

## **Does Better Financial Literacy Lead to Better Fiscal Citizenship?**

By Karim Daher

As evidenced by recent surveys and public pools, Lebanese are disenchanted with their overall tax system and consider the obligation to pay taxes as a burden. They are decrying the many defects of their present tax system without even being familiar or acquainted with it. They do nothing to modify the situation and only watch tax revenues flow into the pocket of their politicians as they say (according to national survey results 70% of the Lebanese people believe that collected taxes are directly used by politicians to fund their political agendas). This rise in deficiency in the tax consciousness and knowledge of Lebanese outlines the need for a better financial literacy through an adapted educational and public approach. To some extent, citizens do not pay tax or avoid or deliberately fail to report income because they do not understand the tax law and principles. Evidence also suggests that citizens are more likely to evade taxes that they consider unfair. Those who cannot understand tax rules may also question the fairness of the tax system and feel that others are reaping more benefits than they are. This may make them more likely to evade taxes. However, clarifying and simplifying tax rules can only help to make people understand the tax law better but would not be likely to make it easier to enforce the law or to strengthen tax consciousness and fiscal citizenship if not accompanied concomitantly with other measures undertaken to that end by the public authorities notably with a view to disseminate information to the public, simplify the tax regulations and procedures, promote transparency and accountability in the National Budget and Accounts, change popular perceptions of taxation for more fairness and equity.

I will base the hereafter developments on three sections embodying proposals and examples that should help for the development of tax consciousness and awareness and better fiscal citizenship.

### **I- Fiscal and Financial literacy are necessary to foster tax compliance.**

The national survey conducted in 2012 by the “Institut des Finances Basil Fuleihan” shows that Lebanese citizens are fairly familiar with concepts of public finance management. They can reasonably understand the public finance’s concepts but find difficulty in defining the debt service and understanding the progressive tax. The study proves that the level of knowledge of Lebanese citizens is not at a satisfactory level, notably when it comes to women who seemed to be less informed than men.

However, the survey did not tackle the following issues:

- Are the respondents keen to learn more about fiscal and budgetary issues?
- What are the sources of their knowledge? School, university, media?
- Do they regularly keep up with media information about taxes and budget?
- Do they believe that they can or should be enabled to participate in budgetary processes?

#### **A- Fiscal Knowledge:**

Fiscal citizenship is the voluntary execution by citizens of their tax and fiscal obligations: to fill in the tax return, to submit it to the tax authorities before the due date and to spontaneously pay the tax. In other words, fiscal citizenship is a mindset and a behavior. It is a matter of tax consciousness.

With a view to influence citizens' tax consciousness in a positive manner, educational awareness initiatives should be implemented. According to an optimistic approach indeed, taxpayers are basically honest. If they do not comply with tax laws, it is because they lack sufficient information about their rights and obligations. We should acknowledge that tax laws are complex and to some extent, people do not pay taxes because they do not understand taxation. Therefore, there is a possibility to modify taxpayers' behavior by providing them with the necessary fiscal knowledge which must tackle the following issues:

- The image of the Tax and its objectives should be improved and valued. This implies that the citizens should be aware that their contribution is an honorable and rewarding act. The prominent economist Jean Monnet used to tell that his grandfather insisted on wearing his Sunday clothes while going religiously to pay his taxes. To put it in another word, there was a time when taxpayers welcomed tax day as a chance to fulfill their civic duty and to contribute to the commonweal.
- Citizens must understand therefore that paying taxes is a consequence of the social contract between the State and the citizens. It is an important part of belonging to a political and social community. It is a civic duty to contribute to the welfare and public interest, an altruistic act vis-à-vis the society that will not necessarily benefit them but someone else. This is still more necessary that human being is selfish by nature. In another word, the taxpayer should understand that the tax is a social debt laying on him and not a credit voucher that he has against the State. This is the concept of the Partner State in opposition to the welfare state.
- Citizens must learn about the several types of taxes applicable in Lebanon. They must be enabled to understand the process of raising revenues and spending public funds. Consequently, the tax authorities should simplify the tax regulations and provide practical information to the basic taxpayer in simple language with a view to helping him in correctly filling out his return and asserting his rights.
- Citizens must believe that the main reason why the government imposes taxes is to generate income to manage the economy and redistribute resources through various means (i.e. education, health, social security, retirement, culture, etc.).

#### **B- Methods to spread Fiscal Knowledge:**

With the aim of developing voluntary tax compliance and fiscal citizenship, the following measures should be implemented on the national level:

- Public information campaigns have a significant role in educating, informing citizens and affecting change. With this end in view, the concerned public administrations can (i) organize public conferences and seminars throughout the country and in every region, although underprivileged, which allow citizens to talk to tax experts and obtain at no cost practical information in simple language as well as simplified informative pamphlets adapted for each category of citizens (i.e. students, families, property-owners, farmers, craftsmen, handicapped, all type of associations, etc. ); (ii) use radio and television to broadcast tax education programs. For this purpose, journalists should have taxation skills and knowledge in order to facilitate communication of intelligible information to citizens.

- Fiscal citizenship starts in school. It is not only linked to civic education. It is also linked to mathematics (how to calculate taxes), history (the history of taxation) and geography courses (taxation is an instrument to reduce inequalities). Governments all over the world are aware that they should spare no efforts to disseminate tax knowledge in school and universities. Since 2006, for instance, the Ministry of Education in Côte d'Ivoire has included the fiscal citizenship in school curriculum. In Germany, children are taught at an early age why the government requires tax revenues and for what they are used. However, teachers and educators must be keen to use simplified language and original methods such as to include reference to real cases and data and interactive presentations.

-Insofar as cartoons and sitcoms reflect a certain amount and sample of cultural behavior and humor, they may be used as a means for changing the citizen attitude towards the fiscal awareness and consciousness especially for those who are not educated yet or enough. Cartoons will tackle variety of topics from tax history to tax-return preparation and filing requirements in addition to some of the substantive rules of the prevailing applicable taxes. Those cartoons will undoubtedly give taxes a prominence in the public consciousness.

- In order to arouse public interest in tax matters and eliminate misunderstandings as well as to be provided with active cooperation and exchange of experience and obtain a national survey at all levels, open competition and discussions should be organized in the course of the legislative enactment of sensitive fiscal laws that will create a new or increase an existing tax with a view to provide for public expenditures and investments. This project will be submitted to the review and feedback of all unions and professional organisms, as well as schools and universities, trade, industrial and manufacturers' associations, farmer's unions, NGOs and other similar organizations which represent the taxpayer's interest. The project will be debated by each of those organisms in order to obtain their input and proposals as for instance for the category of taxes (direct/indirect) that should be increased or adopted and at which level and to what extent. All individuals will be thereupon involved at all levels in the drafting of new fiscal legislation, acquiring knowledge in financial and fiscal matters and offering their opinions and ideas. They will also listen to other ideas and criticisms with a view to achieving harmonization of interests. This greater citizen participation in the budgetary process will constitute kind of active referendum and will contribute to achieve higher levels of budgetary transparency and accountability. It will also certainly benefit and increase voluntary compliance.

- Publish a fiscal and budgetary guide and a summary of the content of all budgetary documents in an easily understandable form at the national and municipality levels.

- Publish informative pamphlets for each group of taxpayers. A similar effort has been already undertaken by the Institute of Finance Basil Fuleihan in cooperation with the Ministry of Finance but should be expanded and generalized.

## **II- The State's Reciprocal Obligations as a fundamental part of the Social Contract.**

Taxation is a fundamental part of the Social Contract between the State and its citizens. A contract that helps to understand the meaning of fiscal citizenship.

According to the former Bavarian Minister of Finance Dr. Kurt Miebler<sup>1</sup>, if we are to talk about taxpayer education (and/or citizen's financial literacy), we are actually speaking of self-education. In this case, we are referring to the legislator and the administration, in other words the persons that represent the citizens, since in democratic states the laws of the people originate from the people. The State is as a result entrusted with the mission of creating a favorable climate for the development of a tax consciousness through a new educational approach and other additional measures to influence or educate the citizen's tax conscious in a positive manner. This should be undertaken by the State and should not be expected to result first from the citizen.

On the other hand, the taxpayer usually suspects that tax revenues are being squandered or used for the sole benefit of a restricted small category of privileged persons. Therefore, the relationship between State expenditures and taxation should be kept transparent through ample public information, serious internal control and eventually external auditing of the public finance to allow better accountability.

Regarding government spending, the survey revealed that 70% of the respondents think that taxes aim to finance agendas of political leaders, 60% believe that taxes aim to finance government officials' salaries and 60% believe that taxes aim to finance development projects in the country. The perception of citizens of government spending and the fairness of the system plays an important role in their compliance decision. The government should therefore undertake necessary measures in order to ensure compliance with the principles of justice and equity and promote greater transparency to enhance citizens' participation in the fiscal and budgetary processes.

### **A- Modify and modernize the current Tax System:**

The Lebanese current tax system is based on a large system of income-tax withholdings and relies mainly as well on broad-based indirect taxes such as consumption (sales) taxes and VAT, owing to the fact that they are invisible and that painless tax can ease the collection process and hence allow for the unobstructed financing of the public finance and expenditures. This system exempts the vast majority of everyday Lebanese nationals and residents from filing an income tax return. Therefore our tax system should evolve in order to serve significant social and citizenship purposes. The filing of tax returns should be generalized to the largest number of taxpayers in order to awaken enhanced notions of tax consciousness and fiscal citizenship as well as to forge civic identity.

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<sup>1</sup> Dr Kurt Miebler, "Individual Behavior and Tax Consciousness: the educational approach".

It will serve to raise the tax consciousness of the average citizen, compared with the low level of tax consciousness that would prevail under the withholding system and the prevailing indirect taxes. According to Lawrence Zelenak<sup>2</sup>: by making the filing of tax returns and connected payment of taxes salient for individuals, the return-filing process compels taxpayers to confront the extent of their total financial contributions to the government. This ought to make tax payers more cognizant of how public officials are raising revenue and spending tax dollars. There is no better way to encourage citizens to develop such understanding than to make them an obvious part of the tax-paying system. In short, the pain of paying taxes should propel taxpayers to be more politically and civically engaged and make them better citizens. Indeed, it will foster fiscal citizenship and define the economic duties and obligations that come with citizenship. Besides, in such system and even if low-income persons do not ultimately pay income tax due to the applicable exemption levels, the process of filing for their benefits and revenues may nevertheless make them more engaged citizens. In this regard it may be uphold that the fiscal citizenship confers also a right to earn a wage sufficient to support oneself and one's family at a level of basic decency.

However and despite the foregoing, one should admit that in order to meet its objectives the return-based tax system should be fair, conducive to economic prosperity, easily enforceable and relatively simple. The key to tax simplification is for the Treasury to avoid complexity and to make fewer distinctions across economic activities and taxpayers' personal characteristics. The solution will be to adopt a simple tax system comparable to the current Lebanese system adopting a broad tax base with rates that are the same across different income sources of type of expenditure. Hence, progressivity may be embodied in the rate structure with rates rising along and proportionally with income, as they are now, and scales of exemption amounts. Nevertheless and although the several encouraging arguments set forth here before, the several surveys on tax compliance suggest that tax evasion occurs more often when taxpayers are given increased opportunities to evade. Thus, and considering some of the well-known statistics on tax noncompliance by type of income and occupation, studies show that for wage earners who have their income taxes withheld by employers, the compliance rate is nearly 100%. By contrast, self-employment business income, which is not subject to information reporting and consists in filing of self-tax returns, has a compliance rate closer to 48%<sup>3</sup>. This implies that the public authority should not neglect other necessary accompanying measures to promote fiscal citizenship more effectively notably in creating the conditions that can ensure that all citizens are paying their fair shares of tax burden.

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<sup>2</sup> Lawrence Zelenak "Learning to Love Form 1040: Two Cheers for the Return-based mass income tax"; University of Chicago Press. 2013

<sup>3</sup> Joel Slemrod, "Cheating Ourselves: The Economics of Tax Evasion", J. Econ. Persp., Winter 2007.

### **B- Abide by the Principles of Justice and Equity:**

- Taxation should be adapted to citizens' paying capacity. When citizens are convinced that their contribution involves a fair amount, then they will be ready to fulfill their obligations. The progressive tax fulfills this purpose.
- Compliance with tax regulations particularly and with all regulations in general requires that all citizens abide by them equally. In other words, all citizens should be treated equally under the law. Therefore, tax amnesties should not be granted and tax optimization should be fought as they increase feelings of unfairness.
- The State should maintain an effective social contract between citizens and the Government. Against the tax burdens imposed on citizens, political leaders and governmental actors have a reciprocal obligation to ensure an equitable distribution of resources among the citizens. Taxpayers' resistance to the payment of taxes seems to lie in the fact that they do not receive a specific compensation for their contribution. They must be able indeed to notice that paying taxes improve their living conditions as tax compliance is linked to the quality of public services available to citizens. Denmark can serve as a model in this regard. Although the country has one of the highest taxation levels in the world, Danish people do not seem to complain about it. The welfare system subsidized by the State makes up for the tax pressure. It gives citizens equal access to a number of services free of charge: health care, education, child care, etc. The developed welfare state gives credibility to public officials. It is evidence that public funds are handled properly and used correctly. As a matter of fact, Denmark is the least corrupt country in the world in 2015.

### **C- Enhance Citizens' Participation in the Fiscal Policy and Budgetary Process:**

Although the survey does not inform us about the level of involvement of the respondents in the fiscal policy and budgetary process, we should point out that the participation of citizens is necessary in order for the public finance management to be in line with the requirements and expectations of the society. Citizens should be enabled therefore to participate in the decision making process which entails that:

- Citizens should have access to accurate fiscal information. With this end in view, Government should be willing to undertake all available measures towards transparency.
- The public authority bodies should carry out on their internet sites public consultations about drafts of laws and other regulations and acts and explain the reasons for them to be passed and the expected results. After such consultations, they will be compelled to publish a report about the criticisms and proposals accepted and rejected.
- Tax officials should benefit from the necessary training and knowledge in order to provide taxpayers with practical information in an understandable language, to assist and inform them about the potential risks and consequences they are likely to incur if they do not comply with their obligations. This measure can help increase the popularity of tax administration.
- Citizens should be encouraged to attain public maturity and learn to hold the government accountable to them.

- Develop an active cooperation between tax administration and the organizations representing the interests of taxpayers.
- Lebanon should adhere to good practices recommended by public finance guidelines set by the IMF (1999) since Lebanon's budget coverage is far from adhering to such practices (nearly 19% of the public spending has been outside the regular budget). Hence, when budgets exclude major expenditures items, then it's doubtful that resources are being allocated to priority programs and that legal control and public accountability are both enforced<sup>4</sup>. Expenditure control is a key element of budgetary process and accountability.

### **III- Breaking the vicious cycle:**

Tax noncompliance is a way to defy and challenge peacefully the legitimacy of the State. Declining trust in government can lead to noncompliance decision => vicious circle: tax noncompliance generates less income. Less income may reduce social welfare which leads to more inequalities and less trust in government and so on. In contrast, the wider perspective of tax compliance requires a degree of honesty, adequate tax knowledge and capacity to use this knowledge, timeliness, accuracy and adequate records in order to complete the tax returns and associated tax documentation.

Currently, the Tax authorities are inclined to consider the taxpayer as basically dishonest seeking to find legal gaps and prepared to commit tax violations. It will use all kind of means and measures to enquire, harass and pester the taxpayer for finding a clue or a sign of fraud or evasion or at least a mistake. This will create a negative and suspicious environment and the citizen will respond negatively to such environment despite the educational measures referred to here before which will become as a matter of fact useless. Such public behavior even if it may achieve on the short-term a relative success with regard to the collection of more taxes for the Treasury, will be harmful on the long term. The perception of the society towards such duty will change and the refusal and resistance to pay taxes will then be considered as an act of legitimate self-defense. The dishonest taxpayer in the public's opinion will be estimated and considered as clever while the honest taxpayer will be ranked as foolish and stupid.

This approach should be literally modified and based on the idea that the taxpayer is basically honest. This is actually the philosophy that applies for the returned-based tax regime adopted in Lebanon which makes the income tax a declared tax (*impôt déclaratif*) with a presumption of regularity. The taxpayer will then consider that the quasi-voluntary nature of the return-based tax system is "an expression of the government's trust in him". He may respond positively by acting in a manner worthy of that trust and be more willing to pay taxes and have greater faith and confidence in the public sector. Thus, this different new approach of the public authority and connected change of behavior with the taxpayer, providing him with the necessary information, education and good treatment will undoubtedly influence the citizen attitude.

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<sup>4</sup> Savatore Shiavo-Campo: "Lebanon: Reforming Government Budget Preparation". IMF-METAC publication 2009.

There will be a community spirit and collaboration and the citizens will recognize the need to contribute to common welfare by paying their taxes. Although and to remain realistic we should never expect the taxpayer to come to the tax office discharging his duty smiling and happily. This is rather to dream of utopia.

Finally, it must be stressed that without an adequate helping environment, no measures will make sense. To the contrary they may prove to be counterproductive.

By way of proof, a country like Croatia, which financial situation was a bit similar to ours with an annual fiscal deficit in excess of 5% of the GDP (incapacity to finance public spending with public revenues) a large increasing public debt (80% of the GDP) as well as slow economic growth and high unemployment, has undertaken in the last decade a number of measures to step up transparency and citizen participation in fiscal and budgetary processes. Although many measures, acts and regulations have been adopted, the results are far from being at a satisfactory level. Among the many obstacles and reasons for such failure, the most prominent are: the lack of interest and low level of informedness of citizens; the insufficient political will of those in power; the inadequate organizational skills and expertise of the public administration; the low level of education of the Croatian population (only 16% have had a tertiary level of education)<sup>5</sup>.

In consequence, and in order to increase the chances of success of such policies and achieve an optimal equilibrium between citizens' wishes and the capacity of governments to conduct fiscal and budgetary policies that are as effective as possible, the various interested parties (government, OECD, IMF, World Bank, and local decision makers) have to do everything needful to enhance and generalize financial education as a prerequisite or at least to ensure that it starts working more effectively. The preliminary step should consist in the allotment of a joint budget and a close coordination between the Ministries of Finance, Education and Social Affairs in order to implement a structured plan and accomplish a Mission aiming to reach reasonable targets in the forthcoming years under the umbrella of a Tax reform notably in the National Budget. This may imply, for the proper execution of the foregoing, the use of earmarked taxes to prioritize programs such as in the case of education. This may lead to increase the taxpayer's knowledge of how taxes are channeled, which in turn could increase taxpayers vigilance over the efficiency of the service provided.

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<sup>5</sup> Katarina OTT & Mihaela BRONIC- Citizen Participation in Fiscal Policy and Budgetary Process in Croatia- Institute of Public Finance- Newsletter- No 96/May 2015/ISSN 1333-4417