1. TAX CORRUPTION AS A BUSINESS TRANSACTION

1.1. TAX CLIENTELISM AND TAX CORRUPTION

This study approaches tax-related corruption as the *misuse of official powers for private gain in connection with the delivery of services to taxpayers and the collection of taxes, or most broadly, in connection with the application and enforcement of tax legislation by the administration*. Thus, the subject of the following analysis and recommendations is administrative corruption predicated on the payment of taxes and on tax fraud and other tax offences. This kind of corruption is referred to here as *tax* (or *tax-related*) *corruption* only to distinguish it from other kinds of corruption in the tax administration, such as: corruption related to public procurement or to the recruitment of tax officers, or the various forms of clientelism, nepotism, embezzlement, etc.[1] If these latter kinds of corruption have fallen outside the scope of this study, it is not because they are nonexistent or irrelevant. Indeed, some of them may occur on a greater scale and may have more serious repercussions for the institutions and the market organisations than conventional tax corruption. More importantly even, they are a powerful generator of tax corruption throughout the administration.

This study's emphasis is on the forms and manifestations of corruption which occur most commonly in the taxation process and which could be limited by political and administrative measures of visible medium-term effect. Those other kinds of corruption mentioned above require a longer-term impact and/or one that is beyond the scope of tax policy and administration. Political clientelism, for instance, is chiefly related to the mechanics of governance and party politics in the legislative and the executive branch. Public procurement corruption, for another example, is a function of the relevant legal and institutional framework. The empirical material on which this study builds concerns mainly conventional corrupt transactions, about which sufficient and sufficiently reliable information, based on personal experience, can be provided by both taxpayers and tax officers.

In the context of this discussion, *the patronage of vested business interests by those who set the tax rules* merits particular attention. We refer to this kind of corruption as *tax clientelism*. Unlike conventional tax corruption, it does not seek the help of civil servants merely to *get around* the rules but to *change* the rules to advance certain private interests. This is a way to influence both policymaking and lawmaking. There are reasons then to distinguish such 'rule-setting' corruption from administrative corruption and to refer to it as *'state capture'* [2].

Accordingly, the question should be asked whether such corruption is possible in the tax administration. The Finance Ministry (MoF) is responsible for tax policies, and

[1] See a typology and definitions of corrupt practices in *Нончев* [Nonchev] (2004).

[2] *Hellman, Jones and Kaufman* (2001) have coined the phrase 'state capture' to denote government patronage of vested business interests in transition economies. See also *Gray et al* (2004).

Parliament makes the laws. This does not mean, however, that the administration is not involved in the rule-setting process. While it does not enact the legislation, it does participate in its drafting. Besides, it is solely responsible for the drafting of secondary, or implementing, instruments, which are much more important for practical purposes. Last but not least, given the gaps and inconsistencies in the existing tax legislation, its application is largely dependent on GTD's guidelines drafted by its Methodology and Appeals Department. All of this then suggests that the distinction between state capture and administrative corruption is not entirely justified. Indeed, it is only relevant to the extent that administrative involvement is a condition necessary but not sufficient to capture the State. The legislature, and to some extent (concerning secondary legislation), the Finance Ministry, are ultimately responsible for the legal environment. But the rules of the game cannot work on the ground without the active support or at least, the acquiescence, of key members of the tax administration. And while they may not be directly exposed to inappropriate inducements from business, there are other ways to have tax officials rewarded for the drafting and substantiation of proposals that serve vested interests.

On the other hand, the direct involvement of tax officials in state capture cannot be ruled out either. It can happen where the administration has powers to initiate statutory changes or to issue binding interpretations of the existing legislation.[3] Moreover, in such cases, the deterrents of parliamentary oversight or public pressure are not that effective: tax officials involved in state capture are not directly accountable for the damage their regulatory ideas may cause to many, much as they cannot entirely guarantee a positive outcome for a few. (Exactly the opposite is true of course in conventional tax corruption.)

It is useful, for the purposes of fighting it, to distinguish between these two forms of rule-setting corruption. In the case of indirect involvement, the tax administration drafts the rules on orders from a political client, while in the case of direct involvement, the orders come from a business client. Accordingly, countermeasures should be targeted outside the tax administration in the former, and within it, in the latter case. All other things being equal, as the institutions attain greater maturity, the administration's opportunities to set the rules on orders from business should become narrower. However, in a transition economy, the administration's role in the rule-setting process is significant and has not been fully studied yet.[4]

Even though tax clientelism, nepotism, procurement-related corruption, and embezzlement, i.e., the kinds of corruption not predicated on interaction with taxpayers, have remained outside the scope of this analysis, the countermeasures proposed here are relevant also to them. Reducing the tax burden and streamlining the administration's involvement in the drafting of tax legislation would narrow the opportunities of making inappropriate use of civil servants' expertise in the setting of rules to serve vested business interests, i.e., *tax clientelism*. The measures proposed in the field of HRM, concerning in particular selection, appraisal, career development, and com-

[3] For example, micro businesses (e.g., taxi drivers, video rentals, real estate agents) perceive the backbreaking franchise taxes they have been made to pay as serving the ambition of big players in their respective industries to crowd them out or take them over.

[4] It would be necessary, for this purpose, to select the appropriate tools for empirical research: in-depth interviews and focus groups, to analyse the processes of policy-making and legislative drafting, and the administration's role in each phase.

pensation, would certainly leave less room for *nepotism* and *influence trading*. Streamlining internal control and reporting would do a lot to prevent all kinds of financial or administrative abuse in the tax administration.

There is also another kind of 'non-tax-related' corruption in the tax administration which, in this typology, occupies the middle ground between getting around the tax payment rules and the misuse of official powers in all other ways. It is the provision of assistance to certain undertakings by divulging privileged information about a competitor or by disrupting a competitor's operations on otherwise lawful pretexts (e.g., a tax audit or examination) at certain critical points, such as the closing of an important business deal or the delivery of service to a strategic customer. Technically speaking, such actions do not set new rules of the game but rather, similarly to tax-related corruption, bend or break the existing ones. Yet, the briber's benefit does not materialise in superior service quality or unlawful tax savings but in unlawful access to company secrets or administrative leverage.

1.2. TAXPAYERS' CORRUPT MOTIVES

This study's diagnosis of tax-related corruption is based on the understanding that, like any business transaction, a corrupt transaction is the function of the supply and demand of certain services, which certain civil servants are ready to provide to taxpayers at a certain price. Accordingly, we should first analyse the demand side (the taxpayers), and then, the supply side (the administration), in terms of their respective individual motives and environmental drivers.

Tax-related corruption implies the reciprocation of benefit between a tax officer and a taxpayer to the detriment of the Treasury and of the other taxpayers. 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 from waiting in line for a service or of the tax refund made sooner–less the bribe. 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 and accordingly, the stronger his or her corrupt motives. 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. Therefore, indicators measuring the tax burden, the administration's effectiveness, bribe levels and the effectiveness of bribes can serve as a basis for the analysis of taxpayers' corrupt motives and tendencies.

Recent years have seen a significant reduction of the tax burden in Bulgaria, which has placed Bulgarian businesses at a relative advantage internationally. Yet, surveys suggest, albeit inconclusively, that bribe levels have been on the rise.[5] Does this counter the proposition that business's corrupt motives weaken with tax cuts?–Firstly, bribe

[5] See Vitosha Research (2004b), *Gray et al* (2004); FIAS (2004). The limited time horizon of these surveys means that their findings should still be regarded as preliminary or indicative, rather than conclusive or even less so, describing a trend.

levels are not the best indicator of business's response to the tax burden. More appropriate in this regard are the spread and incidence of corruption, measured respectively by the proportion of undertakings which use bribes and by the number of bribes offered. *Coalition 2000* keeps track of these in its CMS and, even though no steady trend has emerged, they have rather been falling for the tax administration, which does lend support to the argument that lower taxes mean less tax corruption. As to the observation that the bribes that are still being offered tend to be bigger, it probably has to do with other supply and demand drivers of corrupt services. On the demand side, bribe levels rising in absolute terms, might be a reflection of business's growing sales and profits. The World Bank's BEEPS surveys, for example, do monitor bribe levels in proportion to sales and profits. Yet, if taken in isolation, this indicator may also lead to the wrong conclusions about both the level of corruption and policy's effectiveness.

The explanation lies in the 'pricing' mechanisms which determine the bribe level. As a rule, supply competition does not exist in the corruption market: the tax administration, so far as tax-related corruption is concerned, is the only supplier. For the purposes of tax evasion, the administration's only competitor is the law: as long as the bribe is lower than the tax liability plus the evasion penalty in the event of detection, the taxpayer has every interest to pay the bribe. In such a supplier's market then, the taxman is the price-maker, and the taxpayer, having to choose the lesser evil of either paying the price or incurring more costs, is the price-taker. In addition, the higher the probability of detection and punishment, the higher the 'risk premium' that the tax officer builds into the price of the service. Therefore, all other things being equal, anticorruption measures may push the average level of informal payments up, resulting in higher average corruption expenses for the businesses prepared to pay them. Not that there is anything wrong with this, as long as the increase in bribe levels decreases the number of such businesses and the number of corrupt transactions.

Another aspect of corruption, as important as the direct corruption costs incurred by businesses and households, is its indirect economic cost. Of that, the fiscal cost of corruption in the tax administration is relatively straightforward and easier to measure–as a proportion of uncollected tax revenue, i.e., taxes evaded or unlawfully refunded. In this regard, the following question is valid: If taxes as such do not generate incremental national income–being merely a transfer of funds from the private to the public sector in respect of public goods produced, not infrequently to inferior quality and with low efficiency and doubtful effectiveness–then, what conceivably could be the economic cost, if any, of taxes uncollected or saved?

The question of what size government is best is the biggest question in public finance. Without going further into this discussion, we should note that, in the context of tax policy and administration, the question is not about the size of the tax burden but about its equitable distribution. The lack of uniformity in the application and enforcement of the tax legislation, i.e., the redistribution of the tax burden from tax-evaders to compliant taxpayers, impedes competition and distorts market and pricing mechanisms. Conversely, uniform application and enforcement helps increase budget revenues and reduce the tax burden across the board, thereby weakening corruption motives.

Secondly, in the pursuit of their self-seeking interests, businesses contribute to the creation of a corrupt environment of unfair competition, which costs them more in the

medium run than their direct bribe expenses.[6] Surveys of the business environment in Bulgaria have found that unfair competition is business's greatest problem[7] , and likely, its strongest motive to choose tax corruption. Indeed, unfair competition is largely the product of individual acts of corruption. If a business is unaware of this, its decisions to seek corruption-related quick fixes are conditioned solely by direct costs. Are Bulgarian businesses aware of the indirect economic cost of corruption?–The answer, it would seem, is 'Yes'–for quite a few of the big taxpayers at least. According to a 2003 corporate capital survey, 39 per cent of the respondents related their understanding of corruption to market distortions; 28.6 per cent cited unfair competition in the same context; and as many pointed a finger at the shadow economy.[8]

1.3. INCENTIVES AND DETERRENTS FOR THE ADMINISTRATION

Tax officers are more inclined to corrupt behaviour the less satisfied they are with their pay levels or with the fairness of career development and financial incentive schemes. Tax officers' 'feel-good factor' is a function of their perceived risk of losing their job in the event of a leadership change and of their assessment of career development opportunities and pay levels, and the extent to which these reflect their qualifications and performance. This is the reason why analysts have increasingly focused their anticorruption recommendations on incentives, rather than deterrents.[9] Of these, HRM tools are the most important and most promising.

In a broader context, tax officers' attitude to corruption is conditioned by their perception of the general state of affairs in society and of the spread of corruption beyond their immediate working environment. Other things being equal, the more pessimistic a tax officer is about social change and the more widespread he or she believes corruption to be, the more likely he or she is to become involved in corrupt dealings. Therefore, this public-opinion element should not be ignored in the analysis of supply-side corruption drivers.

Another important consideration is the severity of the punishment for corrupt behaviour and the likelihood of it being punished, i.e., detected and proved. This is the deterrence aspect of anticorruption policies, which has mostly been the focus of such policies so far. Made up of legal definitions of corrupt behaviour and of provisions for the appropriate criminal or administrative liability, it is a sound basis for preventive action, but both national and international corruption indices suggest that its potential has gradually been spent.

Deterrence based on detection and punishment relies for its effectiveness on internal administrative control, as well as factors external to the administration, such as the effectiveness of judicial proceedings. Indeed, it is with internal control that the detection and evidence gathering process begins, before it ends up in court.

Incentives and deterrents determine a tax officers individual choice of whether to take or refuse a bribe. In addition however, there are a number of factors that decide

[6] See *Tanzi* (1998, p. 582-586).
[7] Vitosha Research (2004b), Appendix 3, Table 1; and also FIAS (2004).
[8] *Ангелова и др.* [Angelova et al.] (2003, p. 29, Table 3).
[9] E.g., *Das Gupta et al* (1999).

how possible or successful corrupt behaviour is. Identifying and mitigating these factors is an important part of fighting corruption in the tax administration. The relevant measures come in two groups: *tax policy* and *tax administration*.

Tax policy's anticorruption priorities should focus on streamlining the taxation system by:

(a) lowering tax rates, broadening the tax base, and reducing the number of tax reliefs and exemptions;

(b) narrowing the room for arbitrary interpretation and application of the existing legislation;

(c) minimising taxpayers' voluntary compliance costs. For example, concerning small and medium-sized enterprises (SMEs) in particular, presumptive taxation, such as the franchise tax, should be preferred, to relieve them from the burden of compliance with complex accounting standards and limit the scope for administrative discretion.

The *anticorruption priorities of the administrative reform* should focus on streamlining operations by the division of responsibilities both vertically and horizontally; and on streamlining risk management, and control and audit arrangements, and the appeals procedure.

The effectiveness of all administrative measures–incentives and penalties, and the streamlining of operations, management and control–depends crucially on one precondition, and that is the administrative autonomy of the tax service. This means both organisational and budgetary autonomy. It is the single most important way of ensuring accountability and transparency; it will minimise the chances of involving the administration in political corruption and clientelism. Last but not least, administrative autonomy is necessary to ensure the transparency of the correlation between the operational budgets of administrative and functional units, including individual officers' salaries, and the contribution of each unit and officer to the effectiveness of anticorruption measures and tax collection efforts.

1.4. SELF-REGULATION

Some new versions have emerged of the old proposition that corruption is 'oil in the wheels of business'.[10] Here, we shall only discuss briefly two 'optimistic theories' on the self-regulation of corruption. One of these proposes that the vicious circle of corruption leading to unfair competition leading to more corruption can be broken by competition in the corrupt services 'market' leading to a low-level price equilibrium, i.e., lowering corruption as a business barrier.[11] However, this can hardly work within a single administrative area where the services supplied are fungible. As pointed out already, the tax administration is a single supplier, and its members are hardly capable or desirous of competing with one another. So far as the competition among buyers is concerned, i.e., an increase in the supply of bribes or in the demand for corrupt serv-

[10] See *Tanzi* (1998) for an overview and critique of the relevant literature.
[11] Such a scenario has been proposed, for example, by *Gray et al* (2004, p. 16).

ices, all other things being equal, this can only push prices up. That is to say, if the theory assumes that as more taxpayers offer to bribe them, the tax officers will be prepared to settle for smaller bribe amounts, such a correlation is unknown to have been confirmed empirically.

The competition theory would be rather more plausible where different corrupt services are supplied by different administrations. If a business is assumed to have a spending limit for such services, all other things being equal, the higher corruption cost of, say, winning a public procurement contract would leave it with less funds to pay for the evasion of taxes and customs duties. Limited corruption resources would flow to the highest-return deals and that could create competition between corrupt services and the administrations offering them. Indeed, this hypothesis might explain the reorientation of demand from traditional corruption, such as tax and customs-related, to corruption in the public procurement sector. There are indications of this both in Bulgaria and in other CEE countries, especially with the growing absorption of EU funds.

It must be noted, however, that such competition would have the least effect on tax corruption. The reason is that the concealment of income or the overstatement of expenses, which generate the purchasing power for corrupt services, cannot do without tax corruption. The fact is that tax corruption is the key to all other kinds of corruption. Therefore, if corruption costs for, say, building permits, licences or public procurement contracts are on the increase, the level of tax corruption cannot fall dramatically.

The second 'optimistic theory' on the spread of corruption is that, as corruption becomes more common, the pricelist of corrupt services will be stabilised and the cost of corruption will simply be built into the cost of goods sold and the sales price. Thereby, corruption will cease to be a growing obstacle to business development. In all fairness, such cost management might work in corruption related to the delivery of administrative services or even, in customs fraud, where both parties to the corrupt transaction are assured of their respective benefit. However, in tax audits and examinations, there is always an element of uncertainty: the tax authority may not always establish the full scale of evasion, while the taxpayer may not always know what proportion of documented expenditure will be allowed for tax purposes, considering the administration's discretionary powers of legal interpretation. Thus, even if the pricelist were fixed, the base to which it is to be applied would remain uncertain and negotiable.

In summary, the economic effect of tax-related corruption is measured, above all, by business's direct corruption costs. 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 two parties to corruption reaching some sort of a general agreement on direct corruption costs.