

REFLECTION ON THE DETERRENCE THEORY OF TAXATION IN THE CONTEXT OF REVENUE COLLECTION BY MUNICIPALITIES AND THE SOUTH AFRICAN REVENUE SERVICE

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ABSTRACT

This paper evaluates analyses and reflects on how the deterrence theory as revenue collection measure can be used in revenue collection. It also focuses on the applicability thereof to the South African Revenue Service and the municipal revenue collection strategies, through increasing the penalties as well as raising of the tax audit or the combination of the two. Revenue collection is critical for the survival and sustainability of government. This is the way of creating space that will enable it to provide the essential public services required by the citizens and as a result thereof reduce the dependency of the government on foreign aids. This paper is theoretical in nature and scope and bases its argument on secondary literature sources. It will evaluate and gain insights into how tax compliance can be attained in the context of how the revenue collecting authorities treat and deal with the taxpayers. This will be achieved by analysing the outcome of the force used in revenue collection versus the willingness of taxpayers to meet their tax obligations. The paper concludes that the deterrence theory is the most applicable in the municipalities and the South African Revenue Service revenue collection strategies as taxpayers and ratepayers do not pay rates and taxes willingly but coerced.

Keywords: Deterrence theory, Taxation, Revenue Collection, SARS.

1. INTRODUCTION

Taxes are important source of revenue and the revenue collection is one of the most important functions performed by the state and enables it to sustain itself (Smith, 2003:1; Fjeldstad & Moore, 2009:1; Anyaduba, Eragbhe & Kennedy, 2012:37). It is the responsibility of government at different

levels which include national, provincial and local level to collect taxes. It means that government should not only announce a tax system and wait in hope that taxpayers, through their sense of duty, will voluntarily remit what is owed to the fiscus (Frey, 2003:285; Smith, 2003:1; Slemrod, 2007:25; Croome & Olivier, 2010:1). Any country has limited economic resources available to meet societal needs; taxation is therefore the main means by which a government will be able to raise revenue to meet such public expenditures (Bird & Zolt, 2003:24). In South Africa, and in line with worldwide trends, tax legislation is often complex, intentionally designed to reduce opportunities of tax evasion, which is one of the main concern of the tax authorities, as well as promoting fairness in taxation, although that is not always achieved (Potas, 1993:1-2; Sandmo, 2004:2; World Bank, 2007:7; Coricelli, Joffily, Montmarquette & Villeval, 2007:4). It can therefore be argued that despite all these efforts of curbing tax evasion, they remain prevalent in many countries.

Municipalities are also statutory institutions that collect revenue for service provision. In terms of Section 229(1) (a) of the Constitution, Constitution of the Republic of South Africa, Act, No108 of 1996,

"the government is constituted as national, provincial and local sphere of government which are distinctive, interdependent and interrelated".

Section 151 of the Constitution, states that:

"the local government consists of municipalities..."

It is therefore clear from the constitutional framework that each structure is a creature of statutes and has legislative authority that must be complied with and adhered to. In Chapter 2 of the Local Government Municipal Systems Act (Act 32 of 2000) it is reported

that the municipality must develop its functions and exercise its powers in an economical, accountable and efficient way. It can therefore be argued that, the government cannot therefore abuse its powers as there are checks and balances to be compliant with. Municipalities, like other government institutions, also have the need for financial resources and need to collect their own revenue as envisaged in Section 4(1)(c) of Municipal Systems Act 32 of 2000. Municipalities have two sources of revenue which includes their own revenue and intergovernmental transfers. The intergovernmental transfers are in line with the constitutional provisions in Section 214 of the Constitution. This section stipulates that there should be an equitable share of the revenue that has been raised nationally among the national, provincial as well as the local sphere of government.

There are revenue collection measures and statutory remedies, procedures, systems, competence and training that are made possible by the tax legislation, which gives both South African Revenue Service (SARS) and municipalities the power to ensure maximum collection of revenue including arrear taxes (Davis, Pawana & Cappon, 1989:2; Ivanova, 2015:33). Unless revenue collection by SARS and municipalities is improved, there will always be a possibility of service delivery protests and unrest that could potentially destabilise the country as the government will not be in a position to meet the needs of the citizens. Local government is one of the spheres of government which is the constituted through municipalities which is closer to the people. The municipal residents therefore expect municipalities in their areas of jurisdiction to be provided with services as mandated by the Constitution of the Republic of South Africa (1996) and other pieces of legislation. Failure to satisfy this legislative requirement, residents may confront municipalities through service delivery protests in a verge to force their municipalities to deliver services as might have been promised through the Integrated Development Plan and other forums. It is therefore incumbent on municipalities to ensure that they deliver the services as required by the community and promised to the community if it were to retain their trust and confidence. It can therefore be inferred that, it remains the responsibility of municipal residents to ensure that they pay rates and taxes for the service provided to them so that sustainability in service provision can be maintained. As already indicated revenue collection is critical for the survival and sustainability of country in general and municipalities in particular. This paper

therefore attempts to evaluate, analyse and reflect on how the deterrence theory can contribute and ensure that taxpayers and ratepayers meet their obligation of paying taxes. To do this, the paper provides the literature review in order to locate the article to the broader theoretical framework of the deterrent theory.

2. THE DETERRENCE THEORY

The theoretical approaches of tax compliance have commonly been divided into economic deterrence theory and the wider behavioural theory (Frey & Feld, 2002:7). The behavioural theory encompassed the social and fiscal psychological theories. The use of deterrence theory model was mainly prevalent in the examination of tax evasion (Frey & Feld, 2002:7). The theory can be achieved through a number of approaches and these could be both punitive and persuasive. In the use of the punitive nature of the deterrence theory, it can take the form of increasing the probability of being detected and increasing the tax rate or alternatively through the imposition of tougher penalties. It can also take a form of providing better taxpayer education and increased advertising of incentives in instances of being compliant (Frey & Feld, 2002:7; Sandmo, 2004:7; Feld, Schmidt & Schneider, 2007:1). It has been established that the different tax systems contend with the challenge of taxpayers who are not compliant with their tax payment obligations and the use of the economic deterrent theory was the most favoured in dealing with the tax collection challenge (Hasseldine & Bebbington, 1991:299; Franzoni, 1999:52). According to International Monetary Fund (2015:16) the way of dealing with noncompliance is always akin to stressing deterrence as the way in which revenue collection can be improved. It can however be inferred that the taxpayers always do a balancing decision as they choose how much to evade in contrast to the tax potentially saved and the risk of being detected and penalised (Frey & Feld, 2002:7; Sandmo, 2004:2). It can therefore be argued that in doing this, the taxpayers' test the probability of being caught in their misdemeanours and at what cost will that be and make a determination if they could sustain such punishment, and therefore base their decision on that.

The economic deterrent theory, is regarded as one of the major theoretical areas that have an impact on tax compliance, however this theory has been impacted upon by the development of social and psychological models (Frey & Feld, 2002:7; Frey, B.S.

2003: 385; Devos, 2007:182; Slemrod, 2007:38,43). The theory encompasses deterrence by punishment, which may be a retrospective interference. It holds out a threat of whenever there is a commitment of wrong by the taxpayer and can unleash the punishment (Franzoni, 1999:60-61; Frey, B.S. 2003: 385; Guth & Sausgruber, 2004:1; Feld & Frey, 2006:2; Devos, 2007:184, 387; Feld, Schmidt & Schneider, 2007:1). The economic deterrent theory assumes that taxpayers are moral profit seeking and their actions are motivated by the calculation of costs and the opportunities that come with that. Emanating from the impact that economic deterrent theory has on taxpayers, in the management of their tax affairs, they make consideration of the probability of being caught against the cost of the offence. The taxpayer applies the economic rationale with the assumption that the taxpayer will evade taxation as long as the concomitant pay off of the tax evasion is greater in comparison with the expected cost of being caught (Hasseldine & Bebbington, 1991:302; Franzoni, 1999:56, 60-61; Guth & Sausgruber, 2004:1; Feld & Frey, 2006:2; Feld, Schmidt & Schneider, 2007:1). It is an established fact that through theoretical studies the economic deterrence has a positive impact on deterrence of tax evasion. This is based on the fact that the theory emphasises the use of threat, coercion and intrinsic material incentives. They will use interest rates, perceived probability of being caught in the case of evasion, legal consequences that can come with being caught and the severity thereof will ensure that the thought of punishment will put them into compliance (Hasseldine & Bebbington, 1991:303; Feld & Frey, 2006:9; Feld, Schmidt & Schneider, 2007:1; Pfister, 2009:5).

3. THE DETERRENCE THEORY IN THE CONTEXT OF TAXES AND REVENUE

The deterrence theory is premised on dealing with the challenges of tax compliance, in an attempt to seek an enforcement mechanism that can be complemented or substituted by the appeal to the citizen's tax morality (Ortega & Sanguinetti, 2013:1). According to Alm (2013), there is a widespread evidence that tax evasion or what is called illegal or intentional action which is aimed at reducing the responsibility to pay appropriate taxes is common place in almost all countries (Feld, Schmidt & Schneider, 2007:1). The taxpayer mind-set when engaging in tax evasion is the concept of maximizing the expected utility of the tax evasion gamble. It is based on weighting the benefits that could be attained in the event of successfully evasion when compared with the risk of

being caught and contrasted with punishment that can be imposed in that instance of being caught (Feld, Schmidt & Schneider, 2007:1-2; Alm, 2013:3). The context of tax evasion as opposed to tax avoidance is that in the case of tax avoidance is the legal means used to minimise tax payment while in the case of evasion illegal arrangement are used (Feld, Schmidt & Schneider, 2007:1; Olivier & Honiball, 2008:381). When a taxpayer engages in tax evasion, he wilfully and consciously uses illegal means to evade compliance with tax laws. This practice includes failing to report income received by the taxpayers or fabricating tax deductions or fraudulently use other illegal means to reduce or extinguish the tax liability (Feld, Schmidt & Schneider, 2007:1; Olivier & Honiball, 2008:381).

The deterrence theories generally predict compliance patterns based solely on the ability to pay approach. The government revenue and expenditures are treated separately and taxes are based on taxpayer's ability to pay. It derives from wealth as well as current income; there is no '*quid pro quo*', however it is vital to ensure that those who have the capacity to pay the taxes they do so, failing which the consequence of deterrence theory must be applied (Gaffney, 1971:423; Slemrod, 1990:343; Bird & Zolt, 2003:29; Rai, 2004:58; Chodorow, 2008:697-736; Chigbu, Eze & Ebimobowei, 2012:31; Zhou & Madhikeni, 2013:49-60; Ortega & Sanguinetti, 2013:1). Taxes paid are seen as a sacrifice by taxpayers, which raise the issues of what the sacrifice of each taxpayer should be and on how the measurement of such sacrifice should be done (Rai, 2004:100). The most popular and commonly accepted principle of equity or justice in taxation is that citizens of a country should pay taxes to the government in accordance with their ability to pay (Bird & Zolt, 2003:16; Rai, 2004:72; Chodorow, 2008:740; Batt, 2012: 71; Guj, Bacoum & Limerick, 2013:5; Hasseldine & Bebbington, 1991:301-302). It must be noted that in instances where they deliberately fail to pay the taxes, the use of deterrence theory should force them to comply. It can therefore be argued and appears reasonable and just that taxes should be levied on the basis of the taxable capacity of an individual. In using this principle, it can be stated that if the taxable capacity of one person is greater than that of the other person, that a person who earns more should be asked and expected to pay more taxes in comparison with the one who earns less. It can further be argued that if the taxes are levied on this principle as stated above, then justice can prevail and be achieved. The tax burden will then be evenly

spread based on the ability of the person to pay such taxes, even when taxpayers are not in favour thereof, they should be coerced.

South African municipalities can adopt the deterrence theory principle to enhance their tax and revenue collection capacity in addition to the punishment of interest and penalties; they also have the power to cut electricity supplies (Ortega & Sanguinetti, 2013:1; Sandmo, 2004:2). This, at least on paper could be the best way of dealing with rates and tax matters because it allows those who are indigent to benefit from those who can afford. It also has an element of cross subsidisation on taxpayers or citizens in different income levels. In the modern tax systems in many countries around the world, this basis of taxation has been accepted as the best test for measuring the ability to pay tax per person (Rai, 2004:58; Guj, Bacoum & Limerick, 2013:14).

4. THE DETERRENCE THEORY: AN ANALYSIS

Emanating from the discussion of the tax maxims as outlined, they may be interpreted in terms of the broader principles of social justice which demand that taxation should not only be equitable in the sense of impartiality but there should be elements of fairness and ensure that those who have capacity to pay they do pay. One of the very important subjects of taxation is the problem of incidence of a tax. It refers to the final money burden of a tax or final resting place of a tax. It is the desire of every government, local government included that it should secure justice in taxation. It is only when government knows who pays tax that it can evolve an equitable tax system and it can easily tap important sources of taxation and ultimately collect large amount of money without adversely affecting economic and social life of the citizens of the country (Akintoye & Tashie, 2013:223; Hasseldine & Bebbington, 1991:301-302). This paper proceeds to argue that a sound tax system should also promote equality or theoretical justice, which means that the tax burden should be proportionate to the taxpayer's ability to pay as was discussed in the theory of ability to pay (Rai, 2004:58). It is therefore on this viewpoint alluded that the other critical element of the sound tax system is the administrative feasibility, which means that tax laws must be capable of being convenient, just and effective (Akintoye & Tashie, 2013:223). Tax possesses the power that can destroy and must be exercised with care in order to avoid or minimize the damage of the proprietary right of the taxpayer in the application of deterrence approach

(Akintoye & Tashie, 2013:223; Ortega & Sanguinetti, 2013:1). It can therefore be concluded that tax collection of municipalities in South Africa must maintain the general public's trust and confidence in the sense that it must be used justly and not deceitful. The power to impose rates and taxes by government which is in nature dependant of the power to legislate and implement cannot be delegated for obvious reasons. This limitation arises from the doctrine of separation of powers among the three branches of government. Taxpayers are not relieved from the obligation of paying a tax because of the belief that it is being misappropriated by certain officials, for otherwise, collection of taxes would be hampered and this may results in the paralysation of important local government functions and service delivery. It is therefore dependent on the municipality to apply the deterrence approach.

In practice, the deterrence theory asserts that there should be identification of non-payers and collect monies owned from those most likely to pay as this can also accelerate the tax recovery and collection and increase the revenue performance through the data driven decision making (Fjeldstad & Moore, 2009:5; Fjeldstad & Heggstad, 2012:23; Ortega & Sanguinetti, 2013:1). The best practice segmentation in the tax collection function of municipalities includes an assessment of taxpayer's willingness and the use of deterrence theory on those who are reluctant to make the payment, as well as values in monetary terms of what is at risk (SARS, 2010:50; Cattarelli, 2011:64; SARS, 2011:3; SARS, 2012:4; SARS, 2014:26-29). It can therefore be argued that in the current conjecture even those who have the capacity to pay rates and taxes are not paying hence the huge outstanding municipal debts that is found in South African municipalities. This is the reason why the use of deterrence theory by both the municipalities and SARS is critical as it will force the taxpayers to comply, particularly if the punitive measures can be applied.

5. THE SOUTH AFRICAN MUNICIPALITIES ON ISSUES OF RATES AND TAXES IN THE CONTEXT OF DETERRENCE THEORY

Tariff levels imposed by municipalities are not high to warrant complaints but yet the South African municipalities can only collect fifty percent of their target revenue per annum. This means that there is a need for the municipalities to strengthen their enforcement arm of revenue collection to ensure

that those who are not paying are followed up and the outstanding rates and taxes are collected. Even if this would mean enforcing payment using the hands of law as it is the case with SARS. The use of deterrence approach therefore becomes critical within their means which include cutting of services, penalties and interest on the outstanding amount (Frey & Feld, 2002:7; Sandmo, 2004:2; Ortega & Sanguinetti, 2013:1). On the issue of collection of debtor's book or debts, it is prevalent that the poor collection of the book is an issue of having or not having clear and appropriate policy mechanisms to recover debts. The key issue is the ability to recover debts or avoid the further escalation of the level of unpaid debts. In this regard it is important to consider what the various characteristics or salient features of the various categories of debtors. In this regard various views prevail in that two main categories of debtors should be considered.

With the first category being the underprivileged sector of the South African population, which makes out the majority. This category makes up a very significant part of the debtor's book of municipalities, but falls completely out of the SARS net. The second category is the middle and affluent part of the community, as well as the business sector. This category falls squarely into the SARS and municipal nets. If the ability to recover tax is concerned, SARS only requires an execution strategy, as the various tax Acts provide ample powers of recovery and the use of deterrence theory can therefore be beneficial (Frey & Feld, 2002:7). SARS only focus on the sphere of the community with the ability to pay or assets to attach in the case that non-payment and the collection function includes an assessment of taxpayer's willingness and ability to pay the taxes, as well as values in monetary terms of what is at risk (Cattarelli, 2011:64; SARS, 2011:3; SARS, 2012:4; SARS, 2014:26-29). It can therefore be argued that the ratepayers who are also taxpayers are more prone to pay SARS debt as compared to the municipalities, which can be attributed to the strength of SARS enforcement capabilities which is not there in municipalities, because SARS uses the deterrence theory more strictly and successfully more than the municipalities.

It is evident that tax possesses the power that can destroy and should be exercised with care in order to avoid or minimize the damage of the proprietary right of the taxpayer (Akintoye & Tashie, 2013:223). It can further be argued that the use of the deterrence approach will ensure that all taxpayers and ratepayers

who have the capacity to meet their tax obligations will meet them. In the meantime, this people will enjoy the benefit of the services that the municipalities provide if the benefit theory was to be applied. Tax collection must therefore maintain the general public's trust and confidence in the government particularly in municipalities as a constituent charged with the provision of providing basic services to communities. The use of deterrence approach will therefore be instrumental in enhancing the compliance levels of both SARS and the municipalities.

6. CONCLUSION

This paper argued that the deterrence theory or approach play a pivotal role in improving tax compliance and complies with the basic principles and theories of taxation that are premised on sound tax system that promote fiscal adequacy. The sources of revenue in South African municipalities should be sufficient to meet the demands of public expenditure and financing service delivery. It also became evident from the paper that a sound tax system has the potency to also promote equality or theoretical justice in that it will force every person to be compliant even those who would have deliberately evaded tax. This means that the tax burden should be proportionate to the taxpayer's ability to pay as it is contained in other theory of tax called ability to pay theory. Even if ratepayers have the ability to pay rates and taxes and benefit from the municipal services, they are not committed to make the payments as they do not prioritise the rates and taxes. It can be concluded that the deterrence theory is an important contributor to tax compliance in the South African context in the collection of rates and taxes.

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