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Abstract

How does the street level bureaucrats' (hereafter: SLB) set of incentives influence values of equality in society? While in the literature there is controversy about the accumulating contribution of SLB to social welfare, room remains for discussion about the influence of the structural conditions which are derived from the personal set of incentives of these bureaucrats. In this article, we examine the problematic combination of a set of incentives which encourages SLB to be "intimidating" to the ordinary citizen and make use of uncertainty and asymmetry of information for the benefit of the bureaucrat. Specifically, we refer to the problematic aspects of the tax outcome to the taxpayer who introduces his position to an expert bureaucrat (i.e., the tax official) who, in turn, utilizes strategies of concealment and intimidation during the tax assessment negotiations. We claim that given risk aversion among most taxpayers, uncertainty in the process of the tax assessment increases the bureaucrats' power. As the structural conditions amplify their power, policy outcomes suit the SLBs' interests. The result is social injustice in the sense of increasing economic gaps between wealthy and less wealthy taxpayers. The issue is examined through a theoretical economic analysis of the tax assessment negotiation process. Our theoretical analysis is supported by a textual analysis of primary and secondary sources as well as interviews with tax experts and tax officials in Israel. Lastly, we make some recommendations for improving public policy in this issue.

Introduction

Most citizens who interact with public servants wish to believe that public servants would like to be beneficent with citizens and maximize their welfare on moral grounds. Indeed,

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bureaucrats' desire to execute their job properly is one of the main reasons for the success of bureaucratic mechanisms (Wilson 1989, 159). Sadly, however, in reality this is not always the case. Whyte's (1943) classical research about street corner societies informs us that local policemen do not always invest their time and energy on law enforcement. Often, in practical terms, they permit its violation. They are activated by a set of incentives, often contradictory incentives, from their senior directors, changing politicians, various superior bureaucrats and sometimes even delinquents (Kosar 2011). The set of incentives of SLB is one of the significant components of their activities. Thus, it is useful to comprehend this set of incentives when we analyze bureaucrats' actions.

In this paper we point out the problematic aspects which are derived from the combination of a set of incentives which clash with citizens' interests (and encourage SLB to be “intimidating” to the citizen) together with asymmetry of the information between the bureaucrat and the citizen. This asymmetry is interpreted as uncertainty for the citizen who interacts with the bureaucrat. Specifically, we will point at the problematic aspects citizens face regarding their tax outcome once they discuss their tax assessment with the expert bureaucrat known as the tax official. In many cases, as will be shown, the latter can and does use strategies, such as concealment and intimidation, in this process.

While discussing a case study of income tax assessment for the self-employed in Israel, we will claim that given the fact that most of the taxpayers dislike risk, the uncertainty regarding the outcome of the assessment process increases the tax officials' power. Once the balance of power is moved to their side, the outcomes suit SLB's interests. As we will demonstrate next, the result is social injustice in the sense of increasing the economic gaps between wealthy and less wealthy taxpayers.

The empirical analysis of this paper is based on a textual analysis of primary and secondary resources as well as interviews with taxpayers' lawyers and tax officials at various levels in Israel. The interviewees were sampled on the base of convenience sampling while using the snow-ball sampling method (Cohen and Arieli 2011). Due to the sensitivity of the subject and the potential implications of the interviews on the interviewees' careers and personal lives, all the interviewees remain anonymous, even in the rare cases when we were not explicitly requested to do so.

The paper is structured as follows: In the second section, we present SLB while discussing the role of the set of incentives under which they act and its influence on the discretion and strategies the SLB use. In the third section, the paper refers to tax officials as SLB and emphasizes the asymmetry of information between them and the self-employed taxpayer who interacts with them. In the fourth section, the implications of the asymmetry of this information are discussed regarding the tax assessment process. The fifth section examines a case study of income tax assessment outcome for the self-employed in Israel. Having presented our case study, in the sixth section, we discuss the influences of the asymmetry of information in the assessment process and introduce strategies of concealment and intimidation employed by the tax official. In the last section, we discuss the practical implications of this asymmetry on values of justice and equality as well as suggest various recommendations for amendment of the public policy in the subject.

Street-Level Bureaucrats: Characteristics and Motivations

SLB are "front-line" workers of public administration, they encounter challenges of the new public management and they are made up of social workers, teachers, police, doctors in government hospitals and many more (Ellis 2007; Nielson 2006; Maynard-Moody and Musheno 2003). As field workers, they presumably encounter deficiencies and distortions that the bureaucratic system has created throughout the years (Hill 2003), and work under countless pressures and constraints. The stereotypes they create are very significant regarding the interaction between them and their clients (Lipsky 1980; 1969; May and Winter 2009).

SLB have scope for discretion and decision-making in their role. Mostly their work is complex, and therefore rules, instructions and guidelines are not a satisfactory replacement for their discretion. Sometimes their job requires personal reactions which cannot be substituted by formats or "exercises" planned in advance. Their discretion is important in order to clarify a situation in a sensitive manner and weigh possible ways of action. Certain functions of their job will become difficult or impossible if their discretion is decreased. Their individual decisions and unique actions total the behavior of the bureaucratic organization where they work. Hence, it is argue, public policy is not devised top-down by senior levels, it is implemented and executed bottom-up by the SLB (Lipsky, 1980; Bovens and Zouridis, 2002). Furthermore, SLB construct as well as restrict various opportunities for citizen clients and directly influence the lives and the fate of many people (Lipsky 2010, 3-4).

The literature emphasizes that SLB' values, perceptions, social networks and the intensity in which they make decisions are the main influence on their decision-making processes (Bovens and Zouridis 2002; Isett, Morrissey and Topping 2006; Keiser 2010; Meier and O' Toole 2006). One of the defining characteristic of SLB is face-to-face interactions with their citizen clients (Hasenfeld 1992; Maynard-Moody and Musheno 2003; Prottas 1979). In addition, some have even argued that SLB are the "miners" of public policy: they dirty their hands for society, and they are sometimes even willing to risk their jobs to provide assistance to citizens they believe worthy (Maynard-Moody and Musheno 2003, 156-7).

However, room remains to discuss the set of incentives which motivate SLB in their important work. On the one hand, various works of research indeed describe social workers, firemen, nurses and other SLB as bureaucrats who act for what they believe is in the citizen's favor (Prendergast 2007, 192). On the other hand, the literature points at some other SLB' (i.e., police and immigration officers) characteristics which often lead them to conflicting interests with the wishes and the benefits of citizens. Income tax officials are SLB whose personal interest may clash with their clients' welfare (Prendergast 2007, 180).

Motivations which stem from the maximization of personal interests sometimes have an important role in bureaucrats' calculations. Hence, increasing their budget and coping with specific objectives often become the main goal of many bureaucrats because they reinforce their power and indirectly maximize the material rewards they receive. Therefore, the bureaucrat will always aspire to apply the policy in a way which will maximize his personal interests – at the expense of social welfare. The bureaucrat's expertise helps him use strategies of concealment and lack of clarity regarding the manner of application of public policy (Niskanen 1975; 1971).

Lipsky (1980, 198) points at the structured conflict which exists among SLB between the desire to satisfy the requests of citizen and the desire to comply with efficiency criteria dictated by their directors. Since SLB encounter demanding criteria while doing their duty, only rarely do they have enough resources to deal with these criteria. Hence, they develop "bureaucratic mechanisms" to evade responsibility for their failures (Thompson 1980). "Neutral" regulations may apparently yield discriminating bureaucratic behavior which will normally appear at the expense of the less wealthy citizen. Wealthy citizens are more likely to have the economic ability to decrease the gap between them and the opposing bureaucrat (for instance, by utilizing the aid of experts) whereas less wealthy citizens are less likely to do so. Therefore, in this context asymmetry of information can reinforce elements of inequality.

SLB' significant influence makes the public think that they are the key for society's welfare. However, one should remember that SLB do not determine the interference of the State (Lipsky 1980). In order to succeed, the public administration needs to find the balance between requirements of competitiveness of execution and of accountability (Behn 2001; Radin 2002). Unless the public administration promises values of responsibility to all citizens, its legitimacy will not be accepted (Behn 1999; Fry 1989). As we suggest next, by creating a normative set of incentives, the public administration can succeed in producing and developing for SLB normative coping mechanisms for the various dilemmas they encounter (Mead 2004).

Assessment of Income Tax and Asymmetry of Information

The complexity of tax laws is an integral part of the world of taxation and influences the uncertainty of tax outcome (McCaffery 1990; Paul 1997; Kaplow 1996). For our concern, uncertainty of the tax outcome is derived from the taxpayer's failure to assess the estimations that the tax official gave to his claims. Uncertainty of tax outcome may stem from legal failures, such as the use of vague expressions or a gap between literal interpretation or purposive interpretation of the law. Uncertainty of tax outcome may also stem from administrative failures, such as the refusal of the tax authority to accept the clarification of the law as ruled by the court. Judicial failures, such as contradictory tax court rulings, given the fact that court decisions are a non-representing sample of the judicial contradictions (Lederman 1999) may result in conflicting tax views. And even if the theoretical tax outcome is unequivocal, vague tax procedures may influence the final tax payment. The tax official would like to maximize tax collection, without being exposed to criticism and without letting the tax assessment become a binding precedent. Therefore, the uncertainty of the tax outcome serves the tax official's interest and the tax official may use various strategies to increase the uncertainty.

The taxpayer is constantly exposed to the burden of tax payment. However, the taxpayer is usually involved in fewer tax discussions than is the tax official. In this sense, the tax official is a "repeat player" with accumulated experience, expertise and many financial resources which allow action according to a long term aim (Galanter 1974). The taxpayer is a "one shot player" who mostly prefers to compromise and hence avoid the risk of loss. In contrast, the tax official is less focused on the results of the specific case, and he will, therefore, tend to be more indifferent to the risk of the specific tax assessment discussed (Lederman 1999). Thus, the tax official is expected to develop a strategy resulting in compromise only in cases forecasted as obvious losses. This is the tax official's way to establish a reputation of a "tough player" who negotiates persistently and maximizes long-term benefit.

The tax official may also have various constraints. Tax officials' decisions are made according to the most efficient way to utilize time and resources in order to increase tax collection in the short term. Furthermore, the tax official may deter from legal results which may exceed the specific tax assessment as well as influence tax collections in further tax assessments. Submitting the case to a court's ruling may also result in the discovery of tax assessment errors. Nevertheless, despite those limitations, the power of tax assessment negotiation is clearly in favor of the tax official.

As a bureaucratic organization, the tax authority may not expose to the taxpayer all the information it has even if such information is relevant to the tax assessment process. Furthermore, the tax officer is capable of introducing new arguments during the tax assessment process. The conclusion of the above is taxpayer uncertainty in the tax outcome. Indeed, the prospect of a less satisfied taxpayer appealing to the tax court may affect the tax official's strategy and may decrease uncertainty in the tax outcome but most surely will not revoke it. A tax expert may also be utilized by the taxpayer to decrease the efficiency of concealment and intimidation strategies, and may increase the certainty of the tax outcome. Nevertheless, a less wealthy taxpayer cannot always use this option. This situation also offends values of equality and social justice, as is discussed next.

Asymmetry of Information in the Tax Assessment Process

Whenever a rational person encounters a decision whose result is uncertain ("gamble"), the restraint from anxiety involves a risk which will reflect his readiness to convert the uncertain result to a certain alternative result. A rational person who is indifferent to risk will be ready to convert the result of the uncertain decision to an alternative certain result equal to the uncertain outcome for that particular path multiplied by the probability of that path to indeed come into effect ("the expectancy of the uncertain decision"). A person who dislikes risks will be willing to convert the result of the uncertain decision to an alternative certain result which is lower than the expectancy of the uncertain decision. The calculation of the alternative certain result (the “threat-point”) relies on the individual's degree of risk aversion that is dependent on (1) the function which reflects the benefit which stems from the object of the decision (this function depends on the individual's personality or subjective preferences), (2) a possible addition to the object if the gamble succeeds, (3) the chances for the success of the gamble and (4) the basic amount of the product that the individual already has.

This above analysis is also relevant regarding the supplement to the net fortune which is derived from the tax assessment. Let us assume that two taxpayers address the tax official. One of the taxpayers is wealthy and the other is less wealthy. The tax official requests that the two taxpayers add \$100K to the primary sum of their self-assessment (supposedly null). Let us continue to assume that before taxation, the gross fortune of the wealthy taxpayer is \$300K whereas the gross fortune of the less wealthy taxpayer is \$125K. In the case that the tax official's claim is accepted, after taxation the wealthy taxpayer will have a net sum of \$200K and the less wealthy taxpayer will have a net sum of only \$25K. Assuming the two taxpayers cannot evaluate the estimations that the tax official gave to his claim, they evaluate its probability as 60% and accordingly differentiate the probability of the acceptance of their self-assessment (according to which they will not have to pay supplementary taxes) as 40%. From the taxpayers' perspective, the tax official is at least indifferent to the risk (Lederman 1999, 320). Hence, taxpayers will realize that the scope for the compromised assessment is between \$60K - the assessment expectancy - and \$100K - the position taken by the tax official. Finally, let us assume the same convex utility function which reflects a lower marginal benefit from the remaining fortune after the payment of the tax (which reflects a concave curve of marginal benefit for both taxpayers). Thus, when X stands for the net fortune (after the payment of taxes) and Y stands for the benefit from the net fortune, we may use the next concave curve of marginal benefit, which is suitable for our needs:

$$Y = \sqrt{X}$$

We will herewith examine the tax assessment of compromise for which each taxpayer will be ready to agree in order to avoid the risk of paying a supplement of \$100K for tax in order to acquire certainty regarding the net sum after the tax assessment process.

Let Z be the amount of the net primary fortune before the assessment in thousands of dollars. The net fortune expectancy after opposition is:

$$(Z + 100) * 40\% + Z * 60\%$$

According to the chosen curve, the expectancy of the benefit to the net fortune after the assessment procedure is as follows:

$$\sqrt{(Z + 100)} * 40\% + \sqrt{Z} * 60\%$$

If a compromise is made resulting in a certain net sum of A, after the compromise the sum of the fortune will be Z + A. The certain benefit from the compromise will be:

$$\sqrt{Z + A}$$

If we compare the expectancy of the benefit in the opposition process with the certain benefit from the compromise, we will be able to differentiate the certain sum in the compromise (A) as the curve of the primary fortune:

$$16 + 0.48 * \left(\sqrt{(Z + 100)} * \sqrt{Z} - Z\right) = A$$

Now, we have to place in the formula the primary fortune in the hands of the taxpayers. The less wealthy taxpayer has a net primary fortune of $25K. Hence, his threat point is:

$$16 + 0.48 * \left(\sqrt{(25 + 100)} * \sqrt{25} - 25\right) = 30{,}833$$

Hence, given a tax demand of $100K whose probability is perceived by the taxpayer as 60% and according to the given benefit curve, the less wealthy taxpayer will be ready to compromise and pay $69.2K in order to ascertain a certain supplement to the net fortune of $30.8K.

The wealthy taxpayer has a fortune of $200K. Therefore, his threat point is:

$$16 + 0.48 * \left(\sqrt{(200 + 100)} * \sqrt{200} - 200\right) = 37{,}576$$

Relying on the same constraints and demands, the wealthy taxpayer is ready to compromise and pay "only" $62.4K in order to ascertain a certain supplement to the net fortune of $37.6K.

As the rational risk-averse taxpayers fail to assess the estimations that the tax official gave to his claims, the less wealthy taxpayer is ready to pay higher taxes to ascertain that he will have the net sum from which he will benefit. Hence, the uncertainty in the tax outcome negatively affects the less wealthy taxpayer more than the wealthy one.

Sometimes, the taxpayers may ask to reduce the uncertainty of the tax outcome by addressing a tax expert. A tax expert can better evaluate the probability of the tax official, and may also be aware of the incentives which motivate the tax official. However, it could very well be that in comparison to a less wealthy taxpayer, the wealthy taxpayer has numerous tax litigation cases in the works. Therefore, the cost of hiring a tax expert actually turns out cheaper for the latter than for the former. Furthermore, a less wealthy taxpayer may not be able to pay the tax expert's fee. And even if a less wealthy taxpayer resorts to a professional fee based on success (i.e., fees calculated according to the rate of the tax reduction from the determination of the tax official), the tax advisor may be hesitant in serving the client if the tax assessment is low or when there is a risk that the fee for professional services will not be collected. Hence, not only may the taxpayer be required to pay "external" payments to tax experts in order to acquire more certainty in the tax outcome, the disability of the less wealthy taxpayer to employ tax experts (for lack of means) may further increase the economic gap between wealthy and less wealthy taxpayers.

SLB and Income Tax Assessment for Self-Employed in Israel

Table number 1: Figures of tax collection for the funding of budget framework of Israel for 2011 and 2012 (Millions of dollars)

	2011	2012
The total budget framework, general expense	348,185	365,916
Regular intakes for funding the budget	247,116	258,804
Taxes and compulsory payments allocated from those intakes	214,989	233,826
Direct taxes allocated from those intakes	103,500	111,800
Income tax allocated from those intakes	87,400	94,700
Taxation for self-employed allocated from those intakes	9,300	9,600

Source: Budget proposal for years 2011 – 2012

In Israel, as well as in most modern countries, income tax is a significant constituent in the income of the State and the funding of its activities. Tax laws permit the deduction from the income expenses created in its production. Thus, income tax has to be paid from the profit of the cooperative or the citizen. Principally, this is a progressive tax which is supposed to decrease gaps and encourage a more equal allocation of resources. Tax collection in Israel is legally based on the ordinance of the High British Commissioner from 1941, which determined that the tax authority is responsible for tax collection. Following the government's decision in 2003, various branches - income tax, land tax, customs etc. - in the Finance Ministry were united. . The aim of this union was to allow one director to concentrate on tax collection. This director would be legally authorized to execute the relevant tax laws. The tax authority plays an important role of coping with the budget and various macro-economic objectives. In 2010, a surplus of NIS 12.3 billion in the income of the State of Israel was noted in comparison to the income target that was included in the budget of the State for 2010. The surplus was mainly noted in direct taxes of NIS 8 billion. In indirect taxes, a surplus of NIS 3.7 billion was noted. Among the employees of the tax office, there are roughly 5,300 employees, many of whom are SLB, who work in twenty-six regional district "field units" (the site of the Tax Authority 2011). There are many legal references according to which the tax authority works. In those references there are numerous laws and ordinances. This makes the orientation in the legal official authorization of this authority a complex challenge especially for those who are unfamiliar with the world of taxation.

The tax assessment process in Israel consists of three major steps: After the taxpayer has brought forward his self-assessment when submitting his income, the tax official gives him a "Step A" tax assessment. If the taxpayer chooses to oppose the "Step A" assessment, there is a discussion between the tax official and the taxpayer ("Step B"). At the end of "Step B", the tax official determines a final tax assessment which the taxpayer is entitled to appeal in court.

In order to encourage the tax officials in Israel to increase tax collection, the tax authority uses indices of "tax return per annum" and "incentive pay." The "index of "tax return per annum" examines the sum of the supplement to the tax yielded by the tax official regarding his working hours."Incentive pay" rewards the tax official based on pre-set annual objectives, such as the number and type of tax assessment files for which the tax official is responsible that annum.

In 2010, the Research and Information Centre of the Israeli parliament conducted research to examine the measurement methods and material rewards customary in income tax (Knesset, 2010). According to the findings of the research, even though the aim of "tax return per annum" index is a retroactive examination, in many cases, this index often determines the quota of the tax return goals at the beginning of the calendar year. In other words, the tax officials are expected to achieve the minimal tax return that is determined by their managers at the beginning of the year. During the year, there is an examination as to whether the tax officials met the goals that were set for them. The examination often tests a team's returns as well as a personal test and a partial evaluation of the execution of the employee's work. Furthermore, tax officials and their junior directors give this index great importance. This index is a means for a professional examination of the tax official and for his promotion (or dismissal). Moreover, the index of "incentive pay" yields a connection between the amount of files the tax official has completed and the tax official's salary. Thus, in cases when the tax official has to go through a number of files, he may cease the examination and choose only some of them in order to cope with the amount that was allotted to him. Hence, the accumulative result of the indices is that the tax official must finish going through as many files as possible and submit in them with a maximal tax supplement. This is not a normative measurement method since it creates a personal incentive for the tax official to increase the assessment in a very short time not necessarily according to practical criteria.

Indeed, interviews which we conducted with junior and senior tax officials revealed that the tax return per annum index is an important index in the evaluation of the work of employees as well as of directors. The tax authority incentivizes and rewards its employees to cope with this index. Tax officials are aware of the fact that utilizing such an index may often be at the expense of a specific offense of the taxpayers (interviews, "anonymous 3"; "anonymous 8"; "anonymous 11). However, the tax officials justify their deeds by clarifying that the significant objective of the tax authority is the collection of tax and the increase of the State's treasury. This is done with the maximal utilization of its employees' time resources (interviews, "anonymous 7"; "anonymous 11"). Some of the tax officials interviewed added that the taxpayers could be assisted by an accountant and a lawyer and that this would ameliorate the taxpayer's representation (Interviews, "anonymous 3"; "anonymous 5"; "anonymous 6"; "anonymous 13") thus saving additional tax assessment time.

Asymmetry of Intimidation and Strategies of Intimidation and Concealment

The Israeli taxpayer's right to receive information from the tax authority regarding his tax assessment relates to the "right of the public to know" which stems from the right of "freedom of speech." The aim of those rights is to permit the citizen to enjoy the liberty of changing opinions and free access to resources of information. This is valid as long as no harm is caused to vital interests of the State (High Court of Justice 243/62) The public's right to disclosure is anchored in Israel, inter alia, by the Law of Freedom of Information 1998 (Reshumot 68, 226). Furthermore, the government should act in an transparent manner ("the duty of public fairness") is anchored in more general legal principles, such as contracts and public laws, including the duty of public fairness (High Court of Justice 376/81).

In order to increase tax collection, tax officials often use various strategies which increase the uncertainty in the tax outcome and thus increase the tax collected even though these strategies clash with the right of the public to know and the duty of public fairness. These strategies are described below.

The "Take it or Leave it" Strategy

By introducing a "take it or leave it" offer, the tax official offers the taxpayer a figure that the tax official assumes the taxpayer would be willing to pay as a maximal compromise. Note that the taxpayer's financial situation is often well-known to the tax official. As mentioned before, this makes the evaluation of the maximal offer easier for the tax official. This offer is submitted to the taxpayer as "a final offer," apparently with no possibility for further discussion.

Assuming the taxpayer submitted a self-assessment with null tax to pay as a supplement, and the tax official determined the taxpayer's assessment (at "Step A" of the tax assessment) and included a supplement of $100K. Then (at "Step B" of the tax assessment), the taxpayer opposed the aforementioned determination. Presumably during the tax assessment negotiations, the tax officer submitted to the taxpayer a "take it or leave it" offer to pay a tax supplement, as a compromise of $65K (and threatened that unless the offer were accepted, he would convert the supplement to the tax which was determined before opposition with a sum of $100K as a final sum, which the taxpayer could appeal only in court). Supposedly the taxpayer believed that this was a real threat (the probability is 100%) particularly owing to the taxpayer's failure to assess the estimations that the tax official gave to this additional "threat." Assuming the above, the taxpayer might be intimidated to "compromise" and pay a $65K supplement to the tax.

If we return to the previously analyzed example regarding asymmetry of information, we should realize that the new "offer" by the tax official of $65K is actually lower than the certain maximal supplement to the tax in a compromise in which the less wealthy taxpayer was ready to pay before the threat ($69.2K). Hence, plausibly the less wealthy taxpayer would be happy to accept the new offer that was submitted to him as the final offer. Nevertheless, in the case of the wealthier taxpayer, the tax official's offer is higher than the certain maximal supplement to the tax in the compromise that this taxpayer was ready to pay ($62.4K). Therefore, the wealthy taxpayer would reject this offer of "take it or leave it." Needless to say, as the tax official knows the financial situation of the taxpayer, he may choose to offer the wealthy taxpayer a lower option than the “$65K take it or leave it" offer which he would offer to the less wealthy taxpayer.

The interviews we conducted reveal that the "take it or leave it" strategy is the most common of strategies that tax officials in Israel use (interviews, "anonymous 2"; "anonymous 4"; "anonymous 9"; "anonymous 10"). For example, in one case when a taxpayer reached an advanced stage in an assessment discussion and already appealed to a court, he decided to accept a "take it or leave it" offer in the compromise offered by the tax official. This offer was half the sum of the primary assessment that was submitted by the tax official. In this case, the tax official set the height of the offer according to the balance of the fee the taxpayer had to pay lawyers for professional services, had he continued appealing to court. The assessment was submitted to the taxpayer as a "final take it or leave it" offer. Simultaneously, the tax official urged the taxpayer to accept the offer by detailing the advantages of avoiding the need to appeal to court, especially taking the uncertainty of court ruling's outcome ("Anonymous 7").

The "Threat to Increase the Tax Assessment" Strategy

Another intimidation strategy which the tax officer can adopt in order to increase the uncertainty of tax outcome is to signal that the tax assessment could be increased. Suppose that at the stage of opposition ("Step B" of the tax assessment), the tax official continues threatening that without a compromise, the final assessment will be higher than the assessment set in Step A. Due to the taxpayer's failure to assess the estimations that the tax official gave to this additional intimidation, the taxpayer may consider the threat as serious. This will increase the sum of the assessment the taxpayer will be ready to pay in the compromise.

For example, let us assume that the tax official threatens that the final assessment would be \$120K (\$20K higher than the primary assessment in "Step A"). We should emphasize that at this stage the threat is "on the table" and is thus not interpreted by the taxpayer as a demand to pay \$120K per se. In other words, from the taxpayer's perspective, he can still negotiate, compromise and pay the assessment that was offered to him in Step A: the sum of \$100K (or less). Let us continue to assume that both taxpayers - the wealthy and the less wealthy - evaluate the practicability of the threat as a final assessment of the sum of \$120K at 25%. They also evaluate the chances of the tax official tax assessment in Step A in a sum of \$100K at 35%. Now, both taxpayers will update the assessment expectancy to \$65K:

$$120 * 25\% + 35\% * 100 = 65$$

The amplitude of the new compromise, as is yet to be evaluated by the taxpayers, will spread between \$65K (the new expectancy) and \$100K (the tax assessment from Step A). In fact, with the application of the threat, the taxpayers update the weighted position of the tax official. This position consists of the tax assessment in Step A and the possibility of a new threat of \$120K (that is on the negotiation table) for a weighted sum of \$108.3K at a chance of 60%. Both taxpayers continue evaluating the practicability of the self assessment they submitted (null tax to pay) at 40%.

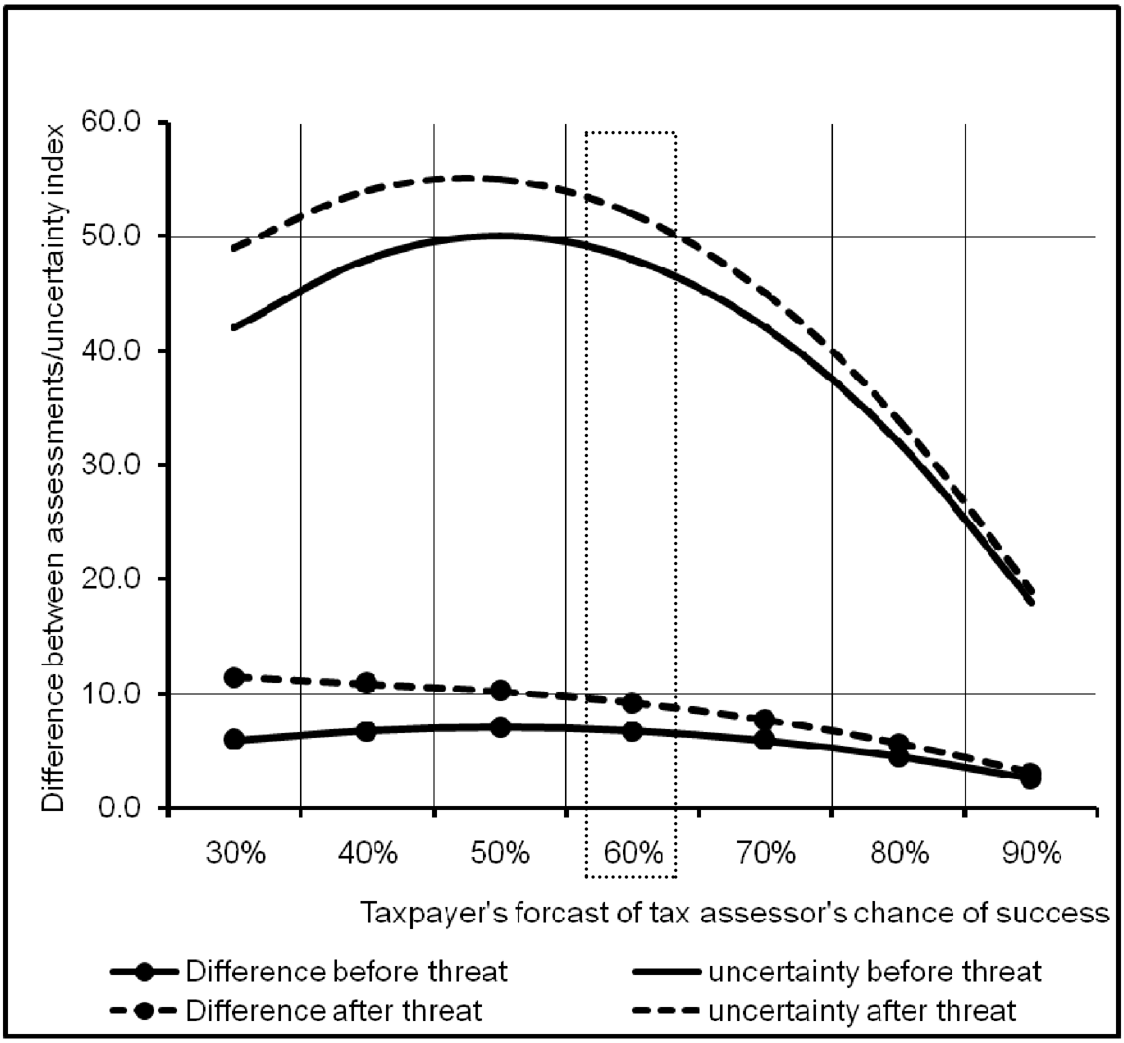
When we place the data in the formulae we previously used, we discover that in light of the additional threat of the tax official, for both taxpayers, the supplement to the tax will increase in the certain compromise. The less wealthy taxpayer will now be ready to pay \$77.1K in comparison to \$69.2K (the sum before the threat). The wealthier taxpayer, on the other hand, will now be ready to pay \$67.9K in comparison to \$62.4K (the sum before the threat).

The interviews we conducted reveal that this problematic behavior is somewhat of a common strategy among tax officials in Israel (Interviews, "anonymous 1"; "anonymous 8"; "anonymous 9"; "anonymous 10"). For example, during an assessment discussion of capital gains tax, the tax official threatened to increase the tax assessment in Step B by more than ten times the tax assessment at Step A, and without offering any practical arguments for the new threat. In this case, the taxpayer who was afraid of a continuing judicial process agreed to compromise and pay a sum five times higher than the sum of his self assessment. During the interview, when the tax official was asked why she didn't increase the sum used as a threat even more, she replied: "I had the impression that the taxpayer would compromise on the sum that is five times as high as the self assessment and a fifty-fifty compromise offer would seem fair…." An interview with tax officer's unit leader later revealed that the tax negotiation (Step B) were conducted towards tax year's end and that the tax officer and all other tax unit members were thus urged to meet that year's "tax return per annum" quota. (Interviews: "anonymous 4"; "anonymous 5").

Consequently, as the tax officer increases the uncertainty of the tax outcome, he pushes up the supplement tax the taxpayer will be willing to consent to pay. The more the taxpayers are uncertain about the tax outcome, the bigger the difference in the maximal assessment in the compromise supplement tax the wealthy taxpayer and the less wealthy taxpayer will be willing to pay.

As we demonstrate now, there is a significant correlation between the increase of uncertainty of the tax outcome which stems from the signaling of the tax official and the increase of the difference between the assessments of the wealthy taxpayer and the less wealthy taxpayer (before and after the threat). In other words, the tax official's intimidation strategy clearly increases the financial gaps between the two taxpayers, as shown in the next graph:

Graph number 1: The correlation between the increase of uncertainty in the tax outcome and the difference in the tax assessments of the wealthy taxpayer and the less-wealthy taxpayer.



This graph introduces (on the vertical axis) the differences between the assessments of both taxpayers in addition to the change of uncertainty of the tax outcome. The change of uncertainty of the tax outcome is described by the index of Average Absolute Deviation (AAD). This index marks the average value of the differences of the positions from the expectancy. The shorter the absolute average distance the closer the positions to the expectancy and the certainty of outcome increases. If the average distance increases, the uncertainty regarding the result increases. In the horizontal axis, the chart details the taxpayer's estimations of the tax official's claims. The case in discussion in which the taxpayers evaluated the chances of their position by 60% is marked on the graph.

It is apparent that the threat of raising the tax assessment to $120K increases the taxpayer's uncertainty of the tax outcome. This increase happens regardless of the taxpayer's expectations of the tax official chances of success prior to the threat. If we study the chart from right to left, we learn the following: If, prior to the threat, the taxpayer is less certain of his position, the supplement of the threat by the tax official has a lesser influence. Accordingly, there is a small difference between the assessment of the wealthy taxpayer and the assessment of the less wealthy taxpayer. Accordingly, if the taxpayer is more certain of his position, the tax official's threat increases his uncertainty. Respectively, there is an increase in the difference of the assessments of both taxpayers.

In the above example, we showed that the tax officer's threat to increase the tax assessment to the sum of $120K caused the less wealthy taxpayer to consent to the compromise in which he would pay $77.1K. This should be compared with the sum of $69.2K which, in his viewpoint, marked the compromise before the threat. Furthermore, the threat caused the wealthy taxpayer to consent to this certain compromise. In this compromise, he would pay $67.9K instead of $62.4K (the primary sum). Hence the difference between the assessments of both taxpayers increases from the sum of $6.7K before the threat to a sum of $9.2K after the threat. That is to say, the bureaucrat's threat increased the financial distance between the less wealthy citizen and the wealthy citizen (whose preferences are identical) by $2.5K.

The use of the AAD index still demonstrates the increase of uncertainty that was created due to the tax official's threat. Before the threat, the ADD index amounts to 48 points:

$$|100 - 60| * 60\% + |0 - 60| * 40\% = 48$$

After the threat to increase the tax assessment, the index increases and it amounts to 52 points:

$$|120 - 65| * 25\% + |100 - 65| * 35\% + |0 - 65| * 40\% = 52$$

Hence, tax official's threat to increase the tax assessment to $120K increased the uncertainty index from 48 to 52 points and it extended the financial distance between a wealthy taxpayer and a less wealthy taxpayer by $2.5K The threat destabilizes the taxpayers' confidence and makes less wealthy taxpayers consent to pay more than wealthy taxpayers.

The threat to increase the tax assessment facilitates the achievement of compromise. This is clear to the tax officials and they intensively use this strategy (interviews, "anonymous 8"; "anonymous 9"; "anonymous 12"). The interviews also teach that the tax officials use intimidating strategies not according to a certain plan, but according to a belief which is based on and developed through their experience in the field.

A Combination of Intimidations

A combination of the threat to increase the assessment with the threat of "take it or leave it" may intensify the effectiveness of each of these strategies had they been used separately. Presumably in the example given after the threat to increase the tax assessment to $120K, the less wealthy taxpayer and the wealthy taxpayer would be happy to accept the "take it or leave it" offer of the sum of $65K. This can be justified by the fact that the two taxpayers have a lower proposal of the supplement to the tax in the compromise. Furthermore, the tactics of concealment and intimidation (which were previously discussed) continue offending the less wealthy taxpayer. Even though the fortune of the less wealthy taxpayer is limited, he is ready to pay higher sums for the offers that are relatively worse than the wealthy taxpayer received. Thus, the tax official's threat influences the less wealthy taxpayer more than it influences the wealthy taxpayer, and the gap between the two taxpayers increases because of the threat. Hence, the equality between the two is also breached. Utilizing the aid of a tax expert is usually possible for the wealthy taxpayer. Therefore, we are convinced that the increase of the uncertainty of the tax outcome due to the tax official's activity increases the financial distance between the two taxpayers.

Conclusion and some Policy Recommendations

As we have shown, a set of incentives which encourages SLB to be intimidating to citizens, together with uncertainty and asymmetry of information, leads to social gaps and harms equality values. Concerning risk aversion among most rational taxpayers, the taxpayer's uncertainty of the tax outcome increases the tax officer's power. Once the bureaucrats manage to steer the power their way, the policy and its effects benefit their interests. As we have demonstrated, the taxpayer's financial ability influences their income tax assessment. Paradoxically, less wealthy taxpayers have to pay more than wealthy taxpayers. The difference in the risk aversion which depends on the taxpayer's primary fortune and fits in with the uncertainty of the tax outcome encourages the less wealthy taxpayer to pay a compromise of a higher tax assessment than the assessment of a wealthy taxpayer (to which his efficiency function is identical). The more the uncertainty increases, the difference of the assessments paid by the compromise increases. In other words, this is a regressive, financial, distributive result. The result is social injustice in the sense of the increase of the gap between the wealthy taxpayers and the less wealthy taxpayers.

As an increase in uncertainty of tax outcome causes an increases of tax compromise payments, the tax official uses intimidating tactics to increase the uncertainty of the tax outcome. This takes place without the tax official being exposed to criticism by his superiors. The uncertainty of the tax outcome is caused because the tax authority does not submit all the information it has to the taxpayer and because the tax official is able to introduce new arguments during the assessment procedure. Beyond its equal aspects, this is a very problematic phenomenon as it offends the trust of the public, government institutions and participatory-democratic values.

The world of taxation will probably always be complex, and assessment discussions will always be a part of human interaction. And yet, how is it possible to decrease the uncertainty of the tax outcome? In other words, what can be done in order to enable the taxpayer to better assess the estimations that the tax official gives to his claims?

Our recommendations as follows are based on our understanding that the causes for uncertainty of the tax outcome can be divided in two: (1) The taxpayer lacks information regarding the probability that the tax official's claims will be accepted in court and (2) The tax official’s ability to add arguments and threats at any stage of the assessment discussion. In essence, we base our recommendation on values of transparency, supported by regulations and external and internal inspection, as well as on the creation of a set of incentives which will cause the bureaucrat to restrict the use of strategies which encourage inequality and the offence of the values of justice. The application of administrative procedures with the focus on the necessity of submitting information from the sovereign to the citizen and the avoidance of the tax official's ability to find various claims to equal taxpayers or add claims which have not been claimed will decrease the uncertainty of the tax outcome. Thus, the assessment procedure will become clearer and fairer for the taxpayer in general and to the less wealthy taxpayer in particular.

Promotion of Procedural Legislation which Promotes Clarity: The information submitted to the public can be divided into four main categories: (1) general past tax information which relates to all taxpayers, for instance, arrangements or general reliefs the tax authority has generally given to all taxpayers; (2) the official interpretation of the tax authority of general forecast tax information; (3) specific past tax information, for example, the agreement the tax authority made with specific taxpayers who underwent a tax incident; and (4) specific forecast tax information, such as a specific tax pre-ruling for which the taxpayer can ask.

In addition it is necessary to adopt, amend and update administrative procedures which are supported by legislation regarding the responsibility to publish the official interpretation of the tax authority, the responsibility to publish all taxation decisions taken by the tax authority and even of compromise arrangements that the tax authority accepted (omitting taxpayers' details), the extension of the regional supervisors to submit preliminary decisions on taxation and relevant information.

Change of the set of Incentives along with an Organizational Change: Real steps on the organizational level of the tax authority whose purpose will be to balance between objectives of tax collection and values of justice and equality may be an important step in changing reality. In the case where a tax official takes advantage of his authority to promote his own interests and benefit at the expense of the interests of the public, it is possible to adopt supplementary and complementary procedures whose aim is to restrict the tax official's ability to increase uncertainty in tax outcome.

We do not recommend restricting the tax officials' entire scope for decision making. Decision-makers should take other steps: adopt administrative procedures which force the tax official to obey previous court rulings; make more difficult the tax official’s possibility to deviate from the formal interpretation of the tax authority; force the tax official to apply taxation decisions and similar assessment arrangements for taxpayers with identical or similar cases; limit his ability to add legal arguments to an assessment in a court order (those which were not mentioned in the previous assessment); reward tax officials who manage with these conditions. In this way, the street-level bureaucrat will have the incentive to act according to the dictated regulations. All these procedures are recommended as guidelines on the individual level but mainly by the creation of an organizational change in which all the employees of the tax authority are involved and the implementation of an organizational culture. The latter recommendations are based not only on achievement, but also on accountability.

Transparency of Available Data: It is necessary to promote an available database (for instance, on the Tax Authority's Internet site). This database would detail information regarding assessments that are in question. Furthermore, the database would detail, in brief, the calculations of the tax official in similar files. The taxpayer could enter at any time and learn what happened in cases similar to his.

This might decrease the tax official's motivation to behave differently in similar cases. Hence, organizations of civil society or even associations of the self-employed would be able to examine tax officials' management and report to the public or to the tax authority irregular management.

Inspection and Regulation: Auditing and regulation enforcement would ascertain inspection and enforcement of the law. Human reality teaches that this is an important element without which it is difficult to manage bureaucratic systems. In this context, it is necessary to distinguish between an internal and external audit for the bureaucratic agency. The existence of a function whose purpose is the promotion of transparency and the subjugation of tax officials to responsible behavior out of wide public view might restrict cases of unfairness and injustice. This function could be a part of the internal control of the tax authority. The inspection, though, could be less effective due to the socialization processes of the internal auditor. Nevertheless, the internal auditor who is familiar with the bureaucratic-organizational behavior in his organization has a latent advantage because he knows the system better than external auditors. An external employee who does not depend on the organization being audited for his working conditions has a great advantage that is based on his independence and lack of dependence. Presumably in the sense of coercion his inspection will be more effective especially if his work is anchored on a legal base.

We cannot conclude this article without mentioning Lipsky's (1980) important observation, which seems to be relevant also for our times. At the end of the day, it is not the SLB who decide on the limits of the State's intervention. Even though the tax officials' influence causes the public to believe that the SLB are the key to the public welfare, their behavior will change according to the rules of the game and the set of incentives that politicians and the senior bureaucracy dictate to them. Therefore, even in times of ambition and competitiveness, decision-makers should remember that in order to be successful, the public administration needs to find a balance between the competitive demands of performance and the upholding of the values of justice, equality and responsibility.

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A List of Interviewees for the Research

1. "Anonymous 1" – A tax inspector (a phone interview)
2. "Anonymous 2" – A tax inspector (withholding), 2011 (a face to face interview)
3. "Anonymous 3" – A deputy district tax governor, 2010 (a face to face interview)
4. "Anonymous 4" – A tax inspector, 2010 (a face to face interview)
5. "Anonymous 5" – A head of tax unit, 2010 (a face to face interview)
6. "Anonymous 6" – A head of tax unit, 2010 (a frontal interview)
7. "Anonymous 7" – A tax inspector (withholding), 2011 (a phone interview.
8. "Anonymous 8" – A deputy district tax governor, 2011 (a face to face interview)
9. "Anonymous 9" – A tax expert (Accountant), 2011 (a face to face interview)

10. "Anonymous 10" – A tax expert (Tax Lawyer), 2011 (a face to face interview).
11. "Anonymous 11" – A deputy district real estate tax governor, 2011 (a face to face interview)
12. "Anonymous 12" – A tax inspector with the special professional division (non district), 2010 (a face to face interview)
13. "Anonymous 13" – A tax inspector, 2011 (a face to face interview)