

1 From a Coercive to a Modern Tax State

The image of the state is formed in citizens' eyes by the tax inspector, the customs man, the cop. While they're on the take, people won't believe the sincerity of our anti-corruption intentions.

– Ukraine President Petro Poroshenko in his first State of the Nation Address, 4 June 2015¹

The Puzzle

Of all the activities that a state takes up, collecting taxes is, perhaps, the most critical. Without extracting revenue from society, a state cannot function and cannot do what it sets out to do. Taxation is the sine qua non of the contemporary state and the social contract. When taxpayers pay their taxes, they enter into a financial relationship with their state, a financial reconciliation, if you will, relinquishing private information about their economic activities while trusting the state to treat them and that information fairly and confidentially.

Taxation is a prime governance function, but it is also one of the only activities where the state and society are forced to interact with one another, and it is one of the few in which citizens have an obligation to give something up to the state. Tax compliance, therefore, is both about revenue extraction for the benefit of state coffers and about an opportunity for citizens to enter into a trusting relationship with their state – one that will be repeated year after year.

At the extremes, there are, perhaps, two ways in which this process can be done. In the first, those of us who file tax declarations have become familiar with the yearly ritual of gathering up receipts and filling out tax forms or filing electronically from the comfort of our own living rooms, sometimes even seeking assistance from a local tax office, replete with help desks. We may be a bit worried about being audited, but don't have too much concern. In other places, however, groups of men, dressed

¹ Bershidsky.

in black, donning eye masks and sporting automatic rifles, are known to burst into the offices of major local and international firms, banks, non-governmental organizations, human rights groups and even private homes, searching for financial data and records. Today's twenty-first century teched-up mafia? No, it's just the tax police.

The question that stands before many transitional and developing states across the globe and the puzzle at the heart of this book is whether such coercive methods are most effective in getting what the state wants. *And, if not, how does a state transition from a deterrent/coercive state to a legal/legitimate tax state?* A modern tax system is all about a modern economy, and the legacy of successful tax reform is a modern, legal and legitimate state capable of administering tax policy.

This book focuses on three states at three distinctly different stages of the transition from a coercive governing regime to such a state. Poland has transitioned successfully to a rule-of-law tax state, implementing client-oriented tax collection policies to ensure high levels of compliance. Russia employs a largely coercive tax system that enjoys moderate levels of tax compliance. Ukraine, meanwhile, has failed to build a tax state that is either effectively coercive or legitimate in the eyes of its citizens, resulting in lower levels of compliance. In essence, Poland has been more effective because it has a state that is more organized, embodied with more resources and more citizen-focused and a society that is more capable of being a compliant partner. Effective governance occurs when state and society interact through trust in a dualistic process.

The true test for countries taking up a fresh-start approach towards altering state–society relations lies in whether the state institutions, agencies and bureaucracies – the real heart and guts of the state apparatuses that sit below the elites and interact with citizens at street level – can be reformed and made less corrupt. This was critical for Poland in 1989, and it is vital for Ukraine today. Through a unique series of taxpayer surveys, this book, like no other, defines in the context of its neighbours the heart of Ukraine's governance crisis as lying in the extraordinarily long-term low levels of trust in their state on the part of Ukrainians. Reforming the tax administration now as part of a larger vision to overhaul the state's relationship with the public would help build a healthier state, capable of implementing its goals for the long run. Such reforms would be truly transformational.

Governance across Central and Eastern Europe and the Former Soviet Union

In many ways, the debate across Eastern Europe and the former Soviet Union over whether and how to transition to a legal, legitimate tax state

is part of the larger, intense debate that has erupted over the past two and a half decades regarding what tasks the state should and should not take up in economic, social and political life. Overstretching the role of the state in society ultimately led to the region's regime crises in the late 1980s and early 1990s. Yet simply shrinking the size and scope of the state's activities may not be a magic panacea, either. For if the state fails to perform well, the dual paths towards a consolidated democracy and a thriving market economy are at risk of derailment. It is clear that a state need not be as big as in Soviet times to fulfil essential tasks and to provide basic public goods. Yet, regardless of how one defines the appropriate limits of the state sector, one must question whether a state is, in fact, capable of doing what it sets out to do.

By focusing on the capacity to ensure tax compliance, this book asks why some transitional states prove more effective in administering policy than others. Specifically, why has the Polish state possessed a capacity to function in ways that the Russian and Ukrainian states have been less capable of? The truly puzzling variation in the capacity of states that once governed so extensively to ensure tax compliance demands further inquiry.

State capacity has varied widely across the post-communist region since the transitions across the two post-socialist regions began with the 1989 revolutions in the Soviet satellite states of Central and Eastern Europe (CEE) and the 1991 collapse of the Soviet Union.

In estimating the levels of governance across these regions, it is important to see how these states rank with respect to worldwide governance. The World Bank has created a statistical compilation of some 352 variables measuring perceptions of a wide range of quality of governance issues drawn from thirty-two sources and thirty different organizations.² One indicator, 'government effectiveness,' combines responses on the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures and the credibility of the government's commitment to policies.

To capture the variation in post-communist governance and the ability to implement state policy goals, Figure 1.1 presents the World Bank's government effectiveness indicators for Poland, Russia and Ukraine and the averages for the fifteen EU member states prior to the 2004 expansion eastward, for the Eastern Europe and Baltics region and for the

² The Governance Indicators are presented in Kaufmann, Kraay and Mastruzzi. The data are available at www.govindicators.org. A similar source for data is the Quality of Governance Institute's dataset at the University of Gothenburg, Sweden, available at <http://qog.pol.gu.se/data>.

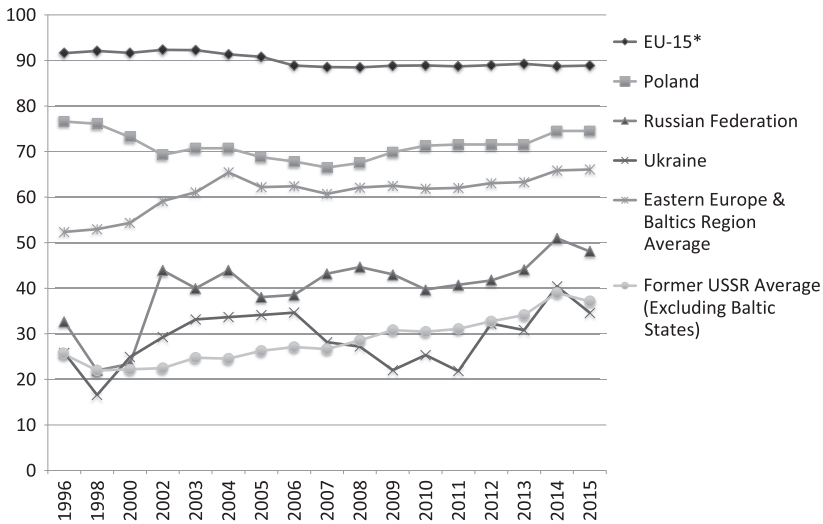


Figure 1.1 World Bank government effectiveness global rankings for Poland, Russia and Ukraine and averages for Eastern Europe and the Baltics, the former Soviet Union and the EU-15 countries, country percentile rankings (0–100), 1996–2014

former Soviet Union region. Poland ranks just above the average level of government effectiveness for the Eastern Europe and Baltics region. Meanwhile, Russia's level of effective governance ranks higher than the average of the former Soviet Union states, and is behind, since 1996, only Armenia and, since 2005, Georgia as well. At the same time, Russia has ranked lower than all the states in Eastern Europe and the Baltics in the World Bank survey, with the exception of Bosnia-Herzegovina. While it nearly always ranked lower than Russia, Ukraine did score higher than the former Soviet Union region average up until 2007, when it slipped below that average.

Other studies find similar results in terms of how Poland, Russia and Ukraine rank on governance issues. Jessica Fortin constructed a quantitative index of state capacity from the first post-communist year to 2006 based on tax capacity (measured by taxes collected as a percentage of Gross Domestic Product (GDP)), property rights enforcement, contract-intensive money (ratio of currency to bank deposits), corruption and infrastructure reform. While Chapter 4 of this book will question whether taxes collected as a percentage of GDP are the best measure for the extractive capacity of a state, Fortin does come up with a ranking quite similar to that of the World Bank – namely, one in which Poland is

in the top five post-communist countries, while Russia ranks both lower than all CEE states and higher than almost all other FSU states, with Ukraine leading the bottom third of post-communist states.³

Why Poland? Why Russia? Why Ukraine?

Selecting Poland, Russia and Ukraine as cases provides for a classic John Stuart Mill comparative design by capturing the region's variations in the capacity of the state to implement policy (here, the capacity to ensure tax compliance) and by providing for a controlled comparison in order to assess whether the culture and legacies of state–society relations or internal institutional history and design hold more causal weight.

All three states, two of which were part of the same state, the USSR, tried to govern very extensively under communism. While Russia has had the best governance in the former Soviet Union, it has had poorer levels of governance than other post-communist states and developed states. Poland, meanwhile, also has been one of the more capable states in Central and Eastern Europe and the largest post-communist state in that region, both in size and in population. Further, while it had less influence from the European Union in reforming its bureaucracies than other contemporaneous prospective entrants did, Poland did receive significant external financial and technical assistance, like Russia and Ukraine. Choosing, then, Poland, Russia and Ukraine as cases for close study allows a comparison to be made with respect to the largest country in each of the twin post-communist regions and allows a comparison to be made between the most effective post-Soviet state, an average performing post-Soviet state, and a successful former Soviet satellite state with respect to providing for good governance.

Moreover, many of the problems that have plagued Russia and Ukraine and other post-communist states have been a burden to Poland as well, posing a real puzzle to explain the variance in governance outcomes. Specifically, like those in Russia and Ukraine, the transition has not been free of poverty or corruption in Poland either. First, the transition to the market economy has meant the loss of jobs for many Poles. Unemployment in 2003, for example, was as high as about 20 per cent.⁴ Inequality, while not as great as in Russia and Ukraine, has been growing in Poland, and a mid-2000s World Bank report suggested that such growing inequality has contributed to an increase in the number of those

³ Fortin, p. 673.

⁴ Data obtained from the Economist Intelligence Unit <www.economist.com>.

below the poverty line.⁵ Second, as in Russia and Ukraine, fortunes were made in the immediate aftermath of the transition from the command economy when individuals, often with ties to state officials, took advantage of ambiguity in the law. Third, those who were a part of the communist regime in Poland, even those who worked in pre-1989 security services, were not purged from participating in current state activity.⁶ Finally, high levels of corruption did exist within the communist-era Polish and Soviet states.

Given the variation in state capacity between Poland and Russia, the Ukraine case becomes necessary. By including Ukraine – a state that is similarly unitary in structure and more analogous in geographical and population size to Poland, but one that has a history and a culture more like those of post-Soviet Russia – in the case selection, aspects that differentiate Poland's state capacity from that of the post-Soviet cases can be isolated while controlling for the size and federalist structure of Russia. The unique presence of a sociopolitical cleavage between Ukraine's provinces, some of whose histories trace back to Polish or Russian rule or both, allows a more focused study on how such differences, which are not as easily discernible in Poland or Russia, can make an impact on state–society relations.

Hence, choosing Poland as a case for comparison with Russia and Ukraine provides opportunities to elucidate obstacles to effective post-communist governance and to define what approaches can realistically work within the confines of a difficult dual transition to democracy and a market economy.

The Study of the State, Post-Socialism and Tax Collection

By its very nature, this study addresses issues raised by those who have recognized that the 'state should be brought back in' to the study of political science and the pursuit of economic development. Those studying the state, such as Atul Kohli, Joel Migdal and Theda Skocpol, have underscored the importance of states possessing the capability to implement official goals.⁷

In particular, several scholars, such as Michael Mann, Peter Evans and James Rauch, have emphasized the importance of 'Weberian bureaucracies', which possess certain personnel characteristics, office structures and an autonomous relationship to the wider society, as significant

⁵ World Bank (2005a), cited in Ash, p. 24. ⁶ Michnik; Ash, p. 24.

⁷ See, for example, Kohli and Shue; Migdal, 1987; Migdal, 1994; Migdal, 1997; Skocpol, 1979; and Skocpol, 1985.

criteria in ensuring policy outcomes.⁸ International aid organizations such as the World Bank and the US Agency for International Development also have begun to recognize that good governance and effective institutional infrastructures are required in order for countries to develop. Indeed, in a macro analysis of twenty-five transitional states for the World Bank, Nauro F. Campos has found that there is a strong correlation between the quality of bureaucracy in a particular country and its level of development, as measured by life expectancy.⁹ By comparing state bureaucracies in three countries, this project contributes to these literatures by identifying the ingredients for building a capable state.

In particular, this study contributes to the ongoing dialogue regarding the impact of neo-liberal economic reform programs on state institutions. Since the early 1990s, neo-liberal advisors to former communist states, such as Jeffrey Sachs and Anders Åslund, have focused on choosing the 'right' reform policies to construct a market economy in order to pre-empt a drawn-out process to create new institutions.¹⁰ The neo-liberal advisors to the newly democratic states believed that institutions to protect property rights in the marketplace would be created through self-interest only after a propertied class was established. On the other hand, Peter Murrell and Adam Przeworski have argued that shock therapy advocates assume erroneously that new formal structures and institutions, necessary for the implementation of any comprehensive economic reforms, can be built without the inclusion of society.¹¹ Largely because the old institutions cannot handle the new way of doing business, these shock therapy critics argued for incorporating society – on both a democratic and an economic level – so that new institutions gradually can be supported by existing informal structures.

Part of the paradox of neo-liberal reforms was that their goal was to keep the post-communist state small in order to allow market forces to arise. 'The debate between shock therapists and gradualists that centred on the issue of the pace of liberalization overlooked the crucial importance of institutions for economic growth', economist Vladimir Popov has written.¹²

State administrations and bureaucracies, indeed, are needed to regulate a market economy. The types and natures of bureaucracies that develop in post-communist settings are important to market reforms. In particular, new, complex institutions such as a central bank and commercial bank network, a finance ministry, a system of commercial law, a

⁸ See, for example, Evans, 1995; Evans and Rauch, 1999; Mann, 1986; and Mann, 1993.

⁹ Campos. ¹⁰ Åslund, 1995; and Sachs, 1994.

¹¹ Murrell; and Przeworski, 1991. ¹² Popov, 2000, p. 56.

court system and a tax collection system must be built prior to or along with the adoption of neo-liberal reforms so that the market can work. Even the main pillar of shock therapy, privatization, requires institutions to ensure that the process goes properly. Further, social welfare institutions need to be effective in easing the burden imposed on the population throughout the changeover.

Yet, despite the need for strong state institutions to foster the development of such market forces, some post-Soviet states have had a relative weakening of the institutional capacity of the state. This study seeks to add increased clarity to the larger debate over institution-building in third-wave democracies undertaking economic consolidation by providing an analysis that explains why and to what extent state institutions have been less effective in the post-Soviet cases than in Eastern Europe.

Second, this research project bridges the gap between the East European and former Soviet Union area studies literatures. In this vein, this work follows the examples of Valerie Bunce, M. Steven Fish, Philip Roeder, Joshua A. Tucker and others who have been able to make significant contributions to the study of regime collapse, democratization, nationalism and voting behaviour precisely through the study of both regions.¹³ Yet, as these scholars have examined different questions, no one, to my knowledge, has looked comparatively in a book-length work at the role of the state in the development of these two regions.

Some scholars have studied the role of the state either in Eastern Europe or in the former Soviet Union. Herbert Kitschelt, for example, has devised a theory on the new post-communist party systems in Hungary, Poland, Bulgaria and the Czech Republic that relies upon the assumption that post-communist bureaucracies vary in how they operate in each state.¹⁴ Similarly, Steven Solnick and Kathryn Stoner have shown that Russia's federalist system has created a lack of institutional mechanisms for consolidation of the central state's power in the 1990s.¹⁵ This book builds on the works of these scholars as it compares the roles of the state in Poland, Russia and Ukraine.

Tax collection is a great policy arena to investigate the role and function of the state. Taxation is such a wonderful and increasingly popular topic for study in the social sciences precisely because it lies at

¹³ See, for example, Bunce, 1999; Fish, 1995; Fish, 1999; Roeder, 1993; Roeder, 1999; and Tucker, 2006.

¹⁴ Kitschelt, Mansfeldova, Markowski and Tóka, 1999.

¹⁵ See, for example, Solnick, 1996; Solnick, 1997; Stoner-Weiss, 1997; and Stoner-Weiss, 1997.

the centre of state–society interactions, at the heart of the fiscal state and at the foundation of a successful market economy. Getting citizens to pay taxes, in particular, presents a major, if not the central, problem for states pursuing greater economic development and growth. ‘It is harder for states that fail to elicit high tax compliance to gain wide approval, because the quality of public goods in such states diminishes’, writes Marcelo Bergman. ‘Conversely, higher compliance is self-sustaining because it enables sound fiscal policies that promote improved consent.’¹⁶

‘[T]axation is not so much a weight or a burden, imposed by one discrete entity on another’, writes Yanni Kotsonis in his study on tax collection in the Russian Empire and the Soviet Union up to 1930. ‘[I]t is equally a nexus where basic categories meet and reshape each other, and a way to express and negotiate the tensions of a modern regime.’¹⁷ In the Russian Empire of the nineteenth and early twentieth centuries, Kotsonis argues that taxes always were about power, not about the purse. ‘In hindsight, it is clear that arrests, exiles, tortures, beatings, and wholesale reprisals avoided the point, if the point was the collection of taxes’, he continues. ‘Either these measures were unrelated to increasing revenue or they removed the delinquents from production and ensured that the tax would not be paid at all, or they punished the wrong people. But taxes were as much a matter of rule and spectacle. They were meant to instil in the population a fear and respect of power, and they inscribed legal distinctions in status by dividing the population into taxable and non-taxable estates.’¹⁸ Hence, the collection of taxes, for which different regimes in different points of time have developed their own systems of rule and spectacle as they mediate the path towards modernity, merits an excellent subject for rigorous study.

Within the field of post-communism, the study of tax yields a variety of differing theoretical approaches that complement each other well. By focusing on the ability of the states to collect taxes, this study will be a valuable complement to existing texts on taxes in Russia and Eastern Europe, including Andrei Schliefer and Daniel Treisman’s *Without a Map*, which focused on fiscal federalism in 1990’s Russia; Scott Gehlbach’s *Representation through Taxation*, which takes a large-*N* political economy approach to explain how and why states structure the tax base, as well as the role that collective goods provision plays in the development of certain economic sectors; Hilary Appel’s *Tax Politics in Eastern Europe*, which focuses on the international and domestic influences of tax

¹⁶ Bergman, p. 2. ¹⁷ Kotsonis, p. 5. ¹⁸ *Ibid.*, p. 51.

policy development; and Gerald M. Easter's *Capital, Coercion and Post-communist States*, which takes a broader fiscal sociology approach with a focus on elites to explain how the distinct ideal-typical tax policies and regimes emerged in Poland and Russia. Through my focus on the internal Weberian aspects of the tax administrations and on the unique application of US tax compliance theory to individual-level survey data, I take a less stationary approach than some of these authors, emphasizing agency, trust and iterative action as potential sources for transition in street-level interactions between bureaucrats and taxpayers. And my approach is much more focused on the implementation of tax policy rather than on the development and adoption of tax policy.

Some twenty-five years after the collapse of communism in Europe and Eurasia, states that once exercised tight control over their populations so that state goals and policies could more or less be implemented now find that they differ greatly among themselves in their ability to do so. For all their shortcomings, communist states were able to govern for decades – roughly from 1917 to 1991 in Russia and parts of Eurasia and from 1945 to 1989 in Central and Eastern Europe. What has happened since then has been a dazzling array of variation in these states' methods and abilities to govern today. It is now time to explore why that has been the case.

To do so, this study seeks to achieve the following:

- At the meta-level, to help discern how a state transitions from a coercive state to a legal, legitimate tax state;
- At the macro-level, to determine how the Polish, Russian and Ukrainian states implement policies to ensure tax compliance; and
- At the micro-level, to establish what exactly is going on inside these countries that affects tax collection and, more broadly, governance.

This study is the first manuscript on taxation to focus on trust, and it is the first work of social science to concentrate on how tax policy actually gets implemented on the ground in Poland, Russia and Ukraine, highlighting the nuances of the transitional Ukrainian case and explaining precisely why and how that 'borderland' country differs from the more ideal types of coercive Russia and compliance-oriented Poland. The meta-level question, of course, is the very real present-day dilemma for Ukraine.

Taxes and Trust presents the culmination of more than fifteen years of original research – including nine bespoke opinion surveys – into how states go about the business of reshaping their relationships with their citizens. Focusing on two states that represent competing models of post-communist development (Poland and Russia) and on a third state caught in between (Ukraine), the book uniquely emphasizes the building and

accumulation of *trust* as the main vehicle for transitioning from a coercive tax state to a modern, legal and legitimate one. For a state failing to gain the public's trust such, as today's Ukraine, reforming street-level bureaucracies like the tax administration would go a long way towards building a healthier state, capable of implementing its goals for the long run.