# SUMMARY

National and international corruption indices suggest that the Bulgarian tax administration has an important role to play in fighting corruption. While the general public and the business community are inclined to think better of the tax administration, in terms of the levels and spread of corruption, by comparison with other institutions, such as customs, the police or the judiciary, corruption in the tax administration is still admittedly rather high. Business largely believes that most, if not all, tax officers are involved in corruption. Over the last five years, one out of five businesses on average has come under corruption pressure at the hands of tax officers. While they would not go as far as to accept the taxpayers' perception of the situation, members of the tax administration do not deny the problem. They see the administration's functional areas for Tax Audit and Operational Control as worst affected in terms of, respectively, the amounts of money changing hands and the frequency of such transactions.

International surveys are inconclusive about the level of corruption in the Bulgarian tax administration on a comparison basis. The World Economic Forum rates it as relatively low within the enlarged European Union. By contrast, the World Bank has found it to be higher than corruption levels in most of the Balkans and the former Soviet republics.

The purpose of this study is not primarily to add another estimate of the level and scale of tax corruption in Bulgaria but rather, to contribute to an in-depth diagnosis of the phenomenon in terms of its drivers at work in individual and institutional behaviour.

In most cases, tax corruption takes the form of a business transaction between two beneficiaries. If it is not a matter of administrative extortion related to voluntary compliance, a bribe is the reciprocation of benefit between a tax officer and a taxpayer to the detriment of business competitors and the Treasury, i.e., the other taxpayers. Furthermore, to understand tax corruption properly and counteract it effectively, we must distinguish between ***tax clientelism*** (or 'state capture') and ***conventional tax corruption***. We define the former as changing the existing statutes and regulations, i.e., the rules of the game, for unlawful consideration to serve vested business interests or a 'political clientele', while the latter is the misuse of official powers in the process of implementation and enforcement of the existing statutes and regulations. It is in this latter case that we should further make the distinction between ***corruption related to fraud and other offences under the tax law and corruption related to the delivery of services to taxpayers*** in connection with voluntary tax and social security compliance. This study goes beyond the narrow understanding of a briber as a mere victim – an understanding which lies behind the victimisation approach to corruption. Unlike corruption related, for instance, to business licensing or permitting procedures, or to the delivery of various public services, tax corruption does not quite lend itself to the victimisation approach. Indeed, taxpayers are largely victims of corruption related to

voluntary tax and social security compliance; however, this kind of corruption takes place on a considerably lower scale than corruption related to fraud and other tax offences.

Like any business transaction, a corrupt transaction is a function of the supply and demand of certain services, which certain civil servants are ready to provide to taxpayers at a certain price: a bribe or another service. Therefore, for the purposes of anticorruption policies, it is equally important to understand the demand-side (i.e., on the part of business) and the supply-side (i.e., on the part of the administration) drivers of corruption.

Broadly speaking, business pays for two groups of corrupt services: tax evasion and 'preferred customer' treatment. To the briber, the net benefit of tax evasion equals the tax saved less the bribe. In the case of preferential treatment, the briber's net benefit equals his or her opportunity cost of time saved less the bribe. Where such preferential treatment concerns a tax refund, the 'service' has a value directly measurable as a proportion of the tax refund. **Hence, all other things being equal, the higher the tax burden and the lower the administration's effectiveness and the price of corrupt services, the higher the briber's incremental benefit.** Another consideration to plug into this equation is the briber's level of certainty that the corrupt tax officer will deliver that for which he or she has been paid.

The understanding that most corrupt transactions reflect the briber's wish to advance his or her own interests has important practical implications for policymaking. First, it explains why tax corruption is hard to fight through changing ethical values. Secondly, it indicates that the impact of „market forces" should not be overestimated. Last but not least, it leads to the conclusion that anti-corruption measures inspired by the victimization approach such as hot lines and other 'whistle-blowing' arrangements may have limited effect. While these are all necessary to some extent and should by no means be discouraged, policy interventions should be guided by the clear understanding that both parties to corruption seek and stand to benefit from it and that anticorruption measures would have to overcome opposition from both.

If, as it is in most cases, the briber's incremental benefit is higher than the bribe amount–which makes the transaction possible in the first place–why monitor and fight corruption at all? This question suggests a counterargument to the victimisation approach: ***tax corruption is 'oil in the wheels of business'.*** To understand why this argument is a mere fallacy, we must introduce another fundamental distinction: that between the individual business cost and the economic cost of corruption. To begin with, at the micro level of an individual business, the effect of a corrupt transaction is not always positive: quite often, the entrepreneur would bribe the tax officer to avoid greater loss, rather than make a profit. This is especially the case where corruption is driven by the excessive bureaucratic burden of voluntary compliance. Secondly, the argument that corruption is 'oil in the wheels of business' is based on the assumption that bureaucratic burden is a given (or exogenous). Thus, bribery is perceived as an almost institutionalised means of overcoming administrative red tape and, therefore, as a business-enabling factor. In reality however, the opposite is true: bribes encourage the administration to increase red tape, so as to get more bribes, and the overall bureaucratic burden grows heavier. The cost-benefit analysis of corruption on the basis of individual transactions distorts the picture as it fails to take into account the

overall long-term economic effect. In other words, the cost of corruption to an individual business depends not only on its own answer to the question „To give or not to give?“ a bribe but, also, on the quality of the environment, more or a less corrupt, in which it operates. As is the case with all negative externalities, the net private gain resulting from a concrete corrupt transaction is smaller than the public loss in terms of market distortion and misallocation of resources in the economy.

Therefore, to argue that business is the 'victim' of tax corruption or that, alternatively, tax corruption is the 'oil' in the business machine does not really work in terms of policy effectiveness and efficiency. Businesses' direct corruption-related costs are but one aspect of the cost of corruption. In the context of a single deal and in the short run, they are indeed likely to be smaller than the benefits. More important, however, is the economic cost incurred by businesses on account of market distortions and unfair competition created by corrupt practices. This cost could hardly be mitigated by more competition in the corrupt services market or by the institutionalisation of bribery.

Despite some early signs of a downward trend, **tax corruption in Bulgaria is still a major obstacle to market competition based on the principles of the level playing field and clear and predictable rules of the game.** To curb tax corruption is therefore a major priority of economic policies seeking to improve the business environment and the economy's competitiveness, and to encourage investment, innovation and growth.

The analysis of what drives businesses to look for ways of getting around the rules (and, if needs be, pay a bribe to get away with it) focuses policymaking on two groups of impacts. The first one covers tax reduction measures; the second one would seek to reduce the bureaucratic cost of compliance.

***Tax burden.*** In recent years, direct taxes in Bulgaria have been significantly reduced. However, this has not resulted in any proportionate decrease in tax evasion or the related corruption. The main reason why the effect has fallen short of expectations is that tax reductions have not been coupled with a reduction of the excessive burden of statutory social security contributions. This latter burden is still a strong disincentive to employers' reporting of their actual labour costs. Accordingly, the twofold effect of this behaviour is to: (i) erode the personal income tax base, as, in the absence of any sources of personal income other than the employment contract, the employer is solely responsible for the filing of a tax return on behalf of its employee; and (ii) widen the spread of various 'book-cooking' practices to conceal the discrepancy between higher wages actually paid out and the ones reported for social security purposes. Needless to say, this situation is a permanent generator of corruption pressure in both directions. Therefore, of tax policy measures, reducing the social security burden has the strongest medium-term anticorruption potential.

***Compliance cost.*** In addition to the direct tax burden, resulting from the tax base and rates, taxpayers incur the administrative cost of voluntary tax compliance. It is measured by the time that management and administrative staff need to study the relevant statutes and regulations, make the necessary filings and tax payments, accommodate the administration's control and audit requirements, etc. Excessive compliance costs arise primarily from inconsistencies and gaps in the existing legislation, which make it difficult for taxpayers to understand the law and also compromise the uni-

formity of its implementation and enforcement. To make things worse, a considerable proportion of excessive compliance costs is generated by the poor quality of taxpayer services. There are two main ways of reducing corruption related to taxpayer services: 1. by limiting direct personal contact between clients and members of the administration, which can be done by greater reliance on e-services and the one-stop-shop principle; and 2. by introducing service level standards that, among other things, set performance time-limits.

The above certainly indicates that from the taxpayer (or business) perspective, the case is very strong indeed for non-compliance and bribery. Ignoring that might distort the assessment of the situation and the measures prescribed to remedy it, or generate unrealistic expectations about the effectiveness of such measures. This notwithstanding however, corruption-related transactions are conditioned primarily by circumstances and motives within the administration, i.e., are supply-side driven. Moreover, quite often, the taxpayer's immediate benefit from offering a bribe is produced by the tax authorities' deliberate action or inaction. **Therefore, corruption drivers within the tax administration should be the main target of anticorruption policies.**

The main causes of the spread of corruption in the tax administration, cited by most sources, include: low pay; inadequate professional integrity; deficiencies in the legal framework; conflicts of professional and personal interest; the 'get-rich-quick' syndrome, or basic greed; bureaucratic red tape. In a survey conducted by *Vitosha Research* tax officers unequivocally defined corruption as **resulting from low pay and poor professional integrity combined with regulatory and organisational incentives for corruption.**

So far, anticorruption measures in the field of taxation have relied mainly on deterrence, i.e., criminal liability and disciplinary action; strengthening of internal control; codification of professional ethics. This has been the rationale behind amendments to the Criminal Code and the Code of Tax Procedure (CTP) since 2002, the Norms of Tax Officers' Conduct introduced in April 2004, the series of attempts at creating a tax police, etc. However, while legal and ethical norms provide a solid framework for fighting corruption, their potential has so far been severely compromised by the ineffectiveness of the criminal and the administrative procedure and by deficiencies in the relevant legislation and the organisation of control and audit. In practice, a negligible proportion of corrupt practices are ever detected or successfully prosecuted, which makes the whole idea of deterrence virtually meaningless.

Therefore, without underestimating punitive measures, **this analysis focuses on the potential of anticorruption policies relying on financial incentives and on ways of eliminating the legal and the institutional factors which invite tax corruption.**

***Financial incentives.*** The reverse correlation between pay levels and levels of corruption is a fundamental theoretical proposition. Bulgarian tax officers, both at the Territorial Directorate level and at the local tax office level, unanimously identify low base salaries as the number-one problem in the tax administration and as a major cause of the spread of corruption. Accordingly, 96 per cent of the tax officers interviewed identified pay raises as a most effective anticorruption measure. The subject is most sensitive to Operational Control and Tax Audit personnel, who are also generally regarded as the most vulnerable. However, this study concludes that very little can be

done in practice to improve the pay situation. There is a significant gap between tax officers' actual income and their estimates of pay levels that would be sufficient to make them resist the temptation of corruption. In most pay categories, tax officers' income is still way below their preferred anticorruption minimum. Therefore, rather than raising base salaries across the board, a more workable solution would be to focus on the performance-based component of gross pay, reflecting and rewarding each tax officer's contribution to the success of anticorruption policies and higher collection rates. **To this end, the existing pay bonus scheme should be revised and streamlined to make it more transparent, reduce its top-down discretionary component and shift its emphasis from rewarding zealous administrative coercion to rewarding excellence in the management of voluntary tax compliance based on a more straightforward linkage with individual performance appraisal.**

The issue of salaries is not just about their absolute levels. It is equally important, in terms of corruption drivers, to focus on the perceived fairness of a tax officer's own salary as compared with those of certain others. In the final analysis, this problem area is all about the effectiveness and fairness of human resource management (HRM). In the Bulgarian tax administration, the main HRM elements–recruitment and selection; performance appraisal and related to that, career development and compensation; and training–are currently under restructuring and modernisation. **In need of further streamlining are the procedures for performance appraisal and career development and the internal competitive selection process; tighter anticorruption 'filters' are required in selection and appraisal, together with a stronger anticorruption focus in the training area.** The level of HRM's fairness and impartiality is what gives employees the assurance that their performance will be judged on merit; that their position and salary will not be jeopardised by changes of leadership; that no one will be unduly favoured to the detriment of others.

Regarding the legal and the institutional factors which encourage the misuse of official powers, this analysis has identified several broad groups of measures: narrow the tax authorities' opportunities for discretionary or selective application of the relevant statutes and regulations; enhance control and audit functions by the introduction of modern risk assessment methods; increase the effectiveness of collection mechanisms and penalties.

***Legal loopholes.*** The last few years have seen a long chain of amendments to the existing legislation in the field of taxation and financial reporting to take account of the changing environment in Bulgaria's transition and EU accession process. **That intensive, and often haphazard, lawmaking effort has only rarely been co-ordinated with efforts to strengthen administrative capacities for implementation and internal control.** As a result, the legal deficiencies and inconsistencies have been compounded by a mismatch between the lawmakers' intent and the administration's capacity to deliver on the ground. Business, for its part, has been faced with the extremely difficult challenge of knowing, at any given time, what its rights and duties really are and of planning its operations accordingly. In such an environment, the administration can easily get away with 'using its judgment' in applying the law, much as business can operate on its verge, blurred as it is. The stage has been set: enter Tax Corruption.

The First (2002–2003) Programme for the implementation of the 2001 National Anticorruption Strategy called for a number of amendments to the substantive and the

procedural tax legislation with a view to preventing the build-up of corruption pressure. Without a proper progress evaluation, those recommendations were dropped from the Second (2004–2005) Programme, attaching priority instead to the detection and investigation of corrupt practices. What is required is a comprehensive review of the existing tax and financial reporting legislation in the light of administrative practice and judicial case law, and the experience of the Methodology and Appeals Department of the General Tax Directorate (GTD). Once the legal 'sticking points' have been identified and discussed with the business associations concerned, a plan should be put in place to streamline the legal framework, complete with implementation responsibilities and a public reporting and evaluation mechanism. A number-one priority in this regard should be the adjustment of administrative structures in support of the political agenda. The entire process should be based on the principles of subsidiarity, administrative accountability, and on the coordinated effort of the Policy Support and the Methodology and Appeals Departments of the newly-created National Revenue Agency (NRA).

***Control and audit.*** The existing control and audit arrangement lays the emphasis on the scope and intensity of control, rather than on a more effective selection of auditees by the application of modern risk assessment techniques. Tighter control relies, above all, on heavier monthly reporting requirements, i.e., on preventive or *ex ante* control. However, efforts to raise collection rates continue to focus on the scope and intensity (in terms of frequency and duration) of tax audits and of operational, i.e., day-to-day control. Businesses surveyed complain about the excessive frequency and duration of on-site audits and examinations by the tax and the social security administrations. **Combined with inadequate internal control and reporting, such an extensive and haphazard approach presents ample opportunities for corruption. Moreover, its cost-effectiveness, in terms of cost per unit of additional tax revenue collected, leaves a lot to be desired.** Therefore, the process of targeting, assignment and reporting of control and audit activities needs to be streamlined as follows:

- Limit the possibilities for discretionary targeting of control and audit efforts by introducing a state-of-the-art risk assessment system.
- Streamline the reporting arrangement for audits and examinations.
- Rotate control and audit teams to prevent corrupt affiliations and the build-up of corruption pressure within control and audit teams.
- Rotate tax auditors by region and industry to prevent corrupt affiliations between auditors and auditees.
- Develop a monitoring system of individual tax officers' audit and control effectiveness.

***Penalties and collection.*** Streamlining the structure of penalties for non-compliance and tax corruption also has a considerable prevention potential. The existing structure leaves a lot of room for administrative discretion and effectively encourages large-scale tax evasion as its operation is regressive beyond the upper bound of fine brackets. Its effect as a corruption deterrent could be strengthened by a more clear coordination between the gravity of the offence and the severity of the penalty.

***Fighting VAT fraud.*** VAT fraud and the related corruption have emerged as the tax administration's greatest challenge. In theory, the chief advantage of the tax-invoice/tax-credit type of VAT system is self-administration: the buyer, if VAT-registered, has the incentive to insist on an invoice from its supplier so as to credit the VAT paid to the supplier to its own tax liability. However, it is exactly on the tax credit arrangement that VAT fraud thrives. The variety of techniques, to make sure that the fraudulent operation is impossible to trace and interdict (see Chapter Four for an illustration), **are all based on the legal possibility for an undertaking to claim a tax credit, and thus a refund, before its accomplice along the supply chain has made the corresponding tax payment; and the penalty in the event of detection is evaded by dumping the tax liability on a fictitious undertaking** or, as is quite common in Bulgaria, on one that has practically no assets and could not be the subject of collection or distraint by the tax authorities.

**The 'missing trader' technique of VAT fraud, especially in its cross-border 'carousel' version, is a serious problem throughout Europe.** Ways to address it include the effective application of the joint liability principle, together with the close cooperation among national tax authorities in the monitoring of trade and financial flows, given the absence of internal customs borders in the European Union.

Bulgaria has adopted a specific solution as an alternative to the joint liability principle, i.e., the VAT account. In theory, it is supposed to act as a safeguard against the accrual of tax liability in the name of a phantom or insolvent undertaking. Right after its introduction, however, it became clear that **the VAT account cannot be relied upon to prevent VAT fraud as it can be drawn down fairly easily and with impunity** (see Chapter Four). **Thus, while it has not done much to limit the abuse of the tax credit arrangement, the VAT account has added to the costs of compliant businesses.** Worse than that, it has effectively eliminated the joint liability risk for offenders. The experience with the VAT account calls for an in-depth cost-benefit analysis. If, as it appears, this arrangement has generated more costs for *bona fide* businesses than fiscal benefits in terms of VAT revenues, it may have to be abandoned. Fairer versions of the joint liability principle should be sought instead. In particular, the following parallel action lines should be explored:

- Narrow the opportunities for undertakings to be registered in the name of, or transferred to, fictitious or nonexistent owners.

- Narrow the opportunities for inordinate tax-credit amounts to be claimed by reporting transactions at artificially high prices.

- Narrow the opportunities for the refund beneficiary to avoid liability.

The first action line would require amendments to the relevant sections of the Commercial Act. Similar to the provisions of CTP Article 226, regarding the conveyance of title in real estate and the sale of motor vehicles, the Commercial Act should restrict business acquisitions prior to the settlement of any payables outstanding to the Treasury. **In addition, a tax audit should be mandated in the event of any change of ownership and/or management.**

**Equally important, criminal liability should be expressly provided for VAT fraud.** The existing Criminal Code does not treat unlawfully claimed VAT refunds as a special

kind of tax or financial crime. This should change, considering that VAT fraud is more akin to organised crime than to conventional tax evasion.

***Policy monitoring and evaluation.*** The list of policy priorities and measures identified here is hardly original or indeed, exhaustive. Some of these were set out already in the 2001 National Anticorruption Strategy or in the two successive Programmes for its implementation (2002–2003; 2004–2005). Yet, while the policy course has been mapped out quite clearly, progress has been modest at best. One of the main reasons has probably been the absence of an effective progress monitoring and evaluation system. That is why, in addition to the identification and analysis of the measures which could yield results in the short to medium run, **we propose a system of monitoring and evaluation indicators to measure the effectiveness of policy measures and help with their adjustment and development.** Without a reliable monitoring and evaluation system, no policy intervention will be assured of success.

The matrix in Chapter Six presents a summary of the conceptual framework and anticorruption priorities identified in the course of the analysis. It does not claim to be a comprehensive diagnostic tool but is rather an open framework designed to focus the diagnostic effort on a more balanced cost-benefit analysis from the perspectives of both parties to a corruption-related transaction and thus, focus measurements not just on the level of corruption but also on **the strength of corruption drivers.** The matrix includes similar questions addressed to taxpayers and tax officers. It is an attempt to extend the diagnostic effort toward 'harder', other than opinion-related, data derived from management information systems and other statistical sources.