

Handbook of Research on Public Finance in Europe and the MENA Region

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A volume in the Advances in Public Policy and
Administration (APPA) Book Series



An Imprint of IGI Global

Published in the United States of America by
Business Science Reference (an imprint of IGI Global)
701 E. Chocolate Avenue
Hershey PA, USA 17033
Tel: 717-533-8845
Fax: 717-533-8661
E-mail: cust@igi-global.com
Web site: <http://www.igi-global.com>

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Library of Congress Cataloging-in-Publication Data

Names: Erdogdu, M. Mustafa, 1962- editor. | Christiansen, Bryan, 1960- editor.

Title: Handbook of research on public finance in Europe and the MENA region /

M. Mustafa Erdogdu and Bryan Christiansen, editors.

Description: Hershey, PA : Business Science Reference, [2016] | Includes bibliographical references and index.

Identifiers: LCCN 2015051226 | ISBN 9781522500537 (hardcover) | ISBN 9781522500544 (ebook)

Subjects: LCSH: Finance, Public--Europe. | Finance, Public--Middle East. |

Finance, Public--Africa, North. | Fiscal policy--Europe. | Fiscal

policy--Middle East. | Fiscal policy--Africa, North.

Classification: LCC HJ1000 .H359 2016 | DDC 336.4--dc23 LC record available at <http://lcn.loc.gov/2015051226>

This book is published in the IGI Global book series Advances in Public Policy and Administration (APPA) (ISSN: Pending; eISSN: Pending)

British Cataloguing in Publication Data

A Cataloguing in Publication record for this book is available from the British Library.

All work contributed to this book is new, previously-unpublished material. The views expressed in this book are those of the authors, but not necessarily of the publisher.

For electronic access to this publication, please contact: eresources@igi-global.com.

Chapter 13

Political Economy of Tax Evasion and Tax Loss in the Real Estate Sector: A Property Tax Reform Proposal for Turkey

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ABSTRACT

This chapter engages with political economy of tax evasion and tax compliance issues, particularly focusing on deficiencies and problems within property taxation system in Turkey. The chapter questions if there are any political preferences, legal arrangements or cultural issues facilitating tax evasion and tax loss in Turkey. It first identifies the degenerating effects of frequent application of tax amnesties, having a lax tax reconciliation institution, and less than logical way tax information confidentiality principle is applied in Turkey. Then, the chapter investigates peculiarities and specific difficulties of real estate sector in general in relation to taxation. Finally, a comprehensive property tax reform based on a semi-public valuation system is proposed to reduce tax loss in this sector.

INTRODUCTION

The most important weakness of the Turkish tax system is related to the large amount of unregistered economic activities and the high percentage of tax fraud among the registered tax payers. What follows is that tax revenue remains low with high economic and social costs. As will be elaborated later, tax constitutes a form of political interaction and it is important to understand how key actors can use the institutions and regulations in their own favor and how they be able to exert pressure over policy design and implementation.

DOI: 10.4018/978-1-5225-0053-7.ch013

Political Economy of Tax Evasion and Tax Loss in the Real Estate Sector

Real estate sector, which is the focus of this chapter, is significantly different from other sectors in terms of the reasons why tax loss and evasion occur. First of all, why unregistered economic activities exist in this sector is not because it is difficult to get hold the tax subject since they have physical bodies that cannot be hidden or transferred to somewhere else. Thus, *the informality in this sector has come out as acquiescence of the current condition by the governments due to the political reasons.*

Probably because of the cultural legacy of the Ottoman Empire, the Turkish tax authorities have always exhibited a mild attitude towards real estate taxation in Turkey. As a result, real estate taxes have occupied almost a negligible share within the public revenue. Income generated from the real estate is taxed mainly in three ways in the Turkish tax system: 1) Taxing the rental income of immovable properties; 2) Taxing the real estate itself; and 3) Taxing the appreciation gains resulted in a transaction. According to Ministry of Finance (2015) figures, the revenue from property taxes was less than 1 percent of Gross Domestic Product (GDP) and only around 3.5% of total tax revenues in Turkey. This is much lower than the average in the OECD where property taxes amount to 2% of GDP and to around 5.5% of total tax revenues.

The chapter is structured as follows. The next section reviews political economy of taxation. It first provides a brief overview of the literature on tax evasion and tax compliance to reveal the motives behind tax noncompliance and then it engages with the political economy of tax related issues, such as power balance, voters' and politicians' perspectives. This section also questions if there are any political preferences and legal arrangements that facilitate tax evasion and tax loss in the real estate sector in Turkey. In answering this question, the section discusses the harmful effects of many tax amnesties enacted, having a lax tax reconciliation institution, and the exaggerated way tax information confidentiality principle is applied in Turkey. The third section investigates peculiarities and specific difficulties of the real estate sector in relation to taxation. The fourth section looks for possible solutions to tax evasion and tax loss problems in the real estate sector in Turkey and proposes a property tax reform based on a semi-public valuation system. The last section provides concluding remarks.

BACKGROUND: POLITICAL ECONOMY OF TAXATION

A Brief Literature Review: Tax Evasion and Tax Compliance

A deliberate omission of a statutory requirement to reduce or eliminate a tax liability is called *tax evasion*. Tax evasion is a pervasive and widespread phenomenon that entails important economic and social consequences. For instance, there can be massive revenue losses¹ with a reduction in spending on health, education, social security, infrastructure, and other needed public programs. Tax evasion also “creates major misallocations in resource use, alters the distribution of income in arbitrary, unpredictable, and unfair ways, and it may contribute to feelings of unjust treatment and disrespect for the law” (Alm, Bloomquist, & McKee, 2015, pp. 1170-1171). In short, “tax evasion represents a violation of fundamental social values leading to deleterious economic and political consequences” (Sossin, 1992b, p. 127). Increasing revenue through a reduction in tax evasion might ease the burden on economic agents who pay taxes and promote growth and equity by enhancing both allocative efficiency and incentives to invest and produce (Wadhawan & Gray, 1998).

Citizens' *tax compliance* is of utmost importance for a state to provide public goods and redistribute wealth. Tax compliance can be defined as the degree to which taxpayers comply with the tax law (James & Alley, 2002, p. 28). Most of the literature on tax compliance has relied on the seminal paper by Allingham & Sandmo (1972), which suggests that tax evasion is negatively associated with the probability of detection and the severity of punishment. Citizens are suspected of being reluctant to pay their share, under the assumption that, rather than voluntarily contributing to public goods, they are motivated to maximize their own benefit (Kirchler, Kogler, & Muehlbacher, 2014, p. 87). Tax evasion is supposed to decrease whenever the expected penalty increases. Even though this model, along with Yitzhaki (1974), has been the workhorse behind most academic research and its results have guided public policies, some of its implications do not square well with the real world evidence. A main point connected to the empirical and experimental findings is that these deterrence models predict far too little compliance and far too much tax evasion (for an overview, see Alm, 2012; Castro & Scartascini, 2013).

The contrast between the evidence and theory has provoked many to develop new theories. To explain the puzzle, two main strands of literature have developed by grounding the research in behavioral economics. One strand modifies the axioms of expected utility theory by adding risk and uncertainty to the models. The other incorporates additional costs of evading to the expected utility function by assuming that the decision-making process of the individual taxpayer is also affected by social interactions. Combining these two strands yields predictions more in line with the empirical evidence (Hashimzade, Myles, & Tran-Nam, 2012). There have been important contributions made in the last decade about tax compliance. For example, Feld and Frey (2007, p. 102) developed the concept of a *psychological tax contract* that goes beyond the traditional deterrence model and explained tax morale as a complicated interaction between taxpayers and the government.

Some recent work² conducted particularly with the involvement of psychologist Erick Kirchler revealed that normative factors play much more important roles than generally assumed for tax compliance. For instance, Hofmann, Hoelzl, & Kirchler (2008) show that "taxpayers' willingness to cooperate is not only influenced by audits and fines, but also by a number of internal variables" (p. 213). Çevik (2012) identifies internal variables as: interpersonal relations, social norms, social categories, culture and state-society-individual relations, social and psychological factors. Nerre (2008) defines national tax culture as "the entirety of all interacting formal and informal institutions connected with the national tax system and its practical execution, which are historically embedded within the country's culture, including the dependencies and ties caused by their ongoing interaction" (pp. 163-164).

As Traxler and Winter (2012) emphasizes, "people are governed by social norms: legal and social sanctions together contribute to compliance" (p. 395). There is empirical evidence supports the claim that the possibility of committing a fraud decreases when there is established social norms (Sour, 2003, p. 57). According to Bobek, Hageman, and Kelliher (2013), "[p]ersonal norms play a much stronger role than any other type of social norm" (p. 465). Traxler and Winter (2012) indicate that the strength of norm enforcing sanctions depends on the expected level of norm compliance. The more frequently deviations from a social norm are believed to occur, the less likely a norm violation is sanctioned (p. 395). Efficiency of tax administration was found to have a significant and positive moderating effect on the relationship between social norms and tax compliance (Çevik & Yeniçeri, 2013). A more legitimate and responsive state appears to be an essential precondition for a more adequate level of tax effort in developing countries (Bird, Martinez-Vazquez, & Torgler, 2004, p. 38).

Political Economy of Tax Evasion and Tax Loss in the Real Estate Sector

We suggest that fairness perception of taxpayers is probably the most important determinant of tax compliance (see also James, 2014 in this respect). As social psychologists Tankard and Paluck (2015) indicate, “individuals’ perceptions of norms guide their personal behavior” (p. 2). What follows is that, “perception can automatically influence behavior” (Ferguson & Bargh, 2004, p. 33). The two most important conditions that build up taxpayers’ perception can be claimed as follows: 1) Fairness perception of the tax system by the citizens; and 2) The quality of public administration and public services. Fairness is a subjective issue and changes from one individual to another. Sheffrin (1993, p. 301) points out that public opinion about fairness of the tax system is fraught with difficulties. This is mainly because of the fact that public opinion is likely to be ill-formed and the effects of taxation are not well understood by the public. As Kirchler et al. (2012) suggest, fairness needs to be achieved on the distributive, procedural, and retributive levels. The trend in tax behavior research indicates a move from understanding taxpayers as selfish individuals trying to maximize their own gain to individuals with a sense of community who are ready to cooperate if all actors in the social system contribute to a climate of mutual trust. Batrancea et al. (2016) identify that fairness concerns arise in taxpayers’ evaluations of overall tax systems and what is expected is the more fair tax systems are perceived, the more compliant citizens will be.

It should be clear that the quality of the public administration is crucial for ensuring high-quality public services and thus societal well-being. As Erdoğan (2015) points out, “it is naïve to expect correct state action without administrative capacity. The existence of an extensive, internally coherent bureaucratic machinery is the first prerequisite for effective state action” (p. 22). Barone and Mocetti (2009) find that the attitude towards paying taxes is more positive when resources are spent more efficiently. They indicate that in the taxpayer’s cost-benefit calculation public spending inefficiency is equivalent to a waste of resources and implies a less favorable ratio between the supply of public goods and the taxes used to finance them. Findings of a recent empirical study provides another support for this position. According to McGee and Benk (2016, chapter 14 in this handbook), “[t]he more confidence in government one had, the more opposed one was to tax evasion.”

The trend in tax behavior research indicates a move from understanding taxpayers as selfish individuals trying to maximize their own gain to individuals with a sense of community who are ready to cooperate if all actors in the social system contribute to a climate of mutual trust. Batrancea *et al.* (2016) identify that fairness concerns arise in taxpayers’ evaluations of overall tax systems and what is expected is the more fair tax systems are perceived, the more compliant citizens will be.

Political Economy of Evasion and Compliance

Taxation is one of the primary powers of any government over the citizens and corporate entities. Taxes are important as they finance various much needed public expenditures. As Shah (2013) succinctly puts it, “[w]e might not like the idea of paying taxes, but without it, democracies will struggle to function, and will be unable to provide public services.” It is not controversial that tax is a social duty. Nevertheless, due to its nature, tax is a burden on taxpayers at least at the time of its collection.

Sossin (1992a) suggest that “[p]aying taxes is, like avoiding or evading them, a form of political interaction” (p. 179). Political opportunism, organized interests, and voters’ demands play important roles in tax policymaking. Alt, Preston, and Sibietta (2009) identify that political economy research suggests three main conflicts of interest that tax policy resolves through institutional processes. “The first is a *class-interest view of politics*: citizens have different views about taxation based on their position in the income distribution. In a world in which citizens have different views about how taxes should be

levied, political systems affect whose interests are represented and how. The second is between *organized and unorganized interests*: organized interests typically have advantages in securing favorable policy outcomes in return for electoral contributions that can be used to persuade voters. ... The third conflict is that between *citizens and government*. Making economic activity taxable allows decision makers in governments to appropriate resources for their own objectives and to use them in ways that citizens may not like” (pp. 1208-1209).

O’Connor (1973) suggests that “[e]very important change in the balance of class and political forces is registered in the tax structure ... Ruling classes normally attempt either to conceal or to justify or to rationalize tax exploitation ideologically” (pp. 202-203). Agenda setting and framing of policy choices may give politicians a central role in coordinating special interests (Ilzetkiy, 2014, p. 32). Tax policy is a popular vehicle for targeting special interests in practice. One way to do this is favorably taxing influential groups. Groups that are bound to profit from preferential regimes naturally form a lobby to influence the design and implementation of such regimes, and to guarantee their permanence (Daude, Gutiérrez, & Melguizo, 2014, p. 10). Another way is to apply tax remission, which is particularly used in developing countries, as a way of vote rising for politicians. Governments tend to see financial remissions as political means of establishing social dialogue between them and their voters. It is brought into agenda just before elections or prior to important political decisions to gain supports (Yaraşır, 2013, p. 179). Interestingly, such political moves find also considerable support from opponent party members as well, since they would not like to be seen in the eyes of their voters as the ones who stop a favor (Savaşan, 2006, p. 57).

Key actors and elites is likely to use the institutions and regulations in their own favor. As Daude, Gutiérrez, and Melguizo (2014) clarify, “key characteristic of the elites is the ability of not only working around the institutional framework, but also working within the institutional framework to assure the ‘right’ decisions are taken” (p. 11). Groups that are bound to profit from preferential regimes naturally form a lobby to influence the design and implementation of such regimes, and to guarantee their permanence. Influence of certain groups enables them, through legal means, to customize the tax system, shifting the burden to others.

Brunori (2003) highlights the important point that political leaders “prefer to meet constituent service demands without incurring the risk of placing the burden of paying for those services on those constituents” (p. 38). One of the best examples for this can be observed the way in which property taxes applied all over the world. Bahl, Martinez-Vazquez, and Youngman (2010) highlight that the low rate of property tax collections are an issue in many OECD countries (see Table 1), and the property tax remains a weak revenue source in developing countries. This is because political pressure keeps property taxes down. Moreover, as Brown and Hepworth (2002) indicates, “[m]any countries have no provision for regular revaluations of the tax base or have postponed revaluations. In Austria, for example, the assessed value is only between 10 and 20 percent of the market value” (p. 40). Obviously, there is a successful political resistance to follow good assessment practices. This happens because “politics generally outweighs economics in this very visible tax and the losers from tax reform tend to be more vocal than the winners” (Slack, 2010, p. 13).

Compared to taxation an easy and politically almost costless source of revenue is borrowing. The reason is that borrowing does not create a pressure in the short term on the taxpayers, who are generally also the electors. Therefore, it is not surprising to see that politicians, who aim to come into power again in the following election, prefer borrowing rather than imposing a tax rise. As Buchanan (1987, p. 1045) explains the heart of the matter, future taxpayers shoulder the burden when government borrows to finance current spending.

Political Economy of Tax Evasion and Tax Loss in the Real Estate Sector

Table 1. Estimates of tax revenues in OECD countries as % of GDP, 2013

	Total tax revenue	Income & profits	Social security	Payroll	Property	Goods & services	Other	EU Custom Duties
Austria (1)	42,5	12,5	14,6	2,9	0,7	11,5	0,2	0,1
Belgium	44,6	15,8	14,2	0,0	3,5	10,8	0,0	0,3
Canada	30,6	14,4	4,9	0,6	3,2	7,4	0,0	..
Chile	20,2	7,2	1,4	0,0	0,8	10,7	-0,0	..
Czech Republic	34,1	7,0	14,8	0,0	0,5	11,7	0,0	0,1
Denmark (1)	48,6	30,7	0,8	0,3	1,8	14,8	0,0	0,2
Estonia	31,8	7,2	11,1	0,0	0,3	13,0	0,0	0,2
Finland	44,0	15,3	12,7	0,0	1,3	14,6	0,0	0,1
France (1)	45,0	10,9	16,8	1,6	3,8	10,8	1,1	0,1
Germany (2)	36,7	11,4	14,0	0,0	0,9	10,2	0,0	0,2
Greece (1)	33,5	7,7	10,6	0,0	2,2	12,9	0,0	0,1
Hungary (3)	38,9	6,4	12,9	1,0	1,3	17,0	0,2	0,1
Iceland	35,5	16,4	3,6	0,4	2,5	12,1	0,5	..
Ireland	28,3	11,7	4,4	0,2	2,2	9,7	0,0	0,1
Israel	30,5	9,7	5,1	1,2	2,7	11,9	0,0	..
Italy	42,6	14,2	13,0	0,0	2,7	10,6	2,0	0,1
Japan (4)	..	9,5	..	0,0	2,7	5,3	0,1	..
South Korea	24,3	7,1	6,4	0,1	2,5	7,5	0,7	..
Luxembourg	39,3	13,9	11,3	0,0	2,9	11,2	0,1	0,0
Mexico (5)	..	6,0	3,1	..	..	..	..	..
Netherlands	..	..	..	..	..	..	..	..
New Zealand	32,1	17,8	0,0	0,0	2,0	12,4	0,0	..
Norway	40,8	18,6	9,7	0,0	1,2	11,3	0,0	..
Poland	..	..	..	..	..	..	..	..
Portugal	33,4	10,9	8,9	0,0	1,1	12,1	0,3	0,1
Slovak Republic	29,6	5,3	13,3	0,0	0,4	10,4	0,0	0,2
Slovenia	36,8	6,6	14,8	0,1	0,7	14,6	0,0	0,1
Spain (1)	32,6	9,6	11,3	0,0	2,1	9,1	0,3	0,1
Sweden	42,8	14,8	9,8	4,6	1,1	12,3	0,0	0,1
Switzerland	27,1	12,3	6,7	0,0	1,8	6,2	0,0	..
Turkey	29,3	5,9	8,0	0,0	1,4	13,5	0,5	..
United Kingdom	32,9	11,7	6,2	0,0	4,1	10,9	0,0	0,2
United States	25,4	12,1	6,2	0,0	2,8	4,3	0,0	..

Source: Revenue Statistics, OECD (2014).

... Not available

1. The total tax revenue has been reduced by the amount of any capital transfer that represents uncollected taxes. The capital transfer has been allocated between tax headings in proportion to the reported tax revenue, except for Austria where it has been allocated to the social security contributions heading.

2. From 1991 the figures relate to the united Germany.

3. The tax revenue figures are on a cash basis.

4. The tax revenue figures exclude revenue for Social Security funds, figures are not available.

5. Central government and Social security funds only.

It is important to recognize that "... taxation is often much more than a powerful method of raising revenue. It is also a major instrument of government policy used to influence the distribution of income as well as discouraging some activities through additional taxation and encouraging others through tax concessions" (James, 2016, chapter three in this handbook).

One other important issue needs to be mentioned is that "... globalization has contributed to the growing unevenness of the income distribution now observed in many countries, both developed and developing ... [and it] has also reduced the governments' ability to pursue redistributive policies that require additional public spending" (Tanzi, 2016, chapter one in this handbook).

As these explanations imply, neither borrowing nor taxation decisions cannot be taken out the political contexts. It is also necessary to understand the political and economic forces which serve to make tax evasion possible, desirable, and even socially acceptable. The next section will examine some political and institutional obstacles that we think facilitate tax evasion and tax loss in Turkey.

Some Political and Institutional Obstacles to Combat Tax Evasion and Tax Loss in Turkey

Tax compliance is quite low and the shadow economy is large in Turkey. According to the results acquired from different studies, the size of the shadow economy in Turkey has been one of the highest in Europe. Turkey ranks the sixth among 31 European countries with the informality share of on average 26.5% during 1990-2013 period (Karaca, 2015). Turkey generates lower revenue than would be warranted by its level of development. This reflects not only the high degree of informality prevailing in labor, product and property markets, but also weaknesses in tax audits, tax litigation processes, and collection of tax debts. Local governments, despite having appropriate tax handles like property taxes do not exploit them adequately, reflecting deficiency of political will and institutional capacity.

Political factors and established institutions have played important roles in shaping the Turkish tax system. In contrast to the predictions in the literature, the high degree of income inequality has not led to high tax burden and more redistributive tax system, because the economic power of elites has contributed to various types of representation failures. Additionally, tax morale and voters' attitudes towards raising the tax burden have been adversely affected by perceptions of corruption and poor quality of public services, in a vicious circle leading to inadequate resources for improving such services. Tax reforms were numerous in Turkey. But, they had a tendency to occur during crisis periods and privileging rapid revenue mobilization over other objectives.

There are several interrelated problems that facilitate tax evasion and tax loss in Turkey. First, tax evasion and tax loss deterrence mechanism has a serious deficiency. According to the Turkish Tax Inspection Council (VDK, 2014, p. 39), the general inspection rate of taxpayers was 2.24% in 2014. This inspection rate is not very low. The main reason why the Turkish Tax system performs less than successful seems less related to the inspection rate, but more related to the enforcement mechanism. Our observation is that mainly because of political reasons, sometimes even if a tax fraud is detected, necessary action are not taken or the sanctions imposed are not deterrent enough. The reverse is also true. Sometimes, just because of political reasons over-inspection is carried out and extreme sanctions are imposed on certain taxpayers.³ As both statistical and empirical findings of Akbulut's (2016) chapter in this handbook suggests, governance related factors such as government effectiveness, accountability, rule of law and level of corruption are more effective on the size of shadow economy as compared to economic indicators such as taxes and spending in Turkey.

Political Economy of Tax Evasion and Tax Loss in the Real Estate Sector

We would argue that there are also three governmental practices which induce and facilitate tax evasion in Turkey. They are: frequent implementation of tax amnesties, having a 'lax' tax reconciliation institution, and exaggerated application of tax information confidentiality principle. These practices would have very negative long-term effects as we will be explained below.

Tax Amnesties

Frequent application of tax amnesties⁴ is one of the most serious problems in relation to tax collection performance in Turkey. As Alm, Martinez-Vazquez, and Wallace (2009) point out, "tax amnesties are a controversial revenue-raising tool" (p. 235). Its advocates argue that tax amnesties raise revenue both in the short-term and long-term, by bringing former non-filers back into the tax system.⁵ They often suggest that future tax revenues may increase if the amnesty is accompanied by more extensive taxpayer services, better education on taxpayer responsibilities, and stricter post-amnesty penalties for evaders and greater expenditures for enforcement. Its critics, on the other hand, claim that the immediate impact on revenues is almost always quite small. Some question whether tax amnesties really produce additional revenue given that they simply collect revenue that could have been raised by normal enforcement procedures anyway (Luitel & Sobel, 2007). They also question the long-term revenue impact of tax amnesties, especially because honest taxpayers might resent the special treatment of tax evaders. If the taxpayers resent the tax breaks given to evaders and if individuals come to believe that the amnesty is not simply a one-time opportunity, then they may reduce their current compliance in anticipation of another, future amnesty (Alm, Martinez-Vazquez, & Wallace, 2009, p. 235).

The historical record has so far demonstrated that "amnesty recoveries are seldom large enough to make any dramatic impact on state finances" (Mikesell & Ross, 2012, p. 557). The editor of a recently published book titled *Is Tax Amnesty a Good Tax Policy?: Evidence from State Tax Amnesty Programs in the United States*, Hari S. Luitel puts clearly that "the ability of a tax amnesty to generate even the short-term tax revenue was not supported by the evidence" (2014, p. 78). International experience shows that the costs of tax amnesty programs often exceed the programs' benefits and the overall level of tax compliance falls after an amnesty (Baer & Le Borgne, 2008, p. 2).

Luitel and Sobel (2007) find that when tax amnesties offered repeatedly, additional tax amnesties generate less short-term revenue than predecessors and tend to magnify revenue losses associated with disincentives for long-term tax compliance. Since amnesties imposes additional costs, Alm, Martinez-Vazquez, and Wallace (2009, p. 249) suggest that developing and transitional countries would be better off avoiding them.

Tax remission is used as a way of gaining support for important political decisions and / or vote rising for politicians in developing countries like Turkey. The number of tax remissions implemented in Turkey proves a good example for how frequent they are used for political purposes. In total, 32 tax remissions have been implemented since the foundation of the Turkish Republic in 1923. Turkey had one party administration until 1946. During that period, six tax remissions had been implemented. After multi-party period started in 1946, a total of 26 tax remissions have been implemented by 46 governments over a period of 68 years.

Tax remissions were implemented more frequently after the single party period and especially in the periods following the military coupes. Within the first three years of the 1960 military coup, five tax remissions and within the first three years of the 1980 military coup, three tax remissions were implemented. It is very clear that tax remission frequency was very high during the first three years of these

two military coups, since on average every nine month a tax remission was implemented. Whereas on average every 43 months a tax remission was implemented in the remaining years, there are almost five times the difference between the first three years of military coup periods and the rest. We interpret this huge difference as tax remissions were used to buy support for the military coups.

In addition to the first three years of the two military coup periods, we identify two other distinct periods in which tax remission frequency is very high. The first one is 1988 – 1992 period and the second one is 2001 – 2003. During 1988 – 1992, four and during 2001 – 2003, three tax remissions were put into effect. In other words, during these two periods, on average every 12 months a tax remission was implemented. It is almost certain that the high frequency of tax remissions in the period 1988 – 1992 was related to the rapidly eroding share of the ruling Motherland Party votes.⁶ On the other hand, the reason behind the high frequency of tax remissions during 2001 – 2003 seems somewhat different and most probably related to one of the most severe economic crisis that Turkey ever experienced.

During the four distinct periods of the Turkish Republic (1960 – 1963; 1980 – 1983; 1988 – 1992; and 2001 – 2003 periods) that lasted all together 13 years, 15 tax remissions were implemented. This means that on average every 10.4 months a tax remission was put into effect during these four periods. On the other hand, the number of tax remissions implemented during the remaining 79 years of the Republic has been 17, which means on average every 55.8 months one tax remission was put into effect. This simple data clearly illustrate that the Turkish governments have implemented tax remissions mainly because of political reasons.⁷

Tax Reconciliation (Tax Dispute Resolution)

Tax disputes between taxpayers and tax authorities are unavoidable. This is irrespective of the quality of the tax system. As Oats and Pemberton (2012, p. 57) claim, some degree of discretionary power is useful for all tax systems and discretionary power smoothens the process of revenue collection. However, too much discretion, potentially erodes trust and creates costly uncertainty which can have an adverse impact on tax morale at an aggregate level.

The most basic dispute resolution mechanism is going to court. Nevertheless, this does not mean that going to court is always the best way, considering the costs and risks it entails. It is for this reason that the Turkish law, like other continental civil law systems, provides for out-of-court administrative dispute resolution mechanisms. The institution of reconciliation is one of the most significant of such mechanisms (Gündüz, 2013). Tax reconciliation institution was brought into force in Turkey in 1963 (for an overview, see Yavaşlar, 2008). Within the scope of this institution tax authority and taxpayer reach a settlement by reducing the taxes and tax penalties assessed by the tax authority.

The reconciliation institution enables one of the two taxpayers who are equal in all aspects in front of the law to pay less tax. What is clearly unfair is that the other person is destitute of this opportunity. According to the official data (GİB, 2015, p. 88), taxpayers, who applied for reconciliation could disregard a total of 58.9% their tax liability and 98.9% fine liability for the tax year 2014. The same figures for the previous year were 87.0% and 99.0%, respectively. It is important to recognize that if something unjust occurs in the process of taxation, the most suitable place to solve this problem is a court that specializes on tax issues. As Öncel, Kumrulu, and Çağan (2008, p. 171) suggest, a real crime and punishment could only be forgiven by authorized bodies within the frame of constitutional principles.

Reconciliation institution has a potential to affect the public conscious in a very negative way. There are mainly two reasons for this. First, responsible tax payers, who comply with all the tax rules, are not paid back within the frame of total deductions that are accepted in these applications. Second, it is not taken into consideration whether the taxpayers who fulfill their tax liabilities will approve the privileges provided for those not fulfilling their tax liabilities. Indeed, these responsible taxpayers are not even considered as a part of this process and they are treated like a non-relevant audience. Third, the burden caused by those who do not fulfill their tax duties falls on responsible taxpayers and their tax burden becomes heavier. This is the natural consequence of decline in tax revenues. Obviously, this is neither fair nor sustainable.

The Veil of Tax Information Confidentiality

Tax information confidentiality is generally regarded as a fundamental human right. According to Blaufus, Bob, and Otto (2014), the majority of countries treat tax information confidentiality. However, there is wide variety in its scope. While a number of countries like Greece and New Zealand publicly list tax evaders to combat tax evasion, others like Finland, Iceland, Norway, and Sweden disclose all tax return information. Theoretically, there is reason to believe that a reduction in confidentiality or privacy of individual information could lead to more or less compliance. Two different effects are expected: first, a shame effect of increased tax compliance due to the anticipated shame of being declared as a tax evader; second, a contagion effect, arising when an individual observes non-compliance of other individuals and therefore reduces his/her own tax compliance.

There are a few studies which have tested the relationship between confidentiality and tax compliance using experimental methods. One such study is carried out in the USA by Laury and Wallace (2005) in a between-subjects design. Their findings suggest that a loss of confidentiality increases compliance. Findings of two other studies are consistent with Laury and Wallace's study. One of these studies conducted by Coricelli *et al.* (2010) a within-subjects design shows that tax publicity reduces both the number of evaders and the amount of tax evaded. The risk of being 'named and shamed' as an evader diminishes the probability that an individual will evade taxes by 8.2%. One other recent study carried out by Bø, Slemrod, and Thoresen (2014) in Norway in this vein attributes an approximately 3% increase in reported income to Internet public disclosure. Findings of another recent study performed by Blaufus, Bob, and Otto (2014) in Germany, on the other hand, suggest that the shame effect is not strong enough to override the contagion effect when both effects are present.

The experimental studies mentioned above are carried out in developed countries, where tax compliance is generally high. We have reasons to believe that in developing countries, where tax compliance is generally low, tax information confidentiality can function as an armor to protect tax evaders. It is fair to say that an important part of economic activity is masked in Turkey, thanks to the exaggerated implementation of tax information confidentiality principle. The Turkish Tax Law (TPL No. 5 and 6) declares that violation of tax confidentiality principle is a criminal offense punishable with imprisonment. Civil servants are not allowed to reveal the information obtained during taxation process to the third parties. They are obliged to keep this information as a secret even after quitting their jobs or after they retired.

The tax information confidentiality principle forms a legal excuse for the Turkish Revenue Administration to conceal tax data from public domain, as if they are strategic state secrets. They systematically reject to provide even some of the general tax data,⁸ which does not indeed have a personal nature. This

attitude not only harms democracy due to the nonfulfillment of the ‘right to information’ but also constitutes a hindrance to eliminating the unregistered economy in Turkey. As Gayer and Mourre (2012) show, “third-party information can dramatically lower the taxpayer’s ability to misreport taxes” (p. 4).

PECULIARITIES AND SPECIFIC DIFFICULTIES OF REAL ESTATE TAXATION

Peculiarities and Politics of Real Estate Taxation

Property tax is widely regarded as an efficient and equitable means of raising revenue (see, Bird & Slack, 2006; Bahl, Martinez-Vazquez, & Youngman, 2010; Slack, 2010; World Bank, 2014). Taxes on land and buildings are generally argued to be more efficient than other types of taxes in that their impact on the allocation of resources in the economy is less adverse. This is because these taxes do not affect the decisions of economic agents to supply labor, to produce, invest and innovate to the same extent as some other taxes (Johansson *et al.*, 2008, p. 20). Moreover, recent empirical work on tax composition and growth indicates that a shift from income taxes to property taxes has a strong positive association with long-run economic growth (World Bank, 2014).

At least four characteristics of the property tax differentiate from other taxes: visibility, inelasticity, inherent arbitrariness, and, in at least some countries, the extent to which it reflects local autonomy. First, the property tax is a highly visible tax. Unlike the income tax, it is not largely withheld at source. Unlike the sales tax, it is not paid in small amounts with each daily purchase. Instead, the property tax generally has to be paid directly by taxpayers in periodic lump sum payments (Bird & Slack, 2006). As a result, taxpayers tend to be much more aware of the property taxes they pay and this would increase the resistance from tax payers (Slack, 2010).

It is well established that revaluation and the use of current market value in principle as the underpinning for the property tax base will improve the equitable distribution of the property tax between taxpayers (Dornfest, 2010). Owing to their attractive economic properties, increased use of real estate taxes could conceivably help ease problems with taxes levied on mobile bases. It could improve the allocation of capital and boost growth in the medium term, reinforcing efforts to consolidate public finances (Gayer & Igoseva, 2012, p. 19).

Although there are many reasons why governments should rely more on property taxes, such taxes are under-utilized in many countries. Tax revenue estimates of OECD countries for 2013 in Table 1 shows that property tax revenues rarely exceed three percent of GDP in any country and are often much less than that. The United Kingdom (UK) appears as the highest property tax revenue generating country among the OECD countries. Still, that amount of revenue stood only 4.1% of GDP in the United Kingdom. This figure was almost one-third of the revenue generated from income and profits. But obviously there are other countries in much worse situation. Among the OECD countries, Estonia is an extreme example in this respect. This country could generate just 0.3% of GDP and this was almost one-fourteenth of the amount the UK could collect from properties as a share of GDP for the same year.

Table 2 shows that there has been a significant decline of property taxes in OECD countries since 1965. While the average property tax share of total taxation in OECD countries was 7.9% in 1965, it declined to 5.3% within just 15 years, most probably as a result of neo-liberal resurgence. Since then, it seems that there is a stabilization of property tax share within total taxation. That figure stood as 5.5% for the OECD countries in 2012. An interesting and dramatic change can be observed from the table that

the same figure was as high as 10.5% for Turkey in 1965 and declined to as low as 2.3% within 25 years, before it started to gradually improve later on and stood as 4.2% in 2012. This was almost one-third of the UK could collect tax from properties as the share of its total tax revenue for the same year. The data provided makes it clear that there is a wide variety between countries about how much tax they collect from properties and this may change dramatically from one period to another. What we can infer from this data is that *property taxation is clearly much more related to politics than technics*.

Obviously, there is much room for improvement in the practice of property taxation. However, as Brunori (2003, p. 7) indicates, the property tax is often regarded as the ‘most hated’ tax. According to Gayer and Igoeva (2012, p. 19), the main reason why real estate taxes are very unpopular, is that because people think it is unfair to tax something they already possess. This ‘counter-economic’ perception is an important factor to be taken into account. Sheffrin (2010) suggests that unpopularity of the property tax also stems from the potential for volatility and unpredictability of a tax that is based on market value. With market value assessment, there is the risk of potentially large annual swings in the distribution of the property tax burden in times when property values are rising rapidly and not uniformly (Haveman & Sexton, 2008). Johansson *et al.* (2008) suggest that “unpopularity of property taxation could be reduced if an up-to-date valuation system is applied and people with low incomes and illiquid assets would either pay low real estate taxes or would have a favorable tax treatment” (p. 45).

Specific Difficulties of Real Estate Taxation in Turkey

Clearly, accommodation is a basic human need and its taxation requires a sensitive political arithmetic. Accommodation is expected to have a political sensitivity in all countries. But, we think the history of the Turkish society has made this issue particularly sensitive for Turkey. As opposed to many countries which have experienced feudalism, land ownership in the Ottoman period had belonged to the state, not individuals. While taxes collected from the real estate had almost always been an important source of revenue for the state in Western countries, this was hardly the case in the Ottoman Empire. Thus, it should not be surprising that the Turkish people became very reluctant to pay real estate related taxes when the state started to collect such taxes later.

Most probably due to this legacy, the Turkish authorities have always been reluctant to collect real estate taxes. Even today, we can see the cases supporting this view. For example, ‘the legal real estate values’, which constitute a base for tax declarations, are determined by district appraisal committees (DACs) once for every four years. Unless the Cabinet of Ministers decide otherwise, the tax payable is increased half of the inflation rate in the mid years. The situation was even worse in the previous periods when the inflation used to be very high. Adjustments which should have been made frequently seem as to be delayed intentionally. Consequently, taxes collected from the real estate got eroded due to high inflation rates and became almost insignificant. To put it differently, *reluctance of the politicians’ to collect real estate taxes has played a significant role in the high level of tax loss in this sector*.

As these explanations make it clear, the real estate sector is significantly different from other sectors in terms of the reasons causing tax loss and evasion. First, unregistered economic activities in this sector are not because of the difficulty of assessment, since these tax subjects have actually physical bodies that cannot be hidden or transferred to somewhere else. The informality in this sector has come out as acquiescence of the current condition by the governments due to political considerations. Huts made on state treasury lands and structures nonconforming to the zoning legislation are common in Turkey. In some cases, the state provides water and electricity infrastructures, and even title deeds for these

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Table 2. Taxes on property (4000) as % of total taxation in OECD countries

	1965	1980	1990	2000	2007	2008	2009	2010	2011	2012
Australia	11,5	7,8	9,0	8,8	8,9	8,2	9,5	9,3	8,6	8,6
Austria (1)	4,0	2,9	2,7	1,3	1,4	1,3	1,3	1,3	1,2	1,3
Belgium	3,7	3,1	3,8	4,7	7,2	7,1	7,0	7,3	7,3	7,5
Canada	14,3	9,1	10,0	9,5	10,6	10,9	11,3	11,5	10,9	10,6
Chile	..	..	6,2	7,0	4,9	5,4	4,8	3,6	4,0	4,3
Czech Republic	..	..	..	1,4	1,2	1,1	1,1	1,3	1,5	1,5
Denmark (1)	8,0	5,8	4,2	3,2	3,8	4,1	4,0	4,0	4,1	3,8
Estonia	..	..	..	1,3	0,7	0,9	1,0	1,1	1,0	1,0
Finland	4,0	1,9	2,4	2,4	2,6	2,6	2,6	2,7	2,6	2,8
France (1)	4,3	4,8	6,3	6,9	7,9	7,6	8,0	8,5	8,4	8,5
Germany (2)	5,8	3,3	3,4	2,3	2,5	2,4	2,3	2,3	2,4	2,4
Greece (1)	9,7	4,6	4,6	6,1	5,3	5,5	4,8	3,3	5,5	5,6
Hungary	..	..	..	1,7	2,0	2,2	2,1	3,1	3,1	3,2
Iceland	4,0	6,3	8,4	7,9	6,1	6,1	6,5	7,0	6,7	7,1
Ireland	15,1	5,3	4,6	5,5	8,0	6,3	5,7	5,8	6,6	7,0
Israel	..	..	..	8,6	8,8	9,1	9,4	9,4	9,4	9,0
Italy	7,2	3,7	2,3	4,6	4,9	4,3	6,2	4,8	5,3	6,3
Japan	8,1	8,2	9,4	10,5	9,0	9,4	10,1	9,7	9,7	9,1
Korea	..	8,0	11,8	12,4	12,8	11,9	11,7	11,4	11,4	10,6
Luxembourg	6,2	5,7	8,3	10,6	9,7	7,5	6,7	7,1	7,0	7,1
Mexico	..	1,9	1,5	1,4	1,7	1,4	1,7	1,6	1,5	1,5
Netherlands	4,4	3,6	3,7	5,3	4,7	4,2	3,9	3,8	3,4	3,0
New Zealand	11,5	7,9	6,8	5,3	5,3	5,8	6,7	6,8	6,6	6,2
Norway	3,1	1,7	2,9	2,3	2,8	2,8	2,9	2,8	2,8	2,9
Poland	..	..	..	3,5	3,4	3,6	3,9	3,8	3,7	3,9
Portugal	5,0	1,4	2,7	3,7	4,2	3,8	3,7	3,7	3,5	3,9
Slovak Republic	..	..	..	1,8	1,4	1,3	1,5	1,5	1,4	1,6
Slovenia	..	..	..	1,7	1,6	1,5	1,6	1,7	1,6	1,8
Spain (1)	6,4	4,6	5,5	6,3	8,1	7,0	6,6	6,4	6,0	6,3
Sweden	1,8	0,9	3,5	3,4	2,4	2,3	2,4	2,4	2,4	2,4
Switzerland	9,9	8,3	8,4	9,0	7,9	7,4	7,4	7,4	7,0	6,6
Turkey	10,5	5,4	2,3	3,2	3,8	3,6	3,6	4,1	4,1	4,2
United Kingdom	14,5	12,0	8,2	11,6	12,6	11,7	12,2	12,1	11,6	11,9
United States	15,9	10,7	11,5	10,1	11,4	12,2	13,9	13,0	12,3	11,8
OECD Average	7,9	5,3	5,7	5,5	5,6	5,4	5,5	5,5	5,4	5,5

Source: Revenue Statistics, OECD (2014).

... Not available

1. The total tax revenue has been reduced by the amount of any capital transfer that represents uncollected taxes. The capital transfer has been allocated between tax headings in proportion to the reported tax revenue, except for Austria where it has been allocated to the social security contributions heading.

2. From 1991 the figures relate to the united Germany.

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unlicensed structures. Since illegality in this sector is the result of *political preference*, it would not be realistic to expect necessary actions will be taken after tax inspectors detect wrongdoings.

The level of tax evasion and particularly tax loss is very high in the Turkish real estate sector. As many studies like Kırar (2008), Dođrul (2011), and Büyükduman (2014) revealed, there can be very big differences between the declared transaction value and real value of immovable properties. The share of personal income tax collected from immovable properties was as low as .04% in 2013 and their share was even lower in the central government tax revenue for the same year with just .009% (Ministry of Finance, 2015). The revenue from property taxes was less than 1 percent of GDP and only around 3.5% of total tax revenues in Turkey. This is much lower than the average in the OECD where property taxes amount to 2% of GDP and to around 5.5% of total tax revenues.

Public revenue generated from the real estate sector mainly comes from rental incomes in the Turkish case. Capital gains income tax collected from properties has been very low in Turkey for a quite long time. In 2010, the Turkish Revenue Administration compared the immovable property value declarations made by 1896 taxpayers with the market values. It was founded that undeclared tax base was 5.96 times more than declared tax base (Turkish Revenue Administration, 2011, p. 46).

In terms of tax and other similar obligations, the lowest level of tax loss and evasion in the real estate market is on title deed fees.⁹ This is very much related to a recent change in tax law to oblige taxpayers to declare the real market value of the real estate in question during a transaction. The title deed fee collected from real estate sales was .019% of the aggregate tax revenue in 2013. On the other hand, even for the title deed fees, there are several estimations made that claim taxpayers are still paying much lower amounts than the actual market values. For example, according to a report prepared by the Association of Real Estate Developers and Investors in 2013, the title deed fee paid by taxpayers was only one third of the actual value and thus, the state's annual loss of revenue was around 5 million TL on average.

Value assessment difficulties of the real estate are the main reason for high level of tax loss. Though they may have similar features, the real estate values may vary significantly depending on their locations. Particularly difficult is to assess market value of the real estate which is not subject to sale. In such a case, what is in hand is not a real market price but a fictive value. The critical question begs an answered is that: "How will we tax something that has an unknown market value?" Current procedure is far from following a proper real estate valuation procedure. It is more like an appraisal¹⁰ made with general considerations. Obviously, such appraisals are unlikely to reflect real market values. As Karasu and Karakaş (2012) point out, "[u]sually there is a huge difference between the taxable value and the current market value of the real estate."

In order to solve this problem what needs to be done is first to build a comprehensive real estate valuation system which will be able to come close reflecting market value of the real estate in question. As Bird and Slack (2006) claims, building a real estate valuation system and putting it into practice is not an easy task at all. Nevertheless, we argue that having such a system is crucially important to reduce tax losses in the real estate sector. Having such a working system would not only bring substantial benefits like increased tax revenues, but also serve for tax fairness. In any case, what is certain is that unless a proper real estate valuation system is developed, tax loss in the real estate system is bound to remain high. In the next section, we will introduce an original semi-public real estate valuation system, which we think has a big potential to change this situation radically.

A PROPERTY TAX REFORM PROPOSAL FOR TURKEY

Three main objectives of taxation can be identified as 1) to raise revenue; 2) to reduce inequalities; and 3) to promote economic performance. Çevik (2016, chapter seven in this handbook) makes the important point that “[a]lthough improving the governance and institutions is not a main objective of tax reforms, a legitimate tax system can help to establish a legitimate political interaction through the nation. A legitimate tax system can be obtained by increasing tax policy’s capability to reach foregoing main objectives and consequently by establishing parties’ effective participation in decision making process, that is productive revenue bargaining.”

It is important to recognize that a compliance strategy based on detection and punishment may well be a reasonable starting point for tax administration but not a good ending point. Instead, what is needed is a multi-faceted administrative approach that emphasizes enforcement and also emphasizes such things as service and, especially, trust (Alm & Torgler, 2011).

What is generally overlooked or ignored is that fighting tax evasion and tax loss is not only important to raise revenue but probably more so to establish fairness. Surprisingly, many countries’ laws do not regard tax evasion and tax fraud as disgraceful crimes. However, tax evasion is illegal and unfair confiscation of a value intending to meet social requirements. We think the most significant factor differentiating this act from theft, which is a disgraceful crime, is that, it requires a much severe penalty as it is a crime committed against the whole society. Therefore, we would argue that *to fight effectively with tax evasion the first thing to do is to define it as a disgraceful crime in the Turkish Criminal Code.*

As we have put forward earlier, taxation is mainly a political issue. However, if for a moment we consider taxation as a technical issue, we can see that there are two necessary conditions to prevent tax evasion. First, tax assessment should reflect the actual situation and second, there should be sufficient means to ensure tax collection. Unless these two conditions are satisfied simultaneously, tax loss and evasion are inevitable. Although prevention of tax evasion is critically depends on these two factors, it needs to be recognized that there are several other factors that influence tax compliance. Whether taxpayers will comply or resist their due taxes is closely related to the impact of all these factors on the taxpayers. Under the following subtitles, we will discuss the way in which governments will be able to make sure that economic activities are properly recorded and real estate tax bases reflect market values.

Ensuring Good Records of Tax Related Issues

Tax evasion in the real estate market in Turkey stems from the fact that a considerable amount of real estate sale and rental procedures are unrecorded. Therefore, it is not easy to trace tax generating activities and audit them. In a context where audits cannot be performed, tax evasion becomes easier. It is estimated that around 50-80% of the houses in Turkey and around 50% of the houses in Istanbul are unlicensed. While some of them are huts, some others are buildings, lacking condominium due to disobedience to rules. Not only to reduce tax loss and evasion but also to improve the quality and security of buildings, the state needs to be tough against unlicensed constructions. Within this framework, the state must both prevent illegal constructions and produce a permanent solution for the social problems leading to these unlicensed constructions.

It is fair to say that particularly in the last decade governments have institutionalized some practices that facilitated recording of tax related issues and those practices had quite positive effects on the reduction of tax evasion in Turkey. For example, requiring the use of citizenship number in purchase-sale

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activities made tax evasion much more difficult. Another practice was investing in digital infrastructure so that activity records could be accessed online by the relevant authorities.¹¹ Doing so saved time and it became easier to perform audits.¹² The third practice was bringing a requirement to debit rent payments above a certain amount into the bank accounts of the real estate owners. All these practices helped to reduce unrecorded economic activities and tax evasion in the real estate market.

We think there is at least one other practice which has a significant potential to reduce tax evasion in the real estate sector. It is to ban the use of cash in real estate purchase or sale activities and oblige that the payment could be transferred only via banks. For example, it can be required that for any financial activity costing more than 100 Turkish Lira (TL) payments are made by credit card or via bank transfer. For the people who do not obey this rule, severe penalties including imprisonment can be applied. As Gayer and Igoseva (2012) suggest, “legal sanctions against purchasers of undeclared work and the obligation to use electronic payment systems for purchases over a certain amount may deter tax fraud” (p. 10).

To increase the possibility that rental contracts will reflect market values, we propose establishing a new institution that we may call it as a *guiding authority for rents*. This *fast acting guiding authority* should have a sound knowledge about the current market values and for a rental contract to become legally bounding its approval should be required. The main job of such an authority can be identified as to record the related details of the tax generating activity and to guide the two sides so that the rental contracts will be close to reflect real market values. If this guiding authority is not convinced that the rent value agreed by the two sides do not reflect the current market value, it would issue its approval on the condition that the real estate will be revaluated. Under such circumstances, the tenant should agree to allow the valuation company to do its job in a reasonable time. In such a case, the landowner would be held responsible paying the valuation bill. If the company carried out the valuation process has its names in the state approved valuation companies list and the valuation difference is less than 15% of the declared amount, the state would pay the valuation amount to the land owner and declared amount would be accepted as the tax base. However, if the valuation difference would be more than 15% of the declared amount, the state would pay nothing. Moreover, this time only the exact valuation amount would be accepted for the tax base.

Preventing informal working of contractors and real estate agencies is another significant issue. Tax evasion and fraud problem in the real estate market can be eliminated by recording all the relevant parties on electronic data system and by making sanctions heavier for those who work unrecorded or make people work unrecorded. In this way, tax inspectors may control the whole system much easier. Thus, our suggestion is to employ sufficient number of well-paid qualified tax inspectors and *to make sure that tax inspectors would have been safeguarded against political and interest-based pressures*. It is also important that regular inspections are performed more frequently.

Establishment of a Semi-Public Valuation System

A feature of the real estate is that every one of them is unique and because of variety of reasons even the ones with very similar characteristics might have very different market values.¹³ For example, a real estate might be invaluable just because of its specific geographical location. Hence, it would not be possible to reduce tax losses significantly without having an accurate real estate valuation system that takes into account all the important factors causing differences in market values. Moreover, if such market value would not be reflected on tax bases, what can be done to minimize tax losses would be quite limited.

In Turkey, 'real estate tax values' determined by district appraisal commissions (DACs) play a crucial role for taxpayers in their real estate related tax declarations. According to the Real Estate Tax Code no 1319 Article 29, real estate tax values 'assessed' (or more correctly *determined*) by DACs should be taken as the minimum declaration value. As stated by one of the director in the Revenue Administration during one of our interview, more than 90% of taxpayers make their tax declarations slightly above the real estate value determined by DACs. However, these values are generally much lower than actual market values. Sometimes a minimum declaration value can be as low as one seventh of the market value of the real estate in question. Our view is that *because DACs apply a flawed appraisal, which is far from a proper valuation, they are a part of the problem, rather than a part of the solution*. As mentioned previously, some political considerations take the priority in determining DAC figures and a valuation system reform is required to radically reduce tax losses in this sector.

A major tool to reduce tax loss can be either to develop a sound real estate valuation system for the public sector or to buy such a service from the private sector. In this way, the Revenue Administration would be able to cross-check the tax declarations made by taxpayers with the real estate valuations carried out by professionals. One of the practical issues with this tool is that such valuations would be very costly if valuation becomes a requirement for every real estate. Therefore, we suggest *a hybrid system* that will not cost much, but be rewarding. This system will not cost much to the treasury. Because most of the cost of valuation will be paid by the taxpayers, who made false tax base declarations. This system will be explained below.

The first prerequisite for a successful transformation in the right direction would be to stop employing DACs members with political considerations. Only the qualified people who would be successful in a merit-based central real estate valuation exam would be employed at this institution. The second thing would be to create a semi-public institution that will eventually replace DACs. This semi-public institution could be called as *Real Estate Valuation Council (REVC)*, which will enable coordination among DACs. REVC would standardize valuation norms, determine the priorities in valuations and when it is needed to transfer valuation experts from one district to another. *It is crucial that this council be autonomous, have a transparent structure, and employment is based on merit and accountability*.

The council in question may create a valuation data base throughout Turkey and continuously improve the available data to ensure they always reflect the best available real estate value data. In order to reduce cost and work load, new valuations carried out particularly focus on districts experiencing significant changes that affects the real estate values. To speed up the database formation process, REVC can be given a privilege to benefit from the data of available valuation companies with a low fee. The Capital Markets Board (CMB) could be held responsible to ensure reliability of these data and prevention of any troubles in their transfer.

We also suggest that taxpayers are being obliged to submit their real estate tax declarations according to current market values similar to the current practice regarding the title deed fees. We think that other than politics the main reason why there has not been such a practice for the real estate tax is most probably related to the fact that there is no market transaction to take as a reference point for the tax base. The most rational solution to this problem seems as officially regarding the CMB approved real estate valuations as market values. However, as this value is indeed fictive, it is reasonable that the taxpayers are given a chance to take the tax base as 20% below this value. Declarations could be increased annually based on the Producer Price Index for the following five years. The new revaluation value obtained on the fifth year would be taken as the new tax base for the declaration in the sixth year.

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Within this framework, the state can require a valuation for let us say flats or houses larger than 150 square meters and for workplaces larger than 70 square meters. In order to improve applicability of this suggestion, a total of 80% of the valuation fees might be deducted from the tax payable. Taxpayers in question can be excluded from inspection if they pay 20% more than the minimum real estate value determined by DACs. Otherwise, every year about 5% of the randomly selected real estate would face with two revaluations carried out by two different valuation companies again randomly selected by the REVC. If the tax declaration made by the taxpayer is not below 80% of the two valuation average, no fee is demanded from or no penalty is applied to the taxpayer. On the other hand, if the tax declaration made by the taxpayer is below 80% of the average of the two valuations, then both of the valuation costs and a tax penalty, not lower than five times of the tax loss, are collected from the taxpayer. Taxpayers are informed about the average value of the two revaluations made by these two different valuation companies and are required that they cannot declare their tax base as less than 10% of this value in the following year.

Before launching this practice, the state might invite CMB licensed valuation companies over a particular level of valuation capacity to give a sealed offer for a valuation fee on square meter basis to become one of the 30 companies¹⁴ that their valuations will be officially accepted by the state. Valuation fee averages of 30 companies which make the highest reductions for their valuation fees is found out and a reduction of about 20-40% is calculated from this average. The first 30 or fewer companies which accept to apply this reduced fee¹⁵ are given privilege for two years to become among the state approved companies, where their valuations could be deducted from tax payable by the taxpayers, who had these valuations performed.

Additionally, a cross-check and audit mechanism can be applied as an auto-control mechanism, which would ensure that valuations reflect market prices. The first thing to do for this can be to require valuation companies to provide a brief information (for example, valuation's approval date, names and registry numbers of the approved value, size of the valuated place in square meters, parcel and lot numbers) on their valuations within five working days. Following this declaration, a total of 5% of the valuations performed by valuation companies are randomly selected. In order to assess the validity of real estate valuations, two CMB approved valuation companies are again randomly selected. Average of the two valuations (the interval between the first and the second valuation must not be longer than two months) is taken and is compared to the previous valuation. If the previous valuation shows a deviation of more than 20% of the average of the last two valuations in question, a third valuation from another company is performed. If a deviation of more than 20% as the average of the three valuation in question is found, a penalty is charged to the company that carried out the previous valuation. The amount of such a penalty would be about ten times the cost of the three valuations. Experts who have put their signatures on such a flawed valuation document are given a warning. If the same situation repeats more than three times in the same year, relevant companies are given a warning. Licenses of the valuation experts, who have received three warnings within five years, and companies who have received three warnings in a year are invalidated.

Other Tax Reform Suggestions

It is important to ensure that both the buyer and the seller will pay their fair share of title deed fees. In the usual practice in Turkey, buyers are pressurized to pay title deed fee share of both parties. This increases the burden put on the back of one of the parties and reduces the possibility of honest declaration of the

current market value of the real estate. In order to avoid such a result, payment of title deed fee can be made conditional on signing a statement that one undertakes any legal responsibility that might arise from a false declaration. In addition, a highly deterrent penalty may be imposed if the signature on the bill of the title deed fee is not belong to the person responsible to pay that title deed fee or that person's legal representative.

There are significant proportional differences among value added tax (VAT) rates implemented for the flats and houses in different sizes in Turkey and this encourages tax fraud. Therefore, it would be wise to minimize these differences. For examples, instead of the two rates for above and below 100 square meters, there might be four different VAT rates. One such rate would be set as up to 70 square meters, the other from 70 to 109 square meters, the next from 110 to 149 square meters, and the last for larger than 150 square meters. Reduction of big differences among VAT rates would mean elimination of a factor that encourages tax evasion and tax loss in the sector. Another policy that would reduce tax loss and evasion in the real estate sector would be to take the credit amount loaned from banks to purchase a real estate as a base in the assessment of the real estate's market value. For instance, it might be a condition that the value of a real estate cannot be declared below its credit value.

A very important issue requiring special attention is that real estate taxes are set and collected at the local level in Turkey. This poses challenges to intergovernmental fiscal frameworks. Our view is that currently there is a conflict of interest issue between the central government and local governments. On the one hand, the central government does not have much interest in a real estate tax increase, since that would hardly increase central government revenue. On the other hand, it is politically difficult for local governments to increase real estate taxes significantly because people would blame the local government for this rise and there might be political consequences for this policy change. But, if the central government would get a considerable share (one-third or half) from tax revenue and increasing real estate taxes becomes the state policy, this would very much ease the political pressure on local governments. It follows that it would be much easier to increase real estate taxes in this way.

Obviously, the process of obtaining valuations that are close to market value on a regular basis is not cheap. Moreover, as Slack (2010) warns, "no matter how economically desirable the long run outcome of property tax reform may be in terms of the equity and efficiency of the tax, its transitional effects may be sufficiently undesirable in political terms to kill it" (p. 13). In the same vein Nicodème (2012) stresses that "there are transition problems with any tax reform proposal as changes in the system will generate windfall gains and losses. Gradualism in reforms may be needed in this respect... the usual political economy problems are at stake with losers being often more vocal than winners. This is particularly the case because property taxes are very visible to taxpayers" (p. 28). Furthermore, where the losses are concentrated and the gains are dispersed, as is often the case with tax reform, negatively affected interests will be motivated to spend time and resources in political action that can result in permanent, institutionalized groups (for example, office towers, hotels, seniors, waterfront properties) in opposition to reform (Slack, 2010, p. 13).

Property taxes have important fiscal and non-fiscal effects. Therefore, the design of such a reform is critically important. According to Bird and Slack (2006), one must have modest expectations about a property tax reform and get some critical details right at the first place. This is because of the fact that the property tax is a highly visible and this visibility makes the tax difficult to sell politically. This is why Slack (2010) suggests that success of any tax reform, which is expected to result in major tax shifts among taxpayers, needs to "depend on the introduction of some form of phase-in mechanism.¹⁶ Phase-ins are almost invariably politically necessary to cushion the impact of reform. Some form of relief is

also needed for low-income taxpayers. Property tax credits (or circuit-breakers) that relate property taxes to income are best at designing relief to low-income taxpayers. For elderly taxpayers who have seen their property values increase but their incomes remain fixed, some form of tax deferral would be appropriate” (p. 13).

James (2016, chapter three in this handbook) makes the important point that “... successful tax reform is likely to be a dynamic process rather than a single one-off change. The tax system has to be designed to be sufficiently robust to accommodate continuing change in the socio-economic and political environment and to be sufficiently flexible to accommodate further adjustments as appropriate.” Last but not least, the right mix of IT (information technology) and transparency is critical to what Bird (2016, chapter two in this handbook) calls as ‘smart tax system’. Such a system requires “a well-designed, relatively stable tax system with an appropriate administrative structure that fully utilizes the capacity of IT to assemble and utilize information, staffed with trained people, and properly managed as transparently as possible.”

CONCLUSION

This chapter examined tax evasion and tax compliance issues from a political economy perspective and investigated peculiarities and specific difficulties of real estate sector in general, and the Turkish case in particular. Consequently, a property tax reform based on a semi-public valuation system is proposed to reduce tax loss substantially in the real estate sector.

The chapter argued that one of the main reasons why collection of real estate related taxes are low in Turkey is related to the political preferences and institutional arrangements, which induce and facilitate tax evasion and tax loss. Such governmental practices that this chapter focused on are: frequent implementation of tax amnesties, having a ‘lax’ tax reconciliation institution, and exaggerated application of tax information confidentiality principle.

It is claimed that the coverage of tax information confidentiality principle in the Turkish Tax Law is extremely wide and its application by the tax officials is even wider. The confidentiality principle applied in the Turkish Tax Law forms a legal base to deny public access to almost any kind of information about taxes, as if they are strategic state secrets. This attitude not only masks a considerable part of unregistered economic activities but also can function as an armor to protect tax evaders. What is not acceptable here is that tax authorities remains indifferent to individuals suffering from injustice in taxation while they are very kind to protect the ones who resist fulfilling their citizenship duties.

The frequent application of tax amnesties in Turkey is another very serious problem. A total of 32 tax remissions have been implemented in Turkey since the foundation of the Republic in 1923. Tax amnesties were implemented more frequently after the single party period and especially in the periods following the military coups. During the four short distinct periods of the Turkish Republic (1960 – 1963; 1980 – 1983; 1988 – 1992; and 2001 – 2003) that lasted all together 13 years, 15 tax amnesties were implemented. This means that, on average, every 10.4 months a tax amnesty was put into effect during this four periods. On the other hand, the number of tax amnesties implemented during the remaining 79 years of the Republic has been 17, meaning on average every 55.8 months one tax amnesty was enforced. This simple data clearly illustrate that the Turkish governments have implemented tax remissions mainly for political reasons. The reasons were either to buy support for the military coups or to increase votes.

Tax amnesties are a controversial revenue-raising tool. International experience provides evidence that the perceived benefits of tax amnesty programs are at best overstated and often the costs of tax

amnesty programs exceed the programs' benefits. It is also important to recognize that the additional burden caused by those who did not pay their fair share of taxes is imposed on the other taxpayers. The historical record suggests that amnesty recoveries are seldom large enough to make any dramatic impact on the public revenue and the overall level of tax compliance falls after an amnesty. This seems as because honest taxpayers resent the special treatment of tax evaders, and many believe that the amnesty is not a one-time opportunity. Therefore, attempts to increase short-term revenue need to be carefully balanced against the long term erosion of voluntary compliance and trust. Hence, we see the abundance of tax amnesties as a hindrance to reduce tax evasion in Turkey.

Having a 'lax' tax reconciliation institution outside the judicial processes constitutes another problem. As a result of such an institution one of the two taxpayers, who are equal in all aspects in front of the law, pays less tax. On the other hand, the taxpayers who have paid their taxes in full do not receive any pay-backs over tax reduction rates. Since the other person is destitute of this opportunity, this leads to injustice. To make everything worse, the additional burden caused by the reductions are imposed on the honest taxpayers.

Applying tax amnesties outside the judicial processes and having a 'lax' tax reconciliation institution harms tax justice deeply because tax is perceived as a subject of bargaining. As suggested earlier, taxpayers need to feel that the tax system is being administered fairly and that tax liabilities are not arbitrarily determined. We would argue that leaving these problems unattended would have very negative effects on tax justice and voluntary tax compliance. Apart from those mentioned above, in cases people suspect that tax money is not spent in a way that will bring utmost social benefit or that the benefits are diverted to the politically favored people, it will become even more difficult for individuals to comply with taxes voluntarily.

What is generally overlooked or ignored is that fighting with tax evasion and tax loss is not only important to raise revenues but probably more so to safeguard fairness. Surprisingly, many countries' laws, including Turkey, do not regard tax evasion as a disgraceful crime. However, tax evasion is illegal and unfair confiscation of a value intending to meet social needs. We claim that the most significant factor differentiating this act from theft which is regarded as a disgraceful crime is that, it deserves a much severe penalty since it is a crime committed against the whole society. Therefore, we think that *the first thing to do for fighting effectively against tax evasion in Turkey is to define it as a disgraceful crime in the Turkish Criminal Code.*

Recently, there has been a significant shift in research emphasis from the analysis of enforcement to the incorporation of trust-building measures that encourage cooperation in tax compliance research. We argue that normative factors play much more significant roles than generally thought for tax compliance. What we would like to emphasize is that *government policies are crucial for trust-building.* If citizens of a country feel their taxation system as fair, regard their tax burden as reasonable and feel certain that what they pay will return them as a public service, there would not be much justifiable reason not to pay their taxes. Nevertheless, fulfillment of tax liabilities cannot be left to the mercy of taxpayers only. It is the responsibility of governments to apply sanctions for tax evaders to preserve the rights of other citizens who pay their taxes. When the government fails to perform this duty, honest citizens are victimized and next time it would not be reasonable to expect them to fulfill their tax duties in a responsible way as they did before.

The real estate sector upon which this chapter is focused differentiates significantly from other sectors regarding the factors causing tax evasion. The reason why tax related issues are unrecorded in this sector is not due to the difficulty of detecting tax subjects because they are physical bodies that are not possible

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to hide or transfer. Thus, *the informality in this sector is due to the politicians, who turn a blind eye to the current situation for political reasons.* Hut style houses constructed on treasury land and outlaw constructions are common examples that support this claim in Turkey. Therefore, it is not sensible to expect that after tax inspectors detect an informality, the problem will be solved. *Since the current problem is the result of political preference, solution will depend on the change of political preference in question.*

One of the main conclusions reached at this study is that the quality of public services is very important for tax compliance. Citizens must be able to see a significant improvement in the quality of services provided by government to be sure that the money they pay through taxes is used properly. It is also important to recognize that high corruption in the public sector discourages people to pay their taxes. Thus, fighting with corruption would, indeed, mean fighting with tax evasion and tax loss.

There is a government practice which assumes a large role in the current tax losses in the real estate sector related to the district appraisal commissions (DACs). ‘The real estate tax values’ are determined by DACs and these values tend to be significantly lower than market values. These unrealistic figures determine how the real estate tax declarations will be. When taxpayers make their real estate tax declarations according to these unrealistic figures, they do not face legal sanctions. However, the Ministry of Finance does not allow this to happen in relation to the title deed fee declarations and the result is that the revenue collected from this tax item is quite reasonable. This implies that the solution is very much related to the political will.

It needs to be recognized, however, that tax losses in this sector have another very important reason. That reason is the dramatic effect of locational differences on the real estate values. Even two pieces of real estate with very similar characteristics might have very different market values depending on their locations. Hence, *it would not be possible to eliminate tax loss and evasion without developing a method, which objectively takes into account all the important factors causing differences in the real estate values within the framework of demand conditions and ensure that these values are reflected on the real estate tax declarations.* A framework for such a method is proposed in the previous section of this chapter.

In conclusion, unless an integrated approach based on tax fairness is developed, procedural justice is adhered and respectful modes of communication between the Revenue Administration and taxpayers is established, tax evasion and particularly tax loss is expected to remain very high in Turkey in the foreseeable future. However, increased use of property taxes could help ease problems with taxes levied on mobile bases. Shifting the tax burden from financial intermediation more onto immovable property would make the tax system less distorting and less vulnerable to tax evasion. One of the crucial steps needs to be taken in this direction is to develop an objective a semi-public real estate valuation system that would reflect market values, which this chapter proposed in detail.

ACKNOWLEDGMENT

This chapter is based on a project titled, “Tax Loss Arising from Tax Avoidance and Evasion, as a Result of False Real Estate and Rent Value Declarations: The Case of Istanbul.” It is gratefully acknowledged that this project is financed by Marmara University Scientific Research Projects Coordination Unit with the number: SOS-B-040310-0056. Earlier draft of this chapter benefited helpful comments and suggestions from Savaş Çevik, Larissa Batrancea, Erich Kirchler, Simon James, Tarkan Çavuşoğlu, Yücel Demirer, Bryan Christiansen, and anonymous reviewers. The chapter has also benefited the assistance of Sinan Ataer, Seda Şahin, Medine Akbaba, Bahadır Karatoy, and Serdar Günay for obtaining data.

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ENDNOTES

- ¹ According to *Internal Revenue Service 2012* current estimates report cited in the Alm, Bloomquist, & McKee (2015, p. 1170), 'tax gap' (or difference between taxes owed and taxes paid) in the United States to be \$450 billion annually.
- ² See for instance: Kirchler (2007); Kirchler, Hoelzl, & Wahl (2008); Kirchler *et al.* (2010); Kirchler *et al.* (2012); and Kirchler, Kogler, & Muehlbacher (2014).
- ³ One such case was a record tax fine applied Turkey's biggest media group Doğan in 2009. According to Reuters, the group was fined \$2.5 billion for unpaid taxes and the fine was equivalent to four-fifths of Doğan Yayın and parent Doğan Holding's combined market value of \$3.1 billion lira. This act seemed as "keeping a lid on media criticism of Prime Minister Tayyip Erdoğan's administration" (*Reuters*, September 8, 2009).
- ⁴ Tax amnesties are government programs that typically allow a short period of time for tax evaders to voluntarily repay previously evaded taxes without being subject to penalties and prosecution that discovery of such tax evasion normally brings.
- ⁵ Alm, McKee & Beck (1990) show that amnesties may sometimes increase compliance and tax collection, especially if individuals perceive paying taxes is the social norm and amnesty is accompanied by heightened enforcement efforts.
- ⁶ While Motherland Party could get 45.14% of the votes in 1983 general elections, it could get only 36.31% of the votes in 1987 general elections and 21.80% of the votes in 1989 local elections.
- ⁷ It is interesting to note that a considerable number of tax remissions were implemented while Turgut Özal was on charge. Özal had become deputy prime minister just after the military coup in 1980 and then prime minister in 1983 when the democratic elections were conducted. Although he became President in 1989, Özal was de facto director of the economy until he passed away in 1993. During his term, eight tax remissions were implemented.
- ⁸ For a project about tax loss and evasion in the real estate sector, we needed data on the transactional value of the real estate purchased-sold or rented and data on the values declared by the taxpayers. We knew we could not access personal data due to 'tax confidentiality principle.' The surprising thing for us however was the fact that the Revenue Administration considered even global data on assessment values declared by the taxpayers and accrued amounts as subject to the confidentiality principle and it did not share this data with us. We met 20 public officers about this issue and 16 of them stated they did not possess those data and even if they had possessed it, they would not have

had the right to share them with the third persons. Some of these officers stated that the Ministry of Finance was particularly sensitive on the issue of the confidentiality principle of taxes.

⁹ For a study presenting the case empirically for Konya see Doğrul (2011), for a study presenting the case for Şanlıurfa see Karasu and Karakaş (2012). For a theoretical study presenting the factors giving ways to tax evasion see Hacıköylü and Heper (2010).

¹⁰ An appraisal is only a rough price estimate of a property by the knowledge of the local area and recent sale prices. Whereas a valuation is the process of determining the current worth of a property. A formal valuation can only be conducted by a qualified valuer who has undertaken prescribed education and training to ensure that all features and issues related to a particular property are taken into account.

¹¹ As Tanzi (2016, chapter one in this handbook) indicates, the introductions and growing use of computers in recent decades has made it easier for tax administrations to store, retrieve, and cross-check information on taxpayers all over the World.

¹² Before these two improvements, it was extremely difficult to check out if declarations of taxpayers reflected the truth or not. Moreover, these improvements reduced the possibility of false tax declarations.

¹³ See for instance, Isaac and O'Leary (2012).

¹⁴ We would argue that this is an important privilege. Workloads of the first 30 companies is expected to increase dramatically and the share of fixed expenses per each valuation would be expected to decline significantly. Another advantage of being a state approved company would be that, they may employ new valuation experts and other staff much easier and grow much faster.

¹⁵ First 30 companies of the tender can be given privilege in this issue.

¹⁶ See also James (2016, Ch. 3 of this handbook) in this respect.