable and the average score declined to 1.985. The shift over the nine-year period was significant at the 1% level ($p \leq 8.173e{-}06$).

Table 1
Attitude Toward Tax Evasion—Bulgaria
(1 = never justifiable; 10 = always justifiable)

Score	1990		1999	
	#	%	#	%
1	579	57.4	633	66.9
2	115	11.4	103	10.9
3	89	8.8	74	7.8
4	37	3.7	26	2.7
5	40	4.0	40	4.2
6	47	4.7	26	2.7
7	16	1.6	10	1.1
8	18	1.8	15	1.6
9	22	2.2	8	0.8
10	46	4.6	11	1.2
Totals	1,009		946	
Avg.	2.598		1.985	

$p \leq 8.173e{-}06$

Chart 1 compares the two surveys graphically.

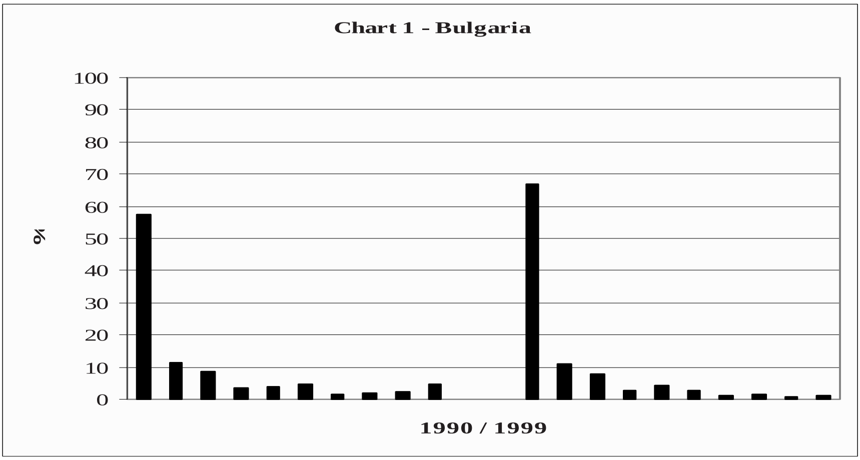


Table 2 shows the results of the Belarus samples. In the 1990 sample, 44.4% thought tax evasion was never justifiable and 55.6% thought it was justifiable in certain circumstances. Tax evasion became more acceptable in the 2000 sample, with only a little more than one-fourth of the sample population taking the position that tax evasion is never justifiable (26.3%). Mean scores also increased over the ten-year period, from 3.344 to 4.219, which was significant at the 1% level ($p \leq 4.355e{-}14$).

Table 2
Attitude toward Tax Evasion—Belarus
(1 = never justifiable; 10 = always justifiable)

Score	1990		2000	
	#	%	#	%
1	432	44.4	240	26.3
2	95	9.8	100	11.0
3	86	8.8	93	10.2
4	64	6.6	73	8.0
5	95	9.8	123	13.5
6	30	3.1	65	7.1
7	52	5.3	48	5.3
8	28	2.9	88	9.6
9	29	3.0	34	3.7
10	61	6.3	49	5.4
Totals	972		913	
Avg.	3.344		4.219	

$p \leq 4.355e{-}14$

Chart 2 compares the two surveys graphically.

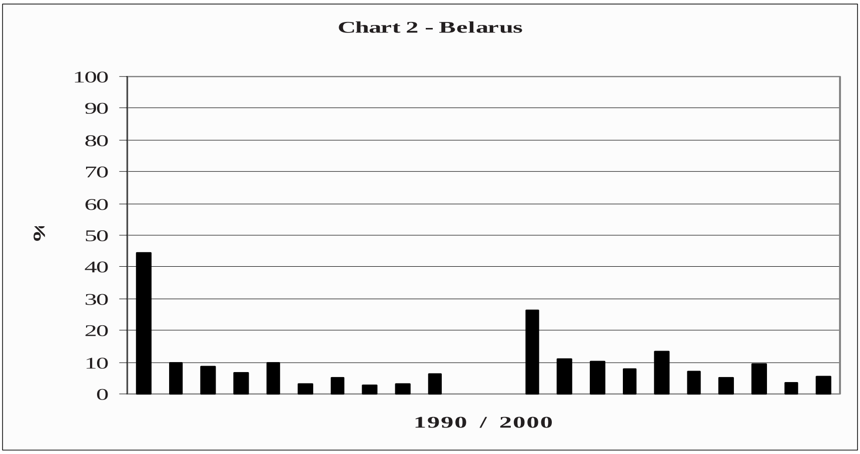


Table 3 shows the results for China. More than four out of five respondents in the earlier survey thought tax evasion was always unethical (81.3%). That percentage dropped slightly in the more recent survey, to 77.1%. The average score also dropped slightly, from 1.540 to 1.519, but the change was not significant ($p \leq 0.7552$).

Table 3
Attitude Toward Tax Evasion—China
(1 = never justifiable; 10 = always justifiable)

Score	1990		2001	
	#	%	#	%
1	810	81.3	759	77.1
2	64	6.4	115	11.7
3	50	5.0	35	3.6
4	14	1.4	12	1.2
5	19	1.9	35	3.6
6	18	1.8	9	0.9
7	3	0.3	4	0.4
8	5	0.5	5	0.5
9	4	0.4	1	0.1
10	9	0.9	10	1.0
Totals	996		985	
Avg.	1.540		1.519	

$p \leq 0.7552$

Chart 3 compares the two surveys graphically.

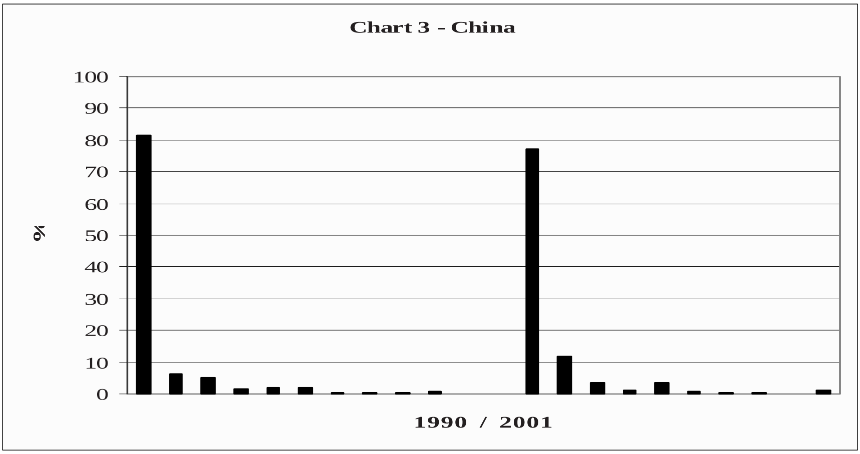


Table 4 shows the results for Estonia. The percentage of respondents who thought tax evasion was never justifiable dropped significantly, from 64.6% in the earlier survey to 39.9% in the more recent survey. The mean score also increased significantly, from 1.963 to 3.151 ($p \leq 2.493e{-}35$).

Table 4
Attitude Toward Tax Evasion—Estonia
(1 = never justifiable; 10 = always justifiable)

Score	1990		1999	
	#	%	#	%
1	641	64.6	388	39.9
2	115	11.6	129	13.3
3	82	8.3	113	11.6
4	25	2.5	69	7.1
5	58	5.8	104	10.7
6	28	2.8	48	4.9
7	11	1.1	47	4.8
8	6	0.6	34	3.5
9	5	0.5	13	1.3
10	22	2.2	28	2.9
Totals	993		973	
Avg.	1.963		3.151	

$p \leq 2.493e{-}35$

Chart 4 compares the two surveys graphically.

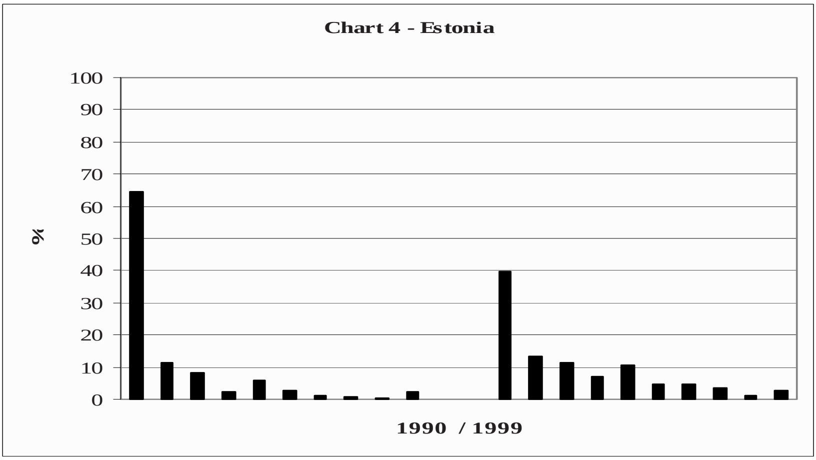


Table 5 shows the results for Latvia. The percentage of respondents who believed tax evasion is never justifiable dropped slightly, from 64.4% in 1990 to 59.8% in 1999. The mean score also declined somewhat, from 2.457 to 2.363. However, the change was not significant ($p \leq 0.3088$).

Table 5
Attitude Toward Tax Evasion—Latvia
(1 = never justifiable; 10 = always justifiable)

Score	1990		1999	
	#	%	#	%
1	573	64.4	591	59.8
2	71	8.0	121	12.2
3	57	6.4	75	7.6
4	32	3.6	38	3.8
5	49	5.5	55	5.6
6	17	1.9	24	2.4
7	13	1.5	27	2.7
8	17	1.9	23	2.3
9	12	1.3	15	1.5
10	49	5.5	20	2.0
Totals	890		989	
Avg.	2.457		2.363	

$p \leq 0.3088$

Chart 5 compares the two surveys graphically.

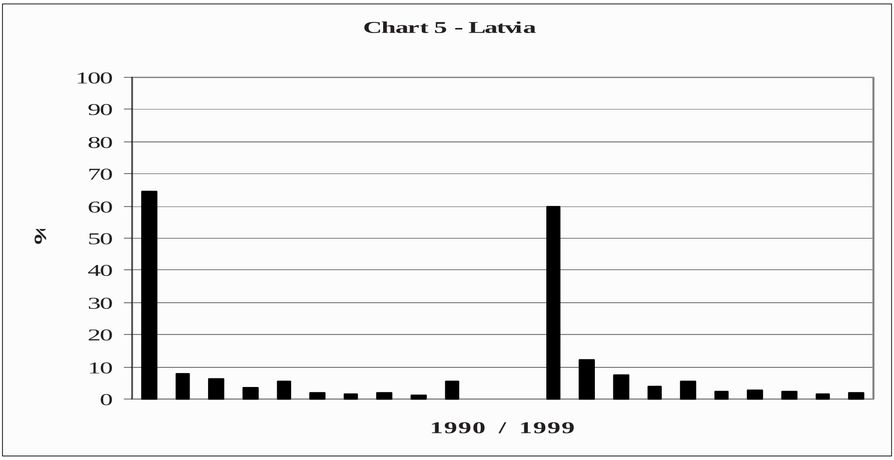


Table 6 shows the results of the Lithuanian surveys. Those who thought tax evasion is never justifiable dropped significantly, from 57.0% in 1990 to 39.0% in 1999. The mean score increased significantly, from 2.265 to 3.777 ($p \leq 3.143e{-}25$). For scores 4 through 10 the percentages increased. A substantial minority (9%) believed that tax evasion is always justifiable.

It is interesting to note that the behavior pattern for Latvia is different than those of Estonia and Lithuania. The change in Latvian views over time was not significant, whereas those for the other two Baltic countries were significant. One might suspect that attitudes toward tax evasion would be similar for the three Baltic countries, but such was not the case.

Table 6
Attitude Toward Tax Evasion—Lithuania
(1 = never justifiable; 10 = always justifiable)

Score	1990		1999	
	#	%	#	%
1	549	57.0	378	39.0
2	133	13.8	103	10.6
3	101	10.5	61	6.3
4	47	4.9	49	5.1
5	61	6.3	128	13.2
6	17	1.8	50	5.2
7	18	1.9	38	3.9
8	13	1.3	49	5.1
9	10	1.0	25	2.6
10	15	1.6	87	9.0
Totals	964		968	
Avg.	2.265		3.777	

$p \leq 3.143e{-}25$

Chart 6 compares the two surveys graphically.

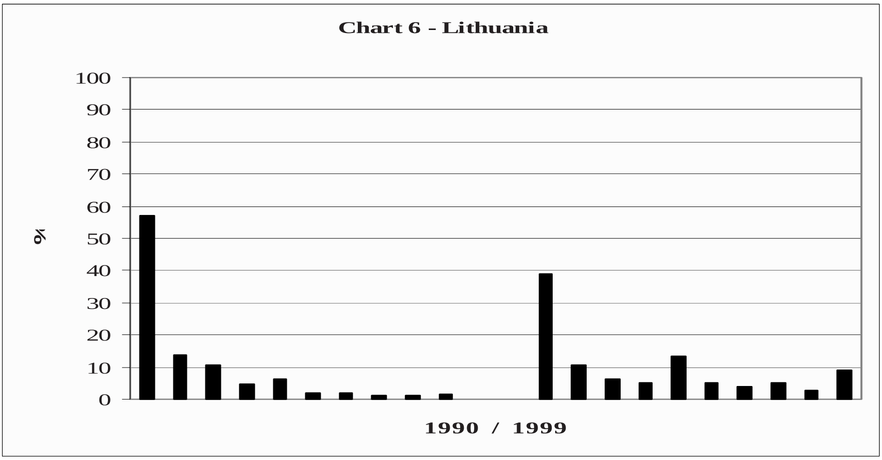


Table 7 shows the results of the Poland surveys. The percentage of respondents who believed tax evasion is never justifiable jumped from 49.3% in 1989 to 59.8% in 1999. The mean score dropped from 2.771 to 2.227, which was significant ($p \leq 2.937e{-}07$).

Table 7
Attitude Toward Tax Evasion—Poland
(1 = never justifiable; 10 = always justifiable)

Score	1989		1999	
	#	%	#	%
1	448	49.3	638	59.8
2	112	12.3	160	15.0
3	93	10.2	79	7.4
4	55	6.1	42	3.9
5	79	8.7	60	5.6
6	34	3.7	19	1.8
7	19	2.1	12	1.1
8	28	3.1	19	1.8
9	11	1.2	9	0.8
10	29	3.2	28	2.6
Totals	908		1,066	
Avg.	2.771		2.227	

$p \leq 2.937e{-}07$

Chart 7 compares the two surveys graphically.

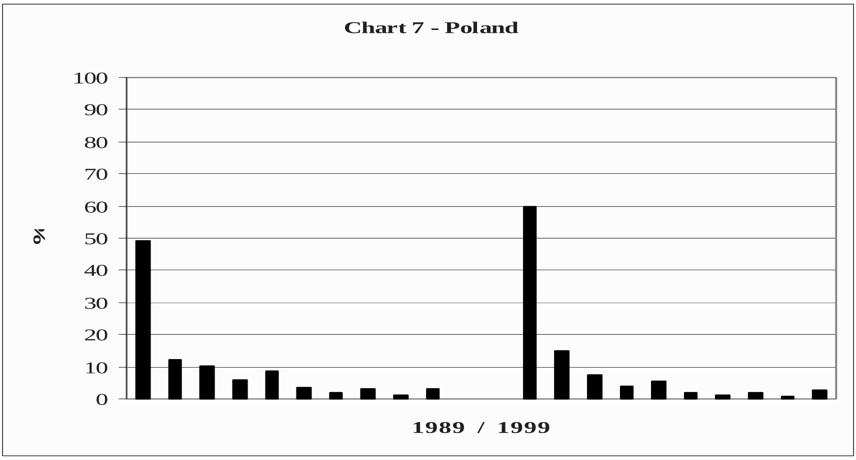


Table 8 shows the scores for the two Russian surveys. The percentage of those who believed tax evasion is never justifiable dropped from 53.0% to 45.6%. The mean score increased from 2.886 to 3.067, which was significant ($p \leq 0.0004783$).

Table 8
Attitude Toward Tax Evasion—Russia
(1 = never justifiable; 10 = always justifiable)

Score	1990		1999	
	#	%	#	%
1	938	53.0	1,086	45.6
2	161	9.1	254	10.7
3	150	8.5	226	9.5
4	84	4.7	151	6.3
5	154	8.7	268	11.3
6	53	3.0	74	3.1
7	51	2.9	94	3.9
8	72	4.1	99	4.2
9	28	1.6	35	1.5
10	79	4.5	94	3.9
Totals	1,770		2,381	
Avg.	2.886		3.067	

$p \leq 0.0004783$

Chart 8 compares the two surveys graphically.

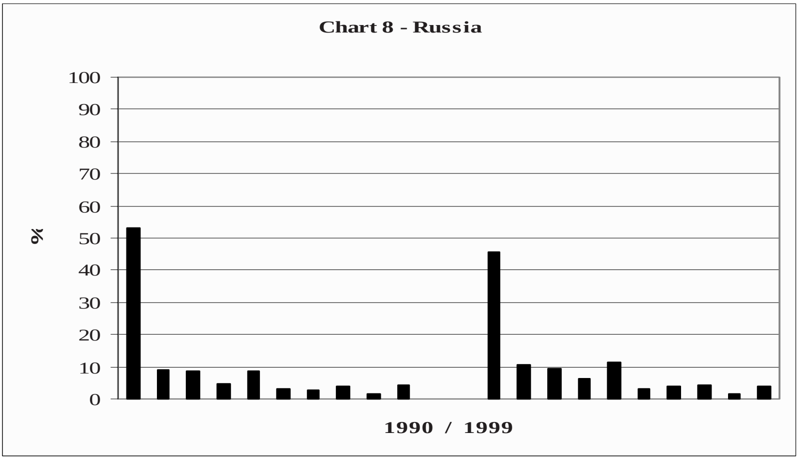


Table 9 shows the results for Slovenia. Those who believe tax evasion is never justifiable dropped from 68.5% to 60.0%. The mean score rose from 2.029 to 2.337, which was significant ($p \leq 0.0009793$).

Table 9
Attitude Toward Tax Evasion—Slovenia
(1 = never justifiable; 10 = always justifiable)

Score	1992		1999	
	#	%	#	%
1	688	68.5	599	60.0
2	79	7.9	111	11.1
3	85	8.5	101	10.1
4	35	3.5	36	3.6
5	28	2.8	24	2.4
6	44	4.4	51	5.1
7	12	1.2	26	2.6
8	12	1.2	18	1.8
9	6	0.6	15	1.5
10	16	1.6	18	1.8
Totals	1,005		999	
Avg.	2.029		2.337	

$p \leq 0.0009793$

Chart 9 compares the two surveys graphically.

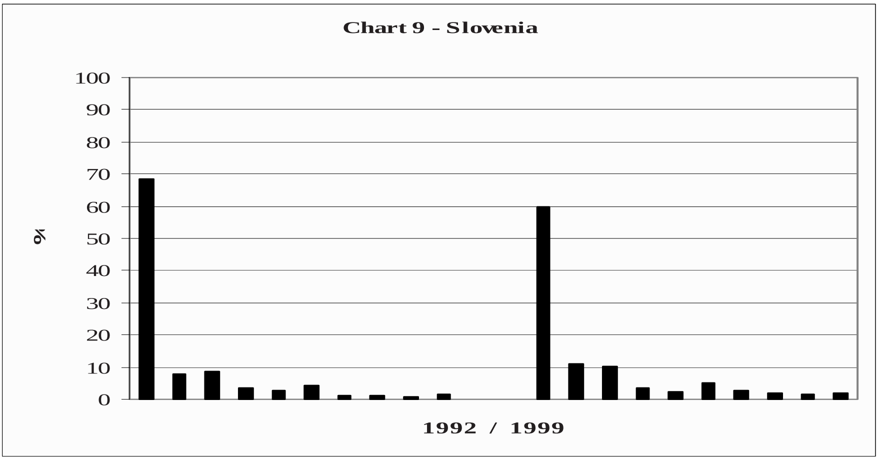


Table 10 shows the results for East Germany. Those who believe tax evasion is never justifiable dropped from 67.2% to 58.9%. The mean score rose from 1.912 to 2.398, which was significant ($p \leq 1.678e–05$).

Table 10
Attitude Toward Tax Evasion—East Germany
(1 = never justifiable; 10 = always justifiable)

Score	1990		1999	
	#	%	#	%
1	892	67.2	570	58.9
2	160	12.0	99	10.2
3	115	8.7	107	11.1
4	42	3.2	37	3.8
5	46	3.5	49	5.1
6	10	0.8	26	2.7
7	18	1.4	15	1.5
8	23	1.7	28	2.9
9	6	0.5	16	1.7
10	16	1.2	21	2.2
Totals	1,328		968	
Avg.	1.912		2.398	

$p \leq 1.678e{-}05$

Chart 10 compares the two surveys graphically.

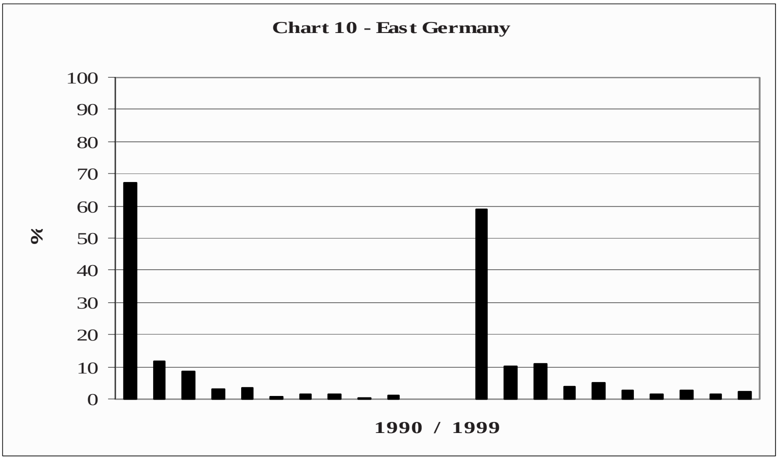


Table 11 summarizes results for the earlier and more recent surveys for each country. As can be seen, the results were significant for eight of the ten countries. The only countries where the results were not significant were China and Latvia. The fact that views in China did not change significantly over time might be explained by the fact that China moved toward a market economy a decade or more sooner than the transition economies of Eastern and Central Europe. If a significant change in attitude is to be expected, it will likely come in the first few years after the start of the transition to a market economy. But this theory does not explain why the views of Latvians did not change significantly over time.

Table 11
Summary of Averages and p Values
(1 = never justifiable; 10 = always justifiable)

	Older year average	Newer year average	p Value
Bulgaria	2.598	1.985	8.173e–06
Belarus	3.344	4.219	4.355e–14
China	1.540	1.519	0.7552
Estonia	1.963	3.151	2.492e–35
Latvia	2.457	2.363	0.3088
Lithuania	2.265	3.777	3.143e–25
Poland	2.771	2.227	2.937e–07
Russia	2.886	3.067	0.0004783
Slovenia	2.029	2.337	0.0009793
East Germany	1.912	2.398	1.678e–05
Averages	2.377	2.704	

Chart 11 shows the changes in attitude that occurred between the earlier and later surveys. As can be seen, the mean score tended to rise, indicating a more flexible opinion as to the justifiability of tax evasion over time. However, mean scores did not rise for all countries in the survey. In a few cases the mean score actually declined, indicating less tolerance for tax evasion over time.

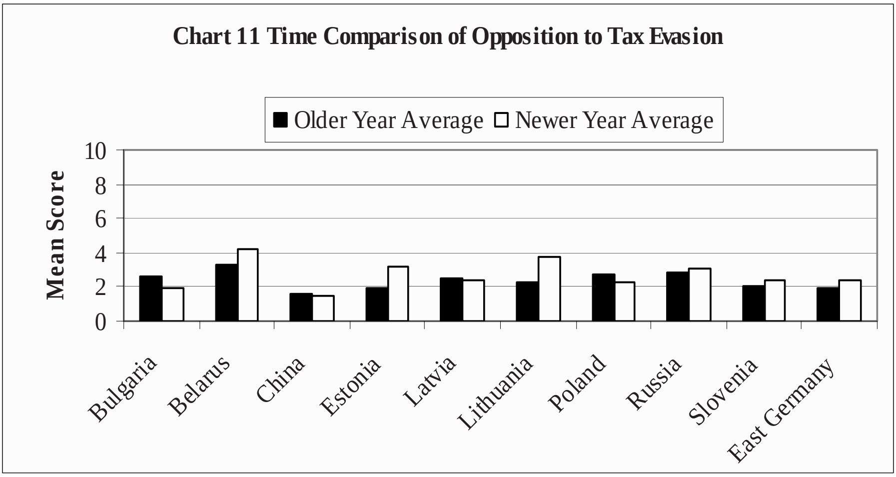


Table 12 lists the countries into the three possible categories. In six of the ten countries the resistance to tax evasion declined significantly over time, which is surprising if one subscribes to the view that people will have more respect for the law if the country is moving away from central planning and toward a market economy, since market economies supposedly have a stronger rule of law than do centrally planned economies that are not democratic. However, one may not always compare the relationship of democracy to attitudes toward tax evasion. China, for example, is not a democracy, although it is moving away from central planning and toward a market economy.

Also, the fact that a country is in the transition to a market economy does not mean that it has established a strong rule of law. Several countries in the present study still have a weak rule of law.

Table 12
Countries Categorized by Attitude

Countries with no change in attitude over time	Countries with decreasing opposition to tax evasion	Countries with increasing opposition to tax evasion
China	Belarus	Bulgaria
Latvia	Estonia	Poland
	Lithuania	
	Russia	
	Slovenia	
	East Germany	

One also cannot draw any firm conclusions based on EU membership, since there are EU members in all three categories. One might expect that countries having a weak rule of law such as Belarus and Russia would be in the category where opposition to tax evasion has been reduced in recent years, but that does not explain why countries with a stronger rule of law like Estonia, Lithuania and East Germany (now part of Germany) are also in the category where opposition to tax evasion has declined significantly over time.

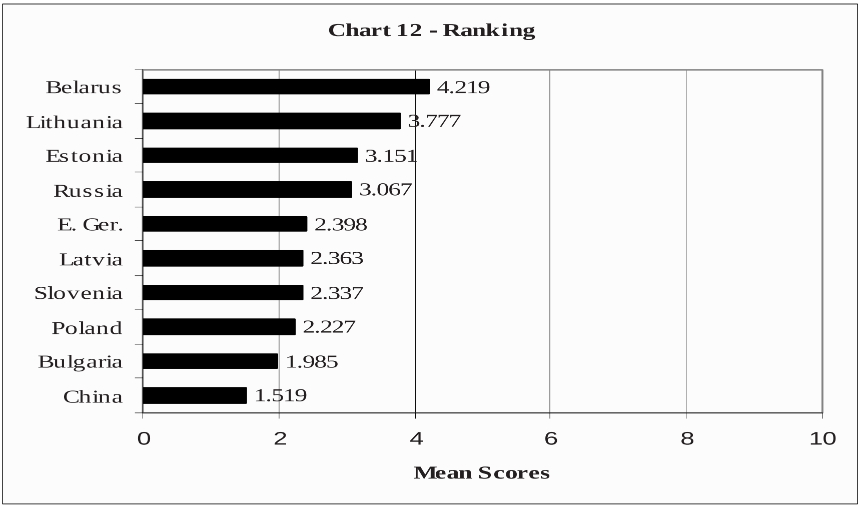
Table 13
Ranking of Means—Most Recent Survey
(1 = never justifiable; 10 = always justifiable)

Rank	Country	Mean (1=never justifiable; 10=always justifiable)
1	China	1.519
2	Bulgaria	1.985
3	Poland	2.227
4	Slovenia	2.337
5	Latvia	2.363
6	East Germany	2.398
7	Russia	3.067
8	Estonia	3.151
9	Lithuania	3.777
10	Belarus	4.219

Table 13 ranks the countries in terms of opposition to tax evasion. The Chinese sample showed the strongest opposition to tax evasion, which a mean score of 1.519 in the most recent survey, which, on a scale from 1 to 10 indicates very strong opposition to tax evasion.

At the other end of the spectrum is Belarus, where there is widespread moral support for tax evasion.

Chart 12 shows the ranking in terms of mean scores.



Concluding Comments

This study examined the views of sample populations in ten transition economies on the justifiability of tax evasion. If one were to summarize the study in a single sentence, one might say that tax evasion is generally viewed as unethical by a large segment of the population but that opposition to tax evasion has generally declined in recent years. But such a statement would not be completely accurate. If 60% of some sample population believes that tax evasion is never justified, one could just as easily say that 40% of the sample thinks tax evasion can be justified in certain cases.

Furthermore, only six of the ten countries included in the sample became significantly less opposed to tax evasion over time. Two countries became more opposed to tax evasion and two countries did not change their views significantly over time. Further research is needed to determine why some countries became less opposed to tax evasion over time while other countries in the same geographic region became more opposed to tax evasion. One might guess that cultural, economic, political and perhaps religious differences had some part to play, but more research is needed. Asking respondents the reasons for their views would also yield some useful information. Different countries may have different reasons for their viewpoints and asking for the reasoning behind their responses would uncover this information. The Inglehart et al. (2004) surveys did not do this, probably because asking for the reasons for responses to hundreds of questions would have been overly burdensome.

Another area of possible research would be to ask individuals in these countries whether they have ever engaged in tax evasion. Their actions might be far different from their theoretical views on tax evasion. Tax evasion is widespread in many transition economies, partly because the mechanism that is in place to collect taxes is not efficient enough to collect all the taxes that are legally owed and partly because of the perception that there is no duty to pay taxes (McGee and Maranjyan 2006).

Different methodologies might yield different results. For example, the Inglehart et al. (2004) surveys gathered data by face-to-face interviews. It is reasonable to expect that results would be different if data were gathered anonymously. There is some support for this viewpoint. For example, some China studies that gathered data anonymously found a high degree of support for tax evasion in China (McGee and Yuhua 2006; McGee and Guo 2006; McGee and Noronha 2007).

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10

Tax Evasion, Tax Misery and Ethics: Comparative Studies of Korea, Japan and China

Robert W. McGee

Introduction

The ethics of tax evasion has been discussed sporadically in the theological and philosophical literature for at least 500 years. Martin Crowe wrote a doctoral thesis that reviewed much of that literature in 1944. The debate revolved around about 15 issues. Over the centuries, three main views evolved on the topic. But the public finance literature has paid scant attention to this issue, perhaps because of the belief that tax evasion is always unethical.

This paper examines the tax evasion ethics data for Korea, Japan and China that was gathered as part of a much larger study on human beliefs and values. Country comparisons were made as well as comparisons based on gender, age, education, religion and marital status to determine whether views on tax evasion differ based on those demographics. Comparisons are then made to tax evasion studies conducted in western countries that examine responses on the basis of gender. The results of these comparisons show that the findings in the present study confirm the findings of some other studies but conflict with those of some other studies.

The present study also examines the data for the most recent Tax Misery Index figures for Korea, Japan, the People's Republic of China, Hong Kong and Taiwan as well as the most recent *Index of Economic Freedom* data for these countries.

Although tax evasion has been discussed extensively in the economics and public finance literature, little has been said about it from the perspective of ethics. There are some exceptions. Martin Crowe (1944), a Catholic priest, conducted an extensive review of 500 years worth of the religious and philosophical literature on the ethics of tax evasion. More recently McGee (1998a) published an edited book on the subject and Torgler (2003) published a doctoral dissertation on tax morale, a portion of which investigated ethical aspects of tax evasion.

R.W. McGee (ed.), *Taxation and Public Finance in Transition and Developing Economies*,
doi: 10.1007/978-0-387-25712-9_10,

Several studies have been done from various religious perspectives, including Christianity (Gronbacher 1998; Pennock 1998), Judaism (Cohn 1998; McGee and Cohn 2006; Tamari 1998), Islam (McGee 1998b; Murtuza and Ghazanfar 1998), Baha'i (DeMoville 1998) and Mormon (McGee and Smith 2006; Smith and Kimball 1998). If one were to summarize these studies in a single sentence it would be that Jews, Baha'is and Mormons are strongly opposed to tax evasion, whereas Christians and Muslims are more flexible on the topic.

Some theoretical country studies have also been done. Ballas and Tsoukas (1998) discuss tax evasion and government corruption in Greece. Morales (1998) reports on the ethics of tax evasion from a Mexican perspective and concludes that the duty to one's family at times supersedes one's duty to the state. Preobragenskaya and McGee (2004) and Vaguine (1998) examine tax evasion in Russia. Smatrakalev (1998) discusses tax evasion in Bulgaria. These studies all conclude that there is a widespread feeling that tax evasion is ethically justifiable in at least some circumstances, a conclusion that corresponds closely to that reflected in the Christian literature that Crowe (1944) discussed in his research.

Some empirical studies and surveys have been conducted to determine the views on tax evasion in several countries. McGee (1999) conducted a survey to determine why tax evasion is so prevalent in Armenia. A more recent study looked at tax evasion in Armenia in more depth (McGee and Maranjyan 2006). Country studies have also been conducted for Argentina (McGee and Rossi 2006), Bosnia (McGee et al. 2006a), China (McGee and An 2006: McGee and Guo 2006), Germany (McGee et al. 2006b), Guatemala (McGee and Lingle 2005), Hong Kong (McGee and Ho 2006), Macau (McGee et al. 2006c), Taiwan (McGee and Andres 2007), Poland (McGee and Bernal 2006), Romania (McGee 2006a) and Slovakia (McGee and Tusan 2006).

If one were to summarize these studies in a single sentence it would be that most people find tax evasion to be ethical in some situations, although some arguments to justify tax evasion are stronger than others. These studies generally found that there are three basic positions on the ethics of tax evasion—it is never ethical, sometimes ethical or always ethical, although support for the *always ethical* position was the weakest of the three. These three positions are discussed in depth by McGee (2006b).

The Present Study

Methodology

The present study used a methodology that is different from those of the other empirical studies mentioned above. It uses data that were collected as part of a much larger study of human beliefs and values. The Human Beliefs and Values Surveys (Inglehart et al. 2004) collected responses to hundreds of questions from 200,000 people in 81 societies representing 85% of the world's population. The data collected are a gold mine for social science researchers. However, the method of collection could be criticized. The interviews were face to face, which introduces a bias, since people might have different answers to some questions if they could answer anonymously. But even with this bias it is possible to examine certain relationships.

Studies have examined the relationship between ethical behavior and other factors such as gender and age. The present study examines these variables in order to determine whether these factors have any relationship to opinions on the ethics of tax evasion.

Comparing the findings in the Human Beliefs and Values Surveys to the various tax evasion surveys cited above would not yield many useful conclusions, for several reasons. For one, different groups were surveyed. The Human Beliefs and Values Surveys gathered the views of a wider demographic, with widely varying age, education and income, whereas the various tax evasion studies gathered data from university students, who are younger, poorer and more educated than the general population.

Another reason why any comparison between the two groups of studies would not yield any strong conclusions is because of the different ways in which the data were gathered. The various tax evasion surveys gathered data anonymously whereas the Human Beliefs and Values surveys gathered data by face to face interviews. Individuals might be less likely to admit they find little or nothing wrong with tax evasion if some stranger is asking them the question face to face. That might explain why the Human Beliefs and Values Survey scores for Slovakia show that Slovaks are strongly opposed to tax evasion whereas the McGee and Tusan (2006) survey of Slovakia revealed just the opposite.

The question used in the Human Beliefs and Values surveys was as follows:

> "Please tell me for each of the following statements whether you think it can always be justified, never be justified, or something in between: Cheating on taxes if you have a chance" (Inglehart et al. 2004, Table F116).

The scale on the survey was from 1 to 10 where 1 represents "never justifiable" and 10 represents "always justifiable."

Findings

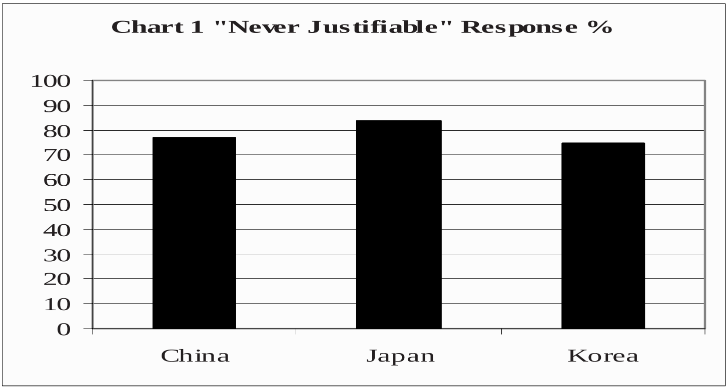
The findings are summarized in Table 1. The most popular response by far for all three countries was the belief that tax evasion is never justifiable. The

Japanese sample had the highest percentage (83.5%) response for that position but all three countries had responses for the "never justifiable" position well above 70%.

Table 1
Overall Scores
(1 = never justifiable; 10 = always justifiable)

Score	China %	Japan %	Korea %
1	77.1	83.5	74.7
2	11.7	6.2	11.6
3	3.6	4.0	6.1
4	1.2	1.5	2.1
5	3.6	2.4	2.8
6	0.9	0.7	1.0
7	0.4	0.1	0.5
8	0.5	0.3	0.3
9	0.1	0.2	0.3
10	1.0	1.2	0.7
Sample Size	985	1,312	1,199
Mean	1.57	1.46	1.59

Chart 1 shows the relative responses for the *never justifiable* position graphically.



The mean scores appeared to be basically the same—1.57 for China, 1.46 for Japan and 1.59 for Korea. All three means hovered between 1.46 and 1.59 which, on a scale from 1 to 10, does not seem like much of a difference. However, Wilcoxon tests revealed that some differences were significant, as Table 2 shows.

Table 2
Comparison of Overall Mean Scores

	p value
China vs. Japan	0.01057
China vs. Korea	0.3436
Japan vs. Korea	0.0002312

Wilcoxon tests found that the Japanese sample was significantly more opposed to tax evasion than were the Chinese or Koreans. However, since all three mean scores were significantly less than 2.0 on a scale from 1.0 to 10.0, it could also be concluded that all three groups believed that tax evasion was never, or almost never justifiable.

The findings in the present study confirm those found in similar studies of Asian countries (McGee 2006c), Vietnam (McGee 2006d) and thirty-three countries from several continents (McGee and Tyler 2007) that used the Human Beliefs and Values survey data. However, the present findings conflict with tax evasion studies of China (McGee and An 2006; McGee and Guo 2006), Hong Kong (McGee and Ho 2006), Macau (McGee et al. 2006c) and Taiwan (McGee and Andres 2007). Those studies found that there was widespread acceptance of tax evasion.

The difference in findings can perhaps be explained by the methodology. In the other studies an anonymous survey instrument was used, whereas the data gathered in the Human Beliefs and Values surveys were gathered in face-to-face interviews. Another difference was the make-up of the groups surveyed. In the other studies of Chinese populations the groups surveyed consisted of university students, who were mostly under age 25. The sample in the present survey consisted of a wider range of ages.

Gender

Many studies have been conducted that compare ethical attitudes of men and women. Some studies found that women are more ethical than men (Akaah 1989; Boyd 1981; Hoffman 1998) while other studies found that there is not a significant difference between the ethics of men and women (Browning and Zabriskie 1983; Harris 1990; Nyaw and Ng 1994). Some studies found that men are more ethical than women (Barnett and Karson 1987; Weeks et al. 1999). This study examines the Inglehart et al. (2004) data to determine whether one gender was more opposed to tax evasion than the other.

Table 3 compares the scores for all three sample populations by gender. By far the most frequent response for all six groups was the *never justifiable* option. All mean scores were significantly below 2.0.

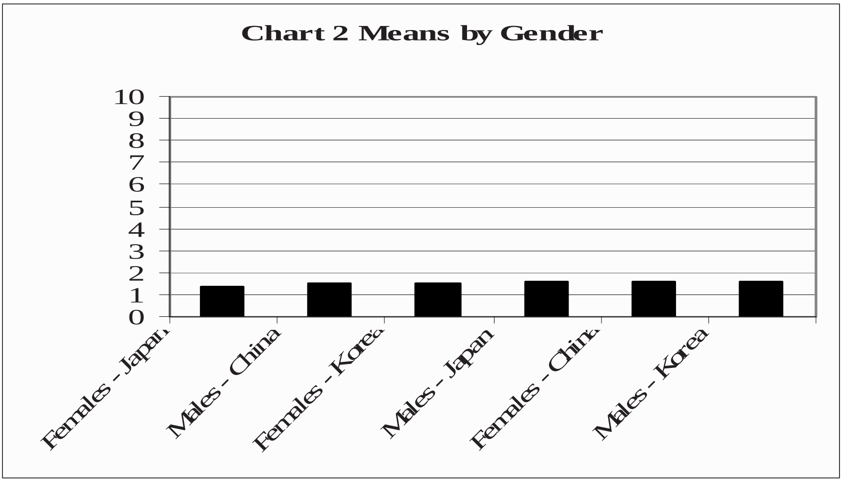
As the mean scores show, Chinese men were more opposed to tax evasion than were Chinese women. But women in the other two groups were more opposed to tax evasion than were the men in those groups.

Table 3
Scores by Gender
(1 = never justifiable; 10 = always justifiable)

Score	China %		Japan %		Korea %	
	Male	Female	Male	Female	Male	Female
1	77.6	76.5	80.2	86.5	72.4	77.1
2	11.8	11.6	7.0	5.5	12.9	10.3
3	3.0	4.1	4.7	3.3	6.5	5.7
4	1.2	1.2	2.1	1.0	2.0	2.2
5	3.7	3.4	2.8	2.0	3.1	2.5
6	1.0	0.8	0.8	0.6	1.3	0.7
7	0.6	0.2	0.0	0.1	1.0	0.0
8	0.4	0.6	0.5	0.1	0.5	0.0
9	0.2	0.0	0.2	0.1	0.2	0.3
10	0.4	1.6	1.8	0.7	0.2	1.2
Sample Size	492	493	615	697	604	595
Mean	1.53	1.61	1.59	1.35	1.63	1.55

The male-female differences were not significant for the Chinese group ($p \leq 0.7215$) or the Korean group ($p \leq 0.1567$). However, Japanese women were significantly more opposed to tax evasion than were Japanese men ($p \leq 0.04061$).

Chart 2 shows the relative mean scores for all six groups.



Age

Some studies have found that people have more respect for government and for authority as they get older (Alm and Torgler 2004; McGee and Tyler 2007). The present study tests this assumption by comparing the scores for the three age groups that the Human Beliefs and Values surveys gathered.

Tables 4–6 show that mean scores declined with age, meaning that people became more opposed to tax evasion as they got older.

Table 4
Scores by Age—China
(1 = never justifiable; 10 = always justifiable)

Score	15–29 %	30–49 %	50+ %
1	70.5	78.1	80.1
2	16.1	10.6	10.6
3	2.1	4.4	2.7
4	1.6	1.2	0.9
5	6.2	3.0	2.7
6	1.6	0.7	0.9
7	1.0	0.2	0.4
8	0.0	0.5	0.9
9	0.5	0.0	0.0
10	0.5	1.2	0.9
Sample Size	193	566	226
Mean	1.73	1.55	1.50

Table 5
Scores by Age—Japan
(1 = never justifiable; 10 = always justifiable)

Score	15–29 %	30–49 %	50+ %
1	74.0	82.6	88.5
2	8.3	7.5	4.1
3	7.9	4;6	1.8
4	4.1	1.0	0.9
5	3.3	2.2	2.1
6	1.2	0.8	0.4
7	0.4	0.0	0.0
8	0.8	0.0	0.4
9	0.0	0.2	0.2
10	0.0	1.2	1.8
Sample Size	242	505	565
Mean	1.64	1.45	1.40

Table 6
Scores by Age—Korea
(1 = never justifiable; 10 = always justifiable)

Score	15–29 %	30–49 %	50+ %
1	71.2	74.6	79.0
2	10.9	11.6	12.4
3	8.0	6.6	2.6
4	2.9	1.8	1.9
5	3.2	3.2	1.5
6	1.6	0.5	1.5
7	1.0	0.5	0.0
8	0.0	0.2	0.7
9	0.6	0.2	0.0
10	0.6	0.8	0.4
Sample Size	313	619	267
Mean	1.73	1.58	1.45

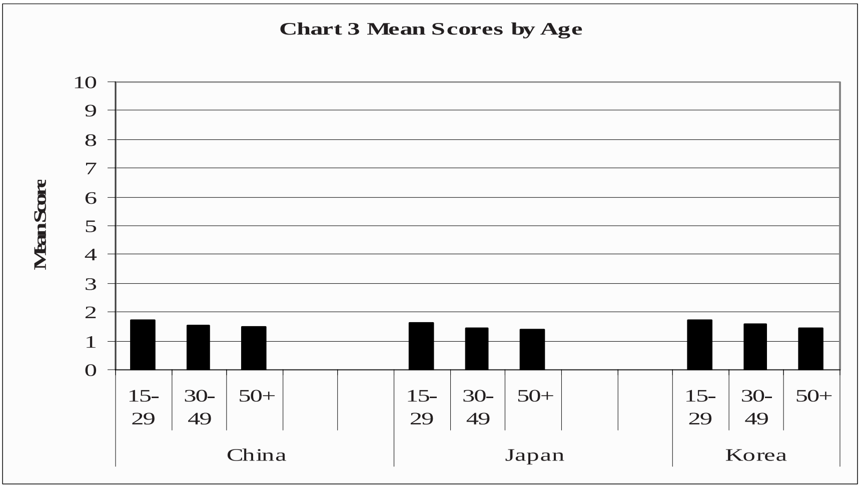
Table 7 shows the significance of the various differences.

Table 7
Significance of Differences by Age

	15–29 vs. 30–49	15–29 vs. 50+	30–49 vs. 50+
China	0.138	0.1043	0.6488
Japan	0.04647	0.001445	0.1152
Korea	0.3091	0.06648	0.2499

The most significant difference in each case was the difference between the youngest and oldest group. The Wilcoxon tests found that people do become more significantly opposed to tax evasion as they get older, a finding that confirms other studies (Alm and Torgler 2004; McGee and Tyler 2007).

Chart 3 compares the mean scores for the three countries for each category. As can be seen, in the total scheme of things, there is not much difference among the three countries, although statistical tests conclude that some statistical differences are significant. The mean scores are declining in each case, indicating that support for tax evasion declines with age. But support is low for all categories.



Education

A study of tax evasion opinion in Vietnam found that the most highly educated group was somewhat less opposed to tax evasion than were the other two groups (McGee 2006d). A study of tax evasion in 33 countries found that opposition to tax evasion eroded as the level of education rose (McGee and Tyler 2007). Thus, it was thought that testing for a relationship between education and the extent of opposition to tax evasion would be worthwhile.

Tables 8–11 show the percentage of the samples that chose each score. The categories for education were compiled as follows:

<u>Lower</u>
Inadequately completed elementary education, or
Completed (compulsory) elementary education, or
(Compulsory) elementary education and basic vocational qualification
<u>Middle</u>
Secondary, intermediate vocational qualification, or
Secondary, intermediate qualification, or
Full secondary, maturity level certificate
<u>Upper</u>
Higher education—lower-level tertiary certificate, or
Higher education—upper-level tertiary certificate

As is seen in Table 8, opposition to tax evasion for the three countries combined deteriorates somewhat as the level of education increases. The differences become more significant as one leaves the lower level of education. However, the mean score for the highest level of education is substantially less than 2.0 on a scale of 1.0–10.00, which indicates that even at the highest level of education there is significant opposition to tax evasion.

Table 8
Responses by Education—China, Japan and Korea Combined
(1 = never justifiable; 10 = always justifiable)

Score	Overall %	Education level Lower %	Middle %	Upper %
1	78.7	82.9	79.4	73.9
2	9.6	10.1	9.0	10.7
3	4.6	1.7	4.7	6.6
4	1.6	0.9	1.7	2.1
5	2.9	2.7	2.6	3.5
6	0.9	0.7	0.6	1.6
7	0.3	0.0	0.4	0.4
8	0.3	0.2	0.3	0.2
9	0.2	0.2	0.2	0.1
10	1.0	0.7	1.1	1.0
Mean	1.54	1.39	1.53	1.66
Sample Size	3,454	585	2,045	824
Comparisons			p value	
Lower vs. Middle			0.144	***
Lower vs. Upper			0.004398	*
Middle vs. Upper			0.04193	**

*Significant at the 1% level
** Significant at the 5% level
*** Significant at the 15% level

Table 9
Responses by Education—China
(1 = never justifiable; 10 = always justifiable)

Score	Overall %	Education level Lower %	Middle %	Upper %
1	77.1	81.0	74.7	69.8
2	11.7	12.8	10.8	11.6
3	3.6	2.2	4.5	4.7
4	1.2	0.7	1.5	2.3
5	3.6	2.0	4.7	4.7
6	0.9	0.5	0.7	7.0
7	0.4	0.0	0.7	0.0
8	0.5	0.2	0.7	0.0
9	0.1	0.0	0.2	0.0
10	1.0	0.5	1.5	0.0
Mean	1.57	1.36	1.71	1.81
Sample Size	985	405	537	43
Comparisons			p value	
Lower vs. Middle			0.04566	*
Lower vs. Upper			0.1588	**
Middle vs. Upper			0.564	

* Significant at the 5% level
** Significant at the 16% level

The means for the education categories in the China sample increased with the level of education, meaning that opposition to tax evasion declined somewhat as level of education increased. However, things must be put in perspective. All three means were substantially less than 2.0 on a scale from 1.0 to 10.0. The difference was most significant as education level increased from lower to middle. One might expect that the difference would be even more significant for the comparison of lower to upper, since the mean scores for those two groups were farther apart than the mean scores for the lower and middle categories. The lower level of significance might be explained by the smaller sample size for the upper category. The same explanation can be given for the comparison of the middle and upper education categories.

Table 10 shows the comparisons for the Japanese sample.

Table 10
Responses by Education—Japan
(1 = never justifiable; 10 = always justifiable)

Score	Overall %	Education level		
		Lower %	Middle %	Upper %
1	83.5	85.4	84.7	78.6
2	6.2	1.5	5.4	9.4
3	4.0	0.0	4.3	5.0
4	1.5	0.8	1.6	1.6
5	2.4	5.4	2.1	1.9
6	0.7	0.8	0.4	1.6
7	0.1	0.0	0.1	0.0
8	0.3	0.0	0.1	0.3
9	0.2	0.8	0.1	0.0
10	1.2	0.8	1.2	1.6
Mean	1.46	1.44	1.42	1.56
Sample Size	1,270	124	828	318
Comparisons			p value	
Lower vs. Middle			0.4587	
Lower vs. Upper			0.1068	*
Middle vs. Upper			0.1265	*

* Significant at the 15% level

The mean for the Japanese sample dipped slightly from the lower to middle category, then jumped somewhat from the middle to the upper category. From the statistics one might conclude that opposition to tax evasion became somewhat weaker as the level of education increased.

Table 11 shows the results for the Korean sample.

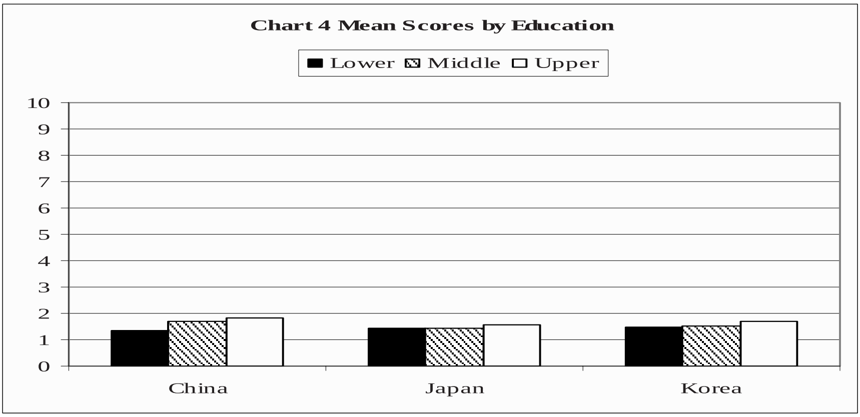
The mean score for the Korean sample increased slightly at first, then jumped by nearly two-tenths of a point. The findings indicate that the opinion toward tax evasion does not change from the lower to middle education group but does change significantly from the middle to upper education group. At first these findings seem inconsistent, since the mean score for the lower group is lower than for the middle group. However, this seeming inconsistency can be explained by the much smaller sample size for the lower category.

Table 11
Responses by Education—Korea
(1 = never justifiable; 10 = always justifiable)

Score	Overall %	Education level		
		Lower %	Middle %	Upper %
1	74.7	82.1	76.6	71.1
2	11.6	8.9	11.9	11.4
3	6.1	1.8	5.3	7.8
4	2.1	1.8	1.9	2.4
5	2.8	1.8	1.8	4.5
6	1.0	1.8	0.9	1.1
7	0.5	0.0	0.4	0.6
8	0.3	0.0	0.3	0.2
9	0.3	0.0	0.3	0.2
10	0.7	1.8	0.6	0.6
Mean	1.59	1.50	1.52	1.71
Sample Size	1,199	56	680	463
	Comparisons		p value	
Lower vs. Middle			0.5229	
Lower vs. Upper			0.1737	
Middle vs. Upper			0.06714	*

* Significant at the 10% level

Chart 4 shows the comparisons by level of education. As can be seen, although the trend is rising as the level of education increases, all groups are at the lower end of the score spectrum.



Religion

Some theoretical studies have examined what the religious literature has to say about tax evasion. Studies of the Jewish (Cohn 1998; Tamari 1998), Baha'i (DeMoville 1998) and Mormon (Smith and Kimball 1998) religions indicate strong opposition to tax evasion. Christians (Crowe 1944; Pennock 1998; Gronbacher 1998) and Muslims (McGee 1998b) were less rigid on the issue. Empirical studies of Mormon (McGee and Smith 2006) and Jewish (McGee and Cohn 2006) opinion also found strong opposition to tax evasion, although the opposition was not as strong as the religious literature would suggest. No theoretical or empirical studies could be found that address the issue of tax evasion under Buddhism, which is one of the major religions in Asia. Thus, there was a need to examine the views of Buddhists on this issue.

Luckily, the Human Beliefs and Values surveys (Inglehart et al. 2004) collected this information. Although many religions were included in the sample, the only religions examined in the present study were those that had a sample size of more than 30. The results are analyzed in Table 12.

Table 12
Responses by Religion
(1 = never justifiable; 10 = always justifiable)

Score	Buddhist %	Protestant %	Roman Catholic %	Not applicable %
1	81.7	73.9	71.2	78.6
2	6.7	9.9	17.2	10.6
3	4.7	7.1	2.7	4.1
4	1.1	4.0	3.8	1.3
5	2.9	1.9	1.6	3.0
6	1.0	0.9	2.2	0.6
7	0.1	0.9	0.0	0.3
8	0.0	0.6	0.5	0.4
9	0.1	0.3	0.0	0.2
10	1.6	0.3	0.5	0.9
Mean	1.52	1.64	1.60	1.52
Sample Size	728	322	184	2,042
			p value	
	Buddhist vs. Protestant		0.0518	**
	Buddhist vs. Roman Catholic		0.04958	*
	NA vs. Protestant		0.1465	***
	NA vs. Roman Catholic		0.13	***
	Protestant vs. Roman Catholic		0.7699	

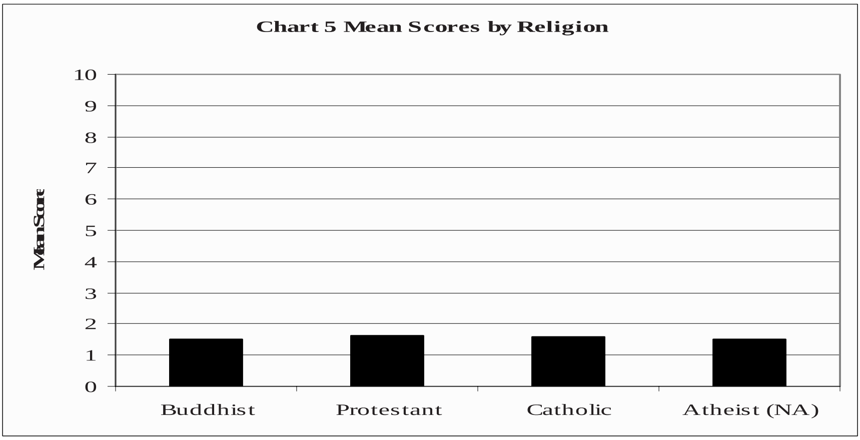
* Significant at the 5% level
** Significant at the 10% level
*** Significant at the 15% level

One category was *not applicable*. Presumably that means atheist or agnostic. However, the Inglehart et al. (2004) study did not say what was included in that category, so we can only speculate. What is interesting is that the mean scores for Buddhists and the Not Applicable group were identical, which might lead one to conclude that Buddhists and atheists share the same opinion when it comes to tax evasion.

The means for Protestants and Roman Catholics were somewhat higher than the means for Buddhists and Not Applicable, indicating that Protestant and Catholic opposition to tax evasion was not as strong as opposition by Buddhists and atheists/agnostics. However, all means were substantially less than 2.0 on a scale from 1.0 to 10.0, indicating strong opposition to tax evasion by all groups.

One might think that the p values for the Buddhist comparisons with Protestants and Catholics might be identical to the p values for the NA comparisons with Protestants and Catholics. But such was not the case. These differences might be explained by the different composition or score distributions in the various samples. Although the means might be identical, if the distributions are not identical, it is reasonable to expect that the p values would also not be identical.

Chart 5 shows the comparative mean scores.



Marital Status

The Human Beliefs and Values survey collected data by marital status. Table 13 analyzes that data.

As can be seen, the means for the married and widowed categories are identical at 1.50. The strongest opposition to tax evasion was for the divorced group. The least opposition to tax evasion occurred in the single/never married group. An analysis of the data concludes that divorced people tend to be more significantly opposed to tax evasion that most other groups, although the difference was smallest between the divorced and widowed groups. The single/never married group was significantly less opposed to tax evasion than were the other groups. However, since the sample means for all groups were significantly less than 2.0 on a scale of 1.0–10.00, one could also conclude that no group was strongly in favor of tax evasion.

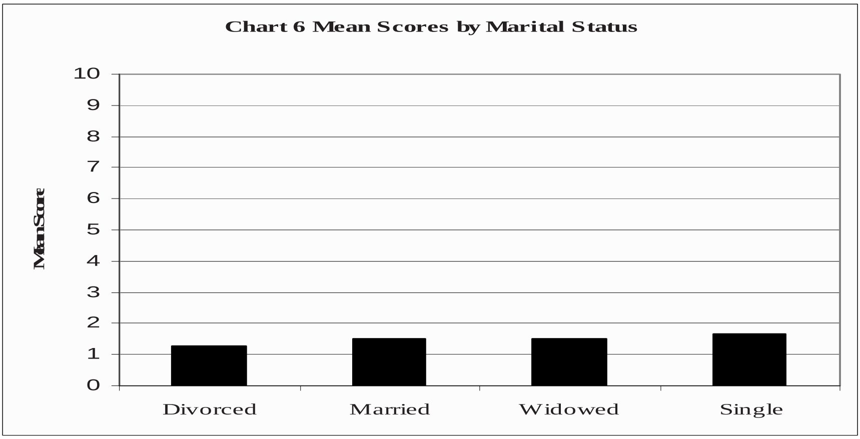
Table 13
Responses by Marital Status
(1 = never justifiable; 10 = always justifiable)

Score	Married %	Divorced %	Widowed %	Single/never married %
1	79.8	91.8	89.8	72.2
2	9.5	3.3	3.1	11.4
3	4.2	1.6	0.0	7.1
4	1.5	0.0	1.0	2.6
5	2.7	1.6	1.0	3.2
6	0.6	0.0	1.0	1.7
7	0.3	0.0	0.0	0.6
8	0.3	0.0	1.0	0.3
9	0.1	0.0	0.0	0.5
10	1.0	1.6	3.1	0.3
Mean	1.50	1.28	1.50	1.67
Sample Size	2,629	61	98	647

	p value	
Married vs. Divorced	0.1143	***
Married vs. Single/Never Married	0.002058	*
Divorced vs. Single/Never Married	0.01226	**
Widowed vs. Divorced	0.8165	
Widowed vs. Single/Never Married	0.00852	*

* Significant at the 1% level
** Significant at the 5% level
*** Significant at the 15% level

Chart 6 compares the means for each group.



Other Studies

As was mentioned above, other empirical studies on the ethics of tax evasion have been made that used a different methodology to determine the receptivity of the populations of various countries to the idea that tax evasion might be ethical under certain circumstances. None of those studies surveyed Korean or Japanese populations. However, several surveys examined the views of Chinese populations. Other surveys gathered opinion data for sample populations in various European countries and the United States. This section summarizes those studies.

Methodology

A survey instrument was constructed and distributed to groups of students at various universities in the respective countries in order to learn the prevailing views on the ethics of tax evasion. The survey consisted of fifteen (15) statements that corresponded to the arguments used to justify tax evasion in the Crowe (1944) study. In the European and American studies, an additional three questions were added to cover various human rights abuses that the Crowe study did not discuss. The three human rights statements were omitted from the Chinese studies so that the individuals who distributed the survey instruments would not get into trouble with the Chinese authorities, since the Chinese government is sensitive about discussing human rights abuses in China. Using a seven-point Likert scale, respondents were asked to place the appropriate number in the space provided to indicate the extent of their agreement or disagreement with each statement.

Findings for Chinese Surveys

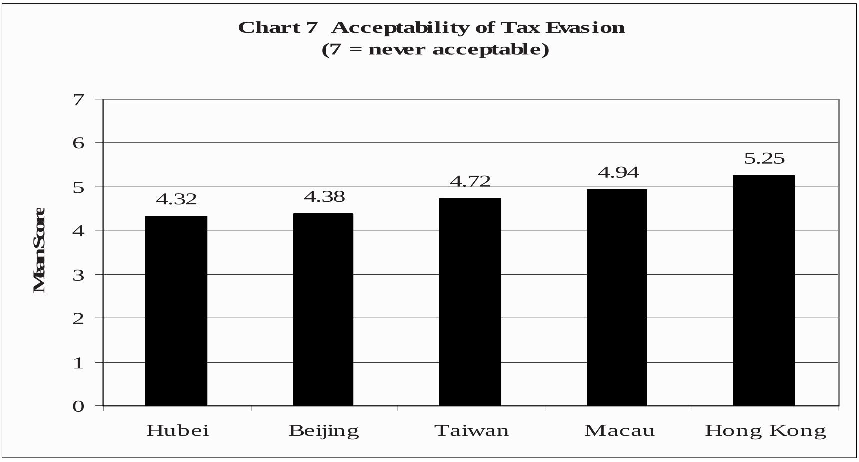
Table 14 lists the statements and shows the relative scores that were given by the various Chinese samples.

Table 14
Summary of Responses
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Beijing (McGee and An 2006)	Hubei (McGee and Guo 2006)	Hong Kong (McGee and Ho 2006)	Macau (McGee et al. 2006c)	Taiwan (McGee and Andres 2007)
1	Tax evasion is ethical if tax rates are too high. (S1)	4.0	3.7	5.3	5.05	4.12
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me. (S2)	4.7	5.7	6.0	5.74	5.06
3	Tax evasion is ethical if the tax system is unfair. (S3)	3.4	3.2	4.5	3.95	3.28
4	Tax evasion is ethical if a large portion of the money collected is wasted. (S4)	3.1	3.1	4.2	4.04	3.49
5	Tax evasion is ethical even if most of the money collected is spent wisely. (S5)	5.3	3.1	4.4	5.76	5.70
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of. (S6)	4.3	3.4	4.7	4.68	5.16
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects. (S7)	5.2	6.0	6.4	5.80	5.78
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me. (S8)	4.9	4.8	6.2	5.58	5.17

9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me. (S9)	5.2	6.0	6.5	5.74	5.45
10	Tax evasion is ethical if everyone is doing it. (S10)	4.7	4.7	6.0	5.25	5.08
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. (S11)	3.2	2.9	3.7	3.58	3.27
12	Tax evasion is ethical if the probability of getting caught is low. (S12)	5.1	5.8	6.0	5.41	5.15
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust. (S13)	3.6	3.3	4.0	3.63	4.33
14	Tax evasion is ethical if I can't afford to pay. (S14)	3.9	3.4	4.8	4.32	4.24
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more. (S15)	5.1	5.7	6.0	5.54	5.46
	Average Score	4.38	4.32	5.25	4.94	4.72

Chart 7 shows the mean scores for the various surveys. As can be seen, Hubei and Beijing were less opposed to tax evasion than were the other samples. Hong Kong was most opposed. Taiwan and Macau were in the middle. Clearly, mainland China is less opposed to tax evasion than are the other Chinese constituencies. One possible explanation for less opposition on the mainland is because of the weaker respect for the rule of law and property rights. If there is less respect for the government, that lack of respect might translate into fewer qualms about evading taxes.



One interesting finding in these studies is that the sample populations are significantly less opposed to tax evasion than was the case in the Inglehart et al. (2004) study. One explanation could be the different methodologies. The Inglehart et al. study gathered data by face-to-face interviews, whereas the studies mentioned above used anonymous survey instruments. Another possible explanation is that the Inglehart et al. studies asked just one generic question on the ethics of tax evasion whereas the other studies asked 15 or 18 fact specific questions. People may be generally opposed to tax evasion but their opinions might change if asked about the ethics of tax evasion in particular fact circumstances.

Gender Differences—Other Studies

Some studies using the methodology described above compared male and female scores. Some studies found that females were significantly more opposed to tax evasion than were the males. Another group of studies found that men were more opposed to tax evasion while a third group of studies found no significant difference between male and female scores. Table 15 summarizes the results of those studies. The results of the present study are also included in the table for comparison purposes.

There are several possible explanations for why studies have arrived at three differing conclusions about the effect of gender on attitude toward tax evasion. In order to determine why women think differently than men on this issue (in some cases but not others), one must examine the history, culture, psychology, religion, philosophy and anthropology of the particular country, which is beyond the scope of the present study and is beyond the expertise of the present researcher. However, insights could be gained if a multidisciplinary approach were used, perhaps supplemented by open-ended questions that respondents could answer anonymously.

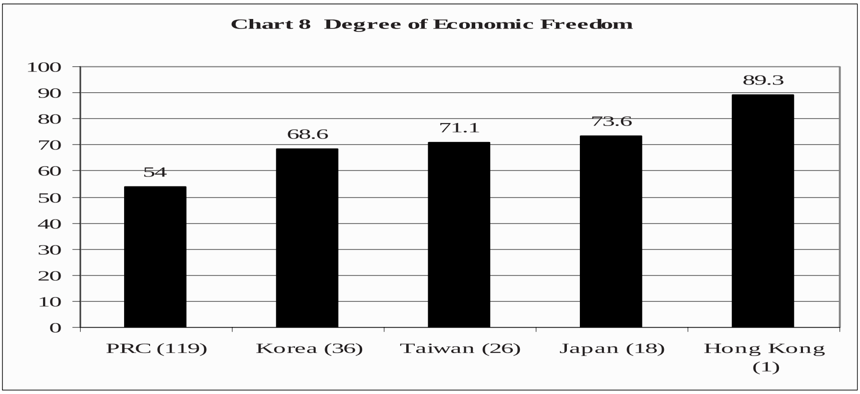
Table 15
Male and Female Opinions
The Ethics of Tax Evasion

Study	Males more strongly opposed to tax evasion	Females more strongly opposed to tax evasion	No diff.
Australia (McGee and Bose 2007)			x
China [Beijing] (McGee and An 2006)			x
China [Hubei] (McGee and Guo 2006)		x	
China (present study)			x
Guatemala (McGee and Lingle 2005)		x	
Hong Kong (McGee and Ho 2006)			x
Japan (Present study)		x	
Jewish (McGee and Cohn 2006)		x	
Korea (Present study)			x
Macau (McGee et al. 2006c)			x
Mormons (McGee and Smith 2006)		x	
Poland (McGee and Bernal 2006)			x
Romania (McGee 2006a)	x		
Slovakia (McGee and Tusan 2006)	x		
Taiwan (McGee and Andres 2007)		x	
USA (McGee and Andres 2007)			x
USA (McGee et al. 2006b)		x	

Actually, such an open-ended question was included in the various McGee survey instruments but the results were inconclusive. Fairness was a significant issue for both male and female respondents, as was ability to pay. In some cases, male and female scores were significantly different for particular statements, but an examination of these differences did not lead to any strong conclusions.

Tax Evasion and Economic Freedom

There may also be a correlation between opposition to tax evasion and the degree of economic freedom. The Heritage Foundation and the Wall Street Journal conduct an annual study of the degree of economic freedom in 161 countries. That study is called the *Index of Economic Freedom*. The scale is 0 to 100, where 100 represents total economic freedom. Chart 8 shows the relative scores for Japan, Korea and the various Chinese constituencies. The numbers in parentheses are the economic freedom rankings; 161 countries were included in the 2007 survey (Index of Economic Freedom 2007).

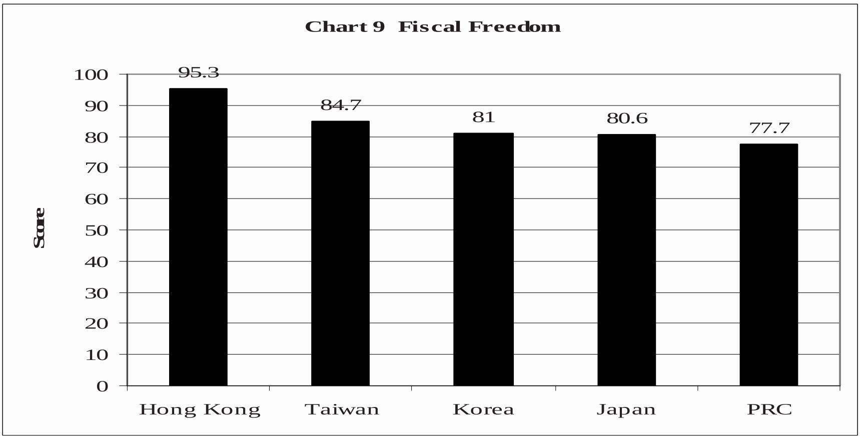


The People's Republic of China is in the 74th percentile. All the other countries are in the top 25%, in terms of economic freedom. Hong Kong is ranked #1, whereas the PRC's rank is 119. If one were to draw any conclusions from this data it would be that opposition to tax evasion is stronger in countries that have more economic freedom. Perhaps that is because such countries have more respect for the rule of law and property rights. Such a conclusion has policy implications. If the PRC wants its citizenry to be more opposed to tax evasion in the future, it must allow more economic freedom.

Another way to compare countries is the Index of Economic Freedom's fiscal freedom score, which can be used as a surrogate for fairness. The various studies mentioned in this part of the paper considered the degree of perceived fairness of the tax system to be an important factor in determining the extent of the ethical obligation to pay taxes. So presumably there is some correlation between perceived fairness and the obligation to pay taxes.

Chart 9 shows the fiscal freedom scores for the PRC, Hong Kong, Taiwan, Japan and Korea. If fiscal freedom and perceived fairness are equivalent, we may conclude that the tax system in the PRC is the least fair and the Hong Kong tax system is the most fair, with Taiwan, Korea and Japan falling in between.

Again, such a conclusion has policy implications. If the PRC wants its people to be more strongly opposed to tax evasion, it must reform its tax system so it is perceived as being fairer than the present system. The quickest and easiest remedy would be for the PRC to adopt Hong Kong's tax system, since that system is perceived as being the fairest of the systems examined in the present study.



Tax Evasion and Tax Misery

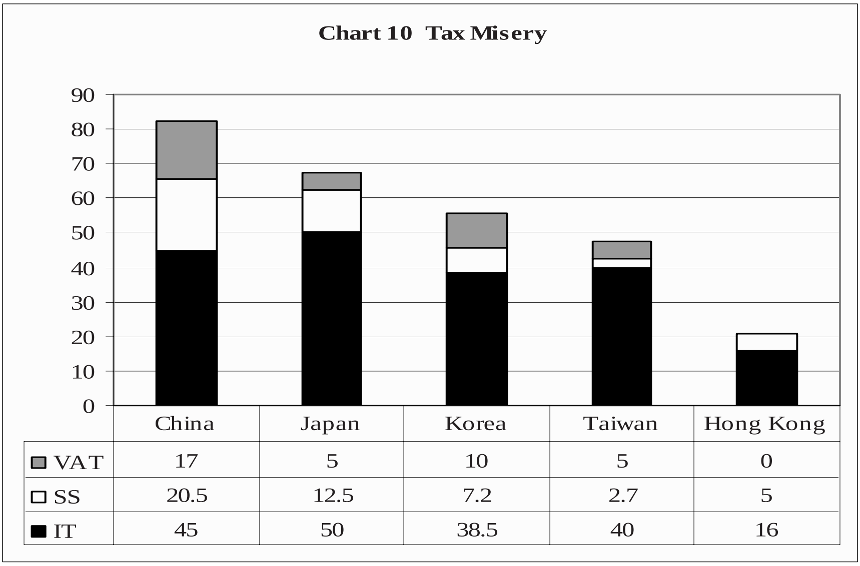
Another way to estimate the willingness to evade taxes is to measure the amount of tax misery that individual taxpayers must endure if they pay all the taxes that are legally owed. Each year *Forbes* magazine does a study of tax misery. The tax misery index is computed by adding the top marginal tax rates for the corporate income tax, personal income tax, wealth tax, value added tax and both the employer and employee share of the social security tax. The higher the total score, the more tax misery.

Table 16 shows the top marginal rates and the total score for the individual income tax, the wealth tax, the value added tax (VAT) and the employee share of the social security tax, since these are the four taxes that individuals must pay. Figures are from the most recent Forbes study (Anderson and Andelman 2007). China has the highest score on the Tax Misery Index, followed by Japan, Korea, Taiwan and Hong Kong.

Table 16
Tax Misery Index for Individuals
Top Marginal Rates

	Individual income tax	Wealth tax	Employee share of social security	VAT	Total
China	45	0	20.5	17	82.5
Japan	50	0	12.8	5	67.8
Korea	38.5	0	7.2	10	55.7
Taiwan	40	0	2.7	5	47.7
Hong Kong	16	0	5	0	21

Chart 10 shows the relative misery by category and country.



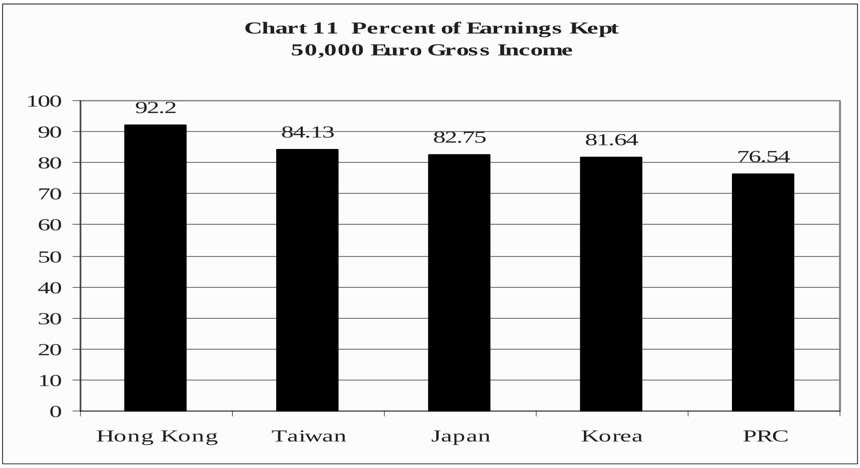
Again, the policy implications are clear. If the PRC wants to reduce the extent of misery suffered by its taxpayers, it must reduce tax rates to more competitive levels. The quick and easy solution would be to adopt the Hong Kong rates, since Hong Kong taxpayers have by far the least amount of tax misery. This solution is not limited to the PRC. Japan, Korea and Taiwan could also adopt the Hong Kong tax rates. Doing so would enhance tax harmonization while at the same time reduce tax misery.

Another way to look at tax misery is the percentage of salary that employees get to keep. The *Forbes* study makes this computation for various income levels for more than 50 countries. Table 17 shows the percentages for a worker who is married with two dependent children and who earns 50,000 euros.

Table 17
Net Salary at 50,000 Euro Level
Married, 2 Dependent Children

	Gross salary	Soc. sec.	Inc. tax	Net	% Net
China	50,000	1,096	10,634	38,270	76.54
Hong Kong	50,000	0	3,902	46,098	92.20
Japan	50,000	5,883	2,740	41,377	82.75
Korea	50,000	2,628	6,553	40,819	81.64
Taiwan	50,000	2,239	5,695	42,066	84.13

Hong Kong workers get to keep the most (92.2%), whereas workers in the PRC get to keep the least (76.54%). Chart 11 shows the relative net incomes in percentage terms.



The percentages may change as the income level increases. Income tax rates in some countries are graduated and the percentage of taxes taken for social security may also change. In some cases, social security taxes cease to be taken after a certain income level is reached. In other words, the income tax may be progressive while the social security tax may be regressive.

Table 18 shows the percentage of income an employee with two dependent children gets to keep at a gross income level of 1 million euros.

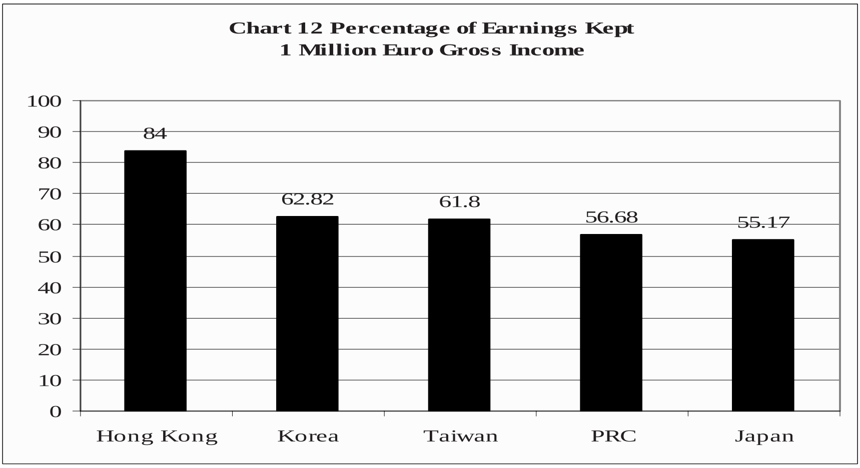
Table 18
Net Salary at 1,000,000 Euro Level
Married, 2 Dependent Children

	Gross salary	Soc. sec.	Inc. tax	Net	% Net
China	1,000,000	1,096	432,122	566,782	56.68
Hong Kong	1,000,000	0	160,000	840,000	84.00
Japan	1,000,000	14,244	434,062	551,694	55.17
Korea	1,000,000	14,666	357,131	628,203	62.82
Taiwan	1,000,000	2,239	379,751	618,010	61.8

Workers in Hong Kong get to keep the most (84%), whereas Japanese workers keep the least (55.17%). Chart 12 shows the relative net incomes in percentage terms.

The order has changed somewhat at the 1 million Euro level. Hong Kong is still first but this time Japan is in last place, whereas the PRC was in last place at the 50,000 Euro level.

Again, these findings have policy implications. Hong Kong has the best score and either the PRC or Japan has the worst score, depending on income level. If countries want to improve their scores, one way to do that would be to have tax rates that are closer to those of Hong Kong.



Concluding Comments

The strongest conclusion that can be drawn from the present study is that all groups were strongly opposed to tax evasion. This finding conflicts with other studies on the ethics of tax evasion, in the sense that the present found taxpayers to be more opposed to tax evasion than were respondents in the other studies. The differing conclusions might be due to the different methodologies that were used in those other studies. Anonymous survey data might tend to produce different results than data gathered in face-to-face interviews. Studies that were done using the same data set and the same methodology as the present study had results that were similar to the present study (McGee 2006c, 2006d; McGee and Tyler 2007).

The sample population from Japan tended to be more strongly opposed to tax evasion than were the sample populations from the other two countries. But the populations sampled in all three countries were nevertheless strongly opposed to tax evasion.

The gender comparison was less definitive in its conclusions. The strongest conclusion that could be made was that Japanese women were significantly more opposed to tax evasion than were Japanese men. That could not be said of the samples from China and Korea. Further research is needed to determine why the Japanese sample is different in this regard.

Another conclusion that can be drawn from the study is that people tend to become more opposed to tax evasion as they get older. This could be because older people have more respect for government and the rule of law than do younger people. The studies mentioned above that compared age with respect for authority found this correlation, so the present study confirms the findings of those other studies.

People also tend to be less opposed to tax evasion as their level of education increases. This could be because the more educated people are, the less they feel that they have an absolute obligation to pay the state whatever it demands in taxes. There could also be an income effect at work. The more educated people are, the more income they make, as a general rule. As income increases, perhaps the feeling that there is an obligation to give that income to the government decreases.

In the category of religion, the survey found that Buddhists and atheists/agnostics tend to be more opposed to tax evasion than do Christians. More research is needed to determine the reason for this significant difference. The survey also found that marital status can make a difference. More research is needed to determine why these differences exist. However, space does not permit a full analysis of these points.

Although opposition to tax evasion was strong, it could not be determined from the data the reason for the strong opposition. The three reasons given in another study (Cohn 1998) were duty to God, duty to the state and duty to other taxpayers. The duty to God rationale is perhaps the weakest rationale in the present study, since a significant portion of the sample did not espouse any religious conviction. However, this rationale might be important for a significant subset of the sample.

The duty to the state rationale is likely a more powerful influence, since the populations of these Asian countries are generally perceived to give a great deal of deference to the state. The duty to fellow citizens probably also accounts for a portion of the strong opposition to tax evasion, especially in the case of Japan. The Japanese culture places strong emphasis on consensus. There is a strong feeling that the group is more important than the individual. This belief might partially explain why the Japanese sample was more strongly opposed to tax evasion than were the samples from Korea and China. However, concern for fellow citizens is a trait that is present in the Chinese and Korean cultures as well, and the mean score for all three countries was significantly below 2.0.

In order to determine the reasons for the strong opposition to tax evasion it would be necessary to ask the sample populations the reasons for their responses. The Inglehart et al. study (2004) did not do this, probably because doing so would have made the study more cumbersome. That study asked hundreds of questions on a wide range of issues. Asking reasons for each response would have greatly increased the cost of the study. The only way to determine the rationale for the various responses would be to ask respondents why they chose the answers they did. Doing this will require another study.

The present study breaks new ground, especially in the cases of Korea and Japan, since there does not seem to be a single study that examined the views of Japanese or Koreans on the ethics of tax evasion. This study also sheds light on tax evasion ethics of the Chinese people, since it examines data based on gender, age, education, marital status and religion. Prior studies have not looked at these factors, with a few exceptions in the case of gender.

The findings of the present study have policy implications. Tax evasion is opposed most strongly in Hong Kong and Hong Kong also has the least amount of tax misery and the highest degree of economic freedom. Opposition to tax evasion is least strong in the PRC and the PRC has the most tax misery and the least degree of economic freedom.

If the PRC is serious about reducing the amount of tax evasion that is going on in the country, it must change the hearts and minds of its people. They must be persuaded that it is immoral to evade taxes. This cannot be done at the point of a gun. It must be done by persuasion and example. It must reduce corruption, since the McGee et al. studies found that corruption is one of the main reasons why people think tax evasion is acceptable. It must increase economic freedom and reduce the amount of tax misery their citizens must endure.

The remedies mentioned above are not limited to the PRC. The same rationale applies to Japan, Korea, Taiwan and any other country that is serious about changing the hearts and minds of its people when it comes to the ethics of tax evasion.

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11

The Ethics of Tax Evasion: A Comparative Study of Bosnian and Romanian Opinion

Robert W. McGee*, Meliha Basic, and Michael Tyler

Introduction

Until recently, not many studies had been done that examine tax evasion from the perspective of ethics. Most studies of the topic take a public finance or economics perspective, or perhaps an accounting or law practitioner approach. The present study focuses on ethical aspects of the issue.

A survey was constructed to solicit the views of business and economics students in Bosnia and Romania, two transition economies that have had varying degrees of success in moving toward a market economy. Romania is now a member of the European Union, which signifies a certain degree of success in the transformation process. Bosnia continues to have economic and other structural problems and is not yet a member of the EU. Both are Balkan countries. Both are former communist countries, although Bosnia, being part of the former Yugoslavia, pursued a more independent path than did Romania.

Review of the Literature

Due to space constraints, the review of the literature will be brief. Some of the relevant literature is listed in the reference section.

The most comprehensive twentieth century work on the ethics of tax evasion was a doctoral thesis written by Martin Crowe (1944), titled *The Moral Obligation of Paying Just Taxes*. This thesis reviewed the theological and philosophical debate that had been going on, mostly within the Catholic

* The authors would like to thank Anca R. Laiu for translating the survey into Romanian and collating the Romanian data and Prof. Mihaela Dinu for distributing the Romanian survey.

R.W. McGee (ed.), *Taxation and Public Finance in Transition and Developing Economies*, doi: 10.1007/978-0-387-25712-9_11,

Church, over the previous 500 years. Some of the debate took place in the Latin language. Crowe introduced this debate to an English language readership. A more recent doctoral dissertation on the topic was written by Torgler (2003), who discussed tax evasion from the perspective of public finance but also touched on some psychological and philosophical aspects of the issue.

Various religious and secular perspectives were included in an edited book (McGee 1998a) and articles examining various religious and secular aspects of tax evasion ethics were published in the *Journal of Accounting, Ethics & Public Policy* starting in 1998. Those studies are listed in the reference section.

Over the centuries, basically three viewpoints have emerged on the ethics of tax evasion. These views are that tax evasion is always unethical, sometimes unethical or never unethical. An examination of these three views was made by McGee (2006a).

Several empirical studies have also examined these three perspectives, many of which are available on the Social Science Research Network website www.ssrn.com. Empirical studies on the ethics of tax evasion have examined the opinions of people in Argentina (McGee and Rossi 2006), Armenia (McGee and Maranjyan 2006), Australia (McGee and Bose 2007), China (McGee and An 2006; McGee and Guo 2006; McGee and Noronha 2007), Colombia (McGee et al. 2007), the Dominican Republic (McGee et al. 2007), Ecuador (McGee et al. 2007), Estonia (McGee et al. 2007), France (McGee and M'Zali 2007), Germany (McGee et al. 2006), Guatemala (McGee and Lingle 2005), Hong Kong (McGee and Ho 2006), Kazakhstan (McGee and Preobragenskaya 2008), Macau (McGee et al. 2006), Poland (McGee and Bernal 2006), Puerto Rico (McGee and López 2007), Taiwan (McGee and Andres 2007), Thailand (McGee 2006b), Ukraine (Nasadyuk and McGee 2006) and Vietnam (McGee 2008). Studies have also solicited the opinions of international business professors (McGee 2005) and orthodox Jews (McGee and Cohn 2006). A study also examined the relationship between views on tax evasion and gender and age (McGee and Smith 2007).

Methodology

A survey instrument was constructed that included the various arguments Crowe (1944) identified that have historically been used to justify tax evasion. Three more recent arguments involving human rights abuses were also included. The survey consisted of 18 statements that reflect all three viewpoints on the issue and used a seven-point Likert scale. The survey was then translated into Bosnian and Romanian and distributed to students at universities in Zenica and Sarajevo, Bosnia & Herzegovina and the Romanian-American University in Bucharest, Romania. The sample size was

132 for Bosnia & Herzegovina and 134 for Romania. Respondents were instructed to insert a number from 1 to 7 in the space provided to reflect the extent of their agreement or disagreement with each of the 18 statements. A score of one (1) represented strong agreement with the statement. A score of seven (7) represented strong disagreement with each statement. Each statement began with the phrase, "Tax evasion is ethical if…".

Findings

Table 1 shows the scores for the Bosnian and Romanian sample as well as the 18 statements that were included in the survey instrument. The average score for all questions was 5.03 for the Bosnian sample and 4.59 for the Romanian sample.

Bosnian scores were higher than Romanian scores for 14 of 18 statements, indicating that Bosnians are more opposed to tax evasion most of the time. Wilcoxon tests found that the scores were significantly different for 12 of 18 statements. However, the significant differences went in both directions. Bosnians were significantly more opposed to tax evasion in 10 cases and Romanians were significantly more opposed in 2 cases.

Table 1
Comparative Scores
(1 = strongly agree; 7 = strongly disagree)

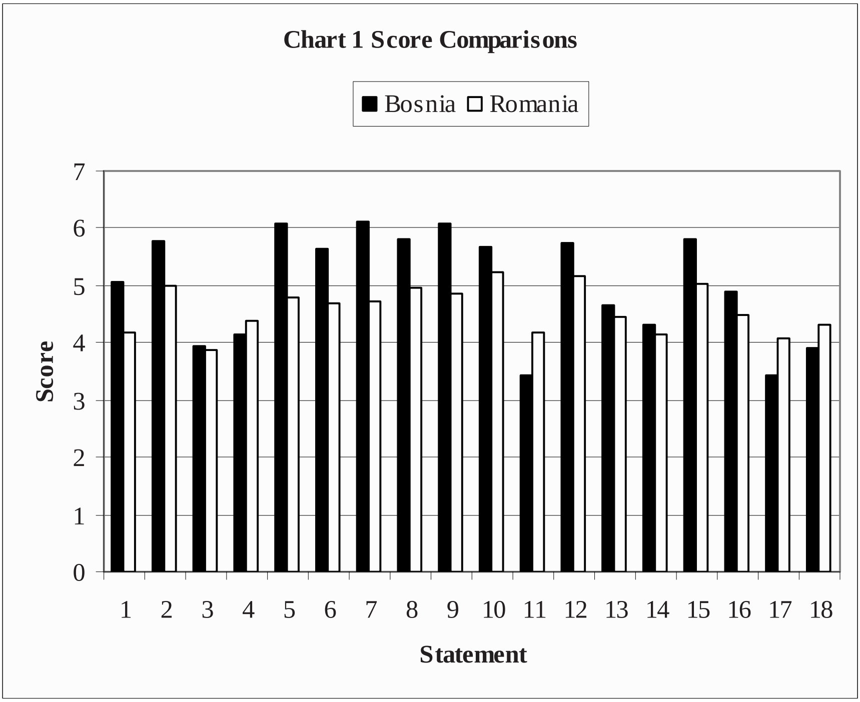
Stmt. #	Statement	Scores		Higher by	*p* value	
		Bosnia	Romania			
1	Tax evasion is ethical if tax rates are too high.	5.06	4.17	0.89	0.0002779	*
2	Tax evasion is ethical even if tax rates are not too high.	5.76	5.00	0.76	0.0009961	*
3	Tax evasion is ethical if the tax system is unfair.	3.93	3.87	0.06	0.9892	
4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.14	4.38	0.24	0.3554	

5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.09	4.80	1.29	8.088e–07	*
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.65	4.69	0.96	5.297e–05	*
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.11	4.72	1.39	1.859e–07	*
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.80	4.95	0.85	0.001053	*
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.09	4.86	1.23	1.152e–05	*
10	Tax evasion is ethical if everyone is doing it.	5.66	5.24	0.42	0.03287	**

11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.44	4.18	0.74	0.01943	**
12	Tax evasion is ethical if the probability of getting caught is low.	5.74	5.16	0.58	0.02425	**
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.66	4.45	0.21	0.4179	
14	Tax evasion is ethical if I can't afford to pay.	4.30	4.16	0.14	0.5903	
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.81	5.03	0.78	0.0003357	*
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	4.89	4.50	0.39	0.1809	
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.44	4.07	0.63	0.01539	**

18	Tax evasion is ethical if the government imprisons people for their political opinions.	3.92	4.32	0.40	0.1272
	Average Score	5.03	4.59	0.44	
	* Significant at	1%	level		
	** Significant at	5%	level		

Chart 1 shows the comparative scores graphically.



Historically some arguments justifying tax evasion have been stronger than others, although empirical studies were not conducted in the 17th, 18th or 19th centuries to determine whether the relative strength of the arguments in the theological and philosophical literature was widespread or confined to theologians and philosophers. That being the case, it was thought that it might be worthwhile to rank the scores for each sample to see which arguments were strongest and which were weakest. The rankings are shown in Tables 2 and 3.

The range was 3.44–6.11 for the Bosnian sample and 3.87–5.24 for Romania. The span of scores for the Bosnian sample was much wider than was the case for the Romanian sample.

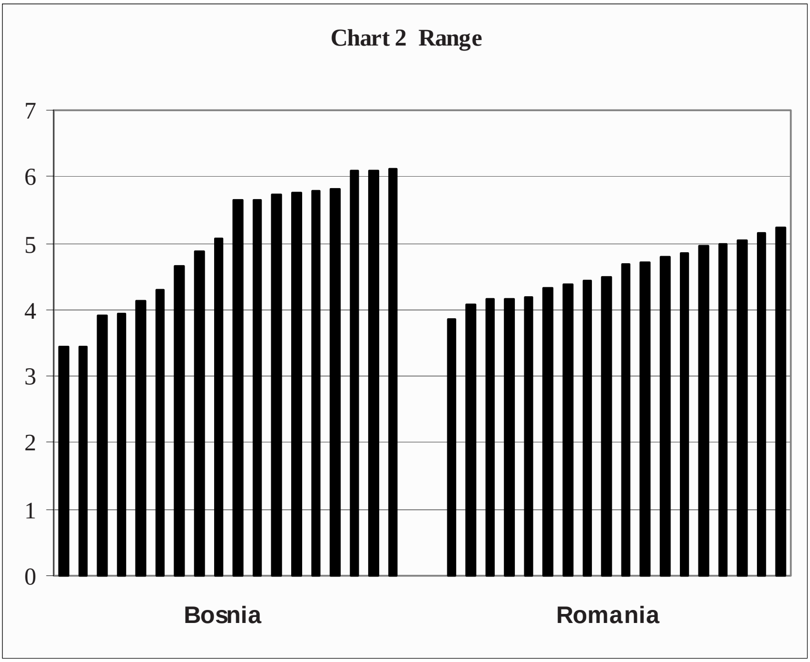
Table 2
Ranking of Arguments—Bosnia & Herzegovina
Ranked from Strongest to Weakest
Arguments Supporting Tax Evasion
(1 = strongly agree; 7 = strongly disagree)

Rank	Argument	Score
1	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.44
1	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.44
3	Tax evasion is ethical if the government imprisons people for their political opinions.	3.92
4	Tax evasion is ethical if the tax system is unfair.	3.93
5	Tax evasion is ethical if a large portion of the money collected is wasted.	4.14
6	Tax evasion is ethical if I can't afford to pay.	4.30
7	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.66
8	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	4.89
9	Tax evasion is ethical if tax rates are too high.	5.06
10	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.65
11	Tax evasion is ethical if everyone is doing it.	5.66
12	Tax evasion is ethical if the probability of getting caught is low.	5.74
13	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	5.76
14	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.80
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.81
16	Tax evasion is ethical even if most of the money collected is spent wisely.	6.09
16	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.09
18	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.11

Table 3
Ranking of Arguments—Romania
Ranked from Strongest to Weakest
Arguments Supporting Tax Evasion
(1 = strongly agree; 7 = strongly disagree)

Rank	Argument	Score
1	Tax evasion is ethical if the tax system is unfair. (S3)	3.87
2	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background. (S17)	4.07
3	Tax evasion is ethical if I can't afford to pay. (S14)	4.16
4	Tax evasion is ethical if tax rates are too high. (S1)	4.17
5	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. (S11)	4.18
6	Tax evasion is ethical if the government imprisons people for their political opinions. (S18)	4.32
7	Tax evasion is ethical if a large portion of the money collected is wasted. (S4)	4.38
8	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust. (S13)	4.45
9	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935. (S16)	4.50
10	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of. (S6)	4.69
11	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects. (S7)	4.72
12	Tax evasion is ethical even if most of the money collected is spent wisely. (S5)	4.80
13	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me. (S9)	4.86
14	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me. (S8)	4.95
15	Tax evasion is ethical even if tax rates are not too high. (S2)	5.00
16	Tax evasion is ethical even if it means that if I pay less, others will have to pay more. (S15)	5.03
17	Tax evasion is ethical if the probability of getting caught is low. (S12)	5.16
18	Tax evasion is ethical if everyone is doing it. (S10)	5.24

Chart 2 shows the range of scores for both samples.



Summary and Conclusions

If one were to summarize the results of the survey in a single sentence it would be that both groups believe that tax evasion is ethically justifiable at least in some cases. This viewpoint agrees with most of the theological and philosophical literature that has been published in the last 500 years. What is not clear is why Bosnians seem to be significantly more opposed to tax evasion overall, but not in all cases, and why Romanians seem to be significantly more opposed to tax evasion in other cases. Perhaps answers to these questions can be found by examining the history, religion, sociology, anthropology and politics of the two countries. We will leave investigations of these areas for another day.

The findings of this study have policy implications. If governments want to increase tax collections by reducing evasion, they will need to take away the reasons people use to morally justify tax evasion. That means they will have to reduce corruption and human rights abuses, spend tax funds wisely and keep tax rates low.

The *2007 Corruption Perceptions Index* ranks both Bosnia & Herzegovina and Romania slightly better than average in terms of corruption, but they both have a long way to go before they are perceived as being uncorrupt. Table 4 shows the relative scores and rankings for selected countries.

Table 4
Relative Corruption
Selected Countries 2007

Country	Rank [out of 180]	Score [10 is best; 1 is worst]
Denmark	1	9.4
Finland	1	9.4
New Zealand	1	9.4
UK	12	8.4
Germany	16	7.8
Slovenia	16	7.8
USA	20	7.2
Estonia	28	6.5
Botswana	38	5.4
Hungary	39	5.3
Slovakia	49	4.9
Latvia	51	4.8
Lithuania	51	4.8
Namibia	57	4.5
Cuba	61	4.2
Poland	61	4.2
Bulgaria	64	4.1
Croatia	64	4.1
Romania	69	3.7
China	72	3.5
India	72	3.5
Serbia	79	3.4
Bosnia & Herzegovina	84	3.3
FYR Macedonia	84	3.3
Montenegro	84	3.3
Albania	105	2.9
Moldova	111	2.8
Ukraine	118	2.7
Belarus	150	2.1
Somalia	179	1.4
Myanmar	179	1.4

Source: Corruption Perceptions Index 2007

Reducing the tax level so that more people do not feel that they are unable to pay would also lessen the extent of tax evasion. One way to measure the relative level of taxation is to compare tax revenue to the gross domestic product (GDP). Table 5 lists the statistics for a number of transition economies.

Table 5
Tax Collections as a Percentage of GDP
Selected Transition Economies

Rank	Country	Tax revenue as percentage of GDP
1	Azerbaijan	14.4
2	China	15.1
3	Tajikistan	15.2
4	Armenia	15.3
5	Slovakia	18.0
6	Georgia	18.2
7	Turkmenistan	18.3
8	Belarus	18.6
9	Lithuania	19.8
10	Albania	21.7
11	Bulgaria	22.3
12	Bosnia & Herzegovina	22.4
13	Uzbekistan	22.7
14	Kyrgyzistan	23.1
15	Kazakhstan	23.6
16	Croatia	24.2
17	Romania	27.1
18	Latvia	27.5
19	Ukraine	29.1
20	Moldova	29.8
21	Macedonia	30.8
22	Estonia	31.9
23	Mongolia	32.3
24	Poland	34.3
25	Russia	36.1
26	Czech Republic	37.6
26	Slovenia	37.6
28	Hungary	37.7

Source: Index of Economic Freedom 2007

Of the 28 transition economies listed, Bosnia & Herzegovina and Romania are in the middle, with ranks of 12 and 17, respectively. Thus, there is room for improvement.

The present study merely looked at the numerical scores for the various arguments that have been used over the centuries to justify tax evasion. More insights could be had by interviewing people in the two countries and asking them the reasons for their views. However, conducting face to face interviews introduces a new bias, since people may be less likely to voice their true opinions in person.

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12

Tax Evasion and Ethics: A Comparative Study of the USA and Four Latin American Countries

Robert W. McGee and Silvia López Paláu*

Introduction

The authors distributed a survey instrument to university students in Colombia, Ecuador, Puerto Rico, the Dominican Republic and the United States to determine their views on the ethics of tax evasion. Participants were asked to indicate the extent of their agreement or disagreement with each statement that has been used to justify tax evasion, using a 7-point Likert scale. Arguments were then ranked from strongest to weakest. Several comparisons were made to determine if the attitude toward tax evasion differed by country, culture or gender.

Although tax evasion has been discussed extensively in the economics and public finance literature, not much has been said about it from the perspective of ethics. There are some exceptions. Martin Crowe (1944), a Catholic priest, conducted an extensive review of 500 years worth of religious and philosophical literature on the ethics of tax evasion, some of which was in the Latin language. More recently, McGee (1998a) published an edited book on the subject. Torgler (2003) published a doctoral dissertation on tax morale, a portion of which investigated ethical aspects of tax evasion.

Several studies have been done from various religious perspectives, including Christianity (Gronbacher 1998; Pennock 1998), Judaism (Cohn 1998; McGee and Cohn 2006; Tamari 1998), Islam (McGee 1998b; Murtuza and Ghazanfar 1998), Baha'i (DeMoville 1998) and Mormon (McGee and Smith 2006; Smith Kimball 1998). If one were to summarize these studies in

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a single sentence, it would be that Jews, Baha'is and Mormons are strongly opposed to tax evasion, whereas Christians and Muslims are more flexible on the topic.

Some theoretical country studies have also been done. Ballas and Tsoukas (1998) discuss tax evasion and government corruption in Greece. Morales (1998) reports on the ethics of tax evasion from a Mexican perspective and concludes that the duty to one's family at times supersedes one's duty to the state. Preobragenskaya and McGee (2004) and Vaguine (1998) examine tax evasion in Russia. Smatrakalev (1998) discusses tax evasion in Bulgaria.

Some empirical studies and surveys have been conducted to determine the views on tax evasion in several countries. McGee (1999) conducted a survey to determine why tax evasion is so prevalent in Armenia. A more recent study looked at tax evasion in Armenia in more depth (McGee and Maranjyan 2006a). Country studies have also been conducted for Argentina (McGee and Rossi 2006), Bosnia (McGee et al. 2006), China (McGee and An 2006; McGee and Guo 2006), Germany (McGee et al. 2006), Guatemala (McGee and Lingle 2005), Hong Kong (McGee and Ho 2006), Macau (McGee et al. 2006), Poland (McGee and Bernal 2006), Romania (McGee 2006a) and Slovakia (McGee and Tusan 2006). If one were to summarize these studies in a single sentence, it would be that most people find tax evasion to be ethical in some situations, although some arguments to justify tax evasion are stronger than others. These studies generally found that there are three basic positions on the ethics of tax evasion—it is never ethical, sometimes ethical or always ethical, although support for the always ethical position was the weakest of the three. These three positions are discussed in depth by McGee (2006b).

The present study surveyed the opinions of university students in Colombia, Ecuador, Puerto Rico, the Dominican Republic and the United States to determine their views on the ethics of tax evasion. The survey instrument consisted of 18 statements that included the 15 main arguments that have been used to justify tax evasion in the past 500 years (Crowe 1944) plus three more recent arguments. Participants were asked to indicate the extent of their agreement or disagreement with each statement by placing a number from 1 to 7 in the space provided. The results were then tallied and the arguments were ranked from strongest to weakest. Country and gender comparisons were also made to determine whether responses varied by country or gender. The responses of accounting and business students were also compared to determine if there were any differences by major. The findings indicate that people in the Dominican Republic are less opposed to tax evasion than are the populations of the other four countries and that females are sometimes more opposed to tax evasion than are males. Surprisingly, accounting students are less opposed to tax evasion than are business students.

Findings

The total sample size was 1195, which consisted of 436 males, 710 females and 49 unknown. The two largest groups surveyed were accounting students and business/economics students. The U.S. sample included some ethnic diversity. Table 1 shows the demographic information. Table 2 shows the mean scores for each of the 18 statements for all five countries. Table 3 ranks the arguments supporting tax evasion, from strongest to weakest. The rankings are based on a five-country average. The strongest argument to support tax evasion is in cases where a large portion of the money collected is wasted. In second place is the case where a significant portion of the money winds up in the pockets of corrupt politicians or their families and friends. The third strongest argument is in cases where the system is perceived as being unfair. The ability to pay argument came in fourth. This viewpoint has a long and strong history in the Catholic theological and philosophical literature. Various human rights arguments came in fifth and sixth place. The unjust war argument, which has been the basis for war tax resistors, was tied for sixth place.

The weakest arguments were the ones that took the position that evasion is justified even if the money is spent wisely or on projects that benefit the taxpayer. There is also a strong aversion to tax evasion where the people who pay taxes will have to pay more because the evaders pay less. Chart 1 shows the range of scores. As can be seen, although some arguments are stronger, none of the arguments produced scores that were in the bottom range.

Table 4 shows the mean differences by country for each of the 18 statements. Mann-Whitney U tests were done to determine the significance of the differences. Positive numbers mean that the country in the column heading has a greater mean than the country in the row heading. The minus sign means the opposite. P values are enclosed in parenthesis. Asterisks refer to the significance level as follows: * Significant at the 1% level, ** Significant at the 5% level, *** Significant at the 10% level. Table 5 summarizes the findings for each of the 18 statements for all five countries.

Table 1: Sample Description

	Colombia		Ecuador		Puerto Rico		Dominican Republic		United States		Total	
	Q	**%**	**Q**	**%**	**Q**	**%**	**Q**	**%**	**Q**	**%**	**Q**	**%**
Panel 1—Gender Composition (Q means number of responses)												
Males	81	39.7	53	37.9	82	35.2	53	29.9	167	38.0	436	36.5
Females	111	54.4	82	58.6	144	61.8	115	65.0	258	58.6	710	59.4
No response	12	5.9	5	3.6	7	3.0	9	5.1	15	3.4	49	4.1
Total sample	204	100.0	140	100.0	233	100.0	177	100.0	440	100.0	1195	100.0
Panel 2—Study Area Distribution												
Accounting	15	7.4	23	16.4	197	84.5	133	75.1	144	32.7	512	42.8
Business–Econ	123	60.3	99	70.7	3	1.3	19	10.7	273	62.0	517	43.3
Religion	5	2.5	2	1.4	0	0.0	2	1.1	1	.2	10	.8
Philosophy	1	.5	0	0.0	0	0.0	0	0.0	0	0.0	1	.1
Law	9	4.4	0	0.0	29	12.4	0	0.0	1	.2	39	3.3
Other	2	1.0	12	8.6	3	1.3	17	9.6	6	1.4	40	3.3
No response	49	24.0	4	2.9	1	.4	6	3.4	15	3.4	76	6.4
Total sample	204	100.0	140	100.0	233	100.0	177	100.0	440	100.0	1195	100.0
Panel 3—Ethnicity												
Non Hispanic White									75	6.3		
Hispanic									218	18.2		
Asian									20	1.7		
Caucasian									19	1.6		
African American									43	3.6		
Other									26	2.2		
No response									794	66.4		
Total sample									1195	100.0		

Table 2: Summary of Responses **(**1 = strongly agree**;** 7 = strongly disagree**)**

S#	Statement	Co	Ec	PR	DR	USA	Avg
1	Tax evasion is ethical if tax rates are too high.	6.04	5.75	5.64	3.68	5.92	5.41
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.48	6.39	6.46	4.74	6.06	6.03
3	Tax evasion is ethical if the tax system is unfair.	5.71	4.96	4.84	3.75	5.33	4.92
4	Tax evasion is ethical if a large portion of the money collected is wasted.	5.47	4.57	4.62	3.63	5.38	4.73
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.36	6.30	6.46	4.61	6.19	5.98
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	6.00	5.56	5.66	4.90	5.85	5.59
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.31	6.08	6.19	4.79	6.13	5.90
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.39	5.99	6.04	4.97	6.14	5.91
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.43	6.14	6.38	4.62	6.08	5.93
10	Tax evasion is ethical if everyone is doing it.	6.61	6.31	6.19	4.54	6.15	5.96

Table 2: Summary of Responses (continued)

S#	Statement	Co	Ec	PR	DR	USA	Avg
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	5.32	4.41	4.29	4.28	5.43	4.75
12	Tax evasion is ethical if the probability of getting caught is low.	6.60	6.37	6.16	4.96	6.15	6.05
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	5.99	5.11	5.19	4.76	5.92	5.39
14	Tax evasion is ethical if I can't afford to pay.	5.74	5.35	5.20	3.69	5.59	5.11
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.43	6.11	6.17	5.21	6.14	6.01
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	5.51	5.24	4.90	4.90	5.21	5.15
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	5.38	5.77	5.66	4.92	5.20	5.39
18	Tax evasion is ethical if the government imprisons people for their political opinions.	5.76	5.72	5.09	5.26	5.12	5.39
	Average score	6.03	5.67	5.62	4.57	5.78	5.53

Table 3: Ranking of Arguments Favoring Tax Evasion—Strongest to Weakest (1 = strongly agree; 7 = strongly disagree)

Rank	S#	Statement	Avg
1	4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.73
2	11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.75
3	3	Tax evasion is ethical if the tax system is unfair.	4.92
4	14	Tax evasion is ethical if I can’t afford to pay.	5.11
5	16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	5.15
6	13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	5.39
6	17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	5.39
6	18	Tax evasion is ethical if the government imprisons people for their political opinions.	5.39
9	1	Tax evasion is ethical if tax rates are too high.	5.41
10	6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.59
11	7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.90
12	8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.91
13	9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.93
14	10	Tax evasion is ethical if everyone is doing it.	5.96
15	5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.98
16	15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.01
17	2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.03
18	12	Tax evasion is ethical if the probability of getting caught is low.	6.05
		Average score	**5.53**

Chart 1: Statements Ranked from Strongest to Weakest Arguments Supporting Tax Evasion

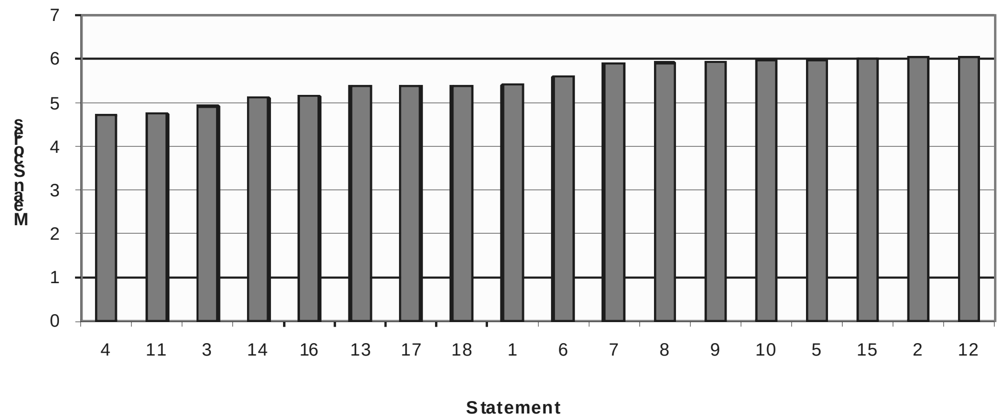


Table 4: Mean Differences by Country

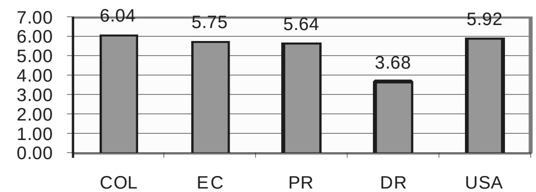
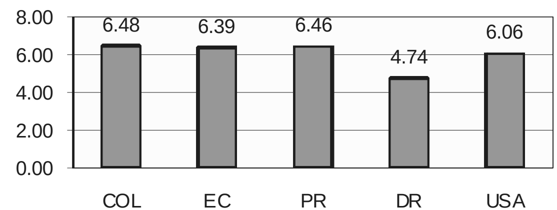
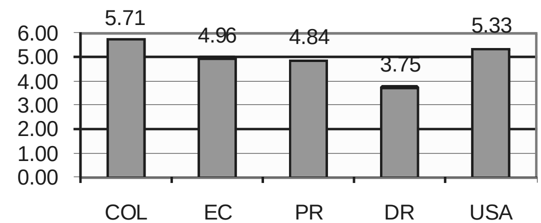
Panel 1—Statement 1					
Countries	Colombia	Ecuador	Puerto Rico	Dominican Republic	Charts country means
Ecuador	0.30 (0.112)				
Puerto Rico	0.40 ** (0.050)	.11 (0.842)			
Dominican Republic	2.36 * (0.000)	2.06 * (.000)	1.96 * (.000)		
United States	0.13 (0.559)	–0.17 (0.211)	–0.27 *** (.090)	–2.23 * (.000)	
Panel 2—Statement 2					
Ecuador	.09 (0.343)				
Puerto Rico	.01 (0.493)	–.07 (0.701)			
Dominican Republic	1.73* (.000)	1.64* (.000)	1.72* (.000)		
United States	0.42* (.000)	0.33** (.012)	0.40* (.000)	–1.31* (.000)	

Table 4: Mean Differences by Country (continued)

Panel 3—Statement 3

Ecuador	0.075* (.001)				
Puerto Rico	0.87* (.000)	0.12 (.672)			
Dominican Republic	1.96* (.000)	1.21* (.000)	1.09* (.000)		
United States	0.38** (.026)	–0.37** (.050)	–0.49* (.004)	–1.58* (.000)	



Panel 4—Statement 4

Countries	Colombia	Ecuador	Puerto Rico	Dominican Republic	Charts country means
Ecuador	0.90* (.000)				
Puerto Rico	0.85 * (.000)	–.05 (.850)			
Dominican Republic	1.84 * (.000)	0.94 * (.000)	0.99 * (.000)		
United States	.09 (.704)	–0.81* (.000)	–0.76 * (.090)	–1.75 * (.000)	

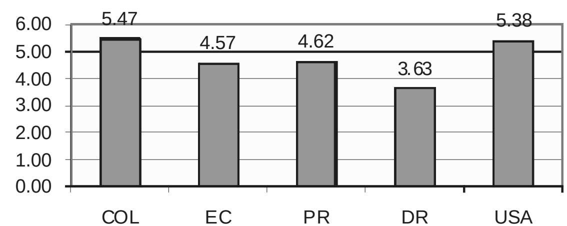
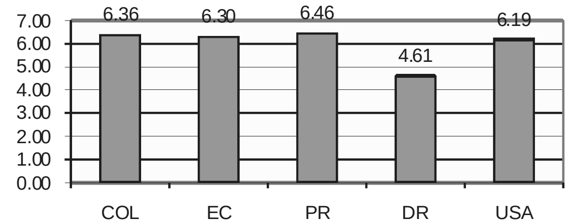


Table 4: Mean Differences by Country (continued)

Panel 5—Statement 5				
Ecuador	.06 (.293)			
Puerto Rico	–0.10 (.888)	–0.16 (.209)		
Dominican Republic	1.75* (.000)	1.69* (.000)	1.85* (.000)	
United States	0.17** (.044)	0.11 (.492)	0.27** (.017)	–1.58* (.000)
Panel 6—Statement 6				
Ecuador	.044** (.015)			
Puerto Rico	0.34** (.041)	–0.10 (.537)		
Dominican Republic	1.10* (.000)	.66** (.011)	.76* (.000)	
United States	.015 (.136)	–0.29 (.132)	–0.19 (.335)	–0.95* (.000)



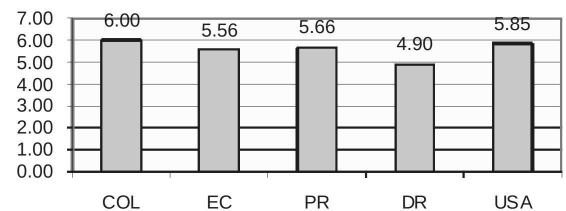
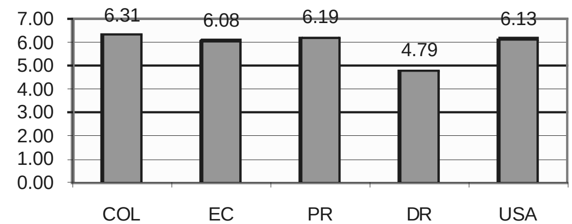


Table 4: Mean Differences by Country (continued)

Panel 7—Statement 7

Ecuador	0.23 (.161)				
Puerto Rico	0.12 (.713)	–0.11 (.295)			
Dominican Republic	1.52 * (.000)	1.29 * (.000)	1.40 * (.000)		
United States	0.18 (.399)	–.05 (.422)	–.06 (.650)	–1.34 * (.000)	



Panel 8—Statement 8

Countries	Colombia	Ecuador	Puerto Rico	Dominican Republic	Charts country means
Ecuador	0.40* (.005)				
Puerto Rico	0.35* (.006)	–.05 (.756)			
Dominican Republic	1.42* (.000)	1.02* (.000)	1.07* (.000)		
United States	0.25* (.007)	–0.15 (.435)	–0.10 (.574)	–1.17* (.000)	

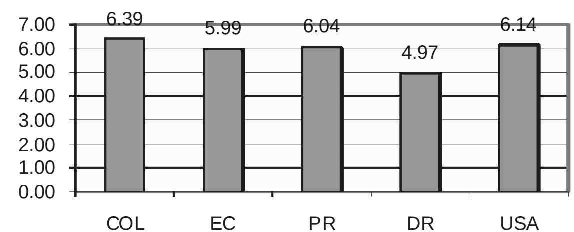
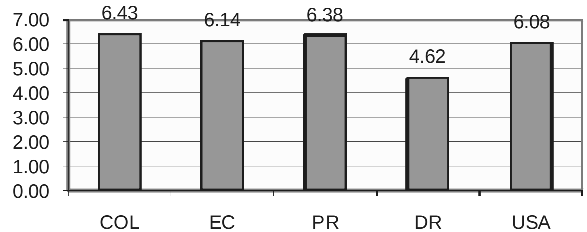


Table 4: Mean Differences by Country (continued)

Panel 9—Statement 9

Ecuador	0.29** (.050)			
Puerto Rico	.05 (.710)	−0.24*** (.094)		
Dominican Republic	1.81* (.000)	1.52* (.000)	1.76* (.000)	
United States	.035* (.001)	.06 (.496)	0.30* (.003)	−1.46* (.000)



Panel 10—Statement 10

Ecuador	0.30*** (.053)			
Puerto Rico	0.42* (.000)	0.12 (.174)		
Dominican Republic	2.07 * (.000)	1.77* (.000)	1.65* (.000)	
United States	0.46* (.000)	0.16** (.028)	0.04 (.361)	−1.61 * (.000)

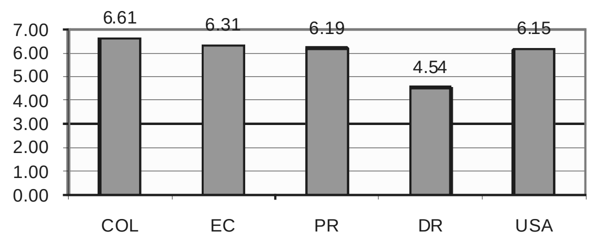
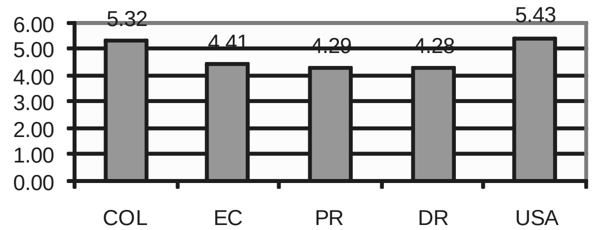


Table 4: Mean Differences by Country (continued)

Panel 11—Statement 11

Ecuador	0.91* (.000)				
Puerto Rico	1.03* (.000)	0.12 (.601)			
Dominican Republic	1.04* (.000)	0.13 (.837)	.01 (.793)		
United States	–0.11 (.960)	–1.02* (.000)	–1.14* (.000)	–1.15* (.000)	



Panel 12—Statement 12

Countries	Colombia	Ecuador	Puerto Rico	Dominican Republic	Charts country means
Ecuador	0.23 (.160)				
Puerto Rico	0.44* (.002)	0.21 (.192)			
Dominican Republic	1.64* (.000)	1.41* (.000)	1.20* (.000)		
United States	.045* (.000)	0.22** (.022)	.01 (.332)	–1.19* (.000)	

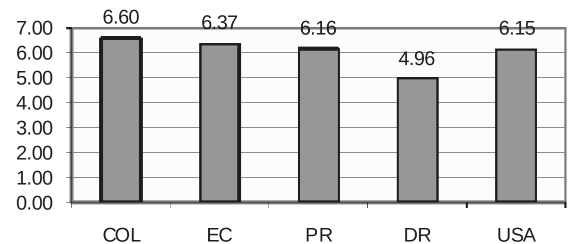
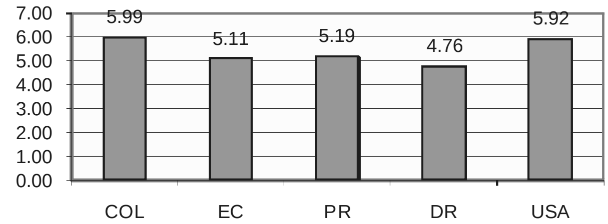


Table 4: Mean Differences by Country (continued)

Panel 13—Statement 13				
Ecuador	0.88* (.000)			
Puerto Rico	0.80* (.000)	0.08 (.763)		
Dominican Republic	1.23 * (.000)	0.35 (.473)	0.43 (.190)	
United States	0.07 (.291)	–0.81* (.000)	0.73* (.000)	–1.16 * (.000)



Panel 14—Statement 14				
Ecuador	0.39*** (.099)			
Puerto Rico	0.54* (.008)	0.15 (.499)		
Dominican Republic	2.05* (.000)	1.66* (.000)	1.51* (.000)	
United States	0.15 (.536)	–0.24 (.194)	–0.39 (.302)	–1.90* (.000)

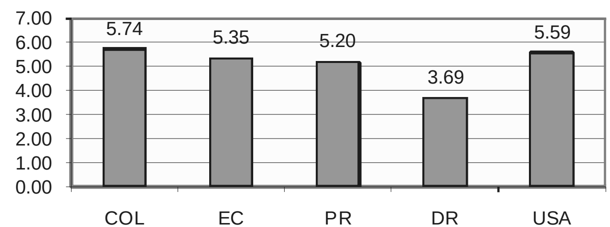
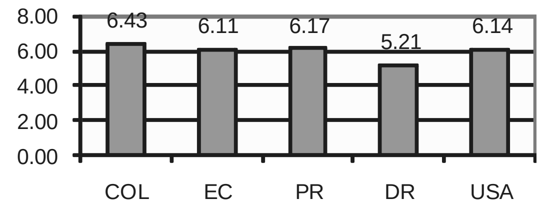


Table 4: Mean Differences by Country (continued)

Panel 15—Statement 15

Ecuador	0.32** (.045)				
Puerto Rico	0.26 (.107)	–.06 (.576)			
Dominican Republic	1.22* (.000)	0.90* (.000)	0.96* (.000)		
United States	0.29* (.005)	–.03 (.816)	.03 (.302)	–0.93* (.000)	



Panel 16—Statement 16

Countries	Colombia	Ecuador	Puerto Rico	Dominican Republic	Charts country means
Ecuador	0.27 (.165)				
Puerto Rico	0.61* (.002)	0.34 (.131)			
Dominican Republic	0.61 * (.003)	0.34 (.143)	.00 (.994)		
United States	0.30** (.033)	.03 (.760)	–0.31 (.112)	–0.31 (.135)	

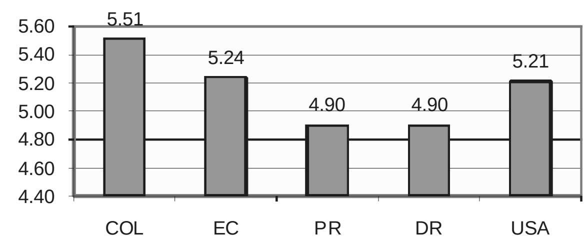
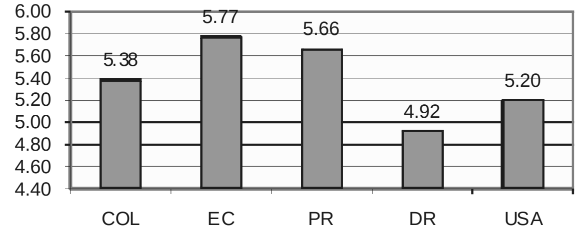


Table 4: Mean Differences by Country (continued)

Panel 17—Statement 17				
Ecuador	–0.39** (.049)			
Puerto Rico	–0.28*** (.068)	0.11 (.709)		
Dominican Republic	0.46 (.194)	0.85* (.002)	0.74* (.002)	
United States	0.18 (.385)	0.57* (.004)	46* (.003)	–0.28 (.382)



Panel 18—Statement 18				
Ecuador	.04 (.776)			
Puerto Rico	0.67* (.001)	0.63* (.006)		
Dominican Republic	0.50 (.159)	0.46 (.268)	–0.17 (.154)	
United States	0.64* (.001)	0.60* (.009)	–0.03 (.714)	0.14 (.254)

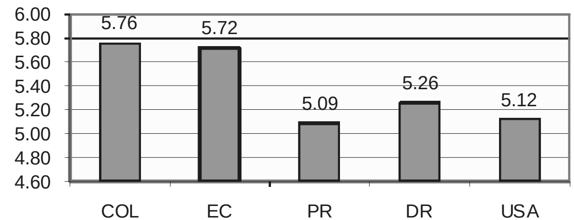


Table 5: Summary of Findings

S#	Statement	Findings
1	Tax evasion is ethical if tax rates are too high.	The Dominican Republic responses were significantly different from the responses of the other countries. Colombia (6.04) had the highest mean and the Dominican Republic (3.68) the lowest. Generally, there was not a significant difference among the other four countries. The population can be separated into two groups—the Dominican Republic and the other four countries.
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	The Dominican Republic (4.74) and USA (6.06) responses are significantly different from the responses of the other countries. Colombia (6.48) has the highest mean and the Dominican Republic the lowest. There are no significant differences among Colombia, Ecuador and Puerto Rico but they differ from the US and the Dominican Republic. The population can be separated into three groups—(1) Dominican Republic, (2) USA, and (3) Colombia, Ecuador and Puerto Rico.
3	Tax evasion is ethical if the tax system is unfair.	The Dominican Republic (3.75) and USA (5.33) scores are significantly different from the scores of the other three countries. Colombia (5.71) has the highest mean and the Dominican Republic the lowest. The population can be separated into four groups—(1) Dominican Republic, (2) Ecuador and Puerto Rico, (3) the USA and (4) Colombia.
4	Tax evasion is ethical if a large portion of the money collected is wasted.	The Dominican Republic (3.63) score is significantly different from the other scores. Colombia (5.47) has the highest mean and the Dominican Republic the lowest. The population can be separated into three groups—(1) Dominican Republic, (2) Ecuador and Puerto Rico, and (3) Colombia and the USA.

Table 5: Summary of Findings (continued)

5	Tax evasion is ethical even if most of the money collected is spent wisely.	The Dominican Republic (4.61) responses are significantly different from the other four country responses. Puerto Rico (6.46) has the highest mean and the Dominican Republic the lowest. The population can be divided into two groups—(1) Dominican Republic and (2) Colombia, Ecuador, Puerto Rico and the USA.
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	The Dominican Republic (4.90) responses are significantly different from responses of the other four countries. Colombia (6.00) had the highest mean and the Dominican Republic the lowest. The population can be divided into two groups—(1) Dominican Republic and (2) Colombia, Ecuador, Puerto Rico and the USA.
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	The Dominican Republic (4.79) responses are significantly different from responses of the other four countries. Colombia (6.31) had the highest mean and the Dominican Republic the lowest. The population can be divided into two groups—(1) Dominican Republic and (2) Colombia, Ecuador, Puerto Rico and the USA.
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	The Dominican Republic (4.97) and Colombia (6.39) responses are significantly different from the responses of the other three countries. Colombia had the highest mean and the Dominican Republic the lowest. The population can be divided into three groups—(1) Dominican Republic, (2) Ecuador, Puerto Rico and the USA, and (3) Colombia.
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	The Dominican Republic (4.62) and Colombia (6.43) scores are significantly different from the scores of the other three countries. Colombia had the highest mean and the Dominican Republic the lowest. The population can be divided into three groups—(1) Dominican Republic, (2) USA and Ecuador, and (3) Colombia and Puerto Rico.

Table 5: Summary of Findings (continued**)**

10	Tax evasion is ethical if everyone is doing it.	The Dominican Republic (4.54) and Colombia (6.61) scores are significantly different from the scores of the other three countries. Colombia had the highest mean and the Dominican Republic the lowest. There is not a significant difference between Ecuador and Puerto Rico. The population can be divided into four groups—(1) Dominican Republic, (2) USA, (3) Ecuador and Puerto Rico, and (4) Colombia.
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	The USA (5.43) has the highest mean and the Dominican Republic (4.28) the lowest, with nearly identical scores for the Dominican Republic and Puerto Rico (4.29). The population can be divided into two groups—(1) the Dominican Republic, Ecuador and Puerto Rico, and (2) Colombia and the USA.
12	Tax evasion is ethical if the probability of getting caught is low.	The Dominican Republic responses were significantly different from the responses of the other four countries. Colombia (6.60) had the highest mean and the Dominican Republic (4.96) the lowest. There were not significant differences between Ecuador and Puerto Rico or between Ecuador and Colombia but there were significant differences between Puerto Rico and Colombia. The population can be divided into three groups—(1) Dominican Republic, (2) Puerto Rico and the USA, and (3) Ecuador and Colombia.
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	Colombia (5.99) had the highest mean, slightly higher than the USA (5.92). The Dominican Republic (4.76) had the lowest mean. There was not a significant difference between Ecuador, the Dominican Republic and Puerto Rico. The population can be divided into two groups—(1) the Dominican Republic, Ecuador and Puerto Rico, and (2) Colombia and the USA.

Table 5: Summary of Findings (continued)

14	Tax evasion is ethical if I can't afford to pay.	The Dominican Republic (3.69) responses were significantly different from the responses of the other four countries. Colombia (5.74) had the highest mean. Generally, there were not significant differences among the USA, Ecuador, Puerto Rico and Colombia. Colombia differs slightly from Puerto Rico and slightly from Ecuador. The population can be divided into two groups—(1) Dominican Republic, and (2) Colombia, Ecuador, Puerto Rico and the USA.
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	The Dominican Republic responses were significantly different from the responses of the other four countries. Colombia had the highest mean (6.43) and the Dominican Republic the lowest (5.21). There were no significant differences among Ecuador, Puerto Rico and the USA. The population can be divided into three groups—(1) Dominican Republic, (2) Ecuador, Puerto Rico and the USA, and (3) Colombia.
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	The lowest mean score was shared by the Dominican Republic and Puerto Rico (4.90). Colombia (5.51) had the highest mean score, which was significantly different from the other scores. The population can be divided into two groups—(1) Colombia, and (2) Ecuador, Puerto Rico, the Dominican Republic and the USA.
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	The Dominican Republic responses were significantly different from the responses of the other four countries. Ecuador (5.77) had the highest mean and the Dominican Republic (4.92) the lowest. Generally, there were not significant differences between Ecuador and Puerto Rico and among Colombia, the Dominican Republic and the USA. The population can be divided into two groups—(1) Puerto Rico and Ecuador, and (2) Dominican Republic, USA and Colombia.

Table 5: Summary of Findings (continued)

18	Tax evasion is ethical if the government imprisons people for their political opinions.	The Dominican Republic responses are significantly different from the responses of the other four countries. Colombia (5.76) had the highest mean, followed closely by Ecuador (5.72) and Puerto Rico (5.09) had the lowest score, followed closely by the USA (5.12). There were not significant differences among the USA, the Dominican Republic and Puerto Rico or between Colombia and Ecuador. The population can be divided into two groups—(1) Puerto Rico, the Dominican Republic and the United States, and (2) Colombia and Ecuador.

Gender

Many studies have been conducted over the years that compare ethical attitudes of men and women. Some studies found that women are more ethical than men (Akaah 1989; Boyd 1981; Hoffman 1998) while other studies found that there is not a significant difference between male and female ethical attitudes (Browning and Zabriskie 1983; Harris 1990; Nyaw and Ng 1994). Some studies found that men are more ethical than women (Barnett and Karson 1987; Weeks et al. 1999).

Several studies of tax evasion have also compared male and female views. Men were found to be more opposed to tax evasion in studies of Romania (McGee 2006a), Slovakia (McGee and Tusan 2006) and Sweden (Vogel 1974). Women were more opposed to tax evasion in studies of China (McGee and Guo 2006), Guatemala (McGee and Lingle 2005), Mormons (McGee and Smith 2006) and Orthodox Jews (McGee and Cohn 2006). A third group of studies found no significant difference between male and female views. These studies were of Argentina (McGee and Rossi 2006), China (McGee and Noronha 2006), Hong Kong (McGee and Ho 2006), Poland (McGee and Bernal 2006) and Thailand (McGee 2006c).

The present study tests for gender differences as well. The results are presented below in Table 6. Females were more firmly opposed to tax evasion for 17 of 18 statements. Even in the one case where the male scores were higher, they were higher by only 0.01. But the differences were significant for only 5 of the 18 statements. The differences were significant for all three of the human rights arguments—Jews in Germany, discrimination and imprisonment for political ideas – and also for the argument that evasion is justified if the money is spent on projects that do not benefit the taxpayer and in cases where everyone is doing it. The most significant difference between male and female scores was for the argument that evasion was justifiable in cases where people are imprisoned for their political ideas.

One possible explanation for the stronger opposition to tax evasion is because females are taught from an early age to obey authority. That was the reason given to explain why women had higher scores than men in a study of Orthodox Jews (McGee and Cohn 2006). Perhaps it is a reason that is true generally. But if so, it does not explain why some other studies found no significant differences between male and female scores.

A study of gender differences in ten Latin American countries found that men and women tend to think the same but they sometimes act differently (López-Paláu 2006). If that is the case, perhaps their response to a question that begins “Would you evade taxes if….?” might yield different results. Thus, there is room for further research on the issue of male-female differences in the area of the ethics of tax evasion.

Some scores were significantly different by country as well.

- Colombia S12, 13, 15, 16, 17 and 18 (6 statements)
- Ecuador none (0 statements)
- Puerto Rico S1, 2 and 7 (3 statements)
- Dominican Republic S14 (1 statement)
- USA S1, 6, 8, 11, 12, 14 and 18 (7 statements)

In general, results suggest that males and females are more similar than different in their ethical perceptions or opinions. The results of this study show significant differences in four countries and in the total sample in some instances, but show no differences in the Ecuador sample. The cases that show significant differences by gender vary among countries, suggesting that the national environment affects gender roles and values. The identification of the factors that lead to gender differences in specific situations and contexts is still needed.

Study Area

As can be seen from Table 7, business student scores were higher than accounting student scores for 17 of 18 statements, indicating that business students were more opposed to tax evasion. In 14 cases the differences were significant. This result is surprising. It was expected that accounting students would be more opposed to tax evasion, since they are trained to know the rules and to follow them. Also, a study of accounting practitioners found that accountants were more strongly opposed to tax evasion than were any other groups (McGee and Maranjyan 2006b).This finding might indicate that accountants in Latin America have a different view toward tax evasion than do accountants in the USA. Chart 3 shows significant differences by study area.

Table 6: Comparison of Mean Scores by Gender

Stmt. #	Statement	Mean scores		Score larger by		*p* value
		Male	Female	Male	Female	
1	Tax evasion is ethical if tax rates are too high.	5.48	5.58		0.10	.113
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.01	6.07		0.06	.139
3	Tax evasion is ethical if the tax system is unfair.	4.97	5.05		0.08	.499
4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.83	4.94		0.11	.384
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.06	6.05	0.01		.446
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.66	5.69		0.03	.267
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.96	5.98		0.02	.313
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.91	6.00		0.09***	.096
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.91	6.02		0.11	.145
10	Tax evasion is ethical if everyone is doing it.	5.94	6.06		0.12**	.047
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.78	4.98		0.20	.171

Table 6: Comparison of Mean Scores by Gender (continued)

12	Tax evasion is ethical if the probability of getting caught is low.	6.04	6.09	0.05	.224
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	5.44	5.58	0.14	.169
14	Tax evasion is ethical if I can't afford to pay.	5.18	5.24	0.06	.289
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.02	6.06	0.04	.135
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	4.99	5.29	0.30**	.030
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	5.19	5.47	0.28**	.035
18	Tax evasion is ethical if the government imprisons people for their political opinions.	5.11	5.47	0.36*	.005
	Average score	5.63	5.65		

*Significant at the .01 level

**Significant at the .05 level

*** Significant at the 10% level

Chart 2: Significant Differences by Gender

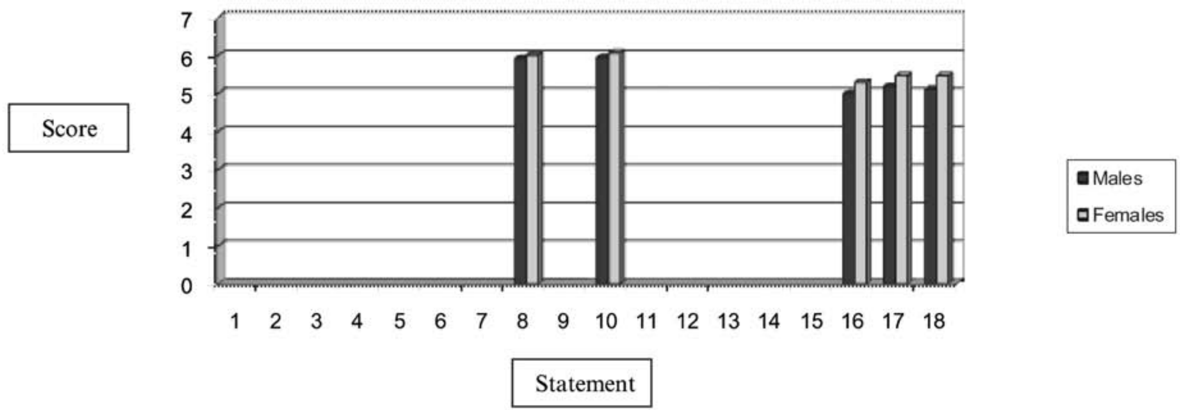


Table 7: Comparison of Mean Scores by Study Area

Stmt #	Statement	Mean scores Acct	Mean scores Business	Score larger by Acct	Score larger by Business	*p* value
1	Tax evasion is ethical if tax rates are too high.	5.18	5.83		0.65*	.001
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	5.89	6.19		0.30***	.061
3	Tax evasion is ethical if the tax system is unfair.	4.73	5.22		0.49*	.003
4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.58	5.16		0.57*	.000
5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.88	6.21		0.33**	.014
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.53	5.81		0.28	.150
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.82	6.12		0.29**	.017
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.78	6.12		0.34**	.014
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.81	6.15		0.34**	.046
10	Tax evasion is ethical if everyone is doing it.	5.78	6.23		0.45*	.000
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.59	5.15		0.56*	.001
12	Tax evasion is ethical if the probability of getting caught is low.	5.88	6.25		0.37*	.003
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	5.35	5.68		0.33*	

Table 7: Comparison of Mean Scores by Study Area (continued)

14	Tax evasion is ethical if I can't afford to pay.	4.98	5.47	0.49*	.002
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.93	6.17	0.24**	.037
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	5.10	5.17	0.07	.390
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	5.43	5.25	0.18	.109
18	Tax evasion is ethical if the government imprisons people for their political opinions.	5.24	5.26	0.02	.954
	Average score	5.42	5.75		

* Significant at the 1% level

** Significant at the 5% level

*** Significant at the 10% level

Chart 3: Significant Differences by Study Area

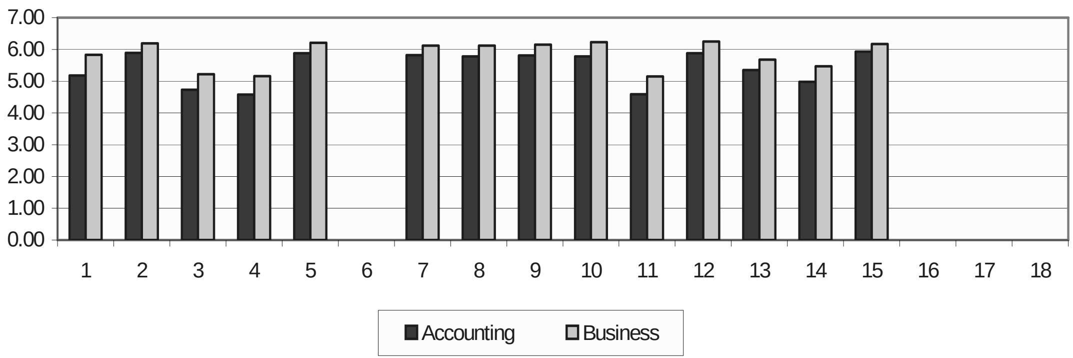


Table 8: Ranked Means

S#	Acct	S#	Business
4	4.58	11	5.15
11	4.59	4	5.16
3	4.73	16	5.17
14	4.98	3	5.22
16	5.10	17	5.25
1	5.18	18	5.26
18	5.24	14	5.47
13	5.35	13	5.68
17	5.43	6	5.81
6	5.53	1	5.83
10	5.78	7	6.12
8	5.78	8	6.12
9	5.81	9	6.15
7	5.82	15	6.17
12	5.88	2	6.19
5	5.88	5	6.21
2	5.89	10	6.23
15	5.93	12	6.25

The most significant difference, both in strength and significance, is the statement that tax evasion is ethical if tax rates are too high. Scores were nearly identical for the statement that tax evasion is ethical if the government imprisons people for their political opinions. Tax evasion was more justifiable in cases where tax funds were used wrongfully or wasted. Statements 15 and 2 are the weakest for accounting students whereas statements 12 and 10 were the weakest for the business students. Table 8 shows the relative rankings for the two groups.

USA Versus Latin American Scores

Since data were available for the USA as well as the four Latin American countries, it was thought that a comparison of scores might be useful. Table 9 shows those comparisons.

As can be seen from Table 9, the two US groups are more strongly opposed to tax evasion than are the Latin American groups. But what is surprising is that the US Hispanics are even more opposed to tax evasion than is the US group as a whole (in 15 of 18 cases), which includes non-Hispanic whites. One might think that the US Hispanic group scores would be closer to the Latin American scores, or at least would be somewhere between the US total scores and the Latin American scores. But such was not the case.

Table 9: Comparison of USA and Latin American Scores

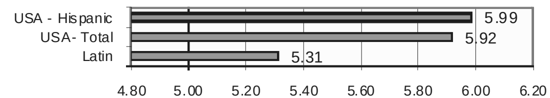
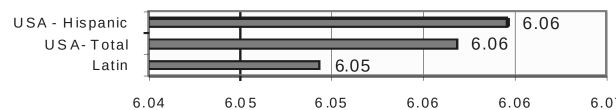
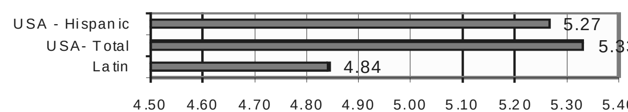
S #	Samples	Latin	Sample mean scores charts
1	USA—Whole	–0.60* (.000)	
	USA—Hispanic	–0.68* (.000)	
2	USA—Whole	–0.01 (.289)	
	USA—Hispanic	–0.01 (.529)	
3	USA—Whole	–0.49* (.000)	
	USA—Hispanic	–0.42** (.020)	

Table 9: Comparison of USA and Latin American Scores (continued)

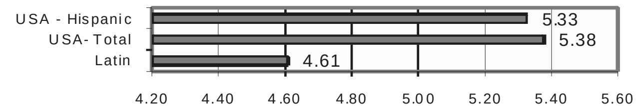
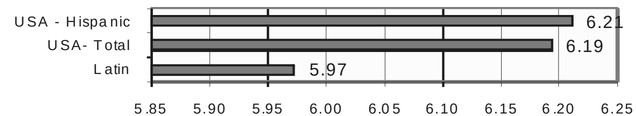
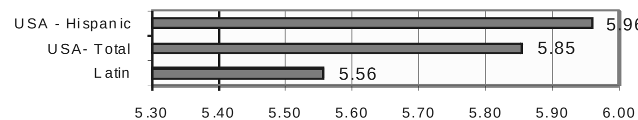
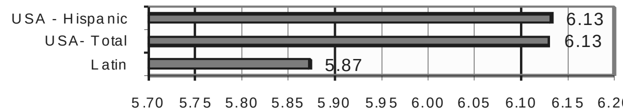
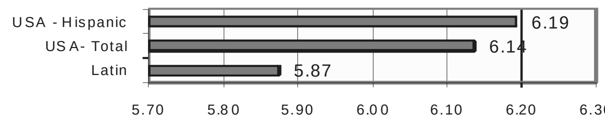
4	USA—Whole	–0.77* (.000)	
	USA—Hispanic	–0.72* (.000)	
5	USA—Whole	–0.22 (.248)	
	USA—Hispanic	–0.24 (.195)	
6	USA—Whole	–0.30** (.048)	
	USA—Hispanic	–0.40** (.031)	

Table 9: Comparison of USA and Latin American Scores (continued)

<table>
<tr><td rowspan="2">7</td><td>USA–Whole</td><td>–0.26**
(.019)</td><td rowspan="2">
</td></tr>
<tr><td>USA–Hispanic</td><td>–0.26***
(.068)</td></tr>
<tr><td rowspan="2">8</td><td>USA–Whole</td><td>–0.26
(.106)</td><td rowspan="2">
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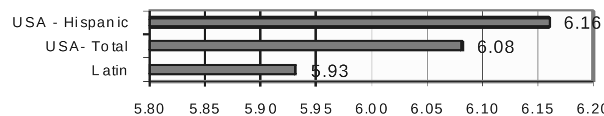
<tr><td>USA–Hispanic</td><td>–0.32
(.163)</td></tr>
<tr><td rowspan="2">9</td><td>USA–Whole</td><td>–0.15
(.920)</td><td rowspan="2">
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<tr><td>USA–Hispanic</td><td>–0.23
(.693)</td></tr>
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Table 9: Comparison of USA and Latin American Scores (continued)

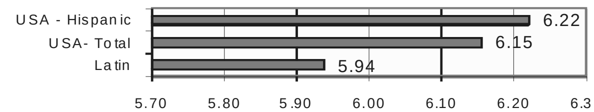
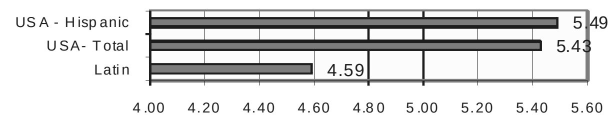
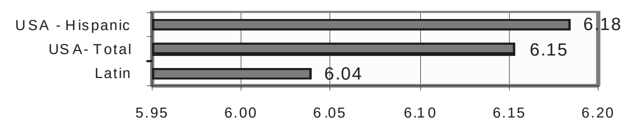
10	USA—Whole	–0.22 (.952)	
	USA—Hispanic	–0.28 (.444)	
11	USA— Whole	–0.84* (.000)	
	USA—Hispanic	–0.90* (.000)	
12	USA— Whole	–0.11 (.594)	
	USA—Hispanic	–0.14 (.789)	

Table 9: Comparison of USA and Latin American Scores (continued)

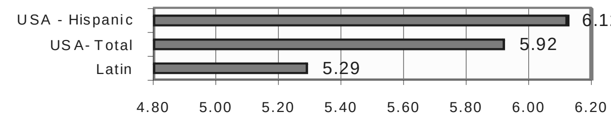
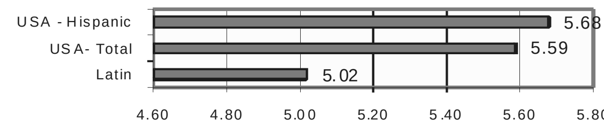
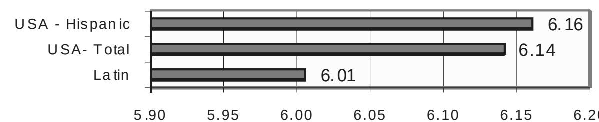
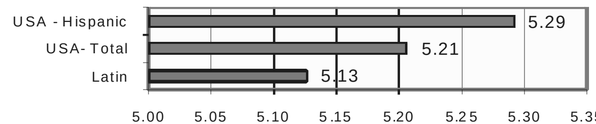
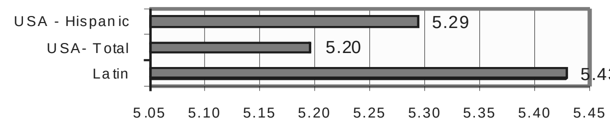
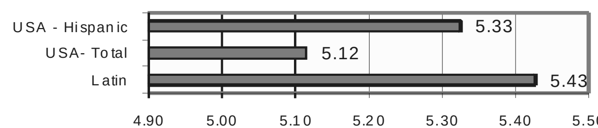
13	USA—Whole	–.63* (.000)	
	USA—Hispanic	–.83* (.000)	
14	USA— Whole	–.57* (.000)	
	USA—Hispanic	–.66* (.000)	
15	USA—Whole	–.14 (.652)	
	USA—Hispanic	–.16 (.496)	

Table 9: Comparison of USA and Latin American Scores (continued)

16	USA—Whole	–.08 (.762)	
	USA—Hispanic	–.17 (.433)	
17	USA— Whole	.23** (.032)	
	USA—Hispanic	.14 (.203)	
18	USA—Whole	.31** (.022)	
	USA—Hispanic	.10 (.521)	

One possible explanation for the higher US Hispanic scores is that US Hispanics support the government and the legal system more so than do non-Hispanic whites. If they have assimilated the cultural values of their adopted country, it is possible that they have become more American than Americans, more conservative than the general population.

This finding is somewhat different than the study of accounting practitioners (McGee and Maranjyan 2006a). In that study, non-Hispanic white accountants were the most firmly opposed to tax evasion of any of the more than 40 groups compared and, although the scores for Hispanic accountants were lower than the scores for the non-Hispanic white accountants, they were higher than the scores for practically any other group, which indicates that any category of accountant is more opposed to tax evasion than are Nonaccountants.

Table 10: Mean Scores by Ethnic Group

Statement	Latin	USA—Total	USA—Hispanic
1	5.31	5.92	5.99
2	6.10	6.06	6.06
3	4.84	5.33	5.30
4	4.60	5.38	5.33
5	5.97	6.19	6.20
6	5.56	5.85	5.96
7	5.87	6.13	6.13
8	5.87	6.14	6.19
9	5.93	6.08	6.16
10	5.94	6.15	6.22
11	4.59	5.43	5.49
12	6.04	6.20	6.18
13	5.29	5.92	6.12
14	5.02	5.59	5.68
15	6.01	6.14	6.16
16	5.13	5.21	5.29
17	5.43	5.20	5.29
18	5.43	5.10	5.33
Average	5.49	5.78	5.84

The scores of the Latin American and USA samples were significantly different for ten statements (1, 3, 4, 6, 7, 11, 13, 14, 17 and 18). The scores for the Latin American and USA–Hispanic samples were significantly different for 8 statements (1, 3, 4, 6, 7, 11, 13 and 14). Statements 3 and 4 had lower US-Hispanic scores than US-Total scores, but both of those scores were higher than the Latin American scores. Latin American scores were higher than scores in the other two categories only for statements 17 and 18, indicating that the Latin American sample was not as sensitive to human rights abuses as were the other two samples.

The strongest argument for the Latin Americans was statement 4 (wasted money—utilitarian rationale), whereas for the USA-Total it was statement 18 (rights—a deontological argument) and for USA Hispanics it was statement 3 (justice rationale). In the Latin American sample the weakest argument was statement 2 (low rates—an economic consideration). The USA-Total sample found statement 12 to be the weakest argument (consequences—teleological rationale—egoist) and for USA Hispanics the weakest argument was statement 5 (prudent use of money—utilitarian rationale). Table 8 shows the means for the three groups for each statement.

Concluding Comments

The study showed that, although some arguments to justify tax evasion are stronger than others, none of the arguments that have been made historically to justify tax evasion are very persuasive, judging from the relatively high scores on a scale of 1–7. A ranking of the arguments revealed that the strongest arguments to justify tax evasion involve situations where the government is engaged in human rights abuses, where tax funds are wasted, where there is corruption within the system or where the tax system is perceived as being unfair. The weakest arguments to justify tax evasion are in cases where there is a perception that people are getting something for their money, where their evasion would cause their fellow citizens to pay more or where everyone else is doing it.

Scores for the Dominican Republic were substantially and consistently lower than for those for the other countries, indicating that tax evasion is less of a moral problem for the average Dominican than for the other four groups sampled. It could be because Dominicans have less respect for their government. If there is an inverse relationship between the extent of corruption in a country and the amount of respect for the government, then one might conclude that the government of the Dominican Republic is more corrupt than the government of the other countries in the sample. A look at the Corruption Perceptions Index (Transparency International 2005) reveals the following:

From Table 11 it appears that corruption alone cannot explain why the scores for the Dominican Republic are substantially lower on the tax evasion surveys, since Ecuador is more corrupt than the Dominican Republic. Also, the scores for Colombia are often not significantly different from the scores of the USA, and are at times even higher, even though Colombia is considered to be more corrupt than either the United States or Puerto Rico. But corruption is seldom the sole explanation for anything, so it cannot be expected to be to sole reason for differences in the perception of tax evasion.

Table 11: Corruption Perceptions Index Scores

Country	Score	Rank (159 countries)
Ecuador	2.5	117
Dominican Republic	3.0	85
Colombia	4.0	55
Puerto Rico	6.3	28
USA	7.6	17

(1 = worst; 10 = best)

The present study also found that females tend to be more opposed to tax evasion than are males, at least in some cases. This finding confirms the findings in some other studies but runs contra to the findings of other studies. Business majors were more strongly opposed to tax evasion than were accounting majors, which was surprising. The Latin American samples were less opposed to tax evasion than were the USA groups but, surprisingly, the USA-Hispanic group was more opposed to tax evasion than was the USA sample population as a whole.

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13

Tax Competition: Can Slovenia Learn Anything from Ireland?

Sheila Killian, Mitja Čok, and Aljoša Valentinčič

Introduction

Tax competition is a topic fraught with ethical and practical questions. Should countries engage in tax competition, entering a 'race to the bottom' in terms of tax rates, in order to attract foreign direct investment (FDI)? Is this a sustainable strategy for the countries concerned? Is it effective in drawing in multinationals? Are there other factors that need to be addressed as well as tax? Can new entrants into the EU effectively learn from the experience of other EU countries that have built their economic strategy on FDI?

This chapter examines these questions in an open, discursive way. We do not claim to provide answers, but to explore the issues using the cases of Ireland and Slovenia. These countries are interesting for a number of reasons. Ireland has been remarkably successful in attracting FDI. Despite being a small country with a peripheral island location at the edge of continental Europe, dominated by a far larger neighbour with better infrastructure and economic development, it has brought in so much investment from abroad that it is now the largest exporter of software in the world, much of it produced by subsidiaries of US multinationals. The Irish economy is booming. There is almost full employment, and from being a nation of emigrants, the country now has net immigration. Most of this is due to foreign direct investment, and most of that is due to the package of low tax rates and extensive tax treaties on offer to multinationals investing in Ireland. By any standards, the country has been successful at tax competition.

Slovenia, although slightly smaller in terms of population (2 m versus 3.5 m of Ireland), is also located near the periphery of the new enlarged European Union, and is also bordering two bigger and more developed member states of the 'old' EU 15 (Italy and Austria). However, in terms of GDP per capita, adjusted for purchasing power parity, is trailing significantly

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behind Ireland. In 2004, Ireland's stood at 139% of the EU25 average, but Slovenia's was only at 78% of the average (Eurostat 2005). Because of historical background—Slovenia had been part of one-or-the-other type of Yugoslavia for more than 70 years—it has strong economic and cultural links to South East Europe and it is thought to have a unique knowledge of the markets of some of aspiring new EU members (Croatia, Serbia and Montenegro). Unfortunately this area has been hit by a number of wars in the 1990s. Recently, Slovenian firms have been investing substantially in this region. However, it must be noted that these markets alone are simply not enough to provide a substantial push to the Slovenian economy. Therefore, Slovenia must put itself in a position where it will be attractive as an entering gateway not only for this area, but also for the wider region and possibly the entire European Union.

We pose the question, can Slovenia learn from the way Ireland has played the game of tax competition. By examining this, we hope to shed light on the wider question of how countries in transition can learn from more established economies.

The chapter is laid out as follows. First the question of tax as an influence on multinationals is examined. Next, the Irish strategy over the last two decades is set out in some detail, and the success or otherwise of this strategy is assessed. The Slovenian position is explained, and finally the question of whether or not the Irish tactics would be helpful to Slovenia is investigated.

Tax and Multinationals

Can tax be used effectively to entice multinationals to locate in emerging economies such as Slovenia? While the Irish example may seem to support the use of tax, other factors also make Ireland attractive, particularly to US multinationals. Firms locating in Ireland often cite the importance of an EU location, the well-educated English-speaking workforce, good infrastructure, political stability and minimal cultural differences in work practices. Perhaps tax alone is insufficient to attract these firms.

However, the literature does indicate that tax rates and tax bases are a factor in corporate decision-making. Scholes et al. (1992) identified a trend of income deferral in response to the schedule of falling corporate tax rates introduced by the US 1986 Tax Reform Act. The phenomenon was confirmed using slightly differing methodologies by studies such as Boynton et al. (1992), Childs (1994), and Guenther (1994). There are obvious costs associated with accelerating or deferring the firm's income in this way, including the financing implications of reporting lower profit, damage to customer and supplier relationships caused by altering the timing of ordering or invoicing, the increased risk of a tax audit, and exacerbation of agency issues where earnings form the basis for executive compensation (Scholes et al. 1992:164). The fact that income deferral was identified in the presence of these non-tax costs adds weight to the findings.

A simpler approach available only to multinationals is to move profit to those companies within the group that are in low-tax locations, thus engaging in geographic rather than inter-temporal income shifting. Anecdotal evidence and the anti-avoidance efforts of the revenue services in those high-tax locations most adversely affected indicate that this is a widespread phenomenon. Klassen et al. (1993) found that shifting income to group companies in low-tax regimes was relatively common practice among larger, less domestically centred groups. Since then the phenomenon as been widely studied[1] using transfer pricing as a key to income shifting. However, because of the private nature of transactions between group companies, empirical evidence is difficult to obtain.

A logical next step is outright relocation of facilities from high tax to low tax jurisdictions, and this is precisely the behaviour that the policy-makers in Ireland seek to encourage. The phenomenon has been studied for many years,[2] but clear-cut results are often clouded by non-tax factors. Norregaard and Owens (1992) identify a number of important non-tax elements for location decisions of global groups, including political and economic stability, infrastructure, interest rates, grants and financing, and potential profitability in different countries, but overall conclude that the way in which profits are taxed continues to be an important deciding factor. This is confirmed by Devereux et al. (2002), who identifies the corporate tax rate as the single most important factor in location decisions, and by commentators such as Fitzgerald (1997) who felt that any increase in the tax rate in the Irish International Financial Services Centre would certainly cause companies which has located there to move out.

So a low tax rate is clearly an important element in attracting multinationals. It is also important to multinationals, where possible, to invest in countries which are not designated as tax havens by their home government or the OECD. This is because in general, profits that have been lightly taxed in a tax haven will incur high home-country taxes on repatriation, while non-haven profits may be repatriated without incurring penal rates of home country tax. The OECD project on harmful tax practices[3] has identified four conditions that must be met in order for a country to be described as a tax haven. These are, in addition to a low rate of tax on profits, secrecy, an unwillingness to share information, and either a tolerance of ‘brass plate’ operations which see no real commercial activity, or a limited application of the low rate of tax to a selection of target firms, the so-called ‘ring fencing’

[1] See for example Bonifiglio (1995) and Brown Gianni (1997)

[2] See Valles (1985) for an early study of the tax-based relocation decisions of US firms

[3] Available online from *http://www.oecd.org/ctp*

test. Any country seeking to engage in tax competition must negotiate these factors to avoid tax haven status.

The main disadvantage to a multinational of operating a subsidiary in a tax haven is that while profits earned there will be subject to low local tax, they will face penal taxes on repatriation to the home country. This is because in general, tax havens are unable to negotiate effective double taxation treaties with a wide range of countries. Double taxation treaties are generally negotiated on a bilateral basis[4] governing the primary and secondary taxing rights of international payments. Davies (2003) notes that in 1997, there were over 2,000 such bilateral treaties in operation worldwide, covering most aspects of foreign direct investment.

The Irish Approach

Ireland has been arguably one of the most successful exponents of tax competition. Despite a peripheral island location, a lack of natural mineral resources, and an economy largely based on agriculture and fishing right up to the 1970s, it has fashioned, apparently from nothing, a booming economy labelled 'the Celtic Tiger'. This success has been driven by foreign direct investment based on low corporate tax rates for inward investment, and a network of over forty double tax treaties with favourable terms for taxation of profits.

So how exactly has this been achieved? Ireland's first tactic was to apply a zero rate of corporate tax on any profits made on the sale of goods that were exported from the country. This gave a huge advantage to all exporting firms over those serving the local market. Because the local industrial base consisted mainly of small domestically centred firms, most of the benefit went to newly established Irish subsidiaries of multinationals.

This export sales relief was originally introduced for a limited period, and when it expired in 1990, it was not renewed. Instead manufacturing relief was more widely granted after this date, allowing profits on goods manufactured in Ireland to be taxed at a reduced rate of 10%. This compared very favourably to the rates of 40% to 50% applying to non-manufacturing profits at the time. In the absence of a formal definition of manufacturing in Irish legislation, case law defined it widely to include plant cloning, banana ripening and the production of computer parts that could more generally be described as assembly. Manufacturing relief was very widely availed of, especially by multinationals. By 1996 the amount of tax relieved under this provision was greater that the total amount of corporation tax actually collected (Revenue 1996). The relief expired in 2000, and could not be

[4]Although recently a tend towards multilateral treaties on a region-wide basis has emerged

renewed in the face of opposition from the EU. It was in any case an unsustainable situation, falling foul of both the OECD 1998 regulations on harmful tax competition, and on the European Union's (1997) code of conduct which Ireland itself had helped to negotiate. The critical point was that the low tax rate applied only to the target group of manufacturing companies, mostly multinationals, and that a higher 'domestic' rate applied to the rest of the businesses within the economy.

Ireland's response was to raise the tax rate marginally from 10% to 12½%, and then to apply it not just to manufacturing firms, but to all incorporated businesses in the state. This allowed Ireland to escape the ring-fencing test imposed by the OECD, and retain its valuable tax treaty network, and its status as a non-haven country.

The policy worked. Sullivan (2004) reports Ireland to be the most profitable location in the world for US firms. The ICT industry has been a particular target. Ireland is now the largest exporter of software in the world. Seven of the world's top ten global ICT companies have bases in Ireland, and two third of all workers in this sector are employed by overseas firms. The country enjoys almost full employment and the sort of spectacular economic success that could not have been imagined in the 1980s.

Some commentators[5] deny that the so-called 'Celtic tiger' economy is in fact a boom, arguing that Ireland's success is simply a delayed convergence effect, making up for decades of underperformance. Honohan and Walsh (2002) argue that Ireland's success comes from a move from agriculture to industry, rather than being 'the outcome of ingenious fiscal policy'. While the author acknowledge that low corporate tax rates make Ireland an attractive location for multinationals, they argue that they simply encourage 'legitimate tax management within the transfer pricing rules', rather than genuine economic activity. MacSharry and White (2001) take a rather contrary view. Written by key insiders,[6] the book credits the economic boom to the levels of FDI, and attributes this mainly to the favourable tax regime, as well as to education, infrastructure and a range of other factors.

Certainly a low tax rate alone is insufficient to attract investment. Critical to the success has been the maintenance of the wide network of double tax treaties. The fact that Ireland is not seen as a tax haven means that dividends paid to the parent company by Irish subsidiaries will not be subject to penalties in the home country, and royalties and other payments can be made with minimal withholding taxes and administration.

There are lessons in the Irish experience for emerging economies, including some obvious pitfalls to be avoided. The policy through the 1980s

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[5] See, for example, Honohan and Walsh (2002) for a good summary of this perspective

[6] Ray McSharry was the Finance minister at the end of the 1980s, and Padraic White was head of the Industrial Development Authority, with responsibility for attracting and maintaining FDI, throughout the 1990s

of favouring exporting firms, and through the 1990s of favouring manufacturing firms meant that smaller indigenous industry was disproportionately taxed, making business taxation regressive in aggregate in this period. The 2004 annual report of the Revenue Commissioners shows that with the wider application of the low rate to all business, this regressive aspect has largely disappeared. Any country starting from a blank slate to design a tax policy would be perhaps best advised to avoid the discriminatory phase practiced by Ireland, and move straight to the more egalitarian 'low tax for all' situation that has prevailed since 2000.

It appears essential that the tax treaty network is maintained, and that as wide a network of treaties as possible is negotiated. While most of Ireland's investment comes from the US, firms from countries as diverse as Finland, the UK, Japan, Germany, France, and South Africa also generate significant employment. The Netherlands is a favourable location for holding companies, so many multinational investments structure their investment in Ireland as the Irish branch of a Dutch BV. It is therefore important that the tax treaties are set up so as to facilitate this.

Success in Ireland has also come at a price. Lowering the tax rate on business has to some extent impaired the ability of government to deliver the sort of social contract it has traditionally promised. At the time of writing, there was considerable public concern about the health service, education of marginalised groups, care of the elderly and rising homelessness. These persistent social problems are in stark contrast to the newfound wealth in the country, and a recent report (NESC 2005) has confirmed that inequality has increased in lockstep with economic success. There is increasing concern that rising inward investment has created a moral hazard for government to simply ride the wave of success, and reduce the attention paid to those who are not in a position to benefit from employment in a multinational firm, or otherwise to benefit from the boom.

Finally, there is concern about the regional development within Ireland. In particular, areas far from urban centres such as the North Western county of Donegal find it difficult to sustain manufacturing jobs. During August 2005, for example, two firms announced their intentions to close and move to lower tax and lower wage jurisdictions, with an aggregate loss of almost two thousand manufacturing jobs. Traditionally, residents of this remote coastal county made a livelihood from fishing and tourism, but these sectors have been de-prioritised in the government's relatively rush to attain inward investment in the manufacturing sector. This means, as explained by one recently laid off worker, that the skill set among older men in particular is redundant, and there is concern that the policy-makers in Dublin do not understand the concerns of this isolated area. 'People have skills that are no good outside this town—like net-making and hand filleting. We might as well be in Iceland for all the government cares.'[7] The case highlights the risks of a blanket prioritisation of inward investment over indigenous industry.

The Slovenian Situation

Ireland has been and is still often put forward in popular discussions in Slovenia as an example of a successful small EU country that has dramatically improved its economic position through the benefits of FDI. However, the Slovenian situation differs remarkably from the Irish one. Slovenia has only enjoyed the free market economy since 1991 after a process of achieving independence from the former Yugoslavia. At the beginning of nineties the loss of markets of former Yugoslavia and the general crisis in the Balkans region influenced the Slovenian economy to a great extent. After an initial slump of GDP, the economy started to recover in 1993 and reached the pre-independence level in 1996. Since then, Slovenia has experienced a stable economic growth of between 2% and 5% per year. During this process, the share of manufacturing and agriculture has generally declined and the share of services in GDP has increased, bringing the structure of the economy close to that of other EU countries. In 2003, services represented 60 % of the GDP, industry 31%, construction 6% and agriculture 3%. The main trading partners of Slovenia are EU countries (66% of exports and 73.9% of imports, following by the countries of former Yugoslavia 17.8% export and 5.8% import and Russia 4.8% and 1.8%, respectively) (Bank of Slovenia 2005).

However, compared to the rest of Central and Eastern Europe, Slovenia has attracted relatively little FDI. According to estimates in World Investment Report 2004 (Table B.3, pp. 380–381), Slovenia's stock of inward FDI was approximately €4.3 bn, compared with Slovakia's €10.2 bn, Hungary's €4.2 bn, Czech's €41 bn and Poland's €52.1 bn. One of the important reasons for this was the voucher-based privatisation which effectively excluded sales of companies to foreigners at the time of privatisation. During the process of privatisation, starting in 1992, 40% of equity was transferred to three government funds: the Pension fund 10%, Compensation fund 10% and Development fund 20%. These 20% were then further sold to investment funds set up at the time of privatisation in exchange for ownership privatisation vouchers, given to all residents of Slovenia and collected from them by these funds. The remaining 60% of shares were privatised by internal distribution to employees, again in exchange for ownership vouchers, by internal management and employee buyouts and by sale of company shares to domestic or foreign investors through public tenders (Hrovatin 1996). However, this latter method was not significantly used.

[7] McKay (2005:3)

At the same time, the privatisation of formerly socially-owned housing was in process, enabling sitting residents to buy housing with a substantial discount (by cash, not by vouchers), which in most cases reached up to 90% of the estimated market value (Stanovnik 1994). It was completed already by 1993.

This deterred foreign investors from investing in large-scale in Slovenia as is typical for other countries in the region. Other important factors include a relatively small domestic market and relatively high labour price. Both of these, however, are shared by Ireland.

As a result, Slovenia's stock of FDI as a share of GDP is only 16.8%, compared with Czech's 54.8%, Slovakia's 43.2%, Hungary's 38.2% or Poland 23.9%, and most strikingly, 129.1% in Ireland (TIPO 2003, 2005). Moreover, most of these investments in Slovenia were not greenfield investments, but takeovers of existing companies. According to a market-research firm Gral-ITEO and TIPO, a government agency that promotes incoming FDIs, the most important reasons for foreign investors to locate in Slovenia are access to the Slovenian market, long-term cooperation with Slovenian companies, access to other markets in South-East Europe through Slovenia, and highly-skilled labour. The position of Slovenia therefore cannot be compared to the Irish position at least to the extent that it does not serve as an entering point to EU markets for American companies. In this respect it is perhaps indicative that Bhattacharya and Groznik (2003) find that the more numerous a particular ethnic population living in the US, the higher is the level of US direct investment into that country. They find that for every millionth immigrant from a particular country into the US, the US investment into that country increases by $1,890, suggesting a strong 'domicile' behaviour of investors. However, the Slovenian position may change with the entry of Slovenia to the EU as its home market will soon—it is hoped—be perceived by foreign investors to be the EU, and not just Slovenia.

The slow growth in FDI continues, despite a relatively favourable system of corporate income tax. Up to 2004, Slovenia's effective corporate tax rate was substantially below the statutory rate of 25%, mostly due to generous investment allowances in the past of up to 40% of the amount invested,[8] making this the effective rate of 10% comparable to rates of other CE countries (Vandenbusche 2005).[9] According to the same source, Ireland's effective tax rate in 2002 was only 2% and the EU average 21%. We see this as an indication that the corporate tax system is not a major reason for the low FDI in the last 10 years. Also, Slovenia has in force a number of conventions

[8] A new corporate income tax system effective from 1 January 2005 has broadened the tax base and has increased the effective tax rate through the reduction of investment allowances and provisions while leaving the statutory tax rate at 25%. Also, the rates for investment allowances were gradually reduced in 2003 and 2004.

[9] The effective tax rate was defined as income tax divided by accounting profit before tax.

to avoid double taxation (35 in force in mid-2005 and 5 not effective yet), including all its main trading partners, for a number of years, for example, with Germany since 1988 (Ministry of Finance of the Republic of Slovenia 2005). Even where these conventions are not formally enforced yet, there is some cooperation with these countries' tax authorities. Again we see the existence of these treaties as a sign that the investments were not deterred by double-taxation problems.

On the other side, the general level of taxation in Slovenia is higher compared with Ireland. In 2002 the tax to GDP ratio in Slovenia reached 39.8%, while in Ireland it was 28.6% (EU Commission 2004). The main reason lies in the system of social security. Slovenian Bismarck's based welfare state is simply more expensive compared with the Beveridge's system of social security in Ireland. In Slovenia, the level of social rights is much higher and is mostly financed through social security contributions, which are set at the rate of 38.2% (22.1% by employee and 16.1% by employer) on gross wages or other sources of income, depending on the employment status. Social security contributions are thus the most important taxes at approximately one third of all taxes and it is not a surprise that the implicit tax rate on labour, which include also personal income tax and payroll tax, in 2002 reached 44.5% compared with 25.9% in Ireland (Gabrijelčič 2005; EU Commission 2004). However, even this is not enough to maintain the existing level of social rights and approximately one third of national pay-as-you-go pension system is financed by the central government through general taxes. On the other side, Irish system relies mostly on taxes (not social security contributions) and offers relatively lower level of social security provided by the government. The standard social security rate on wages in Ireland is 19.95% (7.75% by employee and 12.2% by employer), with lower rates available to state employees and some company directors. However the department of social welfare in Ireland which funds the welfare payments is not solely dependent on the social security contributions it collects, as it also receives direct subvention from general tax revenue.

Conclusions

The position of Slovenia has in the past been significantly different to the position of Ireland, since it has not served as an entry point for companies from an important (i.e. large) economy, and it is surrounded by countries where it was easier and possibly cheaper to buy local companies (e.g. the largest takeover of a Slovenian pharmaceutical firm Lek, d.d., was perceived as being fairly priced). However, with the entry of Slovenia in the EU, it should be in a position to attract Greenfield investment, not based on access to the Slovenian market, but on the EU as a whole or possibly as a base to expand operations in South-East Europe and formerly Yugoslav countries in particular. It must be noted that the effects of formally joining the EU (and NATO earlier on), its participation and active role in peacekeeping forces in former Yugoslavia (i.e., Bosnia and Kosovo) and its role in Organisation for Security and Co-operation in Europe are all likely to have raised the perception of Slovenia as a trustworthy and secure country. While it is likely that neighbouring countries represent bigger markets and have cheaper labour force of comparable skill, this is only an issue if the investment is targeted at the domestic market. Therefore, only through tax system Slovenia will not be able to attract a bigger inflow of the sort of FDI they have traditionally targeted—takeovers of Slovene firms with a view to expansion. However, the sort of FDI targeted by Ireland is mainly large exporting firms who locate in Ireland not for domestic sales, but for low tax, with a wide treaty network, and an EU location. Arguably, this is the market that Slovenia should take on at this stage.

In conclusion, therefore, the policy Slovenia has operated until now has involved opening up its domestic markets to incoming firms, or putting itself forward as a base from which to trade with neighbouring countries. There are limits to the potential success of such a strategy, because there are limits to the regional market. Ireland casts its nets more widely. For example, Ireland is now actively canvassing investment from China into the Shannon region of Ireland, marketing the location as a useful base from which to pursue markets in Europe and North America. At the time of writing, a Russian nanotechnology firm had just established a base there to manage sales into Europe, Asia, the Middle East and Australia.[10] If the country wishes to mimic the success of Ireland, then a broader approach should be adopted to attract in exporting firms, whose interest in selling into the Slovenian market is not the primary trigger for their location there. Consistent with this, Slovenia has recently launched a number of initiatives to attract foreign investors, including passing a special law dedicated to attract FDI including accompanying bylaws. Latest initiatives are a transfer the so-called ‘commercial diplomacy’ to the Ministry of the Economy and a planned ‘road show’ of the largest Slovenian quoted companies on the main European capital markets.

As well as tax competition, there are other ingredients needed to provide the optimal environment for FDI. In Ireland’s case, these included: good quality education, which Honohan and Walsh (2002) argue contributed almost one percentage point to growth in GDP in the 1980s and 1990s; stability in financial and legal systems; infrastructure including telecommunications, road access and a network of inexpensive flights and wage stability based on social partnership. Tax competition alone will not recreate the level of FDI experienced in Ireland, but it is an important key ingredient.

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[10] The firm is NT–MDT Service and Logistics Ltd. Source Shannon Region Investment Location News, Spring Summer, 2005

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PART THREE: COUNTRY & REGIONAL STUDIES

14

A Survey of Argentina on the Ethics of Tax Evasion

Robert W. McGee and Marcelo J. Rossi

Introduction

Most studies of tax evasion take an economic or public finance perspective. Not much has been written from a philosophical or ethical viewpoint. That is probably because most economists are utilitarians and most lawyers are legalists. However, there is a small body of literature that addresses tax evasion issues from a philosophical or theological perspective. The present study is intended to add to that small body of literature while forming a bridge to the public finance literature as well.

The authors developed a survey instrument that included eighteen (18) statements incorporating the three major views on the ethics of tax evasion that have emerged in the literature over the last 500 years. The survey was distributed to a group of business and law students in Argentina. This paper reports on the results of that survey.

Methodology

After reviewing the literature that exists on the ethics of tax evasion, a survey was constructed and distributed to a group of graduate and advanced undergraduate business, economics, theology, philosophy and law students at Austral University in Argentina in order to learn their views on the ethics of tax evasion. This group was selected because they will be the future business and political leaders of Argentina. Due to space constraints, the literature is not reviewed here. However, the relevant literature is listed in the reference section.

The survey consisted of eighteen (18) statements. Using a seven-point Likert scale, respondents were asked to place the appropriate number in the space provided to indicate the extent of their agreement or disagreement with each statement. The statements in the survey reflected the three main viewpoints on the ethics of tax evasion that have emerged over the centuries.

R.W. McGee (ed.), *Taxation and Public Finance in Transition and Developing Economies*,
doi: 10.1007/978-0-387-25712-9_14,

The survey was distributed in Spanish. Two hundred eighteen (218) usable responses were received.

The following hypotheses were made:

H1: The scores will indicate that the average respondent will consider tax evasion to be ethical sometimes.
H2: Faculty will be more strongly opposed to tax evasion [their scores will be higher] than will students for at least 12 out of 18 statements.
H3: Scores will be lower [tax evasion will be more acceptable] when the statement refers to government corruption.
H4: Scores will be higher [tax evasion will be less acceptable] when the statement espouses a selfish motive.
H5: Female scores will be higher than male scores [women will be more strongly against tax evasion than males] for at least 12 out of 18 statements.
H6: Law students will be more opposed to tax evasion [will have higher scores] than will business and economics students for at least 12 of 18 statements.

Survey Findings

A total of 218 usable responses were obtained. Table 1 shows the breakdown by gender. One hundred thirty (130) males and eighty-three (83) females responded to the survey. Five (5) individuals did not indicate their gender.

Table 1
Responses by Gender

Male	130
Female	83
Unknown	5
Total	218

Table 2 shows the responses by major. The largest group consisted of business and economics majors (116). The only other significant group was law students (88). Forty-three (43) of the graduate students were also faculty members.

Table 2
Responses by Major

Business/Economics	116
Theology/Philosophy	8
Law	88
Not specified	6
Total	218

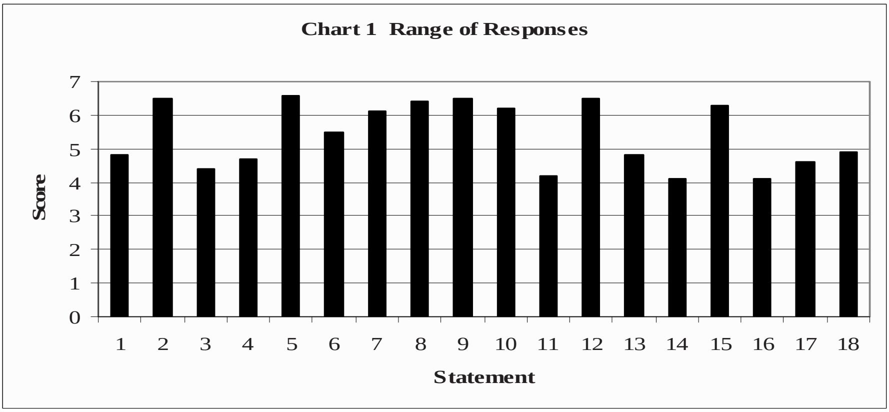
H1: The scores will indicate that the average respondent will consider tax evasion to be ethical sometimes.
H1: Inconclusive.

Table 3 summarizes the responses for each of the 18 statements. It was thought that the average response would show that tax evasion was ethical sometimes, since the studies of Romanian business students (McGee 2005b), Guatemalan business and law students (McGee and Lingle 2005), two Chinese studies (McGee and Yuhua 2006; McGee and Guo 2006) and the Armenian study (McGee and Maranjyan 2006) had that finding. However, such was not the case. If one splits the three options into (1) tax evasion is always or almost always ethical if the score is 2 or less, (2) tax evasion is sometimes ethical if the score is more than 2 but less than 6, and (3) tax evasion is never or almost never ethical if the score is 6 or higher, there seems to be no clear-cut pattern that would justify concluding that the responses fit into any of the three categories. Ten (10) of the responses fall into the *sometimes* category (S 1, 3, 4, 6, 11, 13, 14, 16, 17 & 18), whereas eight (8) responses fall into the *never or almost never* category (S 2, 5, 7, 8, 9, 10, 12 & 15). Furthermore, many of the responses in the *sometimes ethical* category were at the high end of that category. Thus, the only conclusion that can be reached is that the average respondent does not believe that tax evasion is always or almost always ethical. But it cannot be said with a high degree of confidence that the average respondent falls neatly into either of the other two categories, since responses are almost evenly divided between the other two categories. A similar conclusion was reached in the Hong Kong study (McGee and Ho 2006).

Table 3
Summary of Responses
(1 = strongly agree; 7 = strongly disagree**)**

S#		
1	Tax evasion is ethical if tax rates are too high.	4.8
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.5
3	Tax evasion is ethical if the tax system is unfair.	4.4
4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.7
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.6
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.5
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.1
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.4
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.5
10	Tax evasion is ethical if everyone is doing it.	6.2
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.2
12	Tax evasion is ethical if the probability of getting caught is low.	6.5
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.8
14	Tax evasion is ethical if I can’t afford to pay.	4.1
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.3
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	4.1
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.6
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.9
	Average score	5.4

Chart 1 illustrates the range of responses.



This finding is also similar to what was found in the survey of international business professors (McGee 2005a). In that survey eight (8) statements has scores of 6.0 or higher and each of the other ten scores were higher than 4 but less than 6, which indicates an almost even split between the *sometimes* and *never or almost never* categories.

Table 4 shows the breakdown by category for the international business professor, Hong Kong, present study and several other studies. The Hong Kong and Chinese studies consisted of 15 statements. The Armenian study had 14 statements.

In the Argentinean, international business professor and Hong Kong studies, respondents were almost evenly split between the *sometimes* and *always or almost always unethical* categories, with a slight preference for the *sometimes* category, whereas in most of the other studies, respondents were solidly in the *sometimes* category. The findings in the Guatemala study are closer to those of the Argentinean study than to those of the Romanian, Armenian, Beijing and Hubei studies. One explanation for this differing viewpoint might be that Romania, Armenia and mainland China are communist or former communist countries, and respondents from these countries thus perhaps do not have as much respect for the rule of law as do other countries. Another explanation might be that there is more corruption in these countries. Although Hong Kong is now part of communist China, it has had a long tradition of respect for the rule of law, since it was part of the British Empire, and thus influenced by the British rule of law. That could explain why the Hong Kong results are strikingly different from those of the two mainland Chinese studies.

H2: Faculty will be more strongly opposed to tax evasion [their scores will be higher] than will students for at least 12 out of 18 statements.

H2: Rejected

Table 4
Comparison of Views

	Arg	Int'l Bus. Prof. (McGee 2005a)	Hong Kong (McGee and Ho 2006)	Guat. (McGee and Lingle 2005)	Romania (McGee 2005b)	Armenia (McGee and Maranjyan 2006)	China Beijing (McGee and Yuhua 2006)	China Hubei (McGee and Guo 2006)
Tax evasion is always or almost always *ethical* (score of 2 or less)	0	0	0	0	0	0	0	0
Tax evasion is *sometimes* ethical (score of more than 2 but less than 6)	10	10	8	11	18	13	15	13
Tax evasion is always or almost always *unethical* (score of 6 or higher)	8	8	7	7	0	1	0	2
Total	18	18	15	18	18	14	15	15

Table 5 compares the views of students to those of faculty. Students were more strongly opposed to tax evasion in seven cases (S 3, 4, 6, 13, 14, 16 & 17), whereas faculty were more strongly opposed to tax evasion in eight cases (S 2, 5, 7, 8, 9, 10, 11 & 15). In three cases the views of students and faculty were the same (S 1, 12 & 18). Thus, it appears that the views of students and faculty are not significantly different, if one defines significantly different as having higher scores for at least 12 of 18 statements.

Table 5
Summary of Responses
Comparison of Students to Faculty
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Scores		Scores higher by	
		Students	Faculty	Students	Faculty
1	Tax evasion is ethical if tax rates are too high.	4.8	4.8		
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.5	6.7		0.2
3	Tax evasion is ethical if the tax system is unfair.	4.4	4.1	0.3	
4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.7	4.5	0.2	
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.6	6.7		0.1
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.5	5.3	0.2	
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.1	6.3		0.2
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.4	6.7		0.3
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.5	6.8		0.3
10	Tax evasion is ethical if everyone is doing it.	6.2	6.4		0.2
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.2	4.4		0.2
12	Tax evasion is ethical if the probability of getting caught is low.	6.5	6.5		

13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.8	4.7	0.1	
14	Tax evasion is ethical if I can't afford to pay.	4.1	3.9	0.2	
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.3	6.4		0.1
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	4.1	3.8	0.3	
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.6	4.3	0.3	
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.9	4.9		

H3: Scores will be lower [tax evasion will be more acceptable] when the statement refers to government corruption.
H3: Accepted

H4: Scores will be higher [tax evasion will be less acceptable] when the statement espouses a selfish motive.
H4: Accepted.

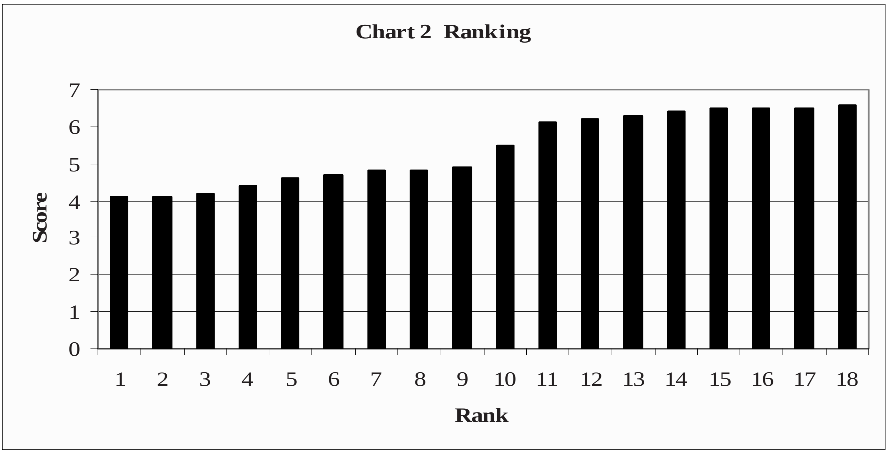
Table 6 ranks the scores for the 18 statements from strongest argument justifying tax evasion to the weakest argument. The strongest argument for justifying tax evasion occurs in cases where the taxpayer is unable to pay or where the taxpayer is a Jew living in Nazi Germany. The third strongest argument in favor of tax evasion is in cases where a significant portion of the money collected winds up in the pockets of corrupt politicians or their family or friends, which confirms the hypothesis that the case for ethical tax evasion is strong where government corruption is present. However, it was not the strongest argument, although the two strongest arguments were only one-tenth of a point ahead, at 4.1 versus 4.2.

The responses in the middle mostly refer to cases dealing with the perception of unfairness or waste. The statements with the highest scores [tax evasion is never or almost never ethical] are the ones that espouse a selfish motive. All of the statements with scores of 6.0 or higher fall into this category. Thus, the hypothesis that tax evasion will be less acceptable when the statement espouses a selfish motive is confirmed. This finding was also made in the surveys of international business professors (McGee 2005a), Romanian business students (McGee 2005b) and Guatemalan business and law students (McGee and Lingle 2005). Thus, the findings are consistent. That is not to say that selfishness is necessarily a bad character trait. Some philosophers argue that selfishness is a good character trait (Rand 1964). This finding merely confirms that statements that espouse selfish motives were found to be less justifiable in the minds of the sample population.

Table 6
Ranking of Student Scores
(1 = strongly agree; 7 = strongly disagree)

Rank	Statement	Score
	Sometimes ethical	
1	Tax evasion is ethical if I can’t afford to pay.	4.1
1	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	4.1
3	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.2
4	Tax evasion is ethical if the tax system is unfair.	4.4
5	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.6
6	Tax evasion is ethical if a large portion of the money collected is wasted.	4.7
7	Tax evasion is ethical if tax rates are too high.	4.8
7	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.8
9	Tax evasion is ethical if the government imprisons people for their political opinions.	4.9
10	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.5
	Never or almost never ethical	
11	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.1
12	Tax evasion is ethical if everyone is doing it.	6.2
13	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.3
14	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.4
15	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.5
15	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.5
15	Tax evasion is ethical if the probability of getting caught is low.	6.5
18	Tax evasion is ethical even if most of the money collected is spent wisely.	6.6

Chart 2 shows the range of ranks from lowest to highest.



H5: Female scores will be higher than male scores [women will be more strongly against tax evasion than males] for at least 12 out of 18 statements.
H5: Rejected

Table 7 compares the male and female scores. It was thought that the female scores would be significantly higher than the male scores, significance being defined here as higher scores in 12 out of 18 statements, but that was not the case. Male scores were higher in 9 cases, female scores were higher in 7 cases, and the scores were identical in 2 cases.

As can be seen from the last two columns of Table 7, the differences between the male and female scores were not very much in most cases. In eight cases the scores were only one-tenth (0.1) or two-tenths (0.2) of a point apart. In no case were they more than six-tenths (0.6) of a point apart. In two cases they were identical.

Table 7
Comparison of Male and Female Scores
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Score			Score higher by	
		Overall	Male	Female	Male	Female
1	Tax evasion is ethical if tax rates are too high.	4.8	4.8	4.9		0.1
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.5	6.6	6.4	0.2	
3	Tax evasion is ethical if the tax system is unfair.	4.4	4.3	4.4		0.1
4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.4	4.7	4.7		
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.6	6.7	6.3	0.4	
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.5	5.5	5.5		
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.1	6.3	5.8	0.5	
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.4	6.5	6.2	0.3	
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.5	6.6	6.2	0.4	
10	Tax evasion is ethical if everyone is doing it.	6.2	6.1	6.2		0.1
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.2	4.2	4.1	0.1	

12	Tax evasion is ethical if the probability of getting caught is low.	6.5	6.5	6.4	0.1	
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.8	4.9	4.8	0.1	
14	Tax evasion is ethical if I can't afford to pay.	4.1	3.9	4.4		0.5
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.3	6.5	6.2	0.3	
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	4.1	3.7	4.7		1.0
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.6	4.4	5.0		0.6
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.9	4.7	5.2		0.5

Chart 3 compares the male and female scores.

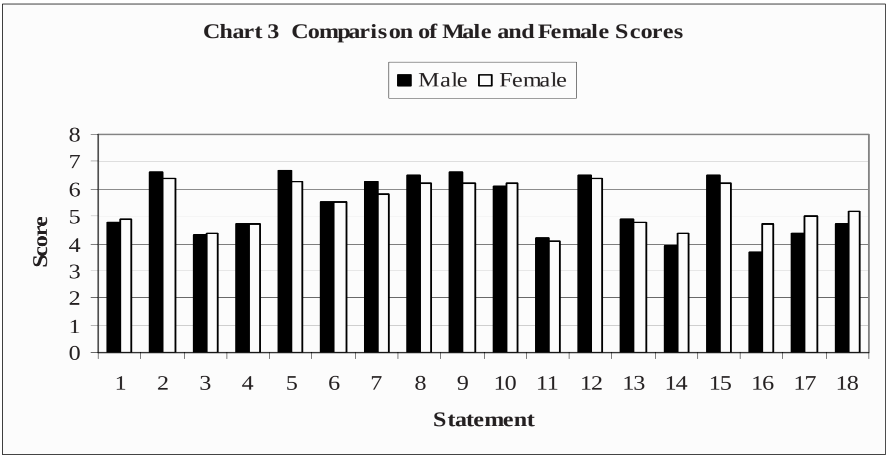


Chart 3 Comparison of Male and Female Scores

Table 8 compares the male and female scores in the present study to those of three other studies that included 18 statements. It was thought that female scores would be higher than male scores, since that was the finding in the international business professor study (McGee 2005a) and the Guatemalan business and law student study (McGee and Lingle 2005), although it was not the case for the study of Romanian business students (McGee 2005b). Thus, the present study reaches the same result as the Romanian study but has the opposite result of the two other studies.

Table 8
Comparison of Male and Female Scores

	Male score higher	Female score higher	Same score
International Business Professors (McGee 2005a)	0	18	0
Romanian Business Students (McGee 2005b)	12	6	0
Guatemalan Business and Law Students (McGee and Lingle 2005)	4	12	2
Present Study (Argentina)	9	7	2

Any attempt to find an explanation for the differences and similarities among the studies would be speculative. One possible explanation is that Argentina and Romania are both Latin countries, in the sense that they both speak a Romance language. But that does not explain why the result in Guatemala is different from Argentina and Romania. One would think that the results for Argentina and Guatemala would be similar. One possible explanation for the difference between Guatemala and Argentina is the difference in immigration patterns. Guatemala, like many countries in Central and South America, had an inflow of immigrants from Spain. So did Argentina. However, in the case of Argentina, there were also immigration flows from Italy, Britain, Germany, France, Poland, etc., which had the effect of diluting the influence of Spanish immigration. More research is needed on this point.

Numerous studies have been done over the years comparing male and female responses to various ethical situations. The results have been mixed. Chonko and Hunt (1985), Glover et al. (1997), and Kohut and Corriher (1994) all concluded that women were more ethical than men. But McCuddy and Peery (1996), McNichols and Zimmerer (1985) and Sikula and Costa (1994) did not find any significant statistical difference between genders. Harris (1990) and Hoffman (1998) found that females were more ethical than men on some issues but equally ethical or unethical for other issues. Weeks et al. (1999) found men to be more ethical sometimes, women to be more ethical at other times, and men and women to be equally ethical in certain instances.

However, one must be cautious when applying these findings to the present study. Just because female scores might be higher than male scores in the tax evasion survey does not necessarily mean that women are more ethical than men. In order to arrive at that conclusion one must start with the premise that tax evasion is unethical, which may not be the case. Indeed, one of the major reasons for conducting the present study is to determine when, and under what circumstances, tax evasion is ethical. Thus, the strongest conclusion that can be reached in the present study is that females are more strongly opposed to tax evasion than are men if their scores are higher than male scores.

H6: Law students will be more opposed to tax evasion [will have higher scores] than will business and economics students for at least 12 of 18 statements.
H6: Rejected

It was thought that law students would be more opposed to tax evasion than would business students because it is the law students who are taught to respect the rule of law. However, a comparison of business and economics and law student scores found that the business and economics students were significantly more opposed to tax evasion than were the law students. The business and economics students had higher scores than the law students for 16 of the 18 statements. The score for the law students was higher in just one case. In one case the scores of the two groups was the same.

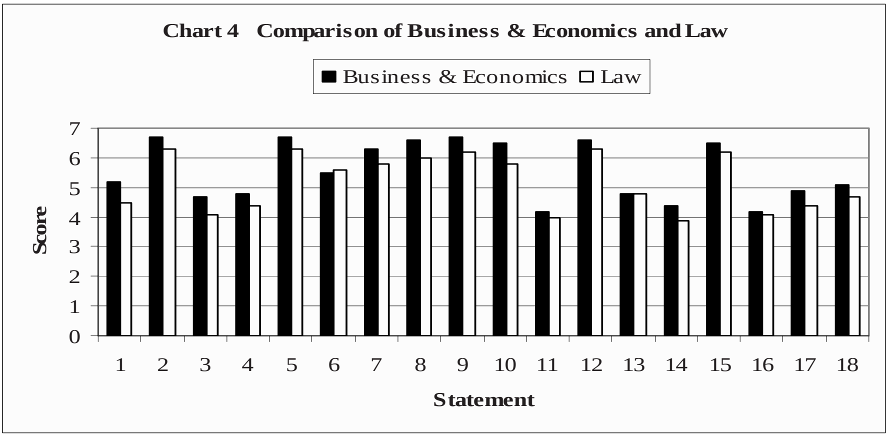
Table 9 compares the scores of the two groups. Not only were the business and economics students' scores higher than the law student scores in almost all cases. They were at least four-tenths (0.4) of a point higher in 12 of 18 cases, indicating a strong difference of opinion.

Table 9
Comparison of Scores by Major Discipline
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Score			
				Larger by	
		Bus. & econ.	Law	Bus. & econ.	Law
1	Tax evasion is ethical if tax rates are too high.	5.2	4.5	0.7	
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.7	6.3	0.4	
3	Tax evasion is ethical if the tax system is unfair.	4.7	4.1	0.6	

4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.8	4.4	0.4
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.7	6.3	0.4
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.5	5.6	0.1
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.3	5.8	0.5
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.6	6.0	0.6
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.7	6.2	0.5
10	Tax evasion is ethical if everyone is doing it.	6.5	5.8	0.7
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.2	4.0	0.2
12	Tax evasion is ethical if the probability of getting caught is low.	6.6	6.3	0.3
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.8	4.8	
14	Tax evasion is ethical if I can’t afford to pay.	4.4	3.9	0.5
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.5	6.2	0.3
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	4.2	4.1	0.1
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.9	4.4	0.5
18	Tax evasion is ethical if the government imprisons people for their political opinions.	5.1	4.7	0.4
	Average Score	5.6	5.2	

Chart 4 shows the scores for the business & economics and law students.



Two other studies compared the views of law students and business students. A summary of those studies is presented in Table 10.

Table 10
Comparison of Law and Business & Economics Student Scores
Argentina, Guatemala and China

	Argentina	Guatemala [McGee and Lingle 2005]	China [McGee and Guo 2006]
Law scores were higher than business & economics scores [Law students were more strongly opposed to tax evasion]	1	1	14
Business & economics scores were higher than law scores [Business & economics students were more firmly opposed to tax evasion]	16	16	0
Scores for law and business & economics were the same	1	1	1
Totals	18	18	15

Table 10 shows that the views of business and economics students in Argentina and Guatemala are basically the same, in the sense that they are more strongly opposed to tax evasion than are law students. This finding is surprising, in the sense that one would think that law students would be more strongly opposed to tax evasion because they are supposedly taught to respect the law. Perhaps law students are more cynical of the law than are business and economics students. That would explain their less strong view on the issue.

This finding supports the thesis of Chesher and Machan (1999), which holds that business people have been getting a bad rap since Biblical times and that their perceived status as being lower than other groups in terms of ethics is not supported by the evidence.

The other interesting finding is that law students in China had higher scores than business and economics students for 14 of 15 statements. Perhaps this is because law students and lawyers in communist countries view the state in more positive terms than do business people and economists.

Some participants wrote the reasons for their opinions in the optional comment section. Here is a sampling of their comments.

- Evading taxes is always unethical.
- Tax evasion is not justifiable. We must encourage clarity and transparency of the system and we must educate for values. We should pursue the common welfare.
- Tax evasion is always unethical, even if taxes are high or the money is wasted.
- Tax evasion is never ethical but in some cases could be justified.
- The ethics of tax evasion will be determined by the distribution of the collection and participation of everybody.
- Ethics does not include the unfair; therefore, in some cases tax evasion is fair despite being illegal.
- What determines if evasion is ethical or unethical depends on the circumstances, way, time and place. The notion of evasion generates an attitude of rejection independently of religion, political thought or social status because it destroys the perception of solidarity related to the State.
- The tax system must be simple, clear and understandable to everybody.
- I think that evasion is part of a contagious system. Everybody evades so why don't I?
- If the system is unfair, laws must be modified. Evasion is not a solution.
- Tax evasion is unethical by itself. It would be considered as some kind of protect or defense against a corrupt or dictatorial state.
- The destination of the funds determines whether evasion is ethical.
- Tax evasion is never ethical except in cases of elementary survival.

- It depends on whether the tax is fair or unfair.
- Evasion is immoral, just like taking other people's property.
- Tax evasion is unethical because it is against the law.
- Evasion can be ethical if the pressure against the individual is abusive.
- There are higher values than paying taxes, like justice, human rights or peace. One cannot be an accomplice of an unfair or immoral system by paying to fund it. Therefore, I am in favor of civil disobedience toward a murderous or immoral government.
- Tax evasion is immoral if the government is a democracy. If I disagree, I should find a licit way to express my claim. But if the government is tyrannical and authoritarian I consider it ethical to evade taxes.
- Ethics depends on the citizen's ability to pay and whether citizens benefit by their payments.
- Whether evasion is ethical depends on the usage of funds.
- Tax evasion can be acceptable when private interests benefit by the collection.
- Tax evasion is selfish behavior.
- Evasion fosters social disintegration (social class differences). What defines the ethical or unethical nature of tax evasion is the motive. In some extreme cases it could be ethical.
- Evading taxes is bad, but the problem is that the system does not motivate people to pay taxes.
- Tax evasion is ethical only for people who are below the poverty line. In other cases it depends on the government and its behavior.
- Tax evasion is not related to ethics.
- What determines the ethics of tax evasion is the quality of life. If a person is dying of hunger taxes cannot be paid.
- No illicit act can be justified.
- Depends on each person's morality.
- The bad image of politicians is the determining factor.
- Evasion is not the way to express disagreement. It is unfair that some people pay while others do not.

Concluding Comments

This study surveyed the opinions of law and business & economics students in Argentina. The results of the study show that, although the view that tax evasion is ethical in at least some cases has wide support, there is also a strong feeling that tax evasion is unethical in some cases. Under some circumstances, tax evasion is viewed as never or almost never ethical. This view is somewhat surprising, given the economic crisis Argentina suffered in December 2001. One would think that the people's faith in government would be lower. Apparently, it has recovered.

Most respondents were opposed to the view that tax evasion is always or almost always ethical. Average scores ranged from 4.1 to 6.6 on a 7-point scale. The strongest arguments justifying tax evasion were in cases where the system was seen as unfair, where the government was corrupt or where human rights were being violated.

The present study can be replicated in several ways. Different groups of Argentinean students could be surveyed, either in different cities or regions of Argentina or in different disciplines, such as philosophy or political science.

Comparative studies might also be made of sample populations from other Latin American countries or countries in other parts of the world. Research by Torgler (2003) indicates that results might differ by country. Conducting comparative studies could confirm the Torgler findings.

Surveying Argentinean business people might also be worthwhile, since their perception of taxation might be different than that of university students. Business owners might have different opinions than employees of business enterprises, too, and this comparison would make for an interesting study.

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15

Taxation in the Republic of Armenia: An Overview and Discussion from the Perspectives of Law, Economics and Ethics*

Robert W. McGee

Introduction

Like many economies in transition, the Republic of Armenia is in the process of adopting market-oriented policies and laws. The current tax law[1] in Armenia was passed by the National Assembly on April 14, 1997 and was signed by the President on May 12, 1997. The transition rules were quite simple. Upon taking effect, the prior law, which was passed on April 19, 1992, became void.[2]

General Provisions

The tax procedures in Armenia come from three different sources: (1) tax legislation and other laws on different types of taxes,[3] (2) government decrees,[4] and (3) legislative norms that are adopted by the Tax Inspectorate or other State administrative bodies.[5] Thus, there are some similarities and differences between the sources of tax rules in Armenia versus those in the United States and other western democracies.

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[1] Republic of Armenia, Law, Passed in the National Assembly on April 14, 1997, *About Taxes*. All references are to the English language version of the law.

[2] Article 39. Unless stated otherwise, all citations to Articles are to Articles of the tax law that was passed on April 14, 1997.

[3] Art. 2, Sec. a.

[4] Art. 2, Sec. b.

[5] Art. 2, Sec. c.

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In the United States, the legislative branch passes tax legislation. The same is true in Armenia. However, in Armenia there are also government decrees, which is not a source of tax law in the United States. The advantage of having government decrees as part of the legal process is that it allows for faster changes in the law. If something needs to be fixed, it can be fixed quickly, without the need to first gather the necessary number of votes from the legislature. The problem with allowing government decrees to have the force of law is that there is no legislative input. If those who have the authority to issue such decrees are incompetent or evil, a great deal of damage may be done. Such decrees can be used to reward friends or punish enemies. One of the strengths of the legal system in the United States is the separation of powers. The legislative branch passes the laws and the executive branch enforces them. This separation of powers doctrine[6] acts as a safeguard against government abuse. The Armenian tax system, or legal system in general, does not have this safeguard built into the system to the same extent, although there are three separate branches of government.

The third source of tax regulations, legislative norms, might be compared to Internal Revenue Code Regulations that are written by the U.S. Treasury Department and to Revenue Rulings and Revenue Procedures, which are written by the Internal Revenue Service in the United States. In Armenia, these legislative norms have the force of law. In the United States, Internal Revenue Code Regulations have the force of law, although occasionally a regulation is declared to be invalid for one reason or another. Internal Revenue Service publications like Revenue Rulings and Revenue Procedures do not have the force of law, but taxpayers who ignore them do so at their peril.

The problem with this source of law is that it is generated by the very people who are in charge of collecting the tax. Thus, there may be a tendency to interpret the law, or to make new law, that benefits the tax collector at the expense of the taxpaying public. One of the main strengths of the Separation of Powers Doctrine is that it provides a legal structure to prevent this potential abuse of power.

The Separation of Powers Doctrine has been substantially eroded in the United States, especially since the 1930s, when a number of administrative agencies were created in the executive branch. These agencies have

[6] The Separation of Powers Doctrine had its origins in the political writings of the 17th and 18th centuries. The United States was the first country to adopt it as part of its constitutional structure. The Separation of Powers Doctrine is constructed around the belief that a government that has its power divided among the executive, legislative and judicial branches has less ability to abuse power than a government that has these powers centralized in a single branch. The legislative branch makes the laws, the executive branch enforces the laws and the judicial branch interprets the laws. A system of checks and balances is thus established to minimize the amount of abuse that might otherwise take place.

grown in size and power to such an extent that the judges who would hear cases on the violation of the Separation of Powers Doctrine are afraid to declare some administrative agency unconstitutional for fear that their ruling would be used as precedent to eventually hold that all such administrative agencies that exercise legislative and judicial power are unconstitutional.[7]

The Armenian tax law states that taxes are compulsory payments, collected for state and public welfare. They are to be collected from legal and physical persons and from enterprises.[8] Those who are philosophically inclined might question the meaning of state welfare and public welfare, and whether they might be appropriate or true recipients of tax revenues.

The philosophical problem with collecting tax revenues for state welfare is that the state is supposed to represent the people, but state welfare, if such a thing exists, runs contrary to the interests of the taxpaying public. It is in the state's interest to expand its power and scope, whereas it is in the interest of individuals to keep the state small enough that it is not able to do much damage to the individuals within its borders or without. There is a built-in and irreconcilable conflict between state interests and individuals interests. At least that is true once the state grows beyond the minimal state.[9]

Collecting taxes for the public welfare is a benign enough goal. The problem is that many states collect taxes for reasons that actually harm public welfare rather than enhance it. An ideal tax, if there is one, has the sole aim of collecting revenue. The problem is that many taxes are created to further social engineering goals rather than revenue collection goals. The graduated income tax, for example, exists mostly to reduce income inequality, which is social engineering at its worst. Karl Marx advocated a graduated income tax in his Communist Manifesto as a means of destroying the free enterprise system, which he disparagingly referred to as capitalism.

Economists have made a number of utilitarian arguments against the graduated income tax.[10] It destroys incentives of the most productive people.

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[7] In the United States, a number of administrative agencies exercise both legislative and judicial power although they are in the executive branch. For example, the Internal Revenue Service, which is a subdivision of the Treasury Department, which is in the executive branch, issues pronouncements such as Revenue Rulings and Revenue Procedures, which have the force of law for all practical purposes, since a taxpayer who ignores them does so at his peril. The Treasury Department writes the regulations that expand, clarify, and sometimes alter the tax laws that the legislative branch has passed. The Internal Revenue Service also has its own court, the Tax Court, which hears and decides thousands of tax cases. It is an administrative court that is in the executive branch.

[8] Art. 3.

[9] For more on the concept of a minimal state from the philosophical perspective, see Robert Nozick, Anarchy, State and Utopia (1974).

[10] For examples, see Walter J. Blum and Harry Kalven, Jr., The Uneasy Case for Progressive Taxation (1953); F.A. Hayek, *The Case Against Progressive Income Taxes*, Freeman 229–232 (1953).

It retards economic growth by reducing the amount of capital available for investment and job creation.[11]

There is also the fairness argument. There are basically only two views of government. Either the government is the servant and the people are the masters, or the government is the master and the people are the servants. The graduated income tax is based on the view that the government is the master. As Karl Marx said, “From each according to his abilities; to each according to his needs.”[12] If government were viewed as the servant, the view might be, “From each according to the benefits received.”

Unfortunately, the tax laws of Armenia tend to be of the Marxist variety.[13] The enterprise profit tax, for example, varies between 15% and 25%, which, although lower than the rates in most countries, is, nevertheless, graduated.[14] The profit tax on gambling games and lotteries, although not graduated, is set at a confiscatory 70%.[15] Individual income taxes are assessed at three rates, 15%, 25% and 30%.[16]

The Armenian tax system engages in other forms of social engineering in addition to attempting to reduce income inequality. The excise tax law for example punishes those who sell or consume caviar, alcohol and tobacco products while rewarding those who make coats from sheep fur for employees and the army.[17]

The value added tax (VAT) is basically assessed at a single rate,[18] although there are exemptions for certain socially desirable activities and products.[19] Exports are subsidized by a zero tax rate.[20]

One concept imbedded in the Armenian tax code that might be adopted by the United States is the provision relating to when tax law changes

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[11] Keith Marsden, Links between Taxes and Economic Growth: Some Empirical Evidence (World Bank Staff Working Paper No. 605, 1983).

[12] Karl Marx, Critique of the Gotha Program (1875). The original wording was “Jeder nach seinen Fähigkeiten, jedem nach seinen Bedürfnissen.” Louis Blanc, the French socialist, said basically the same thing in 1848. George Seldes, The Great Thoughts 274 (1985).

[13] As are those of the United States and every other country that has graduated tax rates.

[14] Republic of Armenia, Law on Enterprise Profit Tax, Art. 33, Sec. 1.

[15] Republic of Armenia, Law on Enterprise Profit Tax, Art. 33, Sec. 2.

[16] The Law of the Republic of Armenia on Personal Income Tax, adopted by the National Assembly on December 27, 1997, Art. 18.

[17] The Law of the Republic of Armenia on Excise Tax, Art. 5, signed into law by the President on June 24, 1997. The tax rate on caviar is 200%. On tobacco products it is 100%. On alcohol the rate varies between 50% and 125%. The rate on coats made of sheep fur for employees or the army is zero percent.

[18] Republic of Armenia, Law on Value Added Tax, Art. 9, signed into law by the President on June 16, 1997.

[19] *Id.*, at Art. 15.

[20] *Id.*, at Art. 16.

should be made. The Armenian tax law states that changes in tax rates, the introduction or termination of a tax may generally take place only at the beginning of a fiscal year.[21] That would eliminate the need to allocate by days or to deal with the complexities that result when the rules are changed during the year, as is so often done in the United States.

The Armenian tax credit is quite simple. Taxes paid by taxpayers in Armenia shall be reduced by the amount of tax collected from the taxpayer outside Armenia.[22] This rule is much less complicated than the U.S. rule. It avoids the possibility of double-taxation.

Armenia assesses six kinds of taxes,[23] the enterprise profit tax,[24] the personal income tax,[25] the excise tax,[26] the Value Added Tax,[27] the property tax[28] and the land tax.

Rights and Responsibilities of Taxpayers: Control over Tax Payments

A taxpayer has the following rights:

a. be introduced to the results of checking his activity,[29]
b. submit to Tax Inspection explanatory notes on tax accounting, and payment,[30]
c. appeal against activities of Tax Inspectorate, as in accordance with the legislation,[31]
d. apply for obtaining tax privileges, as defined by the legislation.[32]

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[21] Art. 8.
[22] Art. 11.
[23] Art. 12.
[24] Republic of Armenia, Law on Enterprise Profit Tax, enacted by the National Assembly on September 30, 1997 and signed by the President on November 27, 1997.
[25] Law of the Republic of Armenia on Personal Income Tax, adopted by the National Assembly on December 27, 1997 and signed by the President on December 30, 1997.
[26] The Law of the Republic of Armenia on Excise Tax, signed by the President on June 24, 1997.
[27] Republic of Armenia, Law on Value Added Tax, enacted by the National Assembly on May 14, 1997 and signed by the President on June 16, 1997.
[28] Property Tax Law.
[29] Art. 14, Sec. a. Please excuse the less than perfect English here. I am working with the English translation.
[30] Art. 14, Sec. b.
[31] Art. 14, Sec. c.
[32] Art. 14, Sec. d.

A taxpayer has the following responsibilities:

a. to account income, and to submit statement of accounts,[33]
b. to account amounts of taxes to be paid, and pay them, unless envisaged otherwise by the legislation,[34]
c. to submit to Tax Inspection tax reports, and other documents, as envisaged by the legislation,[35]
d. to pay in due time taxes, and tax advances, if envisaged by the legislation,[36]
e. provide necessary conditions for checks, conducted by the Tax Inspectorate,[37]
f. submit documents, verifying his rights for tax privileges,[38]
g. to make corrections in the accounts, if errors are found during the checks conducted by Tax Inspectorate.[39]

Taxpayers have a month to register for a taxpayer identification number after receiving a taxpayer's license.[40] Tax liability is terminated upon death,[41] which is different than the treatment in the United States, where the deceased taxpayer's estate assumes responsibility for paying the tax. If a legal person or enterprise is restructured, the outstanding tax liabilities are assumed by the successor.[42]

The restructuring provision is an interesting one because it does not go into any further detail about what constitutes a restructuring. If the restructuring is by transfer of shares, it is easy to identify the old and new owners. But what if the restructuring is by the sale of assets, where the old and new owners are not quite identical? Who is liable for tax in such a case? The law is unclear.

If outstanding tax liabilities have been discovered after the liquidation of a legal person, the court may assign them to the major owners or members of management if these liabilities arose within one year of liquidation as a result of mistakes made by these persons.[43] Thus, there is a one-year statute of limitations in which to pierce the corporate veil.

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[33] Art. 15, Sec. a.
[34] Art. 15, Sec. b.
[35] Art. 15, Sec. c.
[36] Art. 15, Sec. d.
[37] Art. 15, Sec. e.
[38] Art. 15, Sec. f.
[39] Art. 15, Sec. g.
[40] Art. 15.
[41] Art. 16.
[42] *Id*.
[43] *Id*.

Which major owners or managers would be liable is not stated. Would a bookkeeper be liable, or would the bookkeeper's boss be liable? Would the president of the enterprise be liable if it was the bookkeeper who made the mistake without the president's knowledge? If the president told the bookkeeper to calculate the amount of tax liability incorrectly, would the bookkeeper be liable? Would it be joint and several liability with the right of contribution?

Questions might also arise about what constitutes a mistake. Is an underestimate of tax liability a mistake, or is it merely an underestimate? What if a mistake is discovered that, upon correction, would result in a tax refund? Who is entitled to receive the refund?

A number of questions arise because the tax law does not cover these points. Carefully worded language in the corporate charter might spell out who is entitled to a tax refund in the event of liquidation, but it is unlikely that those who draft corporate charters would think to include such a provision.

Information that is obtained illegally during the course of a tax inspection may not be used to collect taxes.[44] Thus, the tax inspector is not able to benefit by breaking the law, which reduces the incentive for doing so.

Information may not serve as the basis for accounting and collecting taxes unless the taxpayer has become familiar with it.[45] This provision provides a measure of basic fairness and also allows the taxpayer to introduce information to challenge the veracity of the information that would otherwise be used to assess and collect taxes.

Legal persons, enterprises without the status of a legal person, entrepreneurs, and state and local government bodies shall provide the Tax Inspectorate with information on the activities associated with the taxpayers, and the income paid to physical persons and taxes collected from the income, in accordance with procedures defined by legislation.[46]

Responsibility for the Violation of Tax Legislation

Taxpayers, and their management in the case of enterprises, institutions and other organizations, are responsible for the correct tax accounting and timely payment unless otherwise envisaged by legislation.[47] Taxpayers who do not submit the accounting documents, or who submit documents that do not

[44] Art. 18.
[45] Art. 19.
[46] Art. 20.
[47] Art. 22.

comply with the requirements, shall have the Tax Inspectorate perform its own accounting, based on the following:[48]

Taxpayer's assets
Taxed turnover
Expenses on the production and turnover
Inventory results
Information obtained from third persons
Prices and costs used by other persons in similar cases
Other norms set by the government

There are penalties for delay in payment. If there is a 90 day delay in paying, a fine equal to 0.1% of the total amount is assessed.[49] If payment is delayed by more than 90 days, the fine is 0.3% of the total amount of tax due.[50] For taxpayers who understand the time value of money, this provision encourages them to delay payment and invest the proceeds in some kind of income generating account.

A fine is imposed if an accounting statement is submitted more than two months late.[51] The fine is equal to 5 of the total amount due for each 15 days of delay, not to exceed the total amount due.[52]

A fine equal to 10% of the outstanding tax liability is assessed if the taxpayer either did not carry out an accounting or if the accounting was done improperly.[53] This penalty might be exceedingly harsh in some cases. For example, take the case of a taxpayer who completed 99% of the accounting properly but made a mistake on some minor item. According to the wording of this penalty provision, the taxpayer is assessed a 10% fine on the entire amount of the tax liability, when in fact the mistake that was made might have been quite minor. What if the mistake was in the government's favor? Apparently, the taxpayer would still be assessed a 10% penalty, which seems grossly unfair.[54]

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[48] *Id*.
[49] Art. 23.
[50] *Id*.
[51] Art. 24.
[52] *Id*.
[53] Art. 25.
[54] If a similar penalty provision were enacted into the U.S. tax code, it is likely that every taxpayer that is audited would have to pay the penalty. In November, 1997, for the eighth time since 1987, MONEY magazine conducted a survey of practitioners to see how accurately they were able to prepare tax returns. In the survey that was published in the March, 1998 issue, all 46 tax preparers who completed the survey made at least one mistake. For the seventh time in the history of the MONEY magazine survey, no two tax preparers came up with the same tax liability. Participants in the survey consisted of 31 certified public accountants, 12 enrolled

If an item is not included on a tax declaration, or is partially concealed, meaning not properly accounted for, the taxpayer is liable for the full amount of tax plus a 50% penalty. If the taxed object is missing or partially concealed a second time, the penalty rises to 100%.[55] There is nothing in this tax law that mentions prison as a possible penalty for concealment of tax liability.[56] However, that does not means that tax evaders cannot go to prison because there is another section in the law that states that other types of penalties and fines might be imposed if other provisions of the tax laws are violated.[57]

If the product of entrepreneurial activity, including goods and services to be delivered or sold, is not registered in accordance with procedures set forth by the government, the fine shall be equal to the total cost of production.[58] If the goods or services are sold at a price that exceeds the registered price, the fine is equal to the difference between the registered price and the actual price.[59] However, neither of these fines shall be collected if the violation occurs during a period in which the taxpayer provides an accounting declaration.[60]

Such a provision is totally missing from the U.S. tax code. In the United States there is generally no need to report prices to the government. Setting prices is seen as an activity that is none of the government's business. It is strange that a government that is trying to convert to a market system would retain such a provision.

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agents and three other individuals who prepare tax returns for a living. See Joan Caplin, *6 Mistakes Even the Tax Pros Make*, MONEY 104–106 (March 1998).

[55] Art. 27.

[56] It might be mentioned that tax evasion is widespread in Eastern Europe and the CIS countries. The main reasons for the widespread evasion are the belief that the government is corrupt and therefore not entitled to any tax revenue, and the absence of an infrastructure that lends itself to the easy reporting of taxable income or its collection. For a discussion of tax evasion in Russia, see Vladimir V. Vaguine, *The "Shadow Economy" and Tax Evasion in Russia*, in The Ethics of Tax Evasion 306–314 (Robert W. McGee, ed. 1998); for a discussion of tax evasion in Bulgaria, see Gueorgui Smatrakalev, *Walking on the Edge: Bulgaria and the Transition to a Market Economy*, in The Ethics of Tax Evasion 316–329 (Robert W. McGee, ed. 1998); for a discussion of tax evasion in Greece, see Apostolos A. Ballas and Haridimos Tsoukas, *Consequences of Distrust: The Vicious Circle of Tax Evasion in Greece*, in The Ethics of Tax Evasion 284–304 (Robert W. McGee, ed. 1998); for a sociological and cultural discussion of tax evasion, see Alfonso Morales, *Income Tax Compliance and Alternative Views of Ethics and Human Nature*, in The Ethics of Tax Evasion 242–258 (Robert W. McGee, ed. 1998).

[57] Art. 32.

[58] Art. 28.

[59] *Id*.

[60] *Id*.

Taxpayers are to pay the taxes and fines within 10 days after receiving notification from the Tax Inspectorate.[61] Failure to do so may result in seizure of the taxpayer's property.[62] The Tax Inspectorate may apply to the court for seizure.

This procedure seems harsh and subject to potential abuse. What if the Tax Inspectorate notification states a tax figure that is grossly overstated? What recourse does a taxpayer have other than paying whatever the Tax Inspectorate thinks is due? What if the amount due is a few dollars? Does the Tax Inspectorate have the right to seize all the taxpayer's property?

In the United States, the policy is much different. The Internal Revenue Service first notifies the taxpayer of the alleged deficiency. The taxpayer has 30 days to respond. A series of 30 day and 90 day letters then go back and forth. If various levels of administrative review do not resolve the issue, the taxpayer can petition the Tax Court to hear the case, or can pay the tax and sue for a refund in either the Claims Court or the appropriate federal District Court. Although there are possibilities for abuse in the U.S. tax system, the due process afforded most taxpayers minimized the potential for abuse.[63] This level of due process is absent from the Armenian tax system.

Evidence of this lack of due process may be seen in the provision that allows the Tax Inspectorate to collect even before taxes are due. There is a provision in the tax law that permits the Tax Inspectorate to collect taxes before the regular due time if there is evidence that a taxpayer with outstanding tax liabilities is destroying the objects of income or concealing income, thus making it impossible to collect taxes. The Tax Inspectorate may require the submission of accounting statements, declarations or other documents before they would ordinarily be due.[64]

Such a rule violates due process and may lead to abuse. There really are no safeguards to prevent the Tax Inspectorate from targeting anyone it wishes, merely to solicit a bribe. From conversations the author has had with numerous Armenians, tax inspectors have a reputation for soliciting bribes. Based on the opinions of the average Armenian, it could be concluded that the average tax inspector is more likely than not to be a bribe taker. Some people

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[61] Art. 29.

[62] Art. 30.

[63] Although the system in the U.S. goes a long way toward eliminating abuse by tax authorities, it has not been able to eliminate abuses. One member of Congress wrote a book that documents some of the many IRS abuses. See George Hansen, To Harass Our People: The IRS and Government Abuse of Power (1984). Also see David Burnham, A Law onto Itself: Power, Politics and the IRS (1989).

[64] Art. 31.

become tax inspectors for that very reason, since the pay is low and the opportunity for making extra income is great.[65]

Getting a Refund

If a taxpayer is entitled to a tax refund, the amount of the refund will be netted with other tax obligations and refunded to him within 30 days after the receiving the application from the taxpayer.[66] There is a special procedure for refunding excess VAT and excise taxes.[67]

If an employer does not withhold taxes for employees, the amount of tax due may be collected from the employer.[68] The exact language of the English language translation reads as follows:

> If an employer does not collect (keep) taxes from the employee in due time, the amounts shall be collected from the employer after discovery, for a period not exceeding the last three months, and the remaining tax obligations shall be covered by the employer.[69]

If the employer withholds too much from the employee's wages, the excess shall be returned within 30 days after discovery, for the period of the previous three years.[70]

Taxpayers who incur a loss as the result of the Tax Inspectorate's violations shall be reimbursed in accordance with legal procedure.[71] This provision is much better than the provision in the U.S. tax code. In the United States, the IRS can unjustly confiscate a taxpayer's house and sell it for ten cents on the dollar. If it later turns out that the house was wrongly confiscated and sold, the taxpayer is only entitled to the ten cents the IRS collected, not the market value of the house. Worse yet, the taxpayer might have to sue the IRS to get even that. In one case, a taxpayer who was entitled to such a refund

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[65] The opportunity to earn a good living from bribes is not limited to tax inspectors. The author has heard of numerous cases of bribe taking by army officials. It is a common practice for soldiers to kidnap a family member and hold her/him hostage until the boy in the family who is of army age either appears for duty or pays a bribe. Police are also notorious for soliciting bribes. On the way from the airport to my hotel after arriving in Yerevan, my driver had to pull over to pay a bribe to a policeman who was monitoring traffic leaving the airport. I was told the practice of pulling cars over is a common one.

[66] Art. 33.

[67] *Id*.

[68] Art. 34.

[69] *Id*.

[70] *Id*.

[71] Art. 35.

had to agree not to sue the IRS as a condition of having the property returned, even after the court said that the taxpayer was entitled to a refund.[72]

Other Provisions

Taxpayers may appeal activities of the Tax Inspectorate officers to the senior body within the Tax Inspectorate within 30 days.[73] A decision regarding the appeal shall be made within thirty days thereafter. Appeals against these decisions may be appealed to a higher body or to the court within one month after receiving notification.[74] The taxpayer and/or his representative may be present during the examination of the appeal.[75] An appeal against the activities of the Tax Inspection officers does not suspend further collection of taxes. However, the tax body that examines the appeal may suspend tax collection until a decision is made.[76]

The provision of an international agreement take precedence over the provisions of the tax law for those international agreements that were entered into after the current law was passed.[77] The previous procedures will be effective for international agreements signed before the current tax law took effect.[78]

Concluding Comments

For one who is familiar with the U.S. tax code, one is struck by the relative simplicity of the Armenian tax law. The Armenian tax law has little or no complexity compared to the mammoth U.S. tax law, which has evolved over more than eight decades.[79] On the other hand, there is not nearly as much guidance, which leaves room for interpretation. But the U.S. tax code also leaves a lot of room for much interpretation. The Armenian tax system has some provisions that could lead to abuse and there are inadequate safeguards to prevent abuse. The U.S. tax system has safeguards, but IRS officials have

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[72] For numerous documented cases of IRS abuse, see George Hansen, To Harass Our People: The IRS and Government Abuse of Power (1984). Also see David Burnham, A Law onto Itself: Power, Politics and the IRS (1989).

[73] Art. 36.

[74] *Id*.

[75] *Id*.

[76] Art. 37.

[77] Arts. 38 and 44.

[78] Art. 44.

[79] The Sixteenth Amendment to the U.S. Constitution, which made an income tax constitutional, was passed in 1913.

often ignored those safeguards and have abused the law on numerous occasions. Such abuses have led Congress to pass several Taxpayers' Bill of Rights legislation. So even if the Armenian legislature amended the tax law to include safeguards, just having them on the books might not be sufficient to prevent abuses. But it might help.

Armenian tax rates are lower than those in most other countries. Thus, Armenia is at a competitive advantage, all other things being equal. All other things are not equal, of course. After the breakup of the Soviet Union there remains a bit of an anti-capitalistic mentality, which impedes investment and economic growth. This mentality is present in all countries to a certain extent. However, it is more prevalent in former Soviet countries, especially those that became part on the Soviet Union in the early days, as Armenia did.[80] Fortunately, Armenia does not seem to be infected by this anticapitalistic virus to the same extent as most other countries of Eastern Europe and the CIS that I have visited. One hesitates to say that Armenians have entrepreneurship in their blood without empirical evidence and scientific studies of genes to back up the statement, but it seems to be true. After the 1915 diaspora brought on by the Turkish genocide, Armenians fled to the Middle East, Europe, North America and elsewhere. Many of them became quite successful in business.

There is also rampant corruption. As mentioned previously, tax officials, the police and the army are known for taking bribes. Someone told me that a World Bank study lists Armenia as the eighth most corrupt government on earth. However, I do not have that study at my fingertips and do not know how that ranking was arrived at, and so am unable to give a citation.[81] Corruption deters some foreign investment but not all foreign investors refuse to invest in countries that are corrupt. Some investors probably prefer such an environment.

Foreign investors hesitate to invest in a company that does not issue financial statements that they can place confidence in. Armenia has gone a long way toward eliminating that competitive disadvantage by the partial adoption of International Accounting Standards. It adopted 15 International Accounting Standards toward the end of 1998 and has plans to adopt most or all of the rest of them within the next two years. Some officials in the Tax Inspectorate resent that they were not consulted before the adoption process

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[80] For more on this phenomenon, see Ludwig von Mises, The Anti-Capitalistic Mentality (1956); Robert Sheaffer, Resentment against Achievement: Understanding the Assault upon Ability (1988); Helmut Schoeck, Envy: A Theory of Social Behaviour (1966).

[81] If there is such a study, one wonders why the World Bank would be so eager to lend (give, actually, since no one ever really repays those World Bank loans) money to such a corrupt government.

was in the final stages.[82] One of these officials, who claims to be a “certified” accountant, stated to me that there is no need for international accounting standards. The Armenian accounting system is fine just the way it is. Some of the people who were involved in the adoption of International Accounting Standards in Armenia are concerned that tax inspectors will punish Armenian companies once they convert their internal accounting records and procedures to comply with International Accounting Standards. The tax inspectors do not have any training in International Accounting Standards, they do not understand them, and what they do not understand they will not approve. The accountants who work in the private sector also are not familiar with the International Accounting Standards, for the most part. How the accounting community of a whole country can get up to speed on International Accounting Standards in a short period of time will be quite a feat. But they are trying, as are the accountants in a number of CIS republics.

[82] The USAID project dealing with accounting reform in Armenia worked with another office in the Finance Ministry. Officials in the Tax Inspectorate did not learn that Armenia was going to adopt International Accounting Standards until it was a done deal.

16

Opinions on Tax Evasion in Armenia

Robert W. McGee and Tatyana B. Maranjyan

Introduction

The vast majority of articles that have been written about tax evasion have been written from the perspective of public finance. They discuss technical aspects of tax evasion and the primary and secondary effects that tax evasion has on an economy. In many cases there is also a discussion about how to prevent or minimize tax evasion. Very few articles discuss ethical aspects of tax evasion. Thus, there is a need for further research, which the present study is intended to partially address.

As part of this study a survey instrument was developed based on the issues that have been discussed and the arguments that have been made in the tax evasion ethics literature over the last 500 years. Similar survey instruments were used to test sample populations in Romania (McGee 2005b) and Guatemala (McGee and Lingle 2005). The survey was also distributed to professors of international business (McGee 2005a). The present study reports on the findings of a survey that was distributed to business and theology students in Yerevan, Armenia.

Review of the Literature

Although many studies have been done on tax compliance, very few have examined compliance, or rather noncompliance, primarily from the perspective of ethics. Most studies on tax evasion look at the issue from a public finance or economics perspective, although ethical issues may be mentioned briefly, in passing. Two books by McGee (1998a 2004) provide comprehensive reviews of the literature on this topic, so we will not attempt to duplicate those reviews here. But a few studies are worth mentioning.

R.W. McGee (ed.), *Taxation and Public Finance in Transition and Developing Economies*,
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One of the most comprehensive twentieth century works on the ethics of tax evasion was a doctoral thesis written by Martin Crowe (1944), titled *The Moral Obligation of Paying Just Taxes*. This thesis reviewed the theological and philosophical debate that had been going on, mostly within the Catholic Church, over the previous 500 years. Some of the debate took place in the Latin language. Crowe introduced this debate to an English language readership. A more recent doctoral dissertation on the topic was written by Torgler (2003), who discussed tax evasion from the perspective of public finance but also touched on some psychological and philosophical aspects of the issue.

There have been a few studies that focus on tax evasion in a particular country. Ethics are sometimes discussed but, more often than not, the focus of the discussion is on government corruption and the reasons why the citizenry does not feel any moral duty to pay taxes to such a government. Ballas and Tsoukas (1998) discuss the situation in Greece. Smatrakalev (1998) discusses the Bulgarian case. Vaguine (1998) discusses Russia, as do Preobragenskaya and McGee (2004) to a lesser extent. A study of tax evasion in Armenia (McGee 1999b) found the two main reasons for evasion to be the lack of a mechanism in place to collect taxes and the widespread opinion that the government does not deserve a portion of a worker's income.

A number of articles have been written from various religious perspectives. Cohn (1998) and Tamari (1998) discuss the Jewish literature on tax evasion and on ethics in general. Much of this literature is in Hebrew or a language other than English. McGee (1999a) comments on these two articles from a secular perspective.

A few articles have been written on the ethics of tax evasion from various Christian viewpoints. Gronbacher (1998) addresses the issue from the perspectives of Catholic social thought and classical liberalism. Schansberg (1998) looks at the Biblical literature for guidance. Pennock (1998) discusses just war theory in connection with the moral obligation to pay just taxes, and not to pay unjust or immoral taxes. Smith and Kimball (1998) provide a Mormon perspective. McGee (1998c, 1999a) comments on the various Christian views from a secular perspective.

The Christian Bible discusses tax evasion and the duty of the citizenry to support the government in several places. Schansberg (1998) and McGee (1994, 1998a) discuss the biblical literature on this point. When Jesus is asked whether people should pay taxes to Caesar, Jesus replied that we should give to Caesar the things that are Caesar's and give God the things that are God's [Matthew 22:17, 21]. But Jesus did not elaborate on the point. He did not say that we are only obligated to give government 10% or 5% or any particular percent of our income.

There are passages in the Bible that seemingly take an absolutist position. Romans 13, 1–2 supports the Divine Right of Kings, which basically holds that whoever is in charge of government is there with God's approval and anyone who disputes that fact or who fails to obey is subject to damnation. It is a sin against God to break any law. Thus, Mao, Stalin and Hitler must all be obeyed according to this view, even though they were the biggest monsters of the twentieth century, because they are there with God's approval.

A few other religious views are also addressed in the literature. Murtuza and Ghazanfar (1998) discuss the ethics of tax evasion from the Muslim perspective. McGee (1998b 1999a) comments on their article and also discusses the ethics of tax evasion under Islam citing Islamic business ethics literature (McGee 1997). DeMoville (1998) discusses the Baha'i perspective and cites the relevant literature to buttress his arguments. McGee (1999a) commented on the DeMoville article.

The present study has been replicated and will be replicated several more times using different groups of respondents. A survey of international business professors found that some arguments justifying tax evasion are stronger than others but none of the arguments were very strong, since most of the professors who responded to the survey were strongly against tax evasion. This survey also found that women were significantly more opposed to tax evasion than were the men (McGee 2005a). A survey of business and law students in Guatemala reached a similar result. However, the law students felt less strongly about condemning tax evasion on ethical grounds than did the business students and female students were more opposed to tax evasion than were male students (McGee and Lingle 2005). A survey of Romanian business students (McGee 2005b) found that respondents often felt tax evasion was ethically justified. Males were slightly more opposed to tax evasion than were women. A survey of German business students also found that respondents were strongly against tax evasion, although some arguments were stronger than others. A comparison of male to female responses was inconclusive, in the sense that it could not be clearly determined which group of respondents was more opposed to tax evasion (McGee et al. 2005).

Three Views on the Ethics of Tax Evasion

Over the centuries, three basic views have emerged on the ethics of tax evasion.

View One

View One takes the position that tax evasion is always, or almost always unethical. There are basically three underlying rationales for this belief. One reason is the belief that individuals have a duty to the state to pay whatever taxes the state demands (Cohn 1998; DeMoville 1998; Smith and Kimball, 1998; Tamari 1998). This view is especially prevalent in democracies, where there is a strong belief that individuals should conform to majority rule.

The second rationale for an ethical duty to pay taxes is because the individual has a duty to other members of the community (Crowe 1944; Cohn 1998; Tamari 1998). This view holds that individuals should not be freeloaders by taking advantage of the services the state provides while not contributing to the payment of those services. A corollary of this belief is the view that if tax dodgers do not pay their fair share, then law abiding taxpayers must pay more than their fair share.

The third rationale is that we owe a duty to God to pay taxes, or, stated differently, God has commanded us to pay our taxes (Cohn 1998; DeMoville 1998; Smith and Kimball 1998; Tamari 1998). This view holds no water among atheists, of course, but the view is strongly held in some religious circles.

View Two

View Two might be labeled the anarchist view. This view holds that there is never any duty to pay taxes because the state is illegitimate, a mere thief that has no moral authority to take anything from anyone (Block 1989, 1993). The state is no more than a mafia that, under democracy, has its leaders chosen by the people.

The anarchist literature does not address the ethics of tax evasion directly but rather discusses the relationship of the individual to the state. The issue of tax evasion is merely one aspect of that relationship (Spooner 1870).

There is no such thing as a social contract according to this position. Where there is no explicit agreement to pay taxes there also is no duty. All taxation necessarily involves the taking of property by force or the threat of force, without the owner's permission. Thus, it meets the definition of theft. Stated as an equation, TAXATION = THEFT. A corollary equation is that FAIR SHARE = 0.

View Three

View Three holds that tax evasion may be ethical under some circumstances and unethical under other circumstances. This view is the prevalent view, both in the literature (Ballas and Tsoukas 1998; Crowe 1944; Gronbacher 1998; McGee 1998a, 1999b) and according to the results of some of the surveys (McGee 2005a, b; McGee and Lingle 2005).

Tax Evasion in Armenia

A few studies have examined taxation in Armenia. Joulfaian and Melikyan (2004) discussed taxes, investment incentives and the cost of capital in Armenia. McGee (2000) discussed taxation in Armenia from the perspectives of law, economics and ethics.

Tumanyan (2003) cites the following main reasons for tax evasion in Armenia:

- The existence of a shadow economy,
- Corruption,
- Low level of legislative performance (legislative discipline),
- Insufficient tax database accounting,
- Insufficient financial, professional, technical and technological equipment for the administration of taxes.

He goes on to say that, according to some estimates, the shadow economy constitutes 50–70% of Armenia's total economy. Low government salaries contribute to the corruption problem. Corruption in the tax and customs offices is widespread. Voskanyan (2000, p. 49) lists low salaries as the main reason for corruption, followed closely by lack of punishment mechanisms. Tunyan (2005) cites a study that estimates the size of Armenia's shadow economy to be about 29%. Davoodi and Grigorian (2006) examine the factors behind the stubbornly low tax collection in Armenia. Alaverdyan and Balayan (2006) discuss current legislative and administrative issues relating to the value added tax system in Armenia. Iarossi et al. (2006) discuss Armenia's tax system as a major obstacle to doing business.

A joint White Paper by the American and European Union Chambers of Commerce in Armenia (2003) also mentions corruption, inefficiency and the feeling of unfairness as problems faced by the Armenian tax system. Many respondents to their survey said they do not request tax refunds for fear of being audited.

McGee (1999b) conducted a series of interviews with Armenian taxpayers to learn what their thoughts were on tax evasion. He was unable to find anyone who rigorously supported strict punishment for evaders. Most of the individuals he spoke to either were evading taxes or would evade them if they could. The two main reasons for evasion according to this study were the lack of a mechanism in place to collect taxes and the widespread feeling that there was no moral duty to pay taxes to a government that is corrupt and does nothing for the people.

People fear the Tax Inspectorate, even within the Finance Ministry, which is nominally in charge of the Tax Inspectorate. It seemingly reports to no one and is viewed as corrupt and full of bribe takers.

The author heard several stories of major bribe taking and shakedowns of taxpayers. In one case, a young man paid several thousand dollars to a general in order to purchase a lifetime exemption from the army. On another occasion, some soldiers kidnapped the mother of someone who was of military age so they could shake down the son for a bribe in return for not being taken into the army, even though the son was legally exempt. One middle aged woman had to pay a bribe to some government officials in order to keep her home. The officials threatened to move another family into her house because they deemed it to be to large for just one family. They went away when she paid the bribe.

One of the more visible signs of corruption is traffic police, who waive people over to the side of the road on a routine basis, not because they broke a law or for traffic control purposes, but merely so they can solicit a small bribe.

With government corruption like this going on it is no wonder that the citizenry does not feel morally compelled to pay taxes. This situation will not change as long as the government continues to engage in corrupt practices.

Survey Results

Methodology

A survey instrument using a seven-point Likert scale was translated into Armenian and distributed to groups of business and philosophy students in Yerevan, Armenia, the capital city. The survey consisted of 14 statements, which included the main issues regarding the ethics of tax evasion that have been debated in the theological and philosophical literature over the last 500 years (Crowe 1944). Participants were instructed to place a number from 1–7 in the space provided to indicate the extent of their agreement or disagreement with each statement. They were instructed to place a 1 in the space if they strongly agreed with the statement and 7 to indicate strong disagreement.

This kind of survey research is relatively new in Armenia. It was at times difficult to get approval to distribute the survey instrument. One administrator accused the person collecting the data of being a CIA agent who wanted to show the people of Armenia in a bad light. Permission to distribute was sometimes denied. However, it was possible to get a total of 85 responses, 52 from business students and 33 from theology students. The following hypotheses were made:

H1: Both groups will fall into the category that believes tax evasion is *sometimes* ethical. *Sometimes*, for purposes of this hypothesis, is defined as having an average score that is more than 2 but less than 6. Tax evasion is considered to be *always or almost always ethical* for scores that are 2.00 or less. Tax evasion is considered to be *never or almost never ethical* for scores that are 6.00 or higher.

H2: The scores for the theology students will be higher [theology students will be more opposed to tax evasion] than the scores for the business students.

H3: Theology students will be more opposed to tax evasion [will have higher scores for at least 8 of the 14 statements] than will business students.

H4: The responses of the two groups will be significantly different at the 5% level for at least 7 of the 14 statements.

H5: Statements that allege corruption or unfairness will have lower scores [evasion will be more acceptable] than questions that have a selfish motive.

Table 1 shows the sources of the data.

Table 1
Participant Profiles

Finance and Banking College	15
Moscow State University of Economics, Statistics and Informatics, Yerevan Branch	31
Members of the Association of Accountants and Auditors of Armenia	6
Total business	52
Theology students, Yerevan State University	33
Total	85

Findings

H1: Both groups will fall into the category that believes tax evasion is *sometimes* ethical. *Sometimes*, for purposes of this hypothesis, is defined as having an average score that is more than 2 but less than 6. Tax evasion is considered to be *always or almost always ethical* for scores that are 2.00 or less. Tax evasion is considered to be *never or almost never ethical* for scores that are 6.00 or higher.

H1: Accepted. Of the 28 scores summarized in Table 2, 25 fell into the category of *sometimes ethica*l; 3 scores were in the *never or almost never* category. The overall average (4.54) and the averages for both the theology students (4.40) and business students (4.64) were more than 2.00 but less than 6.00.

For some reason, business people are considered to be less moral than people in other occupations and professions. They are often depicted negatively in films and novels, more so than are members of other occupations and professions. Very seldom is a medical doctor, pharmacist, scientist or teacher put on the defensive and asked to defend his or her moral standing in the community. Yet business people are put on the defensive constantly. Various philosophers over the years have suggested that it is improper to view business people as less moral than other members of the community (Chesher and Machan 1999; Rand 1967), yet the perception remains.

If one begins with the presumption that tax evasion is unethical at least sometimes, then, given this bias against business people, one would expect that business people would view tax evasion more favorably than would other groups. Theologians are generally considered to be more moral than the average member of the community. Thus, one would expect theologians to be more strongly opposed to tax evasion than are other groups. If we use business students as surrogates for business people and theology students as surrogates for theologians, we can test this hypothesis.

H2: The scores for the theology students will be higher [theology students will be more opposed to tax evasion] than the scores for the business students.

H2: Rejected. The average score for theology students (4.40) was lower than the average score for business students (4.64), indicating that business students, and perhaps business people in general, are more ethical than theology students and, presumably, theologians.

Table 2 shows the average scores, both overall and for each group.

Table 2
Average Scores
(1 = strong agreement; 7 = strong disagreement)

S#		Overall	Theology (sample size 33)	Business (sample size 52)
1	Tax evasion is ethical if tax rates are too high.	3.71	3.67	3.73
2	Tax evasion is ethical even if tax rates are not too high.	5.64	5.03	6.02
3	Tax evasion is ethical if the tax system is unfair.	2.75	2.69	2.79
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.51	3.42	3.56
5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.65	5.55	5.71
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	3.80	3.78	3.81
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.29	5.30	5.29
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.41	5.00	5.67
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	4.80	4.18	5.19

10	Tax evasion is ethical if everyone is doing it.	4.99	4.76	5.13
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.01	3.12	2.94
12	Tax evasion is ethical if the probability of getting caught is low.	4.65	4.44	4.79
13	Tax evasion is ethical if I can't afford to pay.	4.33	4.55	4.19
14	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.06	6.06	6.06
	Average score for all 14 Statements	4.54	4.40	4.64

Chart 1 illustrates the relative scores.

Another way to test the relative views of the two groups would be to compare individual scores for each statement. Table 3 makes that comparison.

H3: Theology students will be more opposed to tax evasion [will have higher scores for at least 8 of the 14 statements] than will business students.

H3: Rejected. As can be seen from Table 3, scores for the business students were higher for 10 of the 14 statements. Theology students had higher scores on only 3 occasions. Scores were the same for S14. Not only were the business scores generally higher, indicating stronger opposition to tax evasion, but the degree of difference was also more for the business students, who scored an average of 0.39 points higher, compared to only 0.18 points in cases where the theology scores were higher.

Table 3
Intergroup Comparison of Scores
(1 = strong agreement; 7 = strong disagreement)

S#		Score		Score larger by	
		Theology	Business	Theology	Business
1	Tax evasion is ethical if tax rates are too high.	3.67	3.73		0.06
2	Tax evasion is ethical even if tax rates are not too high.	5.03	6.02		0.99
3	Tax evasion is ethical if the tax system is unfair.	2.69	2.79		0.10
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.42	3.56		0.14
5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.55	5.71		0.16
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	3.78	3.81		0.03
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.30	5.29	0.01	
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.00	5.67		0.67
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	4.18	5.19		1.01
10	Tax evasion is ethical if everyone is doing it.	4.76	5.13		0.37
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.12	2.94	0.18	

12	Tax evasion is ethical if the probability of getting caught is low.	4.44	4.79		0.35
13	Tax evasion is ethical if I can't afford to pay.	4.55	4.19	0.36	
14	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.06	6.06		
	Average score for all 14 Statements	4.40	4.64		
	Larger on average by			0.18	0.39

While the difference between the business and theology students is significant, based on the definition of significance that was chosen [higher scores for 8 out of 14 statements], there are other ways to measure significance. Although statistical techniques have been criticized as being based on questionable assumptions, like the unproven but assumed existence of a bell shaped curve (Raimondo 2000, pp. 35–36), they are frequently used to determine significance. We therefore decided to use an unpaired t-test to measure significance. The results are summarized in Table 4.

H4: The responses of the two groups will be significantly different at the 5% level for at least 7 of the 14 statements.

H4: Rejected. As can be seen from Table 4, most responses were not statistically significant at the 5% level. S2 was the most statistically significant, followed by S9 and S8.

At first it was difficult to find an acceptable explanation for why the theology students were less opposed to tax evasion than were the economics students. However, when an earlier version of this paper was presented at a conference on Armenia, several participants explained that theology was a business in Armenia. The tenor of the conversations seemed to indicate that there was a certain amount of cynicism regarding the perception of religious fervor of some members of the Armenian Orthodox Church. If that were indeed the case, then it would explain why the theology student scores were lower than the economics students' scores. Another possible explanation might be that theology students were predominantly male whereas economics students were more mixed in terms of gender. However, for this explanation to be valid, one must begin with the assumption that men are less opposed to tax evasion than are women. Some studies have found this assumption to be valid while other studies have found it to be invalid (McGee 2006g).

Table 4
Statistical Data

S#		Probability, assuming null hypothesis	t-test	SD
1	Tax evasion is ethical if tax rates are too high.	0.904	0.121	2.38
2	Tax evasion is ethical even if tax rates are not too high.	0.024	2.30	1.93
3	Tax evasion is ethical if the tax system is unfair.	0.849	0.191	2.36
4	Tax evasion is ethical if a large portion of the money collected is wasted.	0.790	0.268	2.24
5	Tax evasion is ethical even if most of the money collected is spent wisely.	0.726	0.351	2.13
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	0.960	0.497E–01	2.37
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	0.975	–0.309E–01	2.12
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	0.114	1.60	1.89
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	0.054	1.95	2.33
10	Tax evasion is ethical if everyone is doing it.	0.466	0.732	2.31
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	0.740	–0.333	2.42
12	Tax evasion is ethical if the probability of getting caught is low.	0.462	0.739	2.11
13	Tax evasion is ethical if I can't afford to pay.	0.508	–0.665	2.39
14	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	0.993	–0.882E–02	1.48

Table 5 ranks the statements, from strongest arguments favoring tax evasion to weakest.

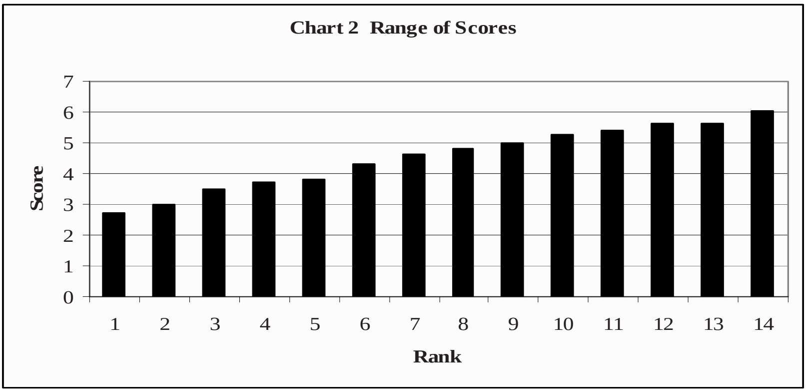
H5: Statements that allege corruption or unfairness will have lower scores [evasion will be more acceptable] than questions that have a selfish motive.

H5: Accepted. The statement that directly addresses corruption was ranked #2. S4 (R#3) could also be considered to be a corrupt reason, or perhaps an unfair reason. Other statements expressing unfairness were ranked 1, 4, 5 and 6. Statements expressing a selfish motive were ranked 8, 10, 11, 12, 13 and 14.

Table 5
Ranking of the Arguments
(1 = strong agreement; 7 = strong disagreement)

Rank		Score
1	Tax evasion is ethical if the tax system is unfair. (S3)	2.75
2	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. (S11)	3.01
3	Tax evasion is ethical if a large portion of the money collected is wasted. (S4)	3.51
4	Tax evasion is ethical if tax rates are too high. (S1)	3.71
5	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of. (S6)	3.80
6	Tax evasion is ethical if I can’t afford to pay. (S13)	4.33
7	Tax evasion is ethical if the probability of getting caught is low. (S12)	4.65
8	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me. (S9)	4.80
9	Tax evasion is ethical if everyone is doing it. (S10)	4.99
10	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects. (S7)	5.29
11	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me. (S8)	5.41
12	Tax evasion is ethical even if tax rates are not too high. (S2)	5.64
13	Tax evasion is ethical even if most of the money collected is spent wisely. (S5)	5.65
14	Tax evasion is ethical even if it means that if I pay less, others will have to pay more. (S14)	6.06

Chart 2 shows the range of scores.



The survey results revealed that there is a widespread perception in Armenia that tax evasion is ethical in at least some cases. If that were not the case, then scores would all hover around 7.00. The fact that the average score is 4.40 for theology students and 4.64 for business and economics students indicates that the perception that tax evasion is not unethical at least sometimes is pervasive.

Comparing the scores for some particular arguments might be worthwhile. For example, S4 stated that tax evasion would be ethical if the money is wasted. It received a score of 3.51 and ranked 3rd. S5 stated that tax evasion is ethical even if most of the money collected is spent wisely. Its score was 5.65 and its rank was 13th. Thus, its score was about 61 percent higher than the score for S4. A test of significance found this difference to be significant at the one percent level (p<= 2.385e–09).

One might also compare the scores for S1 (Tax evasion is ethical if rates are too high.) with S2 (Tax evasion is ethical even if rates are not too high). Their scores were 3.71 and 5.64, respectively, a difference of 52%. This difference was also significant at the one percent level (p<= 7.528e–08).

Comparing average scores tell a lot about perceptions of tax evasion but they don't tell the whole story. A statement can have an average of 4.00 if all the responses were 4 but it can also have an average of 4.00 if half of the respondents selected 7 and the other half selected 1. One way to approach this "average" problem would be to calculate the percent of total responses that list tax evasion as always or almost always unethical. These calculations are shown in Table 6. For purposes of analysis we have defined "always or almost always unethical" to be scores of 6 or 7; never or almost never unethical to be scores of 1 or 2; and "sometimes ethical" to be scores of 3, 4 or 5. The numbers in each column represent percentages of the total.

Table 6
Comparison of Responses

S#		% always or almost always ethical (1–2)	% Sometimes ethical (3-4-5)	% Never or almost never ethical (6–7)
1	Tax evasion is ethical if tax rates are too high.	38.8	29.4	31.8
2	Tax evasion is ethical even if tax rates are not too high.	14.1	20.0	65.9
3	Tax evasion is ethical if the tax system is unfair.	64.3	11.9	23.8
4	Tax evasion is ethical if a large portion of the money collected is wasted.	42.4	30.5	27.1
5	Tax evasion is ethical even if most of the money collected is spent wisely.	16.3	12.8	70.9
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	32.1	36.9	31.0
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	16.5	21.1	62.4
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	9.4	31.8	58.8
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	25.9	20.0	54.1

10	Tax evasion is ethical if everyone is doing it.	22.4	23.5	54.1
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	55.3	21.2	23.5
12	Tax evasion is ethical if the probability of getting caught is low.	20.2	39.3	40.5
13	Tax evasion is ethical if I can't afford to pay.	28.2	30.6	41.2
14	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	3.5	21.2	75.3
	Number of times category ranked #1	4	1	9
	% ranked #1	28.6	7.1	64.3

When this approach is taken the amount of support for each of the three positions becomes highlighted. The statement having the largest degree of support for the "never or almost never" ethical viewpoint is S14, with 75.3% of the total responses. That statement was that tax evasion is ethical even if it means that if I pay less, others will have to pay more. This response shows that there is a strong degree of disagreement with that view, or, stated alternatively, there is strong support for the position that there is a duty to pay taxes because of a duty to fellow taxpayers, not necessarily because there is a duty to the state.

The next highest score in the "never or almost never" category, with a percentage response of 70.9, was statement 5—Tax evasion is ethical even if most of the money collected is spent wisely. In other words, a strong majority of people believe that it is never or almost never ethical to evade taxes if the proceeds are spent on worthy projects.

At the other end of the spectrum are the statements where a large percentage of taxpayers believe it is never or almost never unethical to evade taxes—the 1 or 2 response. The largest majority of 1 or 2 responses were for statement 3, which had 64.3% of the vote—Tax evasion is ethical if the tax system is unfair. Thus, unfairness provides a very strong justification for evading taxes for a large majority of the population.

Table 7
Comparison with Other Tax Evasion Studies
(1 = not opposed to tax evasion; 7 = strongly opposed)

Rank	Group Surveyed	Score
1	Chinese Business & Economics Students [Wuhan] (McGee and Guo 2006)	4.10
1	Moldova Students (McGee and Carasciuc 2006)	4.10
3	Lebanese Business Students (McGee and M'Zali 2006b)	4.17
4	Ukrainian Business & Economics Students (Nasadyuk and McGee 2006a)	4.31
5	Lebanese EMBA Students (McGee and M'Zali 2006a)	4.36
6	**Armenian Theology Students**	**4.40**
6	Chinese Business & Economics Students [Beijing] (McGee and Yuhua 2006)	4.40
8	Ukrainian Law Students (Nasadyuk and McGee 2006b)	4.42
9	Romanian Business Students (McGee 2005b)	4.59
10	**Armenian Economics Students**	**4.64**
11	Polish Business & Economics Students (McGee and Bernal 2006)	4.70
11	Chinese Philosophy Students [Wuhan] (McGee and Guo 2006)	4.70
11	Canadian Business Students [Quebec] (McGee and M'Zali 2006e)	4.70
14	Taiwan Business Students (McGee and Andres 2006)	4.72
15	Mali EMBA Students (McGee and M'Zali 2006c)	4.73
16	Chinese Law Students [Wuhan] (McGee and Guo 2006)	4.80
17	French EMBA Students (McGee and M'Zali 2006f)	4.86
18	German Business Students (McGeeet al. 2005)	4.90
18	Guatemalan Law Students (McGee and Lingle 2005)	4.90
20	Slovak Business Students (McGee and Tusan 2006)	4.91
21	Thailand Accounting Students (McGee 2006c)	4.94
21	Macau Business Students (McGee et al. 2006)	4.94
23	Hong Kong Business & Economics Students (McGee and Ho 2006)	5.00
24	Hong Kong Business Students (McGee and Butt 2006)	5.02
25	Guangzhou [Southern China] (McGee and Noronha 2006)	5.03
25	Bosnian Business & Economics Students (McGee et al. 2006)	5.03
27	Danish Business Students (McGee 2006a)	5.08
28	Argentinean Law Students (McGee and Rossi 2006)	5.20
29	Guatemalan Business Students (McGee and Lingle 2005)	5.30
30	Philosophy Professors (McGee 2006b)	5.36

31	International Business Professors (McGee 2005a)	5.55
32	Orthodox Jews (McGee and Cohn 2006)	5.57
32	Canadian MBA Students [Quebec] (McGee and M'Zali 2006d)	5.57
34	Hong Kong Accounting Students (McGee and Ho 2006)	5.60
34	Argentinean Business & Economics Students (McGee and Rossi 2006)	5.60
36	Seventh Day Adventist Ministers (McGee 2006d)	5.74
37	Southern Baptist Religious Studies Students (McGee 2006e)	6.09
38	Utah Business Students (McGee and Smith 2006a)	6.10
39	Mormons (McGee and Smith 2006b)	6.19
40	Episcopal Seminarians (McGee 2006f)	6.45
40	Accounting Practitioners (McGee and Maranjyan 2006)	6.45

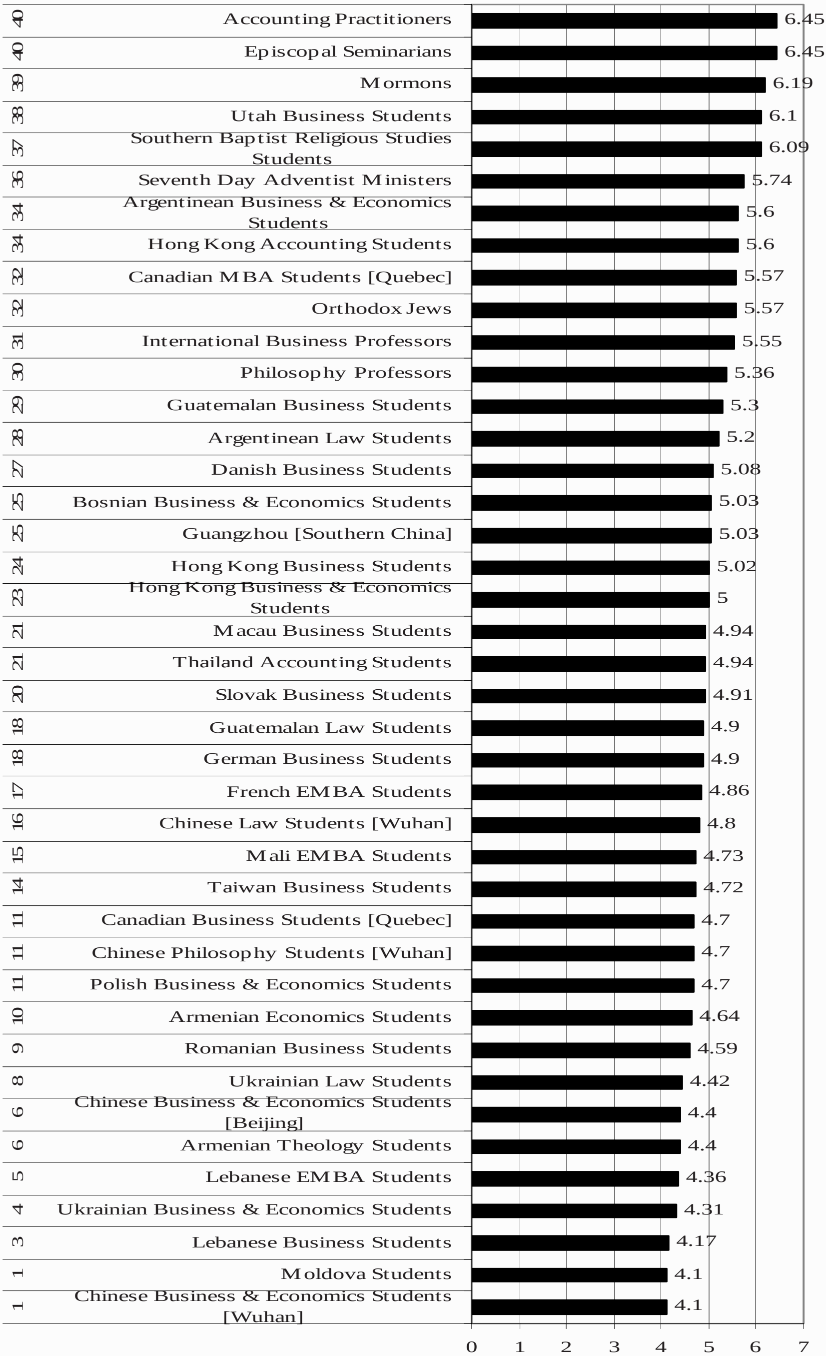
The second highest score in the "always or almost always" category was statement 11 with 55.3% of the total vote—Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. This argument concerns both corruption and unfairness.

Surprisingly, the "sometimes" category had the highest percentage of adherents only once out of 14 statements, or 7.1% of the time. The two dominant positions were "never or almost never" (64.3% of the time ranked #1) and the "always or almost always" category (28.6% of the time ranked #1).

How do Armenian perceptions compare to perceptions in other countries? Similar surveys were conducted in several other countries and among several other groups, making it possible to do comparisons. Those comparisons are given in Table 7.

Table 7 clearly shows that the two Armenian groups surveyed scored lower than most other groups, indicating less aversion to tax evasion than most of the other groups surveyed. Armenian theology students ranked 6th and Armenian economics students ranked 10th out of the 41 studies. The only groups surveyed that were less averse to tax evasion than Armenian theology students were business and economics students in Central China, Moldovan, Ukrainian and Lebanese students. Chart 3 illustrates the relative rankings of the various studies.

Chart 3 Comparison of Studies



Corruption

Since corruption was one of the strongest reasons given for justifying tax evasion, the decision was made to compare the level of corruption in Armenia to corruption levels in other former Soviet republics. The 2005 Corruption Perceptions Index, which measures and ranks corruption in 159 countries, was used to make the comparisons, which are given in Table 8.

Table 8
Perception of Corruption
Former Soviet Republics
(10.0 = least corrupt; 1.0 = most corrupt)

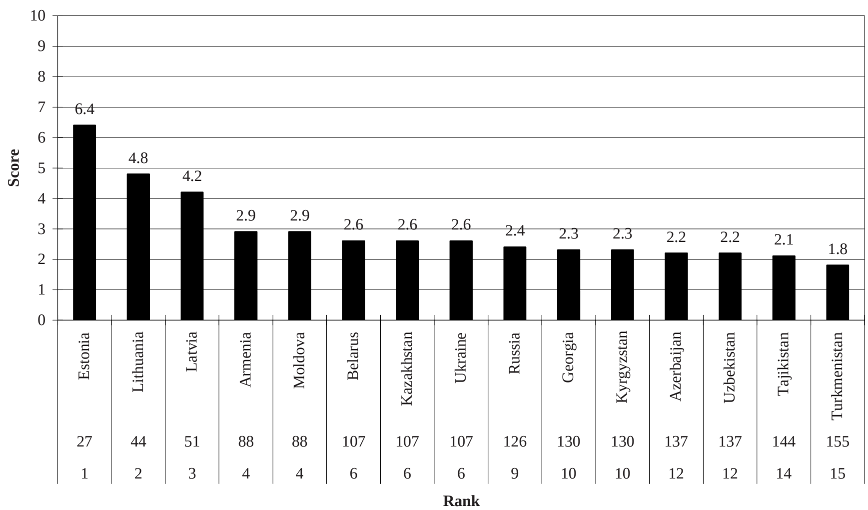
Rank		Country	Score
FSU	World		
1	27	Estonia	6.4
2	44	Lithuania	4.8
3	51	Latvia	4.2
4	**88**	**Armenia**	**2.9**
4	88	Moldova	2.9
6	107	Belarus	2.6
6	107	Kazakhstan	2.6
6	107	Ukraine	2.6
9	126	Russia	2.4
10	130	Georgia	2.3
10	130	Kyrgyzstan	2.3
12	137	Azerbaijan	2.2
12	137	Uzbekistan	2.2
14	144	Tajikistan	2.1
15	155	Turkmenistan	1.8

Source: 2005 Corruption Perceptions Index

Table 8 shows that Armenia is tied for fourth place among former Soviet Union (FSU) countries in terms of corruption, which places it within the top third in terms of cleanness. However, its score of 2.9 places it 88th in the world out of 159 countries included in the 2005 survey, which places it in the bottom half worldwide. Estonia's score (6.4) is more than twice Armenia's score (2.9) and the scores for Lithuania and Latvia are also substantially higher (and better) than Armenia's. The three Baltic republics are the only three former Soviet republics that have scores placing them in the top half, in terms of cleanliness or lack of corruption.

Chart 4 illustrates the relative level of corruption for the 15 former Soviet republics. The bottom figures show the relative ranking within the former Soviet Union. The top figures show the worldwide ranking.

Chart 4 Perception of Corruption Former Soviet Republics
10 = most corrupt; 1 = least corrupt



Another important aspect of analyzing corruption is to determine the trend. One might ask the question: Is the level of corruption increasing or decreasing over time? Comparing annual scores on the Corruption Perceptions Index (CPI) is one way to approach this question. However, making year to year comparisons may be criticized because changes in the CPI are caused not only by changes in perceptions but also by changes in the sample and methodology.

Table 9 shows the scores and ranks for Armenia. Armenia was not included in indexes prior to 1999. It was not included in the 2001 and 2002 indexes, either, because of insufficient data. The CPI looks at a number of surveys from other organizations when compiling its Index. Data must be available from at least three surveys for a country to be included in its Index. In 2002, only 2 surveys included Armenia. However, Armenia's score from the data in those two surveys would have been 3.4, which would have resulted in a ranking of 62 out of 102 countries that were included in the 2002 survey. These figures are included in Table 9 but were not included in the official results of the 2002 CPI.

If any conclusions can be drawn from the data in Table 9 it would be that corruption in Armenia is decreasing somewhat over time. Scores have been increasing over time, which indicates a decline in corruption. The spike in the 2002 score might be attributed to the fact that the score was arrived at by using only two surveys, which was insufficient for inclusion in the CPI for that year. The decline to 2.9 in the 2005 CPI is a cause for concern, since one would hope that the scores would rise over time. However, the 2005 decline might be partially explained by the difference in the sample that year and by changes in methodology. Because of these inherent weaknesses in the CPI data, one cannot automatically conclude that a slight decline in a score from year to year necessarily indicates an increase in corruption. But the consistently low scores for Armenia indicate that much improvement needs to be made before Armenia can be considered a relatively uncorrupt country.

Table 9
Corruption Trend for Armenia

Year	Score (10.0 = least corrupt; 1.0 = most corrupt)	Rank	Countries included in CPI
1999	2.5	80	99
2000	2.5	76	90
2001	–	–	
2002	3.4	62	102
2003	3.0	78	133
2004	3.1	82	146
2005	2.9	88	159

Source: 1999–2005 Corruption Perceptions Indexes

The Perception of Fairness

The present study found that the perception of unfairness in the tax system was one of the strongest justifications for tax evasion. Unfairness is difficult to define, since every individual has his or her own definition of unfairness. Some people think that a graduated income tax is fairer than a flat tax because the rich can afford to pay more than the poor. Kant (1952a, b, c, d, 1983) would disagree, since a graduated tax system treats individuals as means rather than ends in themselves. The graduated income tax is also difficult to justify on utilitarian grounds (Blum and Kalven 1953) and de Jouvenel (1952) would argue that any tax whose purpose is redistribution is inherently unethical.

Tax rates or the amount of taxes taken from taxpayers is another way to look at fairness. A tax system may be considered unfair if rates are too high. But individuals cannot agree on what rate is too high, making a precise definition difficult, if not impossible.

That being said, it is still possible to rate the fairness of tax systems, although any conclusions reached must be tentative. Each year the Wall Street Journal and the Heritage Foundation publish an *Index of Economic Freedom*, which examines 50 variables in 10 different categories. One category is Fiscal Burden, which examines tax rates and the level of government spending. The 2006 *Index* ranks 161 countries and assesses a score from 1(best) to 5 (worst). Table 10 shows the relative scores and rankings of Armenia and the other 14 former Soviet republics.

Table 10
Fiscal Burden
Former Soviet Republics
(1 = best; 5 = worst)

Rank (out of 161 countries)	Country	Score (1 = best; 5 = worst)
11	Estonia	2.0
14	**Armenia**	**2.1**
16	Latvia	2.3
16	Georgia	2.3
22	Lithuania	2.4
22	Kyrgyzstan	2.4
22	Turkmenistan	2.4
28	Moldova	2.5
28	Russia	2.5
34	Tajikistan	2.6
34	Uzbekistan	2.6
44	Ukraine	2.9
74	Kazakhstan	3.5
83	Azerbaijan	3.6
83	Belarus	3.6
35	(Mean) Average	2.6

Source: 2006 Index of Economic Freedom

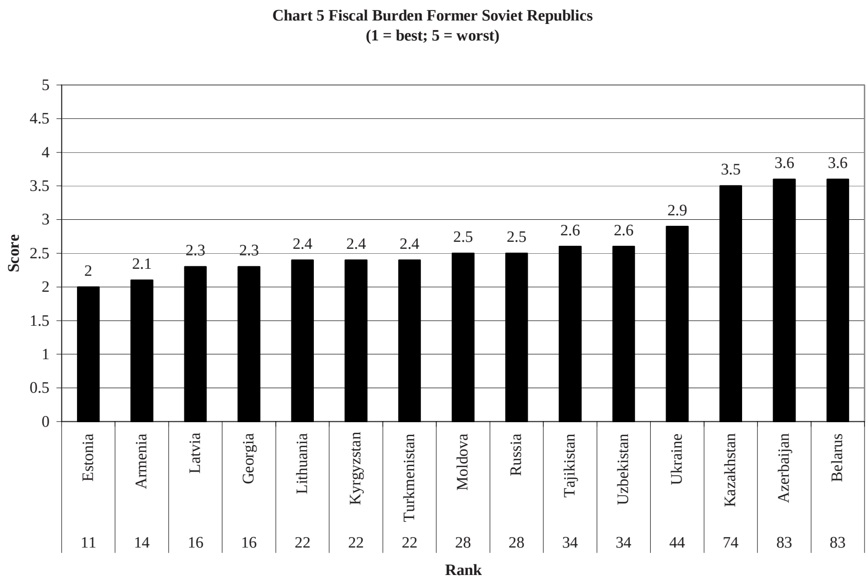


Table 10 shows that Armenia is relatively well off, both in comparison to other former Soviet republics and in the overall rankings. It is ranked #2 among former Soviet republics and 14 overall, out of 161 countries, which places it in the top 10% worldwide in terms of fiscal burden. Chart 5 illustrates the relative rankings.

This finding might seem to be a paradox. On the one hand, Armenia's fiscal burden is substantially less than most other countries, yet the present study indicates that public opinion in Armenia is not very strongly opposed to tax evasion. From this apparent discrepancy one might conclude that fiscal burden or the rate of taxation has less of an effect on perceptions of the ethics of tax evasion than does corruption. This conclusion is supported by a recent study of Danish business students (McGee 2006a). That study found that Danes view tax evasion very negatively even though Danish tax rates are among the highest in the world. The *2006 Index of Economic Freedom* rates Denmark's fiscal burden at 3.8, which is higher than any of the former Soviet republics, and ranks Denmark 94th in terms of fiscal burden, which places it in the bottom half of the 161 countries included in the *Index*. Yet the 2005 *Corruption Perceptions Index* ranks Denmark #4 with a score of 9.5. So it is possible to have a high fiscal burden and still have a strongly negative view of tax evasion, provided the level of corruption is low.

Various authors have done research on the relationship between tax policy and poverty (Brown 2003). Some authors take the approach that government needs to increase tax collections as a percentage of GDP in order to reduce poverty. But such an approach is short-sighted. One cannot make poor people better off by increasing their tax burden. One cannot make an economy richer by taxing the rich, either, since it is the rich (and also the middle class) who have the capital needed for investment and economic growth.

If one begins with the assumption that the private sector can do just about anything more efficiently than government (Bennett and Johnson 1981; Fitzgerald 1988; Poole 1980), the logical conclusion would be to reduce government involvement if the goal is to make an economy more efficient. The government of Armenia has been doing this in recent years, probably not so much by design as because the economy has been growing faster than tax collections. One reason for this divergence is because a certain portion of the tax revenue that could be collected is not being collected due to tax evasion. Table 11 shows the relationship between government expenditures and GDP.

Table 11
Government Expenditures as a Percentage of GDP

2002	2003	2004
18.4	18.2	17.6

Source: Index of Economic Freedom (2006)

Table 12 shows declines in both revenues and expenditures as a percentage of GDP.

Table 12
Armenia: Selected Fiscal Indicators 2002–2005
(Central Government, in percent of GDP)

	2002	2003	2004 Est.	2005 Proj.
Total revenue and grants	18.8	17.8	15.6	15.6
Of which: tax revenue	14.6	14.0	14.1	14.5
Grants	3.5	3.2	0.6	0.6
Total expenditures	19.3	18.9	17.2	18.0
Current expenditure	13.9	12.8	13.3	13.4
Capital expenditure and net lending	5.1	6.1	3.9	4.6
Overall balance (commitment basis)	–0.4	–1.1	–1.7	–2.4
Overall balance (cash basis)	–2.6	–1.5	–1.7	–2.4
Memorandum item:				
Social expenditure	4.9	5.0	5.4	6.3

Source: IMF (2005)

The fact that government revenues and expenditures are declining as a percent of GDP is not necessarily bad news since it means the private sector is expanding faster than the government sector. Since economic growth comes from the private sector—government merely redistributes previously confiscated wealth—this trend will likely have a positive effect on economic growth. But that does not solve the problem of tax evasion. If more of the taxes that are owed could be collected, tax rates could be reduced so that the people who actually pay their taxes would not also have to pay a portion of the taxes that the evaders do not pay.

Concluding Comments

This paper surveyed the opinions of business and theology students in Armenia's capital city. The main finding was that there is widespread moral support for tax evasion, although some reasons were stronger than others, as indicated by the scores. Business students seemed to be slightly more opposed to tax evasion than were theology students, which was surprising, since the usual perception is that theologians are more moral than business people. This apparent anomaly was explained by the fact that theology is often viewed as a business in Armenia rather than a calling.

But the findings of this study go far beyond the opinions of just business and theology students. If their opinions are representative of the Armenian population, and there is no reason to believe that they are not, then Armenia has a serious problem with tax evasion. Although putting mechanisms in place that make tax collection easier might reduce the amount of evasion that goes on, evasion will not cease to be a problem until the country's population finds evasion to be morally unacceptable. All the evidence suggests that this is not yet the case in Armenia.

The perception of corruption seems to be the key to the solution. Until the vast majority of the people trust and respect their government, they will see little moral obligation to pay their taxes. The authors believe that the two main reasons for the widespread evasion of taxes is the perception that corruption is widespread plus the lack of an infrastructure to collect taxes. Thus, reducing corruption and building an infrastructure to collect taxes will reduce the extent of tax evasion.

But those are not the only things that can be done. If the government conducted a selling campaign like Boris Yeltsin did in Russia, it might also reduce the extent of tax evasion. Yeltsin went on Russian national television and showed retirees trying to live on low pensions because the government was not able to collect enough taxes to provide them with better pensions. Yeltsin attempted to put the country on a guilt trip so that they would pay their taxes.

A more positive approach might be to educate the public about the benefits government provides with the tax money it collects. If taxpayers can see the good that their tax money does and the benefits they can receive if they pay their taxes, some people might be persuaded not to evade as much. This suggestion was made by one of the anonymous reviewers to an earlier draft of this article.

Such an approach might be effective with some taxpayers. However, some economists and political philosophers would challenge the underlying premise of this suggestion, and would argue that the people who earn the income have a better idea of how to spend their money than do some government bureaucrats. If that is the case, then trying to educate the taxpaying public to the benefits of paying taxes would be ineffective. More taxes could be collected if the reasons for not paying taxes (corruption) are dealt with rather than trying to provide taxpayers with a list of reasons why they should pay taxes.

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17

Opinions on Tax Evasion in Asia

Robert W. McGee

Introduction

Tolerance for tax evasion varies widely by country and culture. Crowe (1944) examined 500 years of theological and philosophical literature and found that three basic positions on the ethics of tax evasion had evolved over the centuries. Philosophers and theologians had argued that tax evasion was (1) never justifiable, (2) always justifiable, or (3) sometimes justifiable. Those who thought tax evasion could sometimes be justified on ethical grounds generally thought that it could be justified in cases where government was corrupt or where the tax system was perceived as being unfair. Inability to pay was also an argument that often appeared in the literature. Some philosophers who discussed just war theory argued that individuals have no ethical duty to support a government that is engaged in an unjust war (Pennock 1998).

Some religious literature takes the position that tax evasion is never, or almost never justified. The religious literature of the Jewish (Cohn 1998; Tamari 1998), Baha'i (DeMoville 1998) and Mormon (Smith and Kimball 1998) faiths believes that it is against God's law to evade taxes. Some secular philosophers, on the other hand, were unable to find any justification for taxation (Block 1989, 1993).

The Human Beliefs and Values Surveys (Inglehart et al. 2004) collected responses to scores of questions from 200,000 people in 81 societies representing 85% of the world's population. The interviews were face to face, which introduces a bias, since people might have different answers to some questions if they could answer anonymously. The data used in the present study was collected between 1994 and 2003. The survey was published in 2004.

The Human Beliefs and Values survey included the following question [F116] in its survey:

> Please tell me for each of the following statements whether you think it can always be justified, never be justified, or

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something in between: Cheating on taxes if you have a chance.

Participants responded on a ten-point scale where one (1) represented "never justifiable" and ten (10) represented "always justifiable." The present paper examines, compares and contrasts the responses that were given by participants in the Asian countries that were included in those surveys.

Asian Opinion

Table 1 shows the sample sizes and the dates of data collection for the Asian countries that were included in the surveys. Sample sizes varied between 780 and 2,002. Data for most countries was collected between 2000 and 2003, although some data was collected as early as 1994.

Table 1
Sample Sizes and Dates

Country	Sample size	Date of data collection
Bangladesh	1,500	2002
China	1,000	2001
India	2,002	2001
Indonesia	1,004	2001
Japan	1,362	2000
Korea (South)	1,200	2001
Kyrgyzstan	1,043	2003
Pakistan	2,000	2001
Philippines	1,200	2001
Singapore	1,512	2002
Taiwan	780	1994
Turkey	1,206	2001
Vietnam	1,000	2001
Total	16,809	

Table 2 shows the results of the human beliefs and values surveys for the Asian countries that were included in the survey. The "sometimes justifiable" category includes "don't know" and "no answer."

As Table 2 shows, the range of responses varied, although the mean scores were generally under 2.0, which indicates that the people in most Asian countries are strongly opposed to tax evasion. Table 3 ranks the means.

The country most opposed to tax evasion was Bangladesh, with a mean score of 1.06, followed by Turkey, Pakistan, Vietnam, Japan, Indonesia, China, South Korea, Singapore, Taiwan, India, Kyrgyzstan and the Philippines, which had the highest score, at 3.14. The top three scores—the countries most opposed to tax evasion—are predominantly Muslim countries.

Table 2
Acceptability of Tax Evasion [F116]

Country	Mean (1 = never justifiable; 10 = always justifiable)	Never justifiable (%)	Sometimes justifiable (%)	Always justifiable (%)
Bangladesh	1.06	98.1	1.8	0.1
China	1.57	75.9	23.1	1.0
India	2.14	75.5	17.4	7.1
Indonesia	1.54	79.1	20.5	0.4
Japan	1.46	80.5	18.4	1.2
Korea (South)	1.59	74.7	24.6	0.7
Kyrgyzstan	2.73	57.6	38.1	4.3
Pakistan	1.19	88.3	11.7	0.0
Philippines	3.14	40.3	57.2	2.5
Singapore	1.89	67.2	31.2	1.6
Taiwan	1.96	63.3	35.3	1.4
Turkey	1.18	91.7	7.7	0.6
Vietnam	1.32	86.8	12.8	0.4

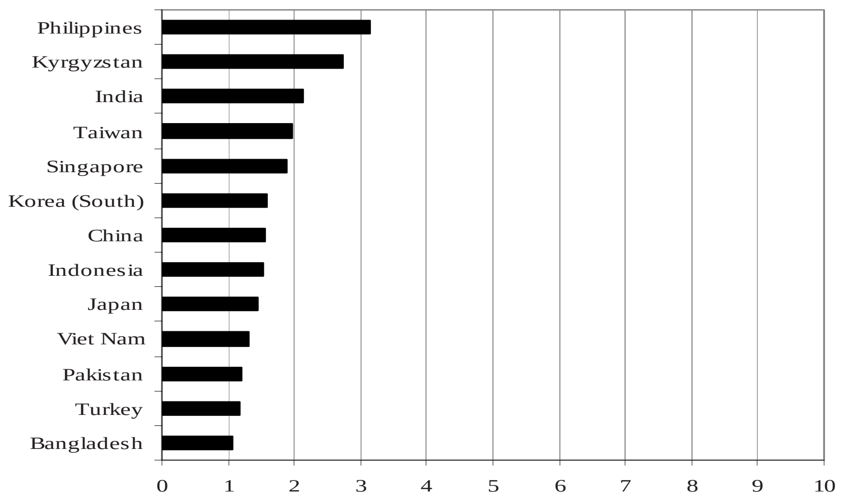
Table 3
Ranking of Means [F116]

Rank	Country	Mean (1 = never justifiable; 10 = always justifiable)
1	Bangladesh	1.06
2	Turkey	1.18
3	Pakistan	1.19
4	Vietnam	1.32
5	Japan	1.46
6	Indonesia	1.54
7	China	1.57
8	Korea (South)	1.59
9	Singapore	1.89
10	Taiwan	1.96
11	India	2.14
12	Kyrgyzstan	2.73
13	Philippines	3.14

The fact that the highest score was 3.14 on a scale of 1 to 10 indicates that even the people of the Philippines are strongly opposed to tax evasion. That does not mean that Asian people seldom engage in tax evasion, however. It just means that when they were asked face to face what their views were on tax evasion their responses were more or less uniform that they were strongly opposed to tax evasion.

Chart 1 shows the relative opposition to tax evasion.

Chart 1 Range of Scores



As can be seen, although the Philippines had the highest score, indicating the least opposition to tax evasion, its score was low compared to the maximum possible score of 10.

When respondents were asked a generic question regarding the acceptability of tax evasion, as was done in the survey, a high percentage responded that tax evasion is never justifiable, indicating that, in theory, tax evasion is considered unacceptable. But would their responses be the same if a more specific question that involved a specific fact situation were asked? The survey asked such a specific question [F131]. Specifically, it asked:

> Please tell me for each of the following statements whether you think it can always be justified, never be justified, or something in between: Paying cash for services to avoid taxes.

The question was not asked for all countries. The only Asian country where this question was asked was Turkey. Table 4 shows the results for Turkey.

Table 4
Acceptability of Tax Evasion [F131]

Country	Mean (1 = never justifiable; 10 = always justifiable)	Never justifiable (%)	Sometimes justifiable (%)	Always justifiable (%)
Turkey	1.37	87.2	12.0	0.8

Table 5 compares the means for the two questions. As expected, the mean score for the specific question [F131] is higher than the mean for the general question [F116]. However, the means are not that far apart and the means are substantially below 1.5 on a scale from 1 to 10, indicating there is strong opposition to tax evasion on moral grounds.

Table 5
Comparison of Means

	Mean (1 = never justifiable; 10 = always justifiable)		
Country	F116	F131	Incr. (Decr.)
Turkey	1.18	1.37	0.19

A few studies have asked specific questions about the ethics of tax evasion to groups in Hubei, China (McGee and Guo 2006), Guangzhou, China (McGee and Noronha 2006), Beijing, China (McGee and Yuhua 2006), Hong Kong (McGee and Butt 2006; McGee and Ho 2006), Macau (McGee et al. 2006) and Thailand (McGee 2006). Those surveys consisted of a series of statements that generally began with "Tax evasion is ethical if…". Respondents were asked to place a number from 1 to 7 in the space provided to indicate the extent of their agreement or disagreement with each statement. Table 6 shows the responses for Statement "Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends."

Table 6
Acceptability of Tax Evasion
(Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.)

Country	Mean (1 = always justifiable; 7 = never justifiable)
China—Beijing (McGee and Yuhua 2006)	3.2
China—Guangzhou (McGee and Noronha 2006)	4.11
China—Hubei (McGee and Guo 2006)	2.9
Hong Kong (McGee and Ho 2006)	3.7
Hong Kong (McGee and Butt 2006)	4.2
Macau (McGee et al. 2006)	3.58
Thailand (McGee 2006)	3.13
Average	3.55

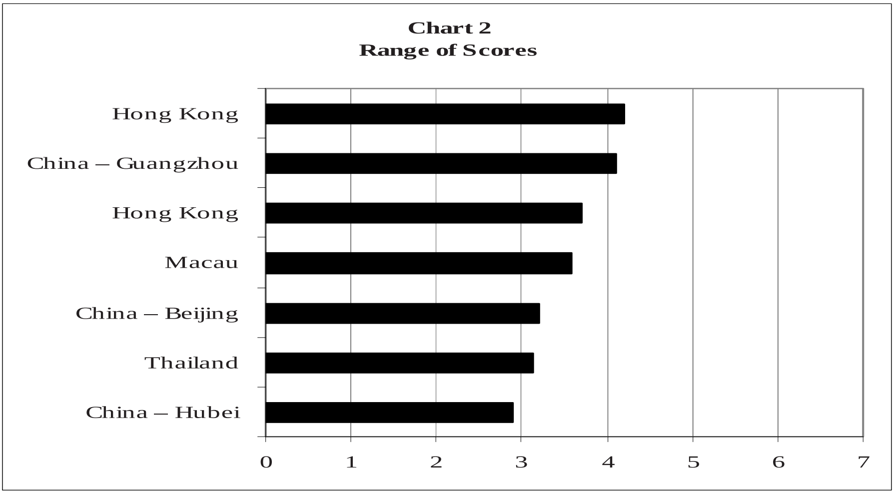
In those surveys, one (1) indicated strong agreement with the statement and seven (7) indicated strong disagreement. Table 6 equates a score of 7 (strong disagreement) with the belief that tax evasion is never justifiable. A score of 1 (strong agreement) was equated with the belief that tax evasion is always justifiable.

Table 7 shows the ranking of the countries.

Table 7
Ranking of Means
(Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.)

Rank	Country	Mean (1 = always justifiable; 7 = never justifiable)
1	China—Hubei (McGee and Guo 2006)	2.9
2	Thailand (McGee 2006)	3.13
3	China—Beijing (McGee and Yuhua 2006)	3.2
4	Macau (McGee et al. 2006)	3.58
5	Hong Kong (McGee and Ho 2006)	3.7
6	China—Guangzhou (McGee and Noronha 2006)	4.11
7	Hong Kong (McGee and Butt 2006)	4.2

Chart 2 shows the range of scores.



One thing that is obvious when one compares the human beliefs and values survey data (Inglehart et al. 2004) to the data from the various McGee studies is that the McGee study scores are higher than the Inglehart et al. scores. One possible explanation is that the methodologies were different. In the Inglehart et al. study participants were asked the questions by an interviewer face to face. This approach might cause participants to say that they are more opposed to tax evasion than would be the case if the survey were conducted anonymously. The surveys in the McGee studies were anonymous.

The scales in the two studies were also different. The scale in the Inglehart study was from 1 to 10 whereas in the McGee studies it was 1 to 7. However, even with the differences in scales it is obvious that participants were less opposed to tax evasion in the McGee studies.

Opinion by Gender

Numerous studies have compared the opinions of men and women on various ethical issues. Some studies found that women were more ethical then men (Boyd 1981; Dawson 1997; Ruegger and King 1992) while others found no statistical difference (Loo 2003; Posner and Schmidt 1984; Stanga and Turpen 1991). A few studies concluded that men are more ethical (Barnett and Karson 1987; Weeks et al. 1999).

Those studies are not directly comparable with the present study, however. To be directly comparable one must begin with the premise that tax evasion is unethical, which might not always be the case. Opinion surveys of Argentina (McGee and Rossi 2006), Guatemala (McGee and Lingle 2005), Bosnia (McGee et al. 2006) and a few other countries found that there is widespread support for the position that tax evasion is sometimes ethically justifiable.

The Human Beliefs and Values survey (Inglehart et al. 2004) disclosed the scores to question [F116] by gender. Table 8 presents the results for the Asian countries where this question was asked.

Table 8
Acceptability of Tax Evasion by Gender
(1 = never justifiable; 10 = always justifiable)

Country	Mean score		Score larger by	
	Male	Female	Male	Female
Bangladesh	1.09	1.02	0.07	
China	1.53	1.61		0.08
India	2.10	2.20		0.10
Indonesia	1.63	1.45	0.18	
Japan	1.59	1.35	0.24	
Korea (South)	1.63	1.55	0.08	
Kyrgyzstan	2.73	2.72	0.01	
Pakistan	1.20	1.18	0.02	
Philippines	3.34	2.93	0.41	
Singapore	1.97	1.80	0.17	
Taiwan	1.85	2.07		0.22
Turkey	1.22	1.14	0.08	
Vietnam	1.28	1.36		0.08

As Table 8 shows, male scores were higher than female scores for 9 of the 13 Asian countries that were asked this question, indicating that females are generally more firmly opposed to tax evasion than men. However, the statistics in the Human Beliefs and Values survey were not presented in a way that made it possible to determine whether the male-female differences were statistically significant. The fact that the mean scores generally did not differ by much indicates that they probably were not. The mean scores were generally quite low, indicating that both groups were strongly against tax evasion.

Table 9 shows the ranking for males and females.

Table 9
Ranking by Gender
(1 = never justifiable; 10 = always justifiable)

Rank	Male		Female	
	Country	Mean score	Country	Mean score
1	Bangladesh	1.09	Bangladesh	1.02
2	Pakistan	1.20	Turkey	1.14
3	Turkey	1.22	Pakistan	1.18
4	Vietnam	1.28	Japan	1.35
5	China	1.53	Vietnam	1.36
6	Japan	1.59	Indonesia	1.45
7	Indonesia	1.63	Korea (South)	1.55
8	Korea (South)	1.63	China	1.61
9	Taiwan	1.85	Singapore	1.80
10	Singapore	1.97	Taiwan	2.07
11	India	2.10	India	2.20
12	Kyrgyzstan	2.73	Kyrgyzstan	2.72
13	Philippines	3.34	Philippines	2.93

Table 10
Average Male and Female Scores for Various McGee et al. Studies
(1 = strong agreement; 7 = strong disagreement with the statement "Tax evasion is ethical if …")

Study	Male score	Female score	Significant?
Thailand (McGee 2006)	3.98	5.00	Yes
Hong Kong (McGee and Butt 2006)	5.01	5.03	No
China—Hubei (central) (McGee and Guo 2006)	4.07	4.42	Yes
Hong Kong (McGee and Ho 2006)	5.25	5.24	No
China—Guangzhou (Southern China) (McGee and Noronha 2006)	5.16	4.99	No
Macau (McGee et al. 2006)	5.00	4.90	No
China—Beijing (McGee and Yuhua 2006)	4.41	4.37	No

Some of the McGee studies also analyzed the scores by gender. Table 10 shows the results of the studies involving Asian countries where gender scores were examined.

In two studies the differences in male and female scores were significant. In five other studies they were not significantly different.

Opinion by Age

A few studies have examined the relationship between age and ethics. The studies generally find that people become more ethical with age (McGee and Tusan 2006; Ruegger and King 1992).

The Human Beliefs and Values survey (Inglehart et al. 2004) also compiled statistics on age for question F116. Table 11 presents the results for the Asian countries where this question was asked.

Table 11
Acceptability of Tax Evasion by Age
(1 = never justifiable; 10 = always justifiable)

Country	Age		
	15–29	30–49	50+
Bangladesh			
Never justifiable (%)	97.5	99.3	97.9
Sometimes justifiable (%)	2.2	0.7	2.1
Always justifiable (%)	0.3	0.0	0.0
Mean	1.11	1.02	1.04
China			
Never justifiable (%)	70.5	78.1	80.1
Sometimes justifiable (%)	29.0	20.7	19.0
Always justifiable (%)	0.5	1.2	0.9
Mean	1.73	1.55	1.50
India			
Never justifiable (%)	79.7	81.1	79.3
Sometimes justifiable (%)	14.4	11.3	11.4
Always justifiable (%)	5.9	7.6	9.3
Mean	2.00	2.15	2.28
Indonesia			
Never justifiable (%)	78.5	77.8	81.8
Sometimes justifiable (%)	20.4	21.7	18.2
Always justifiable (%)	1.1	0.5	0.0
Mean	1.76	1.56	1.42
Japan			
Never justifiable (%)	74.0	82.6	88.5
Sometimes justifiable (%)	26.0	16.2	9.7
Always justifiable (%)	0.0	1.2	1.8
Mean	1.64	1.45	1.40

Korea (South)			
Never justifiable (%)	71.2	74.7	79.0
Sometimes justifiable (%)	28.2	24.5	20.6
Always justifiable (%)	0.6	0.8	0.4
Mean	1.73	1.58	1.45
Kyrgyzstan			
Never justifiable (%)	54.1	58.6	63.8
Sometimes justifiable (%)	41.5	37.1	31.9
Always justifiable (%)	4.4	4.3	4.3
Mean	2.84	2.69	2.58
Pakistan			
Never justifiable (%)	91.0	88.9	97.1
Other (%)	9.0	11.1	2.9
Mean	1.20	1.22	1.08
Philippines			
Never justifiable (%)	36.9	43.8	40.8
Sometimes justifiable (%)	60.0	54.3	56.5
Always justifiable (%)	3.1	1.9	2.7
Mean	3.21	3.09	3.13
Singapore			
Never justifiable (%)	60.4	74.2	73.3
Sometimes justifiable (%)	37.9	24.0	25.8
Always justifiable (%)	1.7	1.8	0.9
Mean	2.07	1.74	1.64
Taiwan			
Never justifiable (%)	61.7	64.0	67.2
Sometimes justifiable (%)	39.1	34.1	32.2
Always justifiable (%)	0.8	1.9	0.6
Mean	2.02	2.04	1.70
Turkey			
Never justifiable (%)	91.0	92.7	92.6
Sometimes justifiable (%)	8.4	6.5	7.4
Always justifiable (%)	0.6	0.8	0.0
Mean	1.20	1.19	1.11
Viet Nam			
Never justifiable (%)	89.7	85.0	90.6
Sometimes justifiable (%)	9.4	15.0	8.7
Always justifiable (%)	0.9	0.0	0.7
Mean	1.31	1.31	1.33

As can be seen, the mean scores generally decline with age, which means that as one gets older, opposition to tax evasion increases. A similar conclusion was found in a study of tax evasion opinion in Slovakia (McGee and Tusan 2006).

Concluding Comments

The purpose of this paper was to examine the studies that have been conducted on the ethics of tax evasion in various Asian countries. Two sets of studies have been conducted. The studies are not directly comparable because of the differing methodologies. However, some things can be learned. Tax evasion is considered to be ethical sometimes, although there is strong moral opposition to tax evasion in general. Different Asian populations have differing views on the ethics of tax evasion. They do not all think the same on this issue. Women are sometimes more firmly opposed to tax evasion than are men and older people tend to be more opposed to tax evasion than are younger people.

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18

Monitoring of Tax Corruption in Transition Economies: Evidence from Bulgaria

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Introduction

The difficulties of measuring economic phenomena, which have value only as far as they remain hidden, such as tax corruption, are obvious. Measures rely largely on opinion surveys that reflect perceptions and assessments of taxpayers. They provide mixed evidence about transition countries. According to the Global Corruption Barometer of Transparency International (2004) in most new market economies tax administration is not among the five most corrupt institutions (Annex 1.1). Conversely, in a recent World Bank study on corruption in transition economies tax corruption is ranked second among other types of corruption in terms of number of companies involved (after bribes for licenses and permits). It also finds that tax corruption is increasing despite the fact that companies are net losers from tax bribery (i.e. average cost of tax corruption in all countries exceeds or equals benefits) (Gray et al. 2004).

The situation of individual countries is hard to capture too. Bulgaria is a case in point. According to the tax corruption ranking of the Global Competitiveness Report, it is among the world top performers, scoring in 2002 higher than any other transition country in Europe except Lithuania and Slovenia (Annex 1.2). In contrast, according to the World Bank ranking, in 2002 Bulgaria is performing worse than any other European transition country. (Gray et al. 2004). Such discrepancies show that measuring tax corruption is not an easy task.[1] The difficulties reflect largely some

[1] They may be attributed to differences in methodology, but the point is that they can hardly provide a reliable guidance to policy makers. Perhaps the only benefit for policy makers would be that at the time they could refer to the GCR scores when promoting externally Bulgaria as an attractive place for FDI, and to the World Bank

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conceptual ambiguities about the underlying drivers, central to which is the concept of the business cost of corruption. Actually, few attempts to measure corruption target tax corruption per se. Most available measures and estimates are obtained in the context of measuring overall corruption levels irrespective of the type of corruption, or the administration concerned. Measures of overall corruption however are largely guided by the concept that bribes are extra costs imposed on the business. Consequently, the level of corruption is derived from perceptions and assessments of entrepreneurs and investment risk experts. Accordingly, one of the basic measures of corruption is the "bribe tax," i.e. the direct financial cost of bribes to the firm.[2]

While there is no doubt that corruption implies considerable cost to the business sector, there are some important qualifications that may help understand better the behavior of the bribers. Above all it may help to distinguish the economic costs of corruption in terms of unfair competition, market malfunction and misallocation of resources from the direct business cost of the bribe for the briber. The business cost concept has stronger validity in regard to corruption in the field of licenses and permits or public services, including services to tax payers. However, it is less clear why bribes paid by firms to evade taxes or import duties, or to win public contracts, or to influence court decisions should be interpreted and measured through indicators such as the "bribe tax," implying that these costs are imposed on the firms.[3] In the above mentioned corruption types, it is the income-maximizing choice of the firms rather than pressure by the public administration that drives demand for these types of corruption services. In this sense revenue corruption related to fraud, as well as corruption in the public procurement or judiciary, need to be distinguished conceptually from corruption related to public services such as licensing, tax services, healthcare, etc.[4]

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scores when promoting internally the necessity of the Bank's revenue administration reform loan.

[2] See for instance Gray et al. 2004, p. 21.

[3] The only plausible argument may go that they are imposed on the firm by the business environment, i.e. a firm's choice to pay bribe for above mentioned benefits is a response to corruption practiced by competitors. This argument may have some "ethical" value for the firms as a justification of their involvement in bribery, but it hardly has much practical value for policy-making. Primary drivers of tax corruption are more important for the latter than the secondary drivers attributed to corrupt environment.

[4] This however does not imply that corruption related to public services is always imposed by the supplier of these services. It may also be a result of income-maximizing choice by the firms. However, from policy perspective there is a substantial difference whether a company pays bribes to evade taxes or to avoid excessive compliance costs.

The importance of having more objective measures of tax corruption is straightforward. No doubt, it remains a major challenge of transition. The TI Global Corruption Barometer's average regional score of tax corruption is 3.4 (Annex 1.1). The Corruption Monitoring Indices of Coalition 2000 in Bulgaria for instance show that more than half of the surveyed companies in the last four years think that all or most of the tax officials are involved in corruption. About 20% of the respondents have experienced corruption pressure by tax officials. On the other hand, a survey of Bulgarian tax officials[5] finds out that they admit that there is corruption among them, but at a fairly limited scale. According to them the public perceptions of wide spread of corruption in the tax administration are largely exaggerated (Fig. 1).[6]

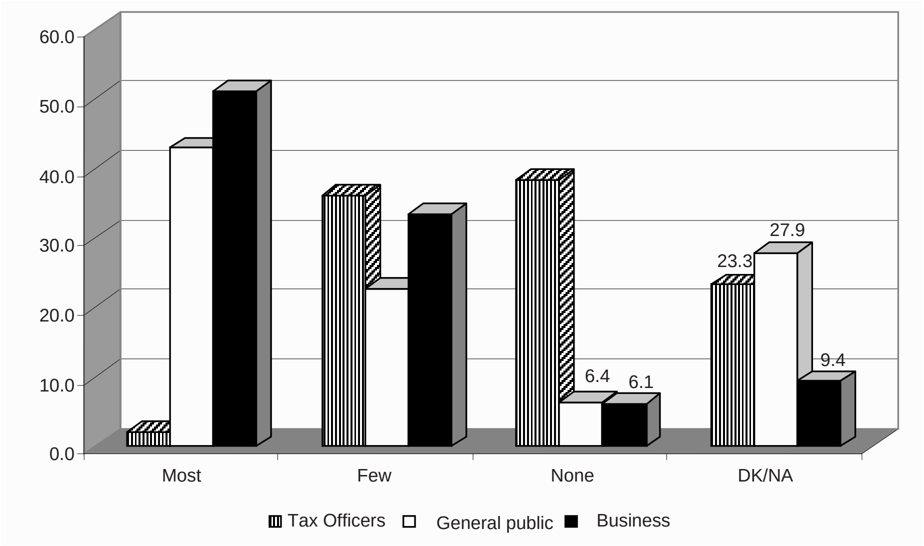

Fig. 1 What is the share of tax officers involved in corruption according to tax officers, the general public and the business community (% of responses) *Members of the general public and of the business community responded regarding the administration as a whole, while tax officers were asked about their respective departments. The general-public and business-community data were sourced from the relevant surveys of Vitosha Research, *Coalition 2000 Corruption Monitoring*, for April–May 2004

[5] The survey was carried out in Bulgaria in March 2004 by Vitosha Research through face-to-face interviews with a sample of 699 tax officials from the local tax directorates in Bulgaria. Part of the findings are available at http://www.vitosha-research.com/focus_bg.htm. If not otherwise indicated, data and evidence referring to tax administration are derived from that survey.

[6] The numbers in brackets in the text indicate the number of exhibit referred to.

This poses important policy questions. Is the business community unjust to the tax administration? If so, it is not only and not mainly a problem for the tax administration. Bad scores might deter investment regardless of the actual level of corruption. Furthermore, wrong perceptions of corruption levels may materialize as firms choose whether or not to evade taxes and offer bribes according to their perceptions about what competitors are doing. In this context, it is not just the tax administration, but the economy and the business that may be the victim of too much or too bad measuring of corruption. How much does the public notion depart from the actual level? What are the economic costs of the departure, and what are the implications for formulating and monitoring policy?

This paper does not provide complete answers to above questions. It rather tries to contribute to the understanding of the demand and supply-side factors of tax corruption in transition economies. It proposes indicators, which might help in "sizing" the problem and in monitoring and evaluation of anticorruption policies. It draws from the vast body of theoretical and empirical research on the topic but departs from other studies in several important ways. First it attaches primary importance to measuring the strength of the drivers of corruption parallel to its level and intensity. This may be more useful in terms of policy formulation and monitoring. Consequently, it focuses on one type of corruption, as the underlying drivers vary across corruption types. Second, it looks at tax corruption as a result of transaction between two beneficiaries. This departs from the prevailing "business cost" concept. In this setting the taxpayer receives some undue favor by the tax officer in return for a bribe as the price for this corruption "service". Third, it uses evidence from both the business and the tax administration to identify the drivers on the demand and the supply side and their relative weight in corruption. Fourth, it distinguishes between bribes for tax evasion and bribes for avoiding excessive compliance costs. Important in this regard is the distinction as well between economic and business costs of corruption. Even though the business suffers from the economic costs of corruption, it is the immediate business benefits that drive bribery. Finally, these are drivers on the demand side. This study argues that most important for the corruption deal are the drivers and deterrents on the supply side, therefore the viewpoint of the tax officials is important.

The paper is organized in five Sections. The First Section locates the place of revenue corruption in the other corrupt practices for the purpose of putting together a definition that is helpful for evaluating its level and drivers. The Second and Third Sections use the transaction framework to study the drivers and deterrents on the demand and the supply side respectively. The Fourth Section derives tools and measures for diagnosing the level of corruption and its drivers. The Fifth Section concludes.

Definition and Typology

The most straightforward definition of corruption is *abuse of power for private gains*. Figure 2 illustrates various types of corruption practices. This typology is far from complete. It is based on the type of power or professional responsibilities that are subject to abuse. Its aim is to locate roughly corruption related to tax collection among corruption practices in general for the sole purpose of defining the object of measuring.

The conventional narrow definition of corruption boils down to abuse of *public* power. When the abuse of power takes place at the level of public administration, it is defined as administrative or bureaucratic corruption. It is largely a part of the so called “petty corruption” which encompasses corruption practices performed at the low public service levels.[7] Petty corruption includes as well bribes related to the delivery of public services and out-of-court fines and enforcement of regulations (e.g. road police etc.). They constitute the most widely spread corruption in transition countries in terms of number of corruption “deals” and people involved on both sides. When the abuse is of *legislative or executive power*, it is defined as grand or political corruption. Furthermore according to the type of power that is subject to abuse, corruption may take place in the judiciary and the other institutions of law enforcement, as well as in relation to the delivery of various public services such as education, health, social benefits, etc.

Further to the distinction according to the type of abused power, the typology of corruption can be extended according to the nature of the gains. Thus a distinction can be made between misuse of power by the agent at the expense of the principal for the agent’s direct benefit (e.g. direct embezzlement); and misuse of power for the benefit of a third party in return of a bribe. In the latter case private gains include not only cash (bribes), but gains in kind as well (gifts, services, including “barter” corruption services, use of influence, etc.), which may benefit the person who provides the service, or friends and relatives, even political parties. These non-bribe benefits imply that not all corruption practices are easy to capture and measure. Corruption for financing of political parties is actually leading concern in all transition countries (Annex 1.2). Furthermore according to the level of government, political and bureaucratic corruption may have central, regional or municipal dimensions. Of course these divisions are far from absolute. Corruption related to privatization, concessions, renting out state or municipal property or land can involve grand or petty corruption at local or central level according to the object of the deal—from parking lots in the city

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[7] In fraud related corruption however, the term connotes hierarchical level rather than the size of the bribes.

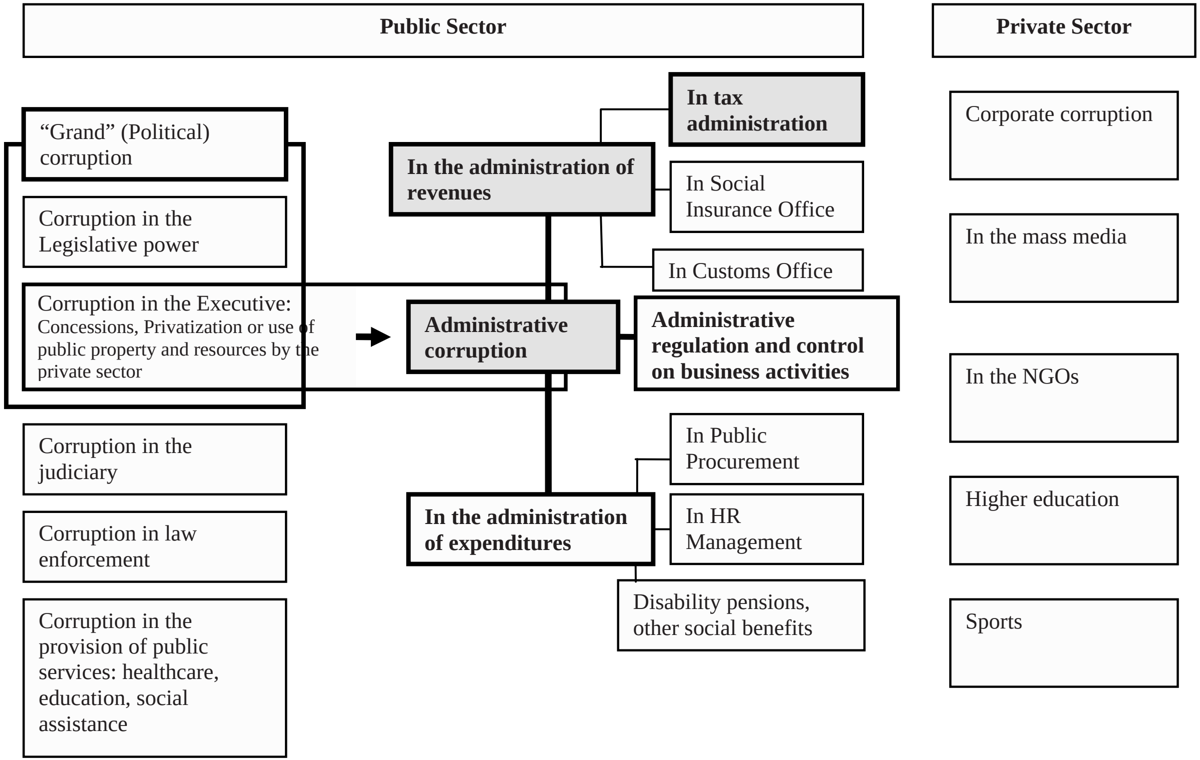

Fig. 2 Tax corruption in the tree of corruption practices

center to extraction of national resources, or use of radio and telecommunication frequencies. The common feature of all these deals is that they involve sale or renting out of limited public resources at prices lower than the market prices, or supplies from the private sector at prices higher than those on the market. Applying non-market prices in the transactions between the public and the private sector implies that the public managers may have the power to perform their functions in someone's private interest against benefits.

Corruption however is neither an exclusive territory of the public sector, nor of the developing and transition countries. In the recent years time and again the world has been witnessing grand scandals in he corporate world, sports, media, NGOs, including trade unions, and international organizations. They constitute a serious challenge to the basic caveat of public economics and regulatory economics, that the level of corruption is largely determined by the size of the government, i.e. no efforts in curbing corruption can yield lasting results if government weight in the economy is not reduced. [8] While this is true in regard to misuse of public power, it is hardly so for the overall level of corruption, including the private sector. The latter is important, not only because of its spillover effects on bureaucratic and political corruption but because it may incur larger costs to investors compared to public sector corruption.[9]

Administrative corruption, to which corruption related to revenue collection belongs, can be divided in three broad categories: corruption in the revenue administration, corruption related to public expenditure management, and corruption related to the administrative regulation and control. The first

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[8] There is some preliminary evidence that with the withdrawal of the state from college education in Bulgaria, corruption there increased (see Coalition 2000 Corruption indices at www.anticorruption.bg).

[9] The borderline between bribing and marketing promotion in the private business practices is often elusive. For instance, if an air carrier gives away free tickets to frequent flyers this falls under the definition of marketing, if it gives it to the person in charge of buying air tickets in a private company, it falls in the twilight border zone between marketing and bribing a corporate client employee, but if this person works for a state agency, then it rather falls under the definition of bribing. In the three cases it may be entered into the books as marketing expense. From a marketing viewpoint the companies are not expected to differentiate between private and public sector clients in fighting for larger market share: what is good for the corporate client should be good for the public sector client as well. On the other hand, in the context of investment risk and cost assessment, a corrupt public official is not necessarily higher risk and cost than corrupt managers, employees, clients, trade unions, or business organizations. The quality of the private sector management, operations and associations may be larger source of uncertainty and risk than the quality of the public sector in investment decisions.

category contains three subcategories according to the agency where it takes place: corruption in tax administration, corruption in customs office and corruption in the collection of social insurance contributions.

In this context tax corruption is defined here as *misuse of administrative power related to the enforcement of tax regulations (i.e. taxpayer services, tax collection, inspections and audits) for private gains*. This allows distinguishing it first from political corruption related to taxes. The aim of the latter is to influence the establishment of the rules of the game, rather than their enforcement (see Section “Corruption for Regulatory Tax Privileges and Benefits”). Second, this definition distinguishes it from corruption practices in the tax administration that relate to the public expenditure management: corruption in public procurement, nepotism, direct embezzlement, etc. Even though these two groups are not directly related to enforcement of tax regulations, their scale and consequences in a transition economy should not be underestimated. They may exceed conventional tax corruption in the value of benefits and bribes and in resultant institutional and market distortions. More importantly they generate it at all levels of the revenue administration and law enforcement.[10]

A bribery related to tax collection is a result of a deal between two beneficiaries, with the bribe or the benefit being the price for the service supplied by the administration. Our survey of tax administration in Bulgaria finds that the initiative for this deal comes more often from the taxpayer (Table 3). One in four tax officers reports direct pressure from bribers and one third have experienced indirect offers. Therefore this analysis starts with the demand-side factors.

Table 3 Sources of Corruption Pressure

Which party initiates the bribery deal (%)

Taxpayers	52.1
Tax officers	1.9
Both parties equally	23.9
Other	0.9
DK/NA	21.3

How often during the last year have you been offered bribe? (% of responses)

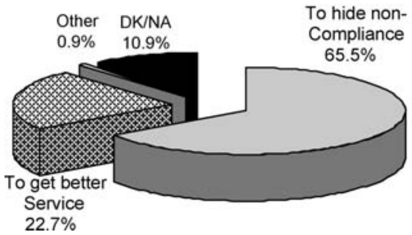
	Directly	Indirect indications
In all or most occasions	1.0	2.9
In rare occasions	24.2	31.0
Never	67.1	58.1
I had no such contacts	5.4	5.6
Don’t know/No answer	2.3	2.4

[10] The reason for leaving them out of the scope of this paper is that they require other policy interventions that may fall outside the domain of the tax administration (as in the case of political corruption) or tax regulations and enforcement (as in the case of expenditure-related corruption), and require a different dataset and methodology, which are not agency-specific.

Demand Side Drivers and Deterrents

Tax corruption can be defined in terms of the services, which are subject to bribery agreement between the taxpayers and the administration. Taxpayers pay bribes for two groups of corruption services: those related to non-compliance, and those related to preferential services (speeding up procedures, tax refunds, etc). According to the surveyed Bulgarian tax officials, taxpayers pay bribes above all to conceal non-compliance and evade penalties:[11] 65.5% of the respondents identify this as the major cause of bribes. Better services remain a leading cause for bribes according to 23% of the respondents (Exhibits 4 and 5).

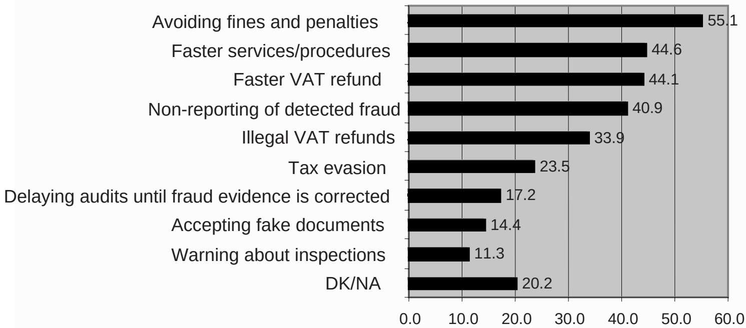
Exhibit 4. Purpose of bribes (% of responses)



Those two categories are related to the enforcement of the established rules of the game. As already mentioned, some business groups may pay bribes, or provide other favors to change the rules of the game. It is usually defined as political or legislative corruption, even though the administration has a role to play in it as well. The three types are examined in more details below.

[11] It is important, however to distinguish between non-compliance driven by income-maximizing choice of the taxpayer (tax evasion), and non-compliance driven by unclear and excessive regulations, or discretionary enforcement of the law which is done in the next two sections.

Exhibit 5 Which are the most common five "services" provided to Taxpayers against bribes? (% of responses)



Corruption Related to Evasion

The first category is related to the enforcement functions of control and auditing. It however has as a prerequisite taxpayer's choice to evade taxes, which is determined by his estimates about expected benefits and costs. The benefits grow with the tax rate, while the expected costs grow with the penalty rate and the probability of detection. Thus, the net benefits are changed significantly by the chances of the tax evader to work out a deal with the tax inspector in case the evasion is detected.

After an initial excessive reliance on stringent controls in transition countries[12] recently there have been excessive expectations that tax cuts can reduce evasion. Theoretical models and empirical tests, however, provide mixed evidence on the relation between tax rates and evasion levels. The classical model of Allingham and Sandmo (1972), assumes that taxpayers are risk-averse. Consequently, the propensity to evade taxes is positively related to income. The richer the taxpayers, the more likely they are to take the risk of being caught, as the relative weight of the penalty as a percentage of their income or wealth is smaller. And, vice versa, the relative cost of the penalty for the low-income evaders is higher. This leads to two opposite effects of the higher tax rate. On the one hand the higher the rate, the higher the return on each unit of concealed income (which is known as the substitution effect). On the other hand, the higher the rate, the lower the taxpayer's after-tax income, and the weaker his motivation to take the risk of evasion (the so called income effect). Yitzhaki (1974) however notes that if the penalty is based on the

[12] See Martinez-Vazquez and McNab (2000) for comprehensive assessment of tax reforms in transition economies.

evaded tax rather than on the concealed income, then the net benefit, (i.e. the tax evaded less the penalty) does not change with the tax rate. There is only income effect, i.e. contrary to the common intuition, evasion should go down with the increase of the tax rates. Conversely, if the taxpayer is risk-neutral, there would be only substitution effect. Despite the numerous extensions of the initial models of tax evasion and the extensive empirical tests[13], the question of the relation between the rate and the level of evasion is not yet successfully resolved. The policy implications are that the effect of reduced tax rates on taxpayers' propensity to evade taxes is ambiguous, depending on attitudes to risk and the penalty structure. The implications for the tax administration however are much more straightforward. According to Becker's (1968) classic theory of crime prevention, tax evasion can be successfully deterred either through optimizing the penalty structure, or through raising the probability of detection. The latter is more expensive, especially if probability of detection is raised mainly through increasing the frequency and coverage of control, rather than introducing more efficient risk management techniques. Excessive reliance on penalty structure is not likely to yield results either. Penalties need to be enforceable.

Moreover, the opportunity to avoid penalty through a bribery deal with the tax inspector changes substantially the evader's estimates of the risks and costs of detection. On the one hand, the opportunity of a bribery agreement reduces the cost, as normally the bribe is lower than the penalty; otherwise, there is no incentive for the briber to pay it. On the other hand, the opportunity of a bribe increases the probability of detection as a corrupt inspector would benefit from the bribe only if s/he detects and proves the evasion.

There have been speculations in the literature that the increase in the penalties can lead to increase in the bribes. The only supplier of this kind of service is the tax auditor. S/he competes only with the law: as far as the bribe is lower than the fine, the evader has the incentive to pay it.[14] In the context of the cost of evasion, the increase of the bribe will increase the motivation of the corrupt inspector to detect the crime, and thus the cost for the tax payer (probability of detection times the bribe due). This may crowd out evasion and corruption toward the higher income levels, as increased costs would require larger-scale evasion to balance it. In balance average evasion and bribe levels may increase, but this will raise further the probability of detection, while at the same time low-scale evasion and corruption will be

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[13] For a review of the literature see Sandmo (2004), Cowell (2004), Slemrod and Yitzhaki (2002).

[14] There have been as well opposing propositions that competition among bureaucrats may reduce bribes (see Gray et al. 2004, p. 16), but they are not substantiated.

reduced.[15] Such a scenario, however hinges on the assumption that corrupt inspectors will take advantage of the increased penalties and increase the bribes. In practice, bribes seem to be often too low relative to the benefit for the briber. This implies that auditors' perceptions of the cost of detection of the bribery (probability times penalty) must be very low. I will return to these supply side drivers in Section Three. Here we are looking at the size of the bribe as a component of taxpayer's costs. In this sense, to interpret the bribe as costs imposed on the business is equivalent to interpreting the penalties for tax evasion in the same way.

Finally, the cost of evasion through bribery depends as well on the probability that the briber will be punished not only for the evasion, but also for the bribery, and on the size of the penalty.

The bottom line is that fighting corruption in tax administration means above all fighting tax evasion. The major demand-side determinants of corruption as well as its major economic consequences are related to tax evasion. In this context among the major indicators for the strength of the drivers of corruption related to evasion are: the perceptions of the taxpayers about the tax rates, the penalty structure for evasion, the probability of detection, the probability of working out a deal with the inspector, the size of the bribes, the rate of institutionalization of corruption, the probability that the briber will be punished and the size of this penalty. All of them are important determinants of the demand for tax corruption services related to evasion and are indispensable in evaluating the institutional setting in terms of corruption risk.

Table 6 Which Tax Is Most Often Subject to Evasion? (%, single choice)

	All	TRS[a]	Audits	Inspections	Collection	Accounting	Appeals	Other
VAT	81.1	75.3%	92.2%	85.1%	81.5%	65.9%	100%	61.8%
CIT	3.0	4.2%	1.3%	0.0%	3.7%	4.5%	0%	8.8%
PIT	1.6	2.8%	0.9%	0.0%	0.0%	0.0%	0%	2.9%
Excise	3.1	3.8%	0.9%	7.5%	3.7%	2.3%	0%	5.9%
Property	0.9	1.7%	0.0%	0.0%	3.7%	0.0%	0%	0.0%
DK/NA	10.3	12.2%	4.7%	7.5%	7.4%	27.3%	0%	20.6%
Base	699	288	232	67	27	44	7	34

[a]TRS: Taxpayers registration and services

The Bulgarian tax administration survey provides some insights within this theoretical framework. It found that the list of most demanded corruption services is headed by VAT frauds. The overwhelming majority—

[15] This conclusion has important implications for measuring corruption levels, as often they are derived mainly from the average size of bribes, to which I will return later.

81% of all tax officials and 92% of the auditors—identify VAT as the most critical area of tax fraud (Table 6). Evasion of income taxes is low, and so is its relative weight in the demand-side drivers of tax corruption. Accordingly, tax officers identify VAT companies and large taxpayers as more likely to violate tax regulations than small taxpayers (Fig. 7).

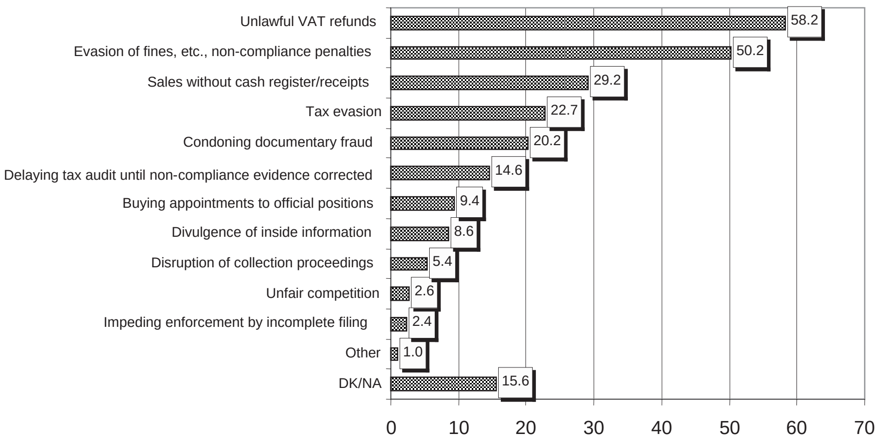

Fig. 7 Top-three corruption-related tax offences (% of respondents)

Corruption Driven by Compliance Costs

Apart from the direct costs of taxation, taxpayers incur the cost of complying with the tax regulations.[16] While the type of corruption in tax administration, examined in the previous paragraph reflects taxpayer's choice to evade taxes, this one is driven by excessive compliance costs. Administrative deficiencies and legislative inconsistencies make these costs a strong driver of corruption in transition countries. On the one hand they increase the time and money spent by taxpayers for understanding and fulfilling their obligations. On the other hand, inequitable law enforcement places them in a disadvantage relative to non-compliant competitors. If entrepreneurs choose not to accept these costs, they may consider either to disregard the regulations, relying in the worst case scenario to pay bribe instead of penalty; or to pay bribe in order

[16] On the definition of compliance and administrative costs see Sanford et al. (1989, chap. 1, pp. 3–23).

to have procedures speeded up. Taxpayer's net benefits from the bribery are measured by the amount of time and money saved by ignoring or speeding up procedures less the bribe. Net benefits may be larger than the benefits of tax evasion especially in the case of VAT refunds. Timely refunds are more important for the liquidity of many companies than savings from evaded taxes.

There are usually two groups of institutional factors that generate demand for this type of corruption services. The first one is related to the long tax code terms for the various administrative procedures and services. Standards of services and e-services are also rare or underdeveloped in transition countries. The second one stems from flaws and imperfections in the tax and accounting regulations, which allow large degree of administrative discretion in the enforcement of the law.

Both bribes to avoid penalties for non-fraudulent violation of tax regulations, and bribes for better services are driven by excessive compliance costs. However they differ substantially. Similar to corruption related to tax evasion, bribes for avoiding penalties imply taxpayer's rational choice to ignore the regulations. The tax officer can only take advantage of the detected violation. In the framework of demand and supply of corruption services, it is corruption related to non-compliance and is largely demand driven. In contrast, corruption for better and faster services involves compliant taxpayers and is largely supply side phenomenon. Delays in procedures may be caused by corrupt officials aiming at a bribe, or because they are busy working for those who have already paid bribes. Thus, they are in a position to create demand for this type of service. Nominally the taxpayer pays for the benefit of unfair advantages over competitors. But in a highly corrupt environment, taxpayers may need to pay bribes to "keep their turn on the line" rather than to "jump ahead."

The Bulgarian tax administration survey indicates that the relative weight of these two types of corruption is considerable. Avoiding fines and penalties is ranked at the top of the lists of corruption services identified by tax employees. (see Exhibit 5 above). These are non-fraudulent violations. VAT frauds and tax evasion are ranked separately. Faster services and tax refunds are ranked second and third in this list. As already shown in Exhibit 4, 23% of the surveyed officials indicate that the leading motive for taxpayers to offer bribes is to get better services. Tax officers' assessment of their relations with the clients indicates large room for this type of corruption services. Interaction between the two parties seems uneasy with a large gap in the understanding of each party's rights and obligations (Fig. 8).

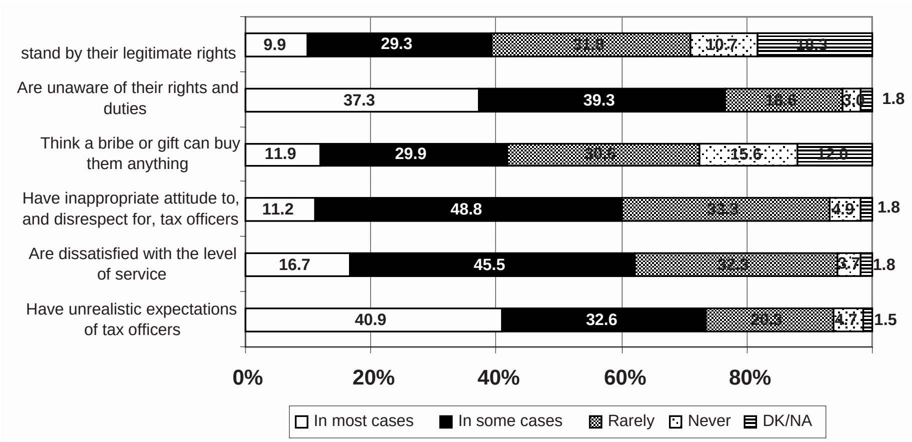

Fig. 8 Contacts with taxpayers assessed
("How often during the past one year have you encountered the following taxpayer behaviour?")

Corruption for Regulatory Tax Privileges and Benefits

As already mentioned, except for the administrative corruption related to enforcement of regulations, there is the big issue of corruption related to changing the rules of the game. As the objective of the latter is to influence policy making and legislation, it is usually distinguished from administrative corruption and referred to as political corruption. But can the rules be written without the participation of those who are responsible for enforcement? Legislators and finance ministers are responsible for policy and law making, but the revenue administration has also important role to play in setting the rules of the game. Normally the tax administration participates at the drafting stage,[17] and more importantly, it creates the secondary implementing legislation. Moreover, regulatory flaws and inconsistencies often require decisions by the central tax directorates, which interpret the regulations. Therefore corruption for regulatory benefits is not only in the sphere of politics and legislation. In this context the distinction between state capture and

[17] One of the flaws in the tax reforms of transition was that significant changes in tax legislation were passed without consultation with tax administration about enforcement feasibility or allowing them time to prepare taxpayers for the change. (Martinez and McNab 2000).

administrative corruption[18] has grounds only in the sense that usually granting regulatory preferences to a business group or lobby requires political support. But even in this case, policy makers need the support of the administration's experts and executives to put their idea into practice. The latter may not share directly the benefits, granted by the business to their superiors, but surely their loyalty would not go unrewarded.

Moreover, as central administration creates the secondary and tertiary legislation (ordinances, instructions, circular letters on the enforcement of the regulations), in transition countries where political and citizens' control on the administration may be weaker, high-rank officials can play active role in changing the rules of the game to serve vested business interests independently of the political elite. Unlike the case where the administration changes the rules of the game to meet demands of the overseeing political establishment, in the second case it does this to meet demand directly from the business.[19]

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Summing up the analysis of the demand-side drivers of tax corruption, taxpayers' benefit is he leading driver of bribery related to evasion. Bad regulations and administrative deficiencies also create substantial part of the demand for corruption services, which either seek to avoid penalties for non-compliance (other than fraud), or to speed up procedures and services. In the latter, the business has less choice than in the case of the corruption, related to evasion, while, conversely, the administration is in a position to navigate the interaction with the client toward bribery outcome. As corruption is mainly related to tax delinquency, it is reasonable to accept the prevailing opinion of the tax officers that the initiative for most corruption deals comes from the business. It is noteworthy, however that, again according to the overall assessment of Bulgarian tax officers, the pressure from the clients is not among the leading causes of tax corruption. In their ranking of the leading bribery drivers, the pressure from taxpayers is ranked 7th (Exhibit 9). Other drivers, which determine the supply of bribery services come higher among the major causes of corruption.

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[18] See for instance World Bank (2000), Hellman et al. (2000). These studies introduced the term "state capture" to denote bribes for changing the rules of the game. As "political clientelism", it denotes patronage by the state of vested business interests, the political clientele.

[19] This type of corruption, when the administration changes the rules in direct deal with the business is not well studied in transition economies. Institutional and oversight deficiencies in many countries, however, suggest that it may take place. Owners of some patent micro-businesses in Bulgaria, such as taxi drivers, video rental shops, real estate agents attribute upward adjustments of the patent tax mainly to payments by monopoly or oligopoly lobbies aiming to crowd them out of the market or to buy them. The initiative for these adjustments, however, rarely comes from the legislators.

Supply-Side Drivers, Restraints and Opportunities

If we ignore temporarily ethical brakes, the choice of a tax officer to take a bribe is determined by his assessment of the expected benefits and costs. The benefits are usually defined as the increase of his utility. Other things equal, the lower the tax officer’s income and the higher the bribe, the bigger the increase in his utility, the larger the incentive to engage in corruption. The costs, in terms of Becker’s (1968) classical theory of crime prevention, are determined by the bribee’s assessment of the probability of detection of the bribery and the cost of the punishment. The lower the probability of detection and the cost of the penalty, the more inclined the tax official would be to take a bribe.[20]

Furthermore, as already mentioned, the tax officer is not necessarily a passive taker of the bribe. In the case of strong incentives and weak brakes he may go beyond the normal call of duty to detect a fraud, or take advantage of ambiguities in regulations, or threaten with high fine, or take too long to provide a service or process an application. Moreover, the tax officer has much stronger positions in the price setting process. As already noted, the taxpayer cannot get the “bribery” service from anyone else. His choice is basically between the cost of the bribe and the cost of the penalty or the cost of the delay. This puts him in a position of a price taker. It is the supplier who is more in a position of a price maker. The value of the bribe is likely to be set by the tax officer in the range starting from the assessment of his costs up to the cost of statutory penalty. His price-setting power is especially high when the legislation leaves the fixing of the fine largely in the hands of the administration.[21]

The Bulgarian tax administration survey provides useful illustration of supply-side drivers and deterrents. Tax officers identify the following as the major causes for corruption in tax administration: low wages; bad ethics; mixing personal benefits and administrative responsibilities; greed for fast

[20] Of course effective penalty depends on proving the bribery act, therefore detection implies proof. One can speculate, however, that even if an investigation of a bribery act ends without proof and punishment it still entails a cost for the bribee in terms of loss of reputation and image and is a deterrent in terms of the investigated official’s future involvement in corruption.

[21] Bulgaria is a case in point. Concerning tax evasion, Bulgarian legislation does not regulate the penalty as a proportion of concealed income or evaded tax, but sets the ceilings for fines at BGL1,000 (EUR1 = BGL1.956) for income taxes and BGL10,000 (EUR5,000) in the case of VAT frauds. This structure leaves much room for discretionary setting of the fines, and thus for corruption pressure. On the other hand it may be argued that in terms of the cost of evasion, the bribe should have the same deterrent power as the fine, i.e. the higher the expected bribe, the lower the motives of the taxpayer to evade taxes.

increase in income; and flaws in regulations (Fig. 8). Thus, the survey defines tax corruption as a result above all of low remuneration, low ethical standards and high compliance costs. External factors such as the wide spread of corruption in society, the demoralizing impact of corruption at the higher levels of power are also important. Surprisingly, however, tax officers attach relatively low weight to elements of the organizational efficiency pertaining to the deterrents, such as staff and expertise shortages, inefficiencies in the control and penalty systems, flaws in audits or enforcement, etc.

Exhibit 9 (a) Which are the major drivers of corruption in tax administration? (%, up to three responses)

Tax officers' low salaries	52.2
The ethics of the tax officers	35.2
Legislation allowing discretionary enforcement	30.9
Mixing administrative duties and personal interests	21.5
The pursuit of fast increase in income	19.3
The wide spread of corruption in society	17.7
Pressure from taxpayers and insufficient protection and safety of tax officers	17.6
Complex and lengthy, bureaucratic procedures	16.9
Demoralizing impact of grand corruption	10.3
Old facilities and equipment and poor work conditions	10.2
Frequent changes in legislation	9.2
The insufficient number of the tax officials	6.3
Inefficient internal control and sanctions mechanisms	4.9
High taxes, fees and fines	3.1
Flaws in enforcement and work processes	2.9
Pressure from colleagues and superiors	1.9
Inefficient service provision (slow procedures)	1.7
Inefficient risk management and selection of audits	1.4
Other (please, specify)	0.9
Don't know/No answer	3.7

Accordingly, the countermeasures, identified by the tax officers are mainly an increase in their remuneration, reducing the opportunities for administrative discretion in law enforcement and e-services (Table 10).

Exhibit 9(b). Problems faced by the tax administer. (% of empl. who defined the problems as serious, i.e. highest in a 3-grade scale).

Problems	Total	TRS[a]	Audits	Inspections	Collect	Account	Appeals	Other	NA
Low remuneration	75.5%	72.2%	77.2%	89.6%	77.8%	68.2%	42.9%	70.8%	100.0%
Old facilities & equipment	61.4%	60.1%	69.0%	56.7%	70.4%	45.5%	71.4%	29.2%	70.0%
Red tape and slow procedures	58.7%	53.8%	65.5%	58.2%	66.7%	54.5%	42.9%	45.8%	80.0%
Frequent changes in tax regulations	58.1%	51.4%	69.4%	52.2%	66.7%	40.9%	57.1%	58.3%	80.0%
Loopholes in the legislation	52.5%	39.9%	67.2%	59.7%	59.3%	38.6%	57.1%	58.3%	50.0%
Low level of taxpayer culture and awareness of their obligations	51.9%	60.1%	45.7%	46.3%	51.9%	45.5%	42.9%	41.7%	60.0%
Refusal by taxpayers to cooperate	40.5%	35.8%	43.5%	58.2%	40.7%	38.6%	28.6%	25.0%	40.0%
Ineffective enforcement (detection and sanctions against frauds)	35.6%	31.9%	40.1%	37.3%	48.1%	29.5%	14.3%	33.3%	40.0%
Frequent staff replacement	27.8%	29.2%	27.6%	28.4%	29.6%	18.2%	28.6%	25.0%	30.0%
Ineffective HR management	26.9%	23.6%	29.7%	23.9%	29.6%	27.3%	28.6%	29.2%	60.0%
High tax rates	26.2%	26.7%	23.7%	28.4%	33.3%	25.0%	14.3%	25.0%	50.0%
Corruption pressure by taxpayers	22.0%	23.6%	19.0%	23.9%	29.6%	25.0%	28.6%	8.3%	30.0%
Abuse by tax officers of their administrative power	20.9%	20.5%	20.3%	22.4%	33.3%	18.2%	14.3%	20.8%	20.0%
Shortage of professionals	16.9%	13.5%	21.6%	14.9%	14.8%	15.9%	42.9%	8.3%	30.0%
Ineffective voluntary compliance management	16.6%	16.0%	16.8%	19.4%	18.5%	13.6%		25.0%	10.0%
Lack of professional ethics and integrity among tax officials	12.4%	10.8%	11.2%	16.4%	25.9%	18.2%		8.3%	20.0%
Poor services provided to taxpayers	11.2%	11.1%	11.2%	13.4%	11.1%	11.4%	14.3%	4.2%	10.0%
Base	699	288	232	67	27	44	7	24	10

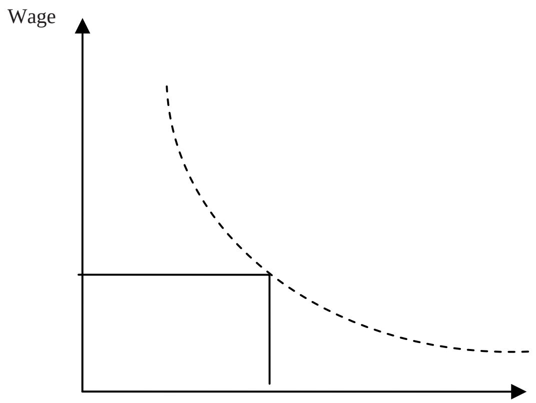
[a]TRS: Taxpayers registration and services

Table 10 Which of the Following Countermeasures Can Reduce Corruption (% of responses)

	Yes	No	Already done	DK/NA
Increasing tax administration remunerations	95.6	0.7	1.6	2.1
Clear legislation with reduced opportunities for administrative discretion	90.7	3.0	3.4	2.9
Optimizing the information to taxpayers on changes of legislation	81.0	4.6	12.4	2.0
E-services for taxpayers	78.5	4.6	11.9	5.0
Incentives for the tax officers to report corruption pressure on them	69.7	11.4	13.7	5.2
Efficient professional training system	68.5	8.4	19.9	3.1
Access of tax officers to unified tax register	63.8	8.2	18.6	9.4
Simplifying appeal procedures	59.8	12.7	15.2	12.3
Higher standards of reporting, control and sanctions	48.4	10.7	34.8	6.2
Rotation of auditors and inspectors	47.1	18.2	24.2	10.6
Optimizing work processes	44.2	5.2	47.4	3.3
Higher recruitment standards	43.9	13.0	37.9	5.2
Code of ethics	26.8	10.2	59.5	3.6
Other (please, specify)	0.9	16.9	0.6	81.7

Incentives

Not surprisingly, Bulgarian tax officers identify low wages as the prime reason for corruption. Low wages constitute the number one problem in all functional units, but “Inspections,” “Collection” and “Audits” seem to be most sensitive to it (Exhibit 9b). Accordingly, there is an absolute consensus (96% of the respondents) on the primary importance of increased remuneration for curbing corruption (Table 10).



The negative relationship between wages and administrative corruption has been well established in the literature. Nevertheless, the capacity of wage adjustments for minimizing corruption is not straightforward. As Exhibit 9 shows, Bulgarian tax officers identify low wages and low ethical standards as the leading motives for corruption. In the words of Tanzi (1998), corruption is partly due to need and partly due to greed. Figure 11 illustrates the negative relationship between corruption and the level of remuneration. The curve CC' indicates that the higher the wage level, the lower the corruption levels. High wages however do not eliminate corruption, as not all corruption is due only to need. Thus corruption levels may indeed be reduced to the point A through increasing the wage level to R. Between point A and O progress in limiting corruption slows down as corruption due to greed prevails. Thus, even though the level of corruption is negatively related to the level of remuneration, above certain level of wages they are not effective tool of reducing corruption. Such a relationship is well documented by empirical tests as well.[22]

Table 12 The Gap between Perceived Anticorruption Minimum Pay Levels and Actual Income Levels

Min pay level (BGL)	What is the remuneration level* (including bonuses) that would reduce the drivers of corruption to a minimum?									Total
	300	400	450	500	550	650	800	1,000	DK/NA	
Respondents %	**3.6%**	**5.7%**	**3.4%**	**14.0%**	**7.2%**	**12.4%**	**16.7%**	**25.8%**	**11.2%**	**100.0%**
Actual per capita household income										
<149	4.0%	0.0%	0.0%	0.0%	0.0%	1.1%	0.9%	1.1%	1.3%	0.9%
150–199	8.0%	0.0%	0.0%	2.0%	2.0%	1.1%	3.4%	2.2%	0.0%	2.0%
200–299	12.0%	15.0%	25.0%	10.2%	10.0%	6.9%	6.8%	6.1%	11.5%	9.2%
300–399	20.0%	27.5%	12.5%	18.4%	22.0%	20.7%	15.4%	14.4%	11.5%	17.0%
400–499	28.0%	17.5%	33.3%	21.4%	16.0%	24.1%	16.2%	11.7%	12.8%	17.5%
500–599	12.0%	15.0%	16.7%	20.4%	18.0%	10.3%	15.4%	11.1%	16.7%	14.6%
600–699	12.0%	15.0%	4.2%	9.2%	14.0%	13.8%	13.7%	15.0%	9.0%	12.6%
700–799	0.0%	0.0%	0.0%	7.1%	10.0%	5.7%	10.3%	12.8%	7.7%	8.3%
800–899	4.0%	5.0%	0.0%	1.0%	2.0%	5.7%	4.3%	10.0%	3.8%	5.2%
900–999	0.0%	2.5%	0.0%	4.1%	2.0%	4.6%	5.1%	5.6%	9.0%	4.7%
>1,000	0.0%	2.5%	0.0%	1.0%	2.0%	4.6%	4.3%	6.7%	6.4%	4.1%
NA	0.0%	0.0%	8.3%	5.1%	2.0%	1.1%	4.3%	3.3%	10.3%	4.0%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

*Monthly wages in BGL. The lev is fixed to the euro in the rate EUR1 = BGL1,956. For reference, the statutory minimum wage in 2004 is BGL120. The highlighted percentages show what share of those that indicated the respective anti-corruption minimum actually enjoy this level of income

[22] See Van Rijckeghem and Weder (1997); Haque and Sahay (1996).

The policy implications of this conjuncture are that, depending on the starting level of remuneration, the costs of wage adjustment may substantially exceed the benefits of reducing corruption. Targeting that optimal level of wages, where the marginal costs of wage adjustment equals the marginal benefit of reduction in corruption is a tough task. Trying to evaluate the cost and feasibility of minimizing corruption through wage adjustments, we used the tax administration survey in Bulgaria to obtain employees' estimates of the wage levels that would minimize their vulnerability to bribery pressures. The responses (Table 12) indicate that there is a large divergence in employees' perceptions about the anticorruption wage levels. Second, it shows a sizable gap between their current household incomes and the self-assessed corruption-proof wage level: 42.5% assess this minimum at levels which are 2–2.5 times the average tax officers' wage in 2003. Very few have indicated that they currently have such income. The "scissors" between the actual income levels of the tax officers and their perceptions about the anti-corruption level of remuneration show that a very small portion of the tax administration is not vulnerable to corruption pressures. Second, it shows that the cost of curbing corruption through wage rises might be too high.

Furthermore, the wage-related drivers of corruption can hardly be neutralized only through raising the pay levels. Tax officers' satisfaction with the wage would depend also on their perceptions of the fairness of the wage and career system, i.e. how objectively they reflect individual performances. This goes beyond the perceptions of own necessities and pertains to the efficiency and fairness of the human resource management, including recruitment, performance evaluation and training, and position and wage development. Rauch and Evans (2000) study recruitment and promotion practices in the public service of 35 developing countries and find strong positive relation between merit-based recruitment and internal promotion on one hand, and the efficiency of the bureaucracy on the other (including the level of corruption as well). Actually their work failed to establish such a relationship between merit-based wages and bureaucratic efficiency (corruption).

The uncertain anti-corruption effect of adjusting the base wages has made tax administrations rely on the non-fixed (targeted award) part of the remuneration. If they are well targeted and linked with the individual contribution to fighting evasion and reducing voluntary compliance costs, bonuses are more flexible and efficient anti-corruption tool than overall wage adjustments. They are superior incentives to wages for at least three reasons. They entail less fiscal cost, they do not require setting the optimal anti-corruption level of wages, and are a better targeted way to reward individual achievements. Moreover, they allow channeling limited resources to the most important functions and units, such as "Audits," "Inspections" and "Collection." The reward system however depends very much on the efficiency and accountability in these units. It would not yield much effect if the selection, assignment, monitoring and evaluation of audit and control procedures is not modernized and optimized, thus leaving opportunities for benefiting selected employees or customers. Furthermore, if the reward system is not to encourage only enforcement, but also voluntary compliance, it may need as well methodology to measure compliance rates and the respective contribution of the departments.[23]

This paragraph studied the supply side drivers toward taking a bribe. Why a tax officer may want or need a bribe, however, is only one side of the coin. Equally important is why he can afford to take a bribe without being punished. This pertains to institutional restraints and opportunities.

Restraints

Restraints can be roughly divided into two groups: penalties and ethical brakes. As already mentioned, the decision of the tax officer to take a bribe depends on his estimates of the probability that the bribery will be punished and the cost of the punishment. In line with these main implications of the crime prevention theory, anti-corruption policies in Bulgaria have prioritized so far stringent control based on the codification of abuses of power for personal gains and the respective strict penalties. Several amendments to the related sections of the penalty code since 2002 aligned legislation to the European standards. Specific clauses on tax-related corruption are included in the Tax Code, while tax fraud provisions are included in the respective tax laws. Administrative control was also strengthened: external and internal public sector audit agencies were reformed and strengthened, the tax administration internal control unit ("Inspectorate") was reinforced and given more powers, foreign consultants were hired to chase delinquent importers beyond custom clearance, and plans to establish tax police emerged on the top of tax reform agenda. In April 2004 the tax administration introduced Code of Ethics. Despite all these control and deterrent mechanisms, the effective penalties for tax frauds and even more so for tax-related corruption are rare.[24]

Our tax administration survey tries to measure the strength of administrative restraints by asking respondents about their estimates of the cost of bribery. It is high. (Table 13) Nevertheless, only 5% of the respondents place the fear of penalty as the leading motive to reject a bribe (Table 14). The majority refers to ethical brakes (67%) or concern for their image (22%). Given

[23] The bonus system in Bulgaria for instance rewards only tax fraud detection, doing little to encourage better services and voluntary compliance management, which might be much more feasible anti-corruption strategy in the short run. For more detailed assessment see Pashev (2005).

[24] See Coalition 2000 annual reports for account of the detected and penalized corruption acts in Bulgaria at www.anticorruption.bg.

the perceptions about the expected penalties, this result implies either extremely strong ethical brakes, or low probability of detection and punishment.[25]

Table 13 (a) What Are the Most Probable Consequences for a Tax Officer Who Has Accepted Bribe? (multiple choice)

The tax officer will be fired	60.9
He will depend on the briber in the future	38.1
The officer will get some penalty (demoted, transferred to another department, fine)	32.5
The detected bribery will be used for pressure against her/him.	17.9
The money/gift would be taken	5.2
There will not be any negative consequences	4.6
Other (please, specify).	0.4
Don't know/No answer	7.3

(b) Who Is to Be Punished More (%; single choice)

Both parties equally	60.7
Tax officers	25.0
Tax payers	8.0
DK/NA	6.3

Table 14 If a Taxpayer Asks You a Favor in Return for Money or Other Benefit, You Would: (% single choice)

Accept it as an act of gratitude	2.4
Accept it because the wages of the tax officers are low	2.7
Reject it because of fear of penalty	5.0
Reject it because it is against your ethical standards	66.9
Reject it because it may ruin your reputation	21.6
Other (please, specify).	1.3

Table 15 How Would You Assess the Following Acts by Tax Officer (%)	Acceptable	Rather acceptable	Rather unacceptable	Unacceptable.	DK/NA
To accept a free lunch/dinner by a taxpayer	4.6	8.4	20.0	65.4	1.6
To accept money favor to solve a taxpayer's problem	0.4	1.7	15.2	81.7	1.0
To provide inside information to taxpayers	0.3	0.3	5.0	93.4	1.0
To receive commissions or consultancy remunerations for taxpayer services	1.0	3.1	8.6	85.8	1.4

Table 16 (a) How Do You Differentiate Between a Bribe and Gratitude

A bribe implies advance agreement	8.7
If the benefit is not requested, it is rather an act of gratitude.	8.3
Depends on the size of the gift: small gifts are not bribes	49.8
If given for overcoming bureaucratic obstacles it is gratitude.	12.4
No, there is no difference	16.9
Don't know/No answer	3.9
A bribe implies advance agreement	8.7
If the benefit is not requested, it is rather an act of gratitude.	8.3

(b) Should the Maximum Level of Gratitude Gifts Be Regulated, and at What Level?

Yes, up to BGL 10	9.3%
Yes, up to BGL 20	4.0%
Yes, up to BGL 50	5.9%
Yes, other level	0.9%
Yes, level n.a.	1.0%
Not necessary	71.0%
DK/NA	8.0%

[25] The survey does not ask directly about employees' assessment of the probability of detection and their attitude to risk. The majority of the respondents, however, define bribery as a direct personal interaction between the briber and the bribee without any intermediaries and third parties involved. This implies that detection is difficult, and even more so is proving and punishing of bribery.

The former seems to be a convincing explanation if one considers the reported intolerance to corruption (Table 15). But on the other hand, if ethical brakes are so strong, would tax officers need such large wage adjustments to neutralize their motivation to take bribes as shown in the previous paragraph. Moreover, responses, related to the difference between bribe and gratitude indicate that the ethical borderline between professional integrity and abuse of power may be fairly elusive for a large part of the administration (Table 16). This may explain the relative tolerance to free lunches and small gifts. This finding weakens the case for ethical brakes. It tips the scale toward the conclusion that the responses in Table 12 reflect rather a weak probability of detection for 67% of the respondents, or weak probability of proof and punishment for 22% of them.

The Bulgarian survey checked as well employees' perceptions about the role of age and years of service on the individual inclination to take bribes.[26] About two-third of all respondents deny any relation whatsoever between the age and the length of service with the propensity to extract bribes, or to yield to corruption pressures from taxpayers. There seem to be wide consensus on that, irrespective of the age and length-of-service of the respondents. This result may reflect the effect of opposite factors related to age and length of service. On the incentive side income gaps might be felt more acutely with age and length of service, while bribery technology, "connections" and the ability to survive may improve. Conversely, on the deterrent side, the cost of detection grows with approaching retirement, as finding alternative employement might be much more difficult.

Another argument related to the efficiency of the ethical brakes asserts that codes of ethics can have limited impact if tax officers are exposed to corruption outside their work environment. Bulgarian tax officers place the spread of corruption in society among the leading causes of corruption in tax administration (see Exhibit 9a above). Accounts of personal experience indicate that tax officers are widely exposed to corruption outside their work: 35% needed to pay bribe or other benefit to doctors, and 12.3% to traffic police. In their assessment of the current challenges to society, they rank corruption fourth, i.e. above such problems as poverty, inefficient health system and judiciary. According to the tax administration, the public offices most affected by corruption are the customs, the judiciary, the public health system, the police and the license and permit authorities.

Important in the context of the ethical restraints is also the opinion of the employees about the social damages and costs of corruption. They seem to

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[26] Torgler and Valev (2004) find that the higher the age, the less likely the individuals are to justify corruption.

be primarily concerned with the loss of public credibility and trust rather than the economic costs (Table 17).

Table 17 In Your Opinion, Which Are the Three Most Harmful Consequences of Tax-Related Corruption?

Erodes public trust in the tax administration	77.3
Discourages compliance	47.9
Leads to fiscal losses	46.4
Creates shadow economy	37.2
Creates bad image of the country abroad	16.7
Discourages foreign investors	12.6
Erodes public ethics	12.3
Impedes reforms and development	9.4
Impedes fair competition	4.6
Impedes private entrepreneurship	3.6
DK/NA	1.7
Other	0.4

Institutional Opportunities

The institutional opportunities for corruption stem mainly from flaws in the tax and accounting legislation, and from inefficiencies in the organization of the work processes. The related anticorruption measures pertain to tax policy reform. They include above all the simplification of the tax code through reducing the various tax exemptions, which are preferred instrument in many transition countries for regulating economic activity. Ambiguities and inconsistencies in the accounting standards also provide large room for discretion and corruption pressures during audits.

Furthermore, bribery can be discouraged through streamlining the selection, assignment and reporting of audits and inspections, as well as through the monitoring and evaluation of their efficiency. It was noted above that even though tax officers place flaws in regulations high among the determinants of corruption; they are less demanding in regard to organizational inefficiencies: poor work conditions, shortage of staff, inefficient internal controls, flaws in enforcement and audit procedures. This finding departs from other assessments and should be treated with caution.[27]

"Sizing" the Problem and Evaluating the Policies

Delineating tax corruption from other corruption practices and studying its underlying drivers and mechanisms would have little practical value could it

[27] See for instance World Bank (2003).

not be used for appraisal of appropriate anti-corruption measures and even more importantly for monitoring and evaluating of their effect. Therefore, evaluating and measuring corruption is central in the context of two interrelated policy issues. The first one is the issue of the economic and fiscal costs of tax corruption in the broader context of ex-ante weighting of the costs and benefits of anticorruption reforms and measures. It is examined below in terms of losses of efficiency, equity and revenues. The second one is the issue of ex-post monitoring and evaluation of anti-corruption measures. A set of indicators are suggested for the purpose of diagnosing the problem and monitoring the efficiency and effectiveness of the assigned policy.

The Economic and Business Cost of Tax Corruption

The fiscal costs of tax corruption are obvious. As far as it encourages non-compliance, it erodes revenues and the capacity of the government to perform its regulatory functions and to provide public goods and services.[28] Most of these services are crucial for investment and growth: business services, infrastructure, education and health, etc. In transition countries, the perception about this causality is usually reversed. Entrepreneurs think that because the government does not deliver its part of the social contract embodied in the budget they are free not to comply with their part of this contract. One way or the other, the fiscal cost of tax corruption is evaluated through the rate of tax evasion and fraud. Even if not directly related to bribes, evasion is largely motivated by the perceived opportunity for bribery deal in case of detection.

The efficiency costs are not that straightforward. There have been even speculations in the literature about the efficiency-enhancing benefits of administrative corruption.[29] Some researchers argue that it can decrease the bureaucratic and regulatory obstacles to investment and growth, so to say to "grease the wheels" of growth. Reference has been made to some of the economies in South-East Asia, which achieved high growth rates despite relatively high corruption levels. Applied to tax administration, the arguments about corruption as a lubricant for the bureaucratic machine might hold in the case of bribes related to better taxpayer services. If the latter is well institutionalized, it decreases the elements of uncertainty. Investors know where and how much to pay and how much exactly the service will cost in terms of time and money. Furthermore, the arguments go, those that are most

[28] There have been also arguments however that bribes save money for public wages, thus allowing lower tax burden, which is conducive to growth (Tullock 1996).

[29] These arguments have been more frequent in the 1960 and 1970, but have gradually declined since the 1990s. For a comprehensive discussion see Martinez-Vazquez et al. (2004) Bardhan (1997).

efficient can perhaps offer the highest bribes (Beck and Maher 1986; Lien 1986). Those that offer bribes to speed up administrative procedures value their time more than the rest. Therefore corruption provides benefits in terms of saved time to those for which the opportunity cost of time is highest (Lui 1985). Even in regard to corruption related to tax evasion, it may be speculated that as far as it helps reduce effective taxation, it reduces tax-driven excess burden, allowing larger share of income to remain within the private sector and be used more efficiently for investment and growth than if it were channeled to public expenditures. The more so, as those that can afford to offer bribes are likely to be the most profitable companies, i.e. the most efficient ones. Therefore, tax corruption may enhance efficiency as it reduces the progressivity of the tax system and the related disincentives to investment and growth. There have been even arguments about the benefits of using bribes for financing of political parties as far as it enhances political stability and the capacity of the ruling party to pursue its growth policies.[30]

It is not difficult to see the flaws of most of these arguments. Corruption can help the investor to overcome various bureaucratic hurdles, but these hurdles may be the result of bribe opportunities. Lacking adequate checks and balances, bureaucrats may use their power to extort bribes by slowing down procedures. Or procedures for non-bribers may not be delayed intentionally, but as a result of preferential treatment of bribers, who jump ahead of the line, often with incomplete documents. One way or another, efficiency is deteriorated because of corruption opportunities and practices, while the administration has an incentive to push regulations and procedures toward more complexity and administrative discretion. There might be gains for those paying bribes relative to non-bribing competitors, but not relative to what their cost would be in a corruption-free environment.

The arguments about the capacity of corruption for the purpose of evasion or avoidance to reduce direct and dead-weight tax burden incurred by the private sector touch on one of the core issues in public finance, i.e. the

[30] Anecdotal evidence from importers and customs officers in Bulgaria indicates that in the early years of transition new political elites might not have had yet strong political clientele to offer financial support, and might have had to rely on institutionalized customs corruption for party financing, taking advantage of high import duties and at the time high sales margins of imports. This specific may reflect as well inertia from the past, when the party used foreign trade and state revenues for political financing; or the lack of strong relations of the new political elite with the business elite (which largely emerged from the old political elite), or the limited number of companies that could afford to make political investment with dubious returns. It may partly explain the perpetual pattern of high customs corruption in Bulgaria and other countries in the region. With import duties declining, the relative share of VAT frauds is growing, which explains as well partly the patterns of tax evasion in Bulgaria.

optimal size of the government. However, in a functioning democracy, the choice of what proportion of national income to redistribute and the corresponding level and structure of revenues is made by the public through the parliamentary mechanisms. Furthermore, a "small government" does not mean just a small share of revenues in GDP, but an equitable distribution of the benefits of the low tax burden to all taxpayers. In most transition countries revenues make smaller share of GDP than in the EU, but the benefits go primarily to the non-compliant entrepreneurs, who are most likely to be bribers as well. The idea, that the latter may be more efficient than non-bribers because they can afford to pay more, lacks solid grounds too. Competing through bribes diverts resources to rent-seeking, i.e. those that can afford to pay bribes are not necessarily the most efficient in terms of productivity. On the contrary, tax corruption leads to unfair competition and a distortion of incentives. Competitive and price advantages extracted through bribes can hardly channel resources to the most productive use and to most competitive companies. Accordingly, resources are diverted not toward increased productivity and efficiency, but toward rent-seeking because this is the market test that companies need to pass in order to compete.[31] Needless to say that price signals driving the efficient allocation of resources do not work. In sum, corruption results in market failure to allocate efficiently recourses.

Finally, while financing through corruption might improve political stability and efficiency under very special circumstances, it is more likely to drive society away from the checks and balances of democracy.

Those are economic costs, i.e. they affect economic efficiency at aggregate level through driving the market away from optimal allocation of resources. Tax corruption incurs, however, extra ***business costs*** at company level, thus discouraging investment. This however is true mainly in the case of bribes for tax services.

Both economic and business costs discourage investment. Bribes for services or to overcome excessive compliance costs are a direct cost to the company, and are correctly referred to as bribe tax. But economic costs may be stronger disincentive to investment, when entrepreneurs can not follow the rules of competition through bribes in a corrupt environment. This is especially important when foreign or domestic investors have the choice to invest in less corrupt economy. For these reasons, tax corruption makes investment and competitiveness policies of transition countries highly inefficient. Most incentives, oriented toward promoting FDI or SME growth, or strategic industrial sectors for upgrading competitive advantages, are weakened either by rent-seeking opportunities for bribers, or by the investment risks they imply for non-bribers.

[31] See Baumol (1990); and Murphy et al. (1991).

There are also the costs of corruption in terms of ***equity losses***. As already mentioned, it affects vertical equity through helping tax evasion and thus reducing the progressivity of taxation. It affects as well horizontal equity allowing bribers to pay less tax than non-bribers. These losses are much more important in an emerging market economy, where at the first years of transition the economic policy agenda was dominated by redistribution of accumulated national wealth to the private sector rather than creating it. The post communist societies were sensitive to well-positioned individuals benefiting of what has been perceived as national assets through corrupt privatization or siphoning out the state enterprises at the expense of the public at large. These equity consequences of corruption eroded the trust and the support of transition, and in Bulgaria for instance led to delays and backsliding in reforms. Furthermore through its fiscal cost, corruption undermines the redistributive capacity of the government and thus may lead to more poverty.

The cost of corruption is likely to fall more heavily on small taxpayers than on big ones. First, small companies face heavier compliance costs as a percentage of their income, and are far more susceptible to corruption pressures from tax officials. Large companies have the necessary human, financial and organizational resources and political connections to deal with corrupt tax officers. Furthermore, most of them are serviced and audited by central large taxpayer units, where internal control and corruption prevention are superior relative to the periphery of tax administration. Last but not least, small companies operate in far more competitive market than large companies and have greater difficulties in passing the cost of tax corruption on to their customers or back to their suppliers (Tanzi 1998). This is true especially in the cases of subcontracting and outsourcing when their clients are large companies.

Last but not least, there are substantial indirect economic and business costs of tax corruption. Above all tax corruption is important prerequisite for any other corruption in two ways. On the one hand bribes channeled to other administrations seldom come from personal balances. They are company costs and often come from unregistered retained company income. The opportunity and the size of such “bribery” funds is largely a function of the level of tax corruption. Moreover, on the “revenue” side, it is again the tax administration that has the strongest anti-corruption resources at its disposal. It is in a position to check the discrepancy between public wages and personal wealth and lifestyle of corrupt administrative officers, or politicians and legislators. Therefore the clues to limiting corruption in society as a whole are very much in the efficiency (i.e. low rate of corruption) in the tax administration. The bigger tax corruption, the larger the opportunities for giving and benefiting from bribes in all other spheres of the public and the private sector. In this sense, the cost of tax corruption should be assessed as well by its spill-over effects on other types of corruption—public procurement, licenses and permits, public services—and the related costs to the economy and the business.[32]

Indicators

Direct measuring of corruption is hardly reliable. Detected and penalized corruption acts are only the tip of the iceberg. Surveys try to capture personal experience, but personal involvement in bribery, which, in the case of taxes often implies more serious violation, is quite sensitive issue to be disclosed in face-to-face interview. Therefore most measures of corruption are derived from perceptions and assessments of taxpayers with all related risk of possible departures from the real situation.

Nonetheless, perceptions are important for anti-corruption policies. Economic behavior is determined by expected rather than actual costs. Thus, investors' perceptions about corruption levels and related investment risks and costs are what matters for the efficient allocation of resources.[33] Similarly, it is the taxpayers' evaluation of the net cost of tax evasion and bribery and of the cost of compliance that drives corruption rather than the actual capacity of the administration to detect and punish evasion, or to process applications. Perceptions, however, might be much more instrumental for policy making if they are used to diagnose the drivers of corruption on the demand and the supply side rather than the actual level of corruption.

Annex 2 presents a matrix of indicators for evaluating corruption levels and the strength of its underlying factors, based on the conceptual framework developed in the previous three Sections. It builds on the extensive literature and practical experience of measuring and monitoring corruption in transition and developing countries as well as on the experience with the corruption survey of tax administration in Bulgaria. It does not offer an accomplished framework but rather an open framework that can guide diagnostics toward more balanced approach to benefits and costs. The "business cost" approach tends to overestimate the costs on the demand side and may fail to explain the persistent patterns of high corruption in transition economies. Distinguishing between bribes that are imposed on the business from bribes that are the price of a service demanded by the business helps understanding better tax corruption. In the latter case bribery is a transaction

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[32] See Martinez-Vazquez et al. (2004) for a discussion of corruption costs in general.

[33] On the other hand it may be argued that the results of the monitoring of corruption also create perceptions, with the ensuing economic costs, thus being self fulfilling. This is not to be interpreted however that an inefficient anti-corruption strategy may be substituted by efficient PR strategy with similar effect on risk assessment and investment.

between two beneficiaries at the expense of compliant taxpayers. This implies that not all tax corruption fits well into the beneficiary-victim framework of the business costs surveys. More often the initiative comes from delinquent taxpayer, aiming at certain benefits. It also follows, that parallel to business surveys, tax administration surveys are indispensable part of the diagnostics. The suggested indicator matrix attempts to incorporate into the diagnostics framework demand and supply side incentives and costs.

Second, the proposed evaluation framework tries to incorporate hard data. In addition like other surveys, it includes reference to personal experience as well. Most surveys either ask respondents about given or received bribes and their size or pose the more neutral question of experienced corruption pressure. The sensitivity of this issue, stemming from the fact that the taxpayer is more often beneficiary rather than a victim makes these results open to questions.[34] Drawing evidence from both sides provides the opportunity to overcome the sensitivity of asking information on personal involvement in wrongdoings by asking instead each party about bribery pressure from the other party (in addition to the opinion questions of which party initiates most deals and why).

Third, the proposed framework tries to go beyond the immediate objective of measuring corruption per se, but to assess as well the intensity of its underlying factors. From policy viewpoint this may have higher value than the speculations about how close the perceived level of corruption is to the actual level.

The perceptions about the level of corruption are examined usually in two dimensions: a) in terms of spread and intensity of corruption acts; and b) in terms of the average value of the corruption deals. The penetration rate can be measured through assessment of the share of taxpayers and tax officers involved in corruption acts. The intensity is measured through the frequency of bribes, or, alternatively, through the more neutral measure of the frequency of cases of pressure toward bribes.

The size of bribes is a central indicator in the "business cost" approach to corruption. It is measured either in absolute terms or as a share of

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[34] The corruption indices of Coalition 2000 in Bulgaria incorporate perceptions as well as evidence about experienced corruption pressure and personal involvement in corruption acts (see the methodology in Nonchev 2004). As effective Bulgarian legislation however incriminates both giving and accepting of bribes and any actions aimed at bribery deal, the evidence about given/offered bribes and their size obtained in a face to face interview can be indicative of changes over time rather than the actual level of corruption at a point of time. International indices try to overcome this sensitivity by avoiding the questions about personal experience, but rather referring "typical company like yours", or "your branch/sector" (see for instance the measures of Global Competitiveness Report and Transparency International).

business gross receipts or profits. [35] These measures can be derived both from taxpayers and tax officers' assessments or personal experience. The use of the size of bribe as an indicator of corruption levels, however, requires certain qualifications in the context of the "transaction" approach to corruption. In the conventional interpretation of the bribe as business cost, the increase of bribes is interpreted as a measure of aggravated corruption problem. Such an interpretation ignores both the causes and likely consequences of the increase of the size of bribes. As already mentioned, the growth in bribes may reflect the success of anti-corruption policies. If incentives and brakes on the supply side are effective, they increase the cost of detection and thus the size of the benefit below which the tax officer would not take the risk of bribery. In brief, the growth in the size of bribes may reflect growing risk premiums set by the supplier of the bribery services. Alternatively, as already mentioned, growing bribes may reflect increased penalties for evasion, or increased evasion and detection of evasion by the auditors. Depending on demand and supply elasticities, in the best case scenario, growing bribes may reduce the spread of corruption, crowding it out to the high levels of income and evasion (which might facilitate control and detection), or to other types of bribery with higher return (e.g. public procurement, etc.) In this sense higher bribes for evasion may be more instrumental than higher penalties in deterring it, as the corrupt auditor will have more incentives to detect the full amount of evasion. This is not to imply that if the administration cannot minimize evasion bribery through penalties, it should rely on the bribe costs incurred by the business. It rather means that the size of the bribes alone is not telling much neither about the cost of corruption, if it is measured separately from the benefits, not about changes in the level, if it is taken separately from the changes in the spread of corruption. A more synthetic measure of bribes, not as business cost but as a ratio of the received benefit might provide more useful information on the value of the deal rather than on the value of the bribe alone.

In addition to the overall level of tax corruption measured through the number and value of corruption deals, the diagnostic framework proposed here underlines the importance of the structure of corruption in terms of type of bribery services obtained as well as in terms of horizontal and vertical patterns of concentration of corruption risks in the administration.

In addition to indicators about the intensity and value of deals, the indicator matrix proposes indicators of the underlying drivers of tax corruption. In line with the conceptual framework presented in Section Two, distinction is made between demand side drivers of evasion on one hand, and excessive compliance costs on the other. The propensity to evade taxes and

[35] The absolute measure of the bribe sizes is used by Coalition 2000, while the second measure is used by the World Bank in its Business Environment and Enterprise Performance Surveys (BEEPS) in transition countries. See Gray et al. (2004).

hence the likeliness of related corruption acts are assessed in terms of indicators of the tax burden and the cost of evasion. They are derived both from hard data about marginal and effective tax rates and compliance gaps, and from involved parties' assessment of the tax burden and the cost of evasion, including the attitude of respondents to risk. The cost of evasion is perceived to incorporate the probability of detection and the expected size of the bribe needed conceal it from authorities. Data and feedback on the percentage of successfully appealed audits can be indicative about the relative weight of regulatory flaws and tax inspectors' pressures in corruption related to non-compliance. Therefore respective indicators and assessment are also included in the diagnostic framework. The strength of the drivers underpinning the second group of corruption services, those related to voluntary compliance is diagnosed through various measures of the costs of tax compliance, as well as the policies of observing standards of services and their monitoring, evaluation and reporting. Important in this regard is the bargaining costs of the bribery deals. It depends on the degree of institutionalization of corruption, i.e. whether entrepreneurs know to whom to pay and for what and whether they know what exactly they get for that and how probable is that the other party will default.

The incentives and opportunities on the supply side are to be evaluated through the tax administration assessment of incentives. These pertain mainly to the perceptions of the fairness and efficiency of the HR system, the core of which is the level of remuneration, including the base wage and the bonus part. On the side of brakes, similarly to the demand side, what matters is the evaluation of the tax officers on the cost of detection of bribery. It is determined by the probability of proving the act, the expected consequences in both the case of proved accusation as well as of withdrawn accusation, and the attitude to risk. In line with the growing evidence in the literature on the importance of ethical brakes, they are also included in the diagnostics framework. The findings can provide guidance on the needs for specialized anti-corruption training of the tax administrators.

Most importantly, the value of asking tax officers about corruption is largely in having first hand evidence on the institutional flaws that lead to increased opportunities for bribes, including those pertaining to the flaws in legislation and the work environment and processes.

Conclusion

Tax corruption is traditionally evaluated in terms of business costs. While, this concept is valid in the case of bribes paid by compliant tax-payers, or bribes paid by taxpayers whose non-compliance is due to flaws in tax and accounting regulations, most corruption in tax administration seems to be related to tax evasion. Drawing evidence from corruption surveys of the business and tax administration in Bulgaria, the study tries to look at tax corruption from slightly different perspective. It examines the problem and its underlying drivers from the viewpoint of transaction rather than imposed extra cost on the business. In the case of detected evasion the bribe is the price paid by the business for concealing the detected fraud. Other corruption services, like those related to speeding up procedures and tax returns may be much more imposed by the supplier, than demanded by the taxpayer. In this sense, the proposed indicator framework identifies the drivers and deterrents, the incentives and the institutional opportunities that determine the demand and supply of corruption services related to compliance and enforcement of tax regulations. The proposed framework is intended as flexible and far from comprehensive diagnostic framework for evaluating the costs of tax corruption, formulating and appraising corresponding remedies. Moreover, the indicators can be used for monitoring and evaluation of the impact of anti-corruption measures in terms of their effect on the level and spread of corruption, and more importantly on the underlying drivers. They might be useful as well in comparing tax corruption across transition countries, which will provide deeper insights about the causes and the remedies.

In a wider context, the policy framework developed here might be relevant in better distinguishing between business costs and benefits when evaluating the institutional opportunities for demand or supply of other corruption "services". Interpreting the bribe as net cost for the briber holds primarily for corruption related to public services and compliance costs (e.g. bribery for speeding up permit and licensing procedures). Most corruption acts imply benefits for the briber, which are usually ignored when asking the bribers about the cost of corruption. These include bribes for evasion of taxes, import duties and social insurance contributions, but as well bribes for winning public contracts, court trials, obtaining undue social benefits (as disability pensions), where the briber is a net beneficiary. This may help to understand better the persistence of corruption patterns in transition economies. Furthermore, the analysis of the demand side drivers in these transactions may help the understanding of the changes in corruption patterns as driven by differing rates of return.

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Annex 2 Tax corruption level and drivers: Indicator matrix

Object of measuring	Indicator	Hard data (templates)	Soft data		Reference data
			Taxpayers' survey evaluation/personal experience	Tax collector's survey evaluation/personal experience	
Level of tax corruption	Share of companies involved		• Share of companies paying bribes[36] to tax administration (scale of 5[37])	• The number of companies paying bribes to tax administration: (scale of 5)	Number of sanctioned taxpayers[38]
	Share of tax officers involved		• Share of tax officers taking bribes: scale of 5	• Share of tax officers taking bribes: scale of 5	Number of penalized officers[33]
	Frequency of bribes		• How often a firm like yours might offer bribes, gifts and other favors to tax officials: scale of 5	• How often taxpayers offer bribes, gifts and other favors to tax officials: scale of 5	
	Size of bribes		• What is the average level of bribes paid scale of 5[39]	• What is the average level of bribes paid scale of 5[34]	
	Personal experience		• How often in the last year had you to offer some benefit to a tax official in relation to your taxpayer obligations through bribes/gifts/favors/ entertainment: scale of 5 each	• How often in the last year you were offered a benefit in relation to your obligations: bribes/gifts/favors/entertainment scale of 5 each	
			• Did your bribe expenses increase in the last year (versus the previous year): a) in absolute terms; b) as a share of company income: increased/decreased/stay the same each one	• Is this increase or decrease versus previous year in terms of : a) number of companies, frequency of briberies/size of bribes offered increased/decreased/stay the same each one	

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[36] Bribes including benefits in cash or in kind such as gifts, favors, free lunches, etc.

[37] A scale of 5 is an approximation of the following values

Rate	1	2	3	4	5	DK/NA
How often	never	rare	sometimes	often	always	
How many	Few	<1/2	about 1/2	>1/2	Almost all	

[38] It is ambiguous: it indicate rate of corruption, but rate of detection as well, therefore it is used only as reference item.

[39] For cross country comparisons the scale might be based on the minimum wage, or the average tax administration wage, e.g.: <1/5; <½, <1; <3; >3.

Object of measuring	Indicator	Hard data (templates)	Soft data: Taxpayers' survey evaluation/personal experience	Soft data: Tax collector's survey evaluation/personal experience	Reference data
Structure			• What are the services most often paid for (rank them): avoiding fines and sanctions for non-compliance; speeding up procedures (including VAT refund); receiving undue tax benefits (exemptions, deduction credit refunds); information about (actions against) competitors	• What do taxpayers most often pay bribes for? (rank them): avoiding fines and sanctions for non-compliance; speeding up procedures (including VAT refund); receiving undue tax benefits (exemptions, deduction credit refunds); information about (actions against) competitors	
Horizontal and vertical patterns			Evaluate the degree of penetration of corruption across administrative functions in terms: • of officials involved • size of bribes • frequency of bribes Evaluate the degree of penetration of corruption across administrative levels in terms of • officers involved • size of bribes • frequency of bribes	Evaluate the degree of penetration of corruption across administrative functions in terms: • of officials involved • size of bribes • frequency of bribes Evaluate the degree of penetration of corruption across administrative levels in terms of • officers involved • size of bribes • frequency of bribes	

Demand side drivers and deterrents

Corruption related to non-compliance	Tax burden	Indicators of the tax burden: Tax Structure marginal and effective rates	• How do you evaluate the tax rates of PIT/CIT/VAT/SIC/Excise/Property and other local: not a problem/some problem/too much a problem • In the last year how often your firm needed to pay bribes to avoid sanctions for non-compliance due to flaws in regulations, or tax evasion; scale of 5 • Which taxes are most often subject to evasion fraud PIT/CIT/VAT/SIC/ Excise/Property/ other	• How do you evaluate the effect of tax rates of PIT/CIT/VAT/SIC/Excise/Property and other local on entrepreneurship: not a problem/some problem/too much a problem Which taxes are most often subject to evasion fraud PIT/CIT/VAT/SIC/Excise/Property/ other	Compliance gaps[40]

[40] They may reflect both excessive tax or compliance costs or income-maximizing behavior of taxpayers, therefore it is suggested as a reference item.

Object of measuring	Indicator	Hard data (templates)	Soft data		Reference data
			Taxpayers' survey evaluation/personal experience	Tax collector's survey evaluation/personal experience	
	Cost of evasion Probability of detection Probability of successful appeal	Penalty schedule Size of bribes Detected cases of evasion Number of audit acts Value of audit acts Number of audit acts appealed to the administration Number of appeals overturned fully Number of court appeals Number of appeals rejected fully in court procedures	• In your opinion is the penalty structure efficient in deterring tax evasion: 1 very efficient 5 not efficient at all, • What is the average level of bribe as a percentage of detected tax liability: less than a fifth/ a third/ up to a half more than a half, determined by the auditor /dn-na/ other • In your opinion what percentage of the tax fraud is detected by tax officers • Of those detected what percentage is actually punished, i.e. penalties are not avoided by bribes • In your opinion, which companies evade more taxes (as a percentage of taxes due) small-large, other dk/na; • Do you think that the probability of detection depends on the size of the fraud • Have you in the last year had an audit or inspection act for non-compliance • Have you in the last year avoided sanctions through bribe • Have you in the last year experienced appeal procedure? Was it successful (yes/no/not completed)	• In your opinion is the penalty structure efficient in deterring tax evasion: 1 very efficient 5 not efficient at all • What is the average level of bribe as a percentage of detected tax liability: less than a fifth/ a third/ up to a half more than a half, determined by the auditor /dk-na/other • In your opinion what percentage of the tax fraud is detected by tax officers • Of those detected what percentage is actually punished, i.e. penalties are not avoided by bribes • In your opinion, which companies evade more taxes (as a percentage of taxes due) small-large, other dk/na; • • Do you think that the probability of detection depends on the size of the fraud	
	Attitude to risk		• Do you have your accommodation or other immovable property insured? • Other things equal, you may choose tax evasion or avoidance, which leads to the same benefit, but the first implies a 50:50 probability of detection and penalty, while the second implies a cost paid to the tax consultant, equal to half the penalty. You choose: evasion/ avoidance/ none/ dk/na		

Object of measuring	Indicator	Hard data (templates)	Soft data		Reference data
			Taxpayers' survey evaluation/personal experience	Tax collector's survey evaluation/personal experience	
Corruption for preferential services (time gains and other benefits related to voluntary compliance)		• Are there standards of services? • Is the rate of compliance with these standards monitored and published?	• In the last year how often your firm needed to pay bribes to speed up procedures services, tax rebates. Scale of 5 • Are there standards of services? • Is the rate of compliance with these standards monitored evaluated and reported (published)? • How do you evaluate the efficiency of the tax administration: scale of 5:1 for simple and stable regulations, low compliance costs; to 5, inefficient high compliance cost and impediment to business. • What is the average percentage of work time spent by : a) the senior management with tax officers, or for compliance with tax regulations; b) accounting and other office staff for dealing with tax requirements and officers on CIT/PIT/VAT/SIC	• Are there standards of services? • Is the rate of compliance with these standards monitored evaluated and reported (published)? • In the last year how often have you encountered the following attitude from taxpayers (1–5) not satisfied with the services/do not know their rights and obligations/have excessive expectations/think that can achieve anything by bribes	The value of overall "time tax" from business environment surveys
		• Rate of institutionalization of corruption • Effectiveness of bribes	• Are the rates of payments for various services established and known in your branch • How much reliable is the bribe. Do tax officers deliver according to the agreement?		
		• Perceptions about the costs of corruption	• Rank the three most probable negative effects of corruption		

Supply side drivers and opportunities

Object of measuring	Indicator	Hard data (templates)	Soft data		Reference data
			Taxpayers' survey evaluation/personal experience	Tax collector's survey evaluation/personal experience	
HR management efficiency and fairness	System of awards performance evaluation, relation to career and wage development Recruitment Training	• Turnover rate • Education level • Absenteeism		Evaluate the fairness and efficiency of the following components of the HR management system • Remuneration • Bonuses • Overall performance evaluation • How is it related to the career and wage development • Recruitment • Professional training	
Brakes	Cost of detection of bribery Attitude to risk Ethics	Number of checked signals Number of penalties Is there code of ethics		• If you are detected with a bribe what is the most likely consequence • If you lose your job your prospects to be employed by the private sector • Do you have your accommodation or other immovable property insured? • Rank the three most probable negative effects of corruption	
The institutional setting: Non-compliance bribes				• What are the major problems of tax administration • What are the major causes for corruption in tax administration • What are the measures leading toward minimizing corruption in tax administration	

19

Tax Compliance of Small Business in Transition Economies: Lessons from Bulgaria

Konstantin V. Pashev[1]

Introduction

The rapid expansion of the small business sector in transition economies poses a number of questions and challenges to tax policy and administration. Does the small business sector need a special tax treatment? What are the policy objectives of such treatment? Does it aim at reducing the direct tax burden, or does it rather seek to reduce compliance and enforcement costs? Does it aim to raise more revenues from the hard-to-tax, or to allocate scarce administrative resources more efficiently? What are the respective benefits and costs?

The small business is the major engine of employment creation and growth, but it is as well a major challenge in terms of compliance management. The answers to those questions are essential in the politicised environment of tax policy making, where politicians tend to emphasise tax incentives for growth, while actual tax design often tends to prioritise revenue targets, sometimes at the expense of economic and administrative efficiency.

There is no doubt about the primary importance of small and medium-size enterprises (SME) in East European transformation. First and foremost, small business' capacity to create employment and provide some source of income are crucial when structural reforms and privatisation of state enterprises leave large part of the labour force out of the payroll. Apart from their indirect social function at the start of transition, later, small enterprises are a major driver of competitiveness. Their creation and growth enhance

[1] This study was completed during a Fulbright senior scholarship research exchange hosted by the Andrew Young School of Policy Studies, Georgia State University, Atlanta GA. I am much indebted to Jorge Martinez-Vazquez and Luc Noiset for helpful comments on previous versions.

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competition, drive restructuring and venturing into new technology and product lines, thus being an important prerequisite for a dynamic and competitive economy. Moreover, in today's highly integrated production networks, where subcontracting, outsourcing, and flexibility are crucial for the survival of the large companies, the competitiveness of the latter depends much on the SMEs' efficiency. This is especially important in the context of the challenges of accession to the EU and convergence. The European Charter for Small Enterprises[2] recognises SMEs as the backbone of EU economy and the key to implementing its Lisbon strategy of making Europe the most competitive and dynamic knowledge-based economy in the world. Last but not least, the importance of the small entrepreneurs is related to the political economy of transition. The small business is the key to the formation and expansion of a middle class and a civil society, which provide the main checks and balances against both backsliding in democratic reforms and political clientelism.[3]

There is little doubt that relative to large enterprises, small businesses face more severe liquidity constraints. As argued below, they incur higher compliance costs as well. This reinforces the case for a special tax treatment for them. Generally, policy choices comprise two groups of instruments. The first one comprises the use of tax preferences and incentives to support the start-up and the growth of small companies. These include lower corporate income tax rates, special tax exemptions and other relieves for small businesses.[4] The European Charter for Small Enterprises for instance, sets the objective that "Tax systems should be adapted to reward success, encourage start-ups, favour small business expansion and job creation, and facilitate the creation and the succession in small enterprises. Member States should apply best practice to taxation and to personal performance incentives."

Apart from incentives, a special tax regime for the small entrepreneurs may seek to raise efficiency of tax collection and compliance management. The relative weight of this kind of policy objectives in transition economies has been growing with the expansion of the informal economy. Its boom has been largely attributed to the rapid expansion of the hard-to-tax segments of the business sector such as micro firms, service providers and self

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[2] The Charter was adopted in June 2000 and joined by candidate countries in April 2002. See http://europa.eu.int/comm/enterprise/enterprise_policy/charter/charter_en.pdf; for the text and http://europa.eu.int/comm/enterprise/enterprise_policy/charter/charter-2004_cc.htm for 2003 implementation reports by candidate countries.

[3] Political clientelism (or state capture) denotes forms of grand corruption, when democratic institutions are captured by powerful business groups and public policy serves the vested interests of this small clientele.

[4] Even though tax preferences for SMEs are common in many advanced countries, its rationale has been seriously challenged in the optimal tax literature (see Holtz-Eakin 1995).

employed. Tax administrations have tried to address this challenge through better auditing, risk management and anti-corruption policies. In addition to the conventional emphasis on enforcement efficiency, they started to attach higher priority to improving the services for the taxpayers and reducing the cost of voluntary compliance. Parallel to establishing large taxpayer units, which account for the collection of more than half of all tax revenues, tax administrations often try to address the challenges of the small business sector's low compliance rates by forms of simplified or presumptive taxes.

Unlike large taxpayers, however, small entrepreneurs are large in number and far from homogenous in terms of income and revenue potential. Therefore, the design of a simplified tax presents challenging dilemmas in regard to efficiency and equity trade-offs. What is the contribution of the small business sector to the shadow economy? How to find the optimal balance between stringent law enforcement, reduced compliance costs and more efficient allocation of administrative resources? Is it better to leave a larger part of the hard-to-tax outside the income tax net and rely instead mainly on consumption taxes? Or, should they better be taxed through some form of simplified tax, such as presumptive or single tax? Do these special regimes help or impede small entrepreneurs' transfer to the standard tax net as they grow? What are the respective benefits and costs of a presumptive tax for the taxpayers and the administration? The international experience and the literature offer a wide range of answers to these questions with a variety of incentive, as well as distributional and revenue outcomes and different costs of collection for the private and the public sector. Taking stock of it, this paper studies the tax administration side of optimising the taxation of small business. The focus is on the costs and benefits of presumptive taxation. Tax incentives and preferences for the small business remain outside the scope of this paper, even though it also looks at the efficiency and equity consequences of presumptive taxes.

Section one of the paper puts the question of small business compliance in the context of the specific challenges faced by the tax administrations in transition countries. It draws heavily on the literature on the shadow economy and tax evasion. Section two studies the specific tax and compliance costs, which place the small business in Bulgaria at a disadvantage relative to other taxpayers and provide strong incentives to non-compliance. It argues that these incentives are mainly related to the disproportionate tax burden of compulsory social insurance contributions and income taxation of sole proprietors, as well as the higher compliance costs faced by the small business in Bulgaria. Section three reviews the theory and practice of presumptive taxation as one of the common tools used to address the challenges of small business non-compliance, and studies their benefits and costs in terms of efficiency and equity. Section four looks at the experience of Bulgaria with two presumptive taxes: the patent tax; and the minimum insurance income thresholds. Section five discusses the opportunities and respective costs of the optimisation of the patent tax. The last section offers some conclusions.

The Small Business and the Shadow Economy in Transition Countries

Small entrepreneurs, self-employed professionals and farmers, are broadly referred to as the “hard-to-tax”.[5] The question of why they are a challenge to the tax administrations in transition countries, and how big this challenge is, has attracted recently much attention in the literature. In general it pertains to the role and the relative weight of the small business sector in the shadow economy of these countries.

Schneider and Enste (2000) define the shadow economy in terms of income unreported to tax authorities, which is generated in the production of legal goods and services by agents that are not registered, or do not pay taxes. Even though the expansion of the shadow economy is a worldwide problem,[6] it is much more pronounced in the countries of transition. Between 1990 and 2001 the shadow economy in the countries of the former Soviet Union grew by 36% to an average of 44.8% of formal output, while in Central and South-East Europe it increased by 25% to an average of 29.2% (Schneider 2003). The severity of the problem for transition countries stems as well from the higher costs they incur relative to more developed countries in terms of losses of revenues, efficiency and equity (Alm and Martinez-Vazquez 2003).

The underlying causes of the boom of the shadow economy in the former centrally planned economies (CPE) have been well documented in the

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[5] Musgrave (1990). For more detailed discussion of the concept and its policy implications see the papers presented at the conference “The Hard to Tax: An International Perspective”, Andrew Young School of Policy Studies, Georgia State University, Stone Mountain, May 15–16, 2003, at http://isp-aysps.gsu.edu/academics/conferences/conf2003/index.html.

[6] Estimates by Schneider and Klinglmair (2004) of the size of the shadow economy in 110 countries of the world indicate that even in the most advanced 21 OECD countries covered by the survey, it expanded by about a quarter between 1989 and 2003, from 13.2 to 164% in average. Even though there is slight reversal in this trend in the last years, the size of the shadow economy in each of these 21 countries is higher in 2003 relative to 1989. The problem is of much larger magnitude, however, in developing and transition countries. In 61 out of 82 non-OECD countries covered by the survey the shadow economy exceeds 30% of official GDP. The remaining 21 (15 of which are in Asia) include countries like Hong Kong, Taiwan, Singapore, Israel, South Africa, which even though not OECD members do not fit well in the group of developing countries.

literature.[7] Some of them lie outside the field of taxation. Excessive costs of compliance with non-tax regulations—such as licenses and permits, hiring and firing restrictions, and related bribe costs—are strong drivers of informality in transition countries with the related consequences for tax compliance. For reasons, to which I will return below, these costs tend to be regressive, affecting more the small entrepreneurs. Therefore non-tax constraints may be strong drivers of tax evasion by the small business. Here, however, we are concerned about the drivers of informality that can be redressed through the instruments of tax policy and administration.

Tax-related constraints have been well studied too. In general they appear to be more in the domain of tax administration and related to compliance costs rather than to tax policy. It is indicative that transition countries have larger informal sectors than advanced countries, even though many of them enjoy lower tax rates.

In the case of Bulgaria the tendency of non-compliance may be attributed first to the legacy of the tax system of the soviet type of state socialism and the wide gap that it should overcome towards serving the market.[8] Under central planning the state owned the enterprises and set input and output prices, as well as final individual tax liabilities. The system implied virtually audit of 100% of the enterprises. In result, at the start of the transition the tax administration of most former CPE lacked traditions of servicing the taxpayer. Conversely, taxpayers lacked traditions of voluntary compliance. Newly emerged business ventures have never before paid taxes.

Furthermore, the negative effect of the legacy of central planning on tax compliance was reinforced by the harsh realities of transition. The failure of the state to perform its social functions and to deliver the public good, as well as the way state resources were transferred to private hands resulted in strong public distrust in government. The contrast with the previous regime in regard to protection from crime and poverty and access to health and education services generated wide perceptions that taxpayers did not owe anything to the state as they could not expect much from it.[9]

The boom of the shadow economy in transition countries is largely attributed to the lack of administrative capacity of the nascent tax administrations. Tax offices had neither the experience, nor the human and information technology resources of a modern compliance and enforcement management. It is worth noting however, that even well-equipped modern

[7] See Johnson et al. (1997); Schneider (2003), Schneider and Burger (2004), and the contributions to Belev (ed. 2003).

[8] For a comprehensive study of tax reforms in transition see Martinez-Vazquez and McNab (2000).

[9] See for instance MBMD (2003) survey on taxpayers' attitude to public services and tax obligations.

administration might not be able to handle much better the challenges of an economy, which in the absence of functioning financial and goods markets, was largely dominated by cash and barter transactions. These challenges have been aggravated by disparities in the pace and sequencing of the various components of institutional reforms.

Bulgaria for instance followed the Polish example in a version of a big-bang type of market liberalisation. It however was not matched by privatisation and restructuring of state-owned enterprises. As industrial output collapsed, a large part of sole entrepreneurships were created in the first half of the 1990s in result of layouts of state enterprise employees. Another substantial part emerged driven by the opportunities of siphoning out the income of the state enterprises—or rather the state under pervasive soft budget constraints—through creating supplier and distributor firms at the entrance and exit of the production lines. The 5–6 year vacuum between the liberalisation and the privatisation explains the large portion of "subsistence" and rent-seeking types of small business ventures. This in turn led to a boom of the hard to tax private business in the sectors of trade and services, and a public enterprise sector operating at a loss, which drastically eroded the tax base. Moreover, limited access to financing and bank services made cash and barter transactions without accounting records pervasive.

There are important mismatches in the pace of tax reforms as well. Martinez-Vazquez and McNab (2000) identify a common flaw in most transition countries: the delay of tax administration reforms relative to tax policy reforms. This is hardly surprising. It is easier and faster to change the regulations than to build the institutional capacity needed for their enforcement. Tax policy reforms however did not advance at the same pace across the various components either. Social insurance and fiscal decentralisation reforms in general lagged behind the restructuring of the indirect taxes (VAT, excises and customs duties) and income taxes. The depth and dynamics of tax restructuring, coupled with the poor coordination between the various components of tax reforms, could not but make regulations complex, unstable and hard to enforce.

There is no doubt however, that tax administration reforms in transition countries were substantially delayed. There may be two reasons for that. First, modernisation of tax administration requires some adequate level of institutional autonomy of the tax office, which the political elites were not ready to provide on issues as sensitive as the collection of revenues. Second, as far as outside incentives are concerned, at least for the accession countries, the reform priorities were mainly guided by the *acquis communautaires* of the EU. This may partly explain the relative delay in areas which remain more or less outside the scope of the *acquis*, such as social security, local revenue autonomy and tax administration.

The delay in modernising the administration in transition countries can be identified in the following major deficiencies of tax collection today:

- bias towards stringent enforcement rather than encouraging voluntary compliance;
- underdeveloped taxpayers' services and especially online services
- obsolete enforcement technology with excessive reliance on extensive coverage rather than better targeting of audits and risk assessment;
- limited resort to third-party reporting and withholding;
- limited human and information resources

All these imply higher costs of collection for both the private and the public sector and explain the large share of tax evasion in transition economies.

The identified drivers of non-compliance are generic for the process of transition and affect large and small businesses alike.[10] But they are likely to have much stronger impact on the small business. Small businesses bear higher costs of compliance as a share of income for at least three reasons. First, there is a fixed cost of understanding tax regulations and adapting to their requirements irrespective of the company's size. The large businesses can benefit from economies of scale, by spreading the fixed cost over more units of output. The small business can save some of these fixed costs mainly by outsourcing of tax accounting.[11] Second, large businesses receive usually better services within the large taxpayer units, while small businesses are taken care of small, understaffed and under-equipped local units. Third, incidence-wise, small companies operate in tougher and more competitive environment than large companies, and are far less in a position to shift the costs of taxation and compliance forth to customers, or back to suppliers. Therefore compliance costs tend to be regressive in the sense that they are negatively related to taxpayers' size and income.

To sum up the arguments so far, the process of transition has generated excessive compliance and enforcement costs, which present serious

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[10] In fact the challenges related to large businesses' tax frauds—such as transfer pricing, fraudulent VAT refunds, e-commerce, etc.—may be of much larger magnitude than non-reporting of income by the hard-to-tax. In general large companies in transition countries may have much more power to avoid enforcement through bribes or political connections. Non-compliance of large businesses however, presents different challenges to tax administration, which remain outside the focus of this study.

[11] Tax compliance studies of small business in the US reviewed by Slemrod (2004, p. 80), indicate that on average self-employed taxpayers spend nearly three times as much of their time on tax compliance as other taxpayers and are almost twice as likely to use professional assistance to prepare their taxes. According to the IRS between 80 and 88% of small businesses rely on tax practitioners to file their returns.

challenges to the emerging small entrepreneurs and the nascent tax administration. This brings us to the core issue in our positive analysis – the impact of the instruments of tax policy and enforcement on small business compliance. Before looking into the concrete economic and tax situation of the small business in Bulgaria, we need to see how small business' evasion patterns relate to the tax policy and enforcement parameters. Next I turn briefly to the literature on tax evasion for some of its theoretical predictions and empirical findings, which are most relevant in this context. These concern mainly the interactions between taxpayer's size (income) and the parameters of tax policy (tax rates) and tax enforcement (probability of detection and penalty rates).

Classical models of tax evasion study individual decision to evade taxes as a choice under uncertainty. It implies a tradeoff between the benefit of successful (undetected) evasion; versus the loss in case of detection and penalty. In the pioneering model of Allingham and Sandmo (1972) the expected gain depends on the tax rate, while the cost depends on the penalty and the probability of detection. The attitude towards risk is determined by income, which is exogenous. If utility-maximising taxpayers are risk averse, their propensity to evade taxes is positively related to income. Intuitively, the lower the taxpayers' income, the heavier the weight of the penalty as a percentage of income, the less likely s/he would be to take the risk of being penalised. In this setting, self-employed and small entrepreneurs are less likely to evade taxes than large business owners. Moreover, for the incorporated businesses the relation between owners' income and evasion decision by the managers is not straightforward. Corporate entities may act as risk-neutral evaders even though their owners may be risk averse.

The effect of the tax rate however is ambiguous, depending on attitudes towards risk and the penalty structure. If utility-maximising evaders are risk neutral, the higher the rate, the more they are likely to evade taxes, as the expected marginal utility of evasion grows with the tax rate. Under assumption of risk aversion, however, this substitution effect may be offset by an opposite income effect. The higher the tax rate, the lower the taxpayer's disposable income, the less willing s/he is to take the risk of being penalised. Yitzhaki (1974) points out, however, that the substitution effect under assumption of risk aversion is in place only if the penalty is proportional to the evaded income. If the penalty is levied on the evaded tax, then the net benefit does not grow with the rate and there is only income effect. Contrary to common intuition, the evaded amount falls with the rise of the tax rate.

The growing literature[12] has extended the original work to incorporate labour supply (making income endogenous); compliance and enforcement costs, avoidance, multiple modes of evasion. Other extensions go beyond the static parameters and model behavior over time, including interactions with the collector. Furthermore, large part of research extends the original framework beyond the mere gamble-like weighting of expected gains and losses towards incorporating such determinants as ethics, reputation, the public tolerance to evasion, etc. Despite their importance for understanding the mechanism of compliance choices, they could not reduce much the ambiguities about the effect of income and the tax rate on compliance.

The persistent ambiguities of the theoretical models make empirical evidence the more so important. Most empirical tests are derived from the US Taxpayers' Compliance Measurement Program (TCMP). It provides unique data on individual returns, but does not cover non-filers. Results on the effect of the tax rate are mixed, but on balance findings that lower tax rate leads to higher compliance rates prevail.[13] In regard to income, however, TCMP data seem to confirm that higher income is related to larger underreporting. But it indicates as well that source of income rather than income level may be a stronger determinant of evasion. A much higher share of self-employed than wage income is concealed. This however, is an issue of third-party reporting and probability of detection rather than taxpayer's ability to pay, and brings us to the question of enforcement parameters.

The policy implications of the theory of tax evasion are most straightforward in regard to the effect of deterrents of evasion, such as the penalty rate and intensity of audits. In line with the predictions of the classical models, most empirical tests report positive relation between probability of detection and penalty versus income reporting compliance. Martinez-Vazquez and Rider (2005) find that taxpayers may employ more than one mode of evasion as substitutes, i.e. switching between modes according to the respective probability of detection. Thus, self-employed taxpayers seem to prefer to understate income, while wage earners tend to prefer to overstate deductions. The opportunity of a second mode of evasion reduces the effect of enforcement in the targeted mode, but not in a magnitude large enough to offset it. In this context they find that a 10% increase in income subject to third party reporting increases income reporting compliance by 1.1%. The compliance gain from eliminating itemised deductions is even much bigger.

The theoretical and empirical findings discussed above call for a closer look at the concrete parameters of tax policy and tax enforcement in

[12] For a comprehensive review of the literature see Slemrod and Yitzhaki (2002), Cowell (2003), Sandmo (2004).
[13] See for instance Clotfelter (1983), Poterba (1987) Alm et al. (1990) and Joulfaian and Rider (1998). For the opposite results see Feinstein (1991).

Bulgaria. In this section I argued that the boom of the shadow economy confronted tax administration of transition countries with a serious challenge and that the small business has a central place in this challenge. Further on, if individual choice to evade taxes is a response to incentives and opportunities, we need to look at the specific incentives and opportunities that small entrepreneurs encounter relative to other taxpayers such as wage earners and large companies. The next section seeks the answers to the question why the small business sector in Bulgaria evades taxes by looking at the specific tax and compliance cost constraints that it faces.

Why Does Bulgarian Small Business Evade Taxes?

Table 1 Relative Weight of SMEs in the Business Economy (%)

	2000	2001	2002
Employment	50.7	51.6	53.8
Turnover	50.2	50.4	52.3
GVA	30.0	31.2	34.2

The Small Business in the Economy of Bulgaria

The SME sector has a large weight in the economy of Bulgaria.[14] It accounts for 99% of all enterprises and over half of the registered turnover and employment in the business economy (Table 1). Its share in GVA expanded

[14] If not otherwise indicated, the data used in this section are from ASME (2004). Small business includes small and medium-sized enterprises (SME) according to the pre-2004 definition in the Bulgarian law, i.e. enterprises with up to 100 employees, annual turnover of BGL3 million and/or assets of BGL2.4 million with subcategories for small enterprises of less than 50 employees; and micro enterprises of less than 10 employees. In 2004 Bulgarian SME law incorporated the EC Recommendation Concerning the Definition of Micro, Small and Medium-Sized Enterprises, (2003/361/EC of May 6, 2003). The ceilings on the number of employees was raised to 250, the turnover and balance sheet ceilings respectively to BGL15 million and BGL8 million for medium-sized companies (50–249 employees) and BGL5 million and BGL1 million for small companies (10–49 employees). Where the need of comparison with the EU requires, and if so indicated, the definition may cover enterprises of up to 249 employees. Departing from EC recommendation, Bulgarian law includes in the SME category only legal entities, while the EC definition includes any form of economic activity irrespective of its legal status, i.e. the self-employed, informal associations and partnerships as well. The business economy excludes agriculture, financial intermediation and most public services, i.e. it comprises the sectors from C to G and K according to Eurostat NACE classification.

from 25.4% in 1998 to 34.2% in 2002. More importantly, with a growth rate above the economy's average, it is a major engine of growth and employment creation. While the economy grew by 5.5% in GVA terms in 2002 versus 2001, the small business sector grew by 13.4%. Likewise, employment increased by 11.5% in the small business sector versus 1.5% in the whole economy.

Table 2 Shares of Enterprise Groups in the Business Economy 2002

	Micro	Small	Medium	Large
% of companies	90.8	7.3	1.6	0.3
% of employed	25.9	18.9	21.7	33.5
% of value added	11.8	14.8	19.0	54.4
% of turnover	23.7	21.3	21.0	34.0
% of labour cost	8.1	13.9	21.9	56.1
% of gross investment	15.8	20.7	18.5	45.0
% of fixed asset	9.9	14.1	17.5	58.5

The robust growth of the sector, however, seems to reflect growing number of ventures rather than productivity gains. Productivity and profitability gaps in relation to large companies remain significant. In 2002 productivity (measured as GVA per employee) grew by 4% in the economy, but only by 1.7% in the SME sector. Large enterprises (with more than 250 employees) are only 0.3% of all business sector enterprises, but account for 45% of total investment, 58.5% of all fixed assets, 56% of the labour expenses and 54% of the value added (Table 2).

The relative inefficiency of the sector reflects largely investment and productivity constraints faced by the sub-sector of the micro companies (with less than ten employees). The productivity and income gaps separating them from the rest of the SME sector are significant. Micro companies account for 91% of all enterprises, but for only 16% of the investment and 12% of the value added in the business economy. In contrast, the rest of the SME sector accounts for 9% of all enterprises, but for 39% of overall investment, 32% of all assets, and 34% of total value added. Figures for 2002 indicate that the small enterprise sub- sector (10–49 employees) grows three times faster than the micro sector. Furthermore, there are large wage disparities. With about two employees in average in 2002, micro enterprises employ 26% of the workforce, but account for only 8% of labour expenses. The rest of the SME sector employs 41% of the workforce and accounts for 36% of labour costs. In comparison, the average micro enterprise sector in the EU is similar in size, but achieves 70% higher share in value added with about 30% lower share in turnover (Table 3).

Table 3 Shares of Enterprise Groups in the Business Economy 2001

	Micro		Small		Medium		Large	
	Bulgaria	EU-15	Bulgaria	EU-15	Bulgaria	EU-15	Bulgaria	EU-15
% of companies	92.0	90.6	6.2	7.9	1.5	1.2	0.3	0.2
% of employed	25.9	27.7	17.0	21.5	21.9	16.3	35.2	34.5
% of value added	11.5	20.1	12.7	19.0	18.1	17.9	57.8	43.0
% of turnover	23.0	18.4	20.5	19.2	16.9	18.9	39.6	43.5

Source: Bulgaria: NSI; EU15: Eurostat: SMEs in Europe—Candidate countries, 2003 edition

The disparities between the micro business sector and the rest of the SME sector places the latter relatively closer to large enterprises than to micro enterprises. In fact some SMEs belong to the large taxpayers group.[15] Therefore in the context of this study it appears to be more relevant to depart from the conventional SME grouping and to focus on micro enterprises. This category fits best in the concept of the hard to tax.

It is beyond doubt that the business performance gap which separates Bulgarian micro enterprises from larger enterprises, as well as from micro business sector in the EU reflects largely higher rates of underreporting of income and employment. But it seems to reflect as well the specifics of the formation of the micro-business sector of Bulgaria. As noted in section one, at the initial years of restructuring large part of Bulgarian small businesses emerged as means of survival of laid-out public sector employees rather than in response to business opportunities. Under conditions of sharp drop in incomes and savings, and lacking financial markets, start-ups had limited chances and short lifespan. The gap, documented in this paragraph, confirms that the majority of the small business sector face the challenges of survival rather than of innovation and expansion. This brings us to the question of their

[15] The initial criterion to include an enterprise in the large taxpayer group in 1998–1999 was a turnover above BGL2.5 million, balance sheet above BGL1 million and tax liabilities above BGL100,000. At the same time up until 2004 Bulgarian legislation defined SME as enterprises with a turnover of up to BGL3 million and balance sheet of up to 2.4 million. The 2004 amendments of Bulgarian SME Law, which followed the EU recommendations on defining the SME categories, raised these ceilings five times. In result, the turnover ceiling for small enterprises
and twice the minimum threshold for placing an enterprise on the large taxpayers list.

place in the shadow economy of Bulgaria and the related challenges to the tax administration.

Bulgaria has one of the largest shadow economies among accession countries.[16] Overall compliance gaps are estimated at about 25% (World Bank 2003). Evasion of payroll taxes is a serious problem. According to survey data, 14% of the respondents acknowledge that they work without any contract of employment at all (MBMD 2003). Employers' estimates are much higher: about 25% (Vitosha Research 2003). Large part of those that have formal registered contract of employment, are insured on lower than actual wages. About 30% of the respondents to the MBMD (2003) survey confirm that the deducted tax is not on the full wage. In fact only half of those with formal employment contracts confirm that the reported wage corresponds to the actual one.

There are no direct measures of compliance of the small business sector. Indirect indications from business surveys however, indicate that compliance gaps may be larger in the micro and small business sector. The evaluation by small entrepreneurs of the share of underreported income and profits in their sectors tend to exceed two-three times the estimates by the representatives of the larger companies. (Vitosha Research 2003) According to these estimates, sole proprietors hide in average 29% of their income. Micro and small companies (up to 50 employees) estimate the share of unreported wages at about 20%, while for the large companies it is less than 7%. The sector averages of respondents' estimates of evasion rates are highest in the traditional hard-to-tax sectors: 26% in retail trade, 20% in services, and 17.2% in construction.[17]

Income Taxation

The income of small entrepreneurs in Bulgaria is taxed either through a progressive personal income tax (PIT) when they operate as sole proprietors and self-employed, or a proportional corporate income tax (CIT) when they operate as limited liability companies. In both cases the tax base is calculated according to the CIT law. About 30–35% of all enterprises pay a lump-sum PIT, called *patent.*[18]

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[16] Schneider (2003) estimate for 2000/2001 is 36.4%. The Global Competitiveness Report (2004) reflects the estimates of the business, and ranks Bulgaria 78th out of 102 countries with an average score equivalent to above 30% of GDP. See as well Vitosha Research (2003), CSD (2004).

[17] See CSD (2004, pp. 54–55).

[18] See more in Pashev (2006).

Bulgarian standard income taxes have been substantially reduced in the years following the crisis of 1996–1997 and the introduction of the currency board (Table 4). In six years the CIT rate was cut by half from a dual rate of 32.5%/28% in 1999 to a single 15% rate in 2005. PIT rates underwent similar adjustment.[19]

Apart from these overall improvements in the tax treatment of business income in Bulgaria, tax reforms have actually led to losses in horizontal equity between the two legal forms of small entrepreneurship. Due to the progressive PIT schedule, the enterprises of the natural persons and the self-employed face tax disadvantage relative to the enterprises of the legal persons above certain income threshold, where the PIT average tax rate (ATR) equals the CIT proportional rate. Successive CIT cuts from 32.5 to 15% reduced this income threshold more than three times—from more than BGL18,000 (EUR9,000) in 1999 to less than BGL6,000 in 2005. This increased the number of sole proprietors that pay higher taxes relative to legal entities with the same incomes. Furthermore, CIT payers enjoy preferences in the form of 10% income tax credit and zero tax rate on reinvested profits in areas of high unemployment. Neither of these incentives is available to sole entrepreneurs.

Table 4 Statutory Income Tax Rates 1999–2005

	Corporate[a]			Personal					
	Central	Local	Combined[b]						
1999	25	10	32.5	Rate	0	20	26	32	40
	20	10	28.0	Bracket[c]	900	1,200	4,200	15,600	
2000	20	10	28.0	Rate	0	20	26	32	40
	15	10	23.5	Bracket	960	1,380	4,560	16,800	
2001	15	10	23.5	Rate	0	20	26	32	38
				Bracket	1,200	1,620	4,800	16,800	
2002	15	10	23.5	Rate	0	18	24	28	29
				Bracket	1,320	1,680	4,800	12,000	
2003		23.5		Rate	0	15	22	26	29
				Bracket	1,320	1,800	3,000	7,200	
2004		19.5		Rate	0	12	22	26	29
				Bracket	1,440	1,800	3,000	7,200	
2005		15		Rate	0	10	20	22	24
				Bracket	1,560	1,800	3,000	7,200	

[a]Until 2000 a lower income tax rate was applied to companies with a profit below BGL50,000 (EUR25,000)
[b]Local + (100 – local) × central
[c]Ceilings of annual income brackets in BGL. The lev is tied to the euro in a rate of EUR1 = BGL1.59983

[19] In result, Bulgaria has relatively low income tax rates by international standards. The Global Competitiveness Report (2004, tables 2.25, 2.26) ranks Bulgaria 8th of 79 countries in regard to the CIT rate and 47th in regard to its PIT rate.

Sole proprietors account for about 80% of all business entities and more than 90% of the small business.[20] Even if the number of those paying patent tax is subtracted, still the overwhelming majority of the small entrepreneurs face increasing tax rates as they grow, and thus stronger incentives to underreport income. In fact, the maximum eligibility threshold of the patent tax also provides incentives to higher-income small enterprises to underreport turnover (and consequently income) in order to operate under the patent tax.

Social Insurance Contributions

Perhaps the major tax constraint faced by the small business in Bulgaria is the mandatory social insurance contributions (SIC). In contrast to income taxes, they remained outside the focus of tax cuts (Table 5). At the rate of 42.7%[21] in 2005, of which 70% is paid by the employer, Bulgarian social and health insurance contributions are high by international standards. Above all they affect small entrepreneurs as a payroll tax. In the case of natural persons, however they additionally affect them as a tax on personal business income. In both cases the cost of evading them is larger than the direct revenue losses, as it implies evasion of PIT as well. In this context, it is understandable why reduction of PIT rates cannot reduce much PIT evasion. In the case of Bulgaria, PIT reporting compliance reflects excessive SIC burden rather than high income tax rates. The former is heavier both in terms of statutory rates and in terms of tax base (as SIC are deducted from gross income). Consequently, in trying to raise small business compliance through cutting only income taxes, tax designers may be pushing the wrong button.

Table 5 indicates that tax reforms might have increased employers' incentive to hide wage expenses. SIC rates not only remained more or less intact during the years of major tax restructuring, but because of the reduction in the CIT rates employer's cost of reporting wages went up.[22] In result, the

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[20] Out of all 877.5 thousand companies registered under the Bulgarian Commercial code as of November 2004, 676.3 thousand (77%) are enterprises of natural persons registered as sole entrepreneurs, and 168,000 (19%) are limited liability companies. http://www.bulstat.nsi.bg/Data.html In regional perspective, the share of sole proprietors is higher than that in all CEEC except for the Czech Republic (Doudeva 2001).

[21] This rate, which includes social and health insurance, is applied to the standard (third category) of employees. The SIC for the special early retirement first and second categories are about 30–40% higher, but they are not typical for the small business sector.

[22] The cost of wage reporting is calculated as the difference between the cost of the compulsory insurance less the savings from CIT as the wage and insurance expenses are deducted from the tax base $CWR = SIC - CIT - SIC \times CIT$.

wage segment of the PIT compliance gap is driven by employers' SIC costs rather than the income tax. For about two thirds of the workforce PIT is withheld at the source. This includes full time and part time wage expenses as well as expenses on professional services, provided by natural persons, who are not registered as employees or sole proprietors. If they have only one source of wage income, employees are not even obliged to tax file returns. In practice, they cannot underreport income. Data on compliance gaps for the withheld and the self-assessed PIT are not available. Rough estimates however suggest that with about 80% of PIT receipts collected by withholding at the source, at least two-third of potential PIT revenues may be independent of the PIT rate, as the decision to report income is not made by the taxpayer but by the withholding third party.[23] Other things equal, employer's choice to report wage income is driven mainly by SIC costs.

Table 5 Employer's SIC Cost of Reporting Wages

Insurance of employees (% of wage)	1999	2000	2001	2002	2003	2004	2005
Pension	35.7	32	29	29	29	29	29
o/w private fund			2	2	3	3	3
Sickness/maternity leave		3	3	3	3	3	3
Accident at work[a]		0.7	0.7	0.7	0.7	0.7	0.7[b]
Unemployment	4	4	4	4	4	4	3.5
Insolvency fund[a]							0.5
Total social insurance	39.7	39.7	36.7	36.7	36.7	36.7	36.7
Health insurance	6	6	6	6	6	6	6
Total insurance	**45.7**	**45.7**	**42.7**	**42.7**	**42.7**	**42.7**	**42.7**
o/w employer	41.2	36.7	34.3	32.2	32.2	32.2	30.25
employee	4.5	9	8.4	10.5	10.5	10.5	12.45
CIT rate[c]	28	23.5	23.5	23.5	23.5	19.5	15
The SIC cost of reporting wages (%)	**1.66**	**4.58**	**2.74**	**1.13**	**1.13**	**6.42**	**10.71**

[a]Paid entirely by the employer
[b]The middle of five rates (from 0.4 to 1.1%) differentiated by economic activity that replaced the single rate of 0.7% in 2005
[c]1999–2000 show the lower of the two effective CIT rates

[23] This conclusion holds under the assumption that the incidence of the income tax falls largely on the employee, which is largely confirmed by empirical work on labor supply elasticities in other countries. Because of the large share of unreported labor in Bulgaria, reliable data on labor elasticities are not available. It may be argued, however, that in theory, if incidence falls on the employee, then, insurance contributions may not influence that much employer's decision to report wage

Of course excessive SIC costs affect not only the small business. In combination with other typical constraints, however, they are strong driver of underreporting of wage expenses by micro enterprises. Most importantly in this context, many of the micro business ventures in practice encounter SIC rates that are higher then the statutory rates shown in Table 5. The reason is that as a countermeasure to underreporting, the government introduced in 2003 minimum insurance income thresholds (MIITs). They act as a presumptive payroll tax differentiated according to industry and job level. As they were introduced at 46% above the statutory minimum monthly wage in average, they led to higher SIC rates on all wages that are below the respective MIIT. As already noted in the previous section micro and start-up companies are paying lowest wages and are most likely to face higher than statutory payroll tax rates. Thus, MIITs provide strong disincentive to the micro businesses to employ, or register labour.

Apart from encouraging the underreporting of employees' incomes, the excessive SIC burden influences as well decision to report business income. There are about 700,000 sole proprietors and 150,000 registered self-employed, (i.e. about one third of the labour force). Unlike wage-earners, the decision to report or hide their personal income is entirely theirs. But again it is likely to be driven by higher SIC (relative to PIT) costs. Moreover, there are large disparities in the tax treatment of the different type of income, with sole proprietors' and self-employed facing highest SIC rates. They pay 35% insurance tax on their income (which includes only pension and health insurance at that), while an employee used to pay less than third of that for wider risk coverage (Table 5). A dividend earner would pay SIC based on the MIIT, while a state employee would have the SIC paid by the budget. Even when they have no income, entrepreneurs that operate as natural persons, pay a minimum insurance contribution equal to about 60% of the minimum wage. The unfavourable tax treatment of the business income of sole proprietors and self employed relative to wage and corporate income explains large part of the SIC compliance gap in the hard-to-tax sector of Bulgaria. According to insurance authorities, only half of the self-employed and a quarter of the farmers pay the compulsory insurance contributions (CSD 2004, p. 12).

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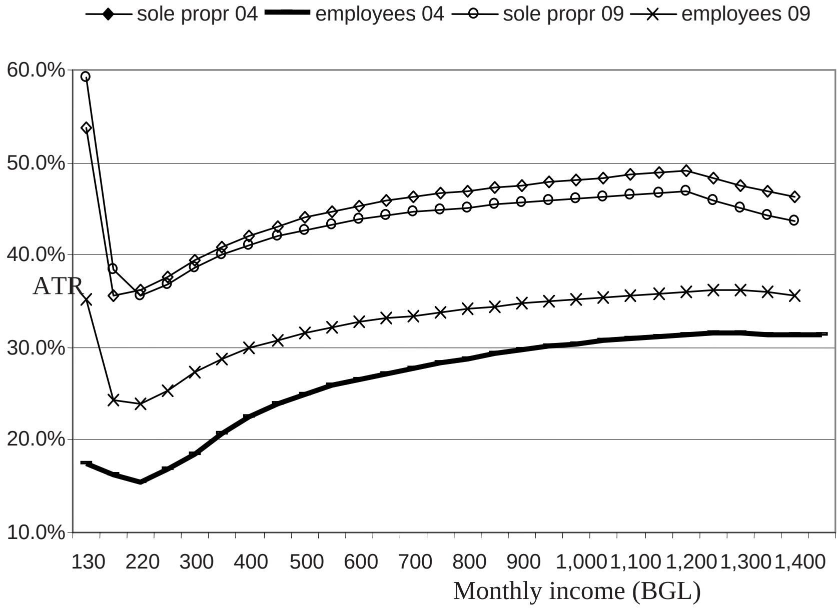
expenses either. The large-scale actual underreporting of wages however shows that employers choose to evade the tax rather than to reduce wages. This, however, is an issue, the explanation of which requires more empirical work and space than the scope of this paper allows.

Figure 1 shows that employees enjoy considerable tax advantage at all levels of income. Other things equal, with the increase of their share in SIC to 50% by 2009[24] the gap will decrease, but still remain significant.



The figure projects only the effect of the change in the shares of the employer and employee contributions from 70/30 respectively in 2005 to 50/50 in 2009. All other parameters are assumed to remain in 2009 as of 2005. Employee's MIIT is assumed equal to the MIIT of self-employed.

Fig. 1 Combined SIC and PIT rates: sole proprietors versus employees 2004–2009

The tax disadvantage of sole proprietors in regard to income from dividends is even increasing with the 2005 reductions of the CIT from 19.5 to 15% and the dividend tax from 15 to 7%. Figure 2 illustrates the "opening scissors" between sole proprietors' and dividend earners' average cumulative (i.e. including SIC) income tax rates.[25]

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[24] The shares of the employer and the employee are fixed in the Social Insurance Code as follows: 80:20 in 2000–2001; 75:25 in 2002–2004; 70:30 in 2005; 65:35 in 2006; 60:40 in 2007; 55:45 in 2008; and 50:50 from 2009 on.

[25] A sole entrepreneur's taxable income is calculated according to the CIT law, but taxed according to the PIT law after paying and deducting 35% SIC. In the case of income from dividends, the company pays CIT (19.5% in 2004 and 15% in 2005), and the distributed profit is subject to a dividend tax at the rate of 15% in 2004 and 7% in 2005. Dividend earners pay as well SIC on a minimum insurance income of BGL200 in 2004 and BGL220 in 2005. For illustration it is assumed here that the company owner is indifferent between company tax cost and his personal tax cost. In

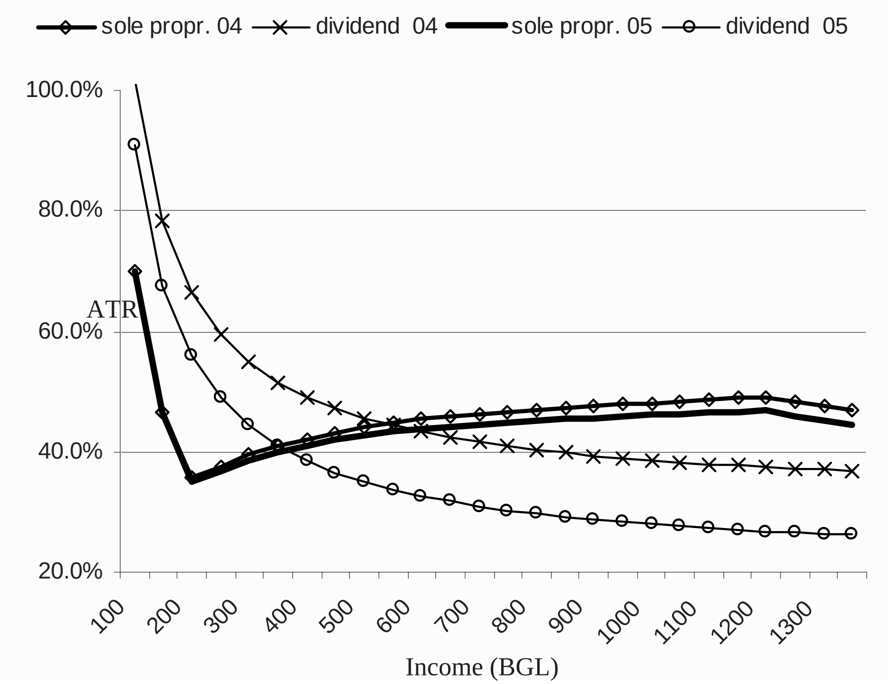

Fig. 2 Taxation of sole proprietor's income versus dividend income 2004–2005

A preferential tax treatment of capital versus personal income is usually justified on efficiency grounds as an instrument to encourage investment and entrepreneurship. It may be a result as well of international tax competition and efforts to attract FDI or prevent capital flight to lower tax areas. To what extent might this increasing disparity promote entrepreneurship and increase investment is questionable in a transition country, where four-fifth of all business entities are natural persons. It is even more difficult to justify the preferential treatment of employee's income, relative to income from sole proprietorship and self employment.

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reality, the owner may have stronger incentives to transfer tax cost to the company, but this will only reduce his personal cost and reinforce the conclusion. Furthermore, s/he might choose to take an executive remuneration up to the amount of the MIIT, so that the company can benefit from CIT savings, while the shareholder will benefit from sharing the SIC cost with the company. But this again would only open further the scissors in Fig. 2. The underlying assumption in this comparison is that the company owner does not have an incentive to take executive remuneration instead of dividends above the level of MIIT, as the combined weight of PIT and SIC is higher than the combined weight of CIT and dividend tax for any level of income.

The Cost of Regulatory and Administrative Deficiencies

Apart from the direct costs of taxation, taxpayers incur the cost of complying with the tax laws.[26] Administrative deficiencies and legislative inconsistencies make these costs quite high for the small business in transition countries. Furthermore, as already argued in section one, they are regressive and thus have stronger negative effect on compliance of small relative to big business.

In Bulgaria however, small businesses may encounter higher compliance costs in absolute terms as well. They stem from the complexity or incompleteness of their tax treatment. The income taxation of sole entrepreneurs is a case in point. As noted above, taxable income is calculated according to the provisions of the CIT law on accrual basis, but taxes are paid according to the rate schedule of the PIT law, which defines income on cash basis. Insurance income is also based on CIT legislation, and is equal to gross personal income. Even the patent taxpayers are obliged to keep accounting records in line with the CIT law for the purpose of SIC payments.

Further to regulatory flaws, higher compliance costs borne by the micro business ventures stem from the lower quality of administrative services provided to them. In general, the concepts of better compliance management through improved taxpayer services and risk assessment are relatively new for Bulgaria. They have become a priority of tax administration reform only in the context of the launching in 2006 of the new unified revenue agency. As for the present, they may be more in effect in the large taxpayer unit.[27] Services to the micro businesses are supplied by the smallest administrative units in the periphery of the tax administration. They suffer most from the typical for transition countries shortage of skilled staff and information technology resources and delayed decentralisation reforms. Enforcement there is also hard to monitor and control internally.

Consequently, constraining tax evasion in the hard-to-tax sector has been oriented primarily on stringent law enforcement, driven largely by the presumption that non-compliance is the norm rather than the exception. A governmental program on improving tax collection for the period 2001–2005 is a good illustration of this bias. It contains mainly measures towards "strengthening the control (ex-ante and ex-post)". There is neither any mentioning of reduced compliance costs through better risk management and efficient taxpayer services, nor any measure towards curbing administrative

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[26] On the definition of compliance and administrative costs see Sanford et al. (1989, chap. 1, pp. 3–23).

[27] Bulgarian large taxpayer unit was established in 1997 and after somewhat long path towards centralization and optimization of its size, in 2003 includes 478 companies, which provide 58% of tax revenues (66% of central taxes), employing only about 1.5% of tax administration workforce.

corruption. Instead, in obvious discrimination against small companies, this program envisages exclusion from public procurement bidding of companies that have not reported profits above some fixed minimum thresholds.[28] A notorious example of an administrative bias towards sanctioning rather than servicing the taxpayer is the treatment of VAT refund. The tax office refuses VAT refund to compliant taxpayers, if there is a non-compliant taxpayer somewhere in the transaction chain.

Despite the priority attached to detection and punishment, the two major policy parameters of enforcement – the penalty structure and the administration of control seem far from optimal and more likely to generate briberies than to deter evasion. The penalty structure for instance does not establish a link between the penalty and the concealed income or the evaded tax. The legislation fixes instead the floor and the ceiling of the penalty in absolute terms,[29] leaving the actual amount to be decided by the administration. On the one hand in the context of the classical models of tax evasion, this increases the uncertainty in regard to the cost of detection. But on the other it leaves much room for administrative discretion and corruption, making compliance choice much more a function of taxpayer's estimates of his chances and costs of working out a deal with the auditor. Furthermore this penalty structure is regressive. Above the statutory ceiling the marginal penalty rate is zero, which in fact encourages large-scale evasion.

As for the administration of audits and inspections, enforcement appears to be biased to expanding the coverage and intensity, rather than improving selection. Business surveys report excessive frequency and duration of tax and social insurance inspections.[30] In addition, requirements for monthly and quarterly filing and lack of online services result in large proportion of staff time and resources being spent on filing and reporting to tax and insurance authorities. In brief, instead of reducing compliance costs, Bulgarian tax administration has been trying to enforce the law through more stringent advance payments and filing requirements (what is labeled "ex-ante control"), and increased number and duration of audits and inspections. This bias in fact creates more opportunities for corruption and increases the cost of collection incurred by compliant taxpayers. It is worth noting, that according to FIAS (2004) survey, Bulgaria ranks first among comparator transition countries in indicators like time spent with the administration (the time tax) and the percentage of sales paid in bribes (the bribe tax). Furthermore, the bribe tax is much heavier for the small enterprises. While large firms report a bribe tax of 4% in average, the micro enterprises report that 6% of their sales

[28] www.minfin.government.bg.

[29] The penalty for underreporting of income for instance ranges from BGL100 to BGL1,000.

[30] See for instance FIAS (2004) and Vitosha Research (2004b) for recent data.

are paid in bribes.[31] This result suggests that micro ventures are much more exposed to corruption pressure. The large business is protected in many ways from random bribe extortions by the services of experienced accountants and lawyers, politicians and high-rank administrators, and in general has larger opportunities to avoid taxes.

Tax corruption and inequitable enforcement of the law entails as well another important cost of administrative deficiencies borne by compliant micro businesses in transition countries – i.e. the cost of competitors' non-compliance. Competitors' competitive advantages in result to non-compliance are in fact a bigger challenge to compliant small businesses relative to the time and money they spent on compliance. Surveys of the leading constraints to investment in Bulgaria rank unfair competition (which includes competition through tax evasion as well) above the burden of tax rates (Vitosha Research 2004a; FIAS 2004). Similarly, an OECD (2003) report finds that small business owners in Bulgaria are especially sensitive to the administration's failure to enforce tax laws. It registers as well wide spread perceptions that law enforcement favours large enterprises. In the context of our analysis, perceptions of unfair competition (through non-compliance) appear to be strong driver of tax evasion in transition countries parallel to the direct cost of compliance.

Conclusion

The focus of recent Bulgarian tax reforms has been on the reduction of income taxes. Even though this is a positive development, there are certain elements of the design of income taxation and social insurance contributions, which discriminate against the most common form of small business, the sole proprietorship, and which have been intensified in the course of the tax reforms. This paper argues that together with regressive compliance costs, these constraints constitute the major source of non-compliance in the small business sector. Therefore the immediate priority in the design of a favourable tax environment for the small entrepreneurs is not a preferential treatment, but eliminating those features in current tax design that put them in a disadvantage.

First, a more neutral treatment of business income from sole proprietorship versus corporate income may have strong incentive to investment in a country, where the overwhelming form of entrepreneurship is the natural person. The gradual elimination of the double taxation of corporate income through phasing out the tax on dividends is a move in the right direction, but

[31] Data refer to overall corruption costs, not tax compliance only.

it widens the gap in the treatment of the two forms of entrepreneurship. The best instrument in this regard would be to allow sole proprietors to benefit from the requirement to record their taxable income according to the CIT law by granting them the option to choose between the progressive PIT rate and the proportional CIT rate in settling their final income liability.

Second, a more neutral VAT treatment of small enterprises through allowing registration below the threshold may improve further horizontal equity.

Third, the SIC treatment of the corporate investment income may be extended to the business income of natural persons and self employed. This means to apply the MIITs as a final tax rather than as a minimum tax. It would not only improve equity between different legal forms of entrepreneurship, but would also free more than quarter of a million patent taxpayers from the obligation to keep accounting records for the purpose of their personal social insurance enforcement. A further step towards more equitable treatment of the small business would require restructuring of the minimum presumptive tax on labour expenses, which now taxes the lowest wages at rates above the fairly high statutory ones. The solution may be sought along the lines of applying the minimum wage as a base for a final payroll tax to start-up and micro business ventures, rather than as a minimum tax. The compliance effect of these adjustments would be twofold. By reducing employers' incentives to underreport wages, it will have stronger impact on PIT compliance rates as well.

The drivers of non-compliance, however are not only and not mainly in the domain of excessive tax costs. The small business encounters higher costs of voluntary compliance. Similarly, higher enforcement costs reduce the probability of detection and encourage tax evasion. In this context, a presumptive tax is believed to be a central instrument of reducing the compliance and enforcement costs of taxing the hard-to-tax. The experience of the two current presumptive taxes in Bulgaria, however, show that they tend to get complicated and drift away from the objectives of simplicity and low costs. The current patent tax structure has expanded to more than 900 rates in 7 years, and the minimum insurance income thresholds, introduced in 2003 are following a similar path. The Bulgarian experience indicates that a presumptive tax can hardly be a perfect substitute of the standard tax schedule, especially if it is overloaded with equity objectives. It should be regarded rather as a complementary instrument that can help the tax administration in transition countries in the short and medium run to handle the challenges of the shadow economy and the large hard-to-tax sector. As a complimentary instrument its best place is in the system of local taxes.

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20

Tax System Change: The Bulgarian Experience

Georgi Smatrakalev

Introduction

In 2000 the US President Bill Clinton visited Bulgaria for the first time in the history of the two countries and on a gathering on St Alexander Nevski square in Sofia he announced: "Bulgaria is a beautiful country and I shall promote it among the American investors and businessmen." Two years later President Bush made almost the same promise in Washington to the Bulgarian Prime Minister. Well, political intentions and promotions will hardly be enough without real economic terms and conditions in order to attract investors' attention. One of the major economic components is the tax system.

This chapter will reveal the major components of the changing Bulgarian tax system during the stages of transition and the present taxes in the country on the eve of its European membership. All Bulgarian regimes have influenced the tax system of the country and have left their marks on it. The changes during the years of transition from centrally planned toward market economy (1989 to present) can be divided into three major groups—creation, reformation and quasi-reformation. The right wing governments of the Union of Democratic Forces (UDF) can be associated with the creation and reformation, while the socialist governments and their satellites with the quasi reformation. That means that most of the European style of taxation was during the regime of the UDF.

The structure of taxation is continually under reform and the number of such tax plans seems to increase during election years. Tax plans can be grouped into four general categories: those that simplify payment of income taxes, those that switch to a value-added tax system, and those that alter the current taxation of savings or labor income. These will be emphasized in the chapter along with: (1) the presentation of the tax system and its historical background; (2) the major revenue sources of the state budget; (3) the main tax sources from income and local taxes; (4) from indirect taxes and (5) harmonization of the tax system with the European Union.

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Historical Development

The lack of interest in the design of tax policy in the past in almost all socialist countries is valid also for Bulgaria. Under state planning, it was physical output that was the subject of policy-making. The financing of government policy through taxation, and the impact on economic incentives through wages and prices received little, if any, attention. Taxes were implicit and their functions were clearly related with their fiscal function. Taxes were not used as a way of regulating the economic activity, since in the planned economy there was no such necessity. Taxes were a measure for suppressing people's income, since even their fiscal function was reduced.

Most government expenditures were raised by extending subsidies and soft budget financing. Taxation was dealt with as deductions and cuts from "marginal labor" or "manufacturing product." The definition of income and profit were not in use. The socialist social security system with its "free" medical, educational and social services was heavily subsidized by the state budget. More on this can be found in Kornai (1992) for the process of budgetary formation and expenditures.

With the era of "perestroika" and the inevitable changes toward democratization of the society the government of the Bulgarian communist party issued Decree 56 in order to inspire the economic activity of the population. The sole idea was somehow to legally transform political power into economic power by acquiring economic benefits without owning the means of production. Therefore businesses functioned based on political connections. For the first time, firms were brought to life and became a part of the economic dictionary of the ruling majority. It was in Decree 56 that the communist government mentioned "profit" as a definition related to corporate income and taxation. Tax rates were incredibly high—50% of profit—and "Melioration" fees and poll taxation were introduced. The system has started to change, but the changes are as small as an ant's steps.

The changes that occurred in the Bulgarian economy have not been sufficient. The needs of an emerging market economy in Bulgaria require an entirely new tax system.[1] How this will happen (through tax design or tax reform) is a very interesting question.

Martin Feldstein (1976) proposes that "optimal tax reform must take as its starting point the existing tax system and the fact that actual changes are slow and piecemeal." This means that reform of the tax system lies more or less in changing the existing tax structure. Obviously, optimal taxation depends on the historical context.

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[1] Such changes, of course have been made and a lot of new tax laws have been established. The problem is that their enactment is not that easy and that most of them are not clear.

In the existing literature there are many writings on optimal taxation and on the pros and cons of tax design and tax reform. Discussions of optimal taxation implicitly assume that the tax laws are being written de novo on a "clean sheet of paper." There is a guide for tax policy in the writings of Rawls (1971). Usually change requires an optimal abstract structure for particular types of taxation or an optimal income tax schedule.

Along with the changes in the political system in 1989 some quasi-economic transformation also began. In fact, Decree 56 was preserved until 1996 although it was amended a couple of times and corporate tax rates were lowered to about 40%. This was the initial capital accumulation. Under a semi-legal tax system the economy has improved and the communists' political power and connections have improved. This will help them renew their political power in the future. Former "comrades" become respected businessmen and heads of corporations that drown state enterprises. "Such corporations" were usually on the entrance and exit of a state enterprise system. They benefit from the dying state system. They supplied the materials and inputs for state production. They marketed products using the cheap labor of state workers. And all this was without paying taxes. Usually the taxes were shifted to the state enterprises. So on one side the state enterprises are losing from the production and on the other they accumulate debts in tax payments.

The changes in the tax system began with the democratic Constitution (1991): "Article 60 [Taxes] (1) Citizens shall pay taxes and duties established by law proportionately to their income and property. (2) Any tax concession or surtax shall be established by law."

At first, under the advice of Charles McClure Jr, (a member of the Ran committee that prepared the communist government program) a new tax was introduced—the turnover tax and excises. It was replaced in 1994 by the Law on Value added tax (VAT) and the Law on Excises. The communist government had at least one good initiative—the creation of a Tax Code that was dropped after its fall in December 1990. Ever since, all tax laws are voted on piecemeal, which increases the excess burden to the taxpayers.

The system began to become institutionalized by adopting in 1993–1994 the first law for the rights and obligations of the tax administration and in the Law on Tax Procedures. So it was made clear who will gather the tax revenues and how. In 1999 the Tax Code on procedures was adopted. So before harmonizing what shall be taxed and how there was a code how it would be accumulated and gathered by the government. The codification of the tax issues does not follow its logical steps. Still there is no tax code for the taxes that exist in the country.

Working with Decree 56 and some amendments on the Law on tax of personal income and the Law on Local Taxes and charges adopted back in 1950 the transition toward a market economy hardly deals with income taxation. This is a touchy topic for any government because income taxation is always a major issue in election campaigns. But in 1996 Decree 56 was replaced by the Law on Taxation of Corporate Profits.

The real change in tax philosophy and in the tax system as a whole started in 1997 with the government of UDF. Then the most important laws and changes have been introduced as: Law for Taxing the Incomes of Individuals (LTII), Law on Corporation Income Taxation (LCIT), Law on Local Taxes and Charges (LLTC), and in indirect taxes, the totally new Law on Value-added Tax (LVAT). With the Tax Code on procedures the main framework of a modern tax system was established in Bulgaria. This also has brought the country much closer to the requirements and standards of the European Union.

The ambition of the present government is stated in its program "PEOPLE ARE THE WEALTH OF BULGARIA" (2001) *"An adequate and consistent tax policy to boost economic growth is a key priority. The Government will propose to cut those direct taxes that will let individuals and businesses retain earnings, increase demand, promote investment and business and improve budget revenue performance in the long run. Such policy measures will sizably cut direct taxes—profit tax, income tax and capital gains tax—in order to attract investment and achieve economic growth. A clear and efficient revenue collection and administration procedure will result in improved collection of customs duties, taxes and excises.*

The Government will make every effort to build a fair and efficient taxation and social security system that offers incentives to work save and invest"

Revenue System

The present revenue system in Bulgaria does not differ much from the other European revenue systems. The tax system contains more or less the same taxes as those in the OECD list of taxes as Brown, C. V. and P. M. Jackson (1990) have outlined. The reform of the tax system started mostly with amendments of the existing tax laws. Only after 1998 was there real implementation of the new tax philosophy and laws, with the aim of bringing the revenue system within the requirements of the market economy. Table 1 shows the relationship between the OECD code and taxes and their Bulgarian equivalents and also the time the laws were issued.

Table 1 The OECD Code and the Bulgarian Tax System

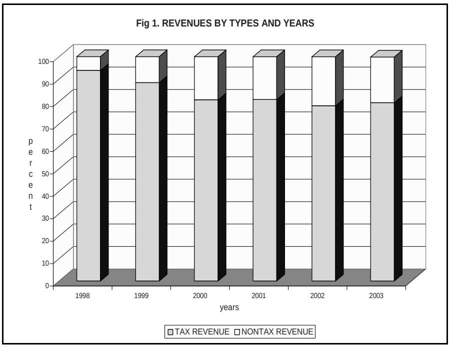
OECD code	Description	Adoption in Bulgaria
	Tax revenues	
1000	*Taxes on income, profits and capital goods*	
1100	Individual taxes on income, profits and capital gains	
1110	On income and profits—Law for taxing the incomes of individuals (LTII)	1998
1200	Corporate taxes on profits and capital gains	
1210	On profits—Law on corporation income taxation	1998
2000	*Social security contributions*[2] *Social security payments code(SSPC)*	1999
3000	*Employers' payroll or manpower taxes—included in LTII*	1998
4000	*Taxes on property—Law on local taxes and charges (LLTC)*	1998
4100	Recurrent taxes on immovable property	
4300	Inheritance and gift taxes	
5000	*Taxes on goods and services*	
5111	Value added tax—Law on Value-added tax (LVAT)	First introduced 1994 and replaced with new law in 2000
5121	Excises—Law on excises (LE)	1994
5123	Customs and import duties—Customs tariffs	
5200	Taxes on use of, or permission to use, goods or to perform activities in connection with specified goods	
5211–5212	In respect of motor vehicles—LLTC	
5213	In respect of other goods—LLTC	
	Non tax revenues	
	Revenue from charges	
	State fees	
	in the Ministry of Finance	
	in the other ministries	
	Fines and sanctions	
	User charges	

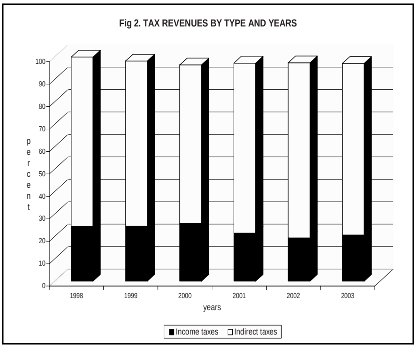
Source: Brown, C. V. and P. M. Jackson (1990) and the author

[2] They will not be of interest here so we shall not examine them in detail.

The revenue distribution among the taxable and nontaxable sources is shown in Fig. 1, which demonstrates the trend to reduce tax revenues on behalf of non-tax revenues over the last years. This is not due to the reduction of the tax burden since revenues from income taxes and the value added tax are growing and this is typical of straight fiscalism. Sometimes governments excuse themselves or hide behind the requirements of the World Bank or IMF. This is the case with the present Bulgarian government that won elections with promises of a drastic decrease in the tax burden is a result some more or less cosmetic populist changes occurred in tax rates and only to a decrease in the purchasing power of the population.

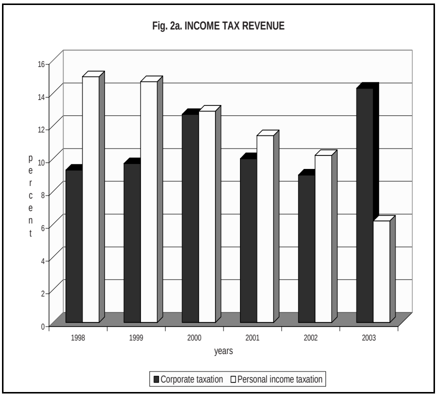
Figure 2 shows the ratio between direct and indirect taxes in Bulgaria and its fluctuations in the last six years. In fact this has changed a lot since the starting of the changes reflecting a more European style in the revenue system. It shows the steady trend toward lowering the tax burden in direct taxation and shifting the revenue system to indirect taxes.

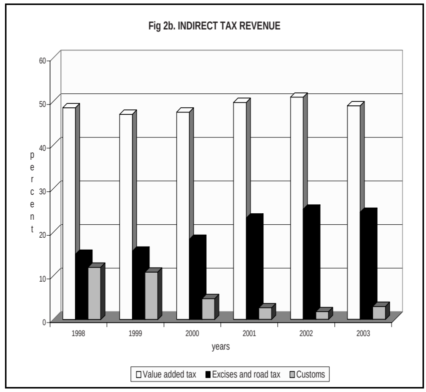




Source: Law for the state budget of the Republic of Bulgaria for 1998, 1999, 2000, 2001, 2002, 2003

Figure 2b gives the distribution of the tax revenue among the different types of direct taxes for the last six years. During the government of the UDF, Bulgaria closely followed European standards in income taxation as shown also in Table 2. Thus, revenues from personal income became greater than from corporate income. Recently there emerged a trend of declining personal income tax revenue, not from the lower tax burden, but because of the lower living standard and the increasing empowerment of the population.





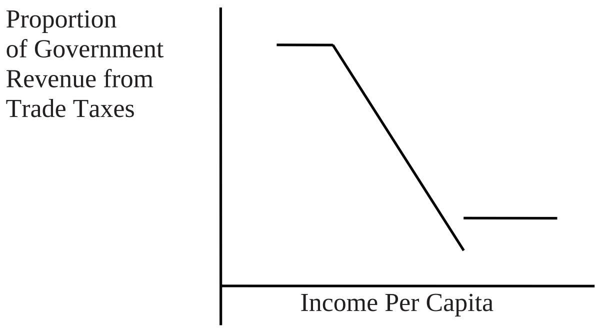
Source: Law for the state budget of the Republic of Bulgaria 1998, 1999, 2000, 2001, 2002, 2003

Table 2 Income Tax Revenue as Percent of Total Tax Revenue

Countries	Personal income taxes			Corporate income taxes		
	1997	1999	2000	1997	1999	2000
EU member states						
Austria	32.2	31.6	29.6	12.7	13.0	12.7
Belgium	40.8	41.2	40.4	17.8	18.0	17.6
Denmark	31.3	31.1	31.2	30.1	29.3	29.8
Finland	48.0	39.6	39.8	19.1	19.1	19.1
France	39.5	38.9	38.0	8.2	10.5	11.0
Germany	35.6	34.4	33.1	10.4	10.9	11.2
Greece	36.2	35.8	35.8	7.7	N/A	N/A
Ireland	23.8	20.1	15.5	13.6	13.4	13.7
Italy	43.3	37.0	36.3	15.7	13.9	15.5
Luxemburg	13.0	10.7	10.9	16.3	15.9	15.2
The Netherlands	33.0	34.1	35.4	10.9	10.6	10.1
Portugal	26.8	26.0	26.2	9.6	9.9	10.0
Spain	33.7	34.0	36.0	10.0	9.6	9.9
Sweden	45.2	44.4	42.8	21.2	21.2	21.4
United Kingdom	24.8	23.3	22.6	13.1	14.3	14.3
BULGARIA	15.0	14.7	12.9	9.3	9.7	12.7

Source: Revenue Statistics 1995–2000 (OECD, Paris 2001). For Bulgaria National Statistical Institute and the Law for the state budget for each year

D. Greenway (1980, 1985) examined the links between trade tax revenue, development level and size of the trade sector for a cross section of countries in the world. His empirical analysis supports the notion that the amount of government revenue that devolves from trade is inversely related to how well-off the country is, and is directly related to how much the country trades (see below).



Relationship Between Income and Trade Taxes

Trade taxes appear to be an important source of government revenue in those countries with low per capita incomes on the one hand, and low ratios of fiscal receipts to GDP on the other. Trade taxes, as a primary source of finance, typically decline in importance as per capita income rises, and economic development progresses with an improvement in administrative machinery that permits expansion in other forms of taxation, according to Greenway and Milner (1991).[3]

The explanation obviously lies in the difficulty and cost of levying alternative taxes upon the domestic economy. Incomes cannot be readily assessed, thus making income taxation difficult. The presence of a large subsistence or nonmonetized sector limits the use of sales tax. Corporate taxation may be limited by the government's decision to grant tax holidays to foreign investors. This inability to impose general forms of taxation results in governments of low income countries having to resort to specific taxes on specific production and consumption activities; these countries suffer because of the costly administrative machinery needed to succeed.

Indirect taxation relied mainly on revenues from the value added tax (VAT) and excises. As can be seen in Fig. 2b there are some fluctuations in the VAT revenues and there is steady growth in the role of excises. As for revenues from customs duties, Bulgaria looks like other developed market

[3] In the developing countries, the tax share ranges from just over 5% in Chile to 62% in Gambia. The average share for all (non-oil) developing countries is 17%. There is however a wide dispersion around the mean and the trade tax share is substantially in excess of this in many cases.

economies. The problem is the decrease in exports and the negative balance of payments. To complicate the matter there are still corrupt practices, and no matter what efforts have been made to end it, and revenues from customs have hardly moved upwards in real terms.

Direct Taxes

Direct taxes in Bulgaria consist of national income taxes and local taxes. National income taxes are comprised of personal and corporate income taxation. Local governments rely on the property tax. Although the direct tax system seems pretty adequate and normal, some peculiarities are outlined below.

Income Taxation

Almost all taxes distort behavior, but a comprehensive income tax is itself a distortion tax and, therefore, not a very efficient tax. The major problem is to select either the set of tax rates (or tax schedules) on different sources of income to minimize inefficiency or to maximize welfare. The exact nature of any tax must be outlined in order to predict its effects more accurately.

Income taxation includes both personal and corporate incomes. It can be divided into taxation on labor income (wages, salaries, self-employment income, business related income, free lance income, services income etc.), and capital income, or income from property and property rights—income from interest, dividends, leases and rents, etc.

The income tax is complex because usually there are different rates for different types of income, exemptions on some types of income (particularly fringe benefits) and allowances/deductions for various categories of expenditure (e.g. expenses related to employment, charitable covenants).

The income tax is entirely a creation of law. It is therefore necessary at the outset to consider the principles applicable to the interpretation of statutes. “Income” means literally “incoming” or “what comes in.” But it is not true to say that everything that “comes in” is income. A person may be said to be in receipt of “any income” in the colloquial sense when he receives money that he can spend or save as he likes, but that does not necessarily mean that what he receives is “income” for tax purposes. Barrett and Green (1986) stated that a tax is “not primarily based on any standards related to justice or equity (although such standards may manifest themselves within the scheme of a particular Act)... [The Government] has complete control over the situation and can be the use of clear and direct language imposes taxes of any extent it wishes.”

It follows that, in broad terms, there are three categories of income: income from property; income from personal exertion; and income from carrying on a business, a process that utilizes a combination of property and labor. In each case, there is a generating force or asset that produces an independent and severable fruit. That fruit is separate in identity from the capital that produced it and is more than an addition or accrual to the original subject matter.

The broad distinction of income in Bulgaria confuses and increases the compliance costs in taxation, since with the existing economic situation there are taxpayers that have two or three sources of income, and in fact they should be aware of the different treatment of their income. And the confusion is greater because at the end returns all incomes are summoned together to form the taxable income.[4]

As a whole, Bulgaria does not differ dramatically in the rates among the other countries around the world according to Table 3. Despite the demonstrated ambition of the present government to “achieve economic growth,” its changes in income taxes do not differ from the trends in the previous government to simply lower the corporate tax rates. This does not increase the expected foreign or even domestic investments. On the contrary capital is withdrawing from the Bulgarian economic scene. There are many more reasons for lower investment activity such as difficult tax compliance, unreal depreciation costs for tax purposes, and the lower purchasing power of the market and its tiny dimensions.

The Bulgarian rates have been lowered with the recent changes of the laws more for the year 2004—corporate rates are 19.5% without SME relief and personal income taxation became 12% up to 29%. So in that way the government keeps the trend of just lowering the rates without finding a new tax philosophy that will decrease the burden and bring an increase in investment flows.

Lowering of the tax rates in Bulgaria for corporations was replaced with high social security contributions in 2003 by establishing the so called thresholds for payment of social security by individuals and businesses. This was a strange move, a quasi reform, because nobody is willing to pay for nothing, and it was a step backwards from market principles. This policy drives the social security system away from its purpose and makes social security payments a sort of tax payment since they are proportional to individual income and combines closely corporate income taxation and personal income taxation in ways undesired by employers or employees.

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[4] This resembles an old story of introducing the post code in a desert of an Arabic country. They put different boxes for the different towns and in the evening a bare foot Bedouin comes with a big bag and gathers all the letters together and sets for to the sorting room of the nearest post office.

Table 3 Rates for Income Taxation Around the World 2001

Countries	Corporation income tax		Personal income tax	
	Standard rate	SME rate	Lower rate	Upper rate
Australia	36		20	47
Austria	34		10	50
Belgium	40.17	28.84	25	55
Brazil	15		0	27.5
United Kingdom	30	20	10	40
Germany	45		0	53
Greece	40	30	0	45
Denmark	34		8	58
Italy	37		19	46
Ireland	32	25	24	46
Canada	46		17	29
China	30(3)	15–24	5	45
Cyprus	25	20	20	40
Luxemburg	30	20	0	36
Malaysia	28		2	30
The Netherlands	36		5.05	60
USA	35	15(25)[5]	15	39.6
France	33.33		10.4	54
Finland	28		50	68.95
Hong Kong	16		2	17
Japan	34.5	25	5	40
COUNTRIES IN CURRENCY BOARD				
Lithuania	29			33
Estonia	26			26
Argentina			6	35
COUNTRIES FROM CENTRAL AND EASTERN EUROPE				
Check Republic	35			40
Hungary	18			42
Poland	36			40
Romania	38			45
Slovenia	25			50
Latvia	25			25
BULGARIA	20	15	20	40

Source: Inventory of taxes, Luxembourg: Office for Official Publications of the European Communities, 2000, European Communities, 2000 (with the annual changes for some of the countries), Individual Taxes: Worldwide Summaries, 2001–2002, Price Waterhouse, 2002 accessed in http://www.netlibrary.com on 12/24/03

[5] According to the profit from $0 to $50,000 15%; from $50,001 to $75,000—25%; from $75,001 to 10 million—34% above 10 million—35%.

Personal income taxation itself has gone through a lot of changes and "relief" in Bulgaria, but still differs from personal income taxation in Europe and the requirements of the European Union.

Simplifying the tax system and improving horizontal equity are secondary motives for tax reform in many countries, but the philosophical underpinning of the tax reform movement is usually efficiency or tax neutrality. These also have to be the basic motives for reform in Bulgaria. However, the Bulgarian government in most cases discourages investing and increases the tax burden.

Upon coming into power the government lowered the tax burden immediately on high incomes by lowering the marginal tax rate from 38% (2001) to 29% (2002). The excuse was that the tax relief was only for 10,000 members of the population. The belief was that by leaving money in the hands of the wealthy employment would improve—a trickle down theory.

In 2003, the government cut tax rates for the lower income earners from 18 to 15%, shifting the burden toward the middle class earners. This is a more than quasi-reform. It is just demagogical and populist activity, since in the long term purchasing power and market strength will shrink. An essential economic truth is that the middle class forms the consumer market and, if the middle class is left with less money, the market will suffer.

In 1996, contrary to the requirements of the Constitution, Bulgaria introduced a pure national creation of a flat tax—so called patent (license) tax for small businesses. The idea was to give relief to the SME and some services with turnover of less than 75,000 leva ($38,000). They have to pay a flat amount of tax per year, which differs only from town to town. On one side this is good and steady revenue for the budget from businesses that in previous years always recorded losses, on the other it was placed in the Law for Taxing the Incomes of the Individuals (LTII) and the tax itself is set by the Parliament for all regions. Although it differs from town to town, it still is related neither with the Constitutional requirement (1), nor with the real revenues in the mentioned services. Most of the services that fell under this flat tax rely on the consumers flow and it is different in the center of the town and in the outskirts but the tax is the same for service providers no matter where they do their business in the town.

In this respect, the income tax as a whole in Bulgaria does not correspond to the rules of a market economy. Most of the tax laws are created piece by piece and do not constitute a tax system appropriate to the needs of economic development.

Other Direct Taxes

All local taxes and charges are considered direct taxes under the Law for Local Taxes and Charges. Although it is a local bill, it is voted on by Parliament so all local taxes are not set locally but centrally. This approach is related to the centralist approach, which contradicts local self-management and the establishment of local programs for employment and investment incentives. Local governments are agents of the central government and, if they are not from the ruling majority, their position is extremely difficult. The central government usually cuts the subsidies for the non-loyal communities and this always reflects the living standard of the tax payers. The existing law includes all kind of property tax, “gift tax,” tax for usage of vehicles, user charges for kindergartens and open air sales, some charges for resort usage etc.

Strangely, even after 12 years of changes and amendments, revenues from property taxes are smaller than revenues from vehicle taxes in the country and in certain cases the relationship is three to one.

Indirect Taxes

Indirect taxes[6] and their changes have an impact on market prices and on the terms of trade between countries, so usually the model and the amount of trade can be affected. For example the introduction of VAT in Bulgaria in 1994 forced Greece to drop its high rate of 36% and equalized it with the Bulgarian rate of 18% at that time. Otherwise there was a chance that some of the Greek products taxed at a high rate in Greece would be found cheaper on the Bulgarian market and inspire economic tourism.

Indirect taxes are levied on traded commodities according to two principles—origin and destination. In the origin principle taxes are levied on the production stage and the producing country receives the tax revenue, while in the destination principle, which is more widely used, taxes are levied on the consumption stage and the consuming country has the revenue.

Theory has shown that the destination principle gives the same results as the origin principle if the tax is completely general in the sense that no activity is untaxed. The introduction of the value added tax (VAT) contributes to the liberalization of trade. In fact, within the European Union, this tax was introduced mainly for its neutrality vis-à-vis trade across member countries and its administration. This is especially true when applied with the credit mechanism on the basis of the destination principle. This neutrality makes the

[6] Attention should be directed only to the Value Added Tax and the excise duties.

VAT extremely popular in the European Union, especially when implemented based on the destination principle. VAT started its existence in Western Europe, but through technological transfer found its way to Latin America and French-speaking Africa.

A VAT applied with the destination principle is ideal for taxing consumption in a world undergoing integration. By allowing a credit on the purchase of capital goods, it allows governments to tax consumption alone. It also guarantees the independence of countries in determining the rates at which they wish to tax consumption. The allocation of world revenue from this tax is determined by two factors alone: the rate at which countries impose the VAT, and the role of their consumption. Because export prices do not reflect this tax, they are distorted by attempts at manipulating trade. And because imports are taxed in the same way as domestically produced goods, they are not discriminated against.

In Bulgaria, the VAT was introduced in 1994 with a standard rate of 18% and a zero rate for exports. Of course some services such as medical, financial, educational, insurance and others are exempt from tax, which at a certain point makes their expenses bigger as they cannot deduct the paid VAT but have to include it into the price of their service or product. In 1996 the socialist government increased the standard rate to 22% tempted by the fiscal possibilities of this tax. With the introduction of the new VAT philosophy in 2000 and a new law, the rate was decreased to 20% and the scope of exemptions was limited.

Excise taxes are other indirect taxes that influence the opening of an economy. The basic characteristics of these taxes are that they fall on specific products rather than on general consumption and they do not distinguish, in a legal sense, between domestically produced and imported products. Excise taxes are imposed for various reasons: to raise revenue; to tax some individuals for benefits they may receive from activities associated with consumption goods (gasoline; to discourage the use of some commodity that is damaging to health (cigarettes); to penalize the users of some commodities for negative externalities they may impose on society (alcoholic beverages); or to make the tax system progressive (luxury tax). Because these taxes are imposed on particular products and not on others, they are, by their nature, distorting.

In open economies, other issues arise in connection with these taxes. In general, excise taxes are imposed on imports with the same rates and the same conditions imposed on domestic production of the taxed commodity. Furthermore, exports are not subjected to these taxes but are taxed (at destination) in the country where the exported commodities are consumed Openness may give some countries the possibility to use these taxes to exploit international movements of goods and people to get some advantage.

Alternatively, openness may reduce a country's degree of freedom in connection with the use of these taxes.

Tariff reduction designed to encourage outward-oriented development will work only if alternative sources can be found to replenish revenue lost in the cause of reducing protection. Integrating reform of tariffs with taxes would seem to be the answer, but so far analyzers—see Halevi (1988) or Tanzi (1995)—have often tended to treat the two instruments separately.

Reducing the bias against exports caused by extensive import protection is an early priority in the move toward outward-oriented development. But trade liberalization can be delayed or aborted if complimentary macroeconomics policies, especially appropriate fiscal policies, are absent. With the enormous decline in the state industrial sector and large budget deficits, revenue losses arising from tariff reductions must be forestalled by tapping other sources of revenue.

Finally, in economic development there is often a tendency for imports to become capital and intermediate inputs as opposed to finished products, thus making it desirable to reduce the average tariff rate to provide incentives for domestic production and reduce the distortion effects of taxes using a wise and flexible tariff policy.

Deep integration would require the complete elimination of both import and export taxes. There is now little debate about where the administrative possibility for a shift exists. These taxes should be replaced by domestic indirect taxes that interfere less with the allocation of resources and with the free movement of goods and without additional costs.

Cost in Taxation and Tax Harmonization

Bulgaria is already an associate member in the European Union and the negotiation for full membership are going on and at the same time it is developing a tax system related to the market economy (It became a full member after this chapter was written). This is an appropriate moment to establish such a tax system using tax principles that are as close as possible to the requirements and perspectives of the United Europe. It is more than clear that none of the Western recipes can work on Bulgarian soil. Simply implementing a ready made scheme won't work. The goal should be to comply with the European standards and at the same time to limit the costs involved in existing taxation.

A tax system has costs of various kinds. Taxes require transfer of funds between the private sector to the public (government) sector. However there is no market transaction. Taxpayers receive various government services in return for their tax payments. As Allers (1994) writes, there is no direct relationship between services received and the amount contributed to the budget. So we can divide the transfers into taxes that flow from the private to the public sector and benefit payments going the other way.

In the operation of a tax system there are *operating costs* for both private and public sectors. If the public sector is put on the left side of the cost spectrum several different costs can be examined. The major costs are *administrative costs* that incur in administering an existing tax code, including *enforcement costs.* They are regular and rise from the continuing operation of a tax, or they can be "*other Exchequer costs*" arising from the existence of a lag in tax payment. The latter is strongly related to personal income taxation since the transfer may be delayed sometime for a year or more, while most of the businesses are making advance tax payments. To eliminate this effect Bulgaria introduced advance payment for all self-employed and service render after they reach the annual nontaxable income level. The percent for advance payment was 15% and increased to 20% in 2003.

On the right side, where the private sector is, there are mainly *compliance costs* for meeting the requirements of a given tax structure. Dean (1975) defines compliance costs as "all those extra costs that the entrepreneur must budget for simply in order to comply with tax requirements." These are the costs that would not have been incurred in the absence of a tax.

Arising from the compliance costs can be *temporary costs* caused by unfamiliarity with a tax, and the *psychic (psychological) costs* of the burden of anxiety imposed by the requirement of tax compliance. Johnston (1963) makes a distinction between *unavoidable* and *avoidable costs* related with compliance. The first are those necessarily incurred in order to comply with legal requirements, while the latter are tax planning costs incurred in order to minimize one's tax bill, or to maximize the receipts of benefits. Since firms and individuals change the pattern of their behavior and activities because of taxation, an *excess burden (dead weight loss)* of taxation arises.

For both sectors there are *commencement costs* that are, once and for all costs incurred at the inception of a new feature of the tax system. And finally, there are social costs, experienced by the community as a whole and arising from the operation of a tax as stated in Sanford et al. (1989) or Allers (1994). These costs are related to the excess burden of taxation and affect both sectors.

All these costs are elements of the tax system and are inevitable while making decisions on any market transaction, though some of them are not often an issue in tax planning. It is not the objective of this chapter to examine in detail all costs but examining some of them will help in clarifying Bulgarian taxation, because in Bulgaria the majority of these costs are extremely high.

In the state budget the rate of non-tax revenues from fees, sanctions and charges grew from 6.2% for 1998 to 20.4% in 2003 while the revenue from corporate tax grew only from 9.3 to 14.3% and income tax dropped from 15 to 6.2%. In relation to charges and sanctions, that means that the compliance cost are extremely high and most of the businesses are simply punished for doing business. For example in relation to the changes introduced in VAT where if there is an illegal member in the chain the others are not getting their VAT back. It is punishment for the regular payers on behalf of the criminals.

It is clear that relatively high compliance costs may put the national economy at a competitive disadvantage with other countries. A comparatively high price level will hamper exports, for example, and high compliance costs may discourage foreign enterprises to invest or set up subsidiaries. In fact sometimes it is not the tax itself that discourages investment but rather high compliance costs. In the Bulgarian case, it is very difficult for any foreign investor to keep up with the changes going on in the tax system, and this increases compliance costs.

All costs associated with taxes can be examined as costs of market transactions. This puts another view on taxation, where transfers from the private to public sector in exchange for some services or benefits are usually viewed as another cost added to the cost of any given market transaction. For example, if there is a decision to be taken for investment allocation, the tax issue will be considered seriously before any investment decision is made. On the other hand, if an employee wants a certain job he should definitely know how much of his income he will share with the government. All these issues are closely related to tax planning and transaction costs.

Transaction cost is a cost of running an economic system. Coase (1937) states, and also Demsetz (1968) and Williamson (1975), that the cost of affecting an exchange or other economic transaction may vary from one economic system to another; it can be stated that the tax itself can be examined as the cost (price) of the income that should be received. This gives a chance to study income taxation from the viewpoint of transaction-cost economics which, as O. Williamson (1995) stated is “an interdisciplinary undertaking that joins economics with aspects of organization theory and overlaps extensively with contract law. It is the modern counterpart of institutional economics and relies heavily on comparative analysis.”

This definition of transaction-cost economics applies it to income taxation and allows determination of another side of tax theory. It is a good way to combine law and economics to explain legal institutions, procedures, decisions and the like in terms of the economic theories. This is what Backhaus (1995) pointed out and develops some of the ideas of Williamson.

Hall and Jorgenson (1991) assume that income taxes rest where they are put, and hence the burden is reckoned to lie on the factors of production, and that indirect taxes are passed forward with the burden estimated to be on the consumers of the product.

Even though fiscal degradation affects every major source of taxation (consumption taxes, business taxation, capital income taxation, social contributions), its effects differ greatly according to the nature of the tax concerned. Even consumption taxes, which are harmonized to a much greater extent than direct taxes, are not immune from the risk of fiscal degradation.

The personal income tax plays a role, especially in border regions, in creating incentives to cross-border migrations both for work and for residence. However, high levels of social security contributions and personal income tax may lead workers, especially the self-employed, to relocate their activity in the underground economy in order to underreport their tax revenues.[7]

In subscribing to the objectives of the "White Paper on Growth, Competitiveness and Employment," the EU member states underlined the need to put an end to the relative overtaxation of labor in order to promote employment within the European Union. The effect on the promotion of employment will depend on the possibility of changing permanently and significantly the relative gross price of labor and nonlabor factors of production.

The elimination of tax barriers in the Single Market is made even more important by the European Monetary Union, because it would appear contradictory to do nothing to remove tax distortions while trying to remove distortions related to misalignments of exchange rates. Improvements in tax systems, so as to make them employment-friendly rather than biased against employment, will contribute to the fight against unemployment at a time when this is the main priority of the Union's policies.[8]

In fact, it is not at all surprising that a comparative study of corporate taxation systems in the European Union shows considerable diversity. The differences are to some extent inevitable since the national systems of taxation reflect economic and social structures developed over long periods. So harmonizing the systems, or merely reducing the differences between them, would be a particularly difficult task in view of the disparities.

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[7] The size of the underground economy varies between countries, but is probably equivalent to between 5% and over 20% of GDP. For more background, see, for example, Evaluation de l'economie au noir, Office de Recherches Sociales Europeenes, November 1995.

[8] Taxation in the European Union, Commission of the European Communities, Brussels, 20.03.1996, SEC (96) 487 final. Discussion paper for the Informal Meeting of ECOFIN Ministers.

Conclusion

The opening of an economy inevitably involves two major problems:

a) trade tariff policy—based on a new real evaluation for an effective level of customs protection of the national production;
b) serious change in the tax system that should stimulate internal and external investments and leave enough money at consumers' disposal for meeting the market supply.

The lack of a clear strategy in trade policy, obscure usage of taxes as regulation mechanisms for the economic processes in the country as well as protection from external impacts, unpredictable political movements and decisions, strong lobbying for economic interests of a shadow economy are leading to a bigger crisis in the economy of Bulgaria as a whole as well as to closing of any trade possibilities.

The decisions that are taken ad hoc have very distorting effects in the economy, lead to difficulties, and discourage those that are interested in investing in Bulgaria. Similar examples of nonsystematic and illogical decisions are quotas for the export and import of products, which are not a great necessity for economic development, but increase the chaos in the trade processes.

All measures have to be very carefully rethought in formulating the policy for possible opening of the economy, as well as the direction of integration and cooperation with the externalities, starting with the neighboring countries and expanding under the central attracting forces of the EU.

Deardorff and Stern (1987) define trade policy as "an acupuncture done with a fork: no matter how carefully you are inserting one edge the other always can make a lot of damage." That is why in an economy with great distortions as in the Bulgarian economy, it is necessary to do away with distortion. Then an effective and normal trade policy and an economic opening can occur.

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21

A Survey of Chinese Business and Economics Students on the Ethics of Tax Evasion

Robert W. McGee and Yuhua An

Introduction

The vast majority of articles that have been written about tax evasion have been written from the perspective of public finance. They discuss technical aspects of tax evasion and the primary and secondary effects that tax evasion has on an economy. In many cases there is also a discussion about how to prevent or minimize tax evasion. Very few articles discuss ethical aspects of tax evasion. Thus, there is a need for further research, which the present study is intended to partially address. The literature on this topic is reviewed elsewhere in this book. Citations to the literature are provided in the reference section.

As part of this study a survey instrument was developed based on the issues that have been discussed and the arguments that have been made in the tax evasion ethics literature over the last 500 years. Similar survey instruments were used to test sample populations in Romania, Guatemala and several other countries. The survey was also distributed to professors of international business. The present study reports on the findings of a survey that was distributed to business and economics students at the University of International Business and Economics in Beijing, China.

Methodology

After reviewing the literature that exists on the ethics of tax evasion, a survey was constructed and distributed it to a group of graduate and advanced undergraduate business and economics students at the University of International Business and Economics in Beijing, China in order to learn the prevailing views on this issue. This group was selected because they will be the future business and political leaders of China.

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The survey consisted of fifteen (15) statements. Using a seven-point Likert scale, respondents were asked to place the appropriate number in the space provided to indicate the extent of their agreement or disagreement with each statement. The survey was translated into Chinese, although some participants preferred to use the English version. One hundred seventy-three (173) usable responses were received.

The following hypotheses were made:

H1: The average respondent will believe that tax evasion is ethical sometimes.
H2: The dominant group will be the group that believes tax evasion is ethical sometimes.
H3: Scores will be lower [tax evasion will be more acceptable] when the statement refers to government corruption.
H4: Female scores will be higher than male scores [women will be more strongly against tax evasion than males] for at least 10 out of 15 statements.

Survey Findings

A total of 173 usable responses were obtained. Table 1 shows the breakdown by gender.

Table 1
Responses by Gender

Male	83
Female	86
Unspecified	4
Total	173

H1: The average respondent will believe that tax evasion is ethical sometimes.
H1: Confirmed.

Table 2 lists the 15 statements and the average scores received for each statement. A score of one (1) indicates strong agreement with the statement. Seven (7) indicates strong disagreement. An average score of 2 or less would indicate that tax evasion is always, or almost always ethical. An average score of 6 or more would indicate that tax evasion is never or almost never ethical. Scores averaging more than 2 but less than 6 would indicate that tax evasion is sometimes ethical. As can be seen from Table 2, all 15 scores are more than 2 and less than 6, which indicates the average respondent believes tax evasion to be ethical sometimes.

Table 2
Summary of Responses
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Score
1	Tax evasion is ethical if tax rates are too high.	4.0
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	4.7
3	Tax evasion is ethical if the tax system is unfair.	3.4
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.1
5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.3
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.3
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.2
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	4.9
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.2
10	Tax evasion is ethical if everyone is doing it.	4.7
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.2
12	Tax evasion is ethical if the probability of getting caught is low.	5.1
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3.6
14	Tax evasion is ethical if I can't afford to pay.	3.9
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.1
	Average Score	4.4

Chart 1 illustrates the range of scores for the various statements.

H2: The dominant group will be the group that believes tax evasion is ethical sometimes.
H2: Rejected

Table 3 shows the range of scores for each of the three groups [1–2 always or almost always ethical; 3–5 sometimes ethical; 6–7 never or almost never ethical]. The first number indicates the percentage of responses that fell

Table 3
Range of Scores
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Score	Range of scores (%) 1–2	3–5	6–7
1	Tax evasion is ethical if tax rates are too high.	4.0	36 (1)	28 (3)	36 (1)
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	4.7	23 (3)	33 (2)	44 (1)
3	Tax evasion is ethical if the tax system is unfair.	3.4	49 (1)	26 (2)	25 (3)
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.1	50 (1)	31 (2)	19 (3)
5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.3	13 (3)	27 (2)	60 (1)
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.3	27 (3)	37 (1)	36 (2)
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.2	14 (3)	29 (2)	57 (1)
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	4.9	17 (3)	33 (2)	50 (1)
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.2	15 (3)	28 (2)	57 (1)
10	Tax evasion is ethical if everyone is doing it.	4.7	21 (3)	32 (2)	46 (1)
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.2	56 (1)	18 (3)	25 (2)
12	Tax evasion is ethical if the probability of getting caught is low.	5.1	13 (3)	33 (2)	54 (1)
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3.6	41 (1)	35 (2)	24 (1)
14	Tax evasion is ethical if I can't afford to pay.	3.9	34 (2)	39 (1)	27 (3)
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.1	19 (3)	28 (2)	53 (1)

into each category. The numbers in parenthesis rank the groups in terms of dominance. The group ranked one (1) had the highest percentage; the group ranked three (3) had the lowest percentage.

In most cases (9 out of 15) none of the three groups had a majority. The dominant group for most statements gained first place by a plurality. However, there was a clear majority for statements 5, 7, 9, 11, 12 and 15 and a near majority for statements 3, 4 and 8.

Table 4 summarizes the ranking data from Table 3. For 10 of the 15 statements, the dominant group (the group with the highest percentage response) was the group that believes tax evasion to be never, or almost never ethical. The "sometimes ethical" group was dominant for only 2 of the 15 statements. Thus, although the average score indicates that respondents believe tax evasion to be ethical sometimes, the dominant group believes tax evasion to be never or almost never ethical. The differences in outcomes is attributable to the fact that a substantial minority believe tax evasion to be always or almost always ethical, as indicated by the first place ranking for 5 of the 15 statements.

Table 4
Degree of Support for the Three Views

Score	First place	Second place	Third place
1–2 (always or almost always ethical)	5	1	9
3–5 (sometimes ethical)	2	11	2
6–7 (never or almost never ethical)	10	2	3

H3: Scores will be lower [tax evasion will be more acceptable] when the statement refers to government corruption.
H3: Accepted

Table 5 ranks the 15 statements from most acceptable to least acceptable. Scores ranged from 3.1 to 5.3, indicating that there are circumstances when tax evasion can be ethically justified. Respondents believ ed that the strongest case for tax evasion was in cases where a large portion of the money collected is wasted. Wasting tax money could be the result of corruption or other reasons or a combination of corruption and other reasons.

The second strongest justification for tax evasion, with a score of 3.2, is in cases where a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.

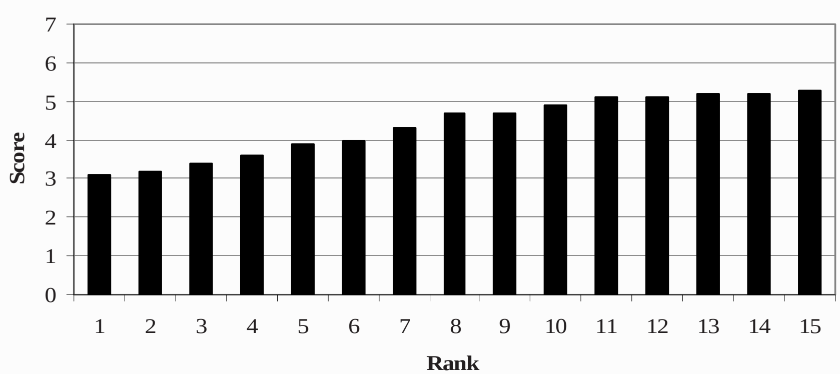
The statement with the third highest score was for a tax system that is perceived as being unfair. Statements involving moral disapproval ranked 4 and 7. Statements ranked 5th and 6th had to do with ability to pay or the perception that tax rates are too high. Respondents were less likely to view tax evasion as ethical if tax funds were spent for worthy projects or if the respondent benefited from the tax expenditures. These findings replicate the findings in the international business professor (McGee 2005a), Romanian (McGee 2005b) and Guatemalan (McGee and Lingle 2005) studies.

Table 5
Ranking
(1 = strongly agree; 7 = strongly disagree)

Rank	Statement	Score
1	Tax evasion is ethical if a large portion of the money collected is wasted.	3.1
2	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.2
3	Tax evasion is ethical if the tax system is unfair.	3.4
4	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3.6
5	Tax evasion is ethical if I can't afford to pay.	3.9
6	Tax evasion is ethical if tax rates are too high.	4.0
7	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.3
8	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	4.7
8	Tax evasion is ethical if everyone is doing it.	4.7
10	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	4.9
11	Tax evasion is ethical if the probability of getting caught is low.	5.1
11	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.1
13	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.2
13	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.2
15	Tax evasion is ethical even if most of the money collected is spent wisely.	5.3

Chart 2 illustrates the range of ranked scores.

Chart 2 Range of Scores



H4: Female scores will be higher than male scores [women will be more strongly against tax evasion than males] for at least 10 out of 15 statements.
H4: Rejected

Table 6 compares the scores of male and female respondents. Males had higher scores for 7 of the 15 questions. Women had higher scores for 6 statements. In two cases, the male and female scores were the same.

Table 6
Comparison of Male and Female Scores
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Score			Score larger by	
		Overall	Male	Female	Male	Female
1	Tax evasion is ethical if tax rates are too high.	4.0	3.9	4.3		0.4
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	4.7	4.2	5.1		0.9
3	Tax evasion is ethical if the tax system is unfair.	3.4	3.3	3.5		0.2
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.1	3.5	2.8	0.7	
5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.3	5.3	5.3		
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.3	4.6	4.2	0.4	
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.2	5.3	5.2	0.1	
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	4.9	5.0	4.7	0.3	
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.2	5.2	5.2		

10	Tax evasion is ethical if everyone is doing it.	4.7	4.7	4.8		0.1
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.2	3.1	3.3		0.2
12	Tax evasion is ethical if the probability of getting caught is low.	5.1	5.3	5.0	0.3	
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3.6	3.8	3.4	0.4	
14	Tax evasion is ethical if I can't afford to pay.	3.9	3.8	3.9		0.1
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.1	5.2	4.9	0.3	

Chart 3 shows the comparison of male and female scores.

Chart 3 Comparison of Male and Female Scores

Table 7 compares the male and female scores for the present study to those of three other studies that used a similar survey instrument. The other three surveys included 18 questions. In the international business professor survey, female scores were higher for all 18 statements, indicating stronger views against tax evasion than the males. Female scores were higher in 12 of 18 cases for the Guatemalan study. The Romanian study found male scores to be higher than female scores in 12 out of 18 cases. No explanation comes to mind for why female international business professors and Guatemalan students are more opposed to tax evasion than are their male counterparts while just the opposite seems to be the case for Romanian and Chinese students.

Table 7
Comparison of Male and Female Scores

	Male score higher	Female score higher	Same score
International Business Professors (McGee 2005a)	0	18	0
Romanian Business Students (McGee 2005b)	12	6	0
Guatemalan Business Students (McGee and Lingle 2005)	4	12	2
Chinese Business & Economics Students (present study)	7	6	2

The survey instrument included space for participants to make additional comments to explain their views on the ethics of tax evasion. The vast majority of respondents left this space blank. However, a few participants did make comments. One comment stated that tax revenue is necessary to run the country and that tax evasion is illegal. Implied in this statement is the belief that what is illegal is also unethical, which may not always be the case. Another participant stated that taxation is a win-win process not only for the country but for the taxpayer, although no further explanation was given.

One respondent viewed taxation as an agreement between the individual or company and the government, whereby taxpayers have the right to determine the tax rate and amount. The taxes that are collected must be used for society. If the tax regulations are unfair, tax evasion may be ethical.

Another participant stated that tax evasion is ethical if the tax rate is too high or if the system is not equitable. Another respondent stated that whether tax evasion is ethical depends on the quality of the governing body, the rationale for taxation and the use to which the taxes collected are put. A respondent who put seven (7) for each statement said that tax evasion is not ethical but that people can optimize their tax structure so as to reduce the amount of taxes paid. Another respondent said that there are legal ways to minimize taxes and that evasion is illegal.

Concluding Comments

This study surveyed the opinions of business and economics students in Beijing, China. The results indicate that the belief that tax evasion is ethical is widespread, although there is a significant segment of the educated population who think that tax evasion is always, or almost always unethical.

Although some arguments justifying tax evasion are stronger than others, the average scores, which ranged between 3.1 and 5.3 on a 7.0 point scale, indicated that the average view falls into the middle category, that is, that tax evasion might be somewhat ethical for any of the reasons given.

The strongest arguments justifying tax evasion occur when the government is deemed to be corrupt or when the tax system is perceived to be unfair. This finding has important policy implications. From these findings one might reasonably conclude that the extent of tax evasion might be reduced if government is perceived as being less corrupt or if the tax system is deemed to be fair.

This study could be replicated in a number of ways. Different groups of Chinese students could be surveyed, either in different cities or regions of China or in different disciplines, such as law, philosophy or political science. Judging from the results of the study of Guatemalan business and law students (McGee and Lingle 2005), the responses obtained could be different for different disciplines.

Surveying Chinese business people might also be worthwhile, since their perception of taxation might be different than that of university business and economics students. It would be interesting to see whether the results might be different for sample populations in Hong Kong, Macao and Taiwan as well, since the populations of these places share a more or less common heritage and culture, although their recent economic and political history has been different.

Comparative studies might also be made of China and Japan, China and Korea or China and some other Asian country to see whether the view of tax evasion may differ by country. The Torgler study (2003) indicated that the view of tax evasion might indeed be different, depending on which Asian country is chosen for study. Replicating this study in other Asian countries would shed light on whether the Torgler findings could be confirmed.

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22

Tax Reform Needs in China and the United States: Perhaps a Chance to Learn from Each Other

Robert Sarikas, Liu Xiaobing, Yin Zi, and Arsen Djatej

Introduction

Johnston (2007) reported that after dipping briefly, taxes are growing around the world. Taxes in the developed world are now exceeding 36% of Gross Domestic Product (GDP). The People's Republic of China and the United States of America are two large and diverse nations with very different histories. The political economy of each nation is unique in many ways. From time to time each nation makes major efforts at tax reform. Each nation spends time and resources considering how to alter their taxation systems, with major efforts seemingly concentrated during certain time periods. Tax reform, as of late 2007, has been much more active in China than in the United States. On Monday 15 October 2007 Chinese President Hu Jintao used the opening of the Chinese Communist Party Congress to call for China to rethink its economic path. Presumably, as in any modern economy, economic changes in China likely will include even more changes to the Chinese tax system. Andrews (2007) reports that Treasury Secretary Paulson made the point that United States corporate tax rates are higher and more complex than in Europe, Japan, and other industrialized nations. However, the government is apparently not planning any tax legislation. Tax reform appears dead due to President Bush's low popularity and Democratic majorities in Congress.

This paper will discuss the major problems of the overall tax systems of first, China and then second, the United States. The paper will then discuss what the two nations might learn from the experience of the other.

Past Reforms and the Current Reform of China's Tax System

China is undergoing a third generation of tax reform. The first round of tax reforms began in the late 1970s. These reforms were intended to stimulate domestic industrial activity and to attract foreign investment to China. There

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was a specific goal of attracting foreign investment, especially advanced technology. Until this time, enterprises in China were creatures of the state, and their profits were considered as belonging to the people and these profits were routinely submitted to the state and this capital was allocated according to the needs and goals of the national planned economy. The second round of tax reform resulted in the first tax law (Zhou 2002). Prior tax rules were implemented using circulars and directives, and were not codified into formal law.

The First Generation of Tax Reform in China—the Early 1980s

The first round of tax reforms were begun in the early 1980s with significant impact occurring in 1983. At this time state-owned enterprises were taxed at a certain rate with the amount of tax flowing to the government and the remaining amount of reported profits permitted to be kept by the enterprise. Also, at this time restrictions on private-owned enterprises were eased, and it even became possible for some enterprises to be partly private and partly state-owned. China had decided to modify its economic structures in a pragmatic and thoughtful way for the national economic good, but had yet to make a commitment to the development of a market economy.

The Second Generation of Tax Reform in China—The Early 1990s

As foreign investment and business increased in China over time the regulatory structures and taxation structures also evolved. By 1992 China had made a choice to modify its national economy into a market economy. This goal motivated the second round of reforms that had a major impact by 1994. Another goal at this time was to expand the financial resources available to the central government. Prior to this time local government (the provinces and cities) controlled and spent most of the tax monies in the nation. A third goal of reform at this time was to deal with the perceived overheating in the national economy caused by a rapid growth in the investment of fixed assets.

Reforms at this time attempted the major changes deemed necessary to continue the evolution from a state-owned and state-planned economy to a socialist market economy. The socialist market economy is intended to provide the people of China with the benefits and safeguards of the socialist system while still providing the strong stimulus for economic growth characteristic of successful market economies. A key to the rapid improvement of China's economic position is access to the most advanced technologies available. Access to these technologies requires integration into the global economy, which is of course in general, a global *market* economy.

The changes implemented in the second generation of tax reform included new laws on the taxation of domestic enterprises and foreign invested enterprises.

Domestic state-owned enterprises were freed of all risk that the state would take any after-tax income. The increased use of the income tax increased tax flows to the central government as all income tax revenues belong to the national government.

With the intent of developing a market economy in China, China planned to rejoin the GATT. To this end, and as a way to generate needed tax revenues for the central government, a Value-Added-Tax (VAT) was made into law. Because of the perceived over investment of fixed-assets at this time, a decision was made to implement a production-type VAT. This meant that investment in fixed-assets was taxable. This was a policy choice designed to reduce the risk of unwanted inflation. The allocation of tax revenues from the new VAT was 75% to the central government and 25% to the local governments, accomplishing a policy goal of increasing the tax revenues to the central government.

The Third and Current Generation of Chinese Tax Reform: 2003–2004

Anthony Tam and Eveline Ko (2002) of Deloitte Touche Tohmatsu stated in November 2002 that, The PRC tax system seems to be approaching another era of major reform since the last major changes took place in 1994. “This new round of tax reform will be characterized by what is viewed as a new and most helpful change to tax reform in China, and that is deliberate incremental approach to implementation”. The idea is that a step-by-step process is the healthiest approach to such fundamental economic change. Yiyi (2004) reports that three main points of this tax reform are the shift from a production-type VAT to a consumption-type VAT, the reform of the export tax rebate system and the elimination of the agricultural tax within five years.

Lin (2003) published a forecast that many others were also making, namely that China would combine the corporate income tax for foreign corporations with the law for Chinese corporations. After years of discussion the Standing Committee of the National People’s Congress, has resolved to submit a draft law to a vote on a unified corporate income tax. The act is unified in that now both resident and non-resident corporations are subject to basically the same corporate income tax with the same rates. Resident corporations will now be taxed on their worldwide income (although of course, non-resident corporations will not). However, if resident corporations have overseas losses, this may not be netted against profitable domestic operations.

Privately owned enterprises have a very low rate of investment at this time, and the tax burden caused by a production-type VAT is seen as the reason. It is thought that the change to a consumption-type VAT will stimulate investment in fixed assets, something that is seen as critical to China's future success as China's industries all face the challenge of world competition. Thus, as China's interest in the GATT generated the VAT some years ago, now the desire to succeed in a WTO-world of fierce competition is driving changes in the structure of the VAT.

China offers partial tax rebates of the VAT to enterprises that export overseas. As China's exports have surged, so has the cost of these rebates. Currently the government of China is not always current on these payments, causing financing problems for some enterprises. The level of these rebates will be reduced over time. This will encourage enterprises to be globally competitive and diminish the economic pressure on the finances of the central government.

Currently China has 60% of its work force employed in agriculture. It is desired that this percentage fall to below 30% because the government believes that no successful developed economy can have over 30% of its workers involved in agriculture. To stimulate investment in agriculture and to encourage improvements in the sector, all agricultural tax will be eliminated within five years.

Problems in China's Tax System Requiring Future Reform

Even as the third-generation of tax reforms begins to be implemented, it is possible to identify three most important problems requiring future reform efforts. As is often the case in other nations, these needed reforms are in large part shaped by the actions taken in past tax reforms, especially the last major reform that passed into law in 1993 and implemented in 1994.

The Reform of the Production-Type VAT

The first of three needed reforms is to re-engineer China's Value-Added-Tax (VAT). This change is motivated by a desire to increase economic growth and generate more revenue in the long run. This is an important element of the current reform effort. However, the reform of the production-type VAT is viewed as such a reform challenge that it is also included as a problem that will require future reform.

The Reform of the Individual Income Tax

The tax on personal income began in 1980. In 1993 the duplicative and overlapping tax regulations governing individual income taxation of different kinds of income was changed. The income tax rate for personal services is now 20%, with the first 800 RMB of each month free of tax. The provision means that less than 1% of Chinese citizens are required to pay individual income tax. The issues that call for reform primarily concern the large amounts of unreported income that the most wealthy individuals earn that go untaxed. Wages and salaries are taxed at the source requiring no individual tax returns to be filed, and the typical high-income taxpayer feels that this is both the beginning and the end of his or her individual income taxpaying responsibilities. This problem is expected to grow increasingly more significant over time, with no apparent solution in sight.

Reform of the Local Government Relationship with the Central Government

Tran-Nam (2002) explains that the State Administration of Taxation (SAT) is a minister-level department directly under the State Council. At the provincial level or lower, tax administration is divided into the office of the SAT and the local tax bureau. The local tax bureaus at the provincial level are under the dual leadership of the Finance Department of the People's Governments and the SAT. Tran-Nam opines that SAT command influence is predominant. Thus, local government (provincial and municipal) are subservient to the central government for purposes of tax administration.

The revenue situation of local governments deteriorated. In China, these local governments are the provincial and municipal governments, and not just the municipal governments. The revenues of local governments declined by about one-third from 1993 to 1994 as a direct result of tax reforms. At the same time revenues to the central government significantly increased. Local governments are desperate for increased revenues. At the same time local governments are seeking to encourage new investment in their locality. New business is offered special concessions to locate in a province. Some inducements become illegal, sometimes causing the local governments to seek new instruments of persuasion that are not illegal.

Problems in the United States Tax System Requiring Reform

Problems in the tax system of the United States primarily involve the income tax. However at the local and state level issues concerning taxes on sales transactions and taxes on property are also critical. The specific problems with the United States tax system as a whole are identified as follows. First, the individual income tax is plagued by increasing complexity, and very likely, declining compliance. Second is the decline in corporate income tax revenues with a growth in the use of tax shelters, especially those involving reincorporation overseas by American corporations. Third is the difficulties faced by local and state governments as they cope with meeting their responsibilities as technological change and economic change impact their revenue needs and their tax bases.

Problems with Complexity in the United States Individual Income Tax

The United States gets a majority of its total tax revenues from the individual income tax. Thus any problems here are an authentic cause for concern. The individual income tax system is more than ninety years old. The economic demands of the Second World War caused for the first time the majority of Americans to become individual payers of income tax. The last major effort at tax reform in this area was in 1986, and the stated goal at that time was simplification. In fact, the legislation clearly failed on that score, although it did succeed in lowering tax rates while increasing what is included in the base of taxable income. The legislation effectively ended the run of most tax shelters, but did so only be adding layers of complexity, such as the notion of "passive income." A growing problem exists with the alternative minimum tax (AMT), which many Americans now pay, although it was never designed to hit the middle class, (Johnston 2002). In 2004 President Bush stated he would lead a bi-partisan effort to overhaul the personal income tax. The effort failed before it could really get started. Andrews (2004) reported that among Republicans, a new consumption tax was viewed as a possible substitute for the individual income tax.

Problems with the United States Income Tax on Corporations

Unusual compared to most national corporate income tax schemes, the United States attempts to tax its corporations on their worldwide income, not just their income earned within the territory of the United States. Taxes paid by United States corporations to foreign governments on income overseas can entitle a United States corporation to a credit for taxes paid, or alternatively a deductible expense. Unlike China, an overseas tax loss can lower their overall tax base when overseas losses are combined with domestic activity.

Certain expert tax advisers now turn the massive complexity of the tax law against the government by essentially looking for drafting errors in the corporate income tax law and using these to eliminate the tax liabilities of many corporations. Many of these exotic planning maneuvers involve the reincorporation of domestic corporations overseas in so-called, "tax haven" countries. While to many the efforts of the Internal Revenue Service and the United States seem strangely under-motivated considering the size of the problem, it may in fact be that a more radical reform is needed rather than some standard tax reform legislation or beefed-up enforcement procedures. Some have called for the ending of the corporate income tax altogether (Shavario 2004). Replacement options include making corporations a pass-through entity similar to partnerships. Another reform alternative would be to replace the corporate income tax with a national consumption tax of some type.

Furman et al. (2007) call for a strengthening of taxation at the business level. They claim “the business tax system is broken.” They continue that, “the business tax code is enormously complex and unnecessarily inefficient, and often it does not raise the revenue it was meant to raise.” They note the widening gap between book income that corporations report to their shareholders and the tax income reported to the Internal Revenue Service. They offer the opinion that this is due to increased sheltering activity. Presumably the availability of these shelters should be reconsidered.

Problems with State and Local Taxation in the United States

State and local governments seem to find the demand for increases in services outstripping the growth in tax revenues. Especially of concern is that technology in the form of the internet threatens the tax base of the sales tax. The economic future of this tax is problematic, especially if the federal government makes internet transactions exempt. The income taxes of those many states that have them are tied into the national income tax system, in that the starting point for the determination of the state tax base is often derived from some element of the national system, meaning any problem with the national tax system can potentially impact the states. Many state and local governments tax land and buildings, including individual residences for the support of primary and secondary education. The lack of other available tax bases means a heavy reliance on property taxes, which can easily develop voter resistance.

What China Might Learn from the United States

The Value-Added Tax in China

In 1993–1994 China endured the pain that all countries experience when they adopt a new tax scheme such as the VAT. From the United States difficulties with the corporation income tax, one might say that China should learn that the pain was worth it, in that it can avoid some of the problems the United States experiences from an over-reliance on the corporation income tax. Further, one could go one to say China should avoid in the future a high rate corporate income tax.

The Individual Income Tax in China

China might take from the United States experience with the individual tax that such a tax should be comprehensive, taxing all individual earnings. Businesses and units of the State should be required to document all payments to individuals to the SAT and the individuals involved in order to increase compliance. Another lesson, might be that the lower the tax rate, the less economic distortion, and the greater the amount of voluntary taxpayer compliance.

Problems Between the Local and Central Governments

Local governments should be allowed to make their own taxes and assess and collect these taxes without interference from the central government. It is possible for the central government and a local government to both simultaneously tax the same tax base. Finally, excessive tax holidays given to attract new business to the locality can impact total revenues in an unhealthy way.

What the United States Might Learn from China

The United States Corporate Income Tax

The United States might do well to emulate China by implementing a consumption tax, such as a Consumption-type VAT. Further, it might want to re-think the notion of taxing United States corporations on their worldwide income, given the success of United States taxpayer corporations in using offshore schemes to minimize, or even eliminate all corporate income tax liability.

The United States Individual Income Tax

The United States might redesign its system so that fewer taxpayers actually have to file tax returns. Complexities such as the Alternative Minimum Tax should be discarded. A lower tax rate might be possible with a national consumption tax, and a lower tax rate could minimize many problems, including declining compliance. China's individual income tax has a special low rate of 20% for such items as interest, dividends, and royalties (Loong 2004). Such a low rate on dividends and interest in the United States would encourage more individuals to invest. However, as of April, 2007 there was public speculation in the Chinese business press (Wu) that China may choose to simplify the individual tax system with all income taxed at the same rate. The policy goal would be to eliminate the opportunity for high-income earners to successfully maneuver to have some of their income taxed at a low rate. The thought is that such a tax change might be made effective by 2010.

The United States State and Local Tax Situation

Sharing of revenue on a fixed proportion basis, as does China with its VAT could be helpful to U.S. states starved for revenue while bombarded with national unfunded mandates. The state and local governments would certainly find envious that Chinese local governments get all individual income tax revenues with no sharing with the national government.

Conclusion

China and the United States have closely linked economies. As China becomes a more mature modern economy its economic and tax policy problems increasingly become similar with the tax policy problems experienced by the United States. China and the United States have frequently made different tax policy choices. It seems that increasingly both China and the Unites States might be able to learn from the tax policy choices made by the other.

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The Croatian Tax System: From Consumption-Based to Income-Based

Helena Blažić

Introduction

Consumption (instead of income) as a superior tax base rather than personal direct taxation has been advocated for a long time.[1] Proposals for a consumption concept were renewed at the end of the last century, in relation to developed economies[2] as well as the transitional economies.[3]

The consumption-based proposals related to income tax should not be confused with proposals for introducing value added tax (VAT) or any other proposals concerning indirect taxes. Consumption-based proposals in the original version ("standard model") claim that individual yearly consumption (and not income) should be the appropriate tax base. This model is referred to in the literature as "personal expenditure tax" or simply "consumption tax." Since the tax base could be practically established by the deduction of savings from income, this model is also called "saving-adjusted income tax" (Rose 1990).

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[1] Some of its most famous advocates were Hobbes, Smith, Mill, Weber, Marshall, Einaudi, Pigou, Schumpeter, Fisher and Kaldor, who first implemented it, only as a supplementary tax in India (1958–1962) and twice in Sri Lanka (1958–1962, 1976–1978). Unfortunately, these attempts were not successful.

[2] Some of the most famous contributions were made by Meade, Bradford, Lodin, Aaron and Galper, Kay and King, Hall and Rabushka, McLure and Zodrow, Boadway, Bruce and Mintz, IFS Capital Taxes Group, Rose and Wenger...(see for instance IFS 1978; Pechman, Ed. 1980; Bradford 1982; Bradford and the U.S. Treasury Tax Policy Staff 1984; Hall and Rabushka 1985; Rose, Ed. 1990; Kaiser 1992; Wiswesser 1999; Keen and King 2002...) including for instance the proposed consumption-based reform alternatives for the USA in the nineties—Nunn-Domenici USA Tax and Flat Tax (for instance Christian 1995; Boyer, Russell 1995; Toder 1995; Holz-Eakin 1996; Feld 1995) and some of first simulations (for instance Aaron, Gale, 1996; Ventura 1999).

[3] For instance McLure 1991; Rose, Wenger 1992.

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Since over a lifetime (under certain assumptions) lifetime consumption equals lifetime labor income, an "alternative model" has been established that reduces consumption-based individual income tax to a "wage tax." Because capital income is excluded from the tax base, this model is also called "interest-adjusted income tax" (Rose 1990) as well as "prepayment tax" (because the tax is paid "in advance" in comparison with the "standard model").[4]

Relevant complementary business taxes[5] take many forms. The "standard model" versions are different sorts of "cash flow taxes"[6] with the immediate write-off of investments (immediate expensing). The "alternative model" recognizes the fact that the abovementioned equivalence of consumption and labor income assumes "normal" or "average" interest rates. Any rate above that should be taxed. So, nontaxation of interest is here restricted to "normal" interest on equity capital called "allowance for corporate equity."[7]

Of course, there are a lot of variants of the basic models as well as combinations of them.[8] Croatia was the first country to introduce consumption-based taxation ("interest-adjusted income tax" and "interest-adjusted profit tax") as a part of its tax reform toward a market economy. The model was later abandoned, but a lot of its (consumption-based) elements have remained.

This paper analyzes the former consumption-based model, and also the subsequent "income-based" model. Unlike the former, the latter is not at all unique, and considerably resembles the current situation in other transition countries. Thus the consumption-based elements of the later model are assessed using comparative analysis with other transition countries (EU

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[4] The famous Hall and Rabushka Flat Tax is mostly that type of tax.

[5] The earlier proposals refer to corporate income tax only (for instance IFS 1978). Some later proposals advocate a uniform tax for the all business entities, including the corporate as well as the noncorporate sector [for instance the Nunn-Domenici USA tax as well as the Flat tax proposal for the USA (for instance Christian, 1995; Boyer, Russell 1995; Toder 1995; Holz-Eakin 1996; Feld 1995)].

[6] R-basis, R+F-basis, but also S-basis (IFS 1978), R+A basis (Boadway et al. 1983), dividend tax (Kaiser 1992).

[7] It is known as the "ACE" tax (Allowance for Corporate Equity) or "equity allowance" (IFS Capital Taxes Group 1991; acc. to Wiswesser 1999 and Keen and King 2002). The first proposal for this sort of tax was from Boadway and Bruce (1982) and Wenger (1983, 1985) (acc. to Wiswesser 1999 and Kaiser 1992). Rose and Wenger (1992) proposed it for Croatia (as well as some other transition countries).

[8] Resulting even in «hybrid» models of direct tax on consumption (for instance see Bradford 1984; Kaiser 1992; Zodrow 2004). Still, the term "hybrid" in this paper is used mostly to denote hybridism between income-based and consumption-based tax models.

members as well as South-Eastern European countries).[9] In the end, future changes in the Croatian tax system from the consumption-based/income based perspectives are presented.

First Implementation of a Consumption-Based Tax System

Croatia was the first country in the world to fully accept the consumption concept in the field of direct taxes (income tax[10] and profit tax[11]) in the alternative form—the “interest-adjusted income tax” and “interest-adjusted profit tax.”

Nevertheless, it is interesting to point out that Croatia is no longer the sole example of consumption-based taxation. In 2004 the small Brčko District in the neighboring transition country strongly affected by the war—Bosnia and Herzegovina—accepted a very similar consumption-based system under the influence of the same proponent.[12]

Advocates of consumption as the appropriate tax base claim that income as a tax base discriminates against saving, which is taxed twice—first as being part of the income that is taxed by income tax and second as capital income that is part of the comprehensive income of the next period.[13] Saving and investment escape this double taxation in consumption-based income and profit taxes, where the METR (marginal effective tax rate) is zero. In Croatia this was achieved[14] in the simplest possible way—by not taxing capital income (interest income in the broader sense) at the individual level at all and

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[9] Since the relevant comparable data were obtainable for Russia too, it is also included in the analysis, although it does not belong either to the first or to the second group of transition countries.

[10] Since the term «income tax» is not used in Croatia in relation to corporations/companies and their taxation (see next footnote), the term «income tax» is equal to “individual/personal income tax” and covers all individuals (including self-employed, even if they are some sort of partnership).

[11] The term “corporate income tax” would not be completely appropriate. The payers of the profit tax are corporations, but also some part of the noncorporate sector (partnerships with “trader status” and even sole traders: the self-employed can opt to pay profit tax). In this way the typical distortion of the classical income tax concept—between the corporate and the noncorporate sector—was avoided, as the consumption tax concept requires, and this remains even now. On the other hand, it could be argued that it is simply replaced by the distortion between business units (enterprises) that pay profit tax and business units that pay income tax (see previous note). In order to mitigate the problem, the Croatian legislation has given the self-employed the option of paying profit tax instead of income tax (still relevant).

[12] Prof. Manfred Rose from Heidelberg University.

[13] In addition, capital income from the corporate sector (dividends and partly capital gains) is taxed once again because of the corporate income tax.

[14] The middle part of this section is based mostly on Blažić (1998).

taxing only profits above the "normal" rate of return at the enterprise[15] level, which is technically made by subtracting the so-called "protective interest" ("equity allowance")[16] from the profit. So, saving and investment neutrality was followed by financial neutrality, because of interest (in the narrower sense[17]), dividends and capital gains being treated in the same way.

The term "protective interest" implies that it protects the normal return on equity from taxation. It can also be said that it taxes only true "economic profit" and not the whole of accounting profit, leaving the "minimum existence for capital" (acc. to Rose 1998) exempt. Since there was no well-developed government bond market in Croatia, which according to the theoretical models (for instance IFS 1978; Kaiser 1992) should determine the rate of such an allowance, this protective interest was first determined by the central bank's prime rate and later statutorily stated (first it was 3% and later 5%). Figure 1 shows the effects of this allowance on equity on the effective tax rate (statutory nominal tax rate being at the end of the implementation of that model 35% and protective interest 5%).

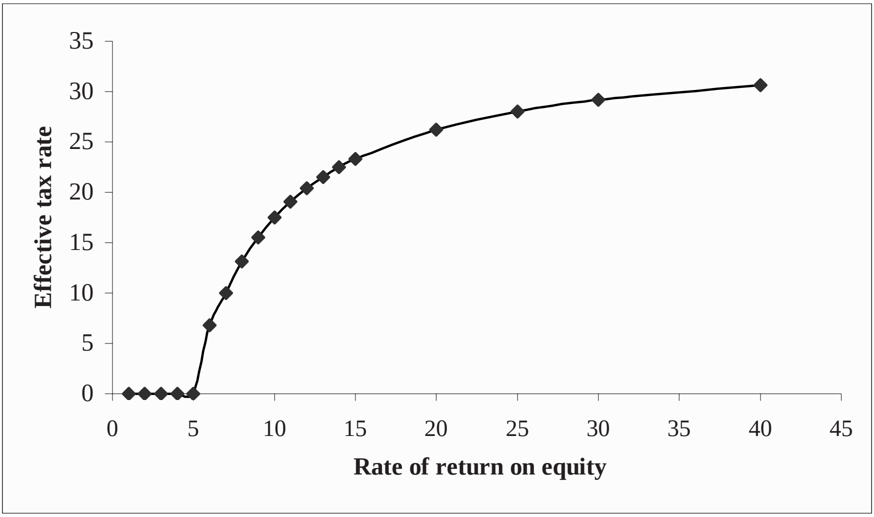

Fig. 1 Tax burden on the real rate of return of business investment in Croatia

[15]The term "enterprise" comprises here both profit taxpayers and self-employed income taxpayers, because the later had the right to deduct "equity allowance" too.
[16]It was calculated by applying "normal" a interest rate (3% and later 5%) defined by the tax law and corrected for the inflation rate to the invested enterprise equity (at the beginning of the year).
[17] Payments connected with debt capital.

It is obvious that the exemption of the 5% rate of return from tax is conductive to some sort of progressiveness in the Croatian “profit tax.” Higher profits (above 5% on equity) lead not only to a higher tax, but also to a higher tax rate. Since this progression is due only to the indirect progression (5% equity allowance) it logically follows that it slightly diminishes (changes to proportionality) for higher rates of return. Likewise, it is sharper for “lower” rates of return (just a little bit above 5%).

One of the principal disadvantages of the “prepayment” concept in comparison with the “standard” consumption concept as well as comprehensive income tax—the ex ante instead of the ex post approach (for instance Graetz 1980) was avoided at the enterprise level, because the capital income (profit) did not escape taxation altogether (Fig. 1). But it still remained at the individual level, having caused horizontal as well as vertical equity problems too.[18] These were especially connected with the substantial capital gains (typical off the transitional economies), as well as with the high interest rates (in the narrower sense[19]) at that time, because of the shortage of capital and the problems in the banking system of Croatia. The imbalance on the Croatian capital market was thus characterized by interest expenses (on debt capital) that were extremely high in comparison with the rate of return on equity capital. This privileged debt capital again, because the attendant interest expenses were deductible in full, which was almost always higher than 5%. The possible limitation of the interest expense deduction to 5% could have formally abolished this discrimination, but effectively would have let to over-taxation, which would additionally have enlarged the interest expense burden of enterprises. On the other hand, interest income (interest received) at the company level is taxable, so the profits that originate from that source (and not from real capital) were not at a disadvantage. The differences between interest received on financial assets and that paid on debts were recognized for tax purposes.

The stated imbalance was even more serious when income tax payers who are self- employed were taken into account. They are allowed to carry out simplified accounting. Their interest income was tax-free and interest expenses were not deductible. They also had the right to deduct protective interest from their “profits” (referred to for the purpose of taxation as “income”), but it was calculated on the value of real long term assets (and not the equity). It is very unrealistic to assume that interest rates charged on debt are equivalent to interest rates from financial investments and this difference was not recognized for tax purposes, as it was in the case of corporations (profit tax). Furthermore, since income from financial investment in Croatia was much higher than the income from real investment, it turns out that the

[18]According to its traditional (ex post) concept. The rethinking of the horizontal equity inside the framework of a “prepayment” consumption model results in its definition not as equality of results, but as equality of opportunities (Kay 1990).

[19] Interest on debt capital.

tax system was giving an additional privilege to subjects that were already market privileged—those who were net creditors and were earning a high proportion of their income from financial investments.

The Croatian consumption-based tax system still had some "mixed system" characteristics regarding personal expenditure tax elements concerning pensions treatment, and comprehensive income tax elements concerning real estate (except owner-occupied housing), because of the inclusion of rental income as well as real estate capital gains (only short term gains, and not applied to owner occupied housing) in the tax base.[20] The latter horizontal inequity did not present any immediate distortion in the sense of inefficiency, taking into consideration elasticity considerations. On the other hand, the lack of financial capital in comparison with the relatively high existing stock of real estate capital in Croatia, puts forward the separate incentive elements of tax policy.

At the enterprise level, protective interest applied constantly to the entirety of equity capital and not only to new investment, giving a windfall gain to owners of old capital. This also meant higher tax expenditure (tax revenue loss) for the government in comparison with tax incentives for new investments only. This was one of the reasons for the rejection of protective interest, although a solution could have been sought in a departure from consumption-based taxation, nevertheless retaining "protective interest" elements. The later examples of Italy and Austria confirmed this. Here protective interest was calculated only on an increase of capital and this part of the profit was not tax-exempt, but taxed at a lower tax rate. Thus, the incentive element was preserved, but tax expenditure mitigated.

Nevertheless, there was also pressure for more "cash flow" type allowances, which bring immediate and more considerable tax relief (up-front allowances), directly favoring new investments only. This was reflected in the accelerated depreciation allowance[21] (introduced in 1997), which together with the equity allowance and the relatively low tax rate[22] offered a remarkable tax incentive for investment. It would be seen later that the future development of the tax system (after the abolition of the interest—adjusted profit tax) moved in that direction.

In spite of some uncertainties about the efficiency effects of the consumption-based models, the international aspects, which are of enormous

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[20]Such a treatment of real estate is the result of the Croatian tax code having departed from the proposed reform draft of the Heidelberg KNS Group (Konsumorientierte Neuordnung des Steuersystems), in which the equity allowance concerning invested real estate capital was planned.

[21] Official straight line rates were allowed to be doubled (depreciation period halved).

[22]At the beginning of the reform the rate was only 25%, followed by the 3% equity allowance. In order to avoid distortions, because of the highest personal income tax bracket rate being 35%, the profit rate was raised to the same level, followed by the increase of equity allowance at 5% in order to offset the rise in the nominal profit tax rate.

importance for a small open economy like the Croatian, are perhaps the main argument in favor of the chosen prepayment model. This is not only (given the current distribution of taxing rights) because corporate profits are taxed principally at source and the following influence of investment into a country, but also because of the attendant household saving trends.

Although it is taxed formally according to the residence principle, the rising international capital mobility and relevant tax avoidance as well as the reduction and even abolition of withholding taxes, suggest the increasing importance of the source principle. For Croatia it meant not only the tax attraction of cross-border savings, but principally an element that prevented an outflow of domestic savings. Although it can not be said that a tax system (domestic and even foreign) reliably influences the level of savings, it affects their allocation, not only between different forms of savings, but also between different countries, especially where a small, open economy is involved. Double taxation treaties are often adduced as one of the greatest obstacles for the unilateral implementation of consumption-based income taxation. Nevertheless, “interest-adjusted” income and profit tax, unlike “saving-adjusted” systems, fit perfectly into the existing double principles and methods for avoiding international double taxation (Lončarević 2004).

Even the advocates of a consumption-based tax system suggest it should be accompanied by the appropriate wealth tax, due to its distributional consequences, which are especially profound under the “interest-adjusted” type. Neither the “European” type net-wealth tax nor the “American” type property tax was present, either at the time of the consumption-based tax in Croatia or now.

2001—Toward an Income-Based System

In 2001 the existing system was replaced by a “mostly” income-based system. The “protective interest” (equity allowance) at the business level was abolished and dividends and interest were introduced in the base of the income tax. Still, the new system retained some consumption-based elements, so it is some hybrid form between income-based and consumption-based tax.

This section presents a comparative analysis of the consumption tax elements at the individual and the business level.

Elements of Consumption-Based Taxation at the Individual Level: Tax Treatment of Saving and Capital Incomes

The current income tax is far from the ideal Schanz-Haig-Simmons comprehensive income tax. Not surprisingly, because this ideal is not completely followed even in developed countries (including USA), let alone in other transitional countries. Here we do not think of the practical problems in implementing this ideal tax base fully,[23] but of the deliberate departures from the model, a lot of them in the consumption-based direction, especially those that are "interest-adjusted."

The new Croatian income tax still excludes most capital income. The interest from savings deposits, as well as securities and capital gains from securities is tax exempt. This element of "interest-adjusted income tax" (the residual of the previous tax system in Croatia) could be found in income tax systems of other transition countries too (Table 1). But they are more inclined to exclude only bank savings or government securities. However, five transition countries do not exempt interest at all. Also, the treatment of capital gains, although more preferential than in developed countries, is still only in some countries as general as in Croatia. It could be concluded that the "consumption-based inheritance" makes the tax treatment of capital income in Croatia in general more favorable than in most transition countries.

Table 1 Tax Exempt Interest and Capital Gains in Transition Countries in 2004[a]

Income / Country	Interest	Capital gains
Albania	Treasury bonds and other government securities	All (except sale of shares)
Bulgaria	Savings accounts with banks and state or state-guaranteed loans	Quoted shares sold through the Bulgarian Stock Exchange, movable property (>1 year)
Bosnia and Herzegovina[b]	Savings and current account and loans to the government—unless the sum of all incomes does not exceed a certain yearly limit (all interest in Central Bosnian canton without possible additional taxation)	All in the Central Bosnian canton (seems to be mostly taxed in other cantons)
CROATIA	**Savings and current accounts with bank and other saving institutions and credit unions, securities**	**All, but immovable property other than own dwellings and property rights (>3 years)**
Czech Republic	Eurobonds issued by resident companies, mortgage bonds	–
Estonia	Receipts from credit institutions resident in any EU Member State or from Estonian branches of credit institutions resident outside the European Union	Exchange of shares in the course reorganizations, own dwelling, restitution and privatization, summer cottage or garden house (>2 years)
Hungary	Generally all[c]	Certain securities[c]

[23] For instance unrealized capital gains, imputed income, barter arrangements, income in-kind, nonmarket income in general.

Latvia	Deposits and investments with credit institutions or credit unions registered in Latvia, mortgage bonds, government or local authority bonds	All, immovable property (>1 year)
Lithuania	Government (and municipal) securities, government regulated savings programs, banks (and other credits institutions') deposits, some loans and securities[d]	Immovable property and registered movable property (>3 years), shares acquired before 1999[e], other (<24 times basic personal allowance)
Macedonia	–	Immovable property (>3 years) and if gain is used to purchase own dwelling
Poland	–[f]	Immovable property if gain is used within 2 years to provide another
Romania	– (but tax rate only 1%)	All (except shares in joint-stock companies and limited liability companies and futures contracts in foreign currency)
Russia	State or municipal securities, most bank deposits[g]	Immovable property (>5 years), movable property (>3 years)
Serbia and Montenegro	–	Gains reinvested in the dwelling of the taxpayer
Slovak Republic	–	Taxpayer's primary home (>2 years), other immovable property (>5 years), movable property, unless it was used for business purposes
Slovenia	Bank deposits	All (but >3 years or exempt also from capital transfer tax for immovable property[h])

[a]Saving type insurance schemes (pension insurance, life insurance) not covered here; years in parentheses denote minimum holding period in order to be tax exempt

[b]Data relate to the major part of Bosnia and Herzegovina: the Federation of Bosnia and Herzegovina. Unlike other two parts (Serbian Republic and Brčko District) it does not have comprehensive (synthetic) income tax, but still a schedular system of income taxation, inherited from the former Yugoslavia. The situation is further complicated by only wages (and other employment income) being taxed at the national level and all other incomes at the cantonal and municipal level, with huge differences among them. In addition, if the entire income is above a certain yearly limit, it is taxed again with the synthetic (comprehensive) income tax, which again is different depending on the canton. In effect, due to the weakness of the tax administration most capital incomes escape taxation (Džafić 2004). In 2005 a major reform is planned, to start with the introduction of VAT and classical (comprehensive, synthetic) income tax

[c]Interest income is defined as interest from savings deposits, interest and gains on publicly issued and traded securities representing debt claims, interest and gains on discount treasury bonds, interest on publicly issued and traded investment fund shares and interest and capital gains on closely held securities and loans granted by individuals to companies or other businesses *if* the return, i.e. interest and capital gains, does not exceed 105% of the prime rate

of the National Bank of Hungary and if the maximum return does not exceed HUF10,000. In addition, the term "interest" includes capital gains derived from capital transactions on the Hungarian stock exchange

[d]Interest on loans if the repayment of the loan commences not earlier than 366 days after its issuance (except shareholder loans or employee loans with interest rates above the market level); and interest on securities if their redemption commences not earlier than 366 days after their issuance (except securities issued by the recipient's employer bearing an interest rate higher than that on similar securities held by others)

[e]Gains on other shares sold not earlier than 366 days after their acquisition are exempt if the taxpayer has not owned more than 10% of the capital of the entity at any time during the 3-year period preceding the end of the tax year during which the disposal takes place

[f]Abolished in 2002, still in force for fixed time bank savings deposits, government (including local) bonds and for participation in investment funds made/purchased before 2001

[g]Unless they exceed the central bank interest rate for domestic currency deposits and 9% per year for foreign currency deposits

[h]For instance first sale of property acquired in the course of privatization

Source: Author's own synthesis from: IBFD: European Tax Handbook, 2004, http://www.nn.hr: Croatian Income Tax Act; Džafić: Oporezivanje dohotka fizičkih lica u (F)BiH, 2004

Still, the analysis is incomplete without the inclusion of the tax treatment of taxed interest and capital gains, as well as other capital income. One of the recent development inside the income tax systems of developed countries—the dual income tax (progressive rates on labor income and flat rate on capital income), could be regarded as a departure from income-based taxation in the direction of consumption-based taxation (its "alternative model"—"interest-adjusted income tax"). This tax is usually associated with Scandinavian countries,[24] but the elements of it—a flat tax on some capital incomes (not necessary all) could be found in a lot of developed countries (for instance Austria, Italy, the Netherlands, France, United States). Needless to say that this trend is especially pronounced in the transition countries.[25] There is almost no transition country without at least some capital income being taxed at the flat rate, mostly realized by the way of final withholding tax. Croatia is no exception. Rental income should be mentioned, because of its

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[24] Although even there his "pure" form was partially abandoned.

[25] Some of them have even entirely moved to the flat tax (or taxes). The most known is the Slovakian case (19%), although here also Estonia (26% with continuous reduction to 20% in 2007) and Latvia (25%), as well as Lithuania (33% general rate, 15% for most capital incomes and some special incomes), Russia (3 flat rates: 13% general rate, 6% dividend rate and 35% for some special incomes) and Serbia (10%, 20% for capital gains) should be mentioned. Still, it should be mentioned, that the use of the term "flat rate" could be misleading, taking into account right "consumption-based" taxation literature. Slovakian tax (as well as "flat" taxes of other countries) should not be regarded as a Hall-Rabushka Flat Tax, which is an "interest-adjusted income tax" with cash flow taxation of business income (Hall, Rabushka 1985). The Estonian tax represents a unique form of taxation, which will be addressed in the next part. Still, in some way, this tax as well as the Latvian tax, is closer to a consumption-based tax than the Slovakian tax.

most favorable rate of 15%[26] (for Croatian progressive tax rates and their comparison with the other transition countries see Table 2).

Table 2 Tax Rates on Earned Income in Transition Countries in 2004

Country	Rates (%)
Albania	0, 5, 10, 15, 18, 20, 23, 25
Bulgaria	0, 12, 22, 26, 29
Bosnia and Herzegovina	5 (10–40)[a]
CROATIA	**15, 25, 35, 45**
Czech Republic	15, 20, 25, 32
Estonia	26[b]
Hungary	18, 26, 38
Latvia	25
Lithuania	33[c]
Macedonia	15, 18
Poland	19, 30, 40
Romania	18, 23, 28, 34, 40
Russia	13
Serbia and Montenegro:	
Serbia	10
Montenegro	17, 21, 25
Slovak Republic	19
Slovenia	17, 35, 37, 40, 45, 50

[a]If all other incomes exceed certain yearly limits rates between 10 and 40% apply depending on the canton (see also note 2 in Table 1)
[b]24% in 2005, 22% in 2006 and 20% as of 2007
[c]The rate of 15% applies to income from sports, entertainment and arts, income from independent activities, except for those carried on under a business certificate and certain types of pension income
Source: Author's own synthesis from: IBFD: European Tax Handbook, 2004; http://www.fbihvlada.gov.ba; Džafić: Oporezivanje dohotka fizičkih lica u (F)BiH, 2004, http://www.nn.hr: Croatian Income Tax Act

The elements of consumption-based tax in the Croatian income tax are not only of the "interest-adjusted" type, but also of the "savings-adjusted" type ("standard model"). As expected from the practice of developed as well as other transition countries, this could be seen in the case of compulsory pension insurance (compulsory social security contributions tax exempt, accrued interest exempt and taxation delayed until the amount of pensions is paid—EET model). An additional tax privilege in transition countries stems from the exemption of pensions from taxation in a lot of countries. In Croatia,

[26] Still, although very favorable for higher incomes, it is not favorable for the lowest incomes (under the exemption threshold). It is not possible for the time being to include rental income into the individual tax return. So, the withholding tax paid can not be refunded, if the income is below the personal exemption. On the other hand, capital gains are taxed at a higher rate (35%), but still under the highest marginal rate (45%), which is also considered as final (no inclusion in tax return).

as in some developed countries, a higher personal exemption (not for elderly people but for “retired ones”) is used, which amounts are double the personal exemption/allowance. As a result, most retired people do not pay income tax.

The common model for the non-compulsory (voluntary) pension schemes, as well as most of the life insurance schemes, is also the already mentioned “saving-adjusted” consumption-based model. It is also possible in Croatia (not obligatory) to use the tax allowance for paid premiums (up to the yearly limit). Here, Croatia offers an additional advantage by exempting the resulting “interest”—“profit shares” from tax and taxing the remaining “principal” (value of premiums paid for which the tax allowance was used) at a flat rate of 15% only. There is no later tax for premiums for which no tax allowance was used—“the interest-adjusted model,” which was present also and exclusively under the old regime (before 2001).

Tax Treatment of Dividends (“Corporate Tax Systems”)

The analysis of the tax treatment of dividends cannot be performed without taking into account the corporate income tax (profit tax). The exemption or flat rate for dividends does not (automatically) mean the departure from income tax in the direction of (an “interest-adjusted”) consumption-based tax.[27] An exemption or flat rate are, in contrast, justified by the income concept itself, namely by mitigation (reduction) or even elimination (avoidance) of double taxation of dividends/distributed profits (first at the corporate level and then at the shareholder level).[28]

Most developed countries have tried to mitigate/eliminate the stated economic double taxation by abandoning the so-called classical system (double dividend taxation) in favor of various integration systems.[29] These could be divided into double taxation reducing/avoiding systems at corporate and at shareholder level. The former systems, which were realized through dividend deduction or split rate systems have been abolished.[30,31] The systems

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[27] In cases of dual income tax (not accompanied by the imputation method) the assessment is complicated. Namely, by serving the purpose of a dual tax, the lower rate serves also for the purpose of the mitigation of double dividend taxation. In effect, dividends should be granted additional preferential treatment in order to fulfill both goals simultaneously.

[28] The most appropriate integration method—the only one that completely follows the S-H-S logic is the full imputation method (corporate income tax treated as advanced payment of personal income tax (withholding tax) and shareholders taxed at their individual marginal tax rates).

[29] Ireland is an interesting exception. It left the imputation system in 1999 and turned to the classical system.

[30] Iceland and Germany were the last countries that employed these systems. Iceland abandoned its dividend deduction system in 1999 and Germany its split rate system in 2001.

at shareholder level could be grouped as imputation systems (partial or full) and schedular systems (Cnossen 1993).[32] Although the former system, as the "purest one" according to the S-H-S principle, was advocated for the EU as the whole, this was never realized. Such an outcome would, also, be very unfavorable for the new transition economies that recently became EU members, due to the complexity of the system. In the meantime, the trend shifted in favor of schedular systems (even the US moved in this direction). Not surprisingly, these systems are used in the transition countries. It could even be said that the developed countries followed this trend, first strongly implemented by most transition countries (mostly concerning the separate—flat rate).

For if we take a closer look, schedular systems could be divided into three techniques:

- Tax credit: only in developed countries, but mostly abandoned;
- Exemption (partial or full—equivalent to zero rate): in both groups of countries, but full exemption especially in transition countries;
- Separate [linear, flat, preferential) rate(s)]: in both groups of countries,[33] but especially typical of transition countries—the rate is lower than the highest marginal rate, usually at the level of the lowest rate, dividends are taxed usually by the way of final withholding tax, but mostly with the option for the lowest incomes (not taxed or taxed at a rate lower that the stated dividend tax rate) to get refunds of paid tax.

The current situation in transition countries is presented in Table 3.

As can be seen from Table 2 and Table 3, most transition countries apply separate tax rates (final withholding tax), which can be characterized as preferential. That is, in all countries, the rate is considerably below the highest marginal tax rate (or the only one—a flat rate in the case of Russia and Lithuania). In Croatia, as well in the Czech Republic and Poland, the rate corresponds to the lowest personal income tax rate. Only in Albania, Bulgaria and Hungary is the rate a little bit above the lowest marginal tax rate (without the zero-rate bracket, of course). Only 70% of the Hungarian dividends are taxed at a relatively high rate (just a little bit below the highest marginal tax rate).

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[31] It is interesting to note that some authors include the specific Estonian system of corporate taxation in that category—namely under "split rate" (Jacobs et al. 2003). In our opinion this is wrong, because "split rate" in the context of economic double taxation and its mitigation means in effect a normal (higher) rate on retained profits and a preferential (lower) rate on distributed profits (in order to mitigate economic double taxation of dividends). In Estonia we have the opposite situation (zero rate on retained profits and taxation only of distributed profits), which corresponds more to consumption-based taxes at the corporate level.

[32] They could also be denoted as "shareholder relief" (Jacobs et al. 2003) when they reduce double taxation (full exemption of dividends results in the avoidance of double taxation).

[33] Even a rising trend in developed countries.

Table 3 Schedular Systems for Dividends in Transition Countries in 2004[a]

Separate tax rate	Exemption
Albania (**10%**)	Estonia (**100%**)[b]
Bulgaria (**15%**)	Latvia (**100%**)
Bosnia and Herzegovina (**min. 10–20%, possible additional 10–20%)**[c]	Macedonia (**50%**)
CROATIA (**15%**)	Serbia and Montenegro: Serbia (**50%**)
Czech Republic (**15%**)	Slovak Republic (**100%)**
Hungary (**20%** on 30% of the dividends, **35%** on the remaining 70%)	Slovenia (**40%**)
Lithuania (**15%**)	
Poland (**19%)**	
Romania (**10%**)	
Russia (**6%**)	
Serbia and Montenegro: Montenegro (**15%**)	

[a]Domestic-source dividends paid to resident shareholders
[b]Dividends are fully exempt at a shareholder level, but there is an income tax at corporate level. That means that retained profits are completely tax exempt and that only distributed profits are taxed at the corporate level. The «distribution tax» is levied at a rate of 26/74 (~35.14%) of the net amount of the profit distribution (26% on the gross amount (distribution + distribution tax) of the distribution
[c]The exact amount of dividend tax depends on the municipalities (only minimum rates stated); additional tax if all incomes exceed the yearly ceiling (see also note 2 in Table 1 and Table 2 with the note 1)
Source: Author's own synthesis from: IBFD: European Tax Handbook, 2004, Džafić: Oporezivanje dohotka fizičkih lica u (F)BiH, 2004; http://www.nn.hr: Croatian Income Tax Act

It could be concluded that the system chosen in Croatia is in accordance with the prevailing situation in transition countries, but also with the newest trends in developed countries. As already said, its biggest advantage (besides the expected efficiency effects) is its simplicity. Since the rate is the same for all income levels, vertical equity is completely neglected here with a regressive effect.[34]

[34] The degree of mitigation of double taxation (called also «dividend relief») for the given level of income (marginal tax rate) is calculated according to the following standardized formula (OECD 1991, Cnossen 1993):

$$\text{Degree of mitigation (degree of dividend relief)} = \frac{Td_k - Td_r}{Td_k - m}$$

where the following notations are used:

- Td_k – Tax under no mitigation – Total corporate (profit) and personal income tax per unit of distributed profit where there is no mitigation = classical system
- Td_r –Total tax burden – Actual combined (total) corporate and personal income tax burden per unit of distributed profit of the system where the degree of mitigation (dividend relief) is measured (here: the total tax burden in the Croatian system).

Still, the preferential treatment sometimes may lead to "under taxation" in comparison with the business income of individuals (self-employed). For successful entrepreneurs, the highest marginal tax rate [or, in the case of a flat rate, the (only one) tax rate] could be above the combined corporate and personal income tax rate [or only the first one, in a case of a full (100%) exemption].

This situation could be found in Poland and Romania, where the highest marginal income tax rate amounts to 40% and the combined corporate and highest personal marginal rate amount to 34.39% and 32.50%.[35] A similar situation obtains in some "flat tax" countries—Latvia and Lithuania, although the former operates a full exemption and the latter separate rate on dividends. The corporate income tax rate in Latvia is lower than the flat rate of individual income tax. The combined burden of both taxes in Lithuania is 27.75% (the personal income tax flat rate being 33%). In the end, this effect is present in Croatia, too. The combined burden of both taxes is 32%, which is not only lower than the highest marginal tax rate of 45% (which occurs rarely, especially in the case of the self-employed), but also than the second highest rate of 35% (which is more frequent).

Profit Tax (Corporate Income Tax) and Elements of Consumption-Based Taxation

As already pointed out, Croatia was the first country to implement the ACE tax (allowance for corporate equity or simply equity allowance, called "protective interest" in Croatia). Its replacement by a lower tax rate (from 35 to 20%) intended to preserve both "revenue neutrality" and the "incentive effect," made capital intensive industries net losers (relative to labor intensive industries).

Still, the critics of the new system (practitioners, but also academics) were not aware of the fact that one consumption-based element was (partially and optionally) replaced by a second: the "alternative type" element by the "standard type" element. The new profit tax enables not only accelerated depreciation, but also immediate write-off (immediate expensing), which is,

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– m – Tax under full mitigation = elimination of economic double taxation of dividend (where full dividend relief exists) – this tax burden corresponds to the marginal tax rate of the personal income tax.

The dividend relief (degree of mitigation of double taxation of dividends) in Croatia is: 0% for first tax bracket – 15%marginal tax rate, 53% for the 25% rate, 123% for the 35% rate and 220% for the 45% rate. For the detailed calculations see: Blažić 2002.

[35] Combined tax rate = Td_r. For separate tax rate (final witholding tax) Td_r = td + (1-td) w, where "w" represents a rate of final withholding tax. In the case of exemption Td_r = td + (1-td-e (1-td))m, where "e" represents the percentage (grade) of exemption (1=full exemption) and "m" represents the highest marginal rate of personal income tax.

as known from the literature, one of the basic characteristics and advantages of the cash flow tax. But, immediate write-off relates only to equipment (and business buildings). This option is suitable for corporations with profits big enough to be able to use the resulting tax saving and not for corporations with losses. Furthermore, a loss carryforward could not be augmented by the protective interest rate, as before, not even by the inflation rate.

This "consumption-based" advantage of the Croatian profit tax is the most generous one in the field of depreciation allowances generally available (for all corporations) in the analyzed transition countries. As can be seen from Table 4, most countries offer accelerated depreciation only. There are numerous investment incentives in transition countries (still some of them being recently abolished or replaced in the new EU members due to the Code of Conduct and State Aid[36]).

Since they all give some tax advantage to investment, in a broader sense, they all could be regarded as some "consumption-based" element. Better to say, incentives/relief connected with the amount invested, sometimes referred as investment tax incentives in a narrower sense, such as accelerated depreciation, investment tax credits and investment allowances could be regarded as "standard type" consumption-based elements (although that could be strictly said only for accelerated depreciation and immediate write-off as its radical variant). On the other hand, extending the same logic to profit as "interest in a broader sense"—capital income, the tax exemption of profit[37] or even a lower profit rate could be seen as an "alternative type" consumption-based element. So, even the "race to the bottom" trend of statutory corporate tax rates in transition countries could be seen in the light of this. Still, one should bear in mind that "interest-adjusted profit tax" implies a distinction of "normal" and "above average" profits (the first being tax exempt[38]).

However, it is hard to tell what the "lower profit (corporate income) tax rate" might be. For instance, the Croatian profit tax rate of 20% was, when introduced in 2001, one of the lowest among the transition countries. In the meantime, most of them have lowered the rates, some of them gradually and continuously. Now, this rate could not be regarded as "low," but rather as average (Box 3) among the transition countries. Perhaps further lowering in the future should be considered as the most possible option.

[36] For the details concerning EU accession and CEE countries see: IBFD: The EU Accession States Tax Memo, 2004.

[37] Tax holiday could be an example, although not an adequate one, because it is temporary.

[38] In the already mentioned examples of Italy and Austria, they are taxed at the lower rate.

Table 4 Investment Tax Incentives (including loss carry over) for Corporations (corporate income tax) in Transition Countries in 2004 (without abolished incentives, that still apply until the expiring date)

Incentive / Country	Tax holiday (including investment related temporary exemptions for existing companies)	Accelerated depreciation[a]	Loss carry over (forward)	Tax allowance (TA)[b], Tax credit (TC)[b], lower rates, exemptions
Albania		Immediate write-off possible for assets other than buildings, structures and intangibles (having SL method) if the value of the entire "pool" is under the ceiling specified	3 years	Regional: TC (10%) for municipalities with high unemployment (100% for production company with 80% employees living in the municipality) Agricultural: only 40% of income from unprocessed plant and animal production is subject to tax
Bulgaria			5 years	
Bosnia and Herzegovina	3 years: first year—100% exemption, second year—70% exemption, third year—30% exemption Free zones: 5 years FDI (min. 20% foreign share)—5 years lower tax according to the foreign share in entire equity	Higher rates (25% and 50% higher) for work in two or three shifts Higher rates (25% higher) for fixed assets that prevent pollution, assets for R&D and education and computer equipment	5 years	100% exemption for profits reinvested in own production and 75% exemption for profits reinvested in other own activities

CROATIA	10 years (full exemption or lower rate (7 or 3%) depending on the amount invested (in effect only for very large investments) and number of employees. Regional (most affected war area—Vukovar area): 5 years starting from 2001, after that lower rate (25% of the general rate) Free zones: for investment above the ceiling exemption for up to 5 years, but may not exceed the amount of the investment	Official SL rates could be doubled (time halved). Additional depreciation in the first year (including the immediate write-off) for equipment and buildings	5 years	Free zones: 50% of income exempted War affected areas: reduced rate of profit tax (25, 50 and 75% of the general rate) depending on the level of war affectedness (3 groups of areas) TA (100%) for R&D
Czech Republic	10 years (for bigger investments in production facilities)	The first-year depreciation is established as a quotient of the acquisition cost and the appropriate coefficient stated in the law. In subsequent years, the residual value must be doubled and divided by the appropriate coefficient minus the number of already depreciated years (some sort of DB).	5 years	Income tax relief for 5 years for bigger investment in production facilities equal to the amount of the increase in their tax liability as compared to the higher tax liability of the previous 2 years TA:10% for most tangibles, 15% for machinery used by sewage plants to clean water or for recycling, 20% for certain machinery used in agriculture and forestry
Estonia	No corporate income tax, only “distribution tax” on fringe benefits, gifts, donations and entertainment expenses, dividends, profit adjustments and nonbusiness expenses			

Hungary		Higher rates (33 and 50%, optionally) for some machinery and equipment	indefinitely (not for financial institutions); losses incurred after the third year of the business activity only with the permission of the tax authorities	TC (35–50%), 10 years, specific amounts of investment and increase in number of employees required as well as other requirements SMEs: TC 40% of interest of loan for tangible assets, investment expenses incurred for putting business assets into use, up to yearly limit Film production: TC for sponsors and film investors of 100% (up to limit for both groups–20% of the film costs), carry forward for 3 years, TA for investors 50%
Latvia		DB for tangibles, immediate write off for R&D Special regions: increased depreciable base for fixed tangible assets	5 years Special regions: 10 years	Special economic zones: 20% of income tax payable (subject to ceiling in relation to investment value and other tax relief); TA for investments in local infrastructure Agricultural enterprises: TC—fixed amount per hectare Substantial investments: TC (40%)—amount of investment in fixed assets and duration (3 years) required, carry forward for 10 years
Lithuania	Free economic zones: 6 years exemption, next 10 years 50% reduction (min. investment and specific activity required)	Double DC for new buildings, machinery and equipment, software, acquired rights trucks and buses	5 years	Small business: reduced rate (13%), but not for company in which a shareholder or family members hold more than 50% of the shares Insurance companies: mostly exempt, agriculture: exempt

Macedonia	3 years starting from the year when profit is earned (if min. 20% foreign capital) 3 years for companies listed on stock exchange (50% reduction) 10 years for free-trade zones 1 year (50% tax reduction) in the first year	Yes, but prior approval of the tax authorities must be obtained if the total of depreciation allowances would exceed by more than 10% the depreciation computed under the SL method.	3 years, but prior approval of the tax authorities; no carry forward in the case of reorganizations	TA for profits invested in environmental protection TA for investments (without cars and furniture) up to yearly limit and for the 30% of inv. value exceeding the limit, unlimited carry forward TA (50%) for profits invested in undeveloped regions
Poland		For certain fixed assets (30% in the first year and later under the general rules) DB for some categories of fixed assets	5 years; up to 50% of the loss may be set off in each year	Special economic zones: exemption up to the amount of max. 50% qualified expenditures (65% for SMEs)—minimum amount of investment required
Romania		By applying a coefficient between 1.5 and 2.5 to the SL rates. Technological equipment and patents up to 50% in the first year. Taxpayers that did not benefit from the accelerated depreciation or other incentives are entitled to deduct 20% of the acquisition cost of depreciable fixed assets and patents first used from 1 July 2002 Immediate write-off for investments made to prevent work accidents or to set up medical units	5 years	TC (20%) for investment above the min. value that promote economic development and new jobs Different activities in free trade zones exempt

		For investment above the min. value that promote econ. development and new jobs		
Russia		Special coefficient (up to 2) to the general rate for agricultural company. For leased fixed assets, the general rate may be increased up to threefold. DB (but not for buildings with life of more than 20 years).	10 years, but limited to 30% of income of that year	
Serbia and Montenegro:	Serbia: 10 years (starting from the first year in which they realize taxable income), min. investment as well as number of employees required. The proportion of tax exemption is set as the ratio between investment in fixed assets and the total fixed assets.	Only in Serbia: normal rates increased by up to 25% for assets used for environmental protection, scientific research and education, as well as for computer equipment. DB Functional depreciation for vehicles and similar assets (according to their performance)	10 years	TC: 20% in Serbia and 15% in MN for fixed assets (except cars, furniture, carpets and art objects). The credit may not exceed 50% of the tax due in Serbia and 25% in MN. Any excess may be carried forward for 10 years.
Slovak Republic		The first-year depreciation is established as a quotient of the acquisition cost and the appropriate coefficient stated in the law. To determine the amount of	5 years (must be divided into five equal portions; where a further	TC for strategic investors: 10 years, min. investment required and 80% of the sales must be connected with the relevant investment activity, credit for companies limited to the lower of the corporate

		depreciation in subsequent years, the residual value must be doubled and divided by the appropriate coefficient minus the number of years already depreciated (in effect DB)	loss occurs during this 5-year period, may also be carried forward	income tax liability and the amount stated in the relevant government decision
Slovenia			5 years	TA (15%) for all assets except cars, additional TA (25%) for equipment and long-term intangible assets; TA limited to taxable base Annual tax-free reserve of up to 10% of the taxable income for investments in long term assets Special economic zones: 10% tax rate

[a]SL–straight line, DB-declining balance
[b]Percent (mostly in parentheses) referring to TA or TC denotes percentage of value of investment for which TA or TC is given; if TA or TC relate to the income (and not investment value) this is specified explicitly

Source: IBFD: European Tax Handbook, 2004; http://www.nn.hr: Croatian Profit Tax Law; Jacobs et al.: Company Taxation in the New Member States, 2003; http://www.fbihvlada.gov.ba : Bosnian Profit Tax Act

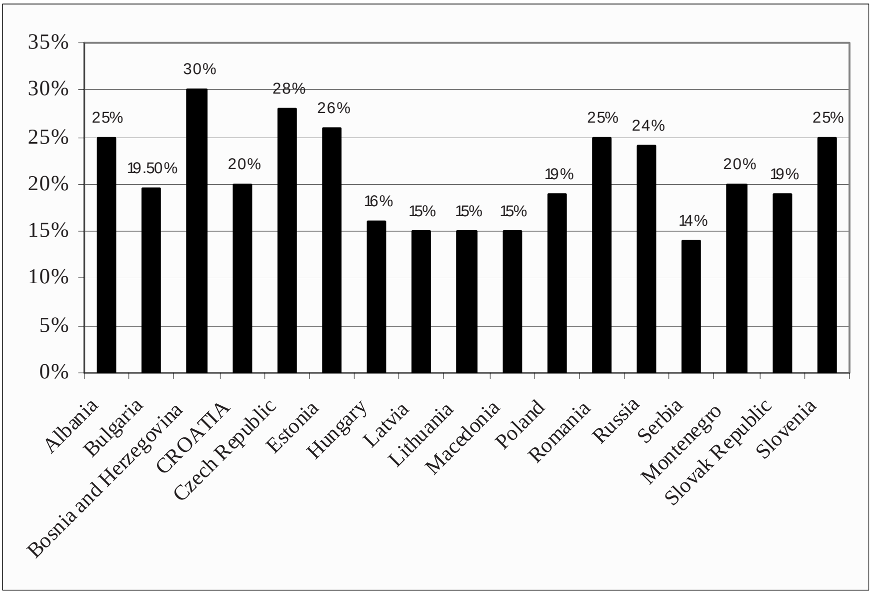

Fig. 2 Nominal (statutory) corporate tax rate in transition countries *Notes*:

- Estonia taxes distributed profits only (including fringe benefits, gifts, donations and entertainment, expenses, profit adjustments and nonbusiness expenses) with "distribution tax"—there is no corporate income tax for retained earnings
- Lithuania, Romania and Montenegro have lower rates for small business (13, 1.5, and 15%)

Source: Author's own synthesis from: IBFD: European Tax Handbook, 2004; http://www.fbihvlada.gov.ba: Bosnian Profit Tax Act

Future System

During the election campaign, the currently ruling party announced the complete comeback of the previous consumption-based system described in the second section. However, it should be pointed out that some elements of this system (nontaxation of some capital incomes) remained even in the current system (Table 1).

Only some part of the announced changes will be put into effect [http://www.mfin.hr (Nov. 2004); Jurić 2004; Sirovica 2004; Spajić 2004; Turković-Jarža 2004]. As promised, the final withholding tax on dividends will be abolished, based on efficiency expectations (incentive to investments and resulting rise in employment and growth). Although the 100% dividend exemption can be seen as a move in the direction of a consumption-based system[39] it can also be justified on the S-H-S income-based tax grounds. So, Croatia will join the rising group of transition countries that exempts dividends completely (Table 3).[40]

On the other hand, there will be a definitive departure from consumption-based elements. The immediate write-off as well as additional depreciation (sort of accelerated depreciation) in the first year (Table 4) will be abolished. Still, the form of accelerated depreciation introduced in the times of the alternative form of consumption-based profit tax—double official SL rates[41] (Table 4) still remains. Moreover, in order to compensate taxpayers for the loss caused by the abolition of immediate write-off and additional depreciation in the first year, official SL depreciation rates will be set at a higher rate (even double, for instance for buildings, computers and software).[42] Because of the accelerated depreciation, which in addition allows for doubling of the official SL rates, the final treatment is really generous. For instance, for computers, computer equipment and software, mobile phones and telecommunication equipment the official SL rate will be raised to 50%. If the accelerated depreciation option is implemented, we will end with immediate write-off for these assets.

Regional investment incentives (see Table 4) for war-affected areas will be limited to 10 years starting from 2005, but the profit tax for the first group (more affected areas) will be abolished (10 years exemption) and for the second group lowered from 50 to 25%. The area of the town of Vukovar (the most war-affected area) will be granted a 10-year profit tax exemption starting from 2005. In addition to the regional incentives for the war affected areas, a regional incentive for mountain areas is going to be introduced—a reduced tax rate (75% of the general rate).

There is the possibility left for the government even to increase the already existing incentives for some free zones or specific activities in the zones, which is an additional departure from neutrality. Investment incentive for R&D is broadened by profit tax exemption for companies registered for R&D.

It seems that there will be no definite comeback to the consumption-based tax, although the preferential treatment of saving and investment seems to be continued. So Croatia will continue to have, like most of the other (transition) countries, some hybrid system between income and consumption. Formally, the system is income-based, but with a lot of different forms of

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[39] With this change there is almost no tax on capital income for individuals (nonbusiness). The only exception is the real estate income and interests for the loans given.

[40] Greece also has a 100% exemption.

[41] In effect that means that the period of depreciation (years) could be halved.

[42] Only for cars if the SL rate lowered from 25 to 20%.

preferential treatment of capital income and saving inside the income tax and investment incentives inside the profit tax.

Instead of a Conclusion

The “destiny” of contemporary tax systems in developed as well as transition countries is the departure from pure theoretical concepts and models (income-based or consumption-based). What we have in effect are hybrid systems with the elements of both income-based and consumption-based models. Still, although the reform of the 1980s advocated the return to the income concept, even at that time the direction toward the consumption concept was present. It is especially pronounced in the tax reform of the transition countries in the 1990s and today.

Croatia is no exception. It succeeded in being “unique” for quite a short time. Furthermore, even the implemented “pure” consumption-based “alternative model” had some minor departures in the income-concept direction. But the model could not be maintained and was abandoned. The new system more or less resembles the situation in other transition countries—an income-based model with tremendous departures in the consumption-based direction. Still, the “consumption-based” inheritance makes the tax treatment of capital income in Croatia in general a little more favorable than in most other transition countries.

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The Ethics of Tax Evasion: A Survey of Estonian Opinion

Robert W. McGee, Jaan Alver, and Lehte Alver

Introduction

Most articles written on tax evasion are published in tax practitioner journals and take a practitioner or legal perspective. However, some authors have taken a philosophical approach (McGee 1994). One of the most comprehensive analyses on tax evasion from a philosophical perspective was a doctoral thesis written by Martin Crowe in 1944. The *Journal of Accounting, Ethics & Public Policy* published a series of articles on tax evasion from various religious, secular and philosophical perspectives in 1998 and 1999. Most of those articles were also published in an edited book (McGee 1998a). Since the publication of that book a few other articles have addressed the issue of tax evasion from an ethical perspective.

The ethics of tax evasion can be examined from a number of perspectives. Some of these are of a religious nature while others are more secular and philosophical. One approach is to examine the relationship of the individual to the state. Another is the relationship between the individual and the taxpaying community or some subset thereof. A third is the relationship of the individual to God. Martin Crowe (1944) examined the literature on these approaches, which are the three main approaches that have been taken in the literature over the past five centuries.

Review of the Literature

Although many studies have been done on tax compliance, very few have examined compliance, or rather noncompliance, primarily from the perspective of ethics. Most studies on tax evasion look at the issue from a public finance or economics perspective, although ethical issues may be mentioned briefly, in passing. The most comprehensive twentieth century work on the

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ethics of tax evasion was a doctoral thesis written by Martin Crowe (1944), titled *The Moral Obligation of Paying Just Taxes*. This thesis reviewed the theological and philosophical debate that had been going on, mostly within the Catholic Church, over the previous 500 years. Some of the debate took place in the Latin language. Crowe introduced this debate to an English language readership. A more recent doctoral dissertation on the topic was written by Torgler (2003), who discussed tax evasion from the perspective of public finance but also touched on some psychological and philosophical aspects of the issue. Alfonso Morales (1998) examined the views of Mexican immigrant street vendors and found that their loyalty to their families exceeded their loyalty to the government.

There have been a few studies that focus on tax evasion in a particular country. Ethics are sometimes discussed but, more often than not, the focus of the discussion is on government corruption and the reasons why the citizenry does not feel any moral duty to pay taxes to such a government. Ballas and Tsoukas (1998) discuss the situation in Greece. Smatrakalev (1998) discusses the Bulgarian case. Vaguine (1998) discusses Russia, as do Preobragenskaya and McGee (2004) to a lesser extent. A study of tax evasion in Armenia (McGee 1999b) found the two main reasons for evasion to be the lack of a mechanism in place to collect taxes and the widespread opinion that the government does not deserve a portion of a worker’s income.

A number of articles have been written from various religious perspectives. Cohn (1998) and Tamari (1998) discuss the Jewish literature on tax evasion and on ethics in general. Much of this literature is in Hebrew or a language other than English. McGee (1998d, 1999a) commented on these two articles from a secular perspective.

A few articles have been written on the ethics of tax evasion from various Christian viewpoints. Gronbacher (1998) addresses the issue from the perspectives of Catholic social thought and classical liberalism. Schansberg (1998) looks at the Biblical literature for guidance. Pennock (1998) discusses just war theory in connection with the moral obligation to pay just taxes, and not to pay unjust or immoral taxes. Smith and Kimball (1998) provide a Mormon perspective. McGee (1998c, 1999a) commented on the various Christian views from a secular perspective.

The Christian Bible discusses tax evasion and the duty of the citizenry to support the government in several places. Schansberg (1998) and McGee (1994, 1998a) discuss the biblical literature on this point. When Jesus is asked whether people should pay taxes to Caesar, Jesus replied that we should give to Caesar the things that are Caesar’s and give God the things that are God’s (Matthew 22:17, 21). But Jesus did not elaborate on the point. He did not say what we are obligated to give to the government or whether that obligation has limits. There are passages in the Bible that may be interpreted to take an absolutist position. For example, Romans 13, 1–2 is read by some to support the Divine Right of Kings.

A few other religious views are also addressed in the literature. Murtuza and Ghazanfar (1998) discuss the ethics of tax evasion from the Muslim perspective. McGee (1998b, 1999a) comments on their article and also discusses the ethics of tax evasion under Islam citing Islamic business ethics literature (McGee 1997). DeMoville (1998) discusses the Baha'i perspective and cites the relevant literature to buttress his arguments. McGee (1999a) commented on the DeMoville article. McGee (2004) discusses these articles in a book from a philosophical perspective.

One empirical study on the ethics of tax evasion was done by Nylén (1998), who did a survey soliciting the views of Swedish chief executive officers (CEOs). McGee (1998e) commented on this study. A study by Reckers et al. (1994) presented participants with a case study and asked them whether they would be willing to evade taxes. Englebrecht et al. (1998) did a study involving 199 subjects who replied to 29 ethical orientation questions, some of which had to do with tax evasion. Inglehart et al. (2004) conducted a large survey of more than 200,000 people in more than 80 countries that asked more than one hundred questions, one of which was about tax evasion. McGee and Tyler (2007) used the Inglehart data to examine the views on tax evasion of 33 countries.

A few other empirical studies have been conducted that solicit views on the ethics of tax evasion using a methodology similar to the present study. McGee and Cohn (2006) surveyed the views of Orthodox Jews. The views of international business academics (McGee 2005a) and various groups in Romania (McGee 2005b), Thailand (McGee 2006), Poland (McGee and Bernal 2006), Hong Kong (McGee and Ho 2006) and China (McGee and Noronha 2007) have used survey instruments similar to the one used in this study. The present study replicates these studies but also does a more thorough and complete demographic analysis than was done in these other studies.

Survey Results

Methodology

A survey instrument was developed to solicit the views of Estonian students, professors and business practitioners on the ethics of tax evasion. The survey consisted of 18 statements that include the major arguments Crowe (1944) discussed plus three more modern arguments. Each statement generally began with the phrase "Tax evasion is ethical if…." Respondents were instructed to insert a number from 1 to 7 in the space provided to reflect the extent of their agreement or disagreement with each of the 18 statements. A score of one (1) represented strong agreement with the statement, while a score of seven (7) represented strong disagreement.

The survey was distributed to faculty, graduate and undergraduate students at Tallinn University of Technology. Three hundred (300) usable responses were collected. Data were compiled and examined based on gender, student or faculty status, major and age.

Table 1 summarizes the demographic makeup of the sample.

Table 1
Demographics

Status	Sample	Gender	Sample
Graduate student	116	Male	75
Undergraduate student	116	Female	222
Faculty	9	Unknown	3
Practitioners	59	Total	300
Total	300		
Major		Age	
Accounting	94	Below 25	173
Business & Economics	139	25–40	88
Other & Unknown	67	Over 40	37
Total	300	Unknown	2
		Total	300

Findings

Table 2 lists the 18 statements and shows the mean scores for each statement. The mean score for all 18 statements was 5.54, which, on a scale of 1 to 7 indicates a strong feeling that tax evasion is generally unethical but can be ethical in certain situations. However, as Table 2 shows, some scores are higher than others, which indicates that some arguments to support tax evasion are stronger than others.

Table 2
Total Sample Mean Scores by Statement
(1 = strongly agree; 7 = strongly disagree)

Stmt. #	Statement	Score
1	Tax evasion is ethical if tax rates are too high.	5.57
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.29
3	Tax evasion is ethical if the tax system is unfair.	4.79
4	Tax evasion is ethical if a large portion of the money collected is wasted.	5.28
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.31
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.77

7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.25
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.22
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.25
10	Tax evasion is ethical if everyone is doing it.	6.08
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.44
12	Tax evasion is ethical if the probability of getting caught is low.	5.93
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	5.06
14	Tax evasion is ethical if I can't afford to pay.	5.20
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.38
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	4.87
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.66
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.44
	Average Score	5.54

Ranking the Arguments

Table 3 ranks the arguments from strongest to weakest. The range is 4.44 to 6.38, which indicates that there is widespread support for the position that tax evasion is ethical in some circumstances.

Table 3
Statements Ranked from Strongest to Weakest Arguments Support Tax Evasion
(1 = strongly agree; 7 = strongly disagree)

Rank	Statement	Score
1	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.44
1	Tax evasion is ethical if the government imprisons people for their political opinions.	4.44
3	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.66
4	Tax evasion is ethical if the tax system is unfair.	4.79
5	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	4.87
6	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	5.06
7	Tax evasion is ethical if I can't afford to pay.	5.20
8	Tax evasion is ethical if a large portion of the money collected is wasted.	5.28

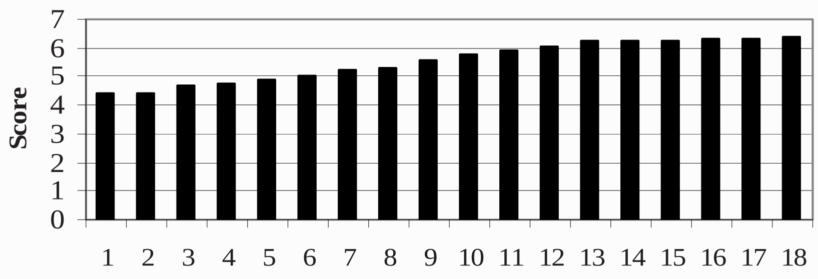
9	Tax evasion is ethical if tax rates are too high.	5.57
10	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.77
11	Tax evasion is ethical if the probability of getting caught is low.	5.93
12	Tax evasion is ethical if everyone is doing it.	6.08
13	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.22
14	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.25
14	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.25
16	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.29
17	Tax evasion is ethical even if most of the money collected is spent wisely.	6.31
18	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.38

The strongest arguments justifying tax evasion were in cases where a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends; if the government imprisons people for their political opinions; if the government discriminates against me because of my religion, race or ethnic background; if the tax system is unfair; or if the taxpayer were a Jew living in Nazi Germany.

The weakest arguments were in cases where others must pay more if the taxpayer pays less; if most of the money collected is spent wisely; if tax rates are not too high because the government is not entitled to take as much as it is taking from me; if a large portion of the money collected is spent on worthy projects; or if a large portion of the money collected is spent on projects that do benefit the taxpayer.

Chart 1 shows the range of scores for the 18 statements.

Chart 1 Range of Scores



Gender Differences

Some studies in gender ethics have found that women are more ethical than men (Akaah and Riordan 1989; Baird 1980; Brown and Choong 2005; Sims et al. 1996), while other studies found that there is no statistical difference between men and women when it comes to ethics (Roxas and Stoneback 2004; Sikula and Costa 1994; Swaidan et al. 2006). A few studies have found that men are more ethical than women (Barnett and Karson 1987; Weeks et al. 1999).

A few studies have compared the views of men and women on the ethics of tax evasion. The findings of these studies are mixed. Studies of international business professors (McGee 2005a), people in Thailand (McGee 2006) and Orthodox Jews (McGee and Cohn 2006) found women to be more opposed to tax evasion, whereas studies of Poland (McGee and Bernal 2006), Hong Kong (McGee and Ho 2006) and China (McGee and Noronha 2007) found no significant difference based on gender. A study of Romania (McGee 2005b) found that men were more opposed to tax evasion than were women.

It was thought that comparing the male and female scores would be interesting for purposes of the present study, although the comparison could not lead to any conclusion regarding the relative ethics of men and women.

Table 4 shows the scores for each statement broken down by gender. The average male score was 5.07, compared to 5.70 for females, indicating that females were, on average, more opposed to tax evasion. Female scores were higher than male scores for all 18 statements. Wilcoxon tests were performed to determine whether any of the differences were statistically significant. Female scores were significantly higher than male scores for 16 of the 18 statements.

Table 4
Comparison of Male and Female Scores
(1 = strongly agree; 7 = strongly disagree)

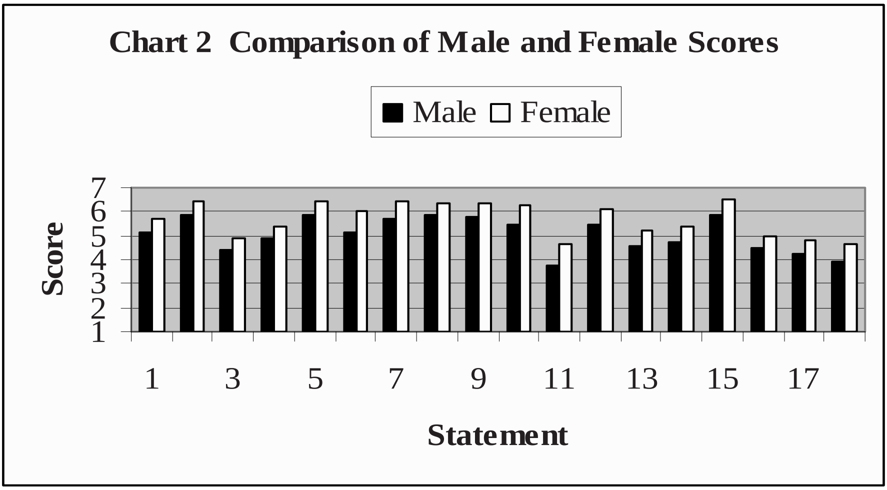
Stmt. #	Statement			Score Larger by		p value	
		Male	Female	Male	Female		
1	Tax evasion is ethical if tax rates are too high.	5.17	5.72		0.55	0.02318	**
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	5.89	6.41		0.52	0.01556	**

3	Tax evasion is ethical if the tax system is unfair.	4.43	4.93	0.50	0.05851	***
4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.88	5.40	0.52	0.09771	***
5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.88	6.45	0.57	0.003542	*
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.17	5.99	0.82	0.005093	*
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.73	6.42	0.69	0.003446	*
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.84	6.34	0.50	0.01989	**
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.80	6.39	0.59	0.02386	**
10	Tax evasion is ethical if everyone is doing it.	5.45	6.28	0.83	0.002693	*
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.72	4.68	0.96	0.002322	*

12	Tax evasion is ethical if the probability of getting caught is low.	5.49	6.07	0.58	0.01801	**
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.58	5.24	0.66	0.02795	**
14	Tax evasion is ethical if I can’t afford to pay.	4.69	5.38	0.69	0.01586	**
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.85	6.55	0.70	2.115e-05	*
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	4.49	5.00	0.51	0.1195	
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.25	4.80	0.55	0.1027	
18	Tax evasion is ethical if the government imprisons people for their political opinions.	3.88	4.61	0.73	0.0164	**
	Average Score	5.07	5.70	0.63		

*Significant at the 1% level
**Significant at the 5% level
***Significant at the 10% level

Chart 2 shows the male and female scores for each statement.



Comparison of Student and Faculty Scores

The sample population consisted of faculty, undergraduate and graduate students and business practitioners. Table 5 shows the mean scores for each group for all 18 statements. Overall, undergraduate students were least opposed to tax evasion and faculty members and business practitioners were most opposed to tax evasion. Wilcoxon tests were performed to determine whether any overall differences between groups were statistically significant. Undergraduate students were found to be significantly less opposed to tax evasion than faculty or practitioners at the 10% level.

Table 5
Comparison of Student and Faculty Scores
(1 = strongly agree; 7 = strongly disagree)

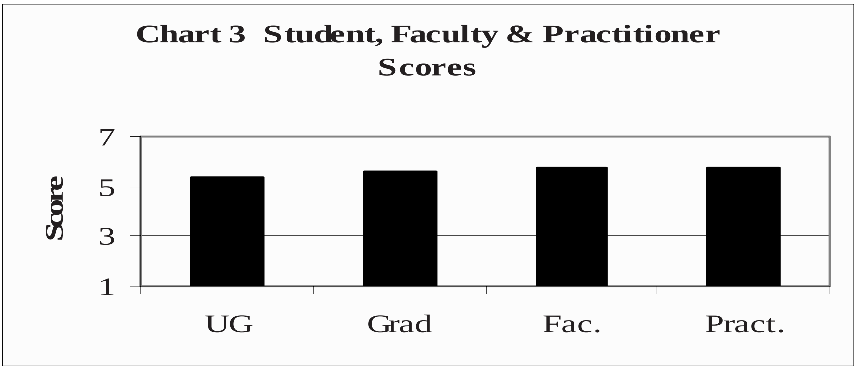
Stmt. #	Statement	Students			
		UG	Grad.	Faculty	Pract.
1	Tax evasion is ethical if tax rates are too high.	5.43	5.70	6.22	5.59
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.17	6.40	6.44	6.36
3	Tax evasion is ethical if the tax system is unfair.	4.56	4.90	5.44	4.85
4	Tax evasion is ethical if a large portion of the money collected is wasted.	5.39	5.24	4.78	5.22

5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.28	6.30	6.56	6.39
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.68	5.80	5.67	5.83
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.13	6.20	6.56	6.59
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.04	6.20	6.33	6.49
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.20	6.10	6.33	6.58
10	Tax evasion is ethical if everyone is doing it.	6.03	6.04	5.89	6.28
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.03	4.67	4.22	4.83
12	Tax evasion is ethical if the probability of getting caught is low.	5.66	5.92	6.67	6.37
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	5.00	5.16	5.00	5.02
14	Tax evasion is ethical if I can't afford to pay.	4.91	5.14	5.11	5.90
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.15	6.47	6.44	6.66
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	4.45	5.04	5.71	5.26
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.17	4.94	5.25	4.98

18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.04	4.61	5.50	4.75
	Average Score	5.35	5.60	5.78	5.78
		P value			
	Undergraduate v. Graduate students	0.3113			
	Undergraduate students v. Faculty	0.06195	*		
	Undergraduate students v. Practitioners	0.08755	*		
	Graduate students v. Faculty	0.275			
	Graduate students v. Practitioners	0.3506			
	Faculty v. Practitioners	0.9874			

* Significant at the 10% level

Chart 3 graphs the relative scores for the four groups.



Comparisons Based on Age

Some studies have found that people tend to become more ethical with age. One possible reason for this change in viewpoint might be because older people have more respect for the rule of law or for authority. For example, Ruegger and King (1992) found that people become more ethical as they get older. Their study divided respondents into the following four groups: 21 or less, 22–30, 31–40 and 40 plus. But Sims et al. (1996) found that older students had fewer qualms about pirating software than did younger students.

Babakus et al. (2004) also found that age made a difference, but what difference age makes sometimes depends on culture. Younger people from the UK, USA and France tend to be less ethical consumers than do older people from these countries, whereas younger Austrians tend to be more ethical consumers than their elders. Age generally did not matter for Hong Kong consumers, except in the case of stealing towels from hotels and blankets from aircraft. Younger people tended to be less tolerant of these kinds of activities than did their elder Hong Kong consumers. Brunei consumers showed mixed results. In some cases younger people were more ethical whereas in other cases older people were more ethical.

A few studies have looked at ethical attitudes toward tax evasion for different age groups. McGee and Tyler (2007) examined tax evasion opinion in 33 countries and found that people become more opposed to tax evasion as they get older. Alm and Torgler (2004) reached the same conclusion. But another study of tax evasion viewpoints involving a Mormon population found that age was not a significant factor (McGee and Smith 2007).

If one begins with the assumption that undergraduate students are younger than graduate students and that graduate students are younger than faculty members and business practitioners, then status as an undergraduate or graduate student or faculty member could be used as a surrogate for age. If that is done, then one could conclude that the results of the present study confirm the results of those age studies that found age to be positively correlated with ethical behavior.

However, such a conclusion is weak because the underlying premise is that tax evasion is unethical, which may or may not be the case. One result of the present study is the finding that there is widespread support for the view that tax evasion is not always unethical. All we can conclude for certain in the present study is that individuals become more opposed to tax evasion with age, a finding that confirms the findings of McGee and Tyler (2007) and Alm and Torgler (2004) but conflicts with the findings of McGee and Smith (2007).

Data were also compiled according to age. The sample population was divided into three groups. Table 6 summarizes the results.

As Table 6 shows, those who are less than 25 years old were significantly less opposed to tax evasion than were participants in the 25–40 age group. Other comparisons found no significant difference between groups.

Table 6
Comparison of Scores by Age
(1 = strongly agree; 7 = strongly disagree)

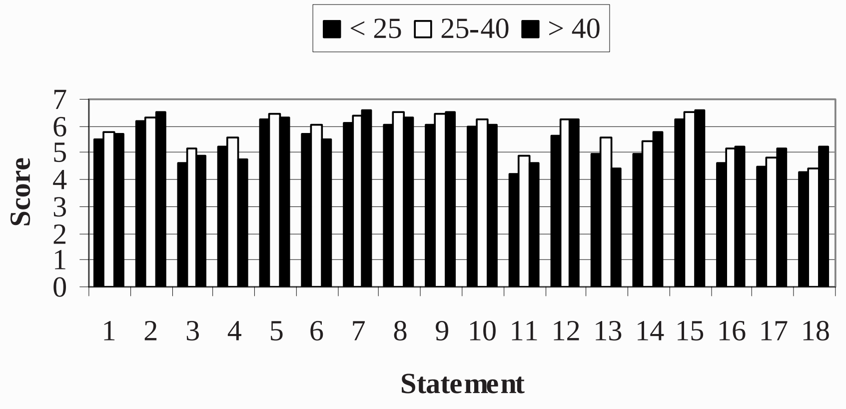
Stmt. #	Statement	<25	25–40	>40
1	Tax evasion is ethical if tax rates are too high.	5.49	5.75	5.68
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.21	6.35	6.51
3	Tax evasion is ethical if the tax system is unfair.	4.61	5.17	4.92
4	Tax evasion is ethical if a large portion of the money collected is wasted.	5.23	5.57	4.76
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.22	6.48	6.35
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.72	6.02	5.53
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.13	6.40	6.56
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.03	6.54	6.30
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.06	6.49	6.54
10	Tax evasion is ethical if everyone is doing it.	5.99	6.24	6.06
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.19	4.86	4.59
12	Tax evasion is ethical if the probability of getting caught is low.	5.67	6.28	6.27
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.96	5.55	4.43
14	Tax evasion is ethical if I can't afford to pay.	4.98	5.41	5.78

15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.24	6.55	6.62
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	4.64	5.14	5.23
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.46	4.81	5.19
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.28	4.40	5.22
	Average Score	5.40	5.78	5.70
		P value		
	Less than 25 v. 25–40	0.07643	*	
	Less than 25 v. Greater than 40	0.1687		
	25–40 v. Greater than 40	0.9118		

* Significant at the 10% level

Chart 4 shows comparisons by age.

Chart 4 Comparison by Age



Comparisons by Major

Table 7 shows the scores broken down by major. The average score for accounting majors was 5.66. The average for business and economics majors was 5.47. A Wilcoxon test was performed comparing accounting majors to business and economics majors to determine whether the differences in scores were significant. The results of that test are reported in Table 7. The differences were not significant overall.

Table 7
Comparison of Student Scores by Major
(1 = strongly agree; 7 = strongly disagree)

Stmt. #		Acct.	Bus.-Econ.
1	Tax evasion is ethical if tax rates are too high.	5.65	5.54
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.33	6.25
3	Tax evasion is ethical if the tax system is unfair.	4.83	4.71
4	Tax evasion is ethical if a large portion of the money collected is wasted.	5.18	5.22
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.24	6.27
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.78	5.79
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.33	6.19
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.19	6.26
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.28	6.27
10	Tax evasion is ethical if everyone is doing it.	6.16	6.00
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.69	4.29
12	Tax evasion is ethical if the probability of getting caught is low.	6.12	5.86
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	5.06	4.99
14	Tax evasion is ethical if I can't afford to pay.	5.64	5.01
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	6.53	6.35
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	5.16	4.71
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.99	4.52
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.75	4.28
Averages		5.66	5.47

Wilcoxon Test of Significance
Accounting v. Bus-Econ. 0.4765

Concluding Comments

This study examined the strength of the various arguments that have been used over the last five centuries to justify tax evasion on ethical or philosophical grounds. The survey found that there is wide philosophical support for tax evasion in certain cases and that some arguments to justify tax evasion are stronger than others. As a general rule, one might say that tax evasion is seen as more justifiable if the government is corrupt, wasteful, if the tax system is considered to be unjust or if the government engages in human rights abuses. Tax evasion might also be justified by some people if the tax rates are too high or if the taxpayer is unable to pay. Many of these arguments have a long history in the philosophical and theological literature. The weakest arguments were in cases where taxpayers receive something in return for their money or where the tax funds are spent wisely.

These findings have policy implications. If a government wants to reduce the extent of tax evasion in the economy, it must eliminate the moral justifications for tax evasion. It must not oppress the people, it must provide services in exchange for the funds collected, it must keep tax rates low and it must have a tax system that is widely perceived as fair.

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25

The Ethics of Tax Evasion: A Survey of Guatemalan Opinion

Robert W. McGee and Christopher Lingle

Introduction

Most articles written on tax evasion are published in tax practitioner journals and take a practitioner or legal perspective. However, some authors have taken a philosophical approach (McGee 1994a). One of the most comprehensive analyses on tax evasion from a philosophical perspective was a doctoral thesis written by Martin Crowe in 1944. The *Journal of Accounting, Ethics & Public Policy* published a series of articles on tax evasion from various religious, secular and philosophical perspectives in 1998 and 1999. Most of those articles were also published in an edited book (McGee 1998a). Since the publication of that book a few other articles have addressed the issue of tax evasion from an ethical perspective. Space does not permit a full review of the literature. However, the literature is reviewed elsewhere in this book. Some relevant literature is listed in the reference section of this chapter. The remainder of this chapter discusses the results of a study of student opinion in Guatemala.

Methodology

A survey was developed that incorporates all the major issues that have been discussed in the tax evasion literature. The survey included 18 statements that reflect all three viewpoints on the issue. It was translated into Spanish and distributed to graduate and upper division undergraduate business and law students at Universidad Francisco Marroquin in Guatemala. This target population was selected because these students will become the future opinion leaders and political leaders of Guatemala. One hundred fourteen (114) usable responses were obtained.

Respondents were asked to indicate their agreement or disagreement with each statement by placing a number from 1 to 7 in the space provided.

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The statements generally started with the phrase "Tax evasion is ethical if…". A score of one (1) indicated strong agreement with the statement. A score of seven (7) indicated strong disagreement.

Survey Findings

The survey included a total of 114 participants, 78 males and 36 females. There were 85 business or economics students, 17 law students and a smattering of students with other majors. Tables 1 and 2 provide the details.

Table 1
Responses by Gender

Male	78
Female	36
Total	114

Table 2
Responses by Major

Major	
Business/economics	85
Theology	4
Philosophy	1
Law	17
Technology	1
Unspecified	6
Total	114

H1: Respondents believe that tax evasion is ethical sometimes. This hypothesis will be considered true if the average score for all 18 statements is more than 2.0 but less than 6.0.

H1: The hypothesis cannot be rejected. The average score was 5.2, as is seen in Table 3, which shows the combined scores for each of the 18 statements.

Table 3
Combined Scores
(1 = strongly agree; 7 = strongly disagree)

Stmt. #	Statement	Scores
1	Tax evasion is ethical if tax rates are too high.	5.2
2	Tax evasion is ethical even if tax rates are not too high.	6.3
3	Tax evasion is ethical if the tax system is unfair.	4.5
4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.4

5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.3
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.8
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.8
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	6.0
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.3
10	Tax evasion is ethical if everyone is doing it.	6.2
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.7
12	Tax evasion is ethical if the probability of getting caught is low.	6.2
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.9
14	Tax evasion is ethical if I can't afford to pay.	4.5
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	4.0
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.3
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.7
	Average Score	5.2

Chart 1 illustrates the range of combined scores.

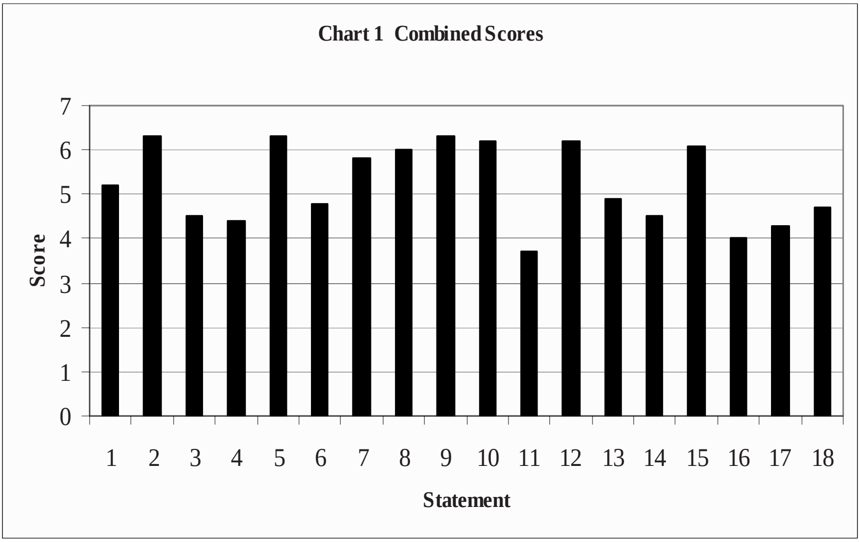
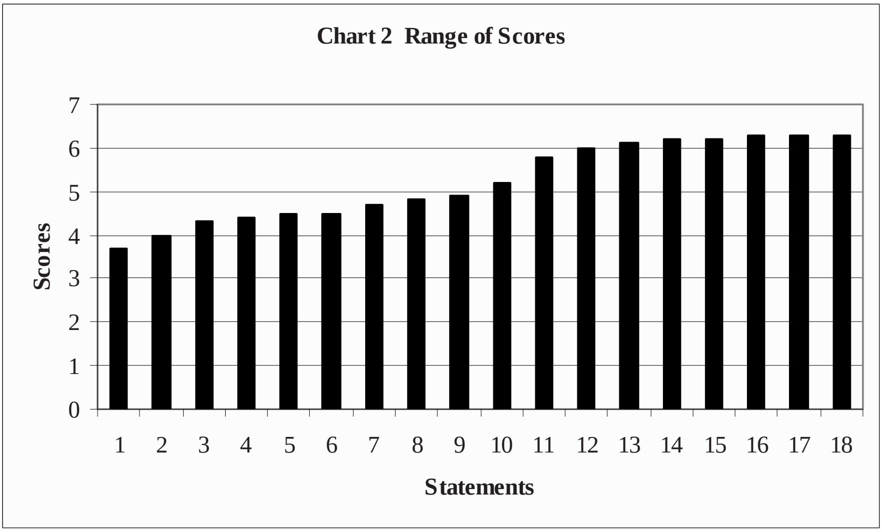


Table 4 shows the ranking of the various arguments that have been used to justify tax evasion over the centuries. Although the survey revealed that some arguments supporting tax evasion are stronger than others, none of the arguments were considered very strong by the survey participants. The strongest argument received a score of only 3.7 on a scale of 1 to 7. Seven of the 18 arguments received a score of 6.0 or higher, indicating very strong disagreement with the statement.

Table 4
Ranking of Arguments
Ranked from Strongest to Weakest
Arguments Supporting Tax Evasion

Rank	Argument	Score
1	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. (S11)	3.7
2	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940. (S16)	4.0
3	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background. (S17)	4.3
4	Tax evasion is ethical if a large portion of the money collected is wasted. (S4)	4.4
5	Tax evasion is ethical if the tax system is unfair. (S3)	4.5
5	Tax evasion is ethical if I can't afford to pay. (S14)	4.5
7	Tax evasion is ethical if the government imprisons people for their political opinions. (S18)	4.7
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of. (S6)	4.8
9	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust. (S13)	4.9
10	Tax evasion is ethical if tax rates are too high. (S1)	5.2
11	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects. (S7)	5.8
12	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me. (S8)	6.0
13	Tax evasion is ethical even if it means that if I pay less, others will have to pay more. (S15)	6.1
14	Tax evasion is ethical if everyone is doing it. (S10)	6.2
14	Tax evasion is ethical if the probability of getting caught is low. (S12)	6.2
16	Tax evasion is ethical even if tax rates are not too high. (S2)	6.3
16	Tax evasion is ethical even if most of the money collected is spent wisely. (S5)	6.3
16	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me. (S9)	6.3

Chart 2 illustrates the range of scores.



H2: Tax evasion will be viewed more favorably (scores will be lower) where the Statement refers to corruption or the perception of unfairness.

H2: The hypothesis cannot be rejected. S11 referred to corruption and ranked #1. S16, S17, S3 and S18 referred to unfairness or human rights abuses. Their ranks were 2, 3, 5 and 7, respectively.

A closer analysis of the rankings and the rationale given by some of the respondents is revealing. The strongest argument in favor of ethically evading taxes is in cases where "a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends." If one were to argue that evasion in such cases is ethical, it might be because the taxpayer's duty is to the government or to fellow taxpayers, not to corrupt politicians or their family and friends. Thus, there is no duty to pay taxes if they go to individuals or groups who are outside the parameters of duty. However, the fact that the score for this statement was 3.7 reveals that a significant number of respondents think there is an ethical duty to pay taxes even if the taxes do not go for any legitimate government purpose.

Another interesting result of this survey is that the Jewish-Nazi question ranked only second and received a score of 4.0, which indicates that respondents generally think that tax evasion is not justified even if you are a Jew living in Nazi Germany. The statement was that "Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940."

Those who chose a number higher than one (1) on this statement are basically saying that Jews have a moral obligation to pay taxes to Nazis, a portion of which will be used to purchase the poison gas or bullets that will be used to exterminate them and their families, which makes one wonder what kind of morale training the respondents have received. An alternative explanation would be that the respondents did not put much thought into their responses. Some respondents chose seven (7) for all the statements, which indicates they believe that tax evasion is never ethically justified. Perhaps some of these respondents did not even bother to read all of the 18 statements before determining which number to put in the space next to each statement.

If any general patterns can be discerned it would be that the strongest arguments supporting the ethical case for tax evasion are in instances where the system is somehow perceived to be unfair. Tax evasion is more ethically justifiable in cases where the government discriminates against or oppresses some segment of the population or where the proceeds are used to support activities of which the respondent disapproves. Tax evasion is least justifiable on ethical grounds in cases where benefits are received or where the proceeds are used for activities of which the respondent approves.

The optional comment section of the survey revealed something of the thought process involved in choosing which number to place in each slot. Here is a summarized version of the responses:

- What determines whether tax evasion is ethical is the use to which the money is put and how high the tax rates are. If rates are too high, then you are working for others.
- Tax evasion cannot be considered ethical. The laws of the country must be obeyed. This is also what Christ wanted to say. The laws of God are the laws of God. People who don't like the taxes can protest.
- If you can't change the government without getting shot in the head, then change countries.
- If the opinions of most of the people in the country are different from yours, then you are wrong and they are right.
- If tax rates are too high, then I am working for the government, not for myself. There will be no incentive to pay and no incentive to work. The situation would be even worse if I knew the people in the government are stealing the money. It does not matter if they are using the money for programs that benefit me directly as long as they are using the money instead of stealing it.
- If corruption did not exist and if public funds were not used badly, there would be no ethical justification for evading taxes.
- In 90% of the cases it cannot be considered ethical to evade taxes. Evasion is ethically justified only in cases where there is corruption or other problems, like extreme coercion or a war of extermination.
- It depends on the situation. Everyone can have different views about what is ethical and what is not.

- People have an obligation to pay taxes because taxes are used to buy freedom, security and justice. But if taxes are used to enrich privileged groups and to destroy the fabric of society, then society is harmed and security and justice are reduced. There is no obligation to pay taxes in such cases.
- Tax evasion is never ethical. Tax evaders are ignoring their responsibilities to their fellow citizens, the government and the country. If government officials act unethically it does not justify evasion. Even though I think evasion is not ethical, I consider it just if the government does not function correctly or if the governors lack ethical and moral values.
- If I do not pay taxes I am stealing from the country.
- If the government exceeds its legitimate authority, then taxes become robbery and it is ethical to stop paying them. The problem is that there is more than one vision of the role that government should play in society. There is no mutual agreement.
- I think it is not ethical that someone requires me to pay for something that I don't use. Tax evasion is ethical; it is a form of self defense.
- I don't think that evading taxes is ethical from any point of view. God gave us instructions to pay. It would be better if taxes were reduced and even eliminated because doing so would bring prosperity and economic growth and it would be one of the best ways to reduce poverty. However, I have an obligation to pay even if I don't want to.
- Tax evasion is justified only if the system is unjust and the tax rates are too high, if I can't pay those taxes, if the funds are spent on immoral projects of if the politicians use the funds inappropriately. In a democratic system there are ways to remedy these problems. If the democratic mechanism does not resolve these problems, then I am ethically justified in evading taxes.
- Tax administrators have stolen money from the people's pension funds. I do not have any moral obligation to pay taxes.
- We have an obligation to pay taxes because we have made the laws and we must obey them, even if some people disagree with those laws.
- When choosing to live in society X or Y individuals must obey the rules of that society. If you don't like something you can work to change it but evading taxes is not a legitimate form of protest.
- Evasion implies the absence of ethics. Evasion is unethical regardless of what the funds are used for.
- I don't look at tax evasion from an ethical perspective. I look at it as a way to compete. If I pay my taxes and others don't, they will have lower costs and a wider margin to price their products. That is not free competition. In such a situation, those who pay their taxes will be driven

out of business. I think my viewpoint has a lot to do with the fact that I live in a third world country. When I lived in the USA I was completely against evasion.

- Whether evasion is ethical depends on how the government raises taxes. Tax evasion is unethical if the taxes for all citizens are equal; no exceptions for special interest groups. Evasion is ethical if there is waste or fraud by corrupt politicians.
- Tax evasion is never ethical.
- The government is a bunch of thieves. When someone evades taxes it is like a thief stealing from a thief.
- Tax evasion is ethical if the funds are used to violate the human rights of citizens

As can be seen, the reasons given for evading or not evading taxes vary widely. Some of the respondents were internally inconsistent in their reasoning.

One issue that popped up if one reads between the lines is whether the issue of the ethics of tax evasion can be determined on majoritarian grounds. In other words, does the ethics of something depend on what the majority thinks? What if the majority changes it mind, as is so often the case? Can tax evasion be justified in one society but not in another merely because evasion is considered unethical by 51% of the population of Country X while only 49% of the people in Country Y consider it to be unethical? Space does not permit a full discussion of this point. However, this point has been discussed elsewhere (McGee 2004), so there is no need to provide a full discussion here.

H3: Business students will be significantly less opposed to tax evasion than will law students, the rationale being that law student will have more respect for the law and thus will be less inclined to break the law. For purposes of this hypothesis, significance is defined as business students having lower scores than law students for at least 12 of the 18 statements.

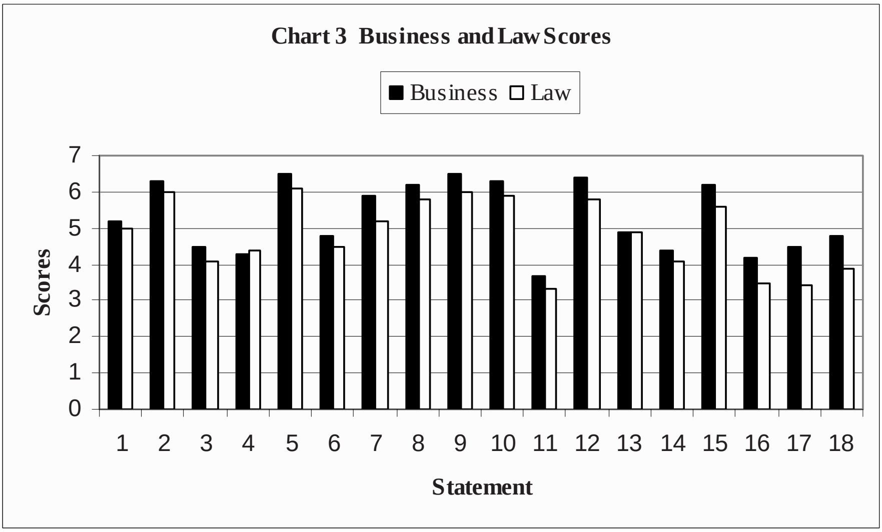
H3: Rejected.

Table 5 compares the scores of business and law students. The average score for business students was larger than the average score for law students for 16 of the 18 statements. Law students had a slightly higher score in one case and in one case the scores were identical. In other words, business students almost always thought that tax evasion was more unethical than did the law students.

Table 5
Comparison of Business & Law Student Scores

Stmt. #	Business students average score	Law students average score	Score larger by Bus.	Score larger by Law
1	5.2	5.0	0.2	
2	6.3	6.0	0.3	
3	4.5	4.1	0.4	
4	4.3	4.4		0.1
5	6.5	6.1	0.4	
6	4.8	4.5	0.3	
7	5.9	5.2	0.7	
8	6.2	5.8	0.4	
9	6.5	6.0	0.5	
10	6.3	5.9	0.4	
11	3.7	3.3	0.4	
12	6.4	5.8	0.6	
13	4.9	4.9		
14	4.4	4.1	0.3	
15	6.2	5.6	0.6	
16	4.2	3.5	0.7	
17	4.5	3.4	1.1	
18	4.8	3.9	0.9	
Avg.	5.3	4.9		

Chart 3 compares the scores of business and law respondents.



There are several ways to define or measure significance. Probability theory could also be applied to these numbers. The probability of getting heads 16 times on 18 flips of a coin is almost zero if one is using a fair coin. Yet that is the number of times that business respondents had higher scores than law respondents.

One could also do comparisons of individual statement scores. Table 6 shows the results for the six statements having the most significant difference in scores.

Table 6
Statistical Significance of Selected
Business and Law Student Responses

S#		t	SD	Probability assuming null hypothesis
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	–2.18	1.42	0.032
12	Tax evasion is ethical if the probability of getting caught is low.	–2.01	1.25	0.047
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	–1.88	1.42	0.063
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	–1.81	2.41	0.073
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	–1.29	1.34	0.200
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	–1.24	2.60	0.218

H4: Female respondents will be significantly more opposed to tax evasion (their scores will be higher) than will male respondents. Significance for purposes of this hypothesis is defined as having higher scores for at least 12 of the 18 statements.

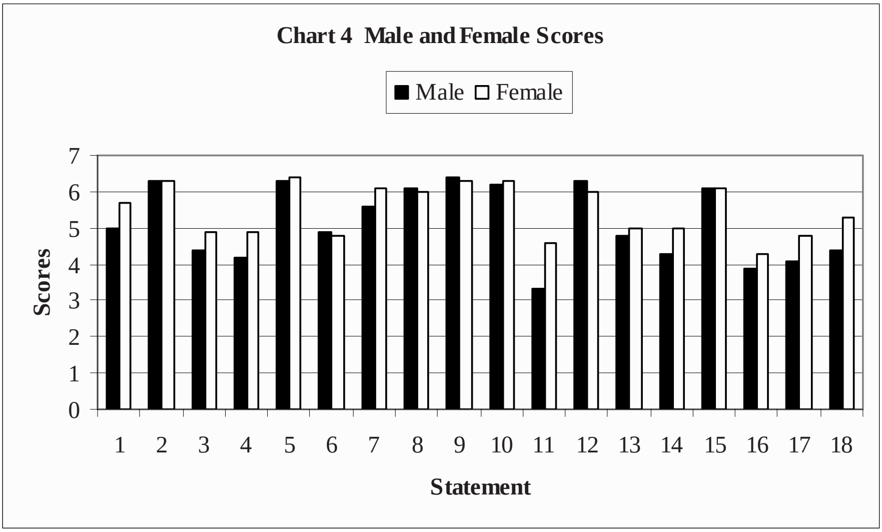
H4: Accepted.

Table 7 compares the scores of male and female respondents. Female scores were higher in 12 cases, compared to 4 cases where male scores were higher. In two cases the scores were identical. In other words, the females in the sample had stronger opinions that tax evasion is unethical in most cases.

Table 7
Comparison of Male and Female Scores

Stmt. #	Male respondents average score	Female respondents average score	Score larger by	
			Male	Female
1	5.0	5.7		0.7
2	6.3	6.3		
3	4.4	4.9		0.5
4	4.2	4.9		0.7
5	6.3	6.4		0.1
6	4.9	4.8	0.1	
7	5.6	6.1		0.5
8	6.1	6.0	0.1	
9	6.4	6.3	0.1	
10	6.2	6.3		0.1
11	3.3	4.6		1.1
12	6.3	6.0	0.3	
13	4.8	5.0		0.2
14	4.3	5.0		0.7
15	6.1	6.1		
16	3.9	4.3		0.4
17	4.1	4.8		0.7
18	4.4	5.3		0.9

Chart 4 illustrates the comparison of male and female scores.



Statistical analysis can also be used to measure the significance of differences in responses. Table 8 lists statistical information about the six statements that had the highest degree of statistical difference.

Table 8
Statistical Significance of Selected
Male and Female Responses

S#		t	SD	Probability assuming null hypothesis
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	–2.67	2.39	0.009
18	Tax evasion is ethical if the government imprisons people for their political opinions.	–1.81	2.37	0.074
1	Tax evasion is ethical if tax rates are too high.	–1.77	2.09	0.079
4	Tax evasion is ethical if a large portion of the money collected is wasted.	–1.54	2.32	0.127
14	Tax evasion is ethical if I can't afford to pay.	–1.37	2.29	0.173
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	–1.37	2.44	0.175

Concluding Comments

The purpose of this survey was not to determine whether tax evasion is ethical or unethical on the basis of majority opinion, but rather to learn the views of the future opinion leaders of Guatemala. That purpose was accomplished. The future opinion leaders of Guatemala believe that tax evasion is unethical most of the time but not all of the time. The moral argument for evasion is stronger in cases where the tax system is perceived to be unfair, where there is corruption or where the government engages in human rights abuses. Eighteen arguments that have been used historically to justify evasion were included in a survey and the strengths of those arguments were ranked. Although none of the arguments proved to be strong, some were stronger than others.

The survey also revealed that at least some of the respondents arrived at their conclusions without much thought, judging from the scores they assigned to some of the statements. Those who assigned a score of 7 to every statement believe that tax evasion is never ethically justified, even if the proceeds were used to exterminate a portion of the taxpaying population and even if the subset of the population that is to be exterminated also pays taxes. Such a position is untenable philosophically, although it is apparently held by some religious groups, judging from the scant religious literature on this point. It could not be determined whether respondents arrived at their conclusions because of religious beliefs or for some other, nonreligious reasons. In many cases, respondents probably included religious beliefs along with nonreligious beliefs when determining what score to assign to each statement.

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26

A Study of Tax Evasion Ethics in Kazakhstan

Robert W. McGee and Galina G. Preobragenskaya

Introduction

In 1944, Martin Crowe, a Catholic priest, wrote a doctoral dissertation titled *The Moral Obligation of Paying Just Taxes*. His dissertation summarized and analyzed 500 years of theological and philosophical debate on this topic, which identified three basic philosophical positions on the issue. Since Crowe's dissertation, not much has been written on the topic of tax evasion from an ethical or religious perspective.

The present paper is an empirical study, the goal of which is to determine the strength of the 15 arguments justifying tax evasion that Crowe identified plus 3 more recent arguments. A survey was constructed using a seven-point Likert scale that included all three positions and all 18 arguments and distributed to 79 business students in Kazakhstan. The 18 arguments were ranked in terms of strength, from strongest to weakest. Comparisons were also made according to major and gender to determine if the viewpoints for these demographics were significantly different.

Review of the Literature

At least two major studies have been done on the ethics of tax evasion. The earliest and most comprehensive twentieth century work was a doctoral thesis written by Martin Crowe (1944), titled *The Moral Obligation of Paying Just Taxes*. This thesis reviewed the theological and philosophical debate that had been going on, mostly within the Catholic Church, over the previous 500 years. Some of the debate took place in the Latin language. A more recent doctoral dissertation on the topic was written by Torgler (2003), who discussed tax evasion from the perspective of public finance but also touched on some psychological and philosophical aspects of the issue. Inglehart et al. (2004) did a huge study that collected the views of more than 200,000 people

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from more than 80 countries on several hundred questions, one of which was tax evasion. McGee (1998) edited a book that contained more than 20 papers looking at tax evasion from various country and religious perspectives.

More recently, a number of authors have done empirical studies that examine tax evasion from the perspective of ethics. Those studies used a survey instrument that was based on the arguments Crowe (1944) discussed to justify tax evasion over the last 500 years. McGee and Cohn (2006) surveyed the views of Orthodox Jews. The views of international business academics (McGee 2005a) and various groups in Romania (McGee 2005b), Argentina (McGee and Rossi 2006), Dominican Republic (McGee et al. 2007), Guatemala (McGee and Lingle 2005), Puerto Rico (McGee and López 2007), Ecuador (McGee et al. 2007), Colombia (McGee et al. 2007), Bosnia (McGee et al. 2006), Ukraine (Nasadyuk and McGee 2006), Estonia (McGee et al. 2007), Australia (McGee and Bose 2007), Armenia (McGee and Maranjyan 2006), Germany (McGee et al. 2006), France (McGee and M'Zali 2007), Thailand (McGee 2006), Poland (McGee and Bernal 2006), Hong Kong (McGee and Ho 2006), Macau (McGee et al. 2006), Taiwan (McGee and Andres 2007) and China (McGee and Noronha 2007; McGee and An 2006; McGee and Guo 2006) have used survey instruments similar to the one used in this study. The present study replicates these studies using Kazakhstan as a case study.

Survey Results

Methodology

A survey instrument similar to that used in the other studies mentioned above was used to solicit the views of students in Kazakhstan on the ethics of tax evasion. The survey consisted of 18 statements that include the major arguments Crowe (1944) discussed plus three more modern arguments dealing with human rights abuses. Each statement generally began with the phrase "Tax evasion is ethical if…." Respondents were instructed to insert a number from 1 to 7 in the space provided to reflect the extent of their agreement or disagreement with each of the 18 statements. A score of one (1) represented strong agreement with the statement, while a score of seven (7) represented strong disagreement.

The survey was distributed to students at KIMEP, a western style university in Almaty, Kazakhstan. Seventy-nine (79) usable responses were collected. Data were compiled and examined based on major and gender.

Table 1 summarizes the demographic makeup of the sample.

Table 1
Demographics

Major	Sample	Gender	Sample
Accounting	32	Male	40
Business & Economics	37	Female	39
Other & Unknown	10		
		Total	79
Total	79		

Findings

Table 2 lists the 18 statements and shows the mean scores for each statement. The mean score for all 18 statements was 4.143, which, on a scale of 1 to 7 indicates a rather weak feeling that tax evasion is generally unethical. However, as Table 2 shows, some scores are higher than others, which indicates that some arguments to support tax evasion are stronger than others.

Table 2
Total Sample Mean Scores by Statement
(1 = strongly agree; 7 = strongly disagree)

Stmt. #	Statement	Score
1	Tax evasion is ethical if tax rates are too high.	4.127
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	4.835
3	Tax evasion is ethical if the tax system is unfair.	3.316
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.595
5	Tax evasion is ethical even if most of the money collected is spent wisely.	4.734
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.291
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	4.304
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	4.481
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	4.949
10	Tax evasion is ethical if everyone is doing it.	4.987
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.253
12	Tax evasion is ethical if the probability of getting caught is low.	4.380
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3.760
14	Tax evasion is ethical if I can’t afford to pay.	3.582

15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.241
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	3.846
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.190
18	Tax evasion is ethical if the government imprisons people for their political opinions.	3.7
	Average Score	4.143

Ranking the Arguments

Table 3 ranks the arguments from strongest to weakest. The range is 3.190 to 5.241, which indicates that there is widespread support for the position that tax evasion is ethical in some circumstances.

Table 3
Statements Ranked from Strongest to Weakest Arguments Support Tax Evasion
(1 = strongly agree; 7 = strongly disagree)

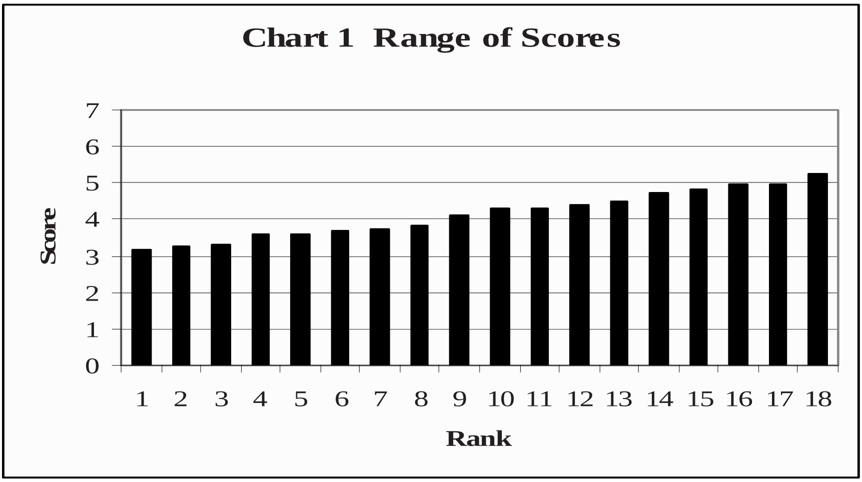
Rank	Statement	Score
1	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.190
2	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.253
3	Tax evasion is ethical if the tax system is unfair.	3.316
4	Tax evasion is ethical if I can't afford to pay.	3.582
5	Tax evasion is ethical if a large portion of the money collected is wasted.	3.595
6	Tax evasion is ethical if the government imprisons people for their political opinions.	3.7
7	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3.760
8	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	3.846
9	Tax evasion is ethical if tax rates are too high.	4.127
10	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.291
11	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	4.304
12	Tax evasion is ethical if the probability of getting caught is low.	4.380
13	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	4.481

14	Tax evasion is ethical even if most of the money collected is spent wisely.	4.734
15	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	4.835
16	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	4.949
17	Tax evasion is ethical if everyone is doing it.	4.987
18	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.241

The strongest argument was in cases where the government discriminates against the taxpayer because of religion, race or ethnic background. The second strongest argument was where a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. Other strong arguments were for cases where the system was perceived as being unfair, where there is inability to pay, where funds are wasted or where the government engages in human rights abuses.

The weakest arguments justifying tax evasion were in cases where others must pay more if the evader pays less, where everyone is doing it, where the taxpayer receives benefits for taxes paid or when there is a perception that the government is not entitled to take as much as it is taking.

Chart 1 shows the range of scores for the 18 statements.



Gender Differences

Some studies in gender ethics have found that women are more ethical than men (Akaah & Riordan 1989; Baird 1980; Brown and Choong 2005; Sims et al. 1996), while other studies found that there is no statistical difference between men and women when it comes to ethics (Roxas and Stoneback 2004; Sikula and Costa 1994; Swaidan et al. 2006). A few studies have found that men are more ethical than women (Barnett and Karson 1987; Weeks et al. 1999).

A few studies have compared the views of men and women on the ethics of tax evasion. The findings of these studies are mixed. Studies of international business professors (McGee 2005a), people in Thailand (McGee 2006), Puerto Rico (McGee and López 2007), Guatemala (McGee and Lingle 2005), Colombia (McGee et al. 2007), China (McGee and Guo 2006), Taiwan (McGee and Andres 2007), Estonia (McGee et al. 2007) and Orthodox Jews (McGee and Cohn 2006) found women to be more opposed to tax evasion, whereas studies of Argentina (McGee and Rossi 2006), the Dominican Republic (McGee et al. 2007), Ecuador (McGee et al. 2007), Poland (McGee and Bernal 2006), Ukraine (Nasadyuk and McGee 2006), Hong Kong (McGee and Ho 2006), Macau (McGee et al. 2006), China (McGee and Noronha 2007; McGee and An 2006) and Australia (McGee and Bose 2007) found no significant difference based on gender. A study of Romania (McGee 2005b) found that men were more opposed to tax evasion than were women.

It was thought that comparing the male and female scores would be interesting for purposes of the present study, although the comparison could not lead to any conclusion regarding the relative ethics of men and women. The only conclusion that could be drawn would be that one group might be more opposed to tax evasion.

Table 4 shows the scores for each statement broken down by gender. The average male score was 4.112, compared to 4.174 for females, indicating that females were, on average, more opposed to tax evasion. Female scores were higher than male scores for all 10 statements. Wilcoxon tests found that none of the differences were statistically significant.

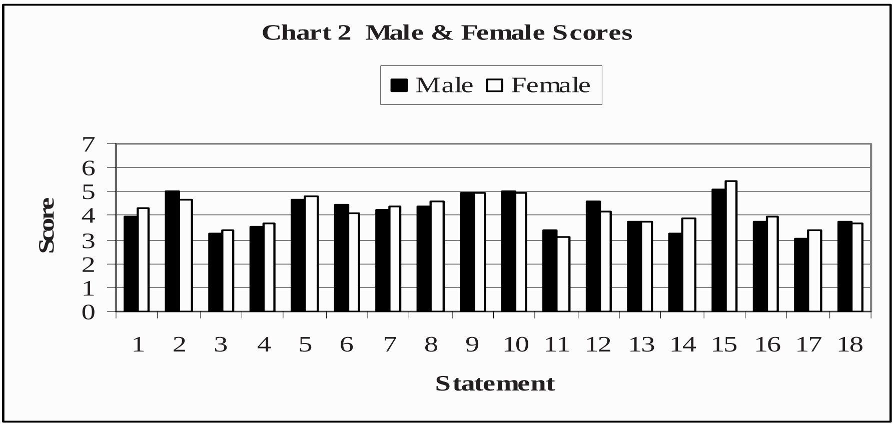
Table 4
Comparison of Male and Female Scores
(1 = strongly agree; 7 = strongly disagree)

Stmt. #	Statement	Male	Female	Score larger by Male	Score larger by Female	p value
1	Tax evasion is ethical if tax rates are too high.	3.925	4.333		0.408	0.3618
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	5.025	4.641	0.384		0.2433
3	Tax evasion is ethical if the tax system is unfair.	3.225	3.410		0.185	0.833

4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.525	3.667		0.142	0.8947
5	Tax evasion is ethical even if most of the money collected is spent wisely.	4.675	4.795		0.12	0.8599
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.475	4.103	3.731		0.3317
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	4.25	4.359		0.109	0.795
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	4.4	4.564		0.164	0.5432
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	4.95	4.949	0.001		0.75
10	Tax evasion is ethical if everyone is doing it.	5	4.974	0.026		0.8216
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.4	3.103	0.297		0.4018
12	Tax evasion is ethical if the probability of getting caught is low.	4.575	4.179	0.396		0.2742
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3.775	3.744	0.031		0.9765
14	Tax evasion is ethical if I can’t afford to pay.	3.275	3.897		0.622	0.1856

15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.075	5.410		0.335	0.7241
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	3.718	3.974		0.256	0.5757
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.025	3.359		0.334	0.5897
18	Tax evasion is ethical if the government imprisons people for their political opinions.	3.725	3.667	0.058		0.9024
	Average Score	4.112	4.174		0.062	

Chart 2 compares and male and female scores.



Comparisons by Major

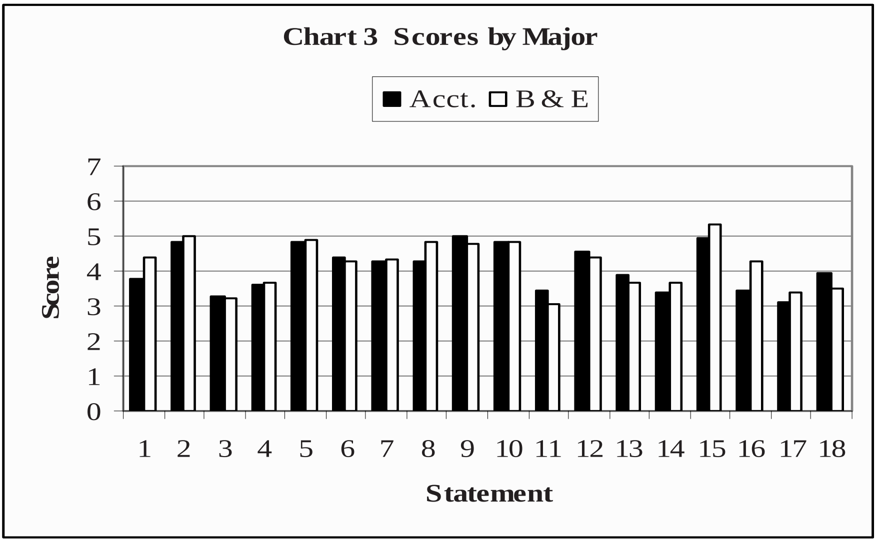
Table 5 shows the scores broken down by major. The average score for accounting majors was 4.103. The average for business and economics majors was 4.192. A Wilcoxon test was performed comparing accounting majors to business and economics majors to determine whether the differences in scores were significant. The results of that test are reported in Table 5. The differences were not significant for any of the 18 statements.

Table 5
Comparison of Student Scores by Major
(1 = strongly agree; 7 = strongly disagree)

Stmt. #	Statement	Acct.	B & E	Score larger by Acct.	Score larger by B & E	p value
1	Tax evasion is ethical if tax rates are too high.	3.781	4.405		0.624	0.1471
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	4.844	5.027		0.183	0.759
3	Tax evasion is ethical if the tax system is unfair.	3.281	3.216	0.065		0.7002
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.594	3.649		0.055	0.9616
5	Tax evasion is ethical even if most of the money collected is spent wisely.	4.813	4.865		0.052	0.909
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.406	4.270	0.136		0.6649
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	4.281	4.324		0.043	0.909
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	4.281	4.811		0.53	0.1574
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5	4.784	0.216		0.871

10	Tax evasion is ethical if everyone is doing it.	4.813	4.811	0.002		0.8098
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.469	3.081	0.388		0.3732
12	Tax evasion is ethical if the probability of getting caught is low.	4.531	4.405	0.126		0.7226
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3.901	3.676	0.225		0.6303
14	Tax evasion is ethical if I can't afford to pay.	3.375	3.649		0.274	0.6825
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	4.938	5.351		0.413	0.3896
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	3.452	4.270		0.818	0.1054
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.125	3.378		0.253	0.626
18	Tax evasion is ethical if the government imprisons people for their political opinions.	3.969	3.486	0.483		0.2869
	Average Score	4.103	4.192		0.089	

Chart 3 compares scores by major.



Concluding Comments

This study examined the strength of the various arguments that have been used over the last five centuries to justify tax evasion on ethical or philosophical grounds. The survey found that there is wide philosophical support for tax evasion in certain cases and that some arguments to justify tax evasion are stronger than others. As a general rule, one might say that tax evasion is seen as more justifiable if the government is corrupt, wasteful, if the tax system is considered to be unjust or if the government engages in human rights abuses. Tax evasion might also be justified by some people if the tax rates are too high or if the taxpayer is unable to pay. Many of these arguments have a long history in the philosophical and theological literature. The weakest arguments were in cases where taxpayers receive something in return for their money or where the tax funds are spent wisely.

The findings of the present study are similar to those of some other studies that were conducted using a similar survey instrument. The finding that both genders view tax evasion as equally ethical or unethical agrees with the findings of studies of Argentina (McGee and Rossi 2006), the Dominican Republic (McGee et al. 2007), Ecuador (McGee et al. 2007), China (McGee and Noronha 2007; McGee and An 2006), Hong Kong (McGee and Ho 2006), Macau (McGee et al. 2006), Poland (McGee and Bernal 2006), Ukraine (Nasadyuk and McGee 2006) and Australia (McGee and Bose 2007) but disagrees with the findings of Guatemala (McGee and Lingle 2005), Puerto Rico (McGee and López 2007), Colombia (McGee et al. 2007), Thailand (McGee 2006), China (McGee and Guo 2006), Taiwan (McGee and Andres

2007), Romania (McGee 2005b), Estonia (McGee et al. 2007), Orthodox Jews (McGee and Cohn 2006) and international business professors (McGee 2005a). More research is needed to determine why there are gender differences in some countries and for some segments of the general population but not for others.

These findings have policy implications. If a government wants to reduce the extent of tax evasion in the economy, it must eliminate the moral justifications for tax evasion. It must not oppress the people, it must provide services in exchange for the funds collected, it must keep tax rates low and it must have a tax system that is widely perceived as fair.

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27

Attitudes Toward Tax Evasion in Mali

Robert W. McGee and Bouchra M'Zali

Introduction

Most studies on tax evasion have taken either an economics or public finance perspective. Not many studies have investigated tax evasion from the perspective of ethics. One exception is a 1944 doctoral dissertation by Martin Crowe (1944), a Catholic priest who examined the Christian (mostly Catholic) theological and philosophical literature of the past 500 years. His study identified a number of arguments that have been used to justify tax evasion over the centuries.

The present study used a survey instrument that includes 15 of those historical arguments, plus 3 newer arguments, and distributed it to a group of Executive MBA students in Mali, a country in West Africa to determine the extent of support for the various arguments that have been made over the past 500 years using a seven-point Likert scale. The arguments are then ranked from strongest to weakest. This study replicates the studies listed in the references section.

Methodology

The survey instrument used in the present study is similar to the instrument used in the studies listed in the reference section. That survey instrument consisted of 18 statements based on the 15 arguments favoring tax evasion that Martin Crowe (1944) discussed plus three more modern arguments dealing with human rights issues. The instrument used a seven-point Likert scale. Each statement began with the phrase, "Tax evasion is ethical if…"

The survey was distributed to Executive MBA students in Mali. The sample included a total of 25 participants, 15 males, 9 females and 1 unknown. The sample size was too small to conduct any tests of significance for gender. However, it was sufficiently large to get some idea of the support for tax evasion.

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Survey Findings

Table 1 shows the average scores for each of the 18 statements.

Table 1
Average Scores
(1 = strongly agree; 7 = strongly disagree)

Stmt. #	Statement	Scores
1	Tax evasion is ethical if tax rates are too high.	4.521739
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	5.478261
3	Tax evasion is ethical if the tax system is unfair.	3.833333
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.608696
5	Tax evasion is ethical even if most of the money collected is spent wisely.	4.826087
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.347826
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.083333
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.791667
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.521739
10	Tax evasion is ethical if everyone is doing it.	5.173913
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.782609
12	Tax evasion is ethical if the probability of getting caught is low.	5.26087
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.565217
14	Tax evasion is ethical if I can't afford to pay.	4.954545
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.454545
16	Tax evasion would is ethical if I were a Jew living in Nazi Germany in 1940.	3.727273
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.090909
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.090909
	Average	4.728526

Table 2 shows the ranking of the various arguments that have been used to justify tax evasion over the centuries. The survey revealed that there is widespread support for tax evasion and that some arguments supporting tax evasion are stronger than others. The strongest argument received a score of 3.61 on a scale of 1 to 7. None of the 18 arguments received a score of 6.0 or higher, indicating weak disagreement with the statements.

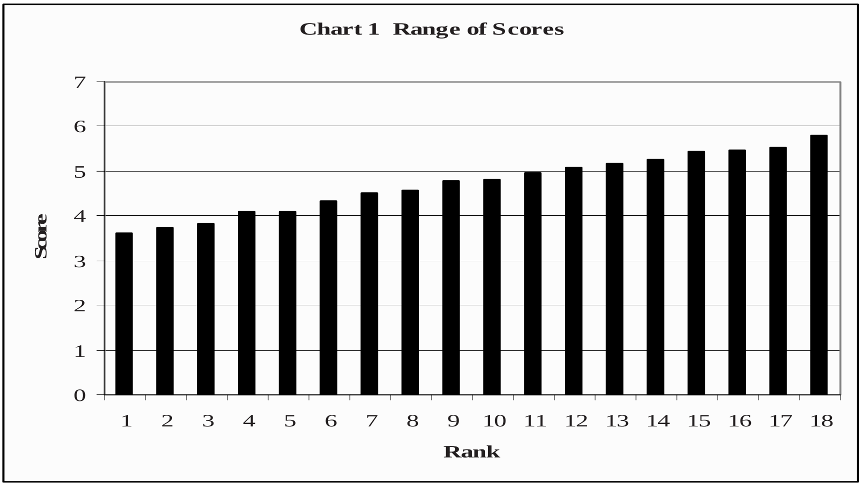
Table 2
Arguments Ranked from Strongest to Weakest Supporting Tax Evasion
(1 = strongly agree; 7 = strongly disagree)

Rank	Statement	Score
1	Tax evasion is ethical if a large portion of the money collected is wasted.	3.608696
2	Tax evasion is ethical if I were a Jew living in Nazi Germany in 1940.	3.727273
3	Tax evasion is ethical if the tax system is unfair.	3.833333
4	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.090909
4	Tax evasion is ethical if the government imprisons people for their political opinions.	4.090909
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.347826
7	Tax evasion is ethical if tax rates are too high.	4.521739
8	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.565217
9	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.782609
10	Tax evasion is ethical even if most of the money collected is spent wisely.	4.826087
11	Tax evasion is ethical if I can’t afford to pay.	4.954545
12	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.083333
13	Tax evasion is ethical if everyone is doing it.	5.173913
14	Tax evasion is ethical if the probability of getting caught is low.	5.26087
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.454545
16	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	5.478261
17	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.521739
18	Tax evasion is not unethical if a large portion of the money collected is spent on projects that do not benefit me.	5.791667

The strongest argument supporting tax evasion is in cases where a large portion of the funds collected is wasted. Other strong arguments included the case of Jews living in Nazi Germany, the perception that the tax system is unfair, where the government discriminates on the basis of religion, race or ethnic background, where the government imprisons people for their political opinions or when a large portion of the funds collected is spent on projects the taxpayer disapproves of.

The weakest arguments for tax evasion were in cases where a large portion of the funds are spent on projects that do not benefit the taxpayer, a large portion of the funds collected are spent on projects that do benefit the taxpayer, where it is perceived that the government is not entitled to take so much money, where others must pay more because the taxpayer pays less, where the probability of getting caught is low or where everyone is evading taxes.

Chart 1 shows the range of scores. None of the scores are more than 6, indicating a strong belief that tax evasion can be ethical under most circumstances.



Concluding Comments

Mali is a small, landlocked country in western Africa. It has a population of about 12 million (CIA 2007). Transparency International conducts annual surveys of corruption in dozens of countries and Mali does not fare too well. According to the most recent survey, firms meet with tax officials an average of 6.87 days per year in Mali, compared to an average of 3.8 days for all countries included in the survey. There is a more than 30% chance that company officials are expected to give gifts to tax inspectors when they visit the company, which is 50% higher than the rate for the region. Companies only report about 74% of total sales on their tax returns. In other words, citizens of Mali expect their tax officials to be corrupt and they are not exceedingly averse to evading taxes.

The present study confirms that belief. Even the more educated class—Executive MBA students—do not believe that evading taxes presents moral problems, at least in many cases. The strongest argument opposing tax evasion scored only 5.79 on a scale of 1 to 7 and the average score for all 18 statements was 4.73, indicating widespread support for tax evasion.

These findings have policy implications. If governments want to collect a higher percentage of taxes that are legally owed they must change the perceptions of their taxpaying citizenry. They must spend funds wisely. They must not be corrupt and the tax system must be perceived as fair. Until these changes take place, the views toward tax evasion will not change.

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Transparency International www.transparencyinternational.com.

28

Pension Reform in Romania: How Far Should It Go?

Oana Diaconu

Introduction

The Romanian government intends to reform pensions along a multi-pillar system by introducing, in addition to the state funded pillar, two private pillars: a mandatory private component (second pillar) and a voluntary private component (third pillar). The government has submitted to the Parliament a draft law on the third pillar and it is currently working on the second pillar legislation. However, the proposed legislation raises a number of issues regarding the most effective way of introducing, regulating and stimulating the private pension market in a transition country.

All the Romanian governments starting with 1996 had plans to reform the pension system. They have acknowledged that the current system, with one of the lowest replacement rates in Europe, less than 30%,[1] cannot provide old age protection for an aging population and raises serious equity issues. There is less awareness of the looming demographic crisis that will hit the pay as you go system around 2030, when a large bulk of the Romanian population will retire.

The poor performance of the current PYGO system in Romania is due to an array of factors. The Romanian government used retirement as a form of social protection for the unemployed. As a result the effective retirement age in the past 15 years has been around 55 (Seitan 2004) and the number of retirees has increased in the same period from 3.4 to 5.7 million, a 70% increase. Moreover, the state has allowed the large state owned enterprises to reschedule the payment of their social security contributions in a country with a relatively large underground economy that does not contribute to the social security budget. The financial problems of old age benefits in Romania have been compounded by the fact that the Romanian Social Security budget includes not only old age pensions but also other benefits like maternity, sick

[1] From the gross wage. The replacement rate in the net wage is 37.2.

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leave, child raising and death benefits.[2] In order to meet its obligations with a shrinking revenue base the government had to impose very high contribution rates and to provide very low replacement ratios to retirees. In 2004 the contributions to social security in Romania were among the highest in Europe, adding up to 49.5%[3] of the gross wage. The high level of payroll taxes has driven a larger part of the labor force into the unofficial sector and has increased tax avoidance among the employees in the official sector.[4]

In 2004 the expenditures side of the Social Security budget represented 7.3% of GDP, and the budget ran a small deficit of 0.73% of GPD. Although the system is not yet in crisis, this is mainly due to the modest benefits it confers to the retiree and to the other assisted categories.

Table 1 Social Security in Romania

GDP (2004) mill. Euros	58,214
Population (2004) mill.	21,685
Number of employee (Sept. 2005) mill.	4,554
Number of retirees* (Sept. 2005)	4,613
Social Security dependency ratio (Sept. 2005)	1.01
Average monthly wage in euros (Sept. 2005)	271
Average monthly pension in euros (Sept. 2005)	78
Replacement ratio (Sept. 2005)	0.29
Social Security Expenditures as % GDP (2004)	7.24
Social Security Income as % GDP (2004)	6.50
Deficit Social Security Budget mill. euros (2004)	429.04

*The number does not include about 1.1 retirees from agriculture whose pensions have been paid from the general budget since January 2005
Source: CNPAS (2005)

However, there are a series of demographic developments that pose a different, significant threat, to the future of state funded pensions in Romania. The old age dependency in Romania, of 46.1 in 2004[5] is comparable to that of other Central and Eastern European Countries (SSA 2004). The Romanian population is expected to age rapidly, and the old age dependency ratio is expected to reach about 50% in 2050, above the European average (Vasile and Uegaki 2003). Besides an aging process common to all European

[2] Part of these benefits will be divested in the near future.
[3] Contributions to all social security programs. Contribution to old age, disability and survivors were 29.5%.
[4] According to my estimates revenue collection for the social security contributions is about 75%.
[5] Population aged 14 and under plus population aged 65 or older, divided by population aged 14–64.

countries, caused mainly by decreases in fertility associated with increases in life expectancy, Romania has a particular demographic situation due to the legacy of the pro-birth policies of Ceausescu's regime.

Initiated in 1966, the strict pro-birth policies generated a very high birth rate until the mid 1980s. The birth rate was 27 per 1,000 inhabitants in 1967, 18–20 afterwards until the mid 1980s, compared to 14.3 in 1966. We can talk about a baby boom taking place between 1966 and 1990. The birth rate collapsed to 13.6 in 1990 and reached 9.8 in 2003. As a result the population aged between 15 and 36 in 2004 represents the bulk of Romania's population and will start retiring around 2030. Unless it is reformed, the PYGO system will not be able to sustain this population shock coupled with the underlying aging process.

In 2000 a new law on social security, (Law 19/2000) has attempted to shore up the public pension system. The law attempted to increase the coverage of the Romanian labor force, raised the standard retirement age gradually until 2014, from 55 to 60 for women and from 60 to 65 for men. The minimum contribution period was scheduled to increase in the same interval from 10 to 15 years. The law also introduced a new formula for pension calculation based on a system of points and the possibility of early retirement. Besides, it reduced some of the retirement privileges linked to early retirement from specific jobs, and updated the system of granting disability pensions.

However, both the former and current government acknowledged that these were short term measures that have to be complemented by a long term strategy for pension reform. The long term strategy envisioned would introduce a multi pillar system, comprised of three pillars: a public pillar, a mandatory private and a voluntary private pillar complemented with some state funded social assistance for special categories of people.

Multipillar Legislation in Romania

The first steps in introducing private pensions in Romania were taken in 2004 when the Parliament adopted two highly criticized laws: the law of occupational pensions and the law on privately managed pension funds. The first law was supposed to take effect in 2005 and the second one in 2008. However, the legislation on the occupational pension fund was so cumbersome, so unfriendly to the market and provided so little benefits to the participants that it was completely unworkable.

The new center-right government decided to re-draw the legislation of both pillars in a more market friendly approach. Meanwhile, the regulator of the private pensions market, The Supervision Commission of the Private

Pension System (henceforth the Commission) was legally created in June 2005. The Commission is an independent entity, under the control of the Parliament, which will regulate, coordinate and supervise the private pension market in Romania. The set up of the Commission will be financed through a World Bank loan. The Commission will later finance its activities from the fees perceived to the private administrators.

After months of discussions with the insurance and asset management companies, with unions and other stakeholders, a draft law on Voluntary Pensions was submitted to the Parliament in November 2005. The new law replaces the occupational private pensions with voluntary private pensions. In other words it allows employees to contribute to a private pension fund independent of the decision of the employers or unions. However, the draft law allows only the contributors who are enrolled in the Public social security system to contribute to the voluntary pension funds and it sidesteps dealing with the categories that do not pay social security contributions.

Employers have to pay the contributions to the pension fund chosen by the employee. The law gives employers and unions the right to propose pension schemes to the employees. The pension funds can be administered by newly created pension companies, by asset management companies or by insurance companies. All of them have to be authorized by the Commission. The funds of the asset management and insurance companies have to be managed and organized separately, without the possibility of transfer. The administrators need to have a depositary that cannot be affiliated to the employer or to the administrator.

During the process of drafting the law there was a heated debate between the asset management and insurance industry on one side and the government on the other side with respect to treating other savings instruments that could have qualified as retirement plans as contributions to the voluntary pensions (and allowing them to receive similar fiscal treatment). That proposal was rejected repeatedly not only by the government but also by the political class. It is likely that Romania, for the time being, is not ready, due to political and budgetary reasons, to adopt legislation that allows a wider range of retirement savings on the voluntary pension market.

The contribution to a pension fund cannot exceed 15% of the gross wage. For the employee the contribution that is deductible from the gross wage cannot exceed 200 euros per year. If the employers are making contributions for the employer the maximum deductible amount is also 200 euros per year.

Investment income and capital gains of the pension fund are not taxed and benefits will be subject to taxation. The law places some restrictions on the investments of the fund’s assets. The assets cannot be invested, for example, in art objects, vehicles or real estate. The law regulates the maximum percentage of the fund’s assets that can be invested in different types of assets: monetary instruments (20%); treasury titles issued by the

Romanian Ministry of Finance or by EU or EEC[6] members (70%); bonds issued by local government entities from Romania or EU/EEC entities (30%); shares from the official markets of Romania or EU/EEC member states (50%); treasury bills issues by other states than EU or EEC member states (15%); bonds issued by local governments of states other than the EU or EEC member states (10%); private bonds (5%); shares in investment funds (5%).

With respect to investment returns, the final draft of the law gave up requiring an absolute return guarantee on the assets.[7] However, the provision has supporters, especially among the unions and left wing parties and may re-appear in the law once debated in the Parliament. What is left in the draft law is a relative return guarantee: the return of a given fund has to be above a minimum return rate calculated for all funds (which is the lesser of the weighted average of all funds minus 4 percentage points and 50% of the weighted average of all funds).

The fees that administrators can charge to the participants are capped. The administration fees consist of two deductions: a fee assessed on the contributions that cannot exceed 5% and a fee on the net assets of the pension funds but no more than 2.4% per year. The caps are however considerably higher compared to the initial proposal of the legislature.

The Draft law requires the providers to set aside technical provisions to the extent they choose to provide either guarantees with respect to asset return and the level of benefits or risk protection to the participants. In order to guarantee the protection of participant's savings against inadequate administration the Draft Law also requires the providers to contribute to a Guarantee Fund, constituted at the industry level. The level of contributions is not specified in the law. At the proposal of the Administrative Committee of the fund, comprised of representatives of the administrators, the Commission authorizes the level and the frequency of the contributions.

The law introduces a series of stipulations that will take effect after Romania becomes an EU member. For example any administrator authorized in the EU/EEC[8] can administer a pension fund in Romania. In other words, authorization in an EU/EEC member state waives the obligation of a pension fund administrator to obtain authorization in Romania. Romanian pension fund administrators can receive contributions from participants from other member states and eligible Romanian citizens can contribute to funds located

[6] European Economic Space (includes Norway, Iceland and Liechtenstein in addition to EU countries)
[7] In the initial proposal there was a zero real annual return that had to be guaranteed by the administrator. In other words the administrator had to guarantee the contributions adjusted for inflation at the end of the pay out period.
[8] European Economic Community.

in other EU/EEC countries. A Romanian administrator, who wants to receive contributions from abroad needs, however, to be authorized by the Commission. The Commission will regulate these transfers in the EU or EES by notifying the supervision authority from these states or requesting information from these authorities. The attempt to regulate the inflows and outflows of contributions from/to EU member states described by the law seems cumbersome and most likely unfeasible.

A law regulating the pay-out phase of the system has to be adopted in three years from the adoption of the present draft law. The government hopes that the law will be adopted in early 2006 and will become effective by mid 2006. In 2006 the government estimates that 300,000 participants will contribute about 50 million euros to the market and 500,000 participants will contribute about 100 million euros in 2007. These expectations are not very realistic given that the Commission has to be organized, has to hire and train its personnel and to elaborate a large amount of secondary legislation.

The government is also working on the second pillar legislation that will amend the law on privately managed pension funds, adopted in 2004. The draft law has not yet been made public but the government wants it discussed and adopted as soon as possible. The government aims to introduce the mandatory private pillar starting with 2008.

Issues Raised by the Proposed Legislation

Romania needs a system of laws that will provide effective and sustainable old age protection for the majority of the population. In order to achieve this general objective the new legislation on voluntary saving pensions has to stimulate providers to develop the market, to increase the voluntary retirement savings in the population and to significantly enlarge the base of participants.

However, the success of the voluntary pension legislation hinges on a number of issues some of which concern the general strategy and the regulatory approach taken by the reform while others concern the provisions of the draft law with respect to participants, investments, fiscal incentives, guarantees etc. I will discuss some of them next.

First, voluntary pension legislation has to develop within a coherent and sound multipillar framework. This framework has to rigorously delineate the scope, the functions of each pillar and the way in which all the pillars will interact. Although the third pillar legislation is politically easier to deal with than with the proposals to “privatize” the state pensions, the success of the third pillar depends essentially on how the second pillar and the first pillar will be structured or modified in the future.

Second, in general, it is not yet acknowledged by the Romanian legislators that the third pillar is based on different principles than the first two mandatory pillars. The objective of this pillar is to offer the participants maximum flexibility with respect to selecting the type of retirement assets most appropriate to their personal needs and thus to encourage them to save voluntarily for old age. Given that participation in this pillar is based on individual choice and responsibility, the free choice of individuals on this market should not be restrained.

The legislature does not acknowledge that the limitation of people's choices for social protection reasons is not justified in this pillar as it will significantly hinder the working and the efficiency of the market. Unfortunately, the voluntary pensions draft law over-regulates the market and the supervision of the market relies heavily on the discretion of the bureaucratic apparatus that will supervise it. This approach is likely to impose a significant burden on the market, especially in a country like Romania, plagued by poor governance and corruption.

The specific provisions of the law, although rather common in the pension legislation of the region also raise some issues of concern. A positive feature in the development of the law was the fact that the legislature gave up imposing a zero real return guarantee on contributions at the end of the accumulation period, as it was initially proposed. Hopefully, the absolute return guarantee will not be reintroduced in the Parliament. Such guarantees are rarely used by regulators internationally, even in the mandatory pillar because they are costly to maintain and restrict the market. In Romania, a zero real return guarantee is not sustainable and would represent a serious burden for the providers and participants. The approach that the Draft Law took, that of imposing relative return guarantees, is more frequent and market friendly, although, its negative effects on the performances of the market are not negligible.

In general, there are several general important points to be made with respect to the issue of requiring the administrators to provide guarantees on the assets' return. First, there is no consensus among pension regulators world wide on what level of guarantees are appropriate in order to achieve the right balance between the protection of participants and the development and performances of the market. Second, while some guarantees may be desirable for the mandatory funded market, their rationale is less obvious for the voluntary private market. Individuals do not have the same risk preferences and allowing the market to accommodate different risk preferences may increase welfare and the overall level of voluntary savings.

Third, expenses are incurred in order to provide guarantees. These expenses are partially reflected in the amount of fees charged to participants and therefore reduce the assets available to the participants at retirement. Safety does not come for free. There is always a trade off between safety and the return that people will receive in the end on their savings. It is very difficult for the regulators to establish the optimum amount of safety that people want. Too much safety will squander the participants' resources.

Fifth, guarantees may induce the companies to offer risky investments in order to attract customers. When a given return is guaranteed to participants on accumulated contributions, especially a zero real return, there is no downside for individuals in gambling on riskier investment plans that have the potential to offer higher returns. The competition for customers among providers could drive the industry to become less reliable and costlier to supervise. Sixth, in countries where the financial markets are not mature, like Romania, some returns are not feasible or are extremely costly.

Theoretically, a stock and bond portfolio with that guarantees a zero real return, as it was required in the initial draft of the voluntary pension law in Romania, can be constructed by investing the contributions in combinations of long term bonds that are indexed for inflation and stock, for each age category (Feldstein 2005). In practice such a portfolio can be built only if: there are indexed bonds offered on the market; these bonds have sufficiently long maturities and there are no investment caps with respect to the fraction of the assets that can be invested in stocks and bonds. In Romania, for example, there are no indexed bonds, there are no bonds with maturities longer than 15 years and the volume of bonds issued by the government is still small.

In these circumstances a large amount of capital has to be kept in reserves in order to guarantee the minimum return, which would impose important costs on the administrators and participants. The relative guarantees, defined as a minimum return to be achieved relative to the performance of the other providers on the market, exist in many countries that have reformed their pension system. In Latin America they are partially responsible for creating an excessive similarity between portfolios and returns and limiting the competitiveness of the market. In general, on developing financial markets the relative guarantees of return have the potential not only to restrict competition, with all the ensuing effects on the portfolios performances, but also to lead to insufficient risk diversification and to increase the market risk (Holzman and Hinz 2005).

However, Romania has been plagued by financial scandals in the past that caused the small investors to lose confidence in the asset management industry. In a country like Romania it may be important to provide a credible environment to the participants. For the time being, a relative return guarantee may be the least harmful way of doing so. Given Romania’s lack of experience with private pension markets the Romanian legislature decided to take a very prudent approach with respect to regulating the investments of pension funds in a first few years with an unstated intention to relax the regulation later, as the market matures.

The Romanian law also imposes quantitative restrictions on the structure of investments, although these restrictions are not very tight and are relatively liberal compared to those imposed by other countries. However, in the voluntary pillar it is important for people to be able to purchase the type of investment that best suits their retirement needs.

For example, for people near retirement it is prudent to invest most of their money in assets that have a very low level of risk, like treasury bills. Given the different accumulation horizons that each age category faces the different investment profiles are rational and should not be restricted by the legislature. Investment restrictions also have negative effects on the costs of investing and on the flexibility of the pension industry to respond to changes in the national and international financial markets.

They force the funds' administrators to choose their investment strategy to conform to the legal restrictions rather that to concentrate on providing the combination of risk and return required by the participants, discourage competition among funds and limit the development of an innovative asset management industry. At the macroeconomic level they encourage the inefficient allocation of resources and the increase in the government debt as the funds become highly dependent on the national government bonds. The view that investment restrictions have negative effects on the market has been reflected in the 2003/41/EC Directive that requires the Member states to apply the prudent man rule in the supervision of pension funds rather than impose quantitative restrictions, like minimum guarantees or investment restrictions.

Effective old age protection requires that no individuals or groups in the population are discriminated against or excluded from the voluntary pension market. As I mentioned before, only the contributors who are enrolled in the public social security system are allowed to contribute to the voluntary pension funds. The reason why the legislature chose to discriminate in this way is not clear.

Also it is not obvious why the law does not allow for the individual payment of the contributions,[9] although it may have something to do with the administrative procedure of calculating the fiscal deductions in the absence of a global income statement.[10] However, the base of contributors will be significantly restricted if the participants are not allowed to contribute individually, not only through their employers. The responsibility of directing the contributions of employees toward potentially numerous pension funds may generate substantial costs for the employers. These costs will be difficult to bear for the small and medium size enterprises and could limit employee participation in voluntary pension schemes.

The fact that the law requires the employer to make these contributions, if the employee wishes to participate, may not preclude the emer-

[9] In the Draft law only the self-employed are allowed to pay their contributions individually. For the employees the contributions are paid by the employers.

[10] As Romania has adopted a flat tax on wage earnings, the fiscal obligations of the employees are calculated and retained by the employers.

gence of a tacit agreement between employer and employees that such contributions shall not be initiated. Recently, in the countries of Central and Eastern Europe there has been a trend toward encouraging individual pension plans in order to enlarge the base of participants.

The fiscal incentives provided by the Romanian legislators are very low by any standards, due to budgetary reasons, but it is possible that they will be increased in the future. However, it does not make sense nor is the international practice to specify the cap for deductions as an absolute sum, as it is specified in the current draft law.

Another important issue for the development of the voluntary pension market in any country is the level of fees that administrators are able to charge. Although the level of maximum fees in Romania has been increased compared to the initial proposals there are good reasons why there should be not caps at all, especially on a voluntary market. The set up costs can be considerable in the voluntary private pension markets.

Usually, contribution based charges require a number of years of losses before companies can recover their set up costs. Even after the set up period the operating costs are likely to be higher than 10% of the contributions. We have to keep in mind that the companies that operate in the voluntary pension market have significantly higher expenses than those operating in the second pillar. This is because they have to actively attract customers and therefore incur considerable distribution costs. In the Czech Republic, over the first six years of the market the operating costs of private[11] funds amounted to 14–18% of the contributions (Lasagabaster et al. 2002). Similar percentages characterize the companies in the Latin American countries. Even in the developed OECD countries the operating costs of the private occupational pension funds amount to 10% of the contributions.

The Romanian legislature obviously does not believe that competition among the current providers and the entry of new firms may lower these fees toward competitive levels, at least not in the short run. However, the caps imposed by the legislature by themselves may significantly contribute to such an outcome. If caps are set by legislation at low levels, as they currently are in Romania and other countries, only few strong firms will survive in the industry and they will capture an important segment of the market. These firms could acquire an important cost advantage over potential entrants in the industry. Therefore caps may deter the entry of new firms in the business with negative consequences on the long run levels of fees.

The policy makers were presented with a trade off between short term protection of the participants and the long term benefits of competition. Romanian legislators showed their preference for short term protection over the benefits of long term competition. Government officials in charge of

[11] These figures pertain, however, to occupational funds.

drafting the law claimed several times that they are interested in having a market with a few “solid” funds rather than many “weak” funds.

This approach is likely to generate serious problems in the future as it did in other countries, like Poland, which came to realize that their past legislation fostered a market that is highly concentrated and now seek remedies to improve competition. But, in general, the more entrenched the few existing private funds become on the market the less likely and ineffective such corrective legislation will be. The regulators have other less harmful options that can improve the short run competitive outcomes of the market such as disclosure requirements that increase its transparency and make the structure of fees more easily comparable.

With respect to the second pillar the essential issue is how the transition costs will be covered and what will be the impact of the reform on the budget deficit and public debt. Currently the Romanian Ministry of Labor is analyzing different scenarios with respect to the percentage of contributions that will be transferred to private administrators, the age intervals for which the contribution to the private system will be mandatory, the ways in which public pensions will be reduced in order to take into account the amounts diverted to the private market. The political debate will probably be centered on the transition costs.

The political class may consider that a reform of this scale would endanger the fragile macroeconomic equilibrium, in a country that only recently managed to reduce inflation under 10% and that is seeking to fulfill the macroeconomic criteria for joining the EU. The matter is complicated further by intention of the center-right coalition to continue reducing the social security contributions. It is likely that, given the current political and economic situation, the percentage of the mandatory contributions allowed to be transferred to the private sector in the next 5–10 years will be small. This will make the whole process rather unsubstantial and in fact will shift the burden of overhauling the system on future legislatures.

This is a very dangerous path of reform. Given the costs of administering the system (the legislators want to implement a centralized system of collecting and distributing the contributions) the new legislation may result in an increase in the burden on the Social Security budget coupled with very small expected benefits for the contributors. This situation could be used by the supporters of PYGO as an argument for delaying or stopping further reform, which in turn, sooner or later, will drive the Romanian pension system into crisis. It remains to be seen whether, after 10 years since a Romanian government first announced its intention to introduce a multi-pillar pension system, Romania will be able to gather enough political and public support, and to find the necessary resources in order to undertake a substantial reform that is crucial for the future well being of its people.

Conclusion

The Romanian public pension system is performing poorly and will face a potentially fatal demographic crisis starting with 2030. For about ten years the government is planning to reform public pensions by introducing a multi-pillar system comprised of a state funded pillar and two private pillars: a mandatory private pillar and a voluntary private pillar. In 2004, the previous social democrat government adopted two highly criticized pieces of legislation aimed to introduce private occupational pensions and mandatory private pensions. The first law proved to be unworkable. Recently, the new center right government has submitted a new draft law by which it intends to reintroduce voluntary private pensions in Romania.

After months of debates with the stakeholders the draft is significantly more market friendly than previous legislative attempts but still raises issues with respect to the best way of introducing, regulating and stimulating private pensions in Romania. The matters of concern are the general reform strategy, the regulation approach, the base of participants, the guarantees on asset return that have to be provided by the market, the investment restrictions imposed by the legislature, etc. The government is also working on legislation for the second pillar that will amend the previous mandatory private pension legislation. However, it is uncertain whether Romania, given its present macroeconomic constraints, will manage to gather the political will to pass the so badly needed second pillar legislation.

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29

Tax Reforms in Russia: The Introduction of the Unified Social Tax

Andrei Kuznetsov and Lubov Goncharenko

Introduction

The transformation from a tax system suited for a centrally planned economy to a system serving a market-based economy has been one of the central elements of the post-communist fiscal reforms in Russia. This proved to be a difficult and uneven process during which achievements and successes were interlaced with false moves and makeshift solutions. Despite the persistent effort on the part of successive governments to improve taxation and increase its effectiveness, the deficiencies of the tax system have been widely regarded by experts inside the country and abroad as one of the main reasons of the poor performance of the Russian economy in the 1990s (Popova and Tekoniemi 1998). Consequently, ongoing tax reforms continue to be a feature of the Russian economic landscape as policymakers are looking for solutions that would both secure sufficient budgetary income and contribute to economic growth in the country.

In this chapter we will describe and analyse the logic and main elements of tax reforms in post-communist Russia using as an illustration the evolution of payroll taxes and social fund contributions from a plethora of controversial payments to the Unified Social Tax (UST).

The First Ten Years

The tax system of the Soviet Union may have served its purpose under conditions of central planning, but has proved to be entirely inadequate by the standards of the market economy as it was too rigid, too centralised and demanded public ownership of everything to function successfully (Tanzi 1993). As soon as the economy started moving towards the market, the speedy introduction of a tax system built on new principles had become a necessity, but it was not a smooth progression. On the face of it, during the

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first decade of post-communist transition, the Russian tax system acquired the structure and many features present in Western Europe (reliance on direct and indirect taxes, including the personal income tax, corporate income tax, payroll taxes, VAT, excises and customs tariff), whilst tax rates were modelled on the US example. Despite resemblance to western designs, however, the actual operation and impact of the tax system were quite dissimilar as they were unfavourably influenced as much by the legacy of socialist taxation as by some disruptive trends that haunted economic reforms in Russia in the 1990s.

As far as the socialist legacy was concerned, underdeveloped tax administration was only the tip of the iceberg. More fundamentally, the taxpayers as well as tax authorities had had no previous experience with modern taxation and therefore psychologically were not prepared for quick changes. The notion of tax burden was new for most taxpayers, voluntary compliance and self-filing were virtually unknown as the old system was characterised by implicit taxation (Martinez-Vazquez and McNab 2000). If we add into the equation growing mistrust towards the government and bureaucracy, it is not surprising that tax evasion emerged as a natural choice for many when economic actors were confronted for the first time with explicit tax requirements.[1]

Things were not helped by the attitude of tax authorities and the politics behind economic reforms. Intrusive supervision had always been a feature of Soviet state bureaucracy. As tax reforms were underway, this translated into the complexity of tax laws and regulations, providing a fertile ground for abuse and discrimination. The situation was exacerbated by an excessive fiscal decentralisation, which inevitably translated into further multiplication of taxes, as many regions of the country were pushing towards maximum autonomy in policymaking. “As a consequence, tax liabilities have often been negotiated rather than determined by law. To make matters worse, tax authorities were allowed to impose highly punitive penalties that often bear no relationship to the actual tax liability. Because of these factors administrative leeway corruption flourished” (Pogoretskiy and Soelner 2002, p. 157). Attempts to introduce a comprehensive tax code were repeatedly delayed by vested interests of the so called oligarchs and bureaucrats, both groups benefiting from the lack of transparency and accountability. When finally introduced in 1999, the code was still suffering from inconsistencies and contradictions that had to be addressed in further legislation.

It was also of great significance that tax reforms were taking place against the background of a major economic collapse when millions of people and thousands of enterprises were fighting for survival. The official data are

[1] The survey by *Public Opinion* research centre in Moscow revealed that as late as 2004 about a third of respondents believed that evading taxes was appropriate whilst more than a half of respondents did not condemn tax dodgers or were indifferent to them (Interfax, 01.11.2004).

conservative, evaluating the share of population with income below the subsistence level, i.e., the rate of absolute poverty, at 30% throughout this period (Zubarevich 2003). As for businesses, the share of loss-making firms exceeded 40% in industry, 60% in transport and 33% in construction (*Finansovyi director*, No. 12, 2003, p. 5). Even under a perfectly working taxation system this would have led to considerable difficulties. However, in Russia the situation was made even more complex by the widely spread interenterprise and wage arrears that besieged the Russian economy in the 1990s. They caused Russian producers to drift away from monetary transactions towards barter. Even employees received their wages as payments in kind where people were not paid in cash but in goods, which facilitated tax evasion. Barter had reached an unprecedented scale: for the majority of industrial firms this form of transaction represented half of their entire turnover and for many as much as 75% (Aukutsionek 2001).

As a result tax collection has become a battle in which the state and the society at large found themselves on the losing end. Entrepreneurs were outraged by high rates and time and effort it took to comply with all the regulations, which they believed were lethal for their businesses, and found it necessary to move their operation into the parallel or "shadow" economy. According to the Expert Institute of the Russian Union of Industrialists and Entrepreneurs (Yegiazorova 1997), up to 75% of firms practiced concealment of a considerable proportion of income, placement of capital abroad and evasion of excise duty and smuggling as the most common forms of "shadow" activity. A report prepared by the Institute of Sociology of the Russian Academy of Science claims that nearly two thirds of the entrepreneurs would be ready to bribe an official and eight out of ten consider tax evasion and fraud a viable business tactic (Dushatski 1998, p. 71). The state, which saw its budget deficit soaring, had to increase its spending on tax enforcement but the results were dismal as business found it cheaper to pay off tax inspectors and tax police or expatriate their capital rather than to pay taxes. According to official statistics, in the late 1990s only 17% of businesses operating in Russia paid their taxes on time and in full, 50% made only occasional payments and 33% made no payments at all (*Nizhegorodski predprinimatel'* 1998, No. 4–5, p. 20).

Mass impoverishment, barter transactions, corruption, tax evasion, capital flight, a catastrophic fall of industrial output and the growth of the shadow economy were those factors that influenced the evolution of views on the role, structure and administration of taxation in Russia in the 1990s. It was realised that quite often the main incentive to evade taxes was provided by the tax system itself due to excessive taxation, lack of transparency and fairness, extreme decentralisation and emphasis on disproportionate punitive action (Yakovlev 1999; Pogoretskiy and Soelner 2002).

This understanding prepared grounds for the revolution in taxation that started in August 2000. The general thrust of this new stage of reforms was pointed towards (a) making taxes more acceptable and "user-friendly" as far as taxpayers were concerned and (b) creating an environment in which paying taxes would make more economic sense to taxpayers than meeting the cost of avoiding them.

This was a fundamental change in perception comparing to the attitude prevailing among policymakers in the 1990s when problems with tax collection were sought to be resolved through establishing a dedicated police force and the ever increasing number of authoritarian rules and regulations. The big prize that inspired the new initiatives was the prospect of returning into the official economy the assets, tentatively evaluated in hundreds of billions of dollars, which had been moved into the “shadow” economy under the previous tax regime. The blueprint for reforms included the simplification of the tax system; introduction of lower tax rates, especially of personal and profit taxes; the abolition of some particularly unpopular taxes; use of a regressive scale for the calculation of some wage and salary taxes.

These ideas were put into practice in three stages in 2001, 2002 and 2004. The main features of the tax system that emerged as a result are as follows. The three old income-tax rates (12, 20, and 30%) were replaced by a 13% flat tax (non-residents have to pay a rate of 30% on income from Russian sources); corporate tax was reduced from 35 to 24%[2]; capital gains on the disposal of securities are subject to a profits tax at 24%; VAT is levied at a general rate of 18% on taxable supplies that include the majority of domestic sales of goods and services[3]; the four separate social security taxes were replaced by a combined Unified Social Tax payable to the Federal budget, the Social Insurance Fund and Medical Insurance Fund on a regressive scale with the maximum rate of 26% whilst employers’ contributions to the Employment Fund have been abolished. Simultaneously most regional sales taxes, special regulations and exceptions were abolished; new accounting rules were brought forward, introducing International Accounting Standards to Russia. Despite these steps towards a more compact, manageable and transparent system, a frustrating multitude of taxes remains: there is also a 5% advertising tax, a 2% property tax, a 1% road tax, plus various registration fees.

The initial response to changes in the tax regime was very favourable: in 2001 alone revenue from personal income tax burgeoned by nearly 47% (an increase of 25.2% in real terms after adjusting for inflation), whilst tax revenue overall rose by 50%; the federal budget showed a surplus of 2.4%. Tax collection continued to improve in the following years, in particular in respect of the personal income tax: it grew in real terms 24.6% in 2002 and 15.2% in 2003. The Organisation for Economic Cooperation and Development called

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[2] Of this amount, 5% is payable to the central government, 17% is payable to the regional government, and 2% is payable locally. Regional governments have the power to reduce the regional element by up to 4%, giving a minimum overall rate of 20%.

[3] There is a reduced rate of 10% for certain basic food products, children’s goods, certain medical products, medicines, drugs, and newspapers and magazines.

Russia's flat tax system a "key accomplishment", rare praise from the organisation known for its critical stance (*The Washington Times*, 28.03.2002). However, not all elements of the reform worked equally well. The introduction of the Unified Social Tax, probably the most important new element of the new taxation strategy after the flat personal income tax, has not produced expected results. In the following sections we will study in a detailed way this very important tax.

The Role of Social Taxes

The dynamics of social taxes in modern Russia cannot be fully understood without reference to the dramatic changes in the welfare state that have happened after the collapse of the centrally planned economy. The extensive provisioning of subsidised or charge-free social services to the public was a crucial feature of the Soviet system. People's income could have been modest, but they felt well protected as far as the provision of education, health, pensions and social services, including housing and supporting utility networks was concerned. Significantly, social services were provided not only by the state but also by state-owned enterprises: total social spending by the enterprise sector amounted to about 25% of the entire consolidated budget in the early 1990s.

The situation changed dramatically with the transition to capitalism. On the one hand, marketisation, leading to the growing risks of unemployment and impoverishment for a considerable part of the population, has greatly increased the need for social support. On the other hand, both the state and enterprises could not sustain the provision of social resources at the customary levels. The consequences were grave. Most people were not accustomed or prepared, or given an opportunity to look after themselves. The amount and quality of traditional welfare was declining dramatically whilst the modern social safety net of the western type was nonexistent. For example, there was no practice of employers and workers contributing to a pension fund, as all pensions were paid from the state budget and funded through general taxation.

In this situation putting in place an efficient system of social payments and taxes was essential. First decisions to this end were taken as early as 1991, but results remained disappointing throughout 1990s. In 1994, to take one typical year, the Pension Fund of the Russian Federation managed to raise only two-thirds of the expected payroll contributions. In the same vein, territorial medical insurance funds managed to collect just 30 to 35% of projected total. The poor performance of social taxes had a number of explanations.

To begin with, the system of payments was extremely complex and its management fragmented and cumbersome. Until 2001 only the rates of taxation were set by the federal law. Social contributions were to be paid directly into non-budgetary specialised funds: the State Pension Fund; the

Social Insurance Fund; regional and federal Medical Insurance Funds and the State Employment Fund. The tax base for these payments, the regime of payment and other administrative issues were regulated by numerous instructions, directives and guidelines released by the managing bodies of all these Funds.

On top of registering with local tax authorities every firm had to register with the local bureaus of each of the four Funds to which they had to report monthly. Each Fund would send out its own inspection to verify compliance and impose its own sanctions on offenders. The parallel existence of different payment requirements confused accountants, made them make mistakes. Stifling control and numerous inspections interfered with normal operations of firms. At the same time the absence of federal laws made it difficult for firms to seek protection in courts in their disputes with the four Funds. The decentralisation of tax collection not only increased the cost for taxpayers but for the state as well: the Funds were less efficient than the state tax service and spent more of its budget per collected ruble than the Finance Ministry. Overall, making each of the funds responsible for collection of its own contributions multiplied collection costs.

Being a form of wage taxes, social payments proved particularly difficult to collect. Numerous tax evasion schemes had emerged, of which *obnalichivanie* (black cash tax evasion) was particularly widespread. Yakovlev (1999) describes this scheme as follows. It is based on the replacement of high-taxed elements of total revenue such as salary or profit with low-taxed elements such as material expenditures, using the contract between the firm-taxpayer and an intermediary “sham” firm. Under the terms of the contract, the taxpayer transfers money to the bank account of the sham firm in exchange for a phoney work report. In exchange the taxpayer receives unaccounted, or “black”, cash. The total amount of black cash returned equals bank payments minus the commission of the sham firm, typically less than 2 to 3% of initial client’s payment. The black cash funds are thus available for unofficial salary payments, investment or discretionary use by the firm management or the entrepreneur.

According to estimates by Yakovlev, in 1993–1996 alone the four social Funds lost from US$20 to US$30 billion as a result of this scheme. Whilst in large firms sharing black cash with employees would be too conspicuous, it has become common that small and medium enterprises operate under a dual salary scheme. Every month they would pay their employees a certain sum in cash, often in a foreign currency, but for the tax inspectors they keep another set of records on their books, showing much lower wages in roubles. The gap between real and “official” salaries may be huge. Employees can make between $100 and $300 per month, while on paper they earn a mere 500 to 1,300 roubles, equivalent to $16 and $42 (Engleman 2002). The reason for this practice is evident from the data in Table 1. It demonstrates that before the reforms of 2001–2004 taxes on wages were equal to up to 67.6% of the total sum of wages.

Table 1
Tax Burden on One Rouble of Payroll

Tax base (roubles)	UST					
	2000		2001–2004		2005	
	Roubles	%	Roubles	%	Roubles	%
50,000	19,750	0.395	17,800	0.356	13,000	0.260
100,000	39,500	0.395	35,600	0.356	26,000	0.260
150,000	59,250	0.395	45,600	0.304	39,000	0.260
200,000	79,000	0.395	55,600	0.278	52,000	0.260
250,000	98,750	0.395	65,600	0.262	65,000	0.260
300,000	118,500	0.395	75,600	0.252	74,800	0.249
350,000	138,250	0.395	80,600	0.230	79,800	0.228
400,000	158,000	0.395	85,600	0.214	84,800	0.212
450,000	177,750	0.395	90,600	0.201	89,800	0.200
500,000	197,500	0.395	95,600	0.191	94,800	0.190
600,000	237,000	0.395	105,600	0.176	104,800	0.175
800,000	316,000	0.395	109,600	0.137	108,800	0.136
1,000,000	395,000	0.395	113,600	0.114	112,800	0.113
	Personal income tax					
	2000		2001–2004		2005	
	Roubles	%	Roubles	%	Roubles	%
50,000	6,000	0.120	6,500	0.13	6,500	0.13
100,000	16,000	0.160	13,000	0.13	13,000	0.13
150,000	26,000	0.173	19,500	0.13	19,500	0.13
200,000	41,000	0.205	26,000	0.13	26,000	0.13
250,000	56,000	0.224	32,500	0.13	32,500	0.13
300,000	71,000	0.237	39,000	0.13	39,000	0.13
350,000	86,000	0.246	45,500	0.13	45,500	0.13
400,000	101,000	0.253	52,000	0.13	52,000	0.13
450,000	116,000	0.258	58,500	0.13	58,500	0.13
500,000	131,000	0.262	65,000	0.13	65,000	0.13
600,000	161,000	0.268	78,000	0.13	78,000	0.13
800,000	221,000	0.276	104,000	0.13	104,000	0.13
1,000,000	281,000	0.281	130,000	0.13	130,000	0.13
	Total					
	2000		2001–2004		2005	
	Roubles	%	Roubles	%	Roubles	%
50,000	25,750	0.515	24,300	0.486	19,500	0.390
100,000	55,500	0.555	48,600	0.486	39,000	0.390
150,000	85,250	0.568	65,100	0.434	58,500	0.390
200,000	120,000	0.600	81,600	0.408	78,000	0.390
250,000	154,750	0.619	98,100	0.392	97,500	0.390
300,000	189,500	0.632	114,600	0.382	113,800	0.379
350,000	224,250	0.641	126,100	0.360	125,300	0.358
400,000	259,000	0.648	137,600	0.344	136,800	0.342
450,000	293,750	0.653	149,100	0.331	148,300	0.330
500,000	328,500	0.657	160,600	0.321	159,800	0.320
600,000	398,000	0.663	183,600	0.306	182,800	0.305
800,000	537,000	0.671	213,600	0.267	212,800	0.266
1,000,000	676,000	0.676	243,600	0.244	242,800	0.243

Source: Ministry of Taxes and Duties of the Russian Federation

On the whole, the system of social taxation in its 1990s guise was a disappointment and had the following drawbacks: it achieved extremely low rates of collections; it had high cost of administration; it was extremely intrusive and disruptive as far as the activities of taxpayers were concerned; it was not transparent or fair, leaving a lot of space for bureaucratic arbitrariness. Overall, this system encouraged tax evasion, did little to establish the culture of paying taxes in the country and possible contributed to social misery during this most difficult period of transition. This was not just because the state could not collect enough resources to support its social programmes, but also because firms were forced to lay off labour or pay lower wages to minimise their tax exposure.[4]

The Introduction of the Unified Social Tax

The Unified Social Tax (UST) was introduced in August 2000 as a solution to the crisis of social payments. It is a federal tax regulated by Chap. 24 of the new Federal Tax Code (Part 2). It became effective on 1 January 2001 and replaced all the payments that the four social funds used to collect independently. Its object of taxation is remuneration of any kind accrued in favour of a natural person employed under a labour or a civil law contract to perform work or render services, and royalty under copyright contracts.

UST has some unique features that distinguish it from other taxes in Russia. This is the only tax for which the law explicitly determines how the proceeds should be used: half of it is allocated to pensions and the rest is split between social and medical insurance. Also a substantial amount of payments goes directly into relevant social funds, but the scale at which these payments are made is now established in the Code itself. There are not many exceptions or special norms, making this tax transparent and equitable. A further new feature is that the tax base for the UST is not the total sum of payroll as before. The tax is calculated for every employee individually. This has to do with another unique characteristic of the UST: it is paid on a regressive scale in order to encourage enterprises to legalise their black cash payments.

Originally the scale of annual payments of UST looked as follows:

35.6% on the first 100,000 roubles; 20% on earnings from 100,001 to 300,000 roubles; 10% on earnings from 300,001 to 600,000 roubles; and 2% on all earnings over 600,000 roubles. It must be noted that this radical move did not create any sizeable threat to the budget as 99% of officially paid annual wage was below 50,000 roubles.

When the UST was introduced in 2001, its top rate of 35.6% was lower than the summary rate of 38.5% that was payable during the previous

[4] According to some estimates, in the mid-1990s the payroll taxes raised a private firm's labour costs to about 1.7 times the take-home wage, not including the excess-wage tax (Mikhalev 1996).

decade. The regressive scale made potential benefits for high earning taxpayers even more substantial. Not surprisingly, the new tax was favourably met by the business community. In 2004 the UST had become the largest money maker for the budget, pushing VAT, traditionally the largest earner, into second place. And yet the introduction of UST has not really brought about the desired breakthrough in the collection of social payments. As a matter of fact, the share of these payments in the GDP has been falling progressively ever since the UST was made operational and never reached the pre-2001 level (see Table 2).

Table 2 UST and Personal Income Tax as a Share of GDP, 2001–2004

	1999 г.	2000 г.	2001 г.	2002 г.	2003 г.	2004 г.
1. GDP (billions of roubles)	4,766.8	7,302.2	9,040.8	10,950.0	13,285.0	16,700
2. All federal taxes (billions of roubles)	1,338.4	2,119.9	2,574.1	3,073.6	3,543.8	4,442.1
3. UST (billions of roubles)	357.9	530.3	602.0	745.4	875.6	1,073.1
4. Personal income tax (billions of roubles)	116.5	174.2	255.5	357.1	455.3	574.0
3. Share of GDP (%):						
- All federal taxes	28.07	29.03	28.47	28.06	26.67	26.59
- UST	7.50	7.26	6.65	6.80	6.59	6.42
- Personal income tax	2.44	2.38	2.82	3.26	3.42	3.43
4. Share of UST in GDP as percentage Of the previous year	–	97	92	102	97	97

Source: Goskomstat of the Russian Federation; Ministry of Taxes and Duties of the Russian Report forms 1-HM for 2001–2004

The UST rate of 35.6% still proved to be very high in the eyes of entrepreneurs, especially if contrasted with the Personal Income rate of 13% and the Corporate Tax of 24%. In fact, it was lower than in some other European transition countries (Bulgaria 44.7%, Poland 47.3%), but higher compared to developed countries of Europe (Sweden 26%, UK 22%).

Almost immediately taxpayers started to exploit loopholes in the Tax Code to avoid UST. In order to implement the principle that payments to employees should be taxed only once, UST was not levied on expenses covered from after-tax profits. After tax profits were defined as the difference between the financial result for the reporting period, computed on the basis of accounting records, and the amount of profits tax and other mandatory payments due. Therefore, after tax, or retained, profits for unified social tax purposes referred to funds remaining at the disposal of an organisation after actual payment of the profits tax. The owners of an enterprise were free to decide how to use these funds.

Under these conditions it made economic sense for employers to show a part of the payroll as profit taxable at 24% and reimburse employees from retained profit by paying them “bonuses”. The budget would receive more corporate tax but not enough to compensate the loss of UST chargeable at the rate that was a third higher. Another tax avoidance scheme based on the same idea that particularly suited small and medium enterprises was not to put employees on payroll but subcontract them as independent entrepreneurs.

The regressive scale failed to encourage people to state their actual wages (Table 3). In 2003 only 118.4 thousand employees, only just 0.002% of the labour force, declared annual income of over 600,000 roubles (about $1,800 per month). Although there are no official statistics, independent experts estimate the number of employees that earned over $2,000 per month at least at 5% of the labour force or 3.3 million people. In other words, only one in 25 eligible taxpayers was tempted by the regressive scale.

Table 3 Proceeds from UST

Year	Proceeds (billions of roubles)
2001	602,009
2002	446,511
2003	486,885
2004	595,280

Source: Goskomstat of the Russian Federation

Predictably, the response of the policymakers was to apply more of the same medicine. Already in late 2003—early 2004 signals were sent out that the UST was to be reduced soon. However, when the amendments to the tax were revealed in January 2005, they sent out a mixed signal about the possible future of the UST. On the one hand, the base rate was reduced from 35.6 to 26%. On the other, the scale has become less regressive.

Since 2005 the UST has the following annual rates: 26% on the first 280,000 roubles, 10% on earnings from 280,001 to 600,000 roubles and 2% on all earnings over 600,000 roubles. The new scale favours those taxpayers who pay wages up to 25,000 roubles per month and leaves the tax burden almost unchanged for wages above this sum. Consequently it is expected that in 2005 no more than 1% of employees are likely to reveal wages that put them on the regressive stretch of the scale. In other words, the main objective of the regressive scale, to bring black cash salaries above the board, remains as remote as before.

Does the UST Have a Future?

After a decade of stringent controls, the Russian tax system has embraced liberalism as a key principle of its organisation. As far as the UST is concerned, the objective has been to increase official wages and draw job remuneration out of the shadow sector. According to the calculations of the Budget and Tax Committee of Russian parliament, under the best of scenarios about 30 billion roubles (US$1 billion) can be expected to be legalised, increasing the tax proceeds of the social funds (ITAR-TASS, 11.06.2004). Nonetheless, despite its liberal credentials, the UST has not achieved this objective so far. Analysis suggests a number of explanations.

UST still has certain features reminiscent of the first decade of post-communist reforms. For example, it remains to be one of the most complex taxes in terms of administration. Employers pay the UST by monthly advances at the end of each calendar month; the balance between the tax due and the sum of advances must be paid not later than on the 20th of the next month and finally the end of the year settlement should be paid not later than 15 days after the annual tax return deadline. The tax is to be dispatched to a number of recipients such as the federal budget, the Social Insurance fund and federal and regional funds of Compulsory Medical Insurance. This requires filling in as many as eleven payment orders every time the tax is paid. Besides, the taxpayer has to submit regular estimates on advance payments to the tax bodies.

More significantly, the hallmark of the new tax, its regressive scale, has failed to make any noticeable difference in the behaviour of taxpayers. Only a tiny fraction of high salaries has been legalised, putting in question the validity of the very idea of regression in this particular situation. Powerful lobbying groups insist that the regressive scale should be abandoned in favour of a low flat rate. Thus, according to the powerful and representative Business Russia Association, a unified social tax of 15% on payrolls would entice 90% of businesses operating in the shadow economy to go legal (American Chamber of Commerce in Russia, 22.02.2005).[5]

Lowering the rate even further and simplifying administration may be indeed a way forward, although it must be noted that after the latest revisions total payroll taxes in Russia came very close to the rates payable in the developed European countries. However, the evaluation of this option requires putting the UST in the context of the national social budget as a whole.

The Finance Ministry estimated that the recent reduction of the rates would cost the already strained budget from 189 to 220 billiard roubles in 2005 alone. In anticipation of this shortfall the government has taken the extraordinary decision to use the resources of the emergency Stabilisation

[5] The specific rate of 15% may be inspired by the example of such fast growing economies of the world as South Korea, in which the respective rate is 15.5%.

Fund as a source for pensions in 2005. It is clear that the problem of social taxes cannot be resolved in isolation from measures that modernise the distribution of social benefits and the social safety net considering that seventy percent of the population are entitled to benefits.

Modernisation may take two directions: achieving greater efficiency by transferring some payments directly to taxpayers and changing the pension and social payments regulations in such a way that they make it less attractive for employees to receive salaries under the table.

For example, it is reasonable to expect that the payment of medical insurance for short-term illnesses is reassigned to employers, the cost of administration is going to fall in comparison with the current centralised system, increasing the effective rate of taxation. However, a central place should be given to pension reforms because of the link between the UST and pensions (pensions are paid entirely out of UST proceeds at the moment), the great size of pension funds and the critical demographic situation in the country.[6] One option is to make employees contribute to the Federal Pension Fund as is the norm in many countries. Some positive results may be achieved through the development of the market for financial services. At the moment it is in an embryonic state mostly due to the lack of trust between financial companies and potential clients. However, an increase in popularity of private pension schemes will put pressure on employees to receive higher official salaries because the current legislation makes the total amount that individuals can invest into the private pension system conditional on their declared salary.

Equally, as the demand for consumer credit and mortgages will begin to grow, employees will realise that their credit standing will depend on employer-supplied proof of actual wages. However, private pension funds and the availability of other financial instrument are unlikely to make any noticeable impact on the behaviour of Russian people because the economic situation in the country unequivocally encourages short-term choices. Suffice it to say that at 60, the average male's retirement age is higher than his life expectancy of 59 and investors' horizons rarely extend beyond 6 months (Uspensky 2003).

There have been remarkable improvements in the performance of the tax system in Russia in the last five years. Despite this it is without doubt that the tax system in Russia has not stabilised yet and is going to see some dramatic adjustments in the near future. The government's strategic line continues to be the creation of a more efficient and transparent system. This attitude was confirmed in the president's state of the nation address at the end of April 2005, when he urged fiscal agencies not to "terrorise" business.

But the fine-tuning of tax rates is far from being over. There are indications that a reduction of VAT may be in the cards as well as the

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[6] The ratio of economically active citizens per pensioner fell from 2.3 in 1990 to 1.7 in 2002, as people died at more than one and a half times the rate they were being born, resulting in a net population loss over 7.5 million during the 1990s.

introduction of additional amortisation premiums for investments and the simplification of the rules of including the cost of R&D and experimental works in expenses. Following this course is going to be a very difficult balancing act as mounting losses will have to be covered somehow. The financial requirements of social security remain immense and may even increase if the adverse social consequences of the transition are not reversed. The price of a mistake can be very high but the pace of reform cannot be slowed if the modernisation targets set by the government are to be met.

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Taxation, Transition and the State: The Case of Russia[1]

Gerard Turley

Introduction

The power to impose and collect tax is a defining characteristic of a modern capitalist state. It was Joseph Schumpeter who, prior to his appointment as Finance Minister in the Austrian Government after World War I, described the capitalist state as the ‘tax-collecting state’. In his 1918 paper entitled ‘The Crisis of the Tax State’, he wrote that ‘… “tax” has so much to do with “state” that the expression “tax state” might almost be considered a pleonasm’. (Schumpeter 1918). For Schumpeter, the origins of the capitalist state (at least in Germany and Austria) arose, not from political needs, but from fiscal needs. It is the fiscal demands and the tax-collecting powers, born out of a ‘common exigency’ that distinguishes the modern capitalist system from its predecessor, the feudal system, he argued.

In contrast, the origins of the socialist state are the political one-party system (Kornai 1992). One of the characteristics of this system, as observed by Mancur Olson, was its ability to collect an extraordinary amount of ‘taxes’ (Olson 2000). It is within this context that we examine the transition from the socialist state to the capitalist state that took place at the end of the twentieth century. As our primary interest lies in a sovereign state’s power to tax, it is appropriate to assess Russia’s (the most important of the successor states to the Soviet Union) transition to a ‘tax-collecting state’. Since transition began, many ex-socialist countries have experienced a dramatic fall in tax revenue. Russia is no exception. In 1992, total government revenue as a share of GDP was 39.3%; by 1998 the revenue/GDP ratio had fallen to 33.4%. Moreover, federal revenues fell from 16.6% of GDP in 1992 to only 11% in 1998, of which 2% was non-cash (IMF 2000). This inability to collect ‘sufficient’ taxes is a manifestation of an ineffective and poorly governed state, supported by weak institutions whose authority is not legitimate in the eyes of its

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citizens. Many Russians view the efforts of central government as the private affairs of the elite and certainly not aimed at enhancing the common interests of its citizens. This crisis of a weak state and poor public governance, manifesting itself in a severe fiscal débâcle, culminated in the August 1998 crash. It was Sergei Kiriyenko, the Russian PM at the time of the August crisis, who said, 'If the state does not learn to collect taxes, it will cease to exist.'[2]

This is an outline of the chapter. We begin in Sect. 2 with a short theoretical analysis of taxation and the models of government. In Sect. 3 we focus on the weak state and the symbiotic relationship that exists between government and business. The symptoms of an ineffective state that are evident in Russia's fiscal system are described in Sect. 4. In Sect. 5 we outline the events of the August 1998 crash—a fiscal crisis that had its origins in a weak and ineffective Russian state. The policy implications arising from our analysis of poor state governance are examined in the final section of the chapter.

The Theory

Our primary interest is in taxation and different models of government. In a well-functioning market economy, governments oversee the provision of public goods and the orderly payment of taxes, where taxes are defined as compulsory, unrequited (in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments) nonrepayable payments exacted by government for public purposes. In post-socialist Russia, the payment of taxes has been problematic. What follows is a stylized account of tax payments (and its sister activity, bribery) in the context of transition from plan to market.

When an enterprise produces goods/services or engages in trade or employs workers, it incurs tax liabilities of all sorts (for example, VAT or export tax or social security tax). Once a tax liability arises and is known to the tax authorities, the enterprise can do one of three things.

One, the tax is paid, either in cash or non-cash form. Non-monetary tax payments are not uncommon in Russia. Explanations vary from liquidity shortages and the demonetisation of the economy that resulted from tight

[2] Ironically, Jeffrey Sachs, much maligned for his advice on Russia's transformation, did recognise the dangerous prospect of state collapse or insolvency in Russia. In 1994, in warning about the dangers of a 'bad' equilibrium for the Russian state, he wrote, 'Several simple examples of immediate relevance to Russia illustrate the risks of state collapse'. He went on to list six, namely tax evasion, criminality, regional separatism, flight from the rouble, foreign debt overhang and panic by government creditors (Sachs 1995). Although Sachs was quite right in his analysis, namely of a state in near collapse, it was his policy recommendations, including his claim, at that time, that radical reform by itself revives the collapsed state, that were to attract most public attention. For lessons on government collapse in transition countries, including Russia, see Roland (2000).

monetary policy to poor financial intermediation leading to lower transaction costs for barter than non-barter to the facilitation of tax avoidance or evasion whereby the barter transaction circumvents the use of bank accounts and the chances of confiscation of revenue by the tax authorities (Gaddy and Ickes 1998; Commander and Mumssen 1999).

Two, the tax is not paid (or paid with such a delay that the tax payment is, given interest charges and inflation rates in the early years of transition, in effect, a subsidy). The delinquent taxpayer (for our purposes, the enterprise) can be either a profit-maker or a loss-maker. If it is a case of profit-making firms not paying taxes, the problem is generally one of a poor payments discipline (aside from the possibility of individual and legitimate tax disputes with the tax authorities). Alternately, if it is a case of loss-making firms not paying taxes, the problem is one of a soft budget constraint, hereinafter SBC (Kornai 1980, 1986).[3]

Three, payments are made arising from the tax liability but are paid in the form of a bribe to government officials in order to, among other things, reduce or eliminate the known tax liability. This behaviour, both on the part of the recalcitrant firm and the politician or bureaucrat, can be described by reference to Shleifer and Vishny's predatory government and corruption model (Shleifer and Vishny 1993, 1998).

We begin with János Kornai's analysis of how the socialist system comprised a paternalistic, all-powerful, helping-hand state that gave rise to the SBC and financial indiscipline on the part of state-owned enterprises (Kornai 1980, 1992).[4] Unlike private firms in a market economy where the state is, in general, neither paternalistic nor pervasive, state-owned enterprises (SOEs) in

[3] A loss-making firm will not be liable for profit tax but it will have other tax liabilities (VAT and excise duties, for example).

[4] Since the term first appeared in 1979, there have been a number of different explanations of the SBC. According to Kornai (1979, 1980), the source of the budget softness, in the context of the socialist system, is the paternalism of the state. Firms are not responsible for losses, or, for profits. This explanation is system-specific, focuses on political considerations and is based on the vertical relationship between superior and subordinate. In contrast, the explanation advanced by Dewatripont and Maskin (1995) focuses on economic causes, namely the inability to commit to no bailout *ex post* and the centralised financial system. Using a game-theoretic model, the SBC is viewed as a time-consistency problem in the presence of irreversible investment. With asymmetric information and adverse selection, bad projects get refinanced – the phenomenon of 'throwing good money after bad'. Schaffer (1989) also presents a game-theoretic model where the centre is unable to make credible commitments to the enterprise. Unlike Kornai's SBC where the paternalism of the state is known, it is possible, under imperfect information, for the state to build a reputation for toughness and, in doing so, is able to impose hard budget constraints on the enterprise. A different explanation, espoused by Stiglitz (1994), argues that, in the context of the financial system, soft budgets arise when financial institutions have an incentive to make large gambles when appraising projects. In this explanation, an insolvent bank may be willing to invest in a risky project because the bank will become solvent if the gamble pays off and, in the case of the project turning bad, will be no worse off than it was before the loan was made i.e. still insolvent.

a socialist economy may face ‘soft’ budget constraints.[5] The budget or financial constraint is softened when the state bails out or refinances loss-making firms. The recurring expectation of a bailout, in whatever form it takes, influences *ex ante* the behaviour of enterprises. This helping-hand model of government depended on a strong and benevolent state whose primary aim was to provide for the enterprise which meant maintaining employment, preventing firm closures and job losses and, ultimately, ensuring security.

As socialist economies are transformed into market economies, the SBC syndrome was expected to diminish.[6] It is true that many of the features of Kornai’s socialist system have indeed disappeared. There are no longer shortages of consumer goods, nor do people spend time and energy queuing for goods. Many firms operate in the private sector offering a variety and quality of goods that were not available under the Soviet system; many firms that remain in the state sector are forced by market conditions to restructure. These economies are now more integrated with the market economies of Western Europe. Of course, it was expected that some aspects of Kornai’s paternalism might linger longer than others, or might manifest themselves in new ways. For example, some loss-making firms (not to mention healthy firms) are still extracting subsidies from the state, but by means of tax arrears and/or utility arrears rather than by explicit on-the-budget subsidies. The incidence of tax arrears and other non-market economic phenomena suggest that, in some respects, the state is still ‘soft’ in its relationship with certain loss-making enterprises. Despite these incidences, for countries like Poland and Hungary, the ‘helping hand’ has been replaced by Adam Smith’s ‘invisible hand’.[7] For Russia and other FSU states, neither the helping-hand model nor Adam Smith’s invisible-hand model can adequately explain the behaviour of the state with respect to some firms in the state-owned (and privatised) enterprise sector.[8]

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[5] Of course, the SBC is more appropriate to the market socialist system where a price mechanism existed rather than to the classical socialist system where money was passive and plans were expressed in terms of physical quantities and output targets.

[6] In the context of transition and economic theory, there are two broad perspectives on the SBC. One approach is the Washington Consensus view, which treats the SBC as an exogenous variable and a matter of direct policy choice. The implication here is that political will is all that is required in order for the budget constraint of firms to be hardened. The alternative perspective is the evolutionary-institutional approach that views the SBC as endogenous to the institutional set-up. Here, the hardening of budget constraints is possible only as an outcome of institutional change. Credible commitment to hardening budget constraints is a matter of devising suitable institutional mechanisms and arrangements (Roland 2000).

[7] The symbiosis of politics and economics that manifested itself in different ways was far more ingrained in the Soviet Union that it was in Central and Eastern Europe and this observation may go some way in explaining the cross-country performance differences since 1990. On the subject of performance, although Russia’s record since 1992 is considerably worse than most of Central and Eastern Europe, it compares favourably to many other CIS countries. This is often ignored in the transition literature on Russia and Eastern Europe.

[8] It is important to acknowledge that the enterprise sector that exists in Russia today is not monolithic. It is made up of state, privatised and *de novo* private firms, profitable and

In addition, Kornai's model of a paternalistic state and SBC has the state redistributing profits from 'profitable firms' to 'loss-making' firms, the so-called levelling effect. Given that price controls were set with social objectives in mind, enterprises were not responsible for losses. Profits were redistributed through various subsidy and tax channels. Bargaining took place along the vertical chain between managers, local bureaucrats and central planners. In today's Russia, some politically-connected, profitable firms manage to engage in socially-costly rent-seeking behaviour, namely, lobbying for subsidies and tax concessions from the government while, at the same time, tolerate delayed trade payments, or payments in kind, from their customers. In turn, politicians (often with short time horizons) extract bribes in return for these lucrative favours, whether they are subsidies, cheap credits, licenses, quotas or permits.

It is in this context that we draw upon the second of the theories, that of Andrei Shleifer and Robert Vishny's 'Politicians and Firms' model (Shleifer and Vishny 1993, 1994).[9] Shleifer and Vishny's model is predicated on a predatory, activist, grabbing-hand state whose aim is self-preservation and wealth accumulation, leading to rent seeking, corruption and bribes.[10] Using standard economic theory of industrial organisation, Shleifer and Vishny (1993) show that the type of organised corruption that was prevalent in the former Soviet Union (where the person paying the bribe was assured of getting the government good) was less damaging than the unorganised crime and corruption that became prevalent in Russia in the early years of the reform period.

According to Shleifer and Vishny (1994), bureaucrats are self-interested economic agents often acting independently of each other who use their power and position to pursue their own agendas. They did so under the

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unprofitable firms, viable and nonviable firms, domestic and foreign firms and so on. In this chapter, we are primarily concerned with the nonviable firms and the well-connected firms (sometimes one and the same) that are often kept alive by political interference.

[9] With respect to the interaction between bureaucrats (government officials) and entrepreneurs (private sector actors), there are different models of government, as explained by Frye and Shleifer (1997) and, again, by Shleifer and Vishny (1998). There is the market-friendly 'invisible hand', the more interventionist-type 'helping hand' and the predatory 'grabbing hand'. As the transition from Soviet-style socialism (a kind of 'clenched hand') to a market economy based on private property and enterprise (Adam Smith's 'invisible hand') continues, Russia seems to be caught halfway, in a state of limbo. Although Frye and Shleifer (1997) refer to the state-enterprise relationship in China as an example of the helping-hand model, we extend its applicability (without changing the basic features of the model i.e. a well-organised, interventionist, welfare-maximising government) and use it to explain the state-enterprise relationship that existed in other socialist countries pre-transition. As indicated by Frye and Shleifer, these models of government are 'ideal types'; in reality, governments may be a mixture of all or a combination of some. A variant of these types of government models is presented in Treisman (1995).

[10] Others, including Jan Winiecki (1992) and Anders Åslund (1994, 1999) have highlighted corruption and the rent-seeking activities of the old elite in explaining Russia's problems in its transition to a market economy. Of course, a predatory view of the state is not new and has followers in both the neoclassical and Marxian traditions.

socialist system by restricting output and keeping prices low, resulting in endemic shortages (Shleifer and Vishny 1992). As bureaucrats did not have any legitimate cash flow rights to goods produced in the state sector, corrupt officials turned their attention to creating, or taking advantage of, shortages in order to enhance their opportunities for collecting bribes. The underground barter economy was used to produce goods that the state failed to supply. In today's Russia, the well-connected, state-owned or privatised firms, often run by the old elite (nomenklatura) engage in rent or subsidy-seeking behaviour rather than profit-seeking behaviour.[11] By lobbying, they manage to extract soft credits, subsidies and tax concessions from the state, often in return for kickbacks. Effort is exerted and resources are wasted in the pursuit of these rents. The effect of this is that compliant firms, often *de novo* private firms, are penalised. The behaviour of these compliant firms is adversely affected as they, in turn, bargain with government officials for tax concessions and soft loans. The cosy networks and personal exchange that exist between officials of government and managers of these enterprises reduce the risk of exposure and, in doing so, reduce the relative transaction costs of bribery. In this type of environment, firms are more likely to seek a maximisation of political connections—relational capital—rather than of profits (Gaddy and Ickes 1998, Åslund 1999).

In developed market economies, the job of market-friendly, representative institutions like the political parties, the media and social organisations is to ensure that the type of distortive and corrupt bureaucratic behaviour described above does not go unpunished. In Russia, these 'checks and balances' were either open to abuse or were simply too weak to prevent the rent-seeking activities of politicians, government officials and nomenklatura-appointed enterprise managers. The political and institutional vacuum that existed in Russia allowed the rent-seeking elite to pursue their political objectives (securing voters' support and maintaining power) and, at the same time, to enrich themselves by accumulating vast sums of personal wealth (Åslund 1999). The more efficient allocation of resources that the transition to capitalism was promised to bring was hindered by the activities of these rent-seeking interest groups (Olson 1965, 2000; McFaul 1995; EBRD 1999). These special interest groups competed for the resources of the state (sometimes colluding with government officials) rather than seeking greater market share. Due to a number of factors, including the large rent-seeking opportunities, the weak central authority, the lack of representative institutions and

[11] In the early years of reform in Russia when inflation was high, certain sectors (agriculture and coal, for example), enterprises and bankers gained large rents, either in the form of subsidised credits, loans at negative real interest rates or arbitrage opportunities. As Treisman (1998) and Hellman (1998) have argued, these winners gained at the expense of the population at large. According to Treisman, the Russian government managed to co-opt the winners and, in the process, achieved lower inflation. Hellman argues, contrary to conventional wisdom, that reform governments must restrain these 'winners' (by expanding political participation and competition) as they are more of a threat to successful reform than the 'losers'.

the failure to build a sufficient constituency for market-oriented reforms, these entrenched groups were able to advance their own narrow interests at the expense of the reform process and the welfare of the population at large.

In summary, Russia's 'peculiar' (a word often used to describe the post-socialist Russian economic system) transition from a planned to a market economy has been a story of winners and losers, and powerful vested groups with conflicting and narrow interests, made stronger by the weakness of political parties, of democratic institutions and of the rule of law. The early years of transition left the Russian state in a state of limbo, some place between the 'helping hand' and the 'invisible hand', what Shleifer and Vishny call the 'grabbing hand'. This view was espoused by Boris Yeltsin in his State of the Federation address in March 1999 when he talked about Russia getting stuck halfway, and left with ' … a hybrid of the two systems …' (i.e. plan and market). This vacuum has being partly filled by oligarchs, rent seekers, corrupt government officials and the mafia. This is what George Soros calls 'robber' capitalism, Grigory Yavlinsky calls 'phony' capitalism, Marshall Goldman calls 'bastard' capitalism and John Gray calls 'mafia-dominated anarcho-capitalism'. It manifests itself in a number of different ways; the problem of tax collection is one of these manifestations. But this is only one side of the story.

There is another side to the story. Russia, in many respects, resembles a market economy. The majority of its output, estimated at 70% in 1999, is produced in the private sector (EBRD 1999). For most goods, prices are not controlled and are close to world levels. Certainly, some Russians are better off today than they were 12 years ago, despite the setbacks associated with transition. As for taxation, the tax/GDP ratio in Russia is higher than the ratio for some of the Organisation for Economic Co-operation and Development (OECD) countries and some of the ex-socialist transition countries. Given Russia's level of income, this level of government capacity is quite surprising. Here is one of post-socialist Russia's many paradoxes. This is the other side of the story, a side that is often neglected and seldom recognised. Leaving this for others to consider, the rest of this chapter explores the relationship between the 'tax-collecting state' and the 'tax-paying enterprises' in a particular transition economy, namely Russia. In effect, it is the story of an economy that has experienced a transformation (albeit traumatic and uneven) from an administrative-command economy to a market economy but whose state is in crisis; an incapacitated state that has failed to change in line with the economy and whose actions, and in some cases inactions, have adversely effected the behaviour of enterprises, not only state and privatised, but also the new private sector (often with new firms going underground or failing to grow, or in some cases, even start up, due to the predatory nature of government and its officials, particularly at regional and local level).[12]

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[12] This view of a dysfunctional Russian state is shared by others, including Sapir (1999), Brown (1999), Gustafson (1999) and Nagy (2000). For example, in their separate accounts of the

The State and the Enterprise Sector in Russia

In this section, we provide an explanation for Russia's tax problems in the context of the state-enterprise relationship. We argue that the real cause of the problem is the ineffective state, the behaviour of an enterprise sector that is often dominated by powerful vested interests and the non-market relationship that exists between the state and parts of the enterprise sector in Russia today.[13] We will deal with each of these in turn.

The State

As we see it, the problem of the state as exists in Russia is twofold. Firstly, although the state has succeeded in building institutions required in a democracy (a constitution, a parliament, an independent judiciary, a media with freedom constitutionally guaranteed), its progress in building institutions that are supportive of a market economy has been less impressive. Among others, these institutions are legal (property rights, courts, bankruptcy procedures), regulatory (monopolies, financial sector and securities markets), administrative (civil service and public administration), financial (adequate financial intermediation, supervision and prudential regulation), fiscal (tax code, tax administration) and social (obligations to workers, welfare provision). Without these institutions in place and working well, Russia cannot properly function as a capitalist democracy. Just as Kornai emphasised the importance of 'norms' under the socialist system, we need to emphasise the importance of institutions in the new market system (North 1990; Kornai 1992). Ironically, much of this requires a strong state.

Secondly, the actions and inactions of the state in post-socialist Russia are at odds with its responsibilities in a market economy. On the one hand, it is not doing what it should be doing, whether that is enforcing the rule of law, building an effective public administration, ensuring property rights and contract enforcement, providing essential public services, legitimising the informal sector, ensuring a social contract or encouraging competition. The national state has, in effect, abdicated on these responsibilities. Weakened, it became particularly vulnerable to the small groups of lobbyists and vested interests (agricultural lobby, bankers, energy sector) that sought privileges and favours. In particular, it is the politically-connected firms that have managed

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August 1998 crisis, they explicitly refer to 'a large-scale failure of state power' (Sapir 1999); 'a bloated state that … was incapable of performing satisfactorily such basic functions as collecting taxes, paying public service workers, and maintaining law and order' (Brown 1999); '... a failure of the central state' (Gustafson 1999) and '…the on-going meltdown of the state' (Nagy 2000).

[13] Of course, this symbiotic relationship between government and business can be traced back to pre-Soviet and Tsarist times, as far back as the fourteenth century and remained a characteristic of the Russian state throughout most of its history (Pipes 1974; Hedlund 1999).

to ‘capture’ the government in pursuit of their own narrow interests (EBRD 1999; Hellman and Schankerman 2000). This leads us to the other dimension of governance in Russia today. In sharp contrast to the above, the state is frequently doing what it should not be doing whether it is softening budget constraints of nonviable firms, indiscriminately bailing out insolvent ‘banks’, exchanging government goods in return for kickbacks, stifling enterprise with punitive taxes, incessant inspections, costly regulations and draconian penalties, keeping power at the regional level at the expense of local government, and maintaining, or in some cases, fostering features of the old system (the privileges and favours, the ‘patron-client’ networks, the regulations, the bureaucracy, the extortion and so on). This view of a state that is irresponsible in its inactions (weak and ineffective) and actions (predatory and interventionist) is shared by others, including Åslund (1994), Mau (2000) and Nagy (2000). Peter Evans (1992) remarks that the ‘…conjunction of leviathan and the invisible hand…’ is not as contradictory or as uncommon as it might appear.[14] In that context, the problem in Russia, as distinct from other countries where a symbiotic relationship between government and business is common (Japan and Korea, for example), is that the Russian state lacks the ‘embedded autonomy’ prevalent in so-called developmental states (Evans 1992).

The Enterprise Sector

The changes in the enterprise sector in Russia since transition began have been mixed, with evidence of significant sectoral and regional differences. Whereas the resources sector generates substantial value added and much needed hard currency earnings, the value added and foreign currency earnings generated by the manufacturing sector are less substantial. This is a legacy of Soviet times when negative value added was quite common and enterprises did not trade directly with foreign firms, other than through the trading bloc CMEA. Although many of these enterprises have been privatised, they (pre-1998 crisis) have been slow to restructure (Frydman et al. 1996; Blasi et al. 1997). Table 1 reports the EBRD’s measure of governance and enterprise restructuring for a number of transition economies, including Russia, for the period 1994–1999. It is evident from the table that the improvement in enterprise restructuring in Russia, in the judgement of the EBRD, has been slow and erratic, since 1994.

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[14] The publication’s editors, Stephan Haggard and Robert R. Kaufman write that, ‘For governments to reduce their role in the economy and expand the play of market forces, the state itself must be strengthened.’ Evans supports this thesis of a complementarity between state and market by quoting from such figures as Karl Polanyi, who in *The Great Transformation* wrote ‘The road to the free market was opened and kept open by an enormous increase in continuous, centrally organised and controlled interventionism’ and Max Weber, writing in *Economy and Society* that ‘Capitalism and bureaucracy have found each other and belong intimately together.’

Table 1 Index of Governance and Enterprise Restructuring/Reform 1994–1999

	1994	1995	1996	1997	1998	1999
Estonia	3.0	3.0	3.0	3.0	3.0	3.0
Georgia	1.0	2.0	2.0	2.0	2.0	2.0
Hungary	3.0	3.0	3.0	3.0	3.3	3.3
Kazakhstan	1.0	1.0	2.0	2.0	2.0	2.0
Lithuania	2.0	2.0	3.0	2.7	2.7	2.7
Russia	1.7	2.0	2.0	2.0	2.0	1.7
Ukraine	1.0	2.0	2.0	2.0	2.0	2.0

Source: EBRD Transition Report 1999.

Note: The classification system is based on the judgement of the EBRD's Office of the Chief Economist. The scores represent the following: 1 = SBC (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance. 2 = moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance. 3 = significant and sustained actions to harden budget constraint and to promote corporate governance effectively (e.g. through privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation). 4 = substantial improvement in corporate governance, for example, an account of an active corporate control market; significant new investment at the enterprise level. 4+ = standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.

In post-privatisation Russia, corporate governance mechanisms are generally weak with insiders retaining control. This resulted from the mass privatisation programme where the stakeholders (incumbent managers and workers) were co-opted in order to secure their support for the privatisation scheme. Much of the capital stock in the Russian state-owned enterprise sector is old and obsolete. Modes of organisation are often antiquated. Labour hoarding by some state-owned and private enterprises is evident, with some social provisions still provided by the enterprise. In rural Russia, many of the mono-enterprise towns remain, isolated from the marketplace and even more isolated from the international capitalist world. Labour mobility is often restricted by enterprise provision of social services, derisory unemployment benefits, wage arrears and, sometimes even, the registration (propiska) system (Broadman and Recanatini 2001). Despite the reforms (and the difficulty in acquiring verifiable evidence), many enterprises in Russia, almost a decade into transition, are still likely to operate with two sets of books, a shell or daughter company, an offshore subsidiary and have unregistered activities. Regular payments to the mafia, government officials and local politicians are not uncommon. Enterprises are as likely to engage in late payment, informal, personalised, private methods of contract enforcement and other non-market activities as they are to engage in prompt payment, formal, anonymous, legal methods of contract enforcement and other market activities.

As with other transition economies, differences in enterprise performance and restructuring in Russia may be accounted for by a number of factors, including ownership, market structure and competition, corporate governance, finance, and budget softness (Djankov and Murrell 2002). Since privatisation began, improvement in enterprise performance has been delayed, and in some cases hampered, by lack of investment finance, domestic and foreign competition, regional administrative barriers and inadequate corporate governance mechanisms (Angelucci et al. 2002). Of course, the enterprise sector in Russia is not monolithic. We can distinguish between state, privatised and new private, with *de novo* private firms showing strong performance relative to both state-owned and privatised firms. Each of these three categories is likely to have a different relationship with the state. Often, the incumbent (state or privatised) is protected by the (subnational) government whereas *de novo* private firms are often harassed by the state (McKinsey 1999; Broadman 2002). We now examine the state-enterprise relationship in more detail.

The State–Enterprise Relationship

Central to the behaviour of enterprises and the slow pace of restructuring is the political economy nexus that exists between the state and the enterprise sector or, more particularly, between subnational government and incumbent state or privatised firms. In a well-functioning market economy, the certain provision of public goods in exchange for the orderly payment of taxes is a central feature of the state-enterprise relationship. This is not the case in Russia (or in many other FSU countries). In the case of a federalist state with weak central authority, the state-enterprise relationship is more likely to be dominated by subsidies, tax breaks, payment arrears, asset-stripping and bribes than by public goods and compulsory, unrequited payments to government i.e. taxes.

Although the state has been weakened in many respects since the dismantling of state socialism, the state still retains ‘interventionist’ features of both the helping-hand and the grabbing-hand models with respect to its relationship with the enterprise sector. Some politically-connected firms manage to extract rent from the state in return for bribes to government officials and bureaucrats. This is the case of the activist, predatory state ensuring its survival, while at the same time enriching public officials (EBRD 1999; Shleifer and Treisman 2000). It is not uncommon for loss-making firms to be bailed out by the state (particularly at the regional level of government) by means of tax and utility arrears. This is the case of the SBC phenomenon (Pinto et al. 2000; Kornai 2001). In this case, it would appear that its behaviour is influenced by a desire to maintain employment and prevent social unrest. McKinsey found that ‘… policies are often put in place to achieve social objectives, namely protecting existing jobs, but in many cases, the suspicion is that they also serve the personal financial interests of government officials in collusion with businessmen …’ (McKinsey 1999).

What has changed is the way that the state channels funds to these loss-making enterprises. Arbitrary pricing and budgetary subsidies have been replaced by new, and often implicit, ways of extracting subsidies from the state, including tax exemptions, arrears and offsets, utilities arrears, non-payment and, in some cases, barter. This intervention by the state (and in increasing amounts by regional government) prevents a redistribution of resources to the sectors of the economy where there is potential for further value added. Although Russia may be a ‘market’ economy in the sense that most of the output, officially or unofficially, is produced in the private sector and resources are allocated through a decentralised price mechanism, it still retains some features of the old Soviet socialist system. One of these features is the state-enterprise relationship that still lingers, preventing the state from carrying out its ‘market’ duties and preventing enterprises from restructuring. By condoning informal activities, reneging on its obligations to its suppliers and its workforce, taking bribes and by allowing rent-seeking behaviour, accepting tax offsets, negotiating tax liabilities with well-connected enterprises, allowing mutual indebtedness and barter chains to flourish, tolerating arrears, allowing the resources sector to subsidise the manufacturing sector, and by maintaining ‘relational capital’ with the enterprise sector, the state is implicated in the economic and political crisis of the 1990s in Russia, culminating in the rouble devaluation and the debt default of August 1998.

Since 1992, governments in Russia have been described at various different stages as soft, weak, corrupt or interventionist. With respect to its relationship with the enterprise sector, we can say that Russian governments have proved to be all of the above at some stage or other. In a market economy the state has responsibilities to the enterprise sector. Among others, it is sometimes an owner (although not often), a creditor (tax collection agency), a legal guardian (courts and contract enforcement, bankruptcy) and a regulatory body (to promote competition and prevent monopoly practices). With respect to the Russian enterprise sector, we can say that as an owner the state is often corrupt, sometimes paternalistic; as a creditor it is sometimes ‘soft’; as a legal guardian it is weak and open to abuse; and, finally, as a regulatory body, it is frequently bureaucratic and interventionist. The state-enterprise relationship suffers as a result, failing to develop into a market-type relationship as exists in mature market economies and in some of the leading transition economies (Hungary and Poland, for example).

To summarise, Russia has experienced a ‘soft’ transition in terms of the symbiosis between politics and economics, or what ex acting-PM Yegor Gaidar refers to as the ‘…intertwining of property and power…’ and of ‘…business and bureaucracy…’(Winiecki 1992; Gaidar 1999b). This is a legacy of the socialist political-economic system, described as ‘…the unique symbiosis of the state with society and the economy’. (Kaminski 1996).[15] This

[15] This symbiotic relationship is portrayed in Ericson’s depiction of the Russian economic system as characteristic of ‘industrial feudalism’ with regional fiefdoms (Ericson 1999). He

is not a case for state desertion, but for the relationship between the state and the enterprise sector to be made more formal within an appropriate institutional setting.

Although this symbiotic relationship is best exemplified by the existing state-enterprise relationship, the implications reach beyond the enterprise sector. For example, the results for many 'ordinary' Russians have been catastrophic, despite the increase in individual liberty and choice. In the early years, this was reflected in rising mortality rates, greater income inequality and even larger numbers of people living in 'poverty'. In later years, it has been reflected in rising crime and in a general mistrust of state institutions and in the entire political process. Recall Thomas Hobbes' treatise *Leviathan* wherein he stated that life without an effective state is '…solitary, poor, nasty, brutish and short'. (Hobbes 1651). As the state continued to weaken, many Russians found themselves disengaging from the national state. It is not surprising that the general public do not have trust in the government or its institutions when arrests and charges against state employees of the Central Bank of Russia (CBR), Goskomstat, the Federal Bankruptcy Service, the State Tax Service (STS) and other state agencies for fraud, evasion and other criminal activities were not uncommon throughout the 1990s.

What are the symptoms of an ineffective state? How does the symbiotic relationship between government and business manifest itself? How can the umbilical cord of the state be detached without damaging the fiscal capacity or the tax powers of the state? In the next section, we focus on Russia's weakened fiscal system and the problems of fiscal discipline and tax collection.

Taxation and Russia's State–Enterprise Relationship

A central feature of the state-enterprise relationship in any economy is the fiscal system and taxation. Moreover, since transition began a decade ago, nothing portrays the fusion between government and business in Russia better than the taxation issue. In a market system, the tax obligation of an enterprise is determined by tax law. In the socialist system, the 'tax' obligation of an enterprise was determined by the bureaucrats and was subject to change, depending on the circumstances. In the early years of post-socialist Russia, the tax obligation of many enterprises was determined, in theory by statutory

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describes the state-enterprise relationship as one where there '…is a tendency at all levels to look to governments, with their ability to command resource flows, for direction, support and the solution of economic problems' and where there '…is a tendency for governments to look to business organisations for access to the resources needed to maintain their power and control.' One of the key findings of the EBRD/WB survey was that 'States and firms continue to be tied together in a web of interactions in which the state provides a wide range of direct and indirect subsidies to firms, while firms provide public officials with some combination of control over company decisions and bribes.' (EBRD 1999).

tax legislation, but in practice, by personal relations and open to negotiation and subject to lobbying and bargaining. Ex acting-PM Yegor Gaidar, in relating the tax collection problem to the SBC and the interface between the state and the enterprise in post-socialist Russia, writes '…the problem of tax collection was not a problem of tax administration in the usual sense. It was more a political struggle about what constituted the essence of the emerging economic system, whether it was to be a system in which the relationship between the state and the enterprises was to be regulated by law or whether it would be business as usual, based on political influence and personal contacts' (Gaidar 1999a).

Taxation in the traditional (pre-reform) socialist system was very different to the Western-style tax system, both in terms of objective and composition. Taxes were mostly transfers within the public sector, from profitable SOEs, that is, state-owned enterprises with surpluses, to loss-making SOEs. For the enterprise, taxes were implicit and negotiable. As for the state, taxes were easy to collect as taxpayers, that is, enterprises, tended (relative to the capitalist system) to be fewer in number and larger in size. In addition, the State Bank, in processing enterprise payments, acted as a tax collection agency. The main forms of 'tax' revenue were enterprise profits tax (= profit remittances), turnover tax and payroll tax. The collapse of the socialist system meant that fiscal institutions, as exist in market economies, had to be built from scratch. Statutory tax systems were required in order to raise enough revenue to pay for the provision of public goods. Income tax systems (both corporate and personal), value-added taxes and tax administration systems were all introduced in the early years of transition. Russia was confronted with a Western-style tax system where voluntary compliance and confrontation between the tax collector and the taxpayer are the norm. For these and other reasons, it was inevitable that the transition to a market economy would bring a fall in the tax share of GDP. By 1998, total government revenue/GDP ratio was 33.4%. Moreover, federal revenues were only 11% of GDP, of which two percent was in non-cash form (see Table 2).[16] We use total government revenue as a share of GDP as this is a good measure of government capacity. Table 2 shows that since transition began, Russia's government capacity has weakened. This is synonymous with recent empirical evidence that poorly performing governments (in our case, Russia), in contrast with better performing governments (many of the ex-socialist Central European countries), collect fewer taxes (La Porta et al. 1999).[17]

[16] This problem of insufficient federal government revenues was even recognised by Anders Åslund (a critic of government intervention) who, in writing about the 1998 crisis, wrote '... Russia's *federal* revenues are small, and the central government can hardly manage without additional resources …' Admittedly, there were improvements in (federal) tax revenue in 1999, due largely to discretionary changes in policy, namely, the reintroduction of export taxes and the centralisation of tax receipts.

[17] Likewise, Shleifer and Treisman (2000) note that 'The most market-friendly governments in the late twentieth century tended to be those that collected and spent the most revenues.'

Table 2 Revenue Share of GDP, 1992–1999

	1992	1993	1994	1995	1996	1997	1998	1999
Enlarged Gov. Revenue[1]	39.3	36.2	34.6	34.1	33.5	36.5	33.4	35.6
Federal Gov. Revenue	16.6	13.7	11.8	12.9	12.5	12.3	11.0	13.4
of which								
- Cash	n.a.	n.a.	11.4	11.0	9.1	10.0	9.0	13.4
- Non-Cash	n.a.	n.a.	0.4	1.9	3.4	2.3	2.0	0.0

Source: Russian Federation: Selected Issues, IMF Staff Country Report No.00/150, 2000.
Note: 1. Consolidated revenues (incorporating extrabudgetary funds), including both cash and non-cash items.

The problem of poor tax collection is more than an administrative problem. The problem is more deep-rooted, with numerous possible causes. For a start, there are a large number of enterprises that are either ‘unprofitable’ or operate in the informal economy. Two, the tax base is narrow and as a consequence there is an excessive tax burden on those liable for tax. This encourages those liable for tax to find ways of reducing their tax bill, legally or illegally. For example, competition for enterprise tax revenues between the different levels of government in conjunction with the practice of tax shifting between regions provides an opportunity for enterprises to lower their effective tax rate. Three, the tax system that operated throughout the 1990s included a plethora of tax concessions and tax breaks, not to mention tax amnesties. Four, the government is often found negotiating the tax obligations of well-connected enterprises. Five, tax liabilities are often overdue, and, in some cases, either written off or reduced. Six, the use of barter and non-monetary exchange makes tax detection more difficult. Seven, tax administration is undoubtedly poor. Tax collection was made more difficult by the *de facto* dual subordination of tax administrators to the central authorities and the subnational governments.

It is also true that Russia has made less progress than other transition countries in moving away from taxing corporations toward taxing individuals. This is a legacy of the socialist system when the state expropriated ‘profits’ from the enterprises. In Russia today (as is common in many other CIS countries), many of these same enterprises, some privatised, are not short of ways of evading detection from the tax authorities. Among others, it includes the use of money surrogates, affiliates or subsidiaries, multiple bank accounts or barter transactions.

For the Russian federation, tax collection is further complicated by the chaotic evolution, since reforms began, of the system of intergovernmental fiscal relations. Russia, with its highly centralised formal system combined with subnational informal autonomy (as opposed to the days of the Soviet Union when subnational governments were mere administrative branches of central government), does not have a well-designed system of fiscal federalism (Lavrov et al. 2000). Among other things, this results in an intense struggle between the federal government and regional governments over revenue-sharing.

The system of intergovernmental fiscal relations and fiscal federalism in Russia is deficient in a number of respects. For one, during the mid-1990s the share of revenues accruing to the subnational government increased in an *ad hoc* and arbitrary fashion, from 31% in 1992 to 38% in 1995, all at the expense of a weakened federal government (Freinkman et al. 1999). Two, federal government has assigned much of its social spending responsibilities to the regions. Equal transfers of revenues have not been forthcoming; these unfunded mandates often resulted in unclear responsibilities and in the case of subnational governments, expenditure arrears. Three, with income differentials between the regions growing, intergovernmental transfers have often been discretionary, non-transparent and politically motivated. Four, bilateral power-sharing agreements between the federal government and individual regions (in particular, some of Russia's 21 republics) have undermined the fiscal system. The centre is often found negotiating from a position of weakness with centrifugal, resource-rich regions whose demands range from devolution of spending responsibilities or conferring of special tax powers to political autonomy. It would seem that the relationship between federal government and the republics is determined more by economic resources, political influence, personalities and bargaining skills than by *de jure* rights.

Five, there is a lack of adequate tax autonomy at subnational level. For taxes that are permanently assigned to subnational governments, limitations, in respect of bases and rates, are often set by federal government. For taxes shared, the revenue-sharing arrangements are often customised and subject to yearly shared rates. Six, the incentives for government officials at subnational levels are often skewed toward low tax (particularly in cash) collection, excessive spending and greater concessions to local enterprises. In particular, the revenue sharing schemes between regional and local governments (with subsidies constituting the largest share of local government spending) provide little or no fiscal incentive for the local government to mobilise revenues or to increase their tax base as any increase in local government own revenue is 'taxed away' by regional government (Freinkman et al. 1999; Zhuravskaya 2000). More generally, '… Tax sharing inherently contains a strong element of political bargaining that is, in itself, a source of "softness." ' (Lavrov et al. 2000).[18] Another tax rights problem in Russia is the overlapping tax base and 'tragedy of the commons' problem, leading to 'overgrazing' (Berkowitz and Li 1999). During the mid-1990s, subnational governments in Russia had the authority to introduce new taxes within their

[18] Actual revenue sharing rates have differed from the sharing rates as stated in budget law on account of differences in the extent of tax arrears between federal and subnational government, various bilateral treaties signed with individual regions (republics) and, in some cases, refusal to remit tax collection to the federal government (Martinez-Vazquez and Boex 1999).

jurisdictions. Often, the result was high aggregate tax rates, depressing economic activity and driving firms underground.[19]

Despite recent improvements, intergovernmental fiscal arrangements remain non-transparent, complicated and uncertain, making for a federal system that undermines the fiscal responsibility of subnational governments. As one public finance expert remarked '…the Russian Federation's current fiscal structure with its 'shared' taxes, obscure transfers, and duplicative expenditure roles seems designed to frustrate rather than facilitate effective subnational government.' (Bird 2000). In the context of financial discipline, the system of intergovernmental fiscal relations described above, that is of unclear expenditure assignments, weak revenue autonomy, transfers that are subject to frequent changes and negotiation, and few restrictions on subnational borrowing (all contrary to the principles underlying the idea of 'market-preserving' federalism), lends itself to soft subnational budget constraints (Rodden et al. 2002).

One implication of intergovernmental relations and fiscal federalism in Russia is the weak position that the federal government often finds itself in *vis-à-vis* the regional governments and the enterprise sector. For example, if the federal government makes a move against the utilities in an attempt to collect taxes, supplies are threatened. Alternately, if the federal government moves on the regional governors, taxes are withheld. Likewise, if the federal government moves on the large enterprises, the managers and regional governors often collude. It is not uncommon for managers of large enterprises to play one level of government off against the other; more often than not it is the federal government that loses out (Treisman 1998; Shleifer and Treisman 2000).[20]

For some, the fiscal problem is as much on the expenditure side (where some spending is quite wasteful, particularly at the regional level, and some is used for private benefit) as on the revenue side. Russia, with a GDP per capita less than $2,000 in 1998, does not have the economic capacity to be a big spender.[21] Whereas federal non-interest spending has declined as a share of GDP, regional spending and expenditure arrears have both increased. Those favouring spending cuts advocate further reductions in budgetary subsidies where they are above 'normal' levels, cuts in government bureaucracy and a reform of entitlements so that social provisions are targeted to where they are most needed. Given the limited means of the national state, much of the welfare spending is misdirected, dispersed without regard to the income levels of the recipients (Åslund 2002). Yet, an equally valid argument

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[19] In the context of fiscal federalism, subnational government incentives and tax rights, there is the obvious contrast, since reforms began, between the Russian and Chinese experience. For more on this, see Berkowitz and Li (1999) and Roland (2000).

[20] The different games played and the ingenious schemes used by the respective stakeholders (federal and subnational governments, enterprises, tax authorities) in Russia's federal tax system are aptly described in Shleifer and Treisman (2000).

[21] EBRD, 2001. In PPP terms, the figure is closer to $4,000.

can be made for more expenditure in the areas of public sector pay, health services, education and the environment (Shleifer 1997).

Tax arrears or overdue tax liabilities in the enterprise sector have been of particular concern to the Russian government. On the issue of tax arrears, all enterprises are not the same. What follows is a stylized account of tax arrears in the enterprise sector. For the purpose of explaining tax arrears, the enterprise sector can be divided into four categories. Some enterprises pay their taxes on time; more pay their taxes but with a delay, some in cash and some in-kind; others who could pay, do not pay; and, finally, there are the firms that cannot pay their taxes and do not pay taxes.[22] The first category forms a disproportionately large part of the corporate tax actually paid by the enterprise sector and is not politically strong. The second category uses tax liabilities as a source of cheap working capital in times of financial difficulty; possibly because the government is considered to be the softest creditor and is paid only after employees, banks and trade suppliers have been paid. The third category is either politically sensitive or politically connected. The final category is continually in financial and economic difficulty but does not (for example, because of weak bankruptcy practices) or is not allowed to (for paternalistic reasons) die. By 1998, much of the tax payments made to the government were not in cash form but in non-monetary forms. According to the OECD, 40% of all taxes paid to the federal government in 1997 were non-monetary (OECD 1997). In sum, we feel that the state must shoulder most of the blame for its inability to collect taxes. Many of the reasons for the low compliance result either directly or indirectly from discretionary government policy. Ultimately, like so many of the other problems that exist in Russia today, the problems are one of economic incentives, institutional weakness, arbitrary government action and an ineffective state.

The problem of tax payments (and the related problem of non-monetary forms of payment) can be summarised as follows. The incidence of tax and inter-enterprise (trade credit) arrears, offsets and other forms of non-monetary payments paints a picture of mutual indebtedness between certain enterprises, between certain enterprises and government and between the federal government and certain regional governments. Some enterprises, whether profitable or unprofitable, do not pay their bills and stay in business. Loss-making enterprises are subsidised either by

[22] Pre-1998, one of these delinquent firms is Gazprom, the gas monopoly and Russia's richest company. Gazprom often acts like a quasi-fiscal institution and has been described as 'the state within the state'. It has political connections, secures favourable tax breaks, has had large tax arrears, often conducts barter-trade and continued to supply non-paying customers. The mutual debts that exist between the government, Gazprom and other enterprises make the budgetary process for the federal government all the more difficult.

(i) profitable enterprises (many of which are in the energy sector) through non-payment, 'discounted' payment, in-kind payment or late payment of bills;[23]
(ii) government through the non-payment or late payment of taxes;[24]
(iii) workers through wage arrears.[25]

In the socialist system, manufacturing enterprises were subsidised by underpriced inputs and low interest charges on the use of capital. Today, the industrial sector is similarly subsidised, with only the form of this subsidisation haven changed. Funds are channeled to the enterprises via quasi-fiscal and fiscal institutions. Some loss-making manufacturing enterprises stay in business with the aid of tax arrears, non- or late payment of bills to their suppliers and utility companies or non- or late payment of wages to their workforce. These economy-wide, non-market activities are allowed to persist and proliferate because they are 'tolerated', 'facilitated' and, in some cases, even 'instigated' by the state. Since the collapse of the Soviet Union direct subsidies have fallen. Since the tightening of monetary policy, growth in new bank credit has decelerated. As enterprises became more credit constrained, they sought out new ways of surviving. Some combination of non-payment of bills (to utilities, to suppliers, to government, to workers), and late payment to suppliers (inter-enterprise arrears) and to government (tax arrears) and use of non-monetary forms of payment (barter, offsets, veksels[26]) allowed for an injection of 'soft' credit to the enterprise sector. Again, this was sanctioned, in

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[23] Gaddy and Ickes 'virtual economy' argument is that enterprises are engaged in exaggerated-price barter transactions whereby the value of a good or service is exaggerated in order to hide the negative value added generated by manufacturing enterprises (Gaddy and Ickes 1998). Value-creating enterprises are also faced with constraints. For example, the energy companies in Russia are prohibited from disconnecting non-paying customers. In return, the government tolerates tax arrears and arrears to the extra-budgetary funds by the utilities. In response to overdue receivables, some utilities have responded by rescheduling or writing off debts in return for an ownership stake in these recalcitrant firms. In this scenario, the utilities can be viewed as conduits, whose purpose it is to channel funds to favoured/troubled firms.

[24] The SBC syndrome. One difference between the SBC in Kornai's paternalistic model and the budget softness as currently evident is the absence of any fiscal redistribution from profitable to unprofitable firms (the leveling effect). Whereas this was a feature under the socialist system, in today's Russia, some profitable companies are also benefiting (by means of tax arrears, export licenses, etc...). This phenomenon is better explained by the Shleifer-Vishny (1994) model where these firms are using their political connections and bribing government officials to take advantage of a weak but self-preserving state and corrupt officials.

[25] There is a popular perception that it is the Russian household sector that ultimately carries the burden through non- or late payment of wages, and of social and welfare benefits. It is not uncommon for some enterprises to use wages arrears to strengthen their case for concessions from the government. This may also be evidence of a subnational SBC when subnational wage arrears get rescued by federal bailouts (OECD 2000; Lavrov 2000).

[26] A veksel is a promissory note issued usually by an enterprise; it is passed through the chain and usually presented for payment by the end-holder who usually gets paid in kind with the products of the issuer. In Russia, where there is a secondary market in veksels with the value of the veksel depending on the credibility of the issuer, veksels are viewed as close substitutes for money.

the past by a strong but benevolent state, determined to prevent firm closures and job losses (the helping hand) and more recently by a weak but predatory state, determined to survive and, in the process, to enrich itself (the grabbing hand). Commander and Mumssen (1999) make a similar assertion when they argue that '…the state increasingly injected net credit into the ailing industrial sector….' because of '…concerns about employment, but also a result of corruption, fraud and tax evasion….'(Commander and Mumssen 1999). In its analysis, the EBRD found that '…payments are consistently made to particular interest groups under the guise of employment protection'. (EBRD 1999).

In Russia today, probably the greatest source of paternalism and budget softness lies with the regional governments. Attempts by the federal government to instigate reforms have been hampered, if not by the Duma, by the regional governments whose influence resides in their control over the use of land, real estate, taxes, utilities and ultimately, local enterprises (state and privatised). In more recent times (a phenomenon that increased as the economic depression deepened), some regions ceased to remit taxes to the 'centre' (partly in response to regional transfers committed by the centre but withheld), engaged in unauthorised spending of budget funds, hid additional resources in extrabudgetary funds, extended soft credits to (often, unproductive) enterprises, regained stakes in local enterprises by means of debt-equity swaps and imposed 'temporary' price controls on certain commodities.[27] This tendency for regions to behave in a quasi-socialist manner has been described by some as evidence of a feudal system where governors treat their regions as fiefdoms (Ericson 1999; Fairbanks 1999).

This crisis of a weak state and poor governance manifested itself in a severe fiscal crash in August 1998, the topic of the next section.

The 1998 Russian Crisis[28]

As stated previously, the long-term problem with the Russian economy is a failure on the part of the state to meet its obligations with respect to the functioning of a market economy. As we have seen, this includes the failure to enforce laws, to collect taxes, to pay wages and pensions, to repay investors and international donors, to encourage competition in the enterprise and banking sectors, to foster market-type institutions and to provide an adequate

[27] Given the way fiscal federalism works in Russia, taxes get passed up to the central authorities (hence, the ability to stop payments to the centre) and enterprise subsidies are expenditure items assigned to subnational governments (hence, subsidies paid by regional and local governments to 'favoured' enterprises).

[28] The author acknowledges the substantial Russian-language literature that is available on this vexed topic. The literature used for this research is in the English language and taken from Western journals. A small number of the authors are Russian.

social security net.[29] Its relationship with the enterprise sector is problematic. It either condones non-market behaviour by some enterprises (subsidies, cheap credits and other rent-seeking activities) or bails out loss-making enterprises (by way of tax arrears, offsets and concessions). In either case, we have evidence of the grabbing-hand or the helping-hand state. This crisis of the state culminated in the August crash of 1998, which we now consider.

The débâcle of August 1998 has been described by many commentators as the worst economic and political crisis in Russia since the dissolution of the USSR (Illarionov 1999; Malleret et al. 1999; Nagy 2000). A brief account of the August 1998 crisis follows.

On July 13, one month before the August 17th crisis, agreement was reached between the international financial organisations and Russia on a loan package worth US$22.6 bn in total, of which US$11.2 bn was additional monies agreed by the IMF. For many, this was viewed as both helpful and necessary if a financial crisis was to be averted in Russia. For others, it was seen as yet another bailout, with the inevitable consequences to follow. Critics of the package believed that the terms agreed (fiscal and structural reforms, particularly relating to tax) were unlikely to be met by the Russian Government and Parliament. Of the total, US$4.8 bn was disbursed at the end of July, down from the anticipated US$5.6 bn. A further $300 m was disbursed by the World Bank, under SAL III. Another measure aimed at boosting market confidence and providing some relief to the Treasury was the swapping of short-term rouble-denominated debt for dollar-denominated debt (Eurobonds). The initial reaction to the package was positive, with a fall in interest rates and a rise in share prices. As we know, this was short-lived.

In its short period in charge, Kiriyenko's Government concentrated on the fiscal system, and in particular on reducing the budget deficit. By 1998, the federal budget deficit had been reduced, with current revenue covering non-interest current expenses. However, many of the new Government's tax collection initiatives were of an administrative nature. The Government did succeed in introducing a much needed new Tax Code but there were delays in enacting Parts II and III. Other measures were inevitably rejected by the populist communist-dominated Duma. Some of the remaining proposals had to be passed by presidential decree.

By late summer as market sentiment deteriorated further, net financing from treasury bills issues was negative i.e. the Government was making net repayments of treasury bills. The Government could no longer roll over treasury bills as holders demanded payment on redemption dates. Matters were made worse by the fact that external reserves continued to fall, forcing the CBR to draw down the IMF monies in order to support the much-

[29] Given the theory of the SBC and the premise made in this chapter, that is, of a weak state (particularly as creditor), it is interesting to note that Gunnar Myrdal, when writing about the developing countries of South Asia, describes those states that fail to enforce basic obligations as 'soft states' (Myrdal 1968).

maligned rouble. Eventually, the Government could no longer meet its financial obligations. On August 17th, the Government conceded.

In essence, there were three separate announcements. First, a change in the exchange rate bands was revealed. There was to be a new ‘currency corridor’. The existing currency bands (+/–15%) with upper and lower limits of 5.27 roubles and 7.13 roubles respectively around a central parity value of 6.2 roubles per dollar were to be replaced with wider limits of 6.0 roubles and 9.5 roubles, respectively. This was a *de facto* devaluation of the lower band of 33%. Second, a 90-day moratorium on private debt repayments to foreign creditors was announced. Although described by the IMF as a ‘temporary restriction on capital payments abroad’, it amounted to a unilateral default on private foreign debt. Third, a mandatory debt conversion of GKOs and OFZs maturing on or before 31 December 1999 into longer-term maturity debt instruments and a suspension of trading in the domestic Treasury bill market was announced. This amounted to a unilateral rescheduling of rouble-denominated government debt and its aim was to give the Government some breathing space in its attempt to meet its obligations. The Government also announced that certain restrictions on foreign exchange operations were to be imposed. The combined decision to devalue and default, prompted by an unsustainable fiscal position and excessive public sector debt, brought an abrupt end to Russia’s commitment to low inflation, to be achieved by a mix of (possibly prolonged) tight monetary policy and an (seemingly inflexible) exchange rate regime.

In this author’s view, the August 1998 crisis was a fiscal crisis that had its origins in a weak and ineffective state. As in other countries where regime changes have arose from major economic and political crises, it was hoped that the events of August 1998 and the subsequent changes in government might provide Russia with the opportunity to rebuild an effective and well-functioning state.

What IS to Be Done?

Despite the doom and gloom preached by others, economic reforms in Russia have made some progress, albeit uneven. The same assessment cannot be made in relation to political and institutional reforms. These are the areas that the government most needs to focus on.

Further reform of the political and electoral process and of government institutions is required, recognising the need for greater competition, democracy and transparency. Despite local, regional and national elections in the past 11 years, the political reforms that took place in the last days of the Soviet Union and in the early days of the market reform period were never fully completed. The party system, as exists in democracies worldwide, has not been fully developed in Russia. This is particularly true at subnational level where local membership is low. Moreover, there are various aspects of the government and its apparatus that need to change. Russia's post-socialist political governance and institutions are, in one observer's opinion, not so different from the central authorities that existed under the Soviet system (Shevtsova 1999). The structures, organisations and the personnel of government, the relationship between the federal, regional and local governments, and the functions of government need to be redefined and reformed in order for corruption and pilfering to decline, economic reform to continue and public support to be restored. Although this redefinition will require a reconstruction of government in many respects, it is imperative that the government fulfils its expenditure obligations and contracts. Institution building (securities market, courts and bankruptcy procedures, land and housing markets, etc...) must continue, recognising that institutions take time to develop. Above all, many elements of the modern state—the judiciary and the legislature, for example—need to be strengthened. Among other things, this will require a meritocratic bureaucracy insulated from political pressures and interest groups. A well-functioning, well-financed public administration would serve Russia well.

As we know from the experience of other countries, the fight against corruption requires a mixture of policies. More legal reform, greater competition and transparency, an improvement in accounting standards, a more simple, less burdensome and more transparent tax system, less discretionary power for state officials and more deregulation (of government controls, licenses and permits) are required. The building of public institutions alongside the promotion of civic groups can help in the fight against corruption.

On the taxation front, there are several issues that need to be addressed. With respect to tax reform, tax rules need to be transparent and not subject to arbitrary changes or political interference. There needs to be a reduction in the number of taxes. Loopholes and exemptions need to be tightened. As regards taxation and fiscal federalism, the bargaining and open negotiation between the various different levels of government must be avoided. Tax (and expenditure) assignments, tax sharing and intergovernmental transfers need to be better designed, largely in accordance with general public finance principles, to improve accountability, autonomy and, in the context of subnational SBC, fiscal discipline of regional and local governments. More generally, in order for tax compliance to improve there needs to be a change in the economic and fiscal incentives faced by taxpayers, subnational governments and the tax officials of the regional and local branches of the Ministry of Taxation and Fees (formerly the State Tax Service). Rather than aggressively pursuing the small and medium-sized businesses as is commonly practised by tax officials, the tax authorities need to use their resources in the pursuit of the large, politically-connected enterprises that are behind in their tax payments. Many of these enterprises either belong to one of the powerful financial-industrial groups (FIGs) or are part of an oligarch empire. These reforms will help to change the perception that the Russian tax system is too complicated, highly distortionary, rife with delinquency and grossly unfair.[30]

In the short term, the federal government in Russia can restore political support, legitimacy and credibility by committing itself to these political, tax and institutional reforms. In the medium to long term, attention must focus on the provision of adequate public services, policies to tackle issues of unemployment, inequality and poverty and a commitment to a stable, strong but limited state with a well-defined capacity and set of responsibilities.[31]

We conclude by returning to Schumpeter's writings and, in particular, his paper on the crisis of the tax state. He wrote that the '…collapse of Russia is a very special case which does not belong here…The fiscal collapse in Russia, too, was only a consequence of the anti-capitalistic *will*.' Although this refers to a different time in Russian history, it is equally appropriate now. The fiscal collapse in Russia at the end of the twentieth century may not have arisen from an 'anti-capitalistic *will*', but rather from a failure to realise that capitalist-oriented economies require capitalist-oriented (tax-collecting) states. Remember it was Schumpeter, a supporter of capitalism and capitalists, who (inaccurately) predicted the demise of capitalism and the rise of socialism.[32] Despite the setbacks of the past 13 years, Russia and other ex-socialist countries have indeed experienced, in a reasonably short period, a similar transition. But in this case, the transition has been from socialism to capitalism.

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[30] Many of the tax reforms outlined above have been implemented since 1999. For a recent account of these reforms, read IMF (2002).

[31] The recent improvement in Russia's economic performance since 1999 does not, in the author's view, change either the basic premise or the lessons outlined in this chapter.

[32] Schumpeter's prediction for Russia (notwithstanding the 70 odd years of the administrative economy) has proven more accurate. He wrote '… the return to the tax state is certain particularly in the Russian case' (Schumpeter 1918).

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31

The Ethics of Tax Evasion: A Survey of Slovak Opinion

Robert W. McGee and Radoslav Tusan

Introduction

This study sought the views of three different subsets of Slovak students on the ethics of tax evasion. There were multiple goals. One goal was to determine the extent to which tax evasion is considered ethical. Another goal was to determine which arguments in favor of tax evasion that have appeared in the Western philosophical and theological literature over the last 500 years are the strongest in Slovakia. A third goal was to determine whether different subsets of the population had differing views on the subject. The responses of students majoring in business & economics, theology and philosophy were compared, as were the responses of men and women. Comparisons were made between the scores of younger students (under 25) and older students (25 or older) to determine whether individuals became more averse to tax evasion as they got older. These results were then compared to similar studies that were done on different, sample populations from other countries.

The results generally confirmed expectations. Responses were different among the three types of students. The male responses were also different than the female responses. Scores also differed by age. Some of the hypotheses made were confirmed while others were rejected. This study replicates studies that were made of international business professors (McGee 2005a), Romanian business students (McGee 2005b) and Guatemalan business and law students (McGee and Lingle 2005). The relevant literature is discussed elsewhere in this book. Citations to that literature are listed in the reference section at the end of this chapter.

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Methodology

After reviewing the literature that exists on the ethics of tax evasion, a survey was constructed in English, translated into Slovak and distributed to business & economics students at the Technical University of Kosice and to philosophy and theology students at the University of Presov, both of which are in the Slovak Republic. This group was selected because they will be the future business and political leaders and theologians of Slovakia.

The survey consisted of eighteen (18) statements. Using a seven-point Likert scale, respondents were asked to place the appropriate number in the space provided to indicate the extent of their agreement or disagreement with each statement. One hundred eighty-four (184) usable responses were received. The following hypotheses were made:

H1: The average respondent will believe that tax evasion is ethical sometimes.
H2: Scores will be lower [tax evasion will be more acceptable] when the statement refers to government corruption.
H3: Female scores will be higher than male scores [women will be more strongly against tax evasion than males] for at least 12 out of 18 statements.
H4: Philosophy and theology students will be more strongly opposed to tax evasion [will have higher scores] than the other two groups.
H5: Older students will have higher scores [will be more opposed to tax evasion] than will younger students for at least 12 of the 18 statements.

Survey Findings

Table 1 shows the breakdown by gender. Seventy-nine (79) males and one hundred five (105) females participated in the survey.

Table 1
Responses by Gender

Male	79
Female	105
Total	184

Table 2 summarizes the results for each of the 18 statements.

Table 2
Summary of Responses
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Score
1	Tax evasion is ethical if tax rates are too high. (S1)	5.34
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me. (S2)	6.11
3	Tax evasion is ethical if the tax system is unfair. (S3)	4.89
4	Tax evasion is ethical if a large portion of the money collected is wasted. (S4)	4.74
5	Tax evasion is ethical even if most of the money collected is spent wisely. (S5)	5.91
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of. (S6)	5.32
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects. (S7)	5.89
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me. (S8)	5.66
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me. (S9)	4.61
10	Tax evasion is ethical if everyone is doing it. (S10)	5.41
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. (S11)	4.04
12	Tax evasion is ethical if the probability of getting caught is low. (S12)	5.26
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust. (S13)	4.89
14	Tax evasion is ethical if I can’t afford to pay. (S14)	4.83
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more. (S15)	5.38
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935. (S16)	2.80
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background. (S17)	3.35
18	Tax evasion is ethical if the government imprisons people for their political opinions. (S18)	3.95
	Average	4.91

Chart 1 shows the average scores for each statement.

Chart 1 Average Scores

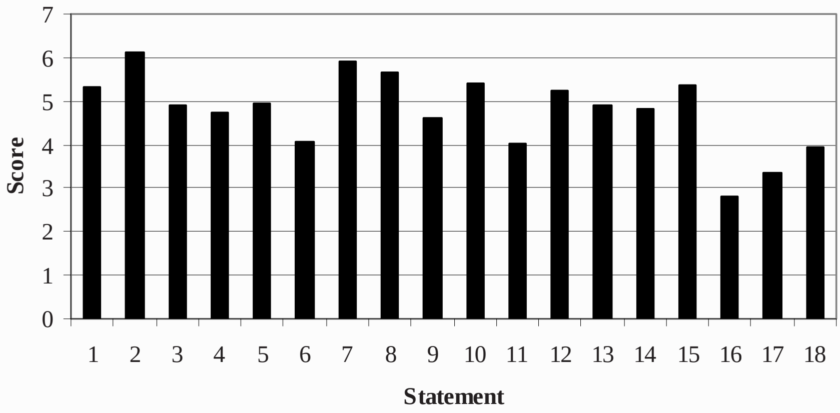


Table 3 ranks the scores from lowest score [strongest argument favoring tax evasion] to highest score [weakest argument]. The three strongest arguments supporting tax evasion all had to do with human rights abuses. The fourth ranked reason was for cases where the government was corrupt, with tax funds flowing into the pockets of corrupt politicians, their family or friends. This reason was also highly ranked in the other studies that were conducted using this survey instrument.

Table 3
Ranking
(1 = strongly agree; 7 = strongly disagree)

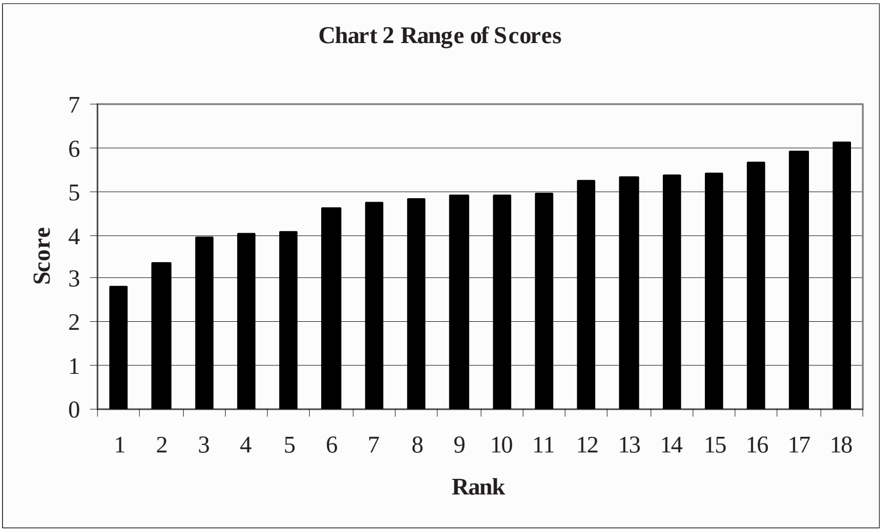
Rank	Statement	Score
1	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935. (S16)	2.80
2	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background. (S17)	3.35
3	Tax evasion is ethical if the government imprisons people for their political opinions. (S18)	3.95
4	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. (S11)	4.04
5	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me. (S9)	4.61
6	Tax evasion is ethical if a large portion of the money collected is wasted. (S4)	4.74
7	Tax evasion is ethical if I can't afford to pay. (S14)	4.83
8	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust. (S13)	4.89

8	Tax evasion is ethical if the tax system is unfair. (S3)	4.89
10	Tax evasion is ethical if the probability of getting caught is low. (S12)	5.26
11	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of. (S6)	5.32
12	Tax evasion is ethical if tax rates are too high. (S1)	5.34
13	Tax evasion is ethical even if it means that if I pay less, others will have to pay more. (S15)	5.38
14	Tax evasion is ethical if everyone is doing it. (S10)	5.41
15	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me. (S8)	5.66
16	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects. (S7)	5.89
17	Tax evasion is ethical even if most of the money collected is spent wisely. (S5)	5.91
18	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me. (S2)	6.11

In fifth place was the anti-government view that tax evasion is ethical even if the taxpayer receives benefits. The weakest argument was in cases where the government is not deemed worthy of putting its hand into the taxpayer's pocket.

The range of scores—from 2.80 to 6.11—also sheds some light on participants' views on the ethics of tax evasion. A score of 2.80 indicates that strong arguments can be made to ethically evade taxes. The fact that only one score was over 6.0 shows that there are not many strong arguments that tax evasion is generally viewed as always or almost always unethical.

Chart 2 shows the range of scores.



H1: The average respondent will believe that tax evasion is ethical sometimes. This hypothesis will be accepted if the median score is greater than 2.0 but less than 6.0.

H1: Accepted. The median score was 5.08 [(4.89 + 5.26)/2], thus falling between 2.0 and 6.0. Although a score if 5.08 is closer to 6.0 than to 2.0, it is clear that the average respondent thinks tax evasion is ethical under certain circumstances.

H2: Scores will be lower [tax evasion will be more acceptable] when the statement refers to government corruption. This hypothesis will be accepted if Statement 11 ranks in the top 6.

H2: Accepted. Statement 11 ranked fourth. The top three scores were for cases involving human rights abuses.

Male and Female Scores

Table 4 shows the scores for males and females and indicates which score was higher for each statement.

Table 4
Comparison of Male and Female Scores
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Male [79]	Female [105]	Score larger by Male	Score larger by Female	*p* Score	
1	Tax evasion is ethical if tax rates are too high.	5.46	5.25	0.21		0.2742	
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.06	6.16		0.10	0.8121	
3	Tax evasion is ethical if the tax system is unfair.	5.23	4.63	0.6		0.006792	*
4	Tax evasion is ethical if a large portion of the money collected is wasted.	5.18	4.41	0.77		0.001847	*

5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.01	5.83	0.18		0.481	
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.51	5.18	0.33		0.2292	
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.85	5.91		0.06	0.7173	
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.80	5.55	0.25		0.1193	
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.87	5.93		0.06	0.6596	
10	Tax evasion is ethical if everyone is doing it.	5.41	5.41			0.7467	
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.52	3.68	0.84		0.004153	*

12	Tax evasion is ethical if the probability of getting caught is low.	5.27	5.26	0.01	0.9632	
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	5.08	4.74	0.34	0.226	
14	Tax evasion is ethical if I can't afford to pay.	5.06	4.65	0.41	0.04948	**
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.48	5.30	0.18	0.3181	
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	3.10	2.58	0.52	0.01125	**
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.61	3.15	0.46	0.04094	**
18	Tax evasion is ethical if the government imprisons people for their political opinions.	3.92	3.50	0.42	0.07063	***
	Average	5.13	4.84			

* Significant at the 1% level
** Significant at the 5% level
*** Significant at the 10% level

A Wilcoxon test was also performed to see whether the differences between male and female scores were statistically significant. The Wilcoxon test was chosen rather than the student t-test because the Wilcoxon test is nonparametric and one does not therefore have to assume that the distribution is normal.

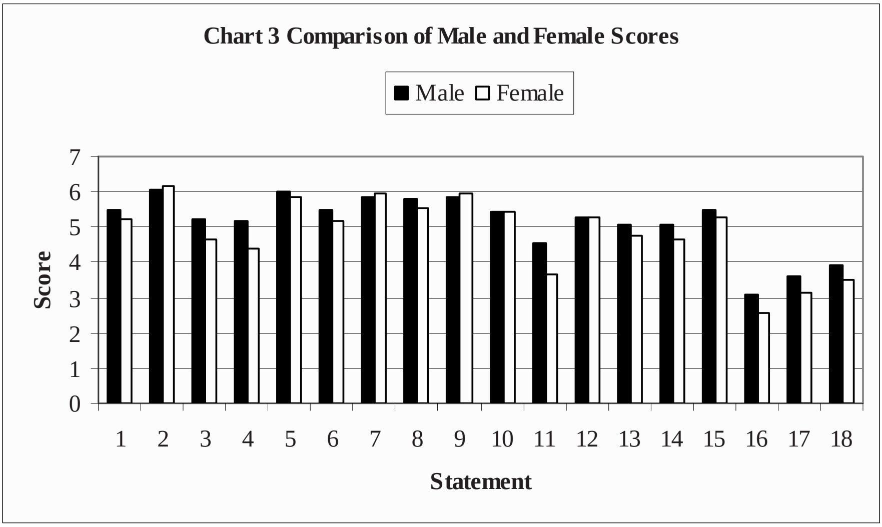
The results of the Wilcoxon test are given in Table 4. The differences in male and female scores for Statements 3, 4 and 11 were significant at the 1% level. The scores for Statements 14, 16 and 17 were significant at the 5% level. The score for Statement 18 was significant at the 10% level. The score for Statement 8 was significant at the 12% level.

Table 5 summarizes the data in Table 4.

Table 5
Frequency Distribution
Male and Female Scores

Male score higher	14
Female score higher	3
Same score	1
Total	18

Chart 3 compares the male and female scores.



H3: Female scores will be higher than male scores [women will be more strongly against tax evasion than males] for at least 12 out of 18 statements.

H3: Rejected. Male scores were higher than female scores in 14 of 18 cases. Female scores were higher in 3 cases. In the other case the scores were identical.

This finding was surprising, given the fact that some other studies using a similar survey instrument found that females often had higher scores than the males. Furthermore, there is some literature to suggest that females are more ethical than males, although the findings of various studies on this point are not consistent. It would be incorrect to conclude that males are more ethical than females based on the results of the present study, however. To arrive at that conclusion one must begin with the premise that tax evasion is unethical. One of the main reasons for the present study is to determine when, and under what circumstances tax evasion is ethical. However, the results of some of those studies are summarized below for information purposes.

Table 6 summarizes the results of prior studies that compare ethical attitudes of males and females for a variety of situations.

Table 6
Comparisons of Ethical Attitudes
Males and Females

Study	Males are more ethical	Females are more ethical	No difference
Akaah (1989)		x	
Akaah and Riordan (1989)		x	
Ameen et al. (1996)		x	
Babakus et al. (2004)			x
Baird (1980)		x	
Barnett and Karson (1989)			x
Barnett and Karson (1987)	x		
Beltramini et al. (1984)		x	
Betz et al. (1989)		x	
Beu et al. (2003)		x	
Brown and Choong (2005)		x	
Browning and Zabriskie (1983)			x
Boyd (1981)		x	
Callan (1992)			x
Chonko and Hunt (1985)		x	
Dawson (1997)		x	
Derry (1989)			x
Dubinsky and Levy (1985)			x
Ferrell and Skinner (1988)		x	
Franke et al. (1997)		x	
Friedman et al. (1987)			x
Fritzsche (1988)			x
Glover (1991)		x	
Glover et al. (1993)		x	
Glover et al. (1997)		x	
Glover et al. (2002)		x	
Harris (1990)		x	x
Harris (1989)			x
Hegarty and Sims (1978)			x
Hoffman (1998)		x	x

Kelley et al. (1990)		x	
Kidwell et al. (1987)			x
Kohut and Corriher (1994)		x	
Lampe and Finn (1992)		x	
Loo (2003)			x
Luthar et al.(1997)		x	
Mason and Mudrack (1996)		x	
McCabe et al. (2006)			x
McCuddy and Peery (1996)			x
McDonald and Kan (1997)			x
McNichols and Zimmerer (1985)			x
Miesing and Preble (1985)		x	
Nyaw and Ng (1994)			x
Ondrack (1973)		x	
Posner and Schmidt (1984)			x
Purcell (1977)		x	
Robin and Babin (1997)			x
Roxas and Stoneback (2004)			x
Ruegger and King (1992)		x	
Schaub (1994)		x	
Schmidt and Posner (1992)		x	
Serwinek (1992)			x
Sierles et al. (1980)		x	
Sikula and Costa (1994)			x
Sims et al. (1996)		x	
Singhapakdi et al. (1999)		x	
Smith and Oakely (1997)		x	
Stanga and Turpen (1991)			x
Stern and Havlicek (1986)			x
Su (2006)		x	
Swaidan et al. (2006)			x
Serwinek (1992)		x	x
Tang and Zuo (1997)		x	
Tsalikis and Ortiz-Buonafina (1990)			x
Weeks et al. (1999)	x	x	x
Whitley (1998)		x	

Source: McGee (2006a)

One might be tempted to conclude from these statistics that males are more ethical than females. However, such a conclusion would be presumptuous. The present study merely found that male scores were higher than female scores. It cannot necessarily be said that males are more ethical than females unless one also assumes that tax evasion is unethical, which may or may not be the case. The data show that there is widespread support for the position that tax evasion is ethical at least in some cases. If scores from one group are significantly higher than scores from another group, all that can be concluded is that one group thinks tax evasion is more unethical than the other group. Whether evasion actually is unethical in a particular case is an entirely different question.

Comparison of Business to Philosophy Students

Table 7 compares the scores of business students to those in philosophy and theology and also lists the differences for each statement.

The analysis in Table 7 suffers from several weaknesses. For one, the philosophy and theology students had to be combined, since the number of individual philosophy or theology students was small. It cannot be assumed that the scores of theology students would be similar or identical to those of philosophy students. Also, with a total sample size for this combined group of just 16, any statistical conclusions will be weak, although not totally useless.

Table 7
Comparison of Business & Philosophy/Theology Students
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Bus. [168]	Phil/Theo [16]	Larger by Bus.	Larger by Phil/Theo	*p* value	
1	Tax evasion is ethical if tax rates are too high.	5.24	6.38		1.14	0.0007521	*
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.06	6.88		0.82	0.0009058	*
3	Tax evasion is ethical if the tax system is unfair.	4.79	6.00		1.21	0.001494	*
4	Tax evasion is ethical if a large portion of the money collected is wasted.	5.67	5.75		0.08	0.008586	*
5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.83	6.88		1.05	9.705e-05	*

6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.29	5.69	0.40	0.2627	
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.84	6.75	0.91	0.0004652	*
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.61	6.13	0.52	0.09733	**
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.28	6.69	0.41	0.002912	*
10	Tax evasion is ethical if everyone is doing it.	5.39	5.63	0.24	0.6181	
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.98	4.25	0.27	0.5906	

12	Tax evasion is ethical if the probability of getting caught is low.	5.26	5.31		0.05	0.6302
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.87	5.00		0.13	0.6233
14	Tax evasion is ethical if I can't afford to pay.	4.79	5.31		0.52	0.1126
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.36	5.56		0.20	0.5072
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	2.79	3.00		0.21	0.8193
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.39	2.94	0.45		0.2404
18	Tax evasion is ethical if the government imprisons people for their political opinions.	3.68	3.75		0.07	0.9941
	Average	5.01	5.44			

* Significant at the 1% level
** Significant at the 10% level

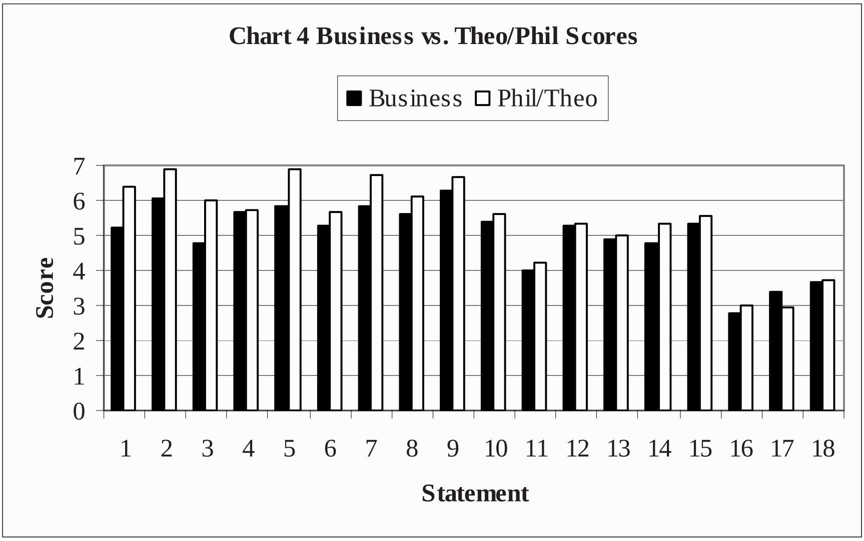
Although the philosophy and theology scores are almost always higher than the business scores, they are statistically significantly higher in less than half of the cases. The far right column of Table 7 shows the Wilcoxon p values.

Table 8 shows the frequency distribution for the two groups. The business score was higher than the philosophy/theology score in just 1 of 18 cases. The consistently higher philosophy and theology scores runs contra to the findings of another study (McGee and Maranjyan 2006). One must be careful not to interpret these findings so as to conclude that business people are less ethical than philosophers and theologians, however. This study merely shows that philosophy and theology students think tax evasion is more unethical than do business students. A study by McNichols and Zimmerer (1985) concluded that the view that business people were less ethical than the general population had evaporated. Chesher and Machan (1999) present a strong case that business people are just as ethical as the general population.

Table 8
Frequency Distribution of Higher Scores
Business & Philosophy/Theology Students

Business score higher	1
Philosophy/Theology score higher	17
Total	18

Chart 4 compares the business and philosophy/theology students.



H4: Philosophy and theology students will be more strongly opposed to tax evasion [will have higher scores] than the other two groups. This hypothesis will be confirmed if the philosophy and theology scores are higher than the business scores on at least 12 of the 18 statements.

H4: Accepted. The philosophy and theology scores were consistently higher than the business scores, although the difference was significant in only about half of the cases.

Comparison by Age

Table 9 shows the scores by age. The two categories are under 25 and 25 and over. The initial thought was that older respondents would be more opposed to tax evasion [would have higher scores] than would younger recipients, based on some prior studies that concluded that people become more ethical as they get older. For example, Ruegger and King (1992) found that people become more ethical as they get older. Their study divided respondents into the following four groups: 21 or less, 22–30, 31–40 and 40 plus. But Sims et al. (1996) found that older students had fewer qualms about pirating software than did younger students.

Babakus et al. (2004) also found that age made a difference, but what difference age makes sometimes depends on culture. Younger people from the UK, USA and France tend to be less ethical consumers than do older people from these countries, whereas younger Austrians tend to be more ethical consumers than their elders. Age generally did not matter for Hong Kong consumers, except in the case of stealing towels from hotels and blankets from aircraft. Younger people tended to be less tolerant of these kinds of activities than did their elder Hong Kong consumers. Brunei consumers showed mixed results. In some cases younger people were more ethical whereas in other cases older people were more ethical.

Table 9
Comparison by Age
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Under 25 [127]	25 and older [57]	Score larger by Under 25	Score larger by 25 and Over	*p* Score
1	Tax evasion is ethical if tax rates are too high.	5.28	5.49		0.21	0.4113
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	6.19	6.00	0.19		0.4303

3	Tax evasion is ethical if the tax system is unfair.	4.77	6.61		1.84	0.1727
4	Tax evasion is ethical if a large portion of the money collected is wasted.	4.69	4.84		0.15	0.695
5	Tax evasion is ethical even if most of the money collected is spent wisely.	5.91	6.02		0.11	0.3845
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.21	5.56		0.35	0.1228
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	5.88	5.86	0.02		0.4781
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.61	5.75		0.14	0.6459
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.96	5.86	0.10		0.8294
10	Tax evasion is ethical if everyone is doing it.	5.33	5.58		0.25	0.4028
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.90	4.26		0.36	0.261
12	Tax evasion is ethical if the probability of getting caught is low.	5.24	5.30		0.06	0.8177
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.94	4.77	0.17		0.5179

14	Tax evasion is ethical if I can't afford to pay.	4.94	4.96		0.02	0.4781
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.43	5.44		0.01	0.3419
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1935.	2.73	3.04		0.31	0.1376
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.20	3.67		0.47	0.07713*
18	Tax evasion is ethical if the government imprisons people for their political opinions.	3.56	4.00		0.44	0.09635*

* Significant at the 10% level

A few other studies also found that people get more ethical with age (Barnett and Karson 1987, 1989; Longenecker et al. 1989; Harris 1990; Kelley et al. 1990; Serwinek 1992; Wood et al. 1988). But one study found that younger purchasing managers were more ethical than older purchasing managers when it came to accepting gifts and entertainment (Browning and Zabriskie 1983), while other studies found no correlation between age and ethical viewpoint (Kidwell et al. 1987; Izraeli 1988; Callan 1992; Kohut and Corriher 1994). Akaah (1996) found no statistical difference between marketing executives of higher or lower ranks. Since those with a higher rank tend to be older than those of lower rank, one may conclude that the ethics of marketing executives do not get either better or worse with age. Glover et al. (2002) found that the more experience an individual had, the more ethical decisions that person would make, which is not quite the same as saying that people become more ethical with age. Marta et al. (2004) found that age does not affect ethical thinking in the Middle East.

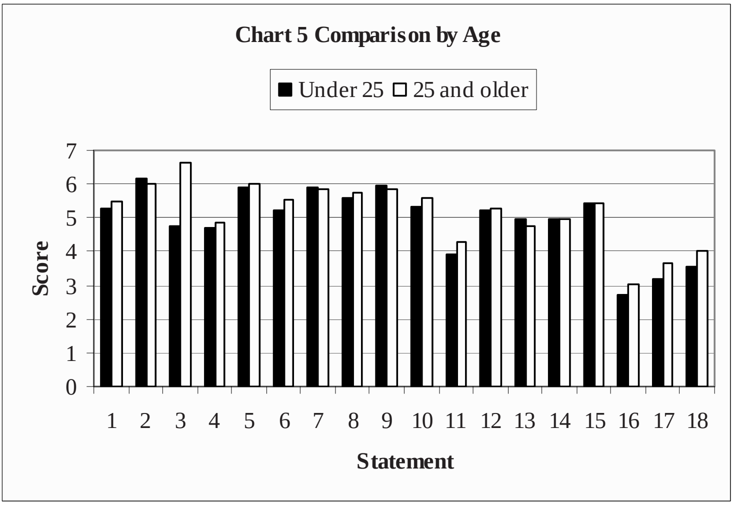
A Wilcoxon test was done to determine the significance of the scores for the two age categories. The scores are shown in Table 9. The differences in the scores for Statements 17 and 18 were significant at the 10% level. None of the other differences were significant if one defines significance as $p \le 0.1000$.

Table 10 shows the frequency of higher scores for each group. As can be seen, the older respondents have higher scores 14 out of 18 times, which might lead one to conclude that the present study confirms the Ruegger and King (1992) and other findings that people get more ethical as they get older. However, one must not jump to conclusions. In order to arrive at that conclusion the underlying premise must be that tax evasion is unethical, which may or may not be the case. The primary focus of the present paper is to determine the prevailing views on when tax evasion is ethical and when it is not. All that can be said for certain regarding the findings in the present study is that older people had higher scores than did younger people.

Table 10
Frequency Distribution of Higher Score
By Age

Older group higher score	14
Younger group higher score	4
Total	18

Chart 5 compares scores by age.



H5: Older students will have higher scores [will be more opposed to tax evasion] than will younger students for at least 12 of the 18 statements.
H5: Accepted. Older students had higher scores for 14 of 18 statements.

Concluding Comments

This study surveyed students in Slovakia. The results indicate that the belief that tax evasion is ethical is widespread. However, the ethical attitude toward tax evasion is more complicated than that. The responses to the survey indicate that tax evasion is frowned upon in some cases more than others and that different subsets of the population have differing views on the issue.

The average scores varied between 2.8 and 6.4 on a seven-point Likert scale, which indicates that the average view falls into the middle category, that is, that tax evasion is ethical sometimes.

The three strongest arguments justifying tax evasion all had to do with human rights abuses – Jews living in Nazi Germany, discrimination or political imprisonment. Corruption, unjust wars and inability to pay also ranked high. These last three reasons were also prominent in the Catholic theological and philosophical literature. There is a higher probability that tax evasion will be seen as unethical when a taxpayer evades taxes for selfish reasons. This finding corresponds with the findings of the international business professor study (McGee 2005a), the Romanian business student survey (McGee 2005b) and the Guatemalan study (McGee and Lingle 2005).

This study could be replicated in a number of ways. Different groups of Slovak students could be surveyed, either in different cities or regions of Slovakia or in different disciplines, such as law, to see if the responses vary either by region or discipline. There is some evidence to suggest that results will vary by discipline. Further research is needed to confirm this preliminary finding.

Surveying Slovak business people might also be worthwhile, since their perception of taxation might be different than that of university students. People who own businesses might have different perceptions of tax evasion than people who are employees of companies, so a study could be done to compare these two groups.

It would be interesting to see whether the result might be different with different Central and East European populations, such as the Czech Republic, Hungary or Poland. The populations of these countries share a common recent economic and political history.

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32

Taxation and Public Finance in the Slovak Republic

Vincent Šoltés and Emília Jakubíková

Introduction

The Slovak Republic belongs to those Middle-European economies that are transforming from planned economies to the market system.

The Slovak Republic was founded on January 1st, 1993 after the Czechoslovak Federative Republic split into two sovereign states—The Czech Republic and The Slovak Republic.

The reform of the taxation and accounting system was one of the most serious steps in the transformation of the Slovak economy. The first taxation system reform in Slovakia was implemented in 1993. The second reform of the taxation system has been in effect since January 1st, 2004 and was accompanied by other reforms, especially from the social area.

The First Taxation Reform in 1993

The decision about realization of this reform was accepted in 1990 and its main ideas were:

- to make the taxation system as compatible as possible with the developed economies,
- to support the motivation and the stimulation of taxation by functions of fiscal taxation in the way of technological progress,
- to create equally competitive conditions,
- to create an ecological decision-making process,
- to support the businesses that are effective and valuable for society,
- to unify taxation conditions for the different entrepreneurial subjects.

The taxation system valid since 1993/1/1 included these taxes:

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Direct Taxes

- Income tax
  - Income tax of physical persons (5 tax levels with a sliding scale from 10% to 38%),
  - Income tax of corporations (original tax rate 40%, later decreased to 29% and finally to 25%).
- Estate tax
  - property tax,
  - tax from apartments,
  - tax from buildings.
- Road tax
- Tax from inheritance, accession tax and tax from estate transfer

Indirect Taxes

- Value added tax (rates 6% and 25%, later 10% and 23%, 14% and 20%)
- Consumption taxes
  - consumption tax from alcohol,
  - consumption tax from beer,
  - consumption tax from wine,
  - consumption tax from tobacco and tobacco products,
  - consumption tax from hydrocarbon fuels and oils (later from mineral oils)

The taxation laws valid from 1993 were changed many times, mainly due to failures but also for political reasons. The opinions of right-wing and left-wing politicians on taxation law are considerably different. Under pressure from them many non-systematic exceptions occurred in taxation legislation that were advantageous or disadvantageous for certain groups of taxpayers. A great number of exemptions and conditions led to unclear laws that created the need to issue further directives and comments.

The number of exemptions and regulations increased to 212, particularly:

Exemptions ………………………….. 90 items
Non-taxable revenues …...………….. 19 items
Tax allowances ……………………... 66 items
Various tax rates ……………………. 37 items

The practice also showed the other failures of the taxation system, e.g. persons could use various tax rates depending on their definition-their income could be taxed using the applicable income tax rate or the rate from capital revenues, whichever was lower. Taxpayers were able to move their incomes into different tax categories, in different time periods or even to move their taxes to other business subjects that were allowed to use lower tax rates.

Another negative feature was that the taxation laws were often suspicious to the taxpayers and “punish” them globally, which was considered by most taxpayers as discrimination. The unfair character of several regulations led to the growth of general tolerance of obstructing and law breaking.

Elimination of these failures and inefficiencies required the implementation of new taxation reform.

The Second Taxation Reform 2004–2006

The goals of the present taxation reform of the Slovak Republic are:

- to eliminate imperfections and inconsistencies of the previous taxation system,
- to cover the taxation of all kinds of income and all levels of income equally, and thus
- to obtain as high a level of taxation fairness as possible.

The concept of this taxation reform is based on these principles:

- justice and proportionality,
- neutrality,
- exclusion of double taxation,
- simplification and exactness,
- effectiveness.

Besides the above mentioned general principles of taxation, the new reform will focus on these aspects:

- Direct income taxation has to fulfill fiscal goals and cannot be used to fulfill other goals, such as social policy, structural or regional policy, and economic policy. Implementation of specific taxation regimes leads to the complications in the taxation system, to an increase of society costs for its application and to an increase of incentive to avoid taxes.

- Taxation principles have to be implemented without considering any interests, aims and goals of several interest groups.
- Urgent requirements of the state budget will occur in a change in tax rates but they cannot influence the implementation of the taxation principles.
- The changes in the taxation reform shall be implemented as soon as possible and at once so that the taxpayers see advantages of this reform and so that the new taxation system really works well during this election period.

The taxation system assesses taxes on:

- income
- property, and
- consumption.

Table 1
Taxation Structure in the Slovak Republic After the Reform

Direct taxes	Indirect taxes
Profit	*General consumption*
Income tax of physical persons and corporations	Value added tax
Property	*Specific consumption*
Tax from motor vehicles	Consumption tax from alcohol
Real estate tax	Consumption tax from beer
	Consumption tax from wine
	Consumption tax from tobacco and tobacco products
	Consumption tax from mineral oils

The nature of the taxation reform is in the implementation of the equal income tax. The incomes of all subjects, meaning physical persons, corporations, foreigner persons and other subjects will be taxed at an equal linear percentage tax rate (called equal tax) at the level of 19 %. The incomes of all possible forms are taxed only once, and thus in their transformation from creation to their usage.

Implementation of the equal income tax will be especially noticed in the area of physical persons' income taxation, which is connected with an immediate decrease of revenues in the state budget. An increased tax rate for the low-income groups of citizens will be compensated by an increased non-taxable minimum.

Implementation of the equal tax system is therefore conditioned by providing the proposed corrections in the area of value added tax and consumption taxes. There occurs a transfer of some taxes from a group of direct taxes to the group of indirect taxes.

An equal value added tax rate (19%) has been used since January 1st, 2004. Slovakia has thus become the first and the only member of the EU with the equal value added tax.

Impact of the Taxation Reform on Public Finances

Table 2 Taxation Revenues of the State Budget in 2004 After the Reform (in mil. SKK)

Taxation revenues in categories	Approved budget	Actual estimation of the MF SR	Difference
Income tax	62,183	68,500	6,317
Property tax	5,171	6,371	1,200
Taxes on domestic goods and services	159,500	152,500	–7,000
Taxes from international trade and transactions	1,630	1,850	220
Total	228,484	229,221	737
Taxation revenues of public administration together on GDP	17.58%	17.64%	0.06%
Taxation revenues of state budget together on GDP	16.19%	16.20%	0.01%

As Table 2 shows, there is only a small difference between the anticipated tax incomes and the actual tax incomes in the budget for 2004 (calculated according to the data for the first 9 months of 2004). The total difference is only +737 mil. SKK, which means that there is only a 0.06% change in the public finances on GDP and 0.01% of taxation incomes of the state budget on GDP. The outcome in the revenues of the income tax and value added tax is very surprising. The revenues from the income taxes did not decrease as was expected, but increased by 6,317 mil. SKK and on the other hand, revenues from the value added tax dropped by 7,800 mil. SKK instead of growing as expected. Revenues from the consumption tax increased by 800 mil. SKK. The reason for the decrease in the income from the value added tax can be explained by the fact that the equal income tax strongly influenced a group of citizens with average month income of 12,000–20,000 SKK, who paid higher income taxes than before.

From the macroeconomic point of view, the proposed taxation reform should result in positive effects for the entrepreneurial environment. A selective taxation policy based on favoring certain branches and types of entrepreneurial subjects is replaced by the more simple and plain taxation policy that creates generally favorable conditions for trade and investments.

The taxation reform in practice has to create a tax structure that would be more suitable for the economy, positively influence the entire business environment, investment and economic growth. The real impact of new taxation reform on the public finances and the Slovak economy will be possible to judge only after a period of time when the reforms of social insurance and income assurance will be fully implemented as well.

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The Act no.523/2004 on the Taxes and Fees Administration.

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Opinions on Tax Evasion in Thailand

Robert W. McGee

Introduction

The vast majority of studies that have been done on tax evasion have been written from the perspective of public finance. They discuss technical aspects of tax evasion and the primary and secondary effects that tax evasion has on an economy. In many cases there is also a discussion about how to prevent or minimize tax evasion. Very few studies discuss ethical aspects of tax evasion. Thus, there is a need for further research, which the present study is intended to partially address.

As part of this study a survey instrument was developed based on the issues that have been discussed and the arguments that have been made in the tax evasion ethics literature over the last 500 years. Similar survey instruments were used to test sample populations in Germany (McGee et al. 2005), Romania (McGee 2005b) and Guatemala (McGee and Lingle 2005). The survey was also distributed to professors of international business (McGee 2005a). The present study reports on the findings of a survey that was distributed to accounting students at Thammasat University in Thailand. The survey instrument consisted of 18 statements that reflect the three views on the ethics of tax evasion that have emerged over the centuries. Participants were asked to rate the extent of their agreement with each statement by placing a number from 1 to 7 in the space provided to indicate the extent of agreement with each statement. Male and female scores were also compared to determine whether the female responses were significantly different from the male responses.

Three Views

Over the centuries, three basic views have emerged on the ethics of tax evasion. View one takes the position that tax evasion is always, or almost always unethical. There are basically three underlying rationales for this

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belief. One reason is the belief that individuals have a duty to the state to pay whatever taxes the state demands (Cohn 1998; DeMoville 1998; Smith and Kimball, 1998; Tamari 1998). This view is especially prevalent in democracies, where there is a strong belief that individuals should conform to majority rule.

The second rationale for an ethical duty to pay taxes is because the individual has a duty to other members of the community (Crowe 1944; Cohn 1998; Tamari 1998). This view holds that individuals should not be freeloaders by taking advantage of the services the state provides while not contributing to the payment of those services. A corollary of this belief is the view that if tax dodgers do not pay their fair share, then law-abiding taxpayers must pay more than their fair share.

The third rationale is that we owe a duty to God to pay taxes, or, stated differently, God has commanded us to pay our taxes (Cohn 1998; DeMoville 1998; Smith and Kimball 1998; Tamari 1998). This view holds no water among atheists, of course, but the view is strongly held in some religious circles.

View two might be labeled the anarchist view. This view holds that there is never any duty to pay taxes because the state is illegitimate, a mere thief that has no moral authority to take anything from anyone (Block 1989, 1993). The state is no more than a mafia that, under democracy, has its leaders chosen by the people.

The anarchist literature does not address the ethics of tax evasion directly but rather discusses the relationship of the individual to the state. The issue of tax evasion is merely one aspect of that relationship (Spooner 1870).

There is no such thing as a social contract according to this position. Where there is no explicit agreement to pay taxes there also is no duty. All taxation necessarily involves the taking of property by force or the threat of force, without the owner's permission. Thus, it meets the definition of theft. Stated as an equation, TAXATION = THEFT. A corollary equation is that FAIR SHARE = 0.

View three holds that tax evasion may be ethical under some circumstances and unethical under other circumstances. This view is the prevalent view, both in the literature (Ballas and Tsoukas 1998; Crowe 1944; Gronbacher 1998; McGee 1998a, 1999b), and according to the results of some of the surveys (McGee 2005a, b; McGee and Lingle 2005).

The Thailand Study

After reviewing the literature that exists on the ethics of tax evasion, a survey was constructed and distributed to a group of accounting students at Thammasat University in Bangkok, Thailand in order to learn the prevailing views on this issue. The group chosen was undergraduate students in the elite English language business program. Their English language skills were sufficiently high that it was not necessary to translate the survey instrument into Thai.

The survey consisted of eighteen (18) statements. Using a seven-point Likert scale, respondents were asked to place the appropriate number in the space provided to indicate the extent of their agreement or disagreement with each statement. Forty-one usable responses were received.

The following hypotheses were made:

H1: The average respondent will believe that tax evasion is ethical sometimes. This hypothesis will not be rejected if the average score for all 18 statements is more than 2 but less than 6.

H2: Scores will be lower [tax evasion will be more acceptable] when the statement refers to government corruption. This hypothesis will not be rejected if the statement dealing with corruption is ranked within the top 6.

H3: Opposition to tax evasion will be strongest [scores will be highest] in cases where it appears that taxpayers are getting something in return for their money, or where there is a perception that there is a duty to other taxpayers to pay taxes, even if there may not be a duty to the government. This hypothesis will not be rejected if the statements that solicit opinions on these point all rank among the 9 highest scores.

H4: Females will be more strongly opposed to tax evasion than will males. This hypothesis will not be rejected if female scores are higher than male scores [women will be more strongly against tax evasion than males] for at least 12 of the 18 statements.

Survey Findings

A total of 41 usable responses were obtained. Table 1 shows the breakdown by gender.

Table 1
Responses by Gender

Male	8
Female	27
Not specified	6
Total	41

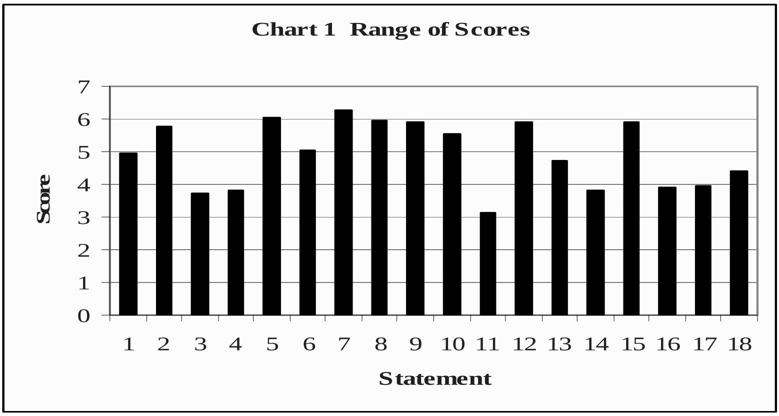
H1: The average respondent will believe that tax evasion is ethical sometimes.
H1: Cannot be rejected.

Table 2 lists the 18 statements and the average scores received for each statement. A score of one (1) indicates strong agreement with the statement. Seven (7) indicates strong disagreement. An average score or 2 or less would indicate that tax evasion is always, or almost always ethical. An average score of 6 or more would indicate that tax evasion is never or almost never ethical. Scores averaging more than 2 but less than 6 would indicate that tax evasion is sometimes ethical. As can be seen from Table 2, all 18 scores are more than 2 and 16 of them are less than 6. The average score is 4.94, which indicates the average respondent believes tax evasion to be ethical sometimes. None of the respondents selected a score of 7 for all 18 statements, which means all respondents thought that tax evasion was at least somewhat justified in certain circumstances.

Table 2
Summary of Responses
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Score
1	Tax evasion is ethical if tax rates are too high.	4.95
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	5.78
3	Tax evasion is ethical if the tax system is unfair.	3.75
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.81
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.06
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	5.06
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.28
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.97
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	5.91
10	Tax evasion is ethical if everyone is doing it.	5.53
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	3.13
12	Tax evasion is ethical if the probability of getting caught is low.	5.91
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	4.75
14	Tax evasion is ethical if I can’t afford to pay.	3.81
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.90
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	3.93
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	3.96
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.39
	Average Score	4.94

Chart 1 shows the range of scores.



H2: Scores will be lower [tax evasion will be more acceptable] when the statement refers to government corruption.
H2: Cannot be rejected.

Table 3 ranks the eighteen statements from most acceptable to least acceptable. Scores ranged from 3.13 to 6.28, indicating that there are circumstances when tax evasion can be ethically justified. If one begins with the premise that tax evasion can be justified where the score is less than 6, then the respondents believe, on average, that tax evasion can be justified, at least sometimes, for 16 of the 18 statements included in the survey instrument.

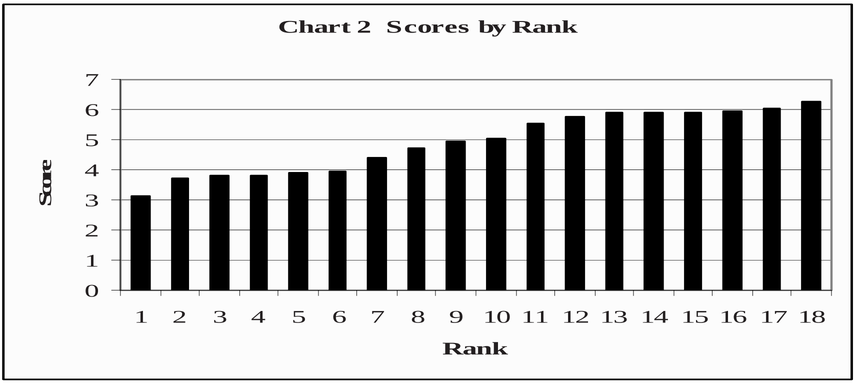
Respondents believed that the strongest case for tax evasion was in cases where a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. That statement had a score of 3.13 on a scale from 1 to 7, which indicates that tax evasion in such cases is viewed as more ethical than for any of the other reasons given. Statements that ranked in the top half generally addressed questions of fairness, leading to the conclusion that respondents thought tax evasion was easiest to justify in cases where there was a perception of unfairness.

Table 3
Ranking
(1 = strongly agree; 7 = strongly disagree)

Rank	Statement	Score
1	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. (S11)	3.13
2	Tax evasion is ethical if the tax system is unfair. (S3)	3.75
3	Tax evasion is ethical if a large portion of the money collected is wasted. (S4)	3.81

3	Tax evasion is ethical if I can't afford to pay. (S14)	3.81
5	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940. (S16)	3.93
6	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background. (S17)	3.96
7	Tax evasion is ethical if the government imprisons people for their political opinions. (S18)	4.39
8	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust. (S13)	4.75
9	Tax evasion is ethical if tax rates are too high .(S1)	4.95
10	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of. (S6)	5.06
11	Tax evasion is ethical if everyone is doing it. (S10)	5.53
12	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me. (S2)	5.78
13	Tax evasion is ethical even if it means that if I pay less, others will have to pay more. (S15)	5.90
14	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me. (S9)	5.91
14	Tax evasion is ethical if the probability of getting caught is low. (S12)	5.91
16	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me. (S8)	5.97
17	Tax evasion is ethical even if most of the money collected is spent wisely. (S5)	6.06
18	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects. (S7)	6.28

Chart 2 shows the ranking of scores from lowest (tax evasion is most acceptable) to highest (tax evasion is least acceptable).



H3: Opposition to tax evasion will be strongest [scores will be highest] in cases where it appears that taxpayers are getting something in return for their money, or where there is a perception that there is a duty to other taxpayers to pay taxes, even if there may not be a duty to the government.

H3: Cannot be rejected.

The rankings in Table 3 clearly show that respondents were most opposed to tax evasion in cases where taxes are spent on worthy projects (S17 and S18), or where tax funds are spent on projects that benefit the respondent (S14). There was also strong opposition to tax evasion in cases where evasion on the part of one person would require others to pay more (S13). Thus, there was a feeling of obligation to other members of the taxpaying community.

H4: Female scores will be higher than male scores [women will be more strongly against tax evasion than will males] for at least 12 out of 18 statements.

H4: Cannot be rejected.

Table 4 compares the scores of male and female respondents. Males had higher scores for only 3 of the 18 questions. Women had higher scores for 15 statements. In 10 cases, female scores were more than a full point higher than the male scores.

Since female scores were higher than male scores in 15 of 18 cases, and since the p values often showed that the female scores for some statements were significantly different from the male scores, it could be said that female respondents were significantly more opposed to tax evasion.

Significance may also be tested by the use of statistics. The Wilcoxon test found that the differences in male-female scores were statistically significant at the 5% level for 5 of the 18 statements. The Wilcoxon test is a parametric test. It was chosen rather than a nonparametric test because it does not include the assumption that the distribution is normal. Thus, it is to be preferred to the student t-test. Table 4 gives the scores for the Wilcoxon tests.

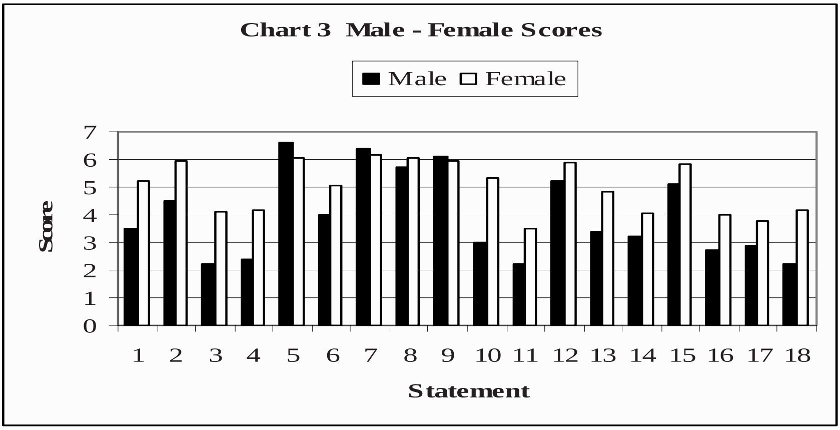
Table 4
Comparison of Male and Female Scores
(1 = strongly agree; 7 = strongly disagree)

S#	Statement	Score		Score larger by		P value	
		Male	Female	Male	Female		
1	Tax evasion is ethical if tax rates are too high.	3.50	5.22		1.72	0.04108	*
2	Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking from me.	4.50	5.93		1.43	0.1355	

3	Tax evasion is ethical if the tax system is unfair.	2.25	4.11		1.86	0.01569	*
4	Tax evasion is ethical if a large portion of the money collected is wasted.	2.38	4.15		1.77	0.02389	*
5	Tax evasion is ethical even if most of the money collected is spent wisely.	6.63	6.04	0.59		0.2465	
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	4.00	5.07		1.07	0.2233	
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	6.38	6.19	0.19		0.8906	
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	5.75	6.07		0.32	0.5426	
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	6.13	5.93	0.20		0.709	
10	Tax evasion is ethical if everyone is doing it.	3.00	5.33		2.33	0.0227	*
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	2.25	3.48		1.23	0.1516	

12	Tax evasion is ethical if the probability of getting caught is low.	5.25	5.89	0.64	0.2979	
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3.38	4.81	1.43	0.1161	
14	Tax evasion is ethical if I can't afford to pay.	3.25	4.07	0.82	0.2629	
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	5.13	5.85	0.72	0.4918	
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	2.75	4.00	1.25	0.103	
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	2.88	3.78	0.90	0.2087	
18	Tax evasion is ethical if the government imprisons people for their political opinions.	2.25	4.15	1.90	0.02555	*
	Average	3.98	5.00	1.02		
	* Significant at the 5% level					

Chart 3 compares the male and female responses.



The survey instrument included space for participants to make additional comments to explain their views on the ethics of tax evasion. The majority of respondents left this space blank. However, a few participants did make comments. Here is a sampling of what they said. The author took the liberty of correcting the English grammar, paraphrasing and combining some answers to avoid repetition.

- For me I wouldn't want to pay tax in Thailand because the government is corrupt, government officials do not use my money wisely and most businesses engage in tax evasion. If you don't engage in tax evasion you will lose in the competitive game.
- To judge whether it's ethical or not very much depends on how one views the world. It's an abstract question with no absolutely right or wrong answer. In certain situations it appears to be very ethical to evade tax.
- According to the laws of Thailand, tax evasion is always wrong. Those who engage in tax evasion might be subjected to a large fine plus interest as well as imprisonment for a couple of years. However, in my opinion, if the tax money is used in a wrong way the ethical argument against tax evasion becomes weaken. But tax evasion is always wrong.
- It doesn't matter whether you or anybody thinks that tax evasion is ethical or not because people should not evade taxes. It's against the law and if you don't want to pay you should find a way to avoid payment.
- Taxes should be paid so that government will have the funds it needs to function. The tax rate should be fair and low enough that everyone can pay, even the poor. There should be no tax evasion because people have a duty to pay.
- If the government has a good tax system and provides enough welfare for the people, or if corruption decreases, people will be more willing to pay.
- Evading taxes is wrong. You will receive the benefit one way or the other.

If one were to limit the analysis of these comments to a single sentence it would be that the opinions expressed more or less mirror the arguments Crowe (1944) found in his review of the theological and philosophical literature going back 500 years. Although tax evasion is generally frowned upon, most of the respondents thought that tax evasion could be justified on ethical grounds in certain circumstances, more or less the same circumstances that Crowe found.

Some of the reasoning the respondents gave cannot be supported on close analysis. For example, political scientists and philosophers generally agree that, even though there may be some duty to the state, that duty is not absolute. The divine right of kings theory is no longer recognized as a valid theory even though it is in the Bible. According to the servant-master theory of government, where the people are the masters and the government is the servant, the moral obligation to pay taxes is less than absolute. There are limits. However, political scientists cannot agree on what the limit is.

Concluding Comments

The goals of this research project have been achieved. The opinions of at least one segment of the Thai population are now known. The segment chosen – accounting students – is a significant sector of the population because these people are the future business leaders of Thailand. At least some of them will be in a position to assist clients or businesses evade taxes.

The fact that they are more opposed to tax evasion in some cases than others has policy implications. The survey found that opposition to tax evasion is weakest in cases where the government is corrupt or where the system is perceived as being unfair. Thus, it may be possible to reduce the extent of tax evasion by reducing government corruption and reducing the perceived unfairness of the tax system.

The results of the surveys of Guatemala (McGee and Lingle 2005), Romania (McGee 2005b) and international business professors (McGee 2005a) reached similar conclusions, which lends evidence to the proposition that the attitude toward tax evasion is similar across a wide spectrum of cultures and geography.

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VAT in Ukraine: An Interim Report

Richard M. Bird

Introduction

Ukraine has become a critical frontier country between the European Union (EU) and Russia. In tax terms, however, Ukraine is clearly much closer to Russia and other countries emerging from the former Soviet Union than it is to the EU. The tax systems of the central and eastern European countries that have recently become members of the EU differ in some important ways from those of countries like Ukraine and other former Soviet countries. The former Soviet countries (apart from the three Baltic countries) remain closer to the old fiscal and administrative systems of the Soviet Union in many ways.[1] For instance, consumption taxes are relatively much more important in former Soviet countries than in the new eastern European members of the EU and much more important than in most of the older EU countries. All the countries that emerged from the former Soviet empire changed their tax systems substantially, notably by introducing value-added taxes (VATs). But the reality of how taxes work changed much more rapidly, and radically, in the 'new' EU countries than in countries like Ukraine.[2]

My aim in this paper is to provide some evidence in support of this proposition with respect to Ukraine's VAT.[3] Any single frame from a moving picture inevitably offers an imperfect image of current reality. Fiscal institutions only change slowly, however, so most of the issues discussed here

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[1] See, for example, Martinez-Vazquez and McNab (2000), Bird and Banta (2000), Mitra and Stern (2003), and Preobragenskaya and McGee (2004).

[2] For an earlier discussion, see the comparison of Poland and Belarus in Bird (1999).

[3] The paper is largely based on two visits to Ukraine, one in March 2002 (see World Bank 2003) and one in September 2005. I have titled the paper an interim report because anything written about this subject is probably going to be somewhat out of date by the time it is published, given the rate at which tax laws and to a lesser extent administrative practices change in Ukraine. Sometimes, of course, what such 'changes' may do is to extend the past: as an example, as the final version of this paper was being prepared at the end of November 2005 the Verkhovna Rada (parliament) by a huge majority (339 out of 414) overturned a presidential veto of the latest VAT 'reform' thus extending the favorable treatment of the agricultural sector discussed later in the present paper.

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are likely to affect VAT performance in Ukraine for some years to come. Indeed, many of the problems discussed here are likely common in other countries that attempt to introduce a modern tax like the VAT into an economic, political and administrative structure in which significant elements remain largely unchanged.

Popular concern about VAT has always focused on its regressivity. Protests and demonstrations against ‘unfair’ VATs are not uncommon (e.g. Botes 2004). Nonetheless international experts have long argued that VATs are good for developing and transitional countries (World Bank 1991; Ebrill et al. 2001). Recently, however, questions have been raised about the universal applicability of this advice. Emran and Stiglitz (2005) have questioned the efficiency aspects of VAT in countries with large underground economies. Desai and Hines (2002) have argued that VAT is more likely to discourage than encourage trade. Rajaraman (2004) has doubted whether VAT can yield sufficient revenue to replace trade taxes. Riswold (2004) has stressed the administrative demands imposed by a VAT. I have recently discussed all these issues in a more general context elsewhere (Bird and Gendron 2005). Here, I focus on the only a few aspects of how VAT has functioned to date in Ukraine, focusing on linkages between tax design, tax administration, and the structure of the economy.

Ukraine’s VAT Is in Trouble

In Ukraine, as in many countries, VAT has become the workhorse of the revenue system. VAT is the largest, most important, tax in Ukraine. How well VAT works is a critical determinant of the performance of the entire fiscal system. But as Table 1 shows Ukraine’s VAT is in trouble. Revenue has declined relative to GDP. VAT’s ‘collection efficiency’ has also declined. The ‘VAT gap’—the gap between potential and actual revenue—remains large.

Table 1 Ukraine’s VAT is in Trouble: Its Decline from 1998 to 2004

Year	VAT as % GDP	VAT on imports as % GDP	VAT on domestic as % GDP	VAT productivity (VAT as % GDP /20)
1998	7.3	1.6	5.7	0.36
1999	6.4	1.0	5.4	0.32
2000	5.6	1.8	3.8	0.28
2001	5.1	1.8	3.3	0.26
2002	6.0	3.0	3.0	0.30
2003	4.7	3.5	1.2	0.24
2004	4.9	3.5	1.4	0.25

Source: Calculations by author from various official and international sources.

The revenue yield of VAT as a share of GDP has declined steadily since the tax came into full effect in the late 1990s.[4] Such a prolonged decline in VAT yields is both unusual and disturbing. As a rule, VAT yield rises when GDP grows (Baunsgaard and Keen 2005). But in Ukraine although real GDP rose by 49% from 1998 to 2004 the VAT-GDP ratio actually fell by 33%. Normally a general consumption tax such as VAT should grow at least at the same rate as GDP: its GDP-elasticity should be approximately unitary. But in Ukraine the arc GDP-elasticity of VAT from 1999 to 2004 was an incredibly low 0.38. In other words, for every 1000 hryvnia of additional GDP generated over this period, VAT revenues rose by only 42 hryvnia.[5] The revenue performance of Ukraine's VAT leaves much to be desired.

Another striking fact is that the share of VAT collected at the border rose from less than a quarter of total VAT revenues in 1998 to almost three-quarters in 2004. The other side of this growing dependence of VAT on imports is that VAT collected on domestic consumption fell sharply, from 5.7% of GDP in 1998 to only 1.4% in 2004. Of course, many countries collect much of their VAT revenue at the border and such rapid growth in imports as Ukraine has experienced is likely to be reflected in an increase in the share of VAT collected from imports. But it is difficult to think of any other instance in which a country has had such a marked and rapid change in the extent to which it depends on imports for VAT revenue. For example, in 2004 two-thirds of the absolute increase in VAT revenues was attributable to increased taxes on imports—even though VAT import revenue actually declined from 6.5% of imports in 2003 to only 3.6% in 2004. Baunsgaard and Keen (2005) show that in general increases in imports and increases in total VAT revenues go hand in hand. No such relation is apparent in Ukraine: for example, although imports increased by 14% in 2003 and 16% in 2004 VAT revenues as a share of GDP actually declined in these years.

Ukraine's VAT has clearly become less efficient as a revenue producer. One crude measure of VAT 'revenue efficiency' is simply to take the VAT share of GDP and divide by the standard rate of VAT (20% throughout this period). The number that results from this calculation depicts the percentage of GDP collected by each percentage point of the standard VAT rate. As Table 1 shows, this number has declined sharply since VAT began in 1998, with a particularly marked decline in 2003 and 2004. A recent study estimated the average VAT 'productivity' for 83 countries for the 1998–2001 period to be .32 (Bird and Gendron 2005). Ukraine's productivity for this period (0.30) is not unusually low. What is unusual, however, is the marked and continuous decline in VAT's revenue productivity that has

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[4] Although a 'value-added tax' was first introduced in 1991 it was only in 1997 that a modern VAT, allowing in principle for freeing both investment and exports from tax, was introduced.

[5] The exchange rate in 2004 was 5.3 hryvnia = U.S. $1.00

occurred in Ukraine in recent years.[6] Something is clearly wrong when both income and trade increases but VAT efficiency declines.

Crude calculations may also be made the size of the 'VAT gap'—the difference between VAT actually collected and that potentially realizable if all consumption were in fact taxed at the stated rate—in Ukraine. To illustrate, if VAT actually taxed all final household consumption at 20% it would have raised an additional 12.1 billion hryvnia (an additional 4.2% of GDP). The VAT 'gap' (potential less actual revenue as % of potential) calculated in this way is 46%. This estimate of what has been called 'gross compliance' (Gallagher 2005) takes into account both evasion and 'erosion' in the form of legal reductions of the tax base through exemptions and zero-rating other than for exports.[7] Interestingly, even a gap of this size is not out of line with that found (by more refined methods) in countries such as Italy and Uruguay, although it is much larger than the gap in countries like Britain and Chile with better VAT administrations (Bird and Gendron 2005).

A more conservative estimate of the VAT gap comes closer to estimating the extent to which the decline in VAT revenues reflects increasing evasion. If VAT productivity as measured in Table 1 had simply remained constant at 1998 levels, in 2004 VAT in Ukraine would have raised an additional 3.3 billion hryvnia (1.5% of GDP). The gap (predicted-actual as % of predicted) is about 16%. In other words, if there was no significant erosion of VAT base in 2004 compared to 1998—probably not too bad an assumption—VAT evasion increased by at least this amount over this period. And of course there was probably a good deal of evasion already on the ground in 1998.

Although there are many problems with such crude numbers the conclusion seems inescapable: something is rotten in Ukraine's VAT. Three possible explanations for this poor performance are possible: changes in economic structure, changes in tax structure, and, as just suggested, changes in administrative effectiveness. Let's consider each of these possibilities in turn.

VAT does not (in principle) tax either exports or investment. In principle a rise in GDP attributable to either an export-driven expansion or an investment boom may therefore result in a decline rather than an increase in VAT revenues because input credits (for exports and investment) may build up more quickly than output taxes. From 1998 to 1999, for example, exports as a share of GDP rose by 29.7% but VAT fell by 11.3%, which seems consistent with this story. From 1999 to 2000, however, although exports rose

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[6] In principle, conceptually better measures of VAT 'efficiency' may be calculated but questions may be raised about all these measures (Bird and Gendron 2005) and in any case they are so highly correlated in the case of Ukraine that the matter is not discussed further here.

[7] Gallagher (2005) calculates a similar gross compliance figure (45%) for Ukraine.

less (14.9%) VAT fell even more (13.9%) and from 2000 to 2001 both exports and VAT declined. The explanation for VAT's poor revenue performance cannot lie in exports. Similarly, investment has not expanded nearly enough since 1998 to account for the observed decline in net VAT revenues. On the whole, Ukraine's VAT performance cannot be explained by changes in economic structure.

Some of the decline in the VAT-GDP ratio before 2002 may perhaps reflect base 'erosion' in the form of increased exemptions (World Bank 2003). But no base changes occurred to explain the continued marked decline in 2003–2004. In early 2005, some exemptions were eliminated following the change in government, but it seems unlikely that this policy reversal, while commendable, will be sufficient to reverse the trend of declining VAT yields.[8]

I noted above that if the collection efficiency of VAT had remained constant at 1998 levels, VAT might have produced another 1.5% of GDP in 2004. This calculation implies that there has been a significant deterioration in the efficiency of VAT administration over this period. The real problem may simply be that VAT administration has never been very strong and that as time has gone on its inherent weaknesses have been increasingly exploited by the growing private sector. But the conclusion is inescapable: the major explanation of the decline of the VAT in Ukraine seems to lie in tax administration.

VAT evasion, the size of the underground economy, and corruption are closely linked. A recent study, for example, found a correlation of 0.66 between the estimated level of evasion and the Transparency International (TI) index of perception of corruption.[9] Of course, nothing is this simple: for example, although the corruption index is about the same in the U.S. and Chile evasion is more than twice as great in the latter. Still, when the perceived level of corruption is as high as it is in Ukraine, a high level of tax evasion—about 38%, if one simply extrapolated the regression estimated in the study just mentioned—is only to be expected. Evasion thus reflects not just weak administration but more systematic structural problems such as the prevalence of corruption and the substantial underground economy discussed later.

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[8] World Bank (2003, 53) estimates, for example, that the cost of the regional VAT concessions eliminated in early 2005 was about 3% of VAT revenues in 2001. Although this cost may have expanded a bit in later years, it seems improbable either that these exemptions account for much of the observed decline in VAT revenues or that their elimination will reverse this trend.

[9] The reference is to a study carried out under the auspices of AFIP, the Argentine tax administration, and available (in Spanish) at *www.afip.gov.ar*.

Fixing up the VAT

Ukraine's tax system, like the country itself, emerged only recently from three-quarters of a century of immersion (and submersion) in the command economy of the Soviet Union. Ukraine has in many ways done well in tax terms. It has both put into place most major taxes and created, virtually from scratch, a tax administration to implement them. But many problems remain. Both the public perception of Ukraine's tax system and the reality of how it works leave much to be desired.

One key problem has been the continuing erosion of the tax base through both legal concessions to various interests and administrative weaknesses. Despite recent reforms too many exceptions remain in the VAT law. For example, the treatment of agriculture is clearly unsatisfactory. Agriculture and much food processing are first taxed (at a special favourable rate) but then allowed to keep the tax. In other words, much of the agri-food can both credit input taxes, and claim refunds, and also the output taxes they charge to purchasers. This treatment guarantees that the agric-food sector is always a net drain on revenue. Moreover, it complicates the tax system and provides an obvious avenue for possible evasion activities. It would be simpler just to exempt agriculture from VAT, as is done in many countries. Political considerations obviously make it difficult to act in this area, but some action there must be if Ukraine is to build a sound tax system.

Equally indefensible is the treatment of housing construction, which should normally be taxed as a proxy for taxing housing services. Although the exemption of so-called 'critical imports'—as determined, apparently to a considerable extent on an ad hoc basis, by the Cabinet— was officially eliminated in May 2000 other questionable exemptions—such as of imports of cars and parts—remain. Such exemptions represent inappropriate industrial policies and have no place in a good VAT. Other items that may be questioned include the treatment of sales by enterprises where a certain proportion of employees are deaf or disabled, the treatment of health resorts, and the treatment of passenger transport. Any conceivable social gains from such provisions are unlikely to offset the damage they do to good VAT administration.

This process of base erosion started immediately following the introduction of the VAT with 10 amendments to the law in 1998 and still more in later years. Such widespread tax concessions facilitate both evasion and corruption. Sometimes, once concessions entered the system they were subsequently enlarged surreptitiously without quick response from the tax administration. Tax concessions create opportunities for abuse. They encourage taxpayers to lobby for still more concessions, just as amnesties provide an incentive to defer payment in anticipation of future tax amnesties. These problems remain important in Ukraine today.

Potential taxpayers have many routes of escape in Ukraine. They (or their tax base) may flee abroad. They may hide in the huge underground economy. They may secure favourable treatment by having changes made in the law or its interpretation. They may, if trapped within the taxation system, seek relief by forgiveness of arrears through amnesty laws. Or they may simply evade. As the tax base has been eroded in all these ways the government in its search for revenues has been driven to launch discretionary and unpredictable enforcement efforts. It has also made repeated attempts to introduce legislative changes to close gaps that arose from earlier policies introduced without sufficient attention to their detrimental systemic effects. The resulting continuing cycle of changes in the effective tax structure, erosion of the tax base, and renewed pressures on the tax administration to meet revenue targets has meant that those taxpayers unable to escape the system have faced uncertain tax burdens, and in some instances have had their taxes increased substantially. Moreover, all too often taxes appear to have been applied in an unduly discretionary fashion.

No one in Ukraine can say with certainty how any transaction will be taxed today, let alone tomorrow. The relatively few taxpayers—mainly wage-earners in the formal sector of the economy and some less favoured enterprises—subjected to the full rigor of the formal tax system face increasing and often arbitrary burdens. Savings and investment are deterred and misallocated. The underground economy expands. Revenues fall, so tax pressure is again increased on those who cannot escape and the vicious cycle continues. Not only is this cycle clearly not conducive to the development of a modern economy, but fiscal implosion—the effective destruction of the tax system—may lie in the not too distant future. This dismal prospect is not yet a spectre looming over Ukraine, but it is definitely more than a small rain-cloud on the distant horizon.

The problem with VAT structure is less one of tax design than of a political environment that has a demonstrated preference for using the tax system as an important means of managing its political constituency. Tax economists as a rule do not favour tax incentives, for good reasons. Either incentives are redundant and ineffective, forgoing revenue and complicating the tax system without adding to capital formation, or else they are distorting and inefficient, directing investment into less than optimal channels. Even the best-designed tax incentive is likely to be worthwhile only when a country has both a stable macroeconomic environment and a stable political and administrative system. Incentives in countries like Ukraine that do not meet these conditions are not costless. Creating what are essentially 'on-shore tax havens' in a country in which there is already a huge underground economy inevitably adds to the difficulty of enforcing taxes fairly and effectively. All too often, attempts to bestow fiscal favours on one sector lead to abuses and then further complexity with few demonstrable offsetting beneficial effects (World Bank 2003).

Administration Matters … a Lot!

As of the end of 2000, there were over 400,000 VAT registrants in Ukraine, of whom 83% were filing returns regularly. But in 1997 almost 600,000 taxpayers were registered for VAT. This reduction did not represent the desirable elimination of deadwood since VAT collections also peaked in 1997. What happened?

For one thing, the introduction of a ‘simplified’ tax system in 1998 not only reduced the number of VAT taxpayers but also reduced VAT collections. The reduction in VAT revenues was not offset by new revenues collected through the simplified system: total tax revenues also fell over this period from 21.3% of GDP in 1998 to only 17.4% in 2001.

In addition, VAT arrears accumulated rapidly, rising from only 10% of VAT collections in 1997 to an astonishing 66% in 1999 before declining largely as a result of write-offs (amnesties) to 47% in 2000 and 36% at the end of 2001. An important reason for the arrears in VAT refunds discussed later was simply because the amount of VAT arrears (taxes assessed but not paid) was itself so large that the fiscally hard-pressed government was reluctant to pay out refund claims—some for VAT that it had never received and some that it thought were fraudulent anyway. The largest cumulated arrears were in energy companies and energy-using heavy industries. At the end of 2001, even after substantial write-offs earlier that year, 20% of all arrears were in the fuel industry, and another 19% in the electric power industry. These two sectors which together accounted for only about 15% of the taxes collected accounted for almost 40% of the taxes not collected. Most VAT arrears arose from inter-enterprise arrears that in turn resulted largely from low cash collection levels and the under-pricing of energy.[10] Since energy (and some other) enterprises could not pay their own bills from their sales proceeds owing to restraints imposed by policy they compensated in part by not paying the government the VAT due on their own sales.

Ukraine’s VAT law was initially, consistent with world-wide practice, based on accrual accounting: tax was due when payment invoices were issued. But this system was soon changed to a cash system, apparently owing to the strong institutional inertia exerted by the previous ‘settlement

[10] Cash collections of taxes in the energy sector increased after early 2000 (when it had been as low as 10%). By 2002 the level was closer to 90%. But energy pricing remains a problem: see Petri (2002).

system' under which enterprises were not liable to pay taxes out of their bank accounts until payments had actually been made into these accounts by those to whom the goods were shipped. The change to a cash basis meant that businesses were able to credit VAT on inputs even when they did not pay for those inputs (Cosyns 2001). It is no surprise that the cash system led to obvious fraud: for example, taxpayers would claim they did not have to pay output taxes owing to non-payment (bad debts) but they would still claim input credits. Although the accrual system was quickly re-established in 1998, its application to the critical energy sector was postponed to 2001 so that there remained a substantial structural loophole in Ukraine's VAT structure conducive to fraud. Even after 2002 'communal services' sector (gas, heating, water, etc.) remained on the cash system of tax accounting.

Not all such basic administrative problems were confined to the energy sector. In 2001, for example, VAT refunds claimed by the mining and smelting sector with respect to exports were 40% more than in 2000 although their reported exports did not increase in terms of GDP. Equally odd is the fact that in 2001, wholesale and retail trade—always a notoriously difficult sector to tax—claimed 652 million hryvnia in refunds although these sectors reported no exports and no great investment. Such figures likely reflect serious underlying administrative problems.

One reason for such problems is that VAT legislation is complex. The system is full of privileges and exemptions that make it difficult to manage. Little assistance is provided to taxpayers to help them cope with these complexities. Nor is much done to guard against abuse. Most VAT 'audits' amount to little more than simple numerical checks. Although the threshold at which an enterprise becomes liable to VAT was raised in 2005 to 300,000 hyrvnia it remains low. There is thus an incentive to split income by Registering branches, affiliates, and other detached units separately—a practice that also increases the number of entities having the right to claim refunds. Taxpayers who produce both exempt and taxable products may attribute most inputs to the taxable activity, again reducing net VAT liabilities. Such avenues for tax evasion need to be watched more closely than they are in Ukraine.

Another problem with VAT administration in Ukraine has been its application at the border. In principle, VAT should be paid on imports before goods clear customs. Similarly, input taxes on exports should be refunded once the exports have left the country. Neither side of this system has worked properly. Imports have been regularly cleared without paying tax and exporters have been able to claim refunds with no evidence that exports have actually occurred. A Cabinet decision in 2002 ordered that refunds should not be paid until the export of goods was confirmed by the State Customs Authority. But it is equally important to ensure that imported goods pay. Although some measures have been taken to reduce the payment of import

VAT by ‘promissory notes’—notes that in the past have not always been honoured s appears to have resulted in some instances in non-payment in the end—it is not certain that this problem has been dealt with effectively. A country that does not collect VAT properly on imports is unlikely to do much better with the more difficult application of the tax in the domestic economy.

Administrative weaknesses do not imply that the tax administration is necessarily incompetent or corrupt. Both these factors may be at play to some extent but the real problems in Ukraine are more fundamental. First, as mentioned earlier, the creation and development of a modern tax administration is always and everywhere a difficult and time-consuming task. Ukraine began down this path only a decade or so ago in a difficult political and economic setting with an unpromising legacy of state-private relations and no trained officials. It is not surprising that there is still much to do. Secondly, many developments over the last few years would have made the task facing even the most motivated, competent, and honest tax administration difficult: the lack of consistent support from political leaders, constant changes in tax legislation, problems with the legal and judicial systems, and the rapidly changing level and structure of private activity.

Consider the list of characteristics commonly said to be necessary for the successful implementation of a modern self-assessed tax like VAT: simple, clear, stable tax laws; adequate service and support to taxpayers in complying with tax obligations; simple procedures for registration, filing, payment, and refund; effective collection enforcement, reasonable audit coverage; strict application of penalties; and provision for independent review (Ebrill et al. 2001, 141). Ukraine does not score well with respect to any of these criteria. One cannot blame poor tax administration outcomes simply on bad people doing bad things. Administering VAT well in the circumstances of Ukraine today is inherently difficult. Nonetheless, it can and should be done better.

Some observers, dazzled by the huge refund arrears accumulated in earlier years, have suggested that many of the problems with VAT in Ukraine arise from problems with the refund system. This argument seems incorrect. For example, the level of new refund claims in 2004 amounted to 41.3% of collections in that year. This number may seem large but it is relatively normal. Harrison and Krelove (2005), for instance, in a study of 28 countries for the 1998–2001 period found that nine countries had ratios in excess of 40%, with an average for the seven transition economies included in the study of 36.8%. Interestingly, Ukraine, which was included in this study, had an average ratio in this period of only 24.1%. Moreover, if one applies the regression equation estimated by Harrison and Krelove (2005) to derive the 'expected' refund levels for Ukraine in 2004, the result is 46.5%—or significantly more than the level actually observed.[11]

The annual level of refund claims in Ukraine is not in itself a problem. For the reasons noted earlier, however, there was a marked accumulation of refund arrears in earlier years. Recently, Ukraine has been paying down this stock of debt. In 2004 Ukraine paid out 13.9 billion hryvnia (excluding so-called 'mutual settlements' of offsetting debts of another 11.3 billion) in VAT refunds. If one nets this amount from VAT collections in 2004, the net cash received by the budget from VAT appears to be only 2.8 billion hryvnia. Indeed, if the 'mutual settlements' mentioned were included, as they should be, it might even appear that VAT was a net budgetary loser in 2004 to the tune of 8.5 billion hryvnia! But such accounting is not sensible. At the beginning of the year Ukraine had accumulated unpaid VAT arrears of 21.2 billion hryvnia. Over the course of the year an additional 6.9 billion hryvnia in new refund claims were made. The total amount of claims (past and present) settled during the year was 25.2 billion hryvnia, leaving an unpaid balance at end of year of only about 3 billion hryvnia. In other words what Ukraine did in 2004 was to pay off almost all of its outstanding refund arrears. It makes no sense to relate this payment of past debts (overdue accounts payable) to the current accounts receivable (VAT liabilities) and accounts payable (VAT refund claims) accrued during the year.

Another common argument in Ukraine is that some—perhaps many—refund claims, past and present, are fraudulent: the value of exports may be inflated, the exports may never have occurred, or the input taxes claimed on exports may be inflated or simply unreal. Such problems, however, arise not because of the refund system but because of problems with VAT administration as a whole. There are many ways to cheat on any sales tax, but in principle—and, with good administration, in practice also — it should be more difficult to cheat with a VAT than with other types of sales tax. VAT fraud may perhaps be more obvious than equivalent fraud with other forms of sales tax because it may show up in the form of explicit budgetary payments (refunds) rather than simply lower budgetary revenues. But the net impact on the budget is the same, and dealing with VAT fraud is no different than dealing with any other tax evasion. The correct treatment with respect to VAT refunds is simply to pay legitimate claims promptly and not to pay fraudulent claims at all. The problem is how to distinguish the good

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[11] The estimated equation (adjusted R squared = 0.8826) is Refunds = 0.16*Exports + 0.75*Growth + 0.19*Literacy + 0.90*Range, where exports is share of exports in GDP, growth is average GDP growth in period, literacy is literacy rate, and range is difference between lowest (non-zero) and highest VAT rates. (A number of dummy variables are included in the original equation, but none are applicable for Ukraine.)

from the bad. The answer lies not in special treatment of refund claims but in better administration of all aspects of VAT.[12]

Good tax administration requires serious analytical foundations, based on sound information and intelligent analysis. One must understand a problem in order to resolve it. The key to a better VAT in Ukraine is not to focus narrowly on the issue of refund fraud but rather to improve VAT administration in general. If this approach is followed, the fraud issue will be resolved. If one focuses just on fraud, however, the underlying problems will remain and may soon cause trouble again. There is no 'magic formula' for good tax administration, but there are many established and workable ways to do this critical and difficult job better that are currently in use all around the world (Bird 2004).

A good place to begin is by identifying the size and nature of problems carefully, for example by making better estimates of the 'VAT gap' than those provided above and then decomposing that gap by sector (energy, agriculture, services, etc) and the nature of the problem (non-registration, false registration, non-filing, under-reporting of sales, over-reporting of purchases, non-payment, etc.). Such studies provide a basis for establishing industry 'norms' (e.g. with respect refund to claim levels), deviations from which should lead to a closer look at the firms in question. Information along these lines is essential to determining the 'risk profile' (with respect to non-compliance) of taxpayers who are of different sizes, in different lines of business, and have different patterns of tax-relevant activity. Taxpayers in stable, well-established businesses with good compliance records are by definition much less likely to offend than those in new, variable businesses and no established record of good compliance. Ukraine has had some relevant experience recently in categorizing exporters claiming refunds into different 'corridors'. Much more needs to be done along these lines.

Of course, risk profiling is simply an ingredient in good tax administration, not a substitute. For example, the timely payment of VAT due needs to be monitored closely: there is no excuse for the persistence of continued VAT arrears of the size of those found in Ukraine. Similarly, a good auditing system is essential; such a system is also both difficult and time-consuming to develop. Achieving a satisfactory level of tax administration is not a once-and-for-all task: every country has to strive continually to maintain performance at a satisfactory level in the face of the constantly changing real world in which the tax system operates. Moreover, good tax administration is not simply a matter of more and better directed effort on the part of the tax administration. Constantly changing and ever more complicated laws may make the task impossible. Tax authorities need both

[12] As mentioned earlier, some 'refund problems' may reflect problems arising outside the tax system, as in the energy sector.

adequate resources and sufficient political support to enable them to do their essential jobs: processing taxpayer information, detecting significant deviations from ‘normal’ patterns, investigating such discrepancies, and, where appropriate, applying the appropriate penalties. Taxpayers also need sufficient support and service to cope with their role in the process—providing the required information in a timely and usable fashion. Unfortunately, the situation in Ukraine remains far from ideal in all these respects. The task facing even the best-intentioned (and most honest) VAT administration will continue to be a difficult one.

IS VAT Fair?

In recent years, many proposals to reduce the VAT rate in Ukraine have been made in part on equity grounds. However, there does not appear to be a good case for rate reduction on any grounds. Equity is of course always a central issue in taxation. From one perspective the principal rationale for taxes in the first place is to secure equity. After all, governments do not need taxes to secure money: they print the money in the first place. Instead, the role of the tax system is to prevent inflation by taking money away from the private sector in an equitable way. Equity, like efficiency and administrability is thus always a key concern in designing any tax system. One person’s notion of equity may, however, differ from the notions of others. Countries can reconcile conflicting views on such matters only through their political institutions.

Tax equity may be viewed from two distinct perspectives. Some may focus on the tax burden imposed on taxpayers in the same and different economic circumstances by particular features of particular taxes. Others may focus on the effects the whole fiscal system—taxes and expenditures together—has on people’s income and levels of well-being. Economists tend to take this broad approach. Most popular discussion of taxation takes the first approach and focuses on the details of particular taxes. The policy implications of these two different ways of approaching the equity of taxation are different. Focusing on the implications for equity of details of particular taxes tends to result in proposals to alter the rates and structures of particular taxes. Such proposals may improve horizontal and vertical equity within the limited group who are subject to the full legal burden of the tax in question. But they may tend to exacerbate inequity more broadly considered. From the perspective of social and economic inequality what matters in the end is the overall impact of the budgetary system on the distribution of wealth and income. Taxes that at first glance seem inequitable may on closer examination turn out to be an essential component of an equitable fiscal system.

For example, in evaluating the fairness of VAT in Ukraine, a critical factor is the importance of the underground or shadow economy. Some argue that the shadow share of economic activity may be as large as the above-ground share known to the authorities. Others reckon it is somewhat smaller.[13] Regardless of its precise size, the simple existence of a large sector of the economy that is effectively not subject to direct taxation affects how one assesses the effects of different fiscal instruments on equity. For example, the value of a nominally progressive personal income tax that impacts mainly on wage-earners and that many high-income recipients escape is far from evident (Bird and Zolt 2005). In Ukrainian conditions, it is thus quite conceivable that VAT, which to some extent also taps the underground economy, may be more progressive than the personal income tax. Even if this is a bit strong, VAT is unlikely to be much if any more regressive than other taxes in Ukraine.

Indeed, VAT may be one of the best taxes in Ukraine. One study, for example, found that the shadow economy paid perhaps 7% of its value added in indirect (VAT and excise) taxes, compared to perhaps 25% in the so-called 'soft' sector of the official economy[14]—agriculture, energy, and many state enterprises—and up to 50% in the less fortunate private official economy (Sultan 2000). A broader VAT base and better administration that extended the reach of the tax even further into both the soft and the shadow economies would enable the same revenues to be obtained with lower rates, thus reducing distortions and improving efficiency. On the other hand, simply reducing the tax rate would not reduce the distortions arising from the present biased structure of effective tax rates. Market-based activities would continue to migrate into the shadow sector or to join the lengthening queue of those seeking relief from the oppressive taxation afflicting those enterprises not already benefiting from tax concessions.

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[13] For example, Sultan (2000) estimated for 1998 that the shadow economy was 60% as large as the official GDP. It should perhaps be noted that such estimates do not imply that measured GDP is understated by such percentages. GDP is a value-added measure, while the usual 'hidden economy' measure is a measure of total activity and hence not directly comparable. Such ratios thus generally overestimate the relative importance of the shadow sector. In addition, some illegal activities (e.g. drug smuggling) included in the shadow sector are generally not included in GDP in any case. An estimated underground economy of, say, 40% may thus imply an underestimation of measured GDP of 20% or less, depending upon the nature of the hidden sector (e.g. the importance of illegal activities), the extent of double counting in the estimate of that sector, and the extent to which the activities measured are included in the measure of GDP. Since all these factors may vary over time, demonstrably do vary over the business cycle, and may also have very different implications with respect to tax evasion in different circumstances, even good estimates of the size of the informal sector do not provide much guidance to tax policy.

[14] The 'soft' sector is that part of the economy that is not subject to a 'hard' budget constraint, for example, because it can be (and frequently has been) bailed out by the government, as in the case of the energy sector discussed earlier.

Cutting VAT rates in the name of either equity or efficiency before broadening bases and tightening administration might thus be a fatal error. Rate cuts may result from or perhaps accompany base broadening and improved administration. But cuts cannot come first without great danger to the revenue. To a considerable extent the future of the Ukrainian tax system lies with the VAT. Every effort should therefore be made to strengthen and improve this tax. Nothing should be done to weaken it. Unfortunately, the recent introduction of a 'simplified' tax system has done just that.

The Dangers of Simplification

A simplified tax system was established in Ukraine in 1998 but came into full effect only in 2000 (Bird and Wallace 2004).[15] The system differs for individuals and enterprises although in both cases it is based on a combination of a turnover threshold and a maximum number of employees. For natural persons subject to personal income tax the parameters are 500,000 hryvnia and a maximum of 10 employees; for legal entities subject to enterprise profits tax the parameters are 1 million hryvnia and 50 employees. Two options are given in the case of VAT. One is a combined income and VAT rate of 10% on sales (turnover) as a proxy for both taxes. Alternatively, a separate 6% rate is applied on sales (turnover) as a proxy income tax, with the taxpayer continuing to have the right to issue receipts and apply credits as a normal VAT payer. Legal entities under the simplified system may thus pay either a single tax of 6% on sales (plus VAT) or one of 10% (and no VAT).

The decline in VAT registrants noted earlier suggests that a considerable number chose to opt out of the VAT system. Total collections from the simplified tax in 2000 came to only 0.5% of budget receipts; in 2001 the comparable figure was 0.8%. Despite official claims to the contrary, these amounts need not represent additional revenue—revenue that would not otherwise have been collected. Instead, the simplified tax may simply substitute for taxes that would otherwise have been collected. It may well result in a net decrease rather than an increase in revenue.

The simplified system creates a major problem for VAT. The 10% simplified regime breaks the VAT chain at a relatively high threshold. Many transactions are thus legally outside the VAT system. Invoices issued by taxpayers who take the 10% option cannot be credited by purchasers. Invoices issued on the purchases of these taxpayers by regular VAT sellers are worthless to them. However, they may easily be used by other taxpayers if sellers agree to issue them in their name, a practice that seems not unlikely in

[15] For a more sympathetic account see Engelschalk (2004).

Ukraine given the size of its shadow economy. The alternative of maintaining the chain in the case of the 6% regime brings all the complexity of the VAT to the small taxpayer. It also implicitly assumes that these taxpayers have the sophistication needed to comply with the VAT—an approach that seems inconsistent with the notion of simplicity that inspired the simplified system in the first place. It makes little sense to consider a person capable of VAT and incapable of income tax compliance in the same article of the law.

More generally, the simplified system creates a significant 'migration' risk because it provides an attractive legal low-tax enclave. Including legal entities like small corporations in a regime created for small informal businesses essentially makes 'informal' for tax purposes a status that has already been formalized at the taxpayer's initiative. To establish a legal entity requires at least two key formal steps, preparing a statutory document and opening accounting books. Legal entities are also obliged to register in the local business registry as well as with the tax and social security administrations. All these steps imply the existence of a minimum business capacity well above that of a really small individual private entrepreneur. There seems no good reason to exempt such enterprises from such normal tax obligations as VAT registration.

A bad reason for doing so—though one commonly heard in Ukraine—is that the normal tax regime is too harshly and arbitrarily applied and too prone to corruption, extortion, and harassment. But insulating (some) taxpayers from such problems does not make the problems disappear. On the contrary, creating a new legal tax haven may make the basic problems more difficult to deal for two reasons. First, two systems are harder to administer than one. Second, political pressure to fix the basic problems with tax administration will be reduced when some can escape the system. Taking people out of the VAT is a particularly bad idea. Information is the lifeblood of an effective VAT administration. Every effort should be made to avoid breaking the information chain, rather than encouraging firms to do so, as the simplified system does. This is not the way to tackle Ukraine's serious fiscal problems.

What Comes Next?

As in most transitional countries VAT quickly became the workhorse of the Ukrainian tax system. The rapid and radical alteration of taxation in Ukraine from a regional administrative branch of a central-planning fiscal system to something more appropriate to a modern 'mixed' capitalist economy has been a considerable success in many ways. But the transition from the old to the new has not all been smooth sailing and is by no means complete.

Further changes in tax law and much greater changes in tax administration will undoubtedly be needed before Ukraine's VAT functions as well as it can and should. How soon and to what extent such changes are made, however, depends largely upon how soon the fundamental underlying political and economic realities reflected in the tax system change. Base erosion through excessive concessions, for example, is likely to persist so long as politicians have to reward specific groups for their support. Similarly, arrears arising from poor energy policy will continue to be hostage to dependence on Russian energy on one hand and the need to maintain employment in energy-dependent industries on the other.

Given such pressures, unduly arbitrary administrative methods (such as withholding VAT refunds and discretionary enforcement) will likely be required to meet budgetary needs from time to time in the future, as in the past. The cycle that has produced such legislative responses as the simplified tax system—responses that complicate rather than facilitate movement in the direction needed for a sustainable long-term fiscal system—also seems likely to continue. The road to a modern tax system is neither short nor straight, and countries attempting to follow this road need to pay careful and continual attention to the task if they are to succeed. Ukraine has in many ways made a good start with the VAT, but the end of its road is not yet in sight.

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The Ethics of Tax Evasion: An Empirical Study of Business and Economics Student Opinion in Ukraine*

Irina Nasadyuk and Robert W. McGee

Introduction

The ethics of tax evasion has been discussed sporadically in the theological and philosophical literature for at least 500 years. Martin Crowe wrote a doctoral thesis that reviewed much of that literature in 1944. The debate revolved around about 15 issues. Over the centuries, three main views evolved on the topic.

Most studies of tax evasion take an economic or public finance perspective. Not much has been written from a philosophical or ethical viewpoint. That is probably because most economists are utilitarians and most lawyers are legalists. However, there is a small body of literature that addresses tax evasion issues from a philosophical or theological perspective. The present study is intended to add to that small body of literature while forming a bridge to the public finance literature as well.

This paper begins with a review of the literature and identifies the main issues and summarizes the three main viewpoints that have emerged over the centuries. It then reports on the results of a survey of Ukrainian business and economics students who were asked their opinions on the ethics of tax evasion. The survey consisted of 18 statements, representing the 15 issues and 3 viewpoints that have emerged over the centuries plus 3 statements representing more recent issues. Participants were asked to signify the extent of their agreement with each statement by placing a number from 0 to 6 in the space provided. One hundred sixty-one (161) usable responses were received. The data were then analyzed to determine which of the three viewpoints was dominant among the sample population.

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Review of the Literature

A review of the literature on the ethics of tax evasion reveals that three major views have evolved over the last 500 years. One view takes the position that tax evasion is always or almost always unethical, either because there is a duty to God to pay taxes, or there is a duty to some community or to society. Another view is that there is never or almost never a duty to pay taxes because the government is a thief, nothing more than a band of organized criminals, and there is no duty to give anything to criminals. The third view is that there is some ethical obligation to support the government of the country where you live but that duty is less than absolute.

One of the most comprehensive analyses of the ethics of tax evasion was done by Martin Crowe (1944), who examined the theological and philosophical literature of the last 500 years. Much of this literature took the *always unethical* or *sometimes unethical* positions. McGee (1994) discusses and summarizes the Crowe study. A more recent work by McGee (1998a) includes the opinions of more than 20 scholars who, collectively, espouse all three viewpoints. The Torgler (2003) study is also comprehensive, although Torgler looks at both ethical and public finance aspects of the issue.

A number of studies have been done that examine tax evasion in a particular country. Vaguine (1998) examines Russia, as do Preobragenskaya and McGee (2004) to a lesser extent. Smatrakalev (1998) discusses the ethics of tax evasion in Bulgaria. Ballas and Tsoukas (1998) discuss the views of Greek taxpayers. McGee (1999e) conducted a series of interviews to determine how people in Armenia think about tax evasion. McGee and Maranjyan (2006) did a follow-up empirical study to determine the views of economics and theology students on the ethics of tax evasion. Surveys have also been conducted of Chinese business and economics students (McGee and Yuhua 2006), Chinese law, business and philosophy students (McGee and Guo 2006) and accounting, business and economics students in Hong Kong (McGee and Ho 2006) as well as international business professors (McGee 2005a), Romanian business students (McGee 2005b) and Guatemalan business and law students (McGee and Lingle 2005). Morales (1998) discusses the viewpoint of Mexican workers. Most of these studies found that taxpayers do not have an ethical problem with evading taxes because their governments are corrupt and they feel that they have no ethical duty to pay taxes to a corrupt government. Morales concludes that a Mexican worker's duty to his family is sometimes more important than his duty to the state.

A number of studies have discussed the ethics of tax evasion from a practitioner perspective. Such studies tend to focus on the accounting profession's ethical code rather than any philosophical concepts. Two studies that take a practitioner's perspective were those of Armstrong and Robison (1998) and Oliva (1998).

If the articles by Cohn (1998) and Tamari (1998) are representative of the Jewish view, one may say that the Jewish view is near absolutist. Since Cohn is an Orthodox rabbi and Tamari is a well-known and highly respected Jewish scholar, one must concede that the viewpoints expressed in their articles at least represent some segment of Jewish thought on the issue. Some of the literature Cohn bases his position on goes back 3300 years. The literature Tamari cites also goes back hundreds of years.

According to Cohn (1998), the Jewish ethical perspective on paying taxes has four components:

- There is a duty to follow the country's statutes.
- Laws prohibit lying.
- A Jewish person must not do anything that could discredit the religion.
- Since it is essential for a Jewish person to perform as many commandments and good deeds as possible, it is essential to stay out of jail, since the Jewish religion cannot be practiced properly in prison.

The Baha'i position is also near absolutist (DeMoville 1998). The literature of this religion espouses the view that people have a duty to obey the laws of the country in which they live, which is the main justification for their position.

Some Christian groups also take this view—that individuals are morally bound to obey the laws of the country in which they live. There are passages in the Christian Bible that support this absolutist view (Romans 13: 1–2), although another passage is less absolutist, holding that people must give to the state the things that are the state's and to God the things that are God's (Matthew 22: 17, 21). The literature of the Church of Jesus Christ of Latter-Day Saints [Mormons] espouses the absolutist view that people have a duty to obey the laws of the country in which they live (Smith and Kimball 1998).

But other Christians are not so absolutist. Gronbacher (1998) reviewed the Christian literature and found passages that allow for a less than absolutist view. Basically, he takes the position that there are limits to the duty one owes to the state to pay taxes. Schansberg (1998) reviews the Biblical literature and arrives at the same conclusion. Much of the literature Crowe (1944) discusses also takes this position. Pennock (1998), another Christian writer, views evasion as ethical when tax funds are used to support an unjust war.

Angelus of Clavisio (1494) took the position that there is no ethical obligation to pay taxes if the government does not use the revenues collected to provide for the common good, at least as long as neither lying nor perjury are involved. Berardi (1898) took the position that there is probably no moral duty to pay a tax even if lying or perjury are involved, since the Prince merely dictates what is owed. Taxpayers never enter into a contract with the Prince, and thus are not bound to pay anything. Genicot (1927) states that partial evasion is justified on the grounds that the government does not have the right to the full amount and that it would be unfair to impose heavier taxes on conscientious men while wicked men usually pay less. Crolly (1877) takes the position that there is no duty to pay taxes unless evasion would result in violence.

Lehmkuhl (1902) takes the position that it is unethical to evade taxes when the result is that nonevaders have to pay more. In other words, there is some moral duty to other taxpayers even if there is no moral duty to the government. But Davis (1938) takes the position that it would be unfair to require honest taxpayers to take up the slack and pay higher taxes to make up for the evasions of others.

The Islamic position on the ethics of tax evasion is also mixed. McGee (1997, 1998b) reviewed Islamic business ethics literature and concluded that tax evasion might be justified in certain cases, such as when the tax causes prices to increase (tariffs and sales taxes) and where the tax is on income, which destroys incentives. But conversations with some Islamic scholars reject this interpretation of the Quran, the Muslim holy book. Murtuza and Ghazanfar (1998) also discuss the Muslim view on paying taxes but they confine their discussion to zakat, the duty to come to the aid of the poor. They do not discuss the relationship between the taxpayer and the state.

McGee critiques the various Christian views (1998c) and various religious views (1999a). Leiker (1998) examines the work of Rousseau and speculates as to what Rousseau's view on the ethics of tax evasion might be.

Not much has been written about the view that people have no duty to pay taxes. Although anarchists take this position, they generally do not focus on tax evasion issues. They tend to discuss the general relationship between the individual and the state. Lysander Spooner, a nineteenth century American lawyer and anarchist, is a case in point. He took the position that the state is always and everywhere illegitimate and that individuals therefore have absolutely no duty to obey any laws (1870). Spooner totally rejects the social contract theories of Locke (1689), Rousseau (1762) and Hobbes (1651).

Block (1989; 1993) examined the public finance literature and could not find any adequate justification for taxation, although he conceded that such justification might exist. It just did not exist in the public finance literature. Public finance writers start with the assumption that taxation is legitimate and go forward from there. They never examine the underlying philosophical foundation of taxation.

A few studies have applied ethical theory to various taxes to determine whether they may be justified on ethical grounds. If one begins with the premise that the state has an obligation to provide services in exchange for tax revenue, the estate tax is on shaky ground, since estate taxes are paid out of the assets of dead people (McGee 1999b) and the state cannot provide any services to this subgroup of the population. Individuals are being used as means rather than ends in themselves, which violates Kantian ethics

(Kant 1952a, b, c; 1983). The 'fair share' argument also violates Kantian ethics for the same reason. McGee (1999c) examined this issue.

Tariffs might also be an ethically suspect form of taxation if the main purpose is to protect domestic producers at the expense of the general public, which is the main use of tariffs today (McGee 1999d). Arguing that there is an ethical duty to pay a tax that benefits a special interest at the expense of the general public (general welfare) is an uphill battle.

The capital gains tax might also be challenged on ethical grounds, especially when it is not indexed for inflation (McGee 1999f). Depending on the facts and circumstances, this tax might actually exceed 100% of income, in cases where the asset has been held a long time and there has been inflation.

Arguing that there is an ethical duty to pay the Social Security tax has also been subjected to challenge (McGee 1999g), at least in the case of the Social Security tax in the United States, which is highly inefficient, therefore violating utilitarian ethics. It also violates Kantian ethics, since one group (workers) is being exploited by nonworkers (retired people). Some authors have said that tax evasion defrauds the government (Cowell 1990), while other authors have said that the government defrauds the taxpayer (Chodorov 1954; Gross 1995; Shlaes 1999).

Methodology

A survey instrument was developed to solicit the views of Ukrainian business and economics students on the ethics of tax evasion. The survey consisted of 18 statements that include the major arguments Crowe (1944) discussed plus three more modern arguments. Each statement generally began with the phrase 'Tax evasion is ethical if….' Respondents were instructed to insert a number from 0 to 6 in the space provided to reflect the extent of their agreement or disagreement with each of the 18 statements. A score of zero (0) represented strong disagreement with the statement, while a score of six (6) represented strong agreement.

The survey was translated into Russian and distributed to graduate students and advanced undergraduate students majoring in business (finance and accounting) and economics at Odessa Mehnikov National University and Odessa State Economics University.

One hundred sixty-one (161) usable responses were collected. The following hypotheses were made:

H1: The prevalent view is that tax evasion is sometimes ethical. This hypothesis will be accepted if average scores are more than one (1) but less than five (5) for at least 12 of the 18 statements.

H2: Tax evasion will be more acceptable [scores will be higher] when the government is perceived to be corrupt. This hypothesis will be accepted if the statement referring to corruption is ranked in the top 6 responses.
H3: Tax evasion will be more acceptable if the system is perceived as being unfair or if the government engages in human rights abuses. This hypothesis will be accepted if scores for statements in those categories are ranked in the top half (1–9).
H4: Tax evasion will be less acceptable where the motive for evasion is a selfish motive. This hypothesis will be accepted if the scores for statements in this category are ranked in the bottom half (10–18).
H5: The dominant group—the group with the largest plurality—will be the group that believes tax evasion is sometimes ethical [scores of more than 1 but less than 5]. This hypothesis will be accepted if this group has the largest plurality for at least 12 of the 18 statements.

Findings

H1: The prevalent view is that tax evasion is sometimes ethical. This hypothesis will be accepted if average scores are more than one (1) but less than five (5) for at least 12 of the 18 statements.
H1: Accepted.

As can be seen from Table 1, all 18 scores are more than 1 and less than 5, which indicates the average respondent believes tax evasion to be ethical sometimes.

Table 1
Combined Scores
(0 = strongly disagree, 6 = strongly agree)

S#	Statement	Score
1	Tax evasion is ethical if tax rates are too high.	3.71
2	Tax evasion is ethical even if tax rates are not too high.	1.34
3	Tax evasion is ethical if the tax system is unfair.	4.13
4	Tax evasion is ethical if a large portion of the money collected is wasted.	3.66
5	Tax evasion is ethical even if most of the money collected is spent wisely.	1.01
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	2.22
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	1.48

8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	1.81
9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	1.32
10	Tax evasion is ethical if everyone is doing it.	1.66
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	4.24
12	Tax evasion is ethical if the probability of getting caught is low.	2.18
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	2.94
14	Tax evasion is ethical if I can't afford to pay.	3.51
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	1.57
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	3.33
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	4.10
18	Tax evasion is ethical if the government imprisons people for their political opinions.	4.23
	Average Score	2.69

H2: Tax evasion will be more acceptable [scores will be higher] when the government is perceived to be corrupt. This hypothesis will be accepted if the statement referring to corruption is ranked in the top 6 responses.
H2: Accepted.

Table 2 ranks the statements from strongest to weakest. The strongest statement in favour of tax evasion was the statement dealing with political corruption. Thus, hypothesis no. 2 is accepted.

Table 2
Ranking of the Arguments
Ranked from Strongest to Weakest Arguments Supporting Tax Evasion
(0 = strongly disagree; 6 = strongly agree)

Rank	Statement	Score
1	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends. (S11)	4.24
2	Tax evasion is ethical if the government imprisons people for their political opinions. (S18)	4.23
3	Tax evasion is ethical if the tax system is unfair. (S3)	4.13

4	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background. (S17)	4.10
5	Tax evasion is ethical if tax rates are too high. (S1)	3.71
6	Tax evasion is ethical if a large portion of the money collected is wasted. (S4)	3.66
7	Tax evasion is ethical if I can't afford to pay. (S14)	3.51
8	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940. (S16)	3.33
9	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust. (S13)	2.94
10	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of. (S6)	2.22
11	Tax evasion is ethical if the probability of getting caught is low. (S12)	2.18
12	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me. (S8)	1.81
13	Tax evasion is ethical if everyone is doing it. (S10)	1.66
14	Tax evasion is ethical even if it means that if I pay less, others will have to pay more. (S15)	1.57
15	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects. (S7)	1.48
16	Tax evasion is ethical even if tax rates are not too high. (S2)	1.34
17	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me. (S9)	1.32
18	Tax evasion is ethical even if most of the money collected is spent wisely. (S5)	1.01

H3: Tax evasion will be more acceptable if the system is perceived as being unfair or if the government engages in human rights abuses. This hypothesis will be accepted if scores for statements in those categories are ranked in the top half (1–9).
H3: Accepted.

Statements ranked 3, 5 and 7 make reference to unfairness. They are all ranked in the top half (top 9). Statements ranked 2, 4 and 8 refer to human rights abuses. They are also all ranked in the top half. Thus, hypothesis 3 is accepted.

H4: Tax evasion will be less acceptable where the motive for evasion is a selfish motive. This hypothesis will be accepted if the scores for statements in this category are ranked in the lower half (10–18).
H4: Accepted.

Statements having a selfish motive were ranked 12, 13, 14, 15, 16, 17 and 18, which are all in the bottom half. Thus, hypothesis 4 is accepted. It might be pointed out that merely having a selfish motive does not mean that the act or view is unethical or immoral. Adam Smith (1776) believed that we all act out of selfishness and that doing so is a good thing for society. Smith took this idea from Mandeville (1714), who espoused the view that private vices are public virtues. Some philosophers advocate selfishness as a valid moral philosophy (Rand 1964). All this finding means is that when selfish reasons are given to justify tax evasion they are seen as weak arguments. The underlying rationale could be that there is some duty to government, to God or to some segment of the community.

H5: The dominant group—the group with the largest plurality—will be the group that believes tax evasion is sometimes ethical [scores of more than 1 but less than 5]. This hypothesis will be accepted if this group has the largest plurality for at least 12 of the 18 statements.
H5: Rejected.

Table 3 shows the range of scores for each statement. The scores and rankings are divided into the following three categories:

0–1 Tax evasion is never or almost never ethical
2–4 Tax evasion is sometimes ethical
5–6 Tax evasion is always or almost always ethical

The dominant group for each statement is the group that has the highest plurality. The first three columns provide the breakdown for each category in terms of percentages. Those percentages are then ranked in the next three columns. For example, for S1 the largest plurality is the 2–4 range, with 45% of the total responses. The second place group is the 5–6 category with 39% of total responses. The 0–1 category drew a mere 13% of total responses. The next three columns show the rankings for first, second and third place for each statement.

The 2–4 range had the largest plurality for only 5 of 18 statements (S 1, 4, 8, 12 &13). It took second place for another 12 statements and ranked third only once. Thus, the hypothesis must be rejected.

Another interesting fact that was uncovered was that the mode—the most frequent response—tended to be at one of the extremes. The mode was either 0 or 1 [strong disagreement with the statement] for 9 of the 18 statements. The mode was either 5 or 6 [strong agreement with the statement] for 8 of the 18 statements. The middle view was the mode in only 1 of 18 cases.

Table 3 shows that the *sometimes* medium position (2–4) took second place for 12 of 18 statements. The *always or almost always ethical* view (5–6) was either the most popular (1) or least popular (3) position for 17 out of 18 statements.

Table 4 summarises the extent of dominance of each group. As can be seen, none of the three categories is clearly dominant. The 0–1 and 5–6 categories each have 7 first place finishes. The 0–1 category has the most third place finishes, with 10.

Table 3
Range of Scores
(0 = strongly disagree; 6 = strongly agree)

S#	Statement	Mode	Range of scores %			Range of scores by rank		
			0–1	2–4	5–6	0–1	2–4	5–6
1	Tax evasion is ethical if tax rates are too high.	5	13%	45%	39%	3	1	2
2	Tax evasion is ethical even if tax rates are not too high.	0	60%	39%	2%	1	2	3
3	Tax evasion is ethical if the tax system is unfair.	6	11%	36%	50%	3	2	1
4	Tax evasion is ethical if a large portion of the money collected is wasted.	6	21%	38%	38%	2	1	1
5	Tax evasion is ethical even if most of the money collected is spent wisely.	0	75%	22%	3%	1	2	3
6	Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.	1	43%	41%	14%	1	2	3
7	Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.	0	61%	32%	5%	1	2	3
8	Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	0	46%	48%	5%	2	1	3

9	Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.	0	66%	26%	7%	1	2	3
10	Tax evasion is ethical if everyone is doing it.	0	60%	24%	14%	1	2	3
11	Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.	6	17%	21%	58%	3	2	1
12	Tax evasion is ethical if the probability of getting caught is low.	0	41%	47%	12%	2	1	3
13	Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.	3	29%	47%	24%	2	1	3
14	Tax evasion is ethical if I can't afford to pay.	6	22%	36%	39%	3	2	1
15	Tax evasion is ethical even if it means that if I pay less, others will have to pay more.	0	55%	40%	4%	1	2	3
16	Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.	6	32%	24%	43%	2	3	1
17	Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.	6	16%	26%	56%	3	2	1
18	Tax evasion is ethical if the government imprisons people for their political opinions.	6	12%	29%	56%	3	2	1

Table 4
Degree of Support for the Three Views

Score	1st Place	2nd Place	3rd Place
5–6 (always or almost always ethical)	7	5	6
2–4 (sometimes ethical)	5	12	1
0–1 (never or almost never ethical)	7	1	10

If the first and second place finishes are combined, the results are as follows:

Table 5
Degree of Support for the Three Views

Score	1st place	2nd place	Total place
5–6 (always or almost always ethical)	7	5	12
2–4 (sometimes ethical)	5	12	17
0–1 (never or almost never ethical)	7	1	8

As can be seen from Table 5, the *sometimes* (2–4) group has the most combined first and second place finishes, with 17. The *never or almost never category* (0–1) had a mere 8 first or second place finishes. Thus, it can be said that the *sometimes* category (2–4) weakly dominates the other two categories. Domination would be stronger if the *sometimes* position (2–4) had more first-place finishes.

The survey instrument included space for optional comments. Some respondents added their comments. The main reasons justifying tax evasion were government inefficiency, corruption and high taxes. Here is a summary of what they had to say:

Tax evasion is ethical if you can't afford to pay.

- Tax evasion is quite logical if an individual is not able to pay. That is why I believe a progressive tax system to be the most reasonable. Also, if the people are not confident in their government, they will evade taxes in every possible way. Here the necessary measures should be taken on behalf of the state to make people aware that the collected money would serve their well-being.

- Taxation is one of the major means of financing the government. The funds collected are used to support those segments of the population that are worse off, to develop science, culture, sport and education. Therefore, taxes benefit all of society. However, in our country tax principles are not always efficient and do not always work, causing tax evasion. Taxes should be paid even if they are not fair. The only case where tax evasion is acceptable is when people cannot pay.
- I think that tax evasion is not ethical no matter how high the tax rates are. This form of fighting or resisting the government is not efficient. If people don't pay enough to finance the budget the government raises taxes, and this process goes on continuously. The government must find some optimal tax rate so that people will pay their taxes in full. Then the budget will be fully funded. Also, the taxes must be reasonable and not ridiculous. The government should not use the tax system to extract blackmail payments from taxpayers. If the government decreases the profit tax, people will not hide their true incomes and will pay in full.
- I think that people should not evade taxes. But government's attitude toward this issue is also important. If government establishes tax rates that are too high to allow the average citizen to work and live, then perhaps evasion is justifiable. On the other hand, setting high tax rates prevents civilian activities from developing and functioning, so they will have no income to pay taxes on. I think that taxes should be reasonable.
- If taxes were not so high, private entrepreneurs and other people would not evade them.
- If the tax system is built in such a way that civilians (entrepreneurs, companies) are able to buy an apartment, a car and minimum accommodations after paying taxes, I consider tax evasion to be unethical.
- I would not evade taxes if the tax rates were much lower and the funds went for good things. If it never happens I will search for ways to evade.
- Tax evasion has taken place in the past and will continue to take place in the future. The question is—to what extent? With the current tax regulations and tax rates, a cut in the rate will cause evasion to decrease significantly.

Inefficient tax policy is the reason for tax evasion

- If government regulations prevent businessmen from earning money, then the practice of tax evasion is inevitable, in particular in former Soviet countries. Businessmen attempt to evade taxes in every possible way. Otherwise, there would be no sense in working.
- Tax evasion is ethical in cases where the government, through its various agencies, does not fulfil its duties, pursues discriminatory politics, etc.

Because tax funds are often used for improper purposes, tax evasion is ethical.

- The mentality defines whether tax evasion is ethical. If funds are directed toward nonsensical purposes or go to corrupt public servants, it is easier to hide income and direct the funds to sources that make more sense to the individual taxpayer.
- In my opinion, tax evasion is highly dependent not on the tax rate but rather on the overall collected funds used to fund collective needs and on how efficiently they are used.
- In my opinion, whether tax evasion is ethical depends on how efficiently the collected funds are used and what share of them is used legally rather than directly into the hands of politicians for private use.
- For me the issue of tax evasion arises when the existing tax system is not perfect, or when the funds are used for the wrong goals or purposes, or when the funds flow into the pockets of the people in power. In a normally functioning state, tax evasion is not ethical.
- I think that tax evasion is acceptable as long as the government's judicial and executive functions remain imperfect.
- Tax evasion is not ethical under any circumstances and is irrational from the economic point of view. Even if people live poorly because of high taxes, evasion is not ethical.
- I think that the first thing to fight in our country is corruption and bureaucracy. If we do that, tax evasion will disappear.

Tax evasion is not the way to fight the government. One should not fight the government by economic means. It is the civic responsibility of the taxpayer to fight through the political process.

- I think that tax evasion is unethical. If you think that tax rates are too high, or that the tax system is unfair or that the government spends money for a war that is not supported by the people, it is the taxpayers who are to blame. They are the ones who have elected the government officials who are engaging in activities that are contrary to the wishes of the people. I think the taxpayers who give their votes at elections are the ones to blame. Another point is that we (the common people) do not have all the information about why the government has made a decision to take part in a war or conflict. Thus, we don't have the opportunity to adequately and objectively judge the morality or immorality of the politicians. Another fact to consider is whether the short-term sacrifice is worth it from a long-run perspective. The only thing that will allow me to sleep soundly (if I evade taxes) is if there is corruption at the top and if public officials engage in theft by taking money from the budget for private use.
- Tax evasion cannot be ethical because it is a violation of spiritual, civic and legal norms. In cases where the government violates political,

> national or other rights of the civilian population, they should fight for their rights within the framework of existing laws through public, political and other institutes, and through their representative bodies. Besides, I believe the most important instrument in this fight is played by the electoral system.

These last two responses were from the only two respondents who have graduate degrees. The first response is from an individual who has completed a master's degree. The second one is from an instructor who has a PhD. They both seem to have a deeper understanding of civic commitment and the relationship of the individual to the state than do the upper level undergraduate students.

One highly emotional response was also received. 'What is lacking is the air tax, so people would suffocate completely. Soon one would not want to live because of the taxes. Nice commercial! Pay your taxes and sleep peacefully! But how can they be paid if the minimum wage is 450 hryvnia (around $70)? What shall we eat then?'

Concluding Comments

This study surveyed the opinions of business & economics students in Odessa. The results of the study show that, although the view that tax evasion is ethical in at least some cases has wide support, there is also a strong feeling that tax evasion is unethical in some cases. Under some circumstances, tax evasion is viewed as never or almost never ethical. Most respondents were opposed to the view that tax evasion is always or almost always ethical. Average scores ranged from 0.01 to 4.24 on a 7-point scale. The strongest arguments justifying tax evasion were in cases where the government is corrupt, the system was seen as unfair, or where human rights were being violated.

A review of the optional comments revealed that there would be widespread support for paying taxes if the government was able to clean up its act, drastically reduce corruption and increase efficiency. There is a tendency to move in this direction as an economy grows and starts doing business with companies and countries where corruption is the exception rather than the rule. Thus, the long-term future looks bright. However, the long-term is more than a few years away. In the meantime, tax evasion and corruption will remain a way of life.

The present study can be replicated in several ways. Different groups of Ukrainian students could be surveyed, either in different cities or regions of Ukraine or in different disciplines, such as law, philosophy or political science.

Comparative studies might also be made of sample populations from other Central and East European countries or countries in other parts of the world. Research by Torgler (2003) indicates that results might differ by country. Conducting comparative studies could confirm the Torgler findings.

Surveying Ukrainian business people might also be worthwhile, since their perception of taxation might be different than that of university students. Business owners might have different opinions than employees of business enterprises, too, and this comparison would make for an interesting study.

The findings of this study have important policy implications. If tax evasion is a problem, the first step in solving or reducing the problem is to find the underlying causes. This survey has identified some causes—government corruption, perceived unfairness of the tax system or human rights abuses. These problems must be addressed if tax evasion is to be reduced.

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Appendix 1
Survey Instrument—English Version

The Russian version was used in the survey. The English version is included here for the convenience of the reader.

The Ethics of Tax Evasion

Instructions: Tax evasion is defined as the illegal nonpayment of taxes. Tax avoidance, on the other hand, involves using legal means to minimize taxes. Please answer the following questions dealing with the ethics of tax evasion.

Please insert the appropriate number in the space provided for the following statements.

0__________1__________2__________3__________4__________5__________6
Strongly Disagree ... Strongly Agree

1.______Tax evasion is ethical if tax rates are too high.

2.______Tax evasion is ethical even if tax rates are not too high.

3.______Tax evasion is ethical if the tax system is unfair.

4.______Tax evasion is ethical if a large portion of the money collected is wasted.

5.______Tax evasion is ethical even if most of the money collected is spent wisely.

6.______Tax evasion is ethical if a large portion of the money collected is spent on projects that I morally disapprove of.

7.______Tax evasion is ethical even if a large portion of the money collected is spent on worthy projects.

8.______Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.

9.______Tax evasion is ethical even if a large portion of the money collected is spent on projects that do benefit me.

10.______Tax evasion is ethical if everyone is doing it.

11.______Tax evasion is ethical if a significant portion of the money collected winds up in the pockets of corrupt politicians or their families and friends.

12.______Tax evasion is ethical if the probability of getting caught is low.

13._____Tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust.

14._____Tax evasion is ethical if I can't afford to pay.

15._____Tax evasion is ethical even if it means that if I pay less, others will have to pay more.

16._____Tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940.

17._____Tax evasion is ethical if the government discriminates against me because of my religion, race or ethnic background.

18._____Tax evasion is ethical if the government imprisons people for their political opinions.

I am a(n): ___master's degree or doctoral student ___bachelor's degree student

___faculty member ___other__________________________________

My major area of study is: ___business/economics ___law or political science

___philosophy ___theology or religious studies ___other
(specify)____________________

(Optional Comments) What are your views on the ethics of tax evasion? What determines whether tax evasion is ethical or unethical? You may use the back of this questionnaire if you need more space.

Appendix 2
Survey Instrument—Russian Version

Вопрос этичности уклонения от уплаты налогов

Цель анкетирования: научное исследование отношения к уклонению от уплаты налогов в Украине и сравнение с общественным мнением по тому же вопросу в США.
Уклонение от уплаты налогов определяется как незаконная неуплата налогов (сюда мы не относим минимизацию налогооблагаемой базы).

Поставьте, пожалуйста, вместо прочерков цифру, соответствующую Вашему отношению к каждому утверждению.

0_________1_________2_________3_________4_________5_________6

решительно несогласны	**абсолютно согласны**

I._____ Уклонение от уплаты налогов этично, если ставки налогообложения слишком высоки.

II._____ Уклонение от уплаты налогов этично, даже если ставки налогообложения не слишком высоки.

III._____ Уклонение от уплаты налогов этично, если система налогообложения несправедлива.

IV._____ Уклонение от уплаты налогов этично, если большая часть собранного таким образом дохода потрачена впустую.

V._____ Уклонение от уплаты налогов этично, даже если собранные средства расходуются разумно.

VI._____ Уклонение от уплаты налогов этично, если большая часть собранных средств тратится на проекты, которые я не одобряю с моральной точки зрения.

VII._____ Уклонение от уплаты налогов этично, даже если большая часть собранных средств тратится на достойные проекты.

VIII._____ Уклонение от уплаты налогов этично, если большая часть собранных средств тратится на проекты, не приносящие мне пользы.

IX._____ Уклонение от уплаты налогов этично, даже если большая часть собранных средств тратится на проекты, которые приносят мне пользу.

X._____ Уклонение от уплаты налогов этично, если каждый поступает так же.

XI._____ Уклонение от уплаты налогов этично, если большая часть собранных средств перетекает в карманы коррумпированных политиков, членов их семей, друзей.

XII._____ Уклонение от уплаты налогов этично, если вероятность наказания мала.

XIII._____ Уклонение от уплаты налогов этично, если часть налоговых сборов идет на поддержание военных действий, которые я считаю несправедливыми.

XIV._____ Уклонение от уплаты налогов этично, если я не в состоянии заплатить их.

XV._____ Уклонение от уплаты налогов этично, даже если это означает, что если я заплачу меньше, другой должен будет заплатить больше.

XVI._____ Уклонение от уплаты налогов было бы этично, если бы я был евреем, живущим в Нацистской Германии 1940 г.

XVII._____ Уклонение от уплаты налогов этично, если правительство дискриминирует меня по причине моей принадлежности к какой-либо религии, расе или национальности.

XVIII._____ Если правительство заключает под стражу людей за их политические взгляды, игнорируя тем самым их гражданские свободы, то со стороны гражданина будет этичным уклоняться от уплаты налогов такому правительству, игнорируя тем самым его экономические требования.

Я: ___аспирант, магистр, кандидат в доктора наук ___студент

___преподаватель ___другое__________________

Специализация: ___бизнес/экономика ___право или политология

___философия

___теология или религиоведение

___другое(поясните)___________

(Дополнительный комментарий) Каков Ваш взгляд на уклонение от уплаты налогов? Что определяет, является ли уклонение от уплаты налогов этичным или неэтичным? Вы можете писать на обратной стороне листа.

Спасибо, что Вы нашли время на заполнение анкеты.

36

A Survey of Vietnamese Opinion on the Ethics of Tax Evasion

Robert W. McGee

Introduction

Although much has been written about tax evasion from the perspective of public finance, not many studies have focused on the ethical aspects of tax evasion. One of the most comprehensive early studies on the ethics of tax evasion was done by Martin Crowe (1944), a Catholic priest who surveyed the philosophical and religious (mostly Catholic) literature that had been written over the previous five centuries. Crowe found that three basic positions had emerged over the centuries. Tax evasion was considered to be: never ethical, always ethical or ethical under certain facts and circumstances.

More recent studies were done by Torgler (2003) and McGee (1994, 1998a). The Torgler study was mostly empirical but did not examine the philosophical and ethical literature in depth. The McGee studies examined the philosophical and ethical literature but did not conduct empirical investigations.

Although very few philosophical studies on the ethics of tax evasion have been made, the ones that have been done span all three viewpoints. Block (1989, 1993) surveyed the public finance literature but failed to find any adequate explanations or arguments to justify taxation. McGee (1994) applied Lysander Spooner's (1870) philosophy to the issue of tax evasion, which challenged the social contract theories of Hobbes (1651), Locke (1689) and Rousseau (1762).

At the other end of the spectrum, a few philosophical studies concluded that tax evasion is never justified. The literature of the Baha'i religion strictly prohibits tax evasion, the main argument being that individuals have a duty to obey the laws of the country in which they live (DeMoville 1998). A study of the Mormon religious literature reached the same conclusion and for the same reason (Smith and Kimball 1998).

Two philosophical studies of the ethics of tax evasion from a Jewish perspective (Cohn 1998; Tamari 1998) both concluded that tax evasion is

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never, or almost never ethical according to the Jewish literature. A third Jewish study, which was both philosophical and empirical in nature (McGee and Cohn 2006), found that, although the Jewish literature was firmly against tax evasion on ethical grounds, the Jews who were surveyed were more flexible on the issue. An empirical study of Mormon views (McGee and Smith 2006) found that many Mormons were also more flexible on the issue than their religious literature would suggest.

Several philosophical studies concluded that tax evasion could be ethical in certain situations. Pennock (1998) concluded that tax evasion was ethical in cases where the country collecting the taxes was engaged in an unjust war. Morales (1998) regarded a man's duty to feed his family was more important than feeding the state's coffers. Gronbacher (1998) and Schansberg (1998) concluded that the Catholic religious literature permits tax evasion in certain situations, a view that concurs with the Crowe (1944) study. Gronbacher's study (1998) of the Christian literature reached the same conclusion. Two Islamic scholars (Murtuza and Ghazanfer 1998) examined their religious literature and reported that Muslims have a duty to God to contribute to the poor. They did not address the issue of the relationship of the individual to the state and the corresponding duty to pay taxes. A survey of the Islamic business ethics literature by a non-Muslim scholar (McGee 1997, 1998b) found that tax evasion can be justified in cases where the effect of the tax is to increase prices or where the tax is on income.

A few empirical studies on the ethics of tax evasion have been conducted. Studies of Argentina (McGee and Rossi 2006), Armenia (McGee and Maranjyan 2006b), Bosnia & Herzegovina (McGee, Basic and Tyler 2006), China (McGee and Guo 2006; McGee and Noronha 2006; McGee and Yuhua 2006), Germany (McGee et al. 2005), Guatemala (McGee and Lingle 2005), Hong Kong (McGee and Butt, 2006; McGee and Ho 2006), Macau (McGee et al. 2006), Poland (McGee and Bernal 2006), Romania (McGee 2005a), Slovakia (McGee and Tusan 2006), Thailand (McGee 2006a), Ukraine (Nasadyuk and McGee 2006), philosophy teachers (McGee 2006b), accounting practitioners (McGee and Maranjyan 2006a) and international business academics (McGee 2005b) asked respondents to give their opinion on the ethics of tax evasion in various specific situations, using a 7-point Likert Scale. All these studies concluded that tax evasion may be ethically justified in certain situations, although some arguments were stronger than others. The Torgler (2003) study reached the same conclusion, using a different methodology.

The Vietnamese Study

The Human Beliefs and Values Surveys (Inglehart et al. 2004) collected responses to scores of questions from 200,000 people in 81 societies representing 85% of the world's population. The interviews were face to face, which introduces a bias, since people might have different answers to some questions if they could answer anonymously. The data used in the Human Beliefs and Values Survey was collected between 1999 and 2002. The survey was published in 2004. The survey gathered data in Vietnam about views toward tax evasion. Question F116 asked:

> Please tell me for each of the following statements whether you think it can always be justified, never be justified, or something in between: Cheating on taxes if you have a chance.

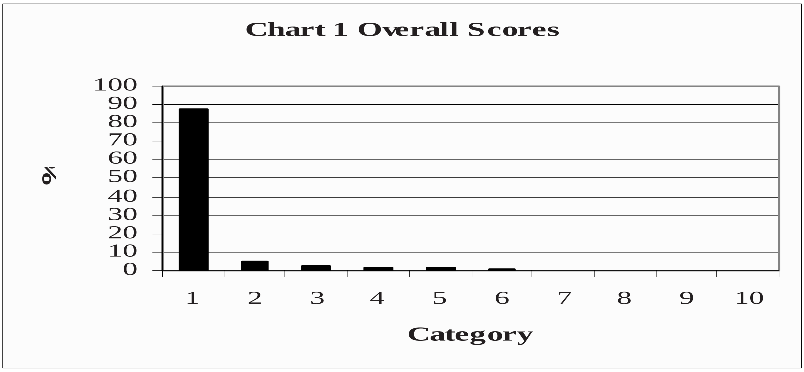
The tables below show the responses when the question was asked to Vietnamese participants. The sample size was 989. The scale used was 1–10 where 1 represents "never justifiable" and 10 represents "always justifiable." The findings clearly show that tax evasion is considered to be unethical by the vast majority of people in Vietnam.

Table 1 shows the overall scores as well as the scores by gender. On a scale of 1–10, where 1 = never justifiable and 10 = always justifiable, 87.8% of the total sample considered tax evasion to never be justifiable. Only 0.4% considered tax evasion to always be ethical. The mean score was 1.32%.

Table 1
Responses to Question F116—Overall and by Gender
(1 = never justifiable; 10 = always justifiable)

Score	Overall %	Male %	Female %
1	87.8	89.8	85.8
2	4.9	2.9	6.8
3	2.7	3.9	1.6
4	1.4	1.2	1.6
5	1.5	1.0	2.0
6	0.7	0.4	1.0
7	0.2	0.0	0.4
8	0.2	0.0	0.4
9	0.2	0.2	0.2
10	0.4	0.6	0.2
Mean	1.32	1.28	1.36

Chart 1 shows the overall scores.



Numerous studies have compared male and female attitudes and opinions on a variety of ethical issues. Some studies have concluded that females are more ethical than males (Boyd 1981; Dawson 1997; Ruegger and King 1992) while other studies have concluded just the opposite (Barnett and Karson 1987; Weeks et al. 1999). A third group of studies found no statistical difference between male and female attitudes (Loo 2003; Posner and Schmidt 1984; Stanga and Turpen 1991).

A few studies have explored male and female attitudes toward the ethics of tax evasion. Women were found to be more strongly opposed than men to tax evasion in studies of accounting practitioners (McGee and Maranjyan 2006), Guatemala (McGee and Lingle 2005), Hong Kong (McGee and Butt 2006, Hubei, China (McGee and Guo 2006), international business professors (McGee 2005b), Orthodox Jews (McGee and Cohn 2006), Spain (Alm and Torgler 2004), Thailand (McGee 2006) and U.S. business students in Utah (McGee and Smith 2006). Men were found to be more opposed to tax evasion in studies of Romania (McGee 2005a) and Slovakia (McGee and Tusan 2006).

The views of men and women toward the ethics of tax evasion were found to be the same in studies of Argentina (McGee and Rossi 2006), Beijing, China (McGee and Yuhua 2006), Guangzhou, China (McGee and Noronha 2006), Hong Kong (McGee and Ho 2006), Macau (McGee et al. 2006), Poland (McGee and Bernal 2006) and Ukraine (Nasadyuk and McGee 2006).

Table 1 also shows the scores by gender for the Inglehart et al (2004) study. If the male score for #1 is compared to the female score, it is seen that males are more likely to believe that tax evasion is never justified by a ratio of 89.9–85.8%. Actually, that is not much of a difference if one considers that the scale is 1–10.

The male-female difference is much less if we change the perspective a bit. Let’s add a new definition – Tax evasion is never or “almost” never justifiable – defined as a score of either 1 or 2. If we combine the scores for 1 and 2, the male score becomes 92.7% and the female score becomes 92.6%.

Some of the McGee et al. studies mentioned above found that women were more opposed to tax evasion than were males, while other studies found no statistical differences between men and women. But all of the McGee et al.

studies found that tax evasion was more acceptable than the Vietnamese in the present study did. One possible explanation for the difference is the methodology used. The McGee et al. studies distributed a survey anonymously, whereas the Inglehart et al. study (2004) gathered the information using interviewers in face-to-face encounters. It is reasonable to expect that people who are asked face-to-face will give responses that are more morally acceptable than will people who can answer anonymously.

A study by Ruegger and King (1992) found that people become more ethical as they get older. Their study divided respondents into the following four groups: 21 or less, 22–30, 31–40 and 40 plus. But Sims et al. (1996) found that older students had fewer qualms about pirating software than did younger students.

Babakus et al. (2004) also found that age made a difference, but what difference age makes sometimes depends on culture. Younger people from the UK, USA and France tend to be less ethical consumers than do older people from these countries, whereas younger Austrians tend to be more ethical consumers than their elders. Age generally did not matter for Hong Kong consumers, except in the case of stealing towels from hotels and blankets from aircraft. Younger people tended to be less tolerant of these kinds of activities than did their elder Hong Kong consumers. Brunei consumers showed mixed results. In some cases younger people were more ethical whereas in other cases older people were more ethical.

Table 2 shows responses by age. Scores for all three categories were 85% or higher for category #1, meaning that the vast majority of all age groups believed tax evasion to never be justifiable. But the scores varied somewhat by age group. As people moved from the 15–29 age category to the 30–49 age group, their belief that tax evasion is never justifiable dropped slightly, from 89.7% to 85.0%. The percent increased to 90.6% for the 50+ age group.

Table 2
Responses to Question F116—Overall and by Age
(1 = never justifiable; 10 = always justifiable)

Score	Overall %	Age 15–29 %	Age 30–49 %	Age 50+ %
1	87.8	89.7	85.0	90.6
2	4.9	3.1	7.3	2.3
3	2.7	2.2	3.9	1.3
4	1.4	1.3	1.3	1.7
5	1.5	1.8	1.5	1.3
6	0.7	0.9	0.4	1.0
7	0.2	0.0	0.2	0.3
8	0.2	0.0	0.2	0.3
9	0.2	0.0	0.2	0.3
10	0.4	0.9	0.0	0.7
Mean	1.32	1.31	1.31	1.33

If the first and second category scores are combined, the percentages for the three age groups become 92.8%, 92.3% and 92.9%, respectively.

Table 3 shows the scores by level of education. The Inglehart et al. study (2004) divided the sample into three educational categories. All three categories chose #1 by 83% or more. The category most receptive to tax evasion was the most highly educated group, whether one looks at the percentages for category #1 or the mean scores. However, all groups were clearly opposed to tax evasion.

Table 3
Responses to Question F116—Overall and by Education
(1 = never justifiable; 10 = always justifiable)

Score	Overall %	Education level Lower %	Middle %	Upper %
1	87.8	87.5	88.7	83.6
2	4.9	5.9	3.7	4.5
3	2.7	1.9	3.7	3.0
4	1.4	1.1	1.8	1.5
5	1.5	1.7	1.3	1.5
6	0.7	0.8	0.8	0.0
7	0.2	0.2	0.0	1.5
8	0.2	0.4	0.0	0.0
9	0.2	0.2	0.0	1.5
10	0.4	0.4	0.0	3.0
Mean	1.32	1.32	1.26	1.69

Table 4 shows the scores for religion. A religion was included in the present study if the sample was 50 or more. If one looks at the scores for only the first category, it is seen that ancestral worshippers are most likely to believe that tax evasion is never justifiable. Buddhists are somewhat more flexible on the ethics of tax evasion, whereas Catholics are definitely less opposed to tax evasion than are the other two groups. This relationship also holds if one compares the mean scores, although the differences are much less. If categories 1 and 2 are combined, the scores are 96.0% for ancestral worshippers, 91.5% for Buddhists and 88.7% for Roman Catholics.

Another way to look at religion is on the basis of how frequently a person attends religious services. If one looks are the percentages only for category #1, the group most opposed to tax evasion is the group that attends religious services less than once a year. In other words, one of the less religious groups also happens to be the group that is most opposed to tax evasion on moral grounds (if one assumes that religious people go to church more often than do nonreligious people).

One interesting finding is that the second highest ranking group is the group that attends services more than once a week. The group with the lowest score went to services once a week.

Table 4
Responses to Question F116—by Religion
(1 = never justifiable; 10 = always justifiable)

Score	Ancestral worshipping %	Buddhist %	Roman Catholic %
1	91.4	85.6	64.2
2	4.6	5.9	24.5
3	1.3	1.3	11.3
4	0.3	1.3	0.0
5	1.0	2.6	0.0
6	0.0	2.0	0.0
7	0.3	0.7	0.0
8	0.1	0.0	0.0
9	0.3	0.0	0.0
10	0.7	0.7	0.0
Mean	1.23	1.42	1.47

But if one wants to put things into perspective, one must look at the total range of scores and compare the range to the actual scores. None of the mean scores were over 1.50 on a scale of 1–10, which indicates that all groups were strongly opposed to tax evasion on moral grounds.

Table 5
Responses to Question F116—by Religious Service Attendance
(1 = never justifiable; 10 = always justifiable)

Score	More than once a week %	Once a week %	Once a month %	Only on special days %	Once a year %	Less often %	Never/ practically never %
1	92.3	80.0	86.7	83.8	91.4	94.3	87.7
2	0.0	8.0	4.4	9.1	0.0	1.4	4.5
3	0.0	4.0	1.1	3.5	2.9	2.1	2.9
4	7.7	4.0	3.3	0.0	2.9	0.0	1.6
5	0.0	4.0	3.3	1.0	0.0	2.1	1.2
6	0.0	0.0	1.1	1.0	0.0	0.0	0.8
7	0.0	0.0	0.0	0.5	0.0	0.0	0.2
8	0.0	0.0	0.0	0.0	0.0	0.0	0.4
9	0.0	0.0	0.0	0.0	2.9	0.0	0.2
10	0.0	0.0	0.0	1.0	0.0	0.0	0.4
Mean	1.23	1.44	1.36	1.37	1.37	1.14	1.34

Table 6 shows the scores by marital status. As was the case in all other demographic categories, the most popular response by a wide margin was category #1—never justifiable. All categories were in the 80s or low 90s. The group most opposed to tax evasion was the “living together as married” group (91.2%), followed closely by the “single/never married” group (90.5%).

When one looks at the mean scores, it is seen that the group least opposed to tax evasion was the divorced group (1.67), followed by the widowed group (1.59). But to put things in proper perspective it must be pointed out that all mean scores were substantially below 2 on a scale of 1–10.

Table 6
Responses to Question F116—by Marital Status
(1 = never justifiable; 10 = always justifiable)

Score	Married %	Living together as married %	Divorced %	Separated %	Widowed %	Single/ Never married %
1	87.2	91.2	83.3	83.3	86.5	90.5
2	5.7	0.0	0.0	16.7	0.0	2.7
3	3.2	2.9	0.0	0.0	0.0	1.4
4	1.3	0.0	0.0	0.0	2.7	2.0
5	1.3	2.9	16.7	0.0	2.7	1.4
6	0.3	0.0	0.0	0.0	8.1	1.4
7	0.1	2.9	0.0	0.0	0.0	0.0
8	0.3	0.0	0.0	0.0	0.0	0.0
9	0.3	0.0	0.0	0.0	0.0	0.0
10	0.4	0.0	0.0	0.0	0.0	0.7
Mean	1.31	1.35	1.67	1.17	1.59	1.30

Concluding Comments

One of the strongest findings of the present study is that there is very little support for tax evasion on moral grounds. This finding holds regardless of which demographic is examined. Another finding is that the scores do not differ much by gender, age, education, religion or marital status.

When the scores of the present study are compared to the scores of the various McGee studies, which had a scale of 1–7, it becomes clear that groups who were asked specific questions were friendlier toward accepting tax evasion than were the test groups in the Inglehart et al (2004) study. That difference might account for the differences in scores between the two groups of studies.

However, the studies also differed in other ways. For example, the Inglehart et al study (2004) gathered data by face-to-face interviews whereas the McGee studies were anonymous. That being the case, it is reasonable to expect that the scores in the Inglehart et al study would have been higher if they had used anonymous surveys instead of face-to-face encounters to gather the data.

The McGee surveys of China, Hong Kong, Macau and Thailand all had scores indicating that the participants considered tax evasion to be acceptable in certain situations. The percentage who replied that tax evasion is never acceptable in these studies was substantially lower than the "never acceptable" response in the Vietnam study. But it would not be accurate to conclude that the Vietnamese are substantially more opposed to tax evasion than are the participants in the Chinese, Hong Kong, Macau and Thai studies because of the different methodologies.

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