5. DETERRENCE AND PREVENTION

Efforts to curb or deter corruption have a long history, but they were first placed in the context of clearly defined long-term objectives by the adoption of the National Anticorruption Strategy (CoM Decision 671/01.10.2001). The Strategy has a special section on policy priorities regarding the tax and the customs administration. These were subsequently fleshed out with medium-term objectives in the framework of two successive Implementation Programmes: for the 2002–2003 period and for the 2004–2005 period. Yet, while the policy course has been mapped out quite clearly, progress has been modest at best, one of the main reasons being the absence of an effective reporting and evaluation system.[32]

Therefore, in the immediate, the emphasis should be laid on the identification of problems regarding the implementation of measures already adopted. It is of crucial importance to try and avoid the rather frequent weakness of strategic planning cycles in the public administration, where excellent strategies and programme documents are put on paper but, shortly before the time is up to report on progress, are replaced with new ('updated') versions to postpone the admission of responsibility for the lack thereof.

The main achievements so far in corruption deterrence and prevention have been in the fields of criminal law and administrative control. With respect to the tax administration, the latter is broadly divided into internal and external control. External financial control and audit is performed by the Audit Office, and the Public Internal Financial Control Agency (PIFCA) provides internal control, together with the tax administration's own Inspectorate departments. Attempts at a codification of professional ethics as a base for administrative liability are relatively recent. Since April 2004, the tax administration has had *Norms of Tax Officers' Conduct*.

The analysis, in the previous chapters, of corruption drivers, affecting respectively the business community and the administration, has shown that, while important, the existing legal and administrative measures are hardly sufficient. They focus on deterrence, and in modern tax administrations, the focus has been shifting steadily toward institutional drivers of corruption and anticorruption incentives (i.e., salaries and benefits, and the related selection, performance-appraisal, and career-development mechanisms).

So far as the tax officers are concerned, they are decidedly in favour of higher pay levels, narrower freedom of arbitrary legal interpretation, and better taxpayer

[32] The only publicly available report is on the second implementation programme and covers a 10-month period (January–October 2004): *Комисия за координация на работата по борбата с корупцията, „Отчет за изпълнение на задачите от Програмата за изпълнение на Националната стратегия за противодействие на корупцията 2004 –2005 г."* [Anticorruption Coordination Committee, *Progress Report on the 2004–2005 Programme for the Implementation of the National Anticorruption Strategy*.] See excerpts from the Strategy, the two implementation programmes and the progress report in Appendix 2.

service as ways to prevent corruption (Table 11). According to them again, the main areas in which relative anticorruption progress has been achieved include: the adoption of ethical norms; the strengthening of control and transparency in operational processes; and the improvements in the staff recruitment and selection system (see Figure 13). Relatively less has been achieved in narrowing the freedom of arbitrary legal interpretation by the administration; and the measures aimed at streamlining the financial incentives system have not performed to their full potential.

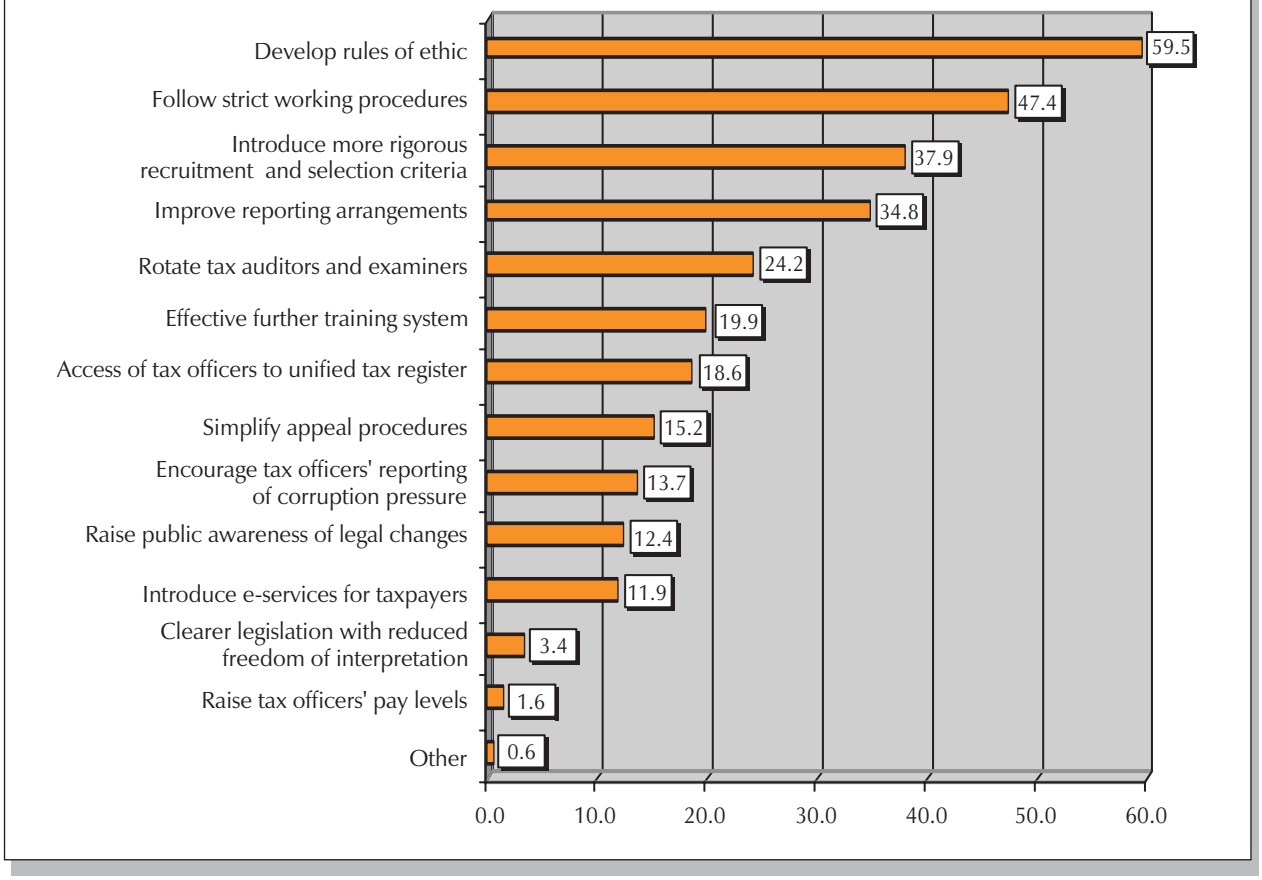
Table 11. What Measures Should be Adopted to Curb Corruption in the Tax Administration?
(% of respondents)

	Yes	No	Done Already	DK/NA
Raise tax officers' pay levels	95.6	0.7	1.6	2.1
Narrow the freedom of arbitrary legal interpretation	90.7	3.0	3.4	2.9
Increase public awareness	81.0	4.6	12.4	2.0
Introduce e-services	78.5	4.6	11.9	5.0
Encourage the reporting of corruption pressure	69.7	11.4	13.7	5.2
Effective further training system	68.5	8.4	19.9	3.1
Control access to the single tax register	63.8	8.2	18.6	9.4
Simplify appeal procedures	59.8	12.7	15.2	12.3
Improve reporting arrangements	48.4	10.7	34.8	6.2
Rotate tax auditors	47.1	18.2	24.2	10.6
Follow strict working procedures	44.2	5.2	47.4	3.3
Introduce more rigorous recruitment and selection criteria	43.9	13.0	37.9	5.2
Develop rules of ethic	26.8	10.2	59.5	3.6
Other	0.9	16.9	0.6	81.7

Source: Vitosha Research, April 2004. Base: 699.

This is why, the focus of this study is on two major groups of anticorruption measures. The first group relates to financial and other incentives in the framework of the HRM system; and the second group brings together measures addressing the legal and the institutional drivers of corrupt behaviour.

Figure 13. The Tax Officers on Anticorruption Measures Already in Effect
(% of respondents)



Source: Vitosha research, April 2004. Base: 699.

5.1. FINANCIAL INCENTIVES AND HRM

Base Salary Levels

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 (See Table 11). As already noted, the subject is most sensitive to Operational Control and Tax Audit staff, who are also generally regarded as the most vulnerable to corruption.

While empirical evidence does exist in support of the reverse correlation between pay levels and corruption,[33] the feasibility of this proposition in corruption prevention

[33] See *Van Rijckeghem and Weder* (1997); *Haque and Sahay* (1996).

is rather limited. The usual stumbling block in high-corruption countries are hard budgetary constraints. Besides, surveys have shown that pay raises do not go far enough in their anticorruption effect to offset their considerable fiscal cost.[34] The question is indeed about the real anticorruption benefit that would justify such a cost.

The survey of tax officers revealed an indirect confirmation of the limited effect of base salaries on corruption. It did not establish any correlation between tax officers' age and length of service, on the one hand, and their susceptibility to corruption, on the other. More than two thirds of the respondents (regardless of age or length of service) deny the existence of any such correlation (see Appendix 6). But, under the existing pay system, tax officers' average income does rise with seniority and, by inference, does not affect corrupt behaviour either way.

A counterargument to this could be that the correlation, reverse or otherwise, does not appear until base salaries have reached a certain critical anticorruption mini-

Table 12. Gap between Perceived Anticorruption Minimums and Actual Income Levels*

	„What should your minimum pay level be for corruption motives to be brought to a minimum?"									
Min. Pay (BGN)	**300**	**400**	**450**	**500**	**550**	**650**	**800**	**1,000**	**DK/NA**	**Total**
Respondents %	**3.6**	**5.7**	**3.4**	**14.0**	**7.2**	**12.4**	**16.7**	**25.8**	**11.2**	**100.0**
Family Income (BGN)										
< 149	4.0 %	0.0 %	0.0 %	0.0 %	0.0 %	1.1 %	0.9 %	1.1 %	1.3 %	0.9 %
150-199	8.0 %	0.0 %	0.0 %	2.0 %	2.0 %	1.1 %	3.4 %	2.2 %	0.0 %	2.0 %
200-299	12.0 %	15.0 %	25.0 %	10.2 %	10.0 %	6.9 %	6.8 %	6.1 %	11.5 %	9.2 %
300-399	20.0 %	27.5 %	12.5 %	18.4 %	22.0 %	20.7 %	15.4 %	14.4 %	11.5 %	17.0 %
400-499	28.0 %	17.5 %	33.3 %	21.4 %	16.0 %	24.1 %	16.2 %	11.7 %	12.8 %	17.5 %
500-599	12.0 %	15.0 %	16.7 %	20.4 %	18.0 %	10.3 %	15.4 %	11.1 %	16.7 %	14.6 %
600-699	12.0 %	15.0 %	4.2 %	9.2 %	14.0 %	13.8 %	13.7 %	15.0 %	9.0 %	12.6 %
700-799	0.0 %	0.0 %	0.0 %	7.1 %	10.0 %	5.7 %	10.3 %	12.8 %	7.7 %	8.3 %
800-899	4.0 %	5.0 %	0.0 %	1.0 %	2.0 %	5.7 %	4.3 %	10.0 %	3.8 %	5.2 %
900-999	0.0 %	2.5 %	0.0 %	4.1 %	2.0 %	4.6 %	5.1 %	5.6 %	9.0 %	4.7 %
>1.000	0.0 %	2.5 %	0.0 %	1.0 %	2.0 %	4.6 %	4.3 %	6.7 %	6.4 %	4.1 %
N/A	0.0 %	0.0 %	8.3 %	5.1 %	2.0 %	1.1 %	4.3 %	3.3 %	10.3 %	4.0 %
	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %

* Highlighted percentages indicate the proportion of the respondents whose actual family income (Column 1) is equal to, or higher than, their perceived anticorruption minimum pay (Row 1)

Source: Vitosha Research, April 2004, base 699, and the author's own calculations.

[34] See more in *Пашев* [Pashev] (2005).

mum. The survey elicited the tax officers' estimates of such a minimum and compared them with their current income levels. The result is a very wide gap indeed between the one and the other, current pay levels being much lower. Almost 26 per cent of the respondents suggested an anticorruption minimum monthly salary of BGN 1,000. Together with those who believe that it should not fall below BGN 800, they make a considerable majority of 42.5 per cent. At present, a negligible proportion of TTD and local-office staff receive comparable salaries. In Table 12, the highlighted percentages show the proportion of those whose current family income is equal to their perceived anticorruption minimum, i.e., those who regard themselves, income-wise at least, as immune to corrupt temptations. Thus, a mere 12 of the 180 respondents (6.7%) who estimate the anticorruption minimum at BGN 1,000 actually have comparable family incomes. Almost half of these 180 report family incomes which are lower than 60 per cent of their perceived anticorruption minimum. Another 16.7 per cent propose BGN 800 as an anticorruption minimum but only one out of seven of them has a family income that makes it a reality. Approximately 43 per cent of all the respondents have family incomes lower than 60 per cent of their respective anticorruption minimum. The overall gap between actual incomes and perceived anticorruption minimums is measured by the number of tax officers whose actual income is below their respective anticorruption minimum, regardless of the relative discrepancy between the one and the other. Thus, it becomes a useful indicator of corruption vulnerability (or the strength of supply-side drivers). More importantly still, it shows the need for considerable public spending if corruption is to be curbed by pay raises.

But 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 HRM's effectiveness and fairness. HRM's main elements include: recruitment and selection; performance appraisal and related to that, career development and compensation; and training. Particularly relevant, in the context of this study, are HRM incentives and penalties related to professional ethics, including ways to encourage officers to report cases of corruption pressure applied on them. Modernising and streamlining these would give employees the assurance that their performance will be judged on merit; that their position and salary will not be jeopardised by changes of leadership[35]; that no one will be unduly favoured to the detriment of others.

Recruitment and Selection

In the last few years, and especially in the framework of the Revenue Administration Reform Project, the foundations were laid of a modern recruitment and selection system for tax officers. Applicants are assessed on the basis of job descriptions reflecting the operational functions of the unit applied for. The system tries to integrate professional qualifications and personal qualities in the selection process, and, as far as possible, eliminate subjectivism. Indeed, recruitment and selection is among the areas in which the tax officers in the survey have seen relative progress being made (see

[35] An aggravating factor in this particular regard is that tax officers in Bulgaria do not enjoy the status of civil servants. On the other hand, in its existing form, it would hardly be attractive to them, as they would have to give up their relatively higher base salaries in return for tenure of a rather doubtful effectiveness.

Figure 13). Nonetheless, according to approximately 6 per cent of the respondents, the buying of appointments is still one of the widest-spread corrupt practices. Apparently, the 'exceptions' to the otherwise well thought-out recruitment and selection process should be fought more rigorously, and overall, the system should be more open to control and participation by the staff of the units for which new appointees are selected. In addition, for the purposes of preventing corruption, applicants should come under a more professional character scrutiny. A special assessment methodology should be developed for the functional areas most vulnerable to corruption pressure, including more focused anticorruption testing in addition to the standard psychological tests.

Performance Appraisal and Career Development

The performance appraisal and career development system is even more important in terms of anticorruption incentives. It is made up of three very potent tools:

(a) base and supplementary compensation-setting;

(b) internal selection (promotion); and

(c) training.

A lot has been done to ensure that these three are linked together in a fair and transparent way. Performance appraisal is always done by a panel of two, including the officer's administrative manager and functional supervisor. However, the fairness of the appraisal could improve appreciably if, in advance of it, every officer were set concrete tasks and objectives to achieve and had a clear awareness of the indicators by which their achievement would be judged. Secondly, in addition to appraisal by superiors, elements of peer and upward assessment should be introduced more broadly. Last but not least, the appraisal should be based, to a greater degree, on client feedback, using techniques such as the so called 'mystery shopping'.

Another salient feature of the system is the wide range between the minimum and the maximum levels of base monthly salaries by position. This does allow greater flexibility and a more effective use of compensation as an incentive. Yet, if the method of setting compensation levels lacks in clarity and transparency, the wide range between the lowest and the highest pay may accommodate unfounded decisions and allow the system to be used for rewarding loyalty to superiors, rather than loyalty to the institution.

Another weakness of the existing performance-appraisal and performance-based compensation scheme is that the correlation between performance and compensation seems to work only in the upward direction. It is counter-productive, if performance has been appraised as 'unsatisfactory', to set an officer's compensation at the lower limit for his or her position. It would be better instead to give the officer time to meet the performance criteria and, in the event of failure during the following appraisal cycle, reappoint the officer to a lower position or terminate his or her contract. In this regard, the system of administrative and disciplinary sanctions should also be streamlined (see more on this under 5.2).

An important element of the career development system is the procedure for internal selection, expressly based on the principle of competition. In this connection,

training also becomes more relevant. Considerable funds have been channelled to this area in recent years in the framework of twinning projects with EU partners and as part of the World Bank loan for the establishment of the National Revenue Agency. In the context of Bulgaria's coming EU accession, the tax administration will have to meet the higher requirements of cooperation with its EU counterparts at all operational levels. In the unequal battle with the well-organised international VAT fraud networks, the Bulgarian tax officers will have less time to waste on the lengthy approval process up and down the administrative hierarchy. Instead, the direct exchange of experience and expertise, and the principle of direct joint operation should spread to the very lowest operational level.

Training and the exchange of experience could gain in effectiveness from a broader training-of-trainers effort. Most important in this regard is the selection of in-house trainers. These should of course be highly experienced professionals, but they should also be highly motivated to seek out new knowledge and master new skills, and above all, be eager to, and capable of, imparting what they have learnt to their co-workers. Officers holding management positions do not rather fit this profile. In addition, self-training should be encouraged, together with various forms of on-the-job training, and the process should be followed up by monitoring and evaluation, and its output, fed back to the performance appraisal system.

Pay Bonuses

Rather than raising pay levels across the board, modern tax administrations rely increasingly on the motivational potential of that portion of tax officers' compensation which is not fixed but is directly dependent on their individual contribution to tax fraud detection and corruption prevention. By way of an incentive, pay bonuses are much more flexible than base salaries and allow a more accurate targeting of limited financial resources. A pay bonus scheme can largely overcome three of the limitations of base salary incentives: budgetary constraints; the difficulty of choosing the most effective anticorruption pay level; and the issue of fairness. In addition, it avoids indiscriminate spending and focuses the financial incentives on the most important functional areas, i.e., Tax Audit, Operational Control, and Inspectorate. For it to be effective however, a pay bonus scheme largely depends on the proper organisation of operations in these functional areas. It will not work to its full potential if it allows certain tax officers or taxpayers to be favoured by the targeting and assignment of tax audits and examinations, or if the reporting of operations is not automated and straightforward. In addition, as the distribution of bonuses is based on each tax officer's comprehensive performance appraisal, such a scheme also depends on the effectiveness and transparency of the HRM system.

In all fairness to the Bulgarian tax administration, its *supplementary financial incentives scheme* (SFI) is superior, in a number of ways, to the similar arrangements in other administrations, and in terms of clarity and transparency, even to many in the private sector. The scheme is funded with appropriations from the so called 'correction revenues'. Pursuant to the Code of Tax Procedure, 25 per cent of tax correction amounts (i.e., additional tax liability assessed) stay with the administration as its own revenues. These are made up of taxes, fees, interest, and fines assessed on the basis of taxpayers' established non-compliance, such as understatement of tax base, overstatement of tax

credit, overstatement of loss carried forward from previous years, etc. All correction amounts are collected pursuant to an effective tax assessment instrument. Of the portion which stays with the administration, 35 per cent[36] (or 8.75% of the total collected) is appropriated to SFI. At that, most of the appropriation is set apart for direct distribution to the 'front-line' officers in the fight against tax fraud and corruption, i.e., at TTDs and local tax offices, which get 90-92 per cent of correction revenues,[37] and the Large Taxpayers TTD alone gets 30 per cent. Thus, the appropriation, which is a direct function of a TTD's performance, is distributed by quotas among its departments and functional units, and most of it goes to: Tax Audit (up to 76% at the Large Taxpayers TTD, and up to 36%, at the other TTDs); Taxpayers Registration and Services (24% at TTDs, and 7%, at Large Taxpayers); and Operational Control (15%) and Collection (5% at TTDs, and 4%, at Large Taxpayers.[38] Some units can have their quota raised by 5-10 percentage points if other units have undistributed quotas left.

In addition to the direct appropriation, TTDs and local tax offices can get other SFI funds in the discretion of the General Tax Director. These can reach up to 46 per cent of the correction revenues accounted for by Large Taxpayers and are again distributed by quotas. It should be noted in this regard that the Large Taxpayers TTD accounts for some 60 per cent of all tax revenues and if operations are streamlined, its share in the administration's own revenues should be much higher than 60 per cent.

Overall, the SFI system is fairly balanced and targets with priority those functional areas which come into direct contact with taxpayers and are most exposed to the risk of corruption. Still, things could be done to improve it. Above all, 8.75 per cent is a rather modest portion of the additional tax liabilities assessed and can hardly afford adequate incentives to the officers at TTDs and local offices which have a limited revenue potential. These mostly rely on the General Tax Director's generosity for their SFI funding.

Secondly, the existing SFI arrangement strongly encourages tax collection by enforcement, while advanced tax administrations increasingly rely on compliance management. In other words, the administration's primary objective should be to help taxpayers steer clear of non-compliance, rather than catch them 'red-handed'. Of course, the main condition for this change of focus is a clear, simple and stable legal framework, and the administration has a rather limited say in that. However, the more user-*un*friendly the legal framework is, the more dependent taxpayers are on the administration for their compliance costs. The existing SFI system does not measure and reward TTDs compliance management performance. There are some valid reasons for this: unlike the detection of non-compliance, compliance management is much more difficult to evaluate and attribute to particular functional units. It is not impossible, however. Modern methods exist of measuring voluntary compliance by type of tax liability, and of its corresponding compliance gap, without which no tax administration today should approach the assessment of its effectiveness. These are gradually

[36] Of the remainder, 60 % goes to capital improvement of the physical facilities and to regulation clothing for the tax officers, and 5% is set apart for pay supplements to the officers of the Ministry of Finance.

[37] The remainder of 8-10% goes to the Regional Tax Directorates (RTD) and the GTD.

[38] The remainder (20% at TTDs and local offices, and 13%, at Large Taxpayers) is distributed as bonuses to TTD management positions and the staff of other functional areas, including: Methodology and Appeals; Finance and Accounting; Legal; General Administration and Procurement; Statistics Analyses and Projections; Human Resource Management; Information Technologies.

making their way into the Bulgarian tax administration and their application at the TTD level is only a matter of information technologies and analytical resources. Besides, even under the existing arrangement, it should not be a problem to account for both correction revenues (resulting from law enforcement) and planned revenue targets (relying on voluntary compliance) for the purpose of distributing pay bonuses. At present, the compliance-management element can only be plugged into the SFI equation by the General Tax Director distributing 46 per cent of correction revenues coming from Large Taxpayers.[39]

Lastly, to enhance its effectiveness, the pay bonus scheme should be more clearly defined in policy. Under its existing arrangement, at least half of the available SFI funds can be allocated, on a discretionary basis, by the General Tax Director. This is of course necessary in order to redistribute some of the correction amounts collected by the Large Taxpayers Directorate to the other TTDs and local tax offices. It should be done, however, on more clear criteria set in advance so that it can work as a meaningful performance incentive to both line staff and supervisors. Another linkage that could be improved is that between the bonus distribution scheme and the system of performance appraisal. While there is some clarity as to the allocation of SFI funds to structural units, it seems hazed by head of unit discretion when bonuses are distributed among staff members.

In the final analysis of performance incentives, it should not be forgotten that even the best HRM system cannot replace a fair and capable manager. It can however help a less fair and capable manager by providing the right tools for greater accountability, transparency and impartiality throughout the organisation. This is the ultimate objective of modern selection, appraisal, and training techniques that ensure a closer link between compensation and career development, and the personal contribution of every member of the organisation to its objectives.

5.2. LEGAL AND INSTITUTIONAL DRIVERS OF TAX CORRUPTION

The legal and institutional drivers of tax corruption include both the deficiencies of the relevant legislation (tax law, commercial law, and financial reporting) and the weaknesses of the institutional arrangements for its implementation by the tax authorities. For analytical purposes, these can be divided into two main groups which require, respectively, two types of anticorruption measures: 1. relating to the legislation and to tax policy; and 2. relating to the prevention of corruption by streamlining operational processes within the administration.

In the field of tax policy, anticorruption measures should focus on tax burden relief, simplification of the legal provisions and closing the legal gaps and loopholes which allow the administration to be selective in their interpretation and application. These measures should by all means also cover matters of criminal liability for fraud and other tax-related offences and involvement in corrupt dealings.

[39] To amend the situation, a weighting factor could be applied to SFI funds reflecting TTDs' voluntary compliance rate, or at least, their performance on planned revenue targets.

The anticorruption dimension of operational processes within the administration includes: the clear definition and separation of responsibilities at each structural level and in each functional area, and the introduction of clear-cut written procedures for both horizontal and vertical communication and interaction; the streamlining of the risk management system and of the arrangements for the planning, assignment, performance, and reporting of tax audit and examinations; and, last but not least, the streamlining of the appeals system. Something that is crucial in this regard is the development of reliable monitoring and assessment of tax compliance (or the compliance gap), and of the effectiveness of tax audit and operational control, and service delivery to taxpayers. A major operational effectiveness factor is the integration of all processes into a single information system, bearing in mind, however, that computerisation can never be an end in itself: national and international experience suggests that, unless the human factor is ready for change, information technologies cannot create the necessary administrative capacity for an effective anticorruption stance.

The following sections cover five main groups of measures against tax-related offences and the corrupt practices predicated on them. Given the scale and relative weight of tax corruption predicated on VAT fraud, the countermeasures in this field will be discussed separately.

Tax Burden Relief

As already noted, the tax burden is a major demand-side corruption driver. Therefore, how the tax burden is defined and measured has a significant bearing on anticorruption policies. The distinction should be made between tax burden in terms of statutory tax rates and tax burden in terms of tax revenues' GDP share.

Given its political sensitivity, the question about the size of tax revenues is among the most broadly debated in economics. However, it is not so much a tax policy question *per se* as it is a question for the government's general public spending policy, i.e., a matter of society's choice between political alternatives. While there is no divergence among economists concerning the view that too much public spending to GDP is an obstacle to private investment and economic growth, it does not follow automatically from this that the opposite is also true, i.e., the less taxes to GDP, the more successful an economy.[40] Investment success is crucially dependent on the quality of human capital, infrastructure, science and technology, administrative services, etc.–all areas in which the public sector has leading responsibilities. In short, business does not pay taxes out of the goodness of its heart–to help the government or the poor, even though they may be something of that in it–but to advance its own strategic objectives. In democracies, the level and structure of public spending are the subject-matter of a social contract (of considerable bearing on business initiative) between the citizens and their elected government on the quantity and quality of public goods and services. Taxes, then, are a means to the performance of this contract, not an end.

[40] Interestingly enough, until a few years ago, the authoritative *Global Competitiveness Report* published by the World Economic Forum in Davos relied, among other things, on public spending to GDP to rate economies' competitiveness. As the scope of the Report widened to include more Third World countries, it turned out that some of the poorest and least competitive economies in Africa had rather low levels of public spending to GDP but were, nonetheless, at the bottom of the scale in terms of economic growth and average per capita income. Based on that finding, public spending to GDP was dropped from the competitiveness index.

Therefore, the tax policy models proposed by experts do not mean to replace or prejudge society's choice but rather, to materialise that choice at the lowest possible cost of economic inefficiency and market distortion. So far as corruption in the tax administration is concerned, tax burden relief is a matter of reducing tax rates. They are the main driver of tax evasion and the corruption predicated on it. Best-size government (in terms of public spending to GDP) is a matter for society to decide. Even as a subject for discussion among economists, it does not leave the realm of public spending policy. In terms of tax policy, the challenge is to cut taxes without prejudice to fiscal objectives. In economists' jargon, this usually means that tax policy measures must be 'neutral' to public spending. And this, in turn, means that the fiscal loss of reducing tax rates must be offset by either broadening the tax base (i.e., fewer tax incentives and exemptions) or increasing collection rates, or still, in a longer-term perspective, by higher absolute tax revenues resulting from economic growth.

Recent years have seen considerable reductions of direct taxation in Bulgaria. The corporate income tax rate has fallen from 32.5 per cent in 1999 to 15 per cent in 2005. Personal income tax rates (which apply to sole proprietors and the self-employed) have fallen from a scale of 20–40 per cent (lowest–highest rate) in 1999 to 10–24 per cent in 2005. (See Table 13.)

However, these significant tax cuts did not narrow the compliance gap, which has been largely explained by the excessive burden of the compulsory social security contributions–a strong reason for employers' underreporting of labour costs.[41]

Employers' response to the social security burden has on the one hand undermined the personal income tax base. Unlike advanced tax systems, wage-bill income taxes in Bulgaria are fully withheld and remitted by the employer. Thus, in the absence of any personal income other than wages or salaries, individuals are not obliged to file a personal income tax return. While this arrangement prevents them from evading taxes, individuals cannot either, even if they so wish, pay tax on their actual income if their employer underreports their wages or salary in order to pay smaller social security contributions. On the other hand, underreporting labour costs means that employers also have to underreport sales and keep two sets of books to make the actual wage payments. This, in turn, undermines the business income tax base.[42]

In a situation like this, the considerable reduction of income-tax rates cannot result in a significantly higher voluntary compliance rate. The size of income unaccounted for has less to do with tax rates than with the underreporting of labour costs. In wage-bill income taxation, collection rates depend, above all, on employers' or self-employed persons' incentives to reduce their social security burden. In corporate income taxation, again, collection rates suffer from the underreporting of sales to pay for off-payroll labour. Needless to say, such 'creative accounting' practices invite corruption pressure both ways. Therefore, reducing the social security burden is at present the measure of highest medium-term anticorruption potential.

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[41] See. *ЦИД* [CSD] (2004).

[42] *Business income*, in this case, includes not only corporate profits but also, the incomes of individual entrepreneurs (unincorporated sole proprietorships), whose tax base is also determined under CITA.

Table 13. Income Taxes in Bulgaria, 1999–2005

	Corporate Income Tax[a]			Personal Income Tax					
	Central	Local	TOTAL[b]						
1999	25	10	32.5	**Rate**	0	20	26	32	40
	20	10	28.0	**Ceiling**[c]	900	1200	4200	15600	
2000	20	10	28.0	**Rate**	0	20	26	32	40
	15	10	23.5	**Ceiling**[c]	960	1380	4560	16800	
2001	15	10	23.5	**Rate**	0	20	26	32	38
				Ceiling[c]	1200	1620	4800	16800	
2002	15	10	23.5	**Rate**	0	18	24	28	29
				Ceiling[c]	1320	1680	4800	12000	
2003	23.5			**Rate**	0	15	22	26	29
				Ceiling[c]	1320	1800	3000	7200	
2004	19.5			**Rate**	0	12	22	26	29
				Ceiling[c]	1440	1800	3000	7200	
2005	15			**Rate**	0	10	20	22	24
				Ceiling[c]	1560	1800	3000	7200	

[a] Until 2001, undertakings showing a financial result lower than BGN 50,000 were subject to a lower rate.
[b] = Local + (100–Local) x Central.
[c] BGN ceiling of annual income bracket to which the corresponding rate is applied.
Source: Pashev (2005).

Narrower Scope for Inconsistent or Selective Application

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 delivery 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.

It has been noted already that underreporting sales is done mainly for the purpose of labour costs unaccounted for with a view to evading social security contributions. In in-depth interviews and focus groups, accountants have shared the view that the gaps in the financial reporting legislation, or else, its excessive requirements, also encourage them to keep two sets of books.[43] It does happen that business costs actually incurred are not allowed by the tax authority. In other cases, the keeping of full accounting records on petty-cash expenses is more expensive, as well as uncertain for tax purposes, than making

[43] To quote from one in-depth interview: „Keeping a cashbox 'on the side' is necessary for actual expenses which will not be allowed for tax purposes however, without the required supporting documents for even the smallest amounts. We do not have a way of knowing what our expenses exactly are before the taxman comes down to tell us what he will allow. So, if in doubt, leave it out!"

the payment out of unregistered 'pocket money'. For example, unlike the practice in many countries, the Bulgarian financial reporting legislation does not allow the recognition of a cash receipt (generated by an electronic cash register) without its accompanying invoice. This means that many undertakings which do not have electronic invoicing must issue handwritten invoices, and the prevailing practice for small transactions is to issue only a cash receipt. A simple solution could be to allow the recognition of electronic cash receipts up to certain amounts without the requirement for an accompanying invoice. This would not only help reduce, to a certain extent, business expenditure unaccounted for, but would also encourage customers to insist on the registration of sales.

The worst problems of this kind arise from CITA and VATA. The numerous amendments these two have seen have made them increasingly difficult, even to experts in the field, to make sense of, and this has inevitably led to a lot of personal judgment in the application process. One unmistakable sign of the growing complexity of the tax legislation is the great number of guidelines and opinions which GTD Methodology and Appeals has had to issue. In the course of a tax audit, the auditors would take account of this 'case law' if they can find a match in it to the situation at hand. And if they cannot, they are likely to use their own judgment, even though they have the right to ask GTD for an *ad hoc* interpretation or opinion. Not surprisingly, there have been identical cases decided differently by different tax offices, and sometimes even, by different officers of the same tax office.

Case Study

A newly founded limited liability company [OOD], non-VAT-registered, buys machinery and puts it on its tax depreciation schedule at cost, VAT included. A year later, the company registers for VAT and claims tax credit, pursuant to VATA Article 68, in respect of its existing assets. Pursuant to CITA Article 22(9), it may not modify its tax depreciation schedule. Thus, under CITA, the company pays less corporate tax because of its higher depreciation allowance based on the asset's cost inclusive of VAT, and also, under VATA, deducts the VAT paid on the asset from its VAT liability. The tax authority's decision in the case could lead to a significant restatement of the company's financial result and hence, of its corporate tax liability. As it is, GTD has no opinion of record on this scenario, in the absence of which such a company's tax liability would largely depend on the discretion of its local tax office or even, its local tax officer.

The scope of administrative discretion, and the level of its misuse, is directly dependent on the answers given to two fundamental questions of tax policy and administration. The first one is about the administration's participation in setting the rules of the game. The risk is real that, should the administration be allowed to set these rules, it would err on the side of its own safety, minimising every possibility of challenge to its decisions, i.e., giving itself the broadest discretionary powers. In this regard, business's misgivings about the administration's involvement in the rule-setting process are understandable.[44] Besides, broad administrative discretion on the application of the law has hardly ever proved itself as the best guarantee of the lawmakers' intent.

On the other hand, the administration does have a responsibility to assume for the law's applicability. Building a Chinese Wall between tax administration and tax

[44] This issue has already been raised here, under 1.1, in connection with 'grand' tax corruption, referred to in this study as 'tax clientelism'. For the business community's view on it (e.g., BIBA), see for example *Kapital* weekly, 23, 11–17 June 2005.

policy can be as harmful as giving the administration the single hand in policymaking. Indeed, one of the mistakes, admitted recently in literature on the tax reform in transition economies, is that almost nowhere were the legal-framework changes, especially those borrowed directly from advanced tax systems, tailored to the existing administrative capacity or accompanied with adequate capacity-strengthening measures.[45]

Bulgaria is a glaring example of this. The work on building a modern administration, equipped with state-of-the-art technical facilities and operational processes, and fully capable of implementing the newly-adopted legislation, had not started in practice until the launch in 2003 of the single revenue agency project, i.e., some 10 years after the first new legal measures had been introduced. But the tax system's effectiveness, like the quality of the business environment, depends to a greater extent on the accurate and uniform application of the existing legislation than on the legislation's own quality and conformity to best international practice. Even the best law is only as good as its application.

The existing legislative arrangement in Bulgaria, and legislative practice especially, has itself been inconsistent with regard to tax law-making. The Legislative and Statutory Instruments Act (LSIA, Article 2a) and Decree 883 on its application (Article 14(2.3) and Articles 53–56) do provide safeguards against the enactment and existence of virtually inapplicable statutes and regulations. Such safeguards are in place both in the drafting process and post-enactment. Pursuant to LSIA Article 2a (introduced at the end of 2003 in connection with the entry into force of the Restriction of Administrative Regulation and Control of Business Act), any person on which a new legislative or statutory instrument imposes duties or restrictions must be notified accordingly in advance and be given one month to make proposals or objections to the appropriate authority. This means that also the tax administration has the opportunity to make such proposals or objections where amendments to the tax legislation have been drafted without its participation.

Yet, the administration is somewhat jealously kept at bay in its attempts to take part in the process of regulatory impact assessment. A sign of this has been the repeal of CTP Article 8 as unconstitutional. It provided that any proposed legal changes concerning tax policy or the work of the tax administration must be accompanied with a revenue impact assessment from MoF and an opinion from the tax administration on how the proposal might impact its operations. The argument on which the provision was repealed went that, based on it, any proposed legislation could be defeated by the administration's passive resistance, contrary to the separation of powers. True as this may be, the constitutional ruling has deprived the legislature of important expertise on the applicability of proposed tax legislation and of a way of securing the administration's commitment to its implementation. Rather than releasing the administration from such functions, the relevant legal provisions should be combined with safeguards against its passive resistance. That is to say, if the administration fails to fulfil its duties in the lawmaking process, it should be made to do so, rather than be left out of the picture altogether. Thereby, a number of implementation problems could be foreseen and addressed already in the legal drafting phase.

Of course, the administration must be ready to assume such duties, which means that its natural ambition to secure more room for its own manoeuvring should give

[45] E.g., *Martinez-Vazquez and McNab* (2000), and the literature cited there.

way to considerations of effectiveness and efficiency in tax collection and the lowering of taxpayers' compliance costs.

A priority in this regard should be to streamline the policy-support function within the administration. In keeping with the principle of subsidiarity, the administrative units responsible for the tax legislation should be brought, as much as possible, closer to the administrative units responsible for its implementation and to the taxpayers, in the interest of both the legislation and the taxpayers. At present, there are two centres for legislative analysis and support in the field of taxation: MoF Tax Policy and the corresponding GTD/NRA departments. This setup requires a lot of coordination and consultation, and dilutes responsibility. In addition, the risk is real, where the primary legislation has been drafted without proper regard to the administration's views, that the secondary legislation and case-by-case guidelines issued by the administration may deviate more widely from the lawmakers' original intent.[46] The tax administration must of course be fully responsible for making sure that the legal changes it proposes are consistent with the government's political commitments to the voters and to the EU, as evidenced by proper impact assessment. To this end, however, an additional dedicated unit at the MoF is hardly necessary.

Undoubtedly, no amount of statutes and regulations, however good, can fully eliminate the need for the implementing authority's judgment. Market realities are such that they always change at a faster pace than the legislation can keep up with, so there will always be situations to which the law cannot be applied in one definitive way. The discretion used in such cases must be, as much as possible, unbiased and consistent with the law's purpose. In this regard, the relevant GTD guidelines and opinions, and their application by line staff, are crucial. Such guidelines and opinions are issued by the Methodology and Appeals Department. The function should be streamlined in the direction of higher centralisation and improvements to the database of guidelines and opinions and to the corresponding communication mechanisms. This will help achieve uniformity of administrative practice and limit the opportunities for undue advantage being taken of the law's deficiencies.

When all is said and done, the elements of uncertainty and incompleteness in the legal environment can only be reduced but never eliminated. Therefore, for the purposes of narrowing the legal and institutional opportunities for corruption pressure, the system of tax appeals and its related internal control system must be streamlined with priority. The existing tax collection practice is focused on non-compliance detection, rather than on the establishment of the true facts and circumstances, as is the purpose of the law.[47] Accordingly, there is a certain asymmetry between the authority's gain from detecting non-compliance but turning a blind eye to it in return for a bribe and the authority's liability for damage caused to a taxpayer by improper application of the law. This requires further CTP balancing so far as sanctions on individual officers are concerned in the event of damage caused to taxpayers by the authority's action or inaction.

[46] A recent example from tax law-making is the tax incentive for investment in regions of high unemployment, introduced under CITA in 2004, which has been effectively denied to many entrepreneurs by its implementing legislation.

[47] CTP Article 10 makes it a duty of tax authorities and public executors to establish, in the course of tax proceedings, all such facts and circumstances as may be relevant to the lawful assessment of public financial claims, *including such facts and circumstances as may cause such claims to be reduced or extinguished* (italics by author).

Improved Taxpayer Service

In addition to the direct tax burden, determined by tax base and tax rate, taxpayers incur the administrative cost of compliance measured by the time a taxpayer's management and accounting staff need to study the applicable legal provisions, prepare tax returns and other filings, pay taxes, accommodate the requirements of tax auditors and examiners, etc.[48] As already noted, compliance costs may rise considerably in proportion to the deficiencies of the legal framework, but also, as a result of weaknesses in taxpayer service. Excessive compliance costs are the main driver of the 'preferred customer' or service-related corruption in the tax administration. Moreover, the burden of voluntary compliance is regressive, i.e., smaller businesses incur a higher compliance cost as a proportion of their income.[49] Hence, it is a powerful driver for small businesses to underreport sales and operate in the shadow economy. Overall, taxation bureaucracy forces non-compliance and thereby, invites corruption.

Excessive compliance costs in taxation and social security are above all the result of the gaps and inconsistencies in the relevant legislation, discussed above, which make it difficult for taxpayers to understand their rights and duties and compromise the uniformity of application. The poor quality of taxpayer services only adds to these difficulties and thus, to compliance costs.

There are two main ways of curbing service-related corruption in the tax administration. The first one is to limit direct personal contacts between service delivery staff and taxpayers. The second one is to adopt service level standards, prescribing, among other things, strict service delivery times.

The most effective way of narrowing the opportunities for collusion between tax officers and taxpayers is by expanding e-services, including Web-based ones. These tend to increase the efficiency of service delivery, do away with queues and live contact. However, in the medium run, e-services are not likely to replace entirely the existing delivery arrangement; for one reason or another, it will remain prevalent for some time to come. This is why, to the extent that personal contact between tax officers and taxpayers cannot be avoided, corruption in this area should be fought by, above all, the broader introduction of the one-stop shop principle and the regulation of time-limits for service delivery.

In the Bulgarian administrative practice, the one-stop shop principle is a relative novelty and is understood, more often than not, as merely a single queue. This, of course, does not necessarily result in shorter waiting times. In terms of its anticorruption effect, this principle works mainly by the division of the service-delivery area into front-office and back-office, i.e., the separation of taxpayers from those who decide the quality of the service and how much time it takes to deliver. This is a way, even in other than e-services, to limit personal contact and the opportunities for mutual corruption pressure. While it may not put an end to bribery altogether, this arrangement would make it much more difficult to negotiate corrupt deals *tкte-a-tкte*; indeed, a corrupt taxpayer or tax officer would have to solicit the cooperation or acquiescence of a much broader circle of staff or even, management.

[48] See *Sanford* (1989, pp. 3-23) on private-sector compliance costs and public-sector administrative costs in the collection of taxes.

[49] See more on this in Pashev (2005).

The second way to raise the efficiency of both conventional and electronic service delivery is by service level standards which prescribe, among other things, delivery times. The administration's *Norms of Tax Officers' Conduct* include a section on Client Service Standards. Despite the title however, the section sets out general principles of service, such as: equality before the law, for the purposes of its application; respect for taxpayers' rights; the administration's duty to answer enquiries competently and in good faith; a ban on the misuse of powers and the use of pressure. While these are of course important, they will not do in lieu of time and quality standards. Advanced tax administrations elsewhere have codified such standards in a *Taxpayers' Charter* which includes, among other things, reciprocal duties of the taxpayers and of the administration.[50] In Bulgaria, CTP does prescribe some time-limits for service delivery, but they work as absolute deadlines. Better than regulation by law, standards, by way of self-regulation, set the quality improvement that the administration seeks to achieve, i.e., the administration's own time-limits should be shorter than the ones prescribed by law for the purposes of administrative liability. In addition, again unlike legal provisions, standards are subject to monitoring and evaluation, and allow to distribute responsibilities and measure workloads across the service delivery process for the purposes of corrective action. Working within the limits of law, standards could define time-brackets for services, such as: 'ordinary', 'fast', and 'rush', which would considerably narrow the opportunities for 'preferred customer' treatment in exchange for irregular payments or gifts. This would generally lower the corruption pressure from taxpayers, who, in the absence of standards, are often inclined to make such payments 'just in case', i.e., in anticipation of any undue delays or being misguided by their unfounded suspicion that any delay at all is only used for extortion. Of course, standards could not be effectively introduced and monitored without a modern information system to support service delivery. Such a system would not only increase productivity and shorten processing times, but would also allow the electronic tracking and management of document flow as a taxpayer's file or enquiry travels from one functional unit to another.

In this regard also, the computerisation of operational processes should lead to less paperwork. If a modern information support system does not result in fewer paper filings made in person, rather than reduce compliance and administrative costs, it actually makes them bigger. A case in point is NSSI's information support system. On the upside, thanks to its introduction, every insured person can now check their health insurance status online and once a year, receive by post a statement of social security contributions made. The facility has come at the cost of a sizeable World Bank loan to invest in state-of-the-art hardware and software, and has in addition increased employers' monthly overhead on filing payroll and social security statements.[51] On the downside however, the winner in all of this has been the administration, rather than its clients. A rule has been introduced whereby the information held on NSSI servers is inadmissible as evidence of social security status. Length of service for such purposes can only be certified by passbook or Forms УП-2 and УП-3 issued by the employer. So, despite the existence of an electronic database, insured persons do not have access to their rights, other than by going through a cumbersome paper-based process. As if this were not enough, where there is a discrepancy between the electronically generated

[50] See *OECD*, 2003; *Пашев* [Pashev] (2004, pp. 93-96).

[51] For employers who, for one reason or another, do not use an electronic signature, this means long hours of waiting in line to file the required information on a diskette.

social security statements and the length-of-service papers, NSSI refuses to certify length of service. Thereby, not only are the administration's and the employers' costs made meaningless, but the insured persons are effectively being made to answer for their employers' non-compliance with the system. This example is solid proof that modern technologies cannot make much difference if their introduction is not accompanied with a shift in the organisation of operational processes from enforcement to service. The new single revenue administration, which will incorporate NSSI, should make an effort to overcome bureaucratic inertia and put information support systems to their best use, i.e., the provision of better service to the public.

Control and Audit

As already noted, corruption in the tax administration is mostly related to evasion and other non-compliance. According to classical theory, taxpayers' motivation to evade rises with their expected gains of evasion as compared with their contingent losses in the event of detection and punishment.[52] A corollary to this is that tax evasion is likelier the less likely detection and severe punishment are. These law-enforcement parameters, i.e., detection rate and severity of punishment, will be discussed in the following section.

The existing control and audit arrangement is focused on heavier and wider control, rather than on a more effective selection of auditees by means of modern risk-assessment techniques. Under it, to 'tighten the screws' means, first and foremost, more, and more detailed, monthly reporting or *ex ante* control. On a monthly basis, businesses are required to file tax statements (for VAT and excise duties) and returns. Stated in the return are social security and insurance contributions on behalf of the employees (including: pensions, health, occupational injuries, employees' claims guarantee in bankruptcy), income tax withheld on employees' wages, etc. In addition, the return contains detailed payroll information as a base on which social security and insurance contributions are calculated.

The main tool by which the administration seeks to increase collection rates is still the scope and quantity (frequency and duration) of tax audit and operational control. What operational control is supposed to do is, among other things, check for any discrepancies between monthly tax-return data and the payment orders (about 10 per month per undertaking) reflecting amounts actually paid in. It is obvious that such a verification is extremely difficult, if not physically impossible. It can only be done by a single data processing system automatically reconciling statements with actual payments. On the other hand, such a system would require additional staff capacity to put the information through it.

Given these constraints, operational control is largely left to the individual tax officer's discretion. Businesses surveyed complain about the excessive frequency and duration of on-site audits and examinations by the tax and the social security adminis-

[52] See *Alingham and Sandmo* (1972). Their classical model concerns the underreporting of income. For a review of the numerous extensions to the theory and the related empirical studies, see: *Sandmo* (2004), *Cowell* (2004). For the practical implications of tax evasion theory in the context of the Bulgarian tax administration, see *Пашев* [Pashev] (2005).

trations.[53] 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.

Some positive experience already exists in targeting control and audit efforts at cases of conspicuous discrepancy between the taxpayer's wealth and their declared income. According to the tax administration's data for 2003, 62 examinations of natural persons concluded with correction tax assessments, the average undeclared income per taxpayer examined reaching nearly BGN 220,000. By mid-2004, 62 more correction assessments had been issued according to which a mere 14 per cent of actual income, on average, had been initially declared. If correction assessments pass the test of administrative and court appeal, this approach could prove much more effective in fighting tax evasion and the related corruption.

Of course, major tax evasion is impossible without the appropriately induced cooperation of tax officers. This is why, there is a need to streamline the administration's operational procedures for risk assessment and targeting, assignment and reporting of audits and examinations, with an emphasis on the anticorruption component. Modern techniques should be applied to assess corruption risk and investigate cases of suspected corruption.

An important aspect of this work is the approach to the composition of control and audit teams. Business surveys report that examinations by a single tax officer prevail. Indeed, there is nowhere in the legal framework an express requirement that audits and examinations should be performed by teams. In practice, tax audits are performed by a team of two, but the inspection of the auditee's accounting records is usually done by one of them, although the audit report is signed by both. Besides, these pairs of auditors are permanent and therefore, not an effective obstacle to corrupt behaviour.

The process of targeting, assignment and reporting of control and audit activities needs to be streamlined by the following five groups of measures:

(a) Limit the possibilities for discretionary targeting of control and audit efforts by introducing a state-of-the-art risk assessment system.

(b) Streamline the reporting arrangement for audits and examinations.

(c) Rotate control and audit teams to prevent corrupt affiliations and the build-up of corruption pressure within control and audit teams.

(d) Rotate tax auditors by region and industry to prevent corrupt affiliations between auditors and auditees.

(e) Develop a monitoring system of individual tax officers' audit and control effectiveness.

The indicators of individual officers' performance are key to the higher effectiveness of control and audit. Where the number of audits and examinations conducted,

[53] See *Витоша Рисърч* [Vitosha Research] (2004c) and *FIAS* (2004).

compared with the number and size of irregularities detected, shows low efficiency, explanations can be sought either in the risk analysis system or in the officer's professional conduct. In either case, such a result should lead to placing the officer concerned under the closer watch of his or her supervisor and of the internal control unit. While such low individual effectiveness and efficiency does not necessarily mean that the officer is corrupt, the information can guide the supervisor in making decisions on team composition and rotation, and the allocation of financial incentives. For its part, the appraisal of individual audit and control effectiveness depends on the functionalities of the management information system and on the existence of proper audit targeting and reporting procedures.

Indeed, not only that, but the potential of any of these five groups of measures may turn out to be limited. Corrupt practices may rapidly spread to the new teams or be perpetuated by old teams' new clients; and individual performance indicators could hardly serve as a basis for explicit countermeasures against corrupt officers. On the other hand, all these improvements come relatively cheap. They do not require more than the streamlining of operational processes by the full utilisation of the new information system that NRA will have. Therefore, on a cost-effectiveness basis, their potential is not to be ignored.

Much could be gained, in terms of overall prevention in the administration, from the declaration of tax officers' personal wealth and comparing that with their family income. Access to the relevant database should of course be controlled in the interest of personal data protection.

It goes without saying that even the best corruption-risk analysis system cannot do without the support of compliant taxpayers. A way to ensure such support is to create an effective whistle-blowing arrangement. This was the aim of the hotlines set up in 2004–2005 by MoF and GTD. However, if, as its most often the case, the taxpayer stands to gain from the tax officer's corruptness, alternative methods of ensuring public support should be sought.

Very good results could be obtained by cooperation between the tax administration and the business associations. Tax-compliant undertakings are worst affected by unfair competition; and they are in a good position to know what actually goes on in their industry and could draw the tax authorities' attention to the high-risk areas. Yet, for the time being, such a cooperation remains in the realm of theory. It is necessary to study and assess the international experience in alternative forms of control, including corruption monitoring and the involvement of internal and external corruption auditors.

Last but not least, the detection and investigation of tax-related offences and corruption suffer from the involvement of too many administrative structures without much coordination among them. For example, internal control is the responsibility both of the Inspectorate elements in the tax administration and of PIFCA; and in the customs administration, of its Inspectorate elements and the Customs Investigation and Intelligence Service (assisted during the last few years by Crown Agents, UK). In addition to these, entities responsible for fraud and corruption prevention include: the Financial Investigation Agency, the Economic Police, NAOCS, NSS. In 2004, a bill was introduced in Parliament on the establishment of a Fiscal Investigation Bureau (the so called 'Tax Police' of the MoF). Even though most of these entities are under MoF or MOHA,

the information-exchange and coordination among them remains the weakest link in the institutional setup for fighting tax-related offences and corruption. Administrative experience suggests that the swarming of coordination bodies is hardly the way to overcome turf mentality if working contacts among the various institutions are not actively sought at every operational level. In the first place, if an existing entity has proved ineffective, the situation will not necessarily be remedied by its replacement with a new entity, unless new, more effective methods of investigation, control and reporting are introduced. Therefore, the existing institutions should undergo an assessment of their objectives, efficiency and effectiveness, and measures should be taken on that basis to consolidate and streamline the prevention and enforcement infrastructure. The budget savings that such an exercise would certainly generate could be reallocated to financial incentives for the officers of the revenue services.

Enforcement Effectiveness

In the context of corruption predicated on tax-related offences, the effectiveness of enforcement is an important factor in the offender's choice to 'cross the line'. All other things being equal, including reasonably effective audit and control, the tendency to evade taxes is as stronger as the enforcement of tax liabilities is slower and less effective.

Under the existing arrangement, the enforcement of tax corrections, subject to a tax audit report, is the responsibility of the administration's Collection units. Under the accounting standards, a financial claim is treated as doubtful if it is three months past due, and as bad or uncollectible, if it is six months past due. The tax administration has adopted this classification. On the other hand, pursuant to CTP Article 146, uncollected tax liabilities are transferred to the public executor, which is the Public Collection Agency, 12 months after they have become past-due. This latter period starts running from the expiration of the voluntary compliance period, i.e., 14 days from service of correction assessment. Overall, the system is cumbersome and slow, and has too many possibilities for appeal and protraction built into it. This in itself opens another door to corruption and misuse of powers.[54]

Ways should be considered of streamlining the claims enforcement system toward greater consistency between the accounting standards and the tax administration's practices, and the more even distribution of responsibility between the tax administration and the public executor. As it stands, CTP (Articles 106 and 241) provides sufficient enforcement powers to the tax authorities. For its part, the public executor has one additional recourse: proceeding to adjudge the debtor a bankrupt. However, the main burden of enforcement responsibility should be laid on the tax administration. In this regard, the period of 12 months before the proceeding is transferred to the public executor is too long. It could be halved, combined with a more straightforward monitoring and evaluation of the administration's effectiveness in enforcement. At present, the significant share of bad tax claims transferred to the public executor is a sign of the administration's low effectiveness in the process. The alternative solution to

[54] The assessment of enforcement effectiveness is distorted by the overwhelming proportion of claims on nonexistent undertakings. For example, according to the administration's report to the Parliamentary Committee of Inquiry into VAT Fraud, approximately 70% of established VAT liabilities are in the name of nonexistent undertakings, i.e., are impossible to collect already at the time they are established.

the problem, i.e., the incorporation of the Public Collection Agency into the new National Revenue Agency, should be considered with some caution. It might create a situation in which claims are more readily written off and compliance and enforcement management efforts are weakened.

The adoption of the Private Claims Execution Act and the amendments to the Code of Civil Procedure (CCP) have created conditions for the more rapid enforcement of private claims. While the Act does mention public claims as well, its application to public enforcement proceedings depends on amendments to the substantive and the procedural tax legislation, which are not on the agenda for the moment.

Something else that is even more urgently needed is to harmonise, as much as possible, the respective CTP and CCP provisions on public claims enforcement. As things are at present, the equality of debtor treatment is compromised by the choice of executor–public or private. In certain respects, the differences between the two procedures are material and may result in heavier debtor encumbrance under CTP (e.g., concerning lien and garnishment). In addition, the fact that the authorities are given a choice between a more favourable and a less favourable treatment invites corruption.

Central to the claims enforcement arrangement is the system of non-compliance penalties. In theory, as a would-be offender weighs the costs and benefits of breaking the law, the low probability of detection could be *partially* offset by more severe punishment. And the emphasis is indeed on 'partially' as the severity of the punishment does not really matter much if it cannot be imposed.

Tax offenders are subject to both administrative and criminal liability. The tax audit proceeding concludes with a correction assessment, including taxes and interest, and any offsets. If the same proceeding has established an offence under the relevant tax legislation, the authority draws up a statement of administrative offence and based on it, an administrative penal order imposing a fine, on individuals, or damages, on legal persons and sole proprietors. These penalties come under the applicable legislation: CITA, PITA, CTP, etc. Members of the governing bodies of non-compliant legal persons are also jointly personally liable for damages (CTP Article 21).

Criminal liability, including imprisonment and fines, is sought under the Criminal Code (CC), but only of natural persons proved guilty in the appropriate proceeding. Legal persons do not come under the Criminal Code and there are no practical ways of establishing their criminal liability.[55] In addition, while tax evasion is a criminal offence, failure to pay assessed taxes is not. The latter is only subject to administrative liability. There is no distinction either under the Criminal Code between unlawful VAT refunds and mere tax evasion.

Court sentences for tax-related offences are a rarity. Given the official estimates of evaded taxes, the conclusion can readily be made that the rate of punishment is very low indeed. This is the result of the low effectiveness of judicial proceedings, as well as tax administration weaknesses. According to the administration's data for 2000–2004,

[55] The Council of Ministers has adopted recently a draft Code of Administrative Procedure which calls for the introduction of a new chapter under the Administrative Offences and Penalties Act providing financial liability for legal persons which have derived, or might derive, unlawful gain from a number of offences, including tax-related ones under CC Articles 256 and 257. The draft is yet to be adopted.

a total of 2,200 cases were referred to the public prosecution authorities, of which sentences were only handed down in four, of which three were suspended.[56] Such virtual impunity is a strong incentive to offend, on doing which the offenders automatically join the ranks of potential corruption seekers.

The severity of the punishment, in the likelihood of it being imposed, is also important. In principle, it must be commensurate with the amount of income underreported or tax evaded. Most of the penalties under the Bulgarian legislation are unrelated to either but are defined as a wide range between a lower and an upper absolute limit, their actual size in each case being left to the enforcing authority's discretion. Such an arrangement has two adverse implications. First, it provides an incentive to underreport or evade in large amounts as the penalty is in fact regressive above its upper limit where the marginal cost per unit underreported or evaded is equal to zero. Second, it allows broad administrative discretion and consequently, encourages corruption pressure. The arrangement should be amended by the setting of lower limits and a progressive scale above them in proportion to the fiscal effect of the offence, so as to discourage large offences and narrow the scope for discretionary enforcement.

Still, for the purposes of anticorruption policy, the penalties for tax-related offences are relevant indirectly. They deter tax evasion and by that, help limit bribery, which is either a tool for breaking the law or a tool for escaping punishment. There are also, however, the punishments or penalties for bribery itself, which have a direct anticorruption effect.

Recent years have seen considerable progress in the legislative regulation of corrupt practices and the corresponding criminal liability (see Appendix 1). A number of relevant amendments were made in 2002–2003 to the Criminal Code.[57] For its part, CTP prohibits tax officers from having other employers or business relationships and from exerting, or suffering others to exert, corruption pressure by action or inaction. Altogether, the Bulgarian anticorruption legislation conforms to modern international standards, but its greatest problem is application, i.e., the actual prosecution and punishment of corrupt behaviour. Sentences for corruption are rare.[58]

The situation is similar so far as disciplinary action against tax officers is concerned. It has turned out that, although a bribe may have been established by marked banknotes, the Labour Code (LC) will not allow any punishment for corruption or bribery, unless it has been established by an effective court verdict. That is to say, corruption must first be established in court before it can be punished by disciplinary action (LC Article 194) or termination of contract for cause (LC Article 330(1) and (2.2) in connection with CC Articles 301(4) and 37(6) and (7)). The justification for this arrangement is the general principle that objective truth can only be established in an adversarial judicial proceeding, while any out-of-court proceeding presents a serious threat of repression.

If the principles of due process and fair trial are not to be circumvented, there is no excuse for the course of justice being as slow as it is. It should be intensified and the

[56] *Доклад на Временната анкетна комисия за разследване на измамите с ДДС към 39-ото НС* [Report of the 39th National Assembly's Temporary Committee of Inquiry into VAT Fraud].

[57] See details in *Велчев* [Velchev] (2003) pp. 130-136.

[58] The annual Corruption Assessment Reports published by *Coalition 2000* (*www.anticorruption.bg*) feature investigation and court statistics of corrupt practices prosecuted and punished.

alternative of summary proceedings, under certain conditions, should be given a serious thought in corruption cases. Another alternative is to put the rules of conduct to more active use and take disciplinary action pursuant to them, outside of judicial proceedings. This would go some way at least to weakening corrupt officers' sense of impunity on account of the judiciary's weaknesses.

According to the report of the 39th National Assembly's Temporary Committee of Inquiry into VAT Fraud, the tax administration has imposed the greatest number of disciplinary punishments compared with the other administrations. Still, their anticorruption effect has been limited. It can be raised by placing disciplinary action clearly into the context of the *Norms of Conduct* and by a broader communication effort among the tax officers concerning their application.

5.3. FIGHTING VAT FRAUD

Fighting VAT fraud is the single gravest challenge to the Bulgarian tax and customs administrations in the short and medium run. Its gravity comes from the need to find the most effective fraud deterrents at the least cost of restrictions on *bona fide* businesses. The problem is that, more often than not, deterrents are successfully circumvented by fraudsters (using, among other things, bribery), while compliant undertakings incur additional costs on account of them. Striking this difficult balance concerns, above all, the principle of joint liability. The mechanics of VAT are such that it brings together, in a common supply chain, both fraudsters and law-abiding traders. Given this, if the tax authority can deny VAT credit on the mere suspicion of involvement in a fraudulent scheme, compliant traders may be placed at a competitive disadvantage and may themselves resort to bribery. On the other hand, if solid proof is required in all cases, before the tax administration can take appropriate countermeasures, this is likely to tie the administration's hands and place it in a catching-up position, while the offenders would enjoy virtual impunity.

When Bulgaria joins the EU, the risks and difficulties related to VAT administration will increase for two reasons. First, Bulgaria will be expected to follow the prevailing EU practice and introduce the option of VAT registration under the required VAT registration threshold. This will allow any small or start-up undertaking to become VAT-registered. Thereby, an undertaking registered for the sole purpose of committing VAT fraud will no longer need initial high-value fictitious transactions which let them into the 'Club', but also make them easily detectable. Furthermore, as the number of VAT-registered undertakings goes up, so will the number of would-be 'missing traders'; control and audit by the administration will become more difficult and expensive without any appreciable gain in effectiveness. This argument is especially valid, given the existing work arrangement, which relies on costly total control rather than on effective risk assessment. In addition, the expansion of the VAT system to cover small undertakings will increase the economic cost of the administration's ineffectiveness (from wilful or accidental errors and omissions, bribe seeking, etc.). As a rule, smaller undertakings have relatively limited capabilities of putting up a defence against administrative extortion.

Secondly, the abolition of the borders between Bulgaria and the other Member States will do away with the border control of trade flows, removing the customs bar-

riers to cross-border VAT fraud (see Chapter Four). Of course, the problem will not be exceptional to Bulgaria. By its structure, VAT is a central tax. Its local application is very difficult, e.g., across tax jurisdictions of different tax rates and given the unlimited freedom of movement of goods, persons, and capital. The best solution in such a union is to apply the principle of origin, i.e., tax the exports at the rate applicable in the country of origin and allow the importer to claim tax credit from its tax jurisdiction in respect of the tax paid to the exporter. In other words, under this arrangement, the tax is applied the same is if the goods had not crossed the border. The reciprocal claims of the participating tax administrations in respect of tax collected and tax credit recognised are settled by a multilateral clearing system.

Such an arrangement, however, is yet to come. It requires a high degree of rates harmonisation among the participating countries and the operational integration of their respective tax administrations. If it becomes a reality, a country's tax revenues will depend heavily on the level of operational interaction between its tax authorities and their counterparts across the border, as well as on their professionalism and integrity. Any large disparities of administrative capacity, including levels of corruption, would result in material discrepancies between declared volumes of import and export, which would in turn disrupt the operation of the international settlement mechanism. This was the reason why a transitional VAT arrangement for intra-community supplies was introduced with the launch of the Internal Market in 1993. The transitional arrangement retains the destination principle: exports are subject to a zero VAT rate, and imports, to the VAT rate in the country of destination. In the absence of border control however, this broadens the opportunities for unlawful VAT refunds by cross-border supplies and missing traders. Their prevention depends primarily on the level of operational interaction between the tax authorities. Therefore, Bulgaria's EU accession will place heavier and more demanding requirements on its tax administration. One certain consequence will be the increase of fraud prevention costs, both in the public and in the private sector, without the benefit of such certainty as to effectiveness. Thus, to strike the right balance between the positive and negative effect of deterrents will become even more difficult. This section discusses some possible solutions, measures and approaches to the problem in the light of the Bulgarian legislation and the relevant theory and international best practice.

Rising above the technicalities involved in the various schemes, VAT fraud is possible because of the right to claim tax credit or more precisely, because of the possibility for a trader to claim tax credit before its accomplice (another trader in the supply chain) has paid the corresponding tax amount. This is why the most extreme and direct ways of clamping down on VAT fraud have to do with the abolition of tax credit.

In theory, one such solution is to replace the *credit-invoice principle* with the so called *'subtraction method'*.[59] This would effectively eliminate the opportunities for unlawful refunds. Moreover, it would limit the so called 'cascade effect' in VAT, i.e., the accrual of tax on tax where a non-registered trader is a supplier to a registered trader (a subcontractor of a large firm or an outsourcing contractor). An even more extreme

[59] According to the credit-invoice principle, the supplier charges the tax (collects it from its buyer) on the full net sales value but only pays the difference between the tax it has collected and the tax it has paid to its supplier. According to the subtraction method, the tax rate is only applied to the difference between the sales proceeds and the cost of goods sold, i.e., the cost of purchasing the goods or the cost of purchasing the supplies to produce them.

solution is to exempt business-to-business transactions from VAT. This is how the sales tax works in USA, where the distinction between intermediate and end supplies is made by the buyer's statement on an exemption certificate that it is not an end consumer. In Bulgaria, a recommendation to a similar effect has been made to the 39th National Assembly's Temporary Committee of Inquiry into VAT Fraud, the idea being to exempt supplies to exporters so that they cannot claim tax credit.

However, these arrangements have a number of weaknesses which, in the final analysis, outweigh their advantages. Number one, they do away with the credit method's greatest strength, i.e., its 'self-administration' (see 4.2). So far as the idea is concerned to exempt exporters' purchases so as to prevent them from unlawfully claiming tax credit, it will only push this fraudulent practice higher up the supply chain.

Last but not least, in the EU, the possibilities for unilateral changes in national VAT arrangements are rather limited. This is one of the areas in which the harmonisation of national legislations has advanced the farthest. In a 2004 special report on the fight against VAT fraud, the European Commission urges the Member States to consider the adoption of measures strictly within the existing VAT arrangement.[60]

The problem is not new to the Bulgarian tax administration. The tax was introduced in 1994 but fraudulent refund schemes only started to spread after the achievement of financial stability. Prior to that, the long time-limits for tax credit refunds and the high rate of inflation rendered such schemes unprofitable. The second half of the 1990s also saw the first high-profile cases of VAT fraud. Major countermeasures had not been introduced until 1999 – 2000. Those included: closing the numerous loopholes in the legal framework, which allowed the unlawful refunding of VAT with impunity; streamlining the Large Taxpayers units; restructuring the tax audit area to account

A 'War Story' Told by an Accountant

In the course of an audit, the tax authority expressed doubts that a certain transaction qualified as an export. The auditee's accountants responded with concrete counterarguments, citing the relevant legal provisions, but the tax authority made no effort to grasp the auditee's case and even dispensed with any documentary evidence in support of either treatment. As the correction assessment was served for signature to it, the auditee found that the contentious transactions had not been recognised as exports and 20 per cent VAT had been charged on them. The assessment was appealed first, by administrative procedure and thereafter, before the court, with all the export supporting documents being presented.

What is the taxpayer's reckoning even if the appeal is successful?

1. Administrative and judicial appeal costs.
2. Correction amount paid to the Treasury, the appeal notwithstanding.
3. Time (which is money!) spent on having a re-audit to revisit the relevant circumstances: 2 months.
4. 'Token of gratitude', as appropriate, to the administration to avoid any further surprises.
5. Correction amount refunded (as paid for no conceivable reason under the law).

Justice has been served, at a price (see above) to the taxpayer, not to mention the administration's additional costs. As to the tax officer who started the whole thing, it is unlikely that he was booked for any of that–more likely in fact, it earned him a reputation for incorruptible vigilance, even though he only knows whether, in his administrative zeal, he was guided by loyalty to the law or by his desire to solicit a 'settlement' from the taxpayer.

[60] See Commission of the European Communities, *Report from the Commission to the Council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud*, Brussels, 16.04.2004 COM(2004) 260.

for VAT-related risks; establishing special units to fight VAT fraud; monitoring fiscal loss; etc. The Code of Tax Procedure, in force since 2000, introduced the joint liability principle. In pursuance of its Article 109, the administration can deny a tax credit refund if any supplier or trader in the supply chain has not paid the tax as due. In practice, this means that, without having proof of any relatedness between the refund claimant and the non-compliant trader, the administration would anyway penalise the former. At the same time, the VAT Register became public, allowing the undertakings to check up on their suppliers. However, the practice was easily defeatable in court. In 2002, the relevant provisions of CTP Article 109 were repealed but the principle of joint liability remained in existence under VATA (Article 65(4)). On the other hand, that same year saw the introduction of the VAT account arrangement, and in 2003, it became obligatory for VAT-registered undertakings. An amendment to VAT Article 65 (Paragraph 8) allowed them the unconditional right to tax credit in respect of VAT payments into the special account, regardless of any non-compliance up the supply chain. The VAT account arrangement was introduced essentially as an attempt at providing joint liability loss relief to compliant taxpayers. As already illustrated (see Chapter Four), it has not been effective against VAT fraud. Fraudsters invented new ways of using the missing/insolvent trader scheme and drawing the VAT account down. Thus, rather than putting an end to fraud, the arrangement relieved the offenders from joint liability. Soon after its introduction, there was a strong pressure from the administration to have the unconditional tax credit refund abolished. As it did not succeed, the tax officers simply found ways around the legal provisions. Administrative practice and jurisprudence abound in cases of VAT refund denial, and appeals from it, despite the taxpayer's compliant use of a VAT account. The undeniable result has been more costs incurred by businesses and the administration.

In the final analysis, the VAT account arrangement has increased the burden of costs on compliant businesses by effectively freezing some of their cash flows. At the same time, it has proved to be neither an effective barrier to fraud, nor an effective guarantee for unconditional tax credit. The arrangement should undergo a cost-benefit analysis, from the perspective of both the private and public sector, in the light of the accumulated administrative and judicial experience. It is worth noting as well that no similar VAT-fraud prevention arrangement exists anywhere else in the world.

The review of fraudulent VAT-refund schemes in Chapter Four has shown that all of them boil down to the scheme organisers' escape from justice by the transfer of all their liabilities to a nonexistent or insolvent trader. Therefore, VAT fraud should be fought along the following three lines:

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

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

(c) 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 the event of conveyance, the conveyor should be required to state the absence of any outstanding tax liability, and that should be certified by the tax authorities. The tax administration has recommended an increase of the minimum authorised capital required for the incorporation of a limited liability company (subject to administrative liability if found lacking), so as to narrow the opportunities for the involvement in fraudulent schemes of indigent persons posing as OOD owners. Another recommendation is to restrict the right of traders once adjudged bankrupts to start or participate in other undertakings. There are such restrictions under the Commercial Act regarding sole proprietorships (ET) and joint-stock companies (AD), but excepting limited liability companies (OOD).

Such measures would limit the transfer of ownership whose main purpose is to prevent the tax administration from taking the appropriate distraint or enforcement action. However, their effect against fraudulent refund schemes should not be overestimated. They might render such schemes more difficult to practice but it is likelier that, in the face of such difficulties, the schemes will simply mutate. For example, the position of fictitious trader could be filled by a front of no corporate or personal property, or else, the governing bodies of the non-compliant undertaking could be renewed to evade personal liability for damages. Incidentally, the statement of tax liability outstanding does not provide much assurance: any such liability may not have been established yet at the time of ownership transfer but may arise subsequently as a result of a tax audit. It would be more appropriate to provide for a tax audit 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.

Measures to clamp down on VAT fraud should not be considered without regard to the burden they may impose on compliant businesses, start-ups and small enterprises in particular. Under the Commercial Act, for example, such measures may create excessive barriers to market entry. In this context, the amendments to CTP proposed by the Parliamentary Committee of Inquiry into VAT Fraud should be approached with caution as they would allow customs to stop an export shipment for up to three business days if the declared export price deviates from the going market price by more than 25 per cent. The monitoring of deviations from market prices (however inconclusive the methods of market price discovery may be) should serve as an input to the risk assessment system, rather than provide grounds to penalise traders. Besides, as Bulgaria joins the EU, customs will no longer be able to exercise such control at internal borders and cross-border VAT fraud will target intra-community supplies. Thus, the proposed measure would hardly prove a serious barrier against export-related VAT fraud, but it would certainly redirect customs corruption to target Bulgarian exporters to third countries.

The top priority in the legislative area is to evaluate critically the VAT-account experience. If it does create more obstacles to law-abiding business than barriers against fraud, it should be abandoned. In its absence, there will be a need to streamline the application of joint liability. Of course, striking the right balance between effective enforcement and the legitimate interests of compliant business is not an easy task. There is no single best solution but there is sufficient international best practice which should be studied. First and foremost, the tax administration should protect compliant traders from unwittingly falling prey to fictitious supply chains. To this end, a publicly

available register should be created of all detected fictitious traders, so as to prevent invoicing in their name. In this connection, more should be done to block the attempted unlawful use of other traders' identification numbers. Lastly, for the purposes of denying tax credit, the burden should be reversed onto the administration to prove the claimant's relatedness to, or participation in, or unlawful gain from, a fraudulent supply chain, rather than being refused the credit until proven innocent in court.

There are two problems with joint liability. Firstly, it is very difficult to prove a link between a tax credit claimant and a non-compliant taxpayer up the supply chain. Secondly, given this, the tax authorities can twist traders' arms for irregular payments, the alternative being to engage in long and costly litigation of uncertain outcome. Thus, the joint liability principle encourages corruption pressure and the selective and inequitable application of the law. Therefore, if the VAT account were abolished, the thrust of antifraud efforts must shift to *ex ante* control and prevention based on a modern risk management system. In addition, the tax administration should consult the representatives of business to adopt clear and transparent rules for the application of the joint liability principle. These should be based on the risk profiles of industries and undertakings. If an undertaking or its owners have a history of bad debt or frequent association with missing-trader chains, their right to tax credit should be restricted in the interest of compliant traders and the Treasury.

The claim is often made that, for a risk assessment system to be effective, it should be classified. Even so, fraudsters do manage to break into it, and only law-abiding taxpayers are 'kept in the dark'. In the end, classification only serves to disguise the absence of any risk assessment at all, or else, creates opportunities for biased targeting of control and coercion.

Risk analysis should combine state-of-the-art information technologies with the best European practices in the administration of taxes. In the high-risk VAT contingent, the undertakings in such industries should be placed under a special watch where the probability of VAT fraud is particularly high: land and livestock farming; raw materials, including paper and metal scrap; computer components; mobile phones; etc. Once such risk profiles are developed, the appropriate industry associations should be involved in the development of preventive measures. The tax administration should adopt a discriminating approach to risk assessment and audit targeting based on product characteristics, company size, etc., to maximise the effectiveness of control and audit.

For their part, industry associations should assume some responsibility for fighting fraud and corruption. The business community is best placed to provide input for risk assessment and effective countermeasures. Besides, it should see its own interest in cooperating with the authorities as this would reduce unfair competition and keep *bona fide* businesses out of the administration's VAT watch-list and away from the additional administrative hassle which being on that list would imply.

Of course, even then, there would be compliant taxpayers who would have to prove that they did not, or could not, have knowledge of any fictitious deals up the supply chain of which they are also part. However, such cases should be few and far between, and could also be helped by significantly shortening the duration of administrative and judicial proceedings. Introducing summary proceedings in tax-related cases should be given serious thought. It could produce an appreciable anticorruption effect by reducing the taxpayer's opportunity cost of not giving a bribe.

Last but not least, VAT fraud prevention would be particularly affected by the fate of a proposal which has recently moved to the centre of public debate: the introduction of differentiated VAT rates. Special, reduced VAT rates on some food products and drugs usually pursue social policy objectives, the idea being to provide tax relief to low-income households which spend most of their income on staples. Such households pay more consumer tax in proportion to their income than higher-income households, flat-rate consumer taxes having a somewhat regressive effect. Therefore, by mitigating this regressive effect, reduced tax rates on food products and drugs tend to improve, in economists' jargon, 'the vertical equity of taxation'. Critics, however, point out that what higher-income households, who also buy reduced-rate products, stand to gain from such an arrangement outweighs by an order of magnitude the relief that low-income households get. In addition, the budget revenue loss deprives low-income households from public goods and welfare benefits which they rely on much more than higher-income households. Thus, the social policy effect of differentiated tax rates is undecided. It would be much more direct if, instead of reducing the tax on food staples, part of the equivalent funds were disbursed to low-income households in the form of food allowances. Thereby, both the fiscal cost and the economic cost (in terms of market distortion and reorientation of demand) of such a measure would become much lower.

Sometimes, differentiated tax rates are also advocated on arguments of external economic competitiveness. However, these have no ground either in theory or in practice. Based on the destination principle, exports are subject to the importing country's tax rate. Therefore, Bulgarian milk, for example, would not become any more competitive abroad if it were taxed at a lower rate in Bulgaria, nor would, for that matter, imported milk become more expensive in Bulgaria if the tax rate on it were raised in its country of origin. Even if the principle of origin were introduced, in some distant future, in respect of intra-community supplies, fiscal measures (be they tax incentives or subsidies) are hardly the most appropriate way of achieving export competitiveness. Such an approach rather discourages producers from improving their productivity; and whenever countries, rather than producers, compete, the taxpayers always end up footing the bill.

While both the social and economic policy benefit of differentiated rates is rather doubtful, the harm they can produce in the fight against VAT fraud is much more straightforward. Reduced rates would significantly increase the number of traders enjoying the same treatment, for the purposes of tax credit, as exporters, but without the fraud-preventing factor (doubtful as it is) of physical inspection by customs. Therefore, the idea must be approached with the utmost caution and subjected to an in-depth cost-benefit analysis.

In summary, no perfect system seems to exist that can work the miracle almost of separating fraudsters from law-abiding taxpayers–delivering deserved punishment on the ones and shielding the others from the tax authorities' errors of judgment. A trade-off is necessary between the interests of business and those of the administration, based on a clear understanding of its net benefit. This implies, for tax officers, that they should learn to live with the fact that fraudsters are after all the exception and not the rule, and also, that they should be ready to accept responsibility and liability for their errors and the damage caused by them to compliant taxpayers. As for business, it should learn to live with the principle of joint liability and such other restrictive measures, especially if it operates in a high-risk sector, as a necessary cost to be incurred if VAT fraud is to be reduced and with it, unfair competition and the need for higher tax rates.