

On the Institutions of Taxation, Accounting, and the Law

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Document date: October 09, 2000

Released online: October 09, 2000

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Often I am lucky enough to visit with or receive visitors from Treasury departments and Finance ministries from around the world. What I always find fascinatingly revealing in discussions with these administrators is just how important the tax function is to the maintenance and building of both a strong free market economy and a viable democracy.

Also important—both in their own right and as part of the tax function—are the accounting and legal pillars that provide so much support to a viable market-based economy and its tax structure. What strikes me, and sometimes disturbs me, during these meetings is just how much the tax, accounting, and legal institutions are taken for granted in countries like the United States.

Did I say that taxation is crucial to democracy? That accountants and lawyers are adding to rather than subtracting from the output of an economy? Yes, you heard me right! In fact, I would go so far as to argue that it is in developing—or failing to develop—tax, accounting, and legal institutions that a significant part of the economic and democratic fate of Russia, China, and much of the rest of the second and third world rests. The corollary is that a well-developed democracy tempts its own fate when it takes those institutions totally for granted and fails occasionally to renew and revitalize them.

Much of this has long been recognized. Certainly the rule of law is crucial not only to maintain some standards of fairness in a society but to channel the inevitable forces of division, giving individuals a nonviolent means of reconciling and even "fighting over" differences. The enforcement of contracts is also recognized as vital if individuals and businesses are to engage in mutually rewarding and income-generating exchanges of goods, services, and assets.

What is more subtle is that for the rule of law—both by citizens and lawyers alike—that sets boundaries around behavior and allows tax systems to work. I have long been convinced that while most people might be willing to step outside of legal boundaries some of the time, in successful market-based systems those same people will usually set limits on their own behavior. Few so oppose the tax system in a successful democracy that they feel justified in cheating in any way as long as they can get away with it. As a piece of anecdotal evidence, go to a meeting of the American Bar Association Tax Section and listen to the lawyers openly question the behavior of their peers when they believe some in their profession have gone too far. Those protestors are not simply engaging in self-serving jealousy regarding others making money. They are also expressing a respect for the law—a respect that arises out of their basic human character and that hopefully was reinforced by sound professional training in law schools.

The accounting function is usually given less recognition for its role in maintaining a strong market-based system, but if one wants a reminder of its importance, just visit a country trying to change from communism. In market economies, prices set signals; measures of wages, profits, and income then become ways that people and businesses decide how to allocate their resources and time. In communist countries, the attempt to override markets with bureaucratically based decision making eventually broke down of its own weight.

Try to imagine hundreds of people bargaining in each factory over what will be produced, what each worker will be given in housing and food, who will supply intermediate goods and services, and who will buy the products of the firm. Then multiply that effort by thousands of business establishments often owned by the government itself. It's not hard to see how bureaucratic red tape and inertia, the inability to judge what to produce and by whom, and corruption became widespread. Those detrimental features are what made leaders like Mikhail Gorbachev realize that communist systems could not be disentangled simply by some new set of bureaucratic rules and tougher penalties on those who were stupid or corrupt.

Unfortunately, the conversion process has been a very painful one in many of these countries—in part

because they tried to convert without enough initial attention to the institutions required in a democracy and a market-based system. Much of the quick and easy academic advice at first given these countries about conversion similarly paid too little attention to the types of institutions being built there.

Accounting systems were required, especially in larger businesses, to start making allocational decisions both within the business itself and between it and those with whom it would contract. But that became extraordinarily difficult in these converting economies because of the few adequately trained accountants in the population. This tended to make it difficult to understand, much less rely on, the natural market determination of the value of goods and services, and of labor and capital, through market prices.

At the same time, the old tax systems were simply one more part of the huge bargaining process within the firms—extracting money one way or the other from wherever it could be obtained. Market-based economies, on the other hand, depend on reliable accounting systems to measure value-added, income, sales, or whatever tax base is being used. On sudden conversion, old firms quickly began to lose money even though being heavily subsidized. They didn't know where their taxes would come from. And if they paid taxes at all on sales, wages, profits, or value-added, the amount paid was often less than the subsidies received.

While the opening of economies allowed many other businesses to start up, new firms usually start small. It is almost impossible in any country, from the richest to the poorest, to enforce the tax laws effectively on small firms and self-employed individuals. Tax collections eroded faster than government spending, and large deficits, money creation, and fiscal disaster were common.

Poorer countries without strong traditions of accounting and law have almost never been able to collect as large a percentage of total income in taxes as occurs in more developed countries. Thus, we have the interesting phenomenon that the richer countries typically collect a larger percentage of total economic income in taxes than do poorer countries with their much greater social needs. That is not to argue that the rich countries should necessarily tax more, simply that it is easier and less disruptive for them to do so.

While developing countries and countries converting to market-based systems seek to develop the necessary accounting, law, and tax institutions, it behooves the developed countries to nurture their own institutions. Law schools and accounting schools must not only teach students pragmatic ways to make money as lawyers and accountants, they must continually re-examine and reinforce professional standards that call their members to a high ethical order.

And the crafting of tax laws themselves requires diligence. Needless tax complexity promotes chaos and confusion and gives the taxpayer a ready excuse for inattention to detail merging toward outright noncompliance. Good fortune in having institutions that work should never lead a country to take them for granted.

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