

Konstantin Pashev

**CORRUPTION AND
TAX COMPLIANCE**

**CHALLENGES TO TAX POLICY
AND ADMINISTRATION**

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ABBREVIATIONS

AD	Joint-Stock Company
BCCI	Bulgarian Chamber of Commerce and Industry
CC	Criminal Code
CCP	Code of Civil Procedure
CEE	Central and Eastern Europe
CITA	Corporate Income Tax Act
CMS	Corruption Monitoring System
CTP	Code of Tax Procedure
ET	Sole Proprietorship
FA	Finance & Accounting Department
FIA	Financial Intelligence Agency
GDP	Gross Domestic Product
GTD	General Tax Directorate
HRM	Human Resource Management
MoF	Ministry of Finance
NAOCS	National Anti-Organised Crime Service
NRA	National Revenue Agency
NSSI	National Social Security Institute
OC	Operational Control
OOD	Limited Liability Company
PIFCA	Public Internal Financial Control Agency
PITA	Personal Income Tax Act
RTD	Regional Tax Directorate
SFI	Supplementary financial incentives
SME	Small and medium-sized enterprise
SS	Social Security (Pillar I)
TRS	Taxpayers Registration and Services
TTD	Territorial Tax Directorate
VATA	Value Added Tax Act

SUMMARY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Narrow the opportunities for undertakings to be registered in the name of, or transferred to, fictitious or nonexistent owners.
- Narrow the opportunities for inordinate tax-credit amounts to be claimed by reporting transactions at artificially high prices.
- Narrow the opportunities for the refund beneficiary to avoid liability.

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

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

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

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

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

INTRODUCTION

Curbing corruption in the tax administration is closely related both to the overall reform of the public administration and to the prevention of shadow-economy practices and in particular, tax fraud and other tax offences. Having a more effective public administration and less corruption is among the main challenges facing Bulgaria on the last stretch of its road to EU accession. EU Member States are particularly sensitive to tax fraud, which, after the country's accession, and especially in the VAT area, will pose a threat to the Union's, as well as to Bulgaria's, interests.

The 2000 Lisbon Agenda has raised additional challenges to the quality of the tax and regulatory environment to ensure more cost-competitive products. Reducing the tax burden and the scope of the shadow economy are among the top medium-term priorities of government today. Success in these areas depends, among other things, on higher collection and voluntary compliance rates. Overall, the effectiveness of lowering taxes by raising collection rates is a function of curbing tax-related corruption.

Tax-related corruption largely determines the levels of all other kinds of corruption. If they did not underreport sales and keep two sets of cashbooks to evade taxes, businesses would not have the corruption money that changes hands in public procurement or in the various licensing or permitting procedures, or in the delivery of public services or even in business-to-business dealings. Consequently, curbing tax corruption would have the effect of curbing all other kinds of corruption by cutting their 'supply lines'.

However, despite their considerable public significance, a number of questions concerning the factors and mechanisms of the corrupt environment and practices in the tax administration remain unanswered. Studies of this problem area rely mostly on surveys among taxpayers. Given that most researchers focus on the breadth and depth of corruption, such one-sidedness is understandable. In this regard, taxpayers' opinion is more important—not because it is necessarily more accurate but because corruption is an important component and indicator of the business environment. Economic agents make their investment decisions on the strength of perceptions, regardless of how close to reality they are. Therefore, as a *stumbling block to investment*, corruption is best seen with the eyes of the public.

If however, the purpose of a study is to analyse the relative weight of tax-related corruption factors and drivers, and recommend countermeasures on that basis, taxpayers' perceptions are not enough: corruption must be analysed from the perspective of business, i.e., the demand side, but also, from its supply side, i.e., from the perspective of the administration. Moreover, any corruption prevention measures recommended without regard to the taxman's opinion would be largely doomed to failure. It is all the more surprising then that almost no such surveys of the Bulgarian tax administration have ever been conducted.

This study is an attempt at an in-depth diagnosis of tax-related corruption in terms of its drivers at work in individual and institutional behaviour. To assess the problem's

scale, we have relied on information from business and members of the public, from the Corruption Monitoring System (CMS) run by *Coalition 2000* and from various other Bulgarian sources. We have also shown the corruption ratings of the Bulgarian tax administration according to various international indices. In addition, specially for the purposes of this study, we have conducted a survey among Bulgarian tax officers, which has allowed an analysis of individual motives and institutional factors on the supply side of corrupt services. While the survey does shed some light on the size and incidence of corrupt transactions, its value lies in the information about the regulatory and management mechanisms and deficiencies which make corruption possible in the first place.

Chapter One outlines the conceptual framework of the study's positive and normative analysis. It sets the objectives of the policy impact on the basis of a transactional typology of the acts of corruption in the tax administration, i.e., in the context of the supply and demand of certain services. Then, the identification of drivers on the supply side and on the demand side of corruption allows a more accurate targeting of policy measures and the monitoring and evaluation of impacts. *Chapter Two* presents an attempt at determining the depth and dynamics of the problem in terms of the various corruption indicators, including the spread of corruption by administrative level and functional unit. *Chapter Three* is an analysis of the techniques and mechanisms of corrupt transactions in the tax administration. The distinction is made between corruption seeking a better quality of service and corruption as an inducement to commit or to cover up at tax offence. Described in this chapter are also the concrete individual motives and institutional factors which drive the administration's corrupt behaviour. In addition, *Chapter Four* dwells particularly on the tax administration's greatest challenge—VAT fraud—describing its various types and mechanisms, including an evaluation of the VAT account arrangement. Based on the above, *Chapter Five* presents the main policy priorities with a view to curbing corruption in the tax administration. Two main groups of measures have been identified: 1. incentives; and 2. ways of eliminating the legal and institutional factors which invite tax corruption. Section 3 of this chapter dwells in particular on measures against VAT fraud. *Chapter Six* proposes a set of indicators to monitor and evaluate progress in the fight against corruption in the tax administration. The main conclusions and policy guidelines are briefly summarised at the end.

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The above notwithstanding, the views and conclusions presented here may not be attributed to any of these individuals in particular, or to the institutions for which they work. The author is solely responsible for any misinterpretation or omission.

1. TAX CORRUPTION AS A BUSINESS TRANSACTION

1.1. TAX CLIENTELISM AND TAX CORRUPTION

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1.2. TAXPAYERS’ CORRUPT MOTIVES

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

Tax-related corruption implies the reciprocation of benefit between a tax officer and a taxpayer to the detriment of the Treasury and of the other taxpayers. Broadly speaking, business pays for two groups of corrupt services: tax evasion and ‘preferred customer’ treatment. To the briber, the net benefit of tax evasion equals the tax saved less the bribe. In the case of preferential treatment, the briber’s net benefit equals his or her opportunity cost—of time saved from waiting in line for a service or of the tax refund made sooner—less the bribe. Hence, all other things being equal, the higher the tax burden and the lower the administration’s effectiveness and the price of corrupt services, the higher the briber’s incremental benefit and accordingly, the stronger his or her corrupt motives. Another consideration to plug into this equation is the briber’s level of certainty that the corrupt tax officer will deliver that for which he or she has been paid. Therefore, indicators measuring the tax burden, the administration’s effectiveness, bribe levels and the effectiveness of bribes can serve as a basis for the analysis of taxpayers’ corrupt motives and tendencies.

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

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

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

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

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

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

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

medium run than their direct bribe expenses.⁶ Surveys of the business environment in Bulgaria have found that unfair competition is business's greatest problem⁷, and likely, its strongest motive to choose tax corruption. Indeed, unfair competition is largely the product of individual acts of corruption. If a business is unaware of this, its decisions to seek corruption-related quick fixes are conditioned solely by direct costs. Are Bulgarian businesses aware of the indirect economic cost of corruption?—The answer, it would seem, is 'Yes'—for quite a few of the big taxpayers at least. According to a 2003 corporate capital survey, 39 per cent of the respondents related their understanding of corruption to market distortions; 28.6 per cent cited unfair competition in the same context; and as many pointed a finger at the shadow economy.⁸

1.3. INCENTIVES AND DETERRENTS FOR THE ADMINISTRATION

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

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

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

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

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

⁶ See *Tanzi* (1998, p. 582-586).

⁷ *Vitosha Research* (2004b), Appendix 3, Table 1; and also *FIAS* (2004).

⁸ *Ангелова и др.* [Angelova et al.] (2003, p. 29, Table 3).

⁹ E.g., *Das Gupta et al* (1999).

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

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

- (a) lowering tax rates, broadening the tax base, and reducing the number of tax reliefs and exemptions;
- (b) narrowing the room for arbitrary interpretation and application of the existing legislation;
- (c) minimising taxpayers' voluntary compliance costs. For example, concerning small and medium-sized enterprises (SMEs) in particular, presumptive taxation, such as the franchise tax, should be preferred, to relieve them from the burden of compliance with complex accounting standards and limit the scope for administrative discretion.

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

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

1.4. SELF-REGULATION

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

¹⁰ See *Tanzi* (1998) for an overview and critique of the relevant literature.

¹¹ Such a scenario has been proposed, for example, by *Gray et al* (2004, p. 16).

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

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

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

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

In summary, the economic effect of tax-related corruption is measured, above all, by business's direct corruption costs. In the context of a single deal and in the short run, they are indeed likely to be smaller than the benefits. More important, however, is the economic cost incurred by businesses on account of market distortions and unfair competition created by corrupt practices. This cost could hardly be mitigated by more competition in the corrupt services market or by the two parties to corruption reaching some sort of a general agreement on direct corruption costs.

2. THE SPREAD OF CORRUPTION

The main tool used in the assessment of the spread of corruption in Bulgaria is the Corruption Monitoring System (CMS) run by *Coalition 2000*. In addition to an overall picture of the scale and dynamics of corruption, CMS offers concrete information about the intensity and the level of corruption as perceived by taxpayers. For the purposes of this study, we have conducted also a special survey of 699 Bulgarian tax officers at territorial tax directorates and local tax offices. The findings of other relevant surveys conducted in recent years have been taken into account,¹² and we have shown the corruption ratings of Bulgaria and of the Bulgarian tax administration according to various international sources on corruption and the business environment.

2.1. NATIONAL MONITORING

The corruption indices published by *Coalition 2000* are based on surveys of the general public and the business community reflecting respondents' perceptions of the scale and dynamics of corruption, and also, their shared corruption-related experience.¹³ As a comprehensive nationwide corruption monitoring system, CMS covers different institutions and corruption-related transactions, including the tax administration and tax corruption, but does not seek to diagnose the problem as it stands within each particular institution or field. In most general terms, CMS suggests that while tax corruption is a major issue, it is not the biggest challenge in the fight against corruption as such. In the taxpayers' opinion, tax corruption is second in scale to the corruption in customs, the police, and Parliament; and it also ranks below the corruption related to public procurement, building permits, imports, and judicial proceedings. For example, business places the tax administration among the most corrupt institutions in the country, but only after customs, the courts, the police, and the various permitting authorities (Appendix 3.1). The tax administration's ranking is similar in terms of actual corruption pressure put on businesses: tax officers follow customs and police officers, physicians, and municipal servants in the proportion (approx. 1 out of five) of businesses reporting instances of bribes being asked by any of these (Appendix 3.5).

The tax administration is not at the top of the list either in terms of bribes actually paid. According to respondents' shared personal experience, bribes related to the payment of taxes are less frequent than bribes paid to evade penalties from the various control authorities or in connection with the payment of customs duties or the issuance of licenses and permits (Appendix 3.3). In terms of average bribe levels for 2004, tax corruption follows corruption related to public procurement, building permits,

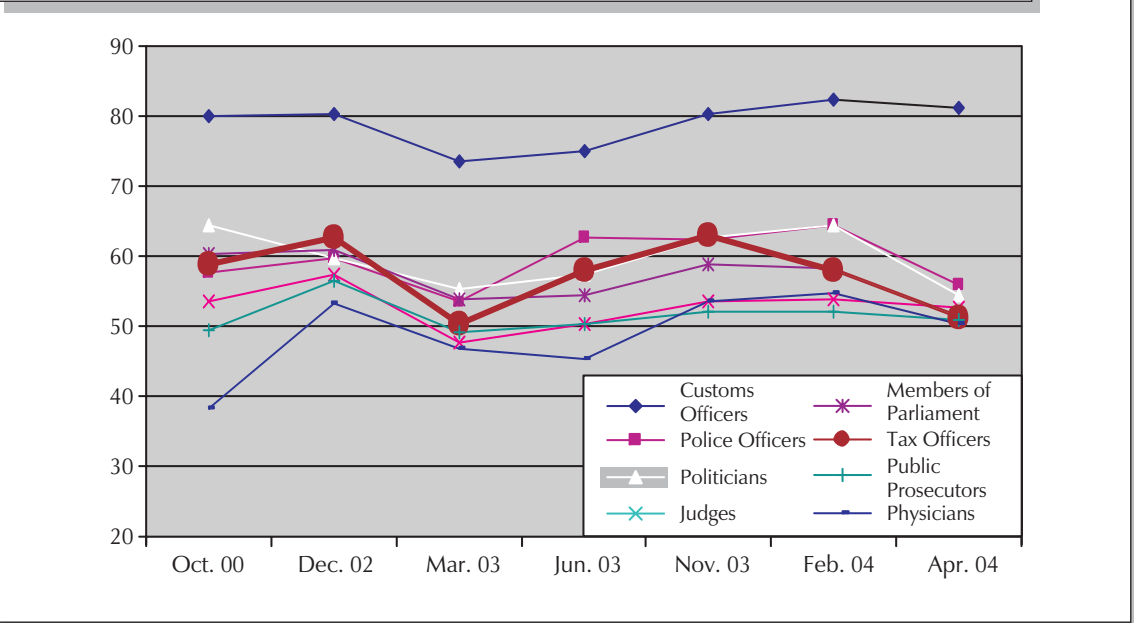
¹² Ангелова и др. [Angelova et al.] (2003); МВМД (2003); Скала [Skala] (2003).

¹³ See *Coalition 2000* (1998) and *Coalition 2000* (2005) for the methodology of CMS indices. The latest surveys referred to here are of the general public and the business community for March and June 2004. See Vitosha Research (2004a), (2004b).

customs duties, judicial proceedings, and title recordation (Appendix 3.4a). The limited time range of these surveys and the small number of respondents prepared to admit having paid a bribe do not allow any final conclusions to be made yet about the dynamics of bribe levels. However, early indications are that the average level of tax-related bribes is rising (Appendix 3.4b). As already noted, in terms of demand-side drivers, the rising 'price' of corrupt services does not warrant any single interpretation. For example, it might not be such a bad news if it were accompanied with a decline in the number of businesses paying bribes and in the incidence of bribe payments. If this is indeed the case, the rise of average bribe levels can be interpreted as an indication of the effectiveness of anticorruption measures causing corrupt officers to charge a higher risk premium.

Despite the strong evidence of the relatively low proportion of tax corruption, business's assessment of its penetration rate in the tax administration remains high. Business respondents largely believe that most, if not all, tax officers are involved in corruption; the proportion of this perception has been steady at 50–60 per cent over the last five years. To qualify this statement, responses do not indicate much difference between tax officers and other members of the public administration, with the notable exception of customs officers, who are generally perceived as more corrupt by far (see Figure 1).

Figure 1. Business's Perceived Spread of Corruption Among the Following:
 (% of response „Almost all or most are involved in corruption“)



Source: Vitosha Research (2004b). Base: 478.

2.2. ARE TAX OFFICERS BEING 'WRONGLY ACCUSED'?

Even though tax officers are definitely not at the top of the corruption chart drawn up by taxpayers, the general public's and the business community's perceptions and shared experience indicate a much higher corruption level than the one assessed by the administration itself. The gap is wide indeed and suggests a divergence of views on tax corruption between the administration and its clients. This divergence is a measure of the administration's and civil society's capability of joining efforts against corruption and should be watched in future.

The tax officers' assessment of the level and spread of corruption in their midst is a composite of the following:

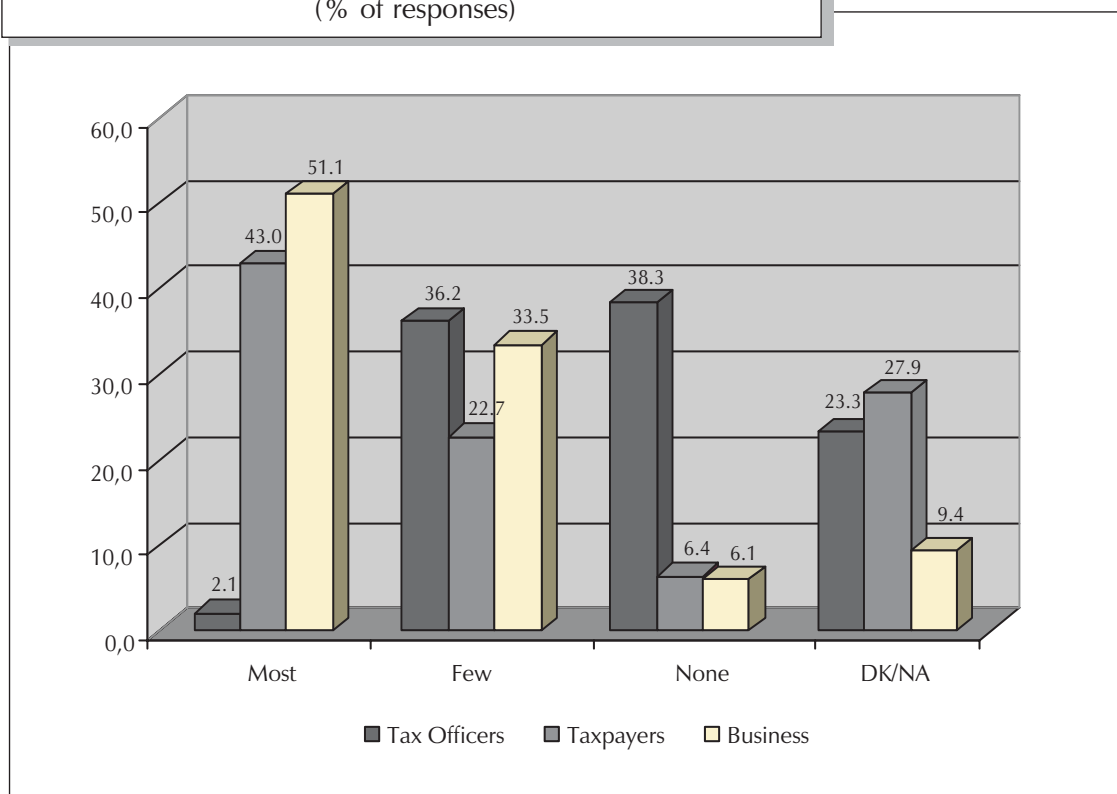
- (a) perceived justice of the allegations of widespread corruption in the tax administration (on a scale from 1, *Justified*, to 4, *Unjustified*);
- (b) corruption rating, in terms of bribe levels and incidence, by administrative level and functional area;
- (c) assessed spread of corruption in the respondent's own department, in terms of co-workers involved (on a scale from 1, *Almost All*, to 4, *None*);
- (d) personal experience: how often during the previous year did co-workers of the respondent, to the respondent's knowledge, receive money/gifts and of what approximate value;
- (e) personal experience: how often during the previous year did the respondent receive money/gifts and of what approximate value.

What do tax officers believe, and what do they know, about corruption in their midst?

The most striking divergence between taxpayers and tax officers concerns the proportion of tax officers involved in corrupt practices. According to 43 per cent of the general public and 51 per cent of business, almost all, or most, tax officers are involved, while a mere 2 per cent of the tax officers share this view about their own functional unit. Conversely, while 38.3 per cent of the tax officers deny any corruption in their midst, only 6.4 per cent of the general public and 6.1 per cent of business are prepared to believe this (see Figure 2).

Of course, all this does not mean that the tax authorities would rather turn a blind eye to corruption in their midst. Rather, they reject the allegations that it is widespread. According to 72 per cent of respondents, these allegations are unjustified. Still, one out of five tax officers believes they are partially or totally true. One interesting observation is that when asked about their own respective departments, the tax officers are divided right down the middle in their opinions: 38.3 per cent deny, but as many confirm, the existence of corruption, even though most describe it as sporadic. The highest percentages, by functional unit, of those who admit that corruption exists were reported in Tax Audit (46.5%) and in Taxpayers Registration and Services (35.8%), which, taken together, account for three quarters of GTD staff and of the survey sample.

Figure 2. The Spread of Corruption in the Tax Administration
(% of responses)



* Members of the general public and of the business community responded regarding the administration as a whole, while tax officers were asked about their respective departments. The general-public and business-community data were sourced from the relevant surveys of Vitoshka Research, *Coalition 2000 Corruption Monitoring*, for April-May 2004.

Table 1. Perceived Spread of Corruption in Respondents' Own Department
(% of responses by department)

Responses	TRS	Tax Audit	OC	Collection	FA	Appeals
Almost all	0.0	0.4	0.0	0.0	0.0	0.0
Most	2.1	1.7	4.5	3.7	0.0	0.0
Few	33.7	44.4	23.9	29.6	27.3	14.3
None	47.9	22.4	34.3	48.1	54.5	57.1
DK/NA	16.3	31.0	37.3	18.5	18.2	28.6
	100.0	100.0	100.0	100.0	100.0	100.0
Base	288.0	232.0	67.0	27.0	44.0	7.0

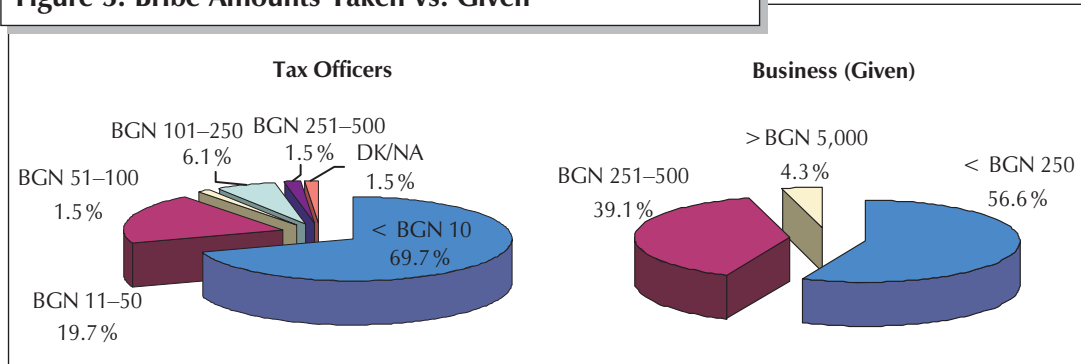
* TRS: Taxpayers Registration and Services; OC: Operational Control; FA: Finance and Accounting.

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

When it comes to *personal experience*, rather than just an assessment, in answer to the question whether, to their knowledge, any co-workers received bribes during the previous year, 36.8 per cent say 'Yes', even though, again, such occurrences are qualified as sporadic.¹⁴ Last but not least, asked about their own bribe-taking experience, 66 of the total of 669 respondents (9.4%) admitted having taken a bribe.¹⁵

The tax officers are however unconvincingly modest in their estimates of the value of bribe money/gifts received. Some 58 per cent chose not to answer the question, and 23 per cent said there was no such thing. Of the remaining 19 per cent, who did offer an estimate, most put the value of bribe money/gifts at fairly small amounts (up to BGN 10 and BGN 50, respectively). A mere 35 of the total of 699 respondents (5%) estimated bribe levels at above BGN 100. Among the 9.4 per cent, who admitted having taken a bribe themselves, small amounts, up to BGN 50, also prevail. Only five of the 699 admitted having taken a bribe bigger than BGN 100. Results such as these are difficult to reconcile with the considerable amounts involved in tax fraud, most of which could not have been committed without the aid of a tax officer. Above all, the tax officers' estimates of bribes taken are highly inconsistent with the taxpayers' estimates of bribes given. Of business respondents, 39 per cent report levels between BGN 250 and 500, and 4.3 per cent, above BGN 5,000.¹⁶

Figure 3. Bribe Amounts Taken vs. Given



Source: Coalition 2000 CMS: Business Sector, April 2004, Table 1.

What is the cause of these wide discrepancies? Is the public unfair to the tax officers? The question seems all the more warranted by the comparison of taxpayers' perceived versus their personally experienced corruptness of tax officers. For example,

¹⁴ A noteworthy observation is that a high percentage of respondents (45-60%) chose not to answer the questions about the spread of corruption. This alone is indicative of, either, widespread tolerance or the lack of transparency in the organisation of operations. That is to say, if anticorruption measures were effective, and the effect were properly communicated throughout the organisation, those who have no opinion on the question would hardly be as many as half of the staff. The more effective anticorruption measures are, and the broader support they enjoy, the lower should the proportion be of DK/NA responses.

¹⁵ It is somewhat surprising that the percentage is higher than the percentage of businesses which admit having bribed tax officers (Appendix 3.3), even though, addressed to the tax officers, the question only covered one previous year. To compare, a similar survey of members of the judiciary conducted in May 2003 yielded a 2-3 times smaller percentage (from 13% in the judicial administration to 22% in the office of public prosecutions) of the respondents who confirmed their co-workers' involvement in corruption; and the percentage of those who admitted their own involvement was five times smaller (1.8%). See Vitosha Research, 2003, p. 11-12.

¹⁶ The direct comparison between the two surveys is limited by differences of scale and time horizon, but is nonetheless indicative.

while 51 per cent of business respondents believe that most, if not all, tax officers are involved in corruption, only one third say they have personally been asked to pay a bribe. Among the general public, this gap between perception and experience is more than 10 times wide.¹⁷ The perception vs. experience ratios concerning the corruptness of other professional groups¹⁸ also affect the tax officers' rating among other members of the public sector. In terms of bribes given, i.e., 'actual corruption', and bribes asked, i.e., 'potential corruption', the tax officers perform much better, compared with other public services, than in terms of public opinion. Thus, based on shared personal experience, they are less corrupt than physicians or municipal servants, but *in the eyes* of the general public and of the business community, they appear to be more corrupt than either of these. How much darker than reality is the picture painted by public opinion?

Admittedly, economic agents make their investment decisions on the strength of perceptions, regardless of how close to reality they are. To a Bulgarian's decision to start his or her own business, or to a foreign investor's choice between Bulgaria and another inward investment destination, their respective *assessment* of the level of corruption and of the related additional cost of doing business is much more relevant than the *actual* level of corruption in Bulgaria. Therefore, if the discrepancy between these two is large, anticorruption measures must be coupled with an open dialogue among all stakeholders and an active public communication effort to raise public awareness of the actual state of play in the fight against corruption.

In this particular instance however, the gap between perception and experience is only partially accounted for by communication impacts or the inertia of public opinion. Asked about the sources on which their perception builds, the respondents attribute 20-30 per cent to the mass media. In the remaining 70-80 per cent, perceptions are allegedly based on personal experience (possibly, not immediately related to one's own business), the experience of friends or relatives or the perceived discrepancy between tax officers' income and lifestyle. All of these are as relevant to the measurement of corruption in the tax administration as is personal experience. Therefore, the discrepancy between perception and experience is not an accurate measure of the extent to which corruption in the tax administration is overestimated, i.e., while it may be overestimated, it is certainly by less than would appear from this discrepancy.

If tax officers are indeed being 'wrongly accused', it is in another way: Public opinion is rather inclined to regard them as unilateral beneficiaries of corruption at the expense of taxpayers, who are perceived as mere 'victims'. This explains why the administration, unlike business, has traditionally been regarded as the primary generator of corruption pressure. The question, therefore, is not about the level of corruption but about its drivers, which we shall come to later, in Chapter Three.

Yet another pointer to the level of corruption in the tax administration is the proportion of the shadow economy, and in particular, taxes and social security contribu-

¹⁷ Vitoshka Research (2004a, Appendix 3, Tables 3 and 5).

¹⁸ For example, the perceived corruptness of politicians, Members of Parliament, and judges is higher than shared personal experience suggests, while physicians and municipal servants are perceived as less corrupt than the respondents have actually experienced. Given that the personal experience base, comprising only respondents who have come into contact with members of the group assessed for corruptness, is smaller than the perceived corruption base (comprising all respondents), the gap between perception and experience is even wider than it appears from the direct comparison of response percentages. Concerning the tax administration vis-a-vis business respondents, this qualification is less relevant as very few of the business respondents have not had to deal with tax officers. Vis-a-vis the general public, however, it is fully valid.

tions evaded. Given that, to succeed, tax evasion largely depends on cooperation from tax officers, unreported business activity is a good indirect indicator of the scale of tax corruption. Schneider (2004) estimates it at 38.3 per cent for 2002–2003. The World Economic Forum ranks Bulgaria 78th out of 102 countries.¹⁹ In 2002, the tax compliance gap amounted to some BGN 3,000 million or 25 per cent of potential tax revenues (*Пауеб* [Pashev], 2004). All of this suggests that the scale of tax corruption in Bulgaria is considerable.

2.3. INTERNATIONAL COMPARISONS

What is the level of tax corruption in Bulgaria from an international comparison perspective? Corruption is an important component of most international indices of institutional development, the business environment, and investment risk. What do these surveys say about the level of corruption in Bulgaria, tax corruption in particular? What is Bulgaria's *relative position* among other countries, and above all, countries in transition and the new EU Member States? The answers are inconclusive and do not place Bulgaria with any particular precision among others, either in Europe or in the Balkans or in Central Asia. (See Appendix 4.) What is certain beyond doubt is that assessing corruption levels is no easy task.

The corruption perceptions index of Transparency International (TI CPI) brings together the various international indices and ratings. It covers at least four ratings per country, running at least three years back. Table 2, below, shows a steady upward trend of Bulgaria's international anticorruption rating over the last five years. Furthermore, Bulgaria alone, of the EU accession countries, has shown steady improvement year-on-year. As a result, in 2003, it came higher than Slovakia, Latvia, Poland, and Romania, on a par with the Czech Republic, and below the undoubted leaders in the Region, Slovenia and Estonia, and the fast improving Hungary and Lithuania. Still, Bulgaria is below the cut-off rating of 5, which, according to TI's standards, places it among relatively corrupt countries.

Table 2. Bulgaria's TI CPI Rating

	1998	1999	2000	2001	2002	2003	2004
Place (of Total #)	66 (85)	63 (99)	52 (90)	47 (91)	45 (102)	54 (133)	54 (145)
Of previous year totals	...	59 (85)	54 (99)	47 (90)	44 (91)	45 (102)	50 (133)
Change	...	7↑	9↑	5↑	3↑	0	4↑
Index ^a	2.9	3.3	3.5	3.9	4.0	3.9	4.1
Standard Deviation ^b	2.3	1.4	0.4	0.6	0.9	0.9	NA
Ratings Included in Index	4	8	6	6	7	10	10

^a Scale: from 1 (*Absolute Corruption*) to 10 (*No Corruption*).

^b Smaller values mean higher uniformity of response.

Source: The author's own calculations based on Transparency International data.

¹⁹ Global Competitiveness Report (2004).

Where are the Bulgarian tax officers in all this? Albeit limited and inconsistent, estimates of their corruptness do feature in indices, such as the Global Competitiveness Report, SELDI, and BEEPS.

The Global Competitiveness Report covers irregular payments in tax collection. In 2003, Bulgaria ranked 31st of 102 countries, on a par with France and higher than a number of EU Member States and accession countries, such as: Belgium (33), Lithuania (36), Portugal (37), Slovakia (38), Czech Republic (45), Poland (49), Latvia (50), Italy (53), Greece (75), and Croatia (54) and Romania (70).²⁰ In all fairness it must be said, this ranking, fairly good as it is, was a considerable setback (by 8 places) from 2002, when Bulgaria had ranked 21st of 80 countries, ahead of USA (22), Estonia (25), Spain (26), France (29), and Hungary (32).²¹

Table 3. Corruption in the Tax Administration, International Rating
(„How often do businesses in your sector pay bribes in connection with tax collection?": from 1, Often, to 7, Never)

	Place	Index	Average
2002	21 st of 80	6.0	5.0
2003	31 st of 102 29 th of the 80 in 2002	5.8	4.8

Source: Global Competitiveness Report, 2004, Table 7.03.

The regional corruption monitoring system in South-Eastern Europe includes a question about bribes asked by tax officers. On this, in 2001 and 2002, for the Balkans, Bulgaria only performed worse than Croatia. (SELDI, 2002 table 5.10)

According to the World Bank's surveys, Bulgaria does not compare so well with others in the Region. In terms of the incidence of bribes, its position is worse than that of all new EU Member States and accession countries, on a par with, or worse than, most of the former Soviet Republics.²² A somewhat redeeming fact is that, against the general trend of tax corruption rising in the Region, it has remained unchanged in Bulgaria.

²⁰ Global Competitiveness Report, 2004, p. 492, Table 7.03, Irregular Payments in Tax Collection.

²¹ In 2004, two of the new countries which joined the rating that year, Luxembourg and Malta, ranked higher than Bulgaria, which means that, based on the 2003 total, a year later, Bulgaria would have ranked 29th. Global Competitiveness Report, 2003, p. 405, Table 7.03, Irregular Payments in Tax Collection.

²² The World Bank's BEEPS surveys (see Appendix 4) for 1999 and 2002 are presented in *Gray et al* (2004). These surveys measure the spread of tax corruption by the percentage of respondents who, asked about the frequency with which 'firms like yours' make irregular payments or gifts to tax officers, gave any answer, on a six-point scale, other than 'Never'. The findings for Bulgaria were largely behind the Government's decision to launch a radical reform of the budget revenue administration in the framework of an investment project to set up a single National Revenue Agency, worth €63 million, of which 34 million came as a loan from the Bank. Implementation started in 2003 and expectations are that the relevant indicators will soon begin to show some improvement.

2.4. SPREAD OF CORRUPTION BY STRUCTURAL LEVEL AND FUNCTIONAL AREA

The effective targeting of anticorruption policies requires a closer look, behind the general national or international corruption ratings, to identify the most vulnerable structural elements. Decisive in this regard is the 'inside' perspective, i.e., the information that a survey of tax officers can provide. The respondents in this survey have ranked structural levels and functional areas within the administration by bribe level and incidence (see Appendix 5).

Half of the respondents either could not, or did not wish to, identify the structural levels at which corrupt transactions are the largest or the most frequent; another 11-12 per cent did not see corruption anywhere; and according to 8 per cent of the respondents corruption is equally common at all levels. Of the remaining 30 per cent, who localised corruption *along vertical lines* in the administration, some two thirds (19 % of all respondents) tend to see it above their level in the hierarchy, i.e., at RTDs, at the Large Taxpayers Directorate or at the GTD. A mere 12 per cent of all 699 TTD and local-office staff believe that the *greatest number* of corrupt transactions take place at their respective structural levels. There is apparently the tendency of laying the blame at someone else's door and seeing corruption mostly in higher administrative echelons.

The distribution of corruption by *functional area* is relatively more straightforward, even though, here again, 40-45 per cent of the respondents could not, or did not wish to, identify the area in which corruption is biggest or most frequent. According to more than half of the remaining respondents, worst hit by corruption are Tax Audit and Operational Control (see Appendix 5). In all functional areas, including Tax Audit itself, the prevailing opinion is that corruption is *biggest* in Tax Audit, followed by Operational Control. Quite a few of the representatives of Tax Audit and of Collection believe that the Appeals area is worst hit. In terms of the *incidence* of corrupt dealings, Operational Control ranks first according to most of the respondents, bearing in mind that auditors accounted for one third of the sample. For their part, the officers from other functional areas claimed that corruption is not only biggest, but also most frequent, in Tax Audit.

In summary, national and international indices show that the tax administration presents the Bulgarian society with a major challenge in its fight against corruption. On the other hand, as perceived by both the general public and the business community, the tax administration is relatively less corrupt than other public institutions, and in particular, customs, the police, and the judiciary. And even though no definitive conclusions can yet be made, there are signs that corruption is on the decrease in the tax administration. International comparisons reveal a mixed picture. Some sources, such as the World Economic Forum, give the Bulgarian tax administration a fairly positive assessment in the context of the enlarged EU. Others, such as the World Bank, place it among the worst performers, below others, even in the Balkans and among the former Soviet Republics.

Outside the comparative context however, and despite some positive changes, corruption in the Bulgarian tax administration remains widespread according to both national and international indices. The business community largely believes that most, if not all, tax officers are involved in corruption. Approximately one out of five busi-

nesses has come, from time to time, under corruption pressure from tax officers. The tax officers themselves, while they do not share the taxpayers' perception of its scale, do not deny the existence of corruption. They see the administration's functional areas for Tax Audit and Operational Control as worst affected in terms of, respectively, the amounts of money changing hands and the frequency of such transactions.

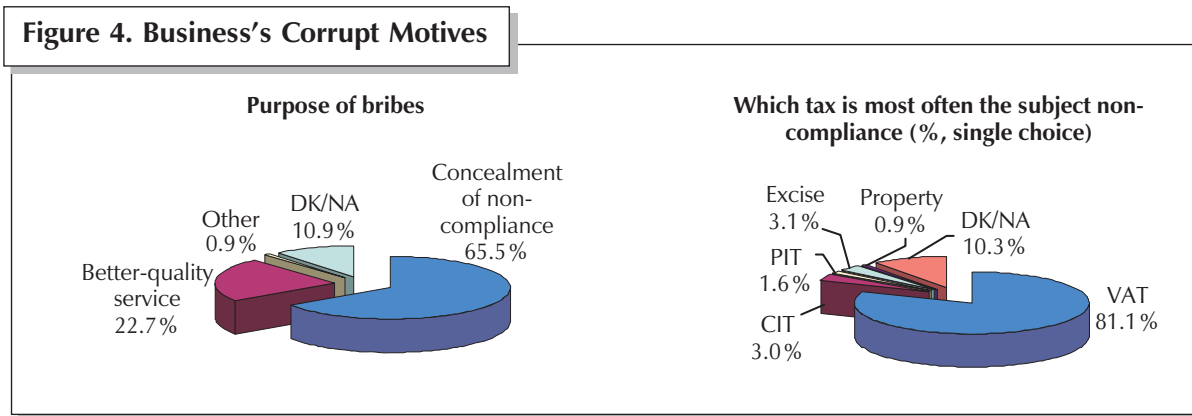
3. TAX CORRUPTION DRIVERS

3.1. WHAT BUSINESS PAYS FOR

The question about the kinds of corrupt service on offer is the starting point of the analysis of what motivates and drives tax corruption from the perspective of business, and of the subsequent identification of effective countermeasures. Businesses pay for two groups of services:

- (a) those related to tax fraud and other offences under the tax legislation; and
- (b) ‘preferred customer’ or better-quality service.

As the tax officers see it, the purpose of corrupt transactions is primarily to conceal fraud and other tax offences, i.e., generally speaking, non-compliance (see Figure 4). The proportion of bribes aiming at better-quality service is however fairly high as well.

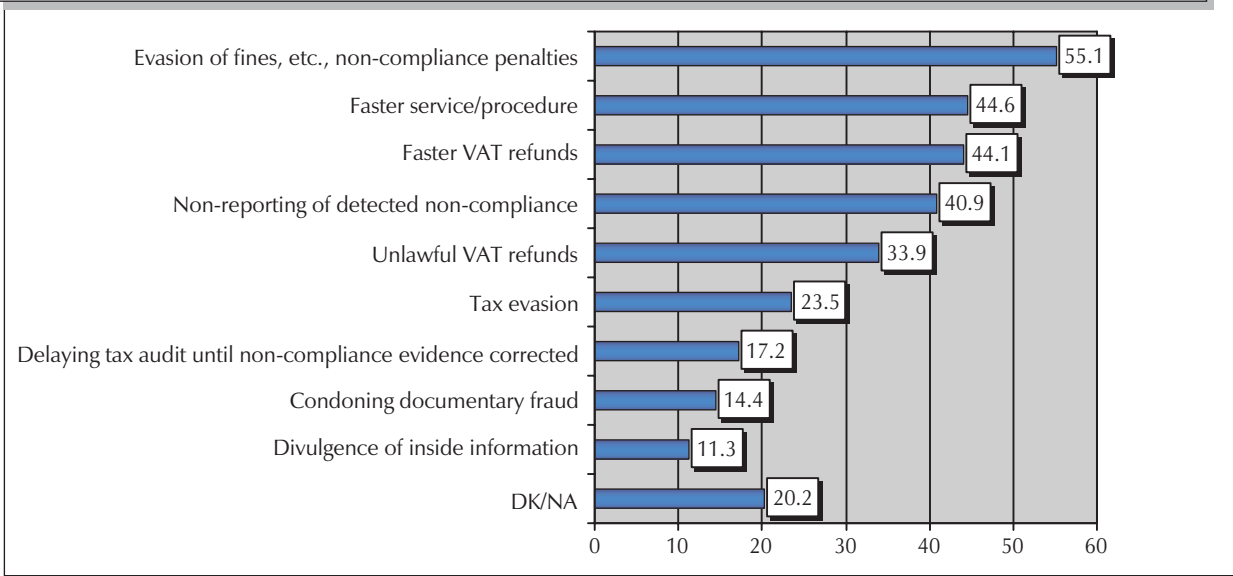


Source: Vitosha Research, April 2004. Base: 699.

The most common corrupt services include: the evasion of fines and other non-compliance penalties; faster service (‘jumping the line’), and in particular, faster refunds; unlawful VAT refunds; tax evasion. The tax officers are almost unanimous in their view that VAT fraud is the most common tax offence. Among the most common corrupt services, they cite unlawful VAT refunds, fines evasion, underreported sales and the evasion of taxes and social security contributions (see Figure 6).

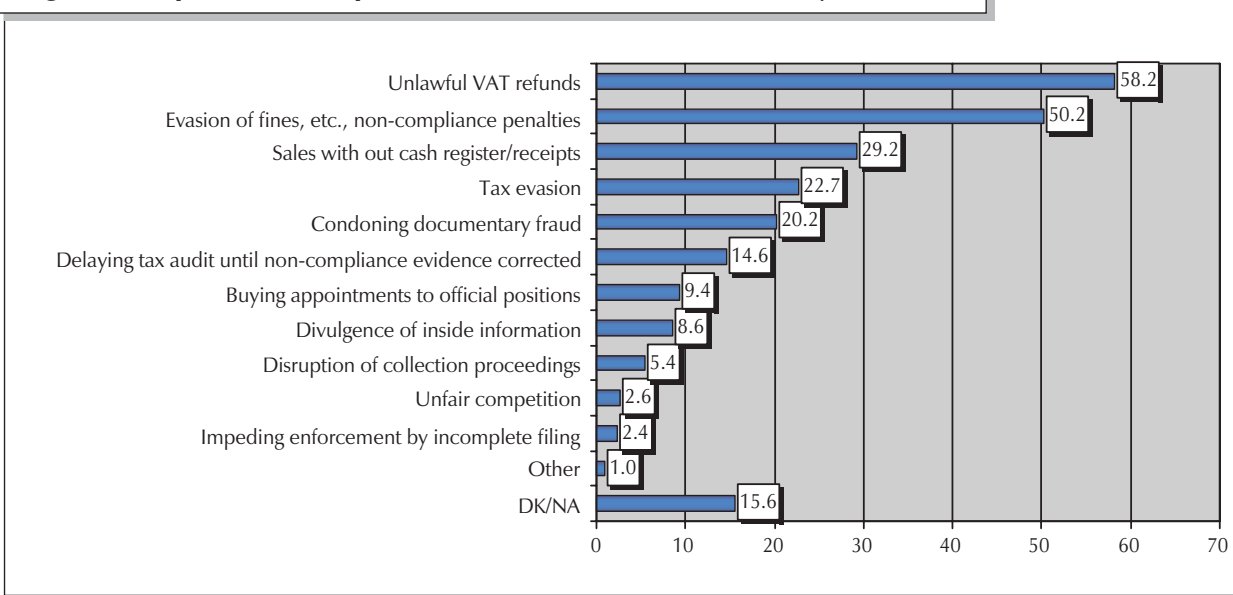
This ‘inventory’ of the most common corrupt services suggests several important policy implications. *First*, most of the ‘services’ are related to tax fraud. These include: ‘turning a blind eye’ to non-compliance detected; unlawful VAT refunds; complicity in tax evasion; trading inside information about imminent tax audits; delaying a tax audit to allow time for a cover-up or assets disposition. All of these involve mainly the

Figure 5. Services Provided for Bribe Money (% of respondents; 5 most common)



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

Figure 6. Top-Three Corruption-Related Tax Offences (% of respondents)



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

functional areas of Tax Audit and Operational Control, which is consistent with the perceived concentration of corrupt practices in these areas. This finding has an important practical dimension: anticorruption measures and resources should be targeted with priority at Tax Audit and Operational Control.

Second, the findings suggest that tax corruption in Bulgaria is not driven primarily by the heavy burden of direct taxation. According to the tax officers, tax evasion, and the related underreporting of income, is not the main purpose of corrupt dealings. Therefore, any further income-tax cuts would hardly produce a significant anticorruption

effect. According to the World Economic Forum's *Global Competitiveness Report* and the economic freedom index of the Heritage Foundation, the burden of direct taxation in Bulgaria is low also on an international comparison basis²³—a view borne out by the survey of tax officers. In answer to the relevant questions, the tax officers did not place the tax burden among the country's main economic problems or the tax administration's main challenges. In order to weaken corruption drivers then, it would be more appropriate to simplify the rules and narrow the scope of the various income-tax exemptions and allowances, so as to limit tax officers' discretionary powers in interpreting and enforcing the law.

Third, VAT fraud is the most common. However, the VAT burden is largely passed on to the end consumer. It is hardly a driver for VAT corruption. What triggers that is rather the tendency of engaging in unlawful price competition and, above all, the desire for windfall profits. Thus, anticorruption measures should focus on the VAT legislation and administration. This would allow a fairly high concentration of available sources to achieve a visible anticorruption effect. A more detailed analysis of VAT fraud follows in Chapter Four.

Fourth, expediting procedures, and especially, the faster refund of tax credit, is among the corrupt services most in demand by business (see Figure 6). This suggests that there is a significant short-term anticorruption potential in simply improving the quality of service and making it faster. A number of measures have been taken in recent years to expedite the VAT refunding process by, among other things, providing a shorter statutory time-limit and introducing special incentives for the users of a VAT account. As a result, confirmed by a World Bank survey, the average waiting time for a VAT refund has come down, from 59 days in 2002 to 41 days in 2004.²⁴ Nonetheless, the tax credit arrangement is still a major generator of tax corruption.²⁵

The level of corruption seeking better quality of taxpayer service is a direct function of the administration's effectiveness. There is still a rather wide gap between the respective expectations and requirements of the service providers and the service recipients, which is largely due to bureaucratic inertia laying the emphasis on the administration of taxes, rather than on the servicing of taxpayers. On the other hand, there are apparently quite a few taxpayers who cannot live with any rules and are prepared to pay extra for just about any time saved. According to 73.5 per cent of the tax officers, taxpayers often expect too much of them; and 77 per cent claim that the taxpayers are not aware of their rights and duties and do not have a proper understanding of the law. Most of the tax officers (62% of the respondents) also say that the taxpayers are frequently dissatisfied with the level of service. On the other hand, quite a few have shared personal experiences of taxpayers' arrogance in the belief that a bribe can solve any problem.

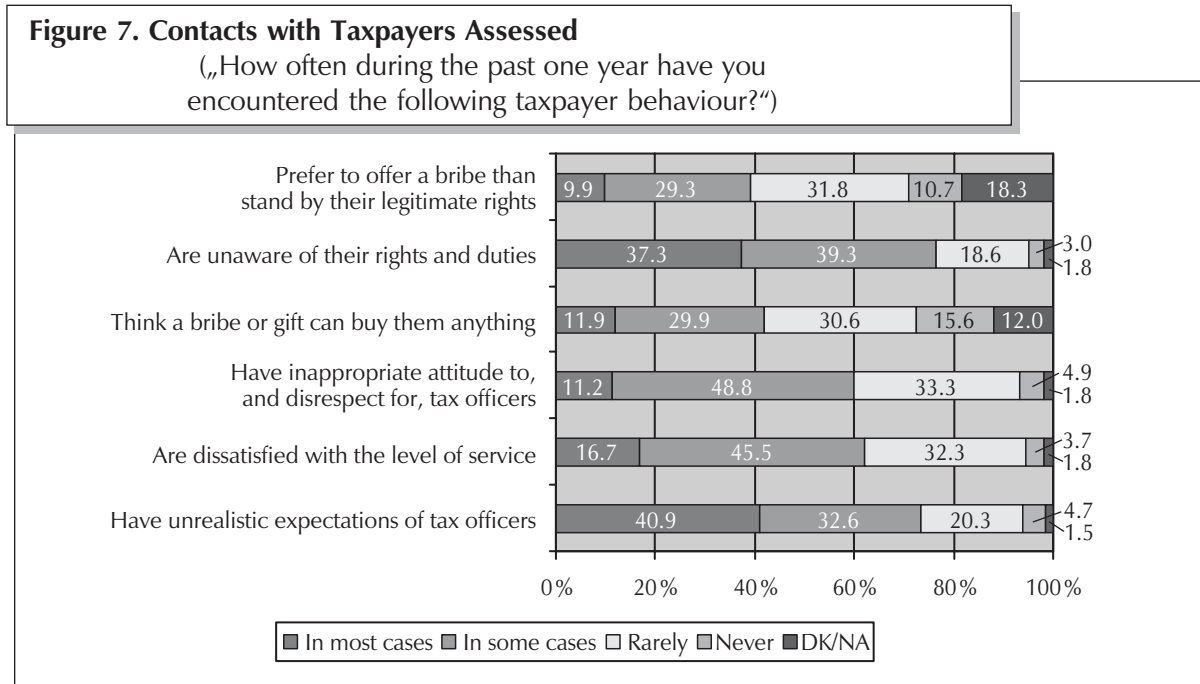
The above results suggest the existence of serious communication problems between tax officers and taxpayers, and accordingly, the introduction of service level standards would have a significant anticorruption effect. A more precise definition of

²³ Global Competitiveness Report 2003 ranked Bulgaria 8th of 79 countries (the further down the scale, the higher the tax burden) in terms of corporate tax rates (GCR 2003, Table 2.25). Heritage Foundation (2004, p. 117) assesses the corporate tax burden at 1.5 (low) on a five-point scale.

²⁴ FIAS (2004).

²⁵ See Chapter Four on VAT fraud-related corruption, and 5.2, on countermeasures.

services and of the time-limits for their delivery would narrow the opportunities for corruption pressure (by unnecessary delays) from tax officers and would set aside business's unfounded suspicions that delays are only used to extort bribes. It would be appropriate, however, to accompany service level standards with the taxpayers' reciprocal commitment to a code of conduct (see more on this under 5.2).



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

The prices of corrupt services are also relevant to understanding taxpayers' motives to get around the rules. A bribe is essentially the price paid for a benefit for which the taxpayer is not eligible. The net benefit, i.e., the gross benefit less the bribe, is among business's leading corrupt motives. Therefore, corruption-related costs, for the purposes of tax evasion, as a percentage of the tax amount evaded are more important in understanding demand-side corruption drivers than other indicators, such as corruption costs as a proportion of annual sales (used by the World Bank) or absolute bribe amounts (used by *Coalition 2000*). The latter is actually more relevant to the analysis of tax officers' motives. (Indicators are discussed at length in Chapter Six.)

The probability of a bribe scenario is determined also by two additional demand-side factors. The first of them is the prospective briber's assessment of the bribe's effectiveness. The more reliable a tool bribes are, the more inclined businesses are to use them. However, Bulgarian businesses are undecided about the effectiveness of bribes as a problem-solving tool. Some 45 per cent of them are confident of getting what they pay for, but a considerable proportion (36%) believe that bribing one tax officer at a time may not be enough.

The second factor has to do with the extent to which bribes have become part of the cost of doing business. Approximately one third of the respondents claim that bribes are customary in their line of business and that informal payments are on the increase. Even more importantly, 27 per cent claim that there is an established 'pricelist'

of corrupt services, well-known to the players in the industry. All this is an indication of the high degree of institutionalisation of bribery as part and parcel of business tactics and business ethics.²⁶

The corrupt services analysed here, and their respective prices, shed light on business's corrupt benefits and motives. The prevailing opinion among the tax officers that corrupt transactions are more often than not initiated by the taxpayers would therefore seem to be valid. More than half of the respondents claim that the pressure for taxman-taxpayer collusion is more likely to come from the taxpayer. Still, 24 per cent concede that, seeking unlawful gain, each party is ready to meet the other half way. At that, the opinion prevails that the corrupt relationship is bilateral and direct, i.e., no go-betweens, such as friends or relatives or co-workers, get involved at any stage of the process. This goes to show that the risk of rejection or complications is regarded as negligible, i.e., the transaction costs of corruption are very low indeed.

The above notwithstanding, business does fall victim to corruption pressure from the tax administration. On average, over the last five years, one out of five businesses has complained about corruption pressure in the collection of taxes (see Appendix 3.5). An even more telling observation is that more than 90 per cent of those who experienced corruption did not take any counteraction. The reasons why include disillusionment with the system, and the unwillingness to waste time and effort, or indeed, the fear of reprisal.²⁷

The institutional opportunities for corruption pressure from the tax administration have to do with the long statutory time-limits for the delivery of administrative service. This is why, when a taxpayer gives a bribe in return for better-quality service, he or she has a greater reason to feel victimised than in the case of giving a bribe to get away with non-compliance. In both cases, of course, the objective is one: gaining an otherwise undeserved competitive advantage.

The second driver of corruption pressure from the tax administration are the weaknesses of the tax and financial reporting legislation, which allow the administration considerable discretion in the process of application and enforcement. To protect them from such corruption pressure, the taxpayers must be given a way to comply independent of a tax officer's say-so. If, to the prejudice of his interests, the taxpayer is prevented from coming to terms with the law, he will try to come to terms with the taxman, to the prejudice of the law.

But business is also, and primarily, victimised by corruption outside the context of a particular corrupt transaction. For a lot of businesses, the cost of unfair competition is so high that bribery is their only means of survival in the existing market environment. This is why, to assess the level of potential corruption, one must focus on the indicators which reflect the institutionalisation of bribery as an element of the business environment.

In summary, most corrupt transactions seek to advance the taxpayer's business interests. To regard business as invariably the victim or the losing party in such transactions is to ignore the demand-side drivers which have to do with business's tendency

²⁶ Vitosha Research (2004b, Appendix 3, Table 5).

²⁷ Vitosha Research (2004b, p. 11-13, Chart 8-9).

of seizing opportunities for unlawful gain whenever such present themselves. Nonetheless, the main causes of corruption, its drivers, and the ways to prevent it reside within the tax administration.

3.2. MOTIVES AND DRIVERS WITHIN THE ADMINISTRATION

Financial Incentives and Institutional Drivers

The main drivers of the spread of tax corruption, as seen by the tax officers, are shown in Table 4. Notably, pressure from taxpayers comes only seventh, which means that, while business may often take the corrupt initiative, it does not determine the tax officers' choice. The drivers at work within the administration are key. The tax officers are decidedly more inclined to look for the reasons and the responsibility for corruption in their midst, rather than among their clients. The top drivers cited by them include: low pay; professional ethics; legal gaps and loopholes; conflicts of interest; get-rich-quick ambitions; and bureaucratic red tape. In short, the tax officers are in no doubt that corruption is *the result of low pay levels combined with poor professional integrity and legal and organisational opportunities for corruption pressure*.

Table 4. Tax Officers on the Main Corruption Drivers
(%, up to three responses)

Tax officers' low pay levels	52.2
Tax officers' low professional ethics	35.2
The freedom of arbitrary interpretation allowed by the legislation	30.9
Conflict of professional and personal interests	21.5
Get-rich-quick syndrome	19.3
General wide spread of corruption	17.7
Pressure from taxpayers	17.6
Complicated and slow bureaucratic procedure	16.9
Demoralising effect of corruption in higher echelons	10.3
Obsolete and depreciated physical facilities	10.2
Frequent changes in the legislation	9.2
Understaffing	6.3
Ineffective internal control	4.9
High fees, taxes and fines	3.1
Tax law application weaknesses	2.9
Peer pressure	1.9
Weaknesses in service delivery	1.7
Ineffective risk assessment and tax audit targeting	1.4
Other	0.9

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

The tax officers' identification of the main challenges to their administration is also indicative. They can be summarised as: again, low pay, plus poor physical facilities, bureaucratic red tape and the instability and deficiency of the relevant legislation (Table 5). Tax officers from all functional areas identify low pay as *the* problem. The most sensitive to it, at 90 per cent, are the members of Operational Control. Another consensus issue is the inadequacy of physical facilities and the poor working conditions, worst affected by which are Tax Audit, Collection, and Appeals. These also suffer from the instability and deficiency of the relevant legislation, and the heavily bureaucratic working arrangements. The greatest number of those who perceive non-compliance detection weaknesses as a problem comes from nowhere else but Collection, Tax Audit, and Operational Control.

A tax officer's susceptibility to corrupt practices is also a function of the damage he or she might incur in the event of detection and punishment. It is interesting to note tax officers' expectations of what might happen to them should they accept bribe money or gifts. Most of them (61%) expect to be fired, and 32.5 per cent expect some other

Table 5. Challenges to the Tax Administration
(% of „Largely a challenge“ by functional area)

	TOTAL	TRS	Audit	OC	Collection	FaP	Appeals	Other	NA
Tax officers' low pay levels	75.5	72.2	77.2	89.6	77.8	68.2	42.9	70.8	100.0
Obsolete physical facilities	61.4	60.1	69.0	56.7	70.4	45.5	71.4	29.2	70.0
Complicated and slow procedure	58.7	53.8	65.5	58.2	66.7	54.5	42.9	45.8	80.0
Frequent legal changes	58.1	51.4	69.4	52.2	66.7	40.9	57.1	58.3	80.0
Legal gaps and deficiencies	52.5	39.9	67.2	59.7	59.3	38.6	57.1	58.3	50.0
Low taxpayer culture and awareness	51.9	60.1	45.7	46.3	51.9	45.5	42.9	41.7	60.0
Lack of cooperation from taxpayers	40.5	35.8	43.5	58.2	40.7	38.6	28.6	25.0	40.0
Non-compliance detection weaknesses	35.6	31.9	40.1	37.3	48.1	29.5	14.3	33.3	40.0
High staff turnover	27.8	29.2	27.6	28.4	29.6	18.2	28.6	25.0	30.0
Ineffective HRM	26.9	23.6	29.7	23.9	29.6	27.3	28.6	29.2	60.0
High tax rates	26.2	26.7	23.7	28.4	33.3	25.0	14.3	25.0	50.0
Corruption pressure from taxpayers	22.0	23.6	19.0	23.9	29.6	25.0	28.6	8.3	30.0
Misuse of official powers	20.9	20.5	20.3	22.4	33.3	18.2	14.3	20.8	20.0
Shortage of skilled professionals	16.9	13.5	21.6	14.9	14.8	15.9	42.9	8.3	30.0
Voluntary compliance weaknesses	16.6	16.0	16.8	19.4	18.5	13.6		25.0	10.0
Lack of professional integrity	12.4	10.8	11.2	16.4	25.9	18.2		8.3	20.0
Taxpayer servicing weaknesses	11.2	11.1	11.2	13.4	11.1	11.4	14.3	4.2	10.0
BASE	699	288	232	67	27	44	7	24	10

kind of disciplinary action (Table 6).²⁸ Only 5 per cent believe that the money or gift would be confiscated. Another telling observation is that quite a few (18%) fear undue pressure on them should they be caught 'red-handed'.

Table 6. Tax Officers' Expected Consequences of Accepting Bribe Money or Gifts
(%, more than one response)

Removal from office	60.9
Subsequent dependence on the briber	38.1
Disciplinary punishment, other than removal	32.5
Undue pressure in lieu of disciplinary punishment	17.9
Confiscation of corruption proceeds	5.2
No adverse consequences	4.6
Other	0.4

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

The issues relating to pay levels, and more broadly, to HRM, and to the legal framework and the organisation of taxpayer servicing and control are key to understanding and counteracting corruption in the tax administration. These are analysed at greater length in the following Chapter. Before that however, it would be worth looking into some elements of the value system, the moral standards and inhibitions, which trigger or deter corrupt behaviour.

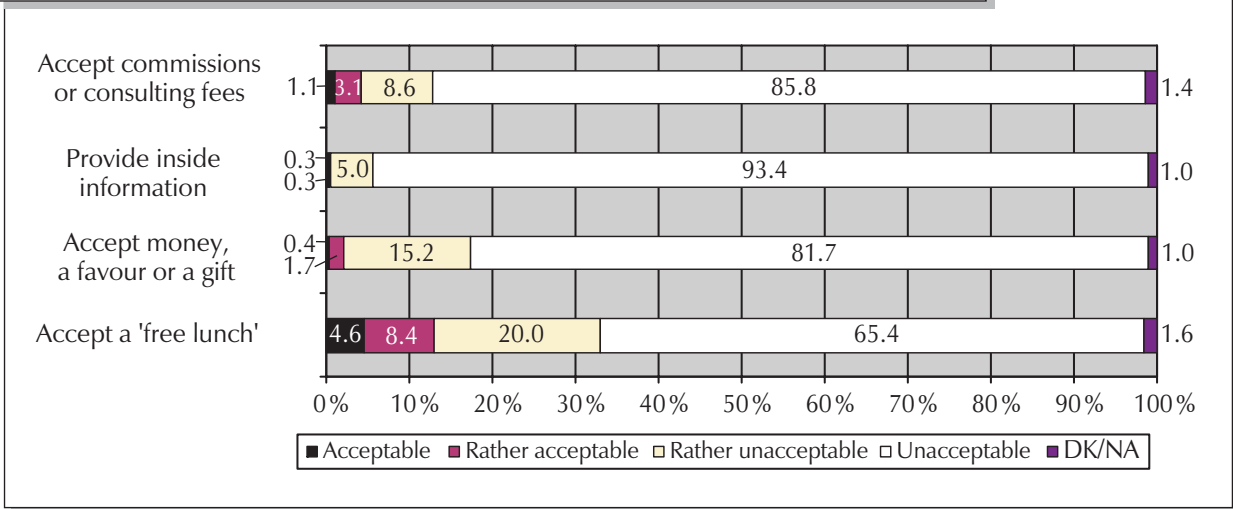
Moral Standards and Inhibitions

Overall, the survey found a high degree of tax officers' declared *personal intolerance* to corruption. For example, 81.7 per cent of the respondents believe that accepting money, a favour or a gift from a taxpayer, in any form whatsoever, is absolutely unacceptable (see Figure 8). Asked whether they would accept money or a gift in return for solving a client's problem, 67 per cent claim this would be incompatible with their professional ethic, and 22 per cent fear that it might harm their reputation. A mere 5 per cent would refuse to take the money or gift for fear of disciplinary action, in a rather striking indication of the low effectiveness of internal control and penalties. This result also suggests that, if corruption is so difficult to prove and punish, anticorruption efforts could achieve a greater effect by focusing on prevention and incentives.

An important element in the analysis of tax officers' susceptibility to corruption is their understanding of what is acceptable, i.e., where they draw the line between tokens of gratitude and unlawful consideration. The strength of their moral inhibitions

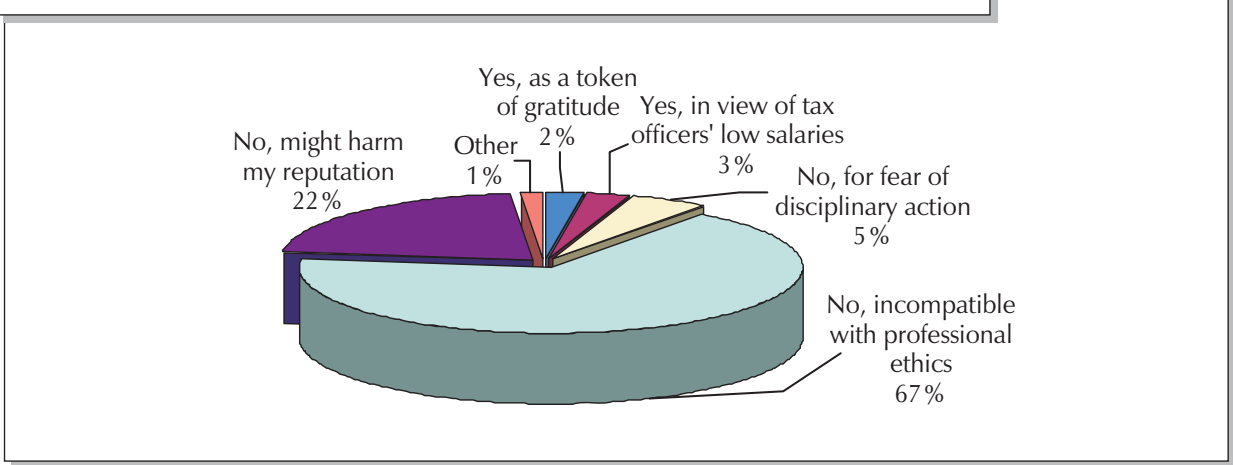
²⁸ An assumption that could be valid in this regard is that expected consequences reflect, in some part, the respondents' perceived probability of detection. For the purposes of identifying corruption drivers and recommending countermeasures, future surveys should therefore distinguish the perceived probability of detection from expectations about the severity of the likely punishment. (See Chapter Six.)

Figure 8. Is the Following Conduct Acceptable of a Tax Officer?
(% of responses)



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

Figure 9. Would You Accept Money or a Gift to Solve a Taxpayer's Problem?
(% of responses)



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

could be gauged from the distinction they make between *accepting a bribe* and *accepting a token of gratitude* (Table 7). Half of them would choose to regard money or a gift offered by a taxpayer as either a bribe or a token of gratitude depending on its amount or value. In this connection, more than one fifth believe that it would be appropriate to establish an upper limit for tokens of gratitude, and 28 per cent of these suggest that it should be set at BGN 50. Quite a few of the respondents believe that no amount or value could qualify as a bribe if it were not the subject of a prior arrangement or the tax officer's solicitation.

Table 7. Bribe vs. Token of Gratitude

	Is there a difference between a bribe and a token of gratitude?	How would a tax officer feel having accepted money or a gift from a taxpayer?						Base	
		Gratified	Uneasy	Obligated	Unimpressed	Other	DK/NA		
All respondents	100.0%	2.3%	23.3%	48.6%	2.4%	1.1%	22.2%	100.0%	699
Depends on amount or value	49.8%	1.7%	23.6%	50.3%	2.3%	1.1%	21.0%	100.0%	348
No difference	16.9%	2.5%	21.2%	44.1%	0.8%	0.8%	30.5%	100.0%	118
Token of gratitude, if for help with minor problems	12.4%	1.1%	25.3%	54.0%	3.4%	2.3%	13.8%	100.0%	87
Bribe, if upon prior arrangement	8.7%	6.6%	18.0%	54.1%	3.3%	1.6%	16.4%	100.0%	61
Token of gratitude, if unsolicited	8.3%	3.4%	34.5%	43.1%	5.2%	0.0%	13.8%	100.0%	58
DK/NA	3.9%	0.0%	11.1%	29.6%	0.0%	0.0%	59.3%	100.0%	27

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

What matters here is not how small or large and gift is, or whether a cut-off value has been set between bribes and tokens of gratitude. More important is whether money or gifts received by tax officers influence their performance in the taxpayer's interest. In this respect, more than half of the respondents who distinguish between bribes and tokens of gratitude and do not regard small or unsolicited gifts as a bribe believe that accepting money or gifts would make the tax officer feel *obliged* to the giver. This is also the prevailing opinion (54.4%) among the respondents who recommend that a cut-off value should be set. The conclusion is that even small tokens of gratitude given and accepted after a service has been delivered, and having therefore no immediate impact on the administrative transaction at hand, may lead to the establishment of a special relationship of corrupt affiliation, and thus, sustain the corrupt environment.

It is worth noting that both the Criminal Code and the Norms of Tax Officers' Conduct are unequivocal in this regard. Within the meaning of the Criminal Code, 'a bribe' is any *undue benefit*, whether tangible or intangible, promised or delivered, in connection with an official's action or inaction in the line of duty. The Norms of Conduct also advise against accepting gifts „lest the officer's impartiality be prejudiced.“ An exception is allowed only for articles of commercial advertising and souvenirs of minor value. Nonetheless, most tax officers do not consider themselves bound by any administrative rules against accepting gifts. Approximately 60 per cent claim that there are no such rules or that they are not aware of any. The remaining 40 per cent do know that their Norms of Conduct are against accepting gifts.

Another indication of the tax officers' attitude to corruption is how they perceive its broader public implications (Table 8). The gravest harm it could cause is undermine

the credibility of the tax administration, spread corrupt influences over honest and loyal officers, and cause damage to the Treasury. The harmful effect on the economy and business comes only second to these. This shows a significant discrepancy with the opinion of the business community, which sees the harm of tax corruption primarily in unfair competition and market distortion.

Table 8. The Three Most Harmful Public Implications of Tax Corruption as Seen by the Tax Officers (% of responses)

Undermines the credibility of the tax administration	77.3
Undermines uncorrupted officers' respect for the rules	47.9
Causes damage to the Treasury	46.4
Promotes the shadow economy	37.2
Harms the country's international reputation	16.7
Discourages inward investment	12.6
Demoralises society	12.3
Delays reforms and development	9.4
Prevents fair market competition	4.6
Thwarts private initiative	3.6
DK/NA	1.7
Other	0.4

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

Last but not least, individual tax officers' tendency to corrupt behaviour depends on how they perceive the spread of corruption outside the tax administration. If they feel victimised by corruption whenever they have to deal with other administrations as clients, it is easier for them to justify their own corrupt behaviour at work. Thus, a tax officer's choice to accept or reject a bribe is largely conditioned by their personal experience and perceived level of corruption in society. Accordingly, the tax officers rank the wide spread of corruption in all spheres of public life among the main drivers of corruption in their midst, on a par with pressure from taxpayers (see Table 4). The tax officers rank corruption also among society's main problems, together with the inefficient economy and above such other problems as poverty and the deficiencies in healthcare, justice and governance. This is apparently the result of personal experience in dealing with the healthcare system and the law enforcement authorities. Approximately 35 per cent report sporadic or frequent occurrences of bribes they have had to give to medical practitioners, and 12.3 per cent have had to resort to bribes, gifts or reciprocal favours in their contacts with authorities under the Ministry of Home Affairs. The alternatives to straightforward bribery are common: for many in the public administration, being on friendly terms with a tax officer is more valuable than a bribe or gift. About a quarter of the tax officers in the survey report such experiences in their contacts with medical practitioners during the past year; 13 and 10 per cent, respectively, have had to promise favours to municipal servants and police officers. Interestingly enough, 8 per cent report such experiences with co-workers. Overall, the perceived wide spread of corruption throughout society is an important indication of tax officers' personal attitudes to bribery.

The review of moral standards and inhibitions raises the need for a focused training effort, combined with an appropriate monitoring and evaluation system, to enhance the tax officers' knowledge of the Norms of Conduct (only recently introduced) and of the existing legal anticorruption measures, and impress upon them a clear idea of the responsibility and liability involved. Of course, practice is the best tutor: if disciplinary action for corrupt behaviour, to say nothing of criminal prosecution, is non-existent in the administration's practice, no amount of training could help.

In summary, business has strong motives to try and evade compliance by bribing tax officers. Ignoring these motives could generate unrealistic expectations regarding the effectiveness of prescribed countermeasures, or indeed, distort the very process of 'diagnosis and therapy'. Taking account of business's motives is important in understanding what triggers a corrupt deal and why business itself has failed to take an active stance against corruption. However, the motives and drivers within the administration decide the outcome of a corrupt initiative. They must therefore remain the main target of anticorruption policies.

4. VAT FRAUD-RELATED CORRUPTION

4.1. THE DAMAGE

The business community, the administration, and the analysts are unanimous in their assessment that VAT fraud is larger by far than the other kinds of tax fraud, both in absolute terms and as a proportion of total budget revenue lost. Still, there is no established methodology in Bulgaria for a more or less accurate quantification of this assessment. According to GTD data, the documented revenue loss caused by offences under the Value Added Tax Act (VATA) amounted to an average of BGN 280-300 million annually, or 10-12 per cent of VAT revenue collected, over the 2000–2004 period. The actual loss, according to the administration's own estimates, was two to four times bigger, for an annual average of BGN 600-1,200 million or 20-45 per cent of VAT revenue collected.²⁹ International estimates have been cursory and sporadic. For example, in 2002, a team of Canadian experts estimated the VAT evaded at BGN 605 million (31.5% of VAT revenue collected) in 1999, and at BGN 454 million (19.4%), in 2000 (SG Group, 2002). According to World Bank 2002 estimates, the VAT revenue lost to tax offenders amounted to almost BGN 900 million or 33 per cent of VAT revenue collected (World Bank, 2003).

The damage caused by VAT fraud is not limited to the public sector. Its adverse effect on the private sector comes primarily in the form of unfair competition and market distortion. These disrupt normal business development based on offering higher quality at lower prices. Businesses which survive are not the most productive ones but those who are better at evading taxes and pulling political and administrative strings.

Lastly, we should not ignore the direct financial loss caused to *bona fide* taxpayers: having unwittingly fallen prey to fraudsters, they risk being denied tax credit.

VAT fraud comes in two broad varieties: 1. *VAT evasion* schemes; and 2. *unlawful VAT refund* schemes, using a chain of fictitious transactions and traders.

4.2. VAT EVASION

In most cases, this kind of VAT fraud aims at tax savings and price advantages in respect of goods and services actually produced and supplied. The loss incurred by the Treasury is equal to the tax unaccounted for and uncollected on the value actually added. The offenders resort to conventional means, such as:

²⁹ Доклад на Временната анкетна комисия за разследване на измамите с ДДС към 39-ото Народно събрание [Report of the 39th National Assembly's Temporary Committee of Inquiry into VAT Fraud].

- (a) underreporting taxable sales; or
- (b) overstating taxable costs to claim a larger tax credit.

Underreporting taxable sales can be done in either of the following ways:

- (a) making sales without issuing an invoice;
- (b) invoicing a sales price smaller than the actual one;
- (c) invoicing smaller quantities than actually sold.

In theory, the main advantage of the tax-credit VAT system is that, even if the trader is not VAT-registered or chooses to evade its VAT liability, the tax is collectable from the next trader down the supply chain. And even if the non-compliant trader is an end supplier, the loss to the Treasury is limited to the tax on the value added by the end supplier, rather than on the full value added along the supply chain.³⁰ None of this is the case in the systems based on a single levying of the tax on consumer sales, such as the US sales tax. In those systems, if the retailer fails to register a sale, the tax on the full value added is lost by the Treasury, rather than just on the value added by the retailer. Moreover, the retailer, of all the suppliers and purchasers in the supply chain, is best placed to evade the tax as the end buyer usually does not need to register the transaction for tax purposes. This is why, in countries where there is a great number of end suppliers and a high risk that they may choose not report end sales, the tax-credit VAT produces a better fiscal effect than the sales tax.

Another advantage of the tax-credit VAT often cited is that the purchaser, especially if not an end consumer, has the incentive of requiring the supplier to issue a VAT invoice so that the purchaser can credit the VAT paid on the supply to its tax liability in respect of value added and charged to its purchasers down the line. The purchaser, if a compliant taxpayer, pressures its supplier to register the supply, thereby helping the tax authorities collect the tax. That is to say, in theory at least, VAT is capable of 'self-administration', unlike the sales tax.

However, in practice, these theoretical advantages offer a rather mixed blessing. If an invoice up the supply chain does not state the actual value of the transaction, traders down the chain, even if they wish to be tax-compliant, may be forced to understate value themselves so as to avoid paying the tax owed, but evaded, by their supplier. A chain reaction is triggered (as illustrated in Table 9): the producer invoices at lower than the actual price, and the distributor and the retailer have no choice but to do the same or, else, the tax evaded by the supplier up the chain will have to be paid by the next supplier down the chain, who has no proper purchase invoice to support its actual cost of goods sold. Even if, as in Scenario A, they choose to report the full value added by them, i.e., pay the full amount of tax on it, they will not be able to invoice actual prices to their buyers as this would mean paying also the VAT evaded by their supplier, together with a higher income tax. And even if the trader is VAT-exempt (as the retailer in the example), the income-tax consideration will make it understate its sales price as well.

³⁰ An exception to this rule is where a VAT-registered end supplier not only evades the tax, but also successfully claims a tax credit. The abuse of the tax-credit system is discussed in 4.3 below.

Table 9. Example: VAT Evasion-Fraud Chain Reaction

Compliant Traders Chain				
	Producer	Distributor	Retailer	Consumer
Net Cost	100	200	300	460
VAT Paid	20	40	60	60
Value Added	100	100	100	
Sales Price Net of VAT	200	300	400	
VAT	40	60	0	
End Sales Price	240	360	460	
VAT Payable	20	20	0	
Scenario A. Value Understated on Invoice by One				
	Producer	Distributor	Retailer	Consumer
Actual Net Cost, of which:	100	200	300	450
Unreported	0	50	50	50
Invoiced	100	150	250	400
VAT Paid	20	30	50	50
Value Added	100	100	100	
Reported Value Added	50	100	100	
Sales Price	200	300	450	
Invoiced Price Net of VAT	150	250	400	
VAT	30	50	0	
End Price Invoiced	180	300	400	
VAT Payable	10	20	0	
Scenario B. Value Understated on Invoice by All				
	Producer	Distributor	Retailer	Consumer
Actual Net Cost, of which:	100	200	300	440
Unreported	0	50	100	150
Invoiced	100	150	200	290
VAT Paid	20	30	40	40
Value Added	100	100	100	
Reported Value Added	50	50	50	
Sales Price	200	300	440	
Invoiced Price Net of VAT	150	200	290	
VAT	30	40	0	
End Price Invoiced	180	240	290	
VAT Payable	10	10	0	

The chain reaction is triggered by the VAT-registered producer, who utilises raw materials worth 100 and adds another 100 of value. The traders also add value of 100 each. Thereby, the product's value becomes 400, and the VAT payable on it, 60 (the end transaction is not subject to VAT). In Scenario A, the traders honour their part of the VAT liability, but in order to avoid the tax evaded upstream, they have to understate costs and prices on their invoices. In Scenario B, the traders make the most of having to understate values on their invoices by themselves evading some of the VAT on their own value added.

If the traders down the chain are forced by the first supplier's behaviour to understate sales prices, they are also less likely to pay the full amount of tax on their own value added. Scenario B (in the example) is rather more likely: the traders down the chain will themselves seek to benefit from the game by not only concealing the understatement of value added before them but also, in their turn, invoicing at prices below their own value added. Thereby, the correlation between crime and punishment is reversed: if, being made to conceal someone else's tax evasion, the traders run the risk of detection and punishment, their rational response will be to maximise profits by further non-compliance to offset contingent losses, in the event of detection and punishment. This becomes an especially powerful driver where the severity of the punishment/penalty is not in any clearly fixed proportion to the gravity of the offence/amount of tax evaded, but is rather left to the discretion of the enforcement authority. And this is exactly the case under the existing Bulgarian legislation.

Despite the self-proliferation of understated invoices down the supply chain, this VAT evasion method is the least popular, the reason being that it is relatively less effective and riskier than the others. For example, if the sales value is understated, the amount of tax evaded is limited to the value added. Underreporting taxable sales based on the quantity of items sold has a relatively greater potential but its application is rather limited to items difficult to keep track of by physical count, such as raw materials and goods rapidly turning over.

The other VAT evasion method is the overstatement of taxable costs so as to claim a larger tax credit. The vehicle used is a fictitious or overstated supplies invoice. Of course, for this method to work, a supplier must be found which is ready to overstate its sales, and accordingly, pay more VAT and profits tax than actually payable. This position is usually filled by undertakings having excess cash of shady origin, which they are trying to inject into lawful circulation, or by phantom undertakings, which either vanish or go bankrupt without having paid their overstated VAT liability. The distinction between the two is rather academic. In practice, the two kinds of undertaking are often related and function together as links in the same chain. The sale of fake VAT invoices serves to launder criminal proceeds, including proceeds from VAT fraud, and the missing traders serve to minimise the laundry costs, which are equal to the VAT and profits tax payable on the fictitious sales. A phantom undertaking can also take part in an unlawful VAT refund scheme (see 4.3 below) and only sell fake invoices as an 'ancillary' operation, to top up its unlawful profits.

4.3. UNLAWFUL VAT REFUNDS

This second major kind of VAT fraud is not about tax evasion but about *unlawful VAT refunds*. Again, the distinction is rather loose, considering that any of the above evasion schemes may trigger unlawful refunds if the tax allegedly paid on supplier invoices exceeds the tax allegedly charged to customers.

The single VAT rate in Bulgaria narrows the opportunities for unlawful refunds in respect of domestic supplies. Things would change if different VAT rates were intro-

duced.³¹ For example, a reduced rate of 7 per cent would work the same for an offending producer as does the existing zero rate on exports. Indeed, it would only make things easier, dispensing with the need to sham exportation and present the goods for physical inspection by customs. In addition, a greater number of undertakings would have to come under more rigorous administrative control. (See more on this under 5.3).

Of course, a single VAT rate can also give rise to a refund in the event of a sufficiently wide time gap between costs and sales proceeds. This scenario is however of rather low probability in the normal course of business (excepting exports). Under the existing Bulgarian legislation, the VAT credit accrued must first be allowed from the tax liability during the following three months before a tax audit is performed and any remainder of the VAT credit is actually refunded.

In addition to unlawful VAT refunds, resulting from understated sales or overstated costs, there are some special schemes based on fictitious transactions, including: *fictitious exports*, the *missing-trader fraud*, and the *carousel fraud*; and their various hybrids and derivatives. In terms of mechanism and scale, these are closer to organ-

Real-Life Examples

The Stoiko Peev Case. This was one of the first high-profile cases of VAT fraud. In 1997, actor Stoiko Peev, dealing in car spares, was accused of defrauding the Treasury of BGN 200,000 in taxes. The case did not reach the court until the end of 2004. (See *Sega* daily of 28 January 1998 and *Banker* weekly of 28 February 2004.)

VAT fraud in the grain trade. In 2003, GTD launched an investigation of several grain merchants in connection with VAT fraud estimated at BGN 3-4 million. The harvest that year being poor, grain prices rose, but prices quoted were artificially pushed even higher in order to claim larger VAT credits. The merchants also filed for VAT refunds in respect of grain exports but suspicions were that the grain never actually left the country. (See *168 Chasa* weekly of 26 September 2003.)

VAT fraud in respect of capital goods. By a series of transactions, *Techphase Trading* got VAT of more than BGN 400,000 refunded. The scheme was launched by *Agropolychim* of Stara Zagora purchasing a nitrogen-oxygen gas station from *Jor Daniel 98* for BGN 250,000. Subsequently, by several fictitious improvements, the asset's value was brought up to BGN 1,500,000. It was then sold at this price to another company, owned by the seller. By several fictitious invoices, the asset was improved again and sold for BGN 2,500,000 to *Techphase Trading*, an offshore company of unknown ownership registered in Cyprus, which claimed and got the VAT refund. (See *Kapital* weekly, 45/2004.)

The Case of Former Soccer Players. In the course of an operation against a major VAT-fraud network in December 2004, the National Anti-Organised Crime Service arrested former *Levski* player Vasil Dragolov and former *Beroü* goalkeeper Valentin Groudev. The scheme had defrauded the Treasury of some BGN 50 million. Another eight of the organisers were arrested in Bourgas, Sliven, Plovdiv, Stara Zagora, Yambol, and Haskovo. (See *Troud* daily of 10 December 2004.)

P. Kalchev's Network. A VAT refund scheme was uncovered in 2004, which had defrauded the Treasury of some BGN 15-16 million. Multiple fictitious sales transactions of imported goods had been used to pump up tax credit, which had then been refunded, dumping the tax liability on insolvent so-called 'traders'. The leader and mastermind P. Kalchev had secured the support of senior tax officials: the Head of a local tax office and a Head of Tax Audit. The investigation also established a link between P. Kalchev's network and the smuggling channel run by N. Metodiev-Pileto ['Birdie'] and a money-laundering operation. (See *Kapital* weekly, 40/2004, and *Pari* of 2 March 2005.)

Fictitious footwear exports. On 22 April 2004, GTD inspectors uncovered a network of tax officers who had unlawfully refunded BGN 11,650,000 worth of VAT in seven months. No fewer than 25 officers of several GTD units in Sofia had been involved. The scheme had used fictitious footwear exports to Cyprus. The investigation was launched after it had been established that the *Sredets* Local Tax Office in Sofia had, with unusual speed and no questions asked, allowed the refund of BGN 900,000 in respect of a single transaction. At the start of the chain was an undertaking that, on paper, bought *Kavaler* shoes for BGN 1,000,000 and resold them to the next undertaking in the chain for BGN 2,000,000. Thereafter, a third undertaking bought the same shoes for BGN 6,000,000 and went on to export them (always on paper) to Cyprus. (See *Paragraf* 22 of 25 December 2004.)

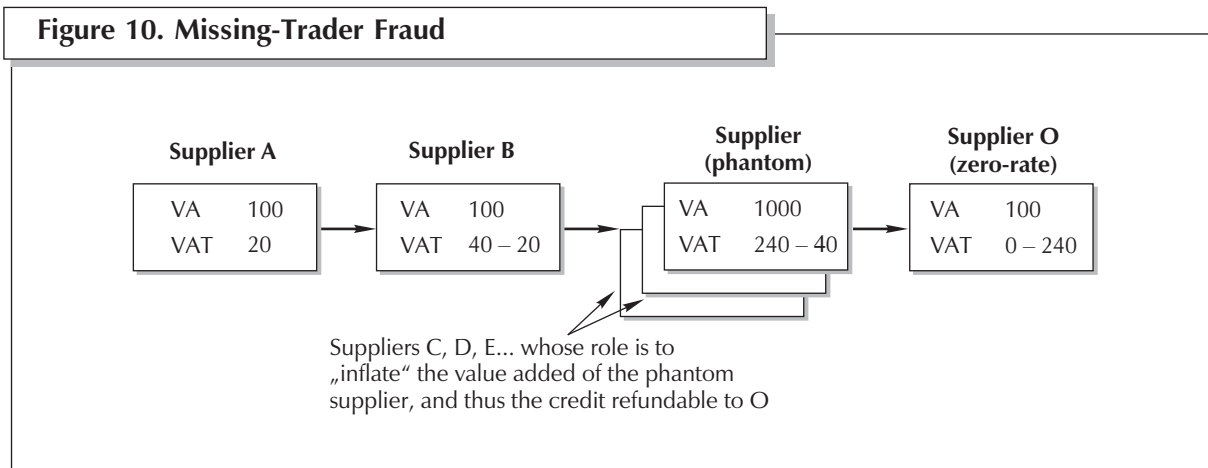
³¹ Among others, BCCI has demanded such changes, and BSP included a similar proposal in its 2005 Election Manifesto.

ised crime than to conventional tax evasion, the main difference being that, unlike conventional VAT evasion, they rely on transactions that never actually take place. This also means that, as no value is added throughout the process, the offenders do not stand to gain, nor does the Treasury stand to lose, unless the end result of the chain of transactions is a net cash flow from the Treasury to the offenders.

Fictitious exports: The producer-exporter performs the export transaction on paper, applying the zero VAT rate on exports and claiming tax credit on its costs, while actually selling the products on the domestic market without sales invoices. Usually, the scheme’s success depends on the co-operation of a customs officer, who processes the paperwork on the export transaction. A more moderate and realistic version of the scheme relies on overstating export quantities where they are difficult to establish accurately by the customs authorities.

Missing trader: In its various modifications, this type of fraud relies on a chain of fictitious transactions which concentrate a large portion of the VAT liability in a phantom undertaking, thereby making it uncollectible. However, for actual cash to flow out of the Treasury, the chain must end with a zero-rate supplier. The basic variety of the missing-trader fraud is illustrated in Figure 10: the supplier of greatest value added is a phantom (Supplier F); down the chain from it is a zero-rate supplier, such as a duty-free outlet or an exporter, which charges zero tax but is entitled to tax credit. If the transactions were genuine, and value had actually been added, the offenders’ gain (and the Treasury’s loss) would equal the VAT amount not paid by F, i.e., 200. However, the transactions being fictitious, the parties to them have no actual value added to hide, and the scheme would be meaningless to them if it did not end with some actual cash flowing out of the Treasury and into their pockets. This is where the zero-rate supplier comes into play, claiming tax credit in respect of fictitious costs and receiving a cash refund.

This basic variety can only serve as an illustration, rather than any practical purpose. Like most modern tax systems, the Bulgarian legislation has placed a number of obstacles to such schemes. The number-one of them is that, rather than being immediately refunded, the **VAT credit is deducted** from the tax liability during the following three reporting periods. Only after that, is any remainder of tax credit, not so de-



ducted, refunded within 45 days. This arrangement is designed to allow *bona fide* traders to deduct credit from real liabilities. Exporters are entitled to priority refund within 30 days. Secondly, actual cash is only **refunded after a tax audit**, and during the audit, the statutory time-limit is suspended. Finally, as a last preventive resort against offenders, the **principle of joint liability** prevents a rightful claimant of VAT credit from receiving it if any of its suppliers is non-compliant.

This triple security arrangement is somewhat relaxed to the benefit of compliant traders by the **VAT account**. Since 2002, businesses have been required to open special bank accounts which, since 2003, they have had to use exclusively for VAT receipts and payments. This is a way to segregate, almost physically, VAT moneys from the undertaking's other cash flows so as to ensure their safe passage to the Treasury. Any tax amount above BGN 1,000 must be paid to a VAT account.

The VAT account offers two advantages with regard to tax credit. Traders which pay to the VAT account not less than 80 per cent of the VAT charged to them, in respect of which they claim tax credit in the same month, including VAT on imports, are entitled to a refund within 45 days from filing a VAT return. Even if a tax audit is ordered (in the tax authority's discretion), this time-limit will not be suspended. Thus, under the VAT account arrangement, the requirement to deduct a tax credit from subsequent VAT liabilities, before any remainder can be refunded, is dropped, together with the requirement for a tax audit, and the waiting time for a refund is limited to 45 days, including the duration of any discretionary tax audit.

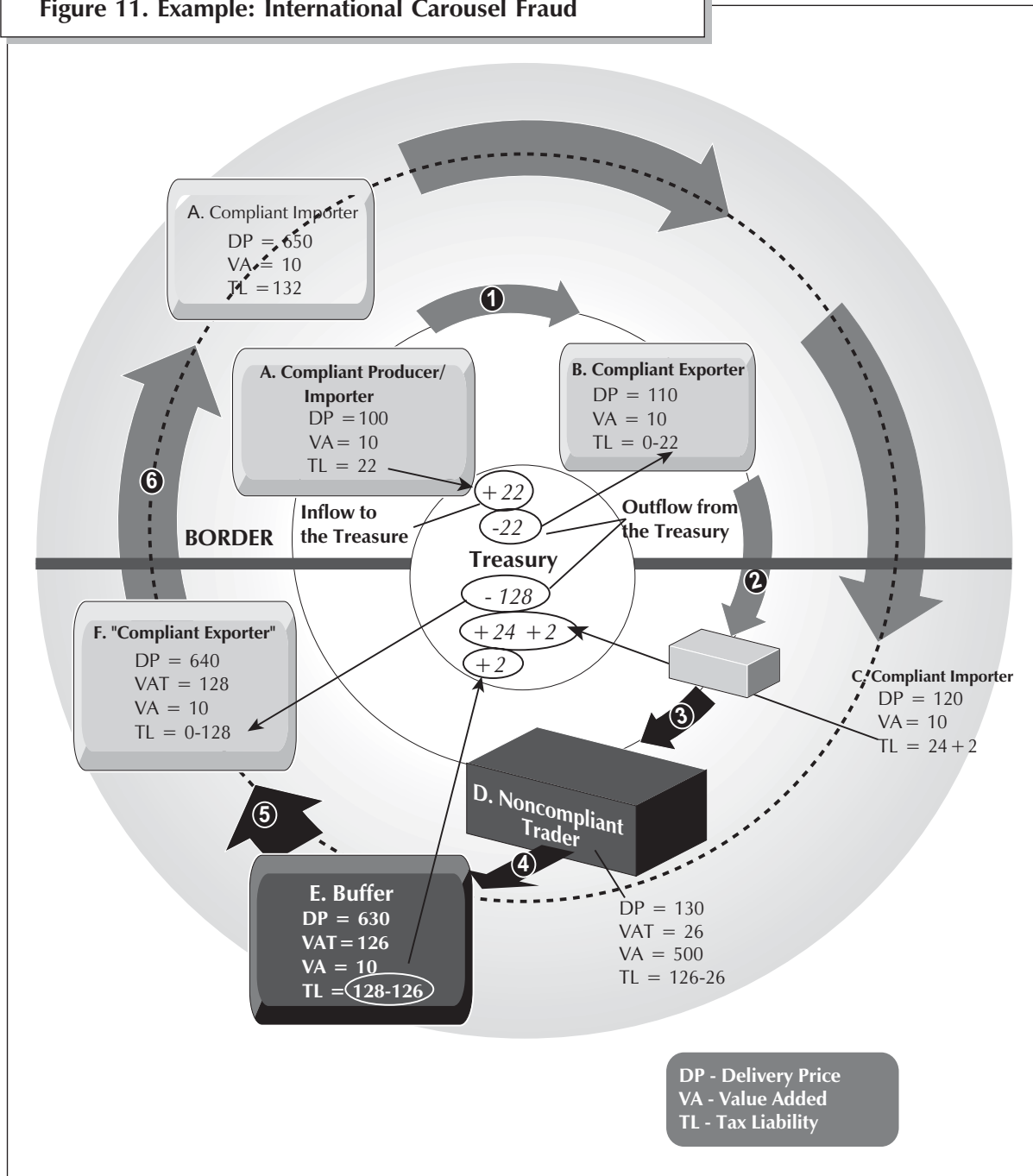
The second advantage has to do with the joint liability principle. The provisions of VATA Article 65(4), which prevent refunds if any trader in the supply chain is non-compliant, do not apply if the subject payment has been made to a VAT account by the end of the reporting period for which a tax credit has been claimed (VATA, article 65(8)).

The existing legal and administrative barriers to unlawful VAT refunds have caused the emergence of three varieties of the missing-trader fraud: 1. the insolvent-trader fraud; 2. the international carousel fraud; and 3. the VAT account drawdown fraud. In practice, a fraudulent scheme would combine elements of these three.

Insolvent-trader fraud: The same method is used as in the missing-trader fraud. The advantage here is that the VAT-liable undertaking actually exists but, having served its purpose, is transferred to indigent and half-literate individuals from whom the government cannot collect.

International carousel fraud: Tracing the chains of fraudulent transactions and thwarting the missing or insolvent-trader schemes becomes a much more difficult and slower process across the border between national jurisdictions. Tax credit is claimed by the exporters and the tax liabilities accrue to undertakings along the chain which disappear without trace. The international carousel fraud relies on multiple cross-border transactions. This, on the one hand, makes tracing and counteraction more difficult, while on the other, it multiplies the missing-trader effect. The carousel fraud is the greatest challenge to revenue administrations in the EU. It has been aggravated by the absence of customs control at the Union's internal borders. Figure 11 provides an illustration which, for simplicity, assumes the same VAT rate of 20 per cent on each side of the border.

Figure 11. Example: International Carousel Fraud



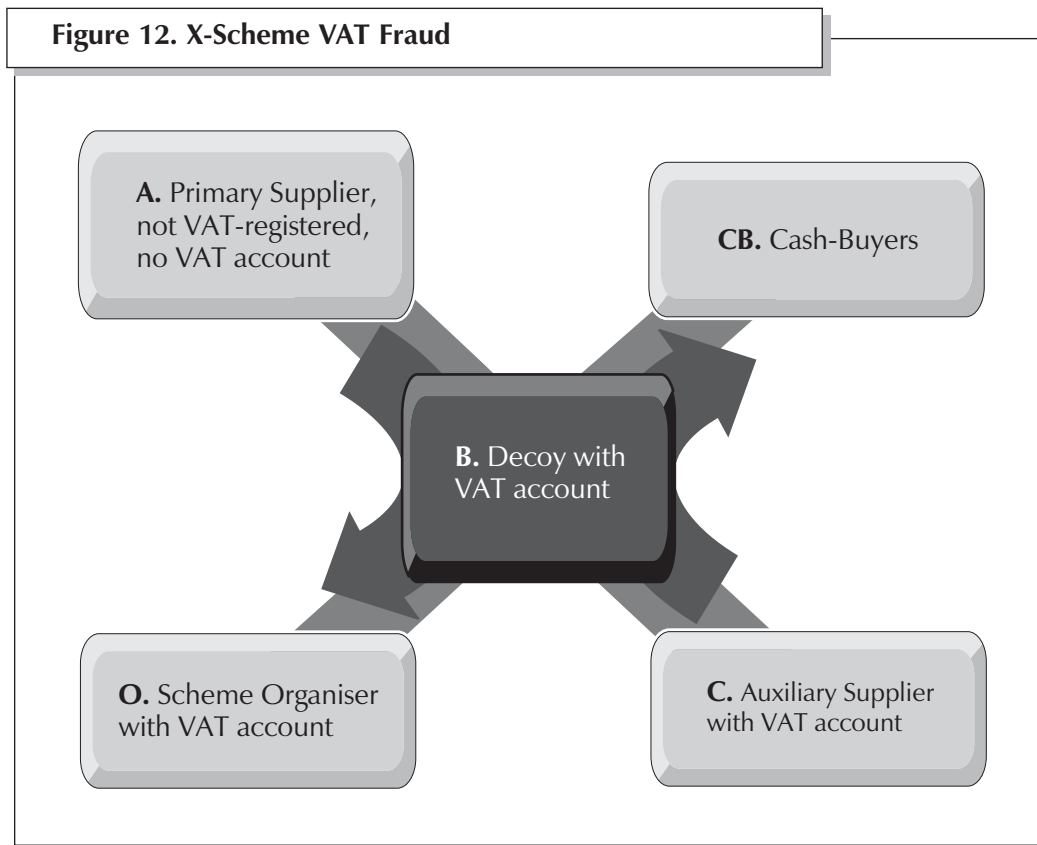
The first round (unbroken lines) results in a refund of 100; as the carousel goes round a second time (dotted lines), the effect doubles. The scheme's capacity is considerable, especially if fictitious traders are involved on both sides of the border.

4.4. VAT-ACCOUNT FRAUD

The VAT account arrangement is an attempt at providing relief to compliant taxpayers caught in the trap of joint liability. Bulgaria has adopted an extreme ver-

sion of the joint liability principle, whereby a trader is denied tax credit if there is—up the supply chain from it—an unregistered or non-compliant VAT payer, without the tax authority having to prove a link between the trader claiming the tax credit and the non-compliant trader. As this, understandably, came under criticism from the business community, the VAT account arrangement was introduced as an alternative to joint liability.

However, according to a GTD report to the Parliamentary Committee of Inquiry into VAT Fraud of the autumn of 2004, the VAT account arrangement has offered offenders new ways of evading the tax. In the administration’s jargon, this is the so called ‘X-scheme of VAT fraud’ or, essentially, a method of drawing down of the VAT account. Taking advantage of the joint liability relief under the arrangement, the scheme’s organiser claims tax credit despite the existence, up the chain, of a non-compliant payer and, simultaneously, draws down that non-compliant payer’s VAT account, which, in theory, is there to guarantee the Treasury’s receivable. Figure 12 illustrates the basic scenario.



The initial (primary) supply comes from a non-VAT-registered trader (A) to a VAT-registered purchaser/supplier (B) at a VAT-exempt price. The latter acts as a decoy: its task is to ensure the right to VAT refund to the organiser (O), as O pays the tax into B’s VAT account. However B’s tax liability will not be collectible—when it is established, B will have no balance left on its VAT account. B’s account is drawn down by purchases from another supplier (C) and the transfer of the VAT on them to its VAT account. On paper, B receives fast moving consumer goods which, again on paper, it immediately turns around and sells to cash-buyers (CB). These are either

end consumers or non-VAT-registered traders or VAT-registered traders whose tax liability is below BGN 1,000. The idea is to avoid payment of the VAT charged on these sales into *B*'s VAT account. In practice, *B* never receives delivery of the goods in order to avoid the risk of distraint in respect of its primary tax liability. What really happens is: *C* delivers directly to the *CBs* and remits the VAT collected from them to the investor in the scheme *O*. As the VAT on the wholesale supply of rapidly marketable goods stays in *C*'s VAT account, it is not lost by the Treasury. To make sure that it is not lost by the scheme organiser either, it is collected from the *CBs*. For all this to happen, however, there must be some real trading, albeit unregistered, going on. The auxiliary supplier *C* is most likely an importer. There are two reasons for this. First, *C* cannot evade the tax anyway, and if it must be done by the book, let it be in importation, where the tax is collected upon the goods' entry and where not doing it by the book is most expensive. Second, the auxiliary supply must be in quantities commensurate with the scale of the fraud and unconstrained by the capacity of domestic suppliers, who, on top of that, are usually well-known.

Table 10. Example: X-Scheme VAT Fraud

(a) Non-VAT-Registered Supplier <i>A</i> delivers goods worth 1,000 to Intermediary/Decoy <i>B</i> . The supply is VAT-exempt.	
(b) Supplier <i>B</i> adds value of 100 and resells the goods to Scheme Organiser <i>O</i> at 1,320 gross, of which 220 goes to <i>B</i> 's VAT account. Thereby, <i>O</i> is entitled to claim a tax credit of 220.	
(c) <i>B</i> draws down its VAT account by transferring 220 to <i>C</i> 's VAT account in respect of goods (rapidly marketable) purchased from it at 1,100 net.	
(d) The goods purchased from <i>C</i> are rapidly placed on the cash market, the VAT on them going straight into the organisers' pockets.	
Evasion Scenario (220 of budget revenue lost)	Unlawful Refund Scenario (440 + of budget revenue lost)
(e) Scheme Organiser <i>O</i> sells the primary goods on the domestic market, charging VAT of 220, which it does not pay as it is exactly offset by its tax credit. The net result is that, being owed VAT of 440 (220 on the primary supply and as much on the auxiliary supply), the Treasury only gets 220—from <i>C</i> 's VAT account in respect of the auxiliary supply.	(e) Scheme Organiser <i>O</i> exports the primary goods, charges the zero VAT rate on the export transaction, and receives a cash refund of 220 in respect of its tax credit. The net result is that, being owed VAT of 440 (220 on the primary supply and as much on the auxiliary supply), the Treasury gets naught. The 220 it does receive from <i>C</i> 's VAT account in respect of the auxiliary supply is exactly offset by the cash refund in respect of <i>O</i> 's exports. Or— (f) Scheme Organiser <i>O</i> exports the primary goods on paper, charges the zero VAT rate on the export transaction, and receives a cash refund of 220 in respect of its tax credit, while in reality, it adds value of, say, 500 and sells the goods domestically for unregistered cash. The net result is that, being owed VAT of 540 (a total of 320 on the two primary supplies and 220 on the auxiliary supply), the Treasury gets naught. The 220 it does receive from <i>C</i> 's VAT account in respect of the auxiliary supply is exactly offset by the cash refund in respect of <i>O</i> 's exports. Or— (g) The same loss effect of 540 is produced if Scheme Organiser <i>O</i> has a genuine foreign buyer ready to accept the goods at an invoice price lower than the actual one (which a foreign buyer might have the incentive to, considering that based on the destination rule it would save VAT on imports). In this case, Scheme Organiser <i>O</i> avoids the costs and risks of selling the primary goods on the domestic unregistered-cash market.

In summary then, the VAT payable on the primary supply is restored to the scheme organiser, having been simultaneously withdrawn from its supplier's VAT account. In the meantime, it has also been used to legalise the auxiliary sales. Therefore, in its basic variety, the X-scheme is a method of VAT evasion, rather than unlawful refund. But it is possible to double, at least, its effect if the organiser (*O*), instead of selling the primary goods on the domestic market, and reporting the sales, exports them fictitiously and sells them domestically for unregistered cash, or else, exports them genuinely but at a lower reported value. In addition, the basic chain could be made much longer and more complicated, with the involvement of a number of witting or unwitting intermediaries, so as to make it difficult to trace and break. (See Table 10 for a numeric example of these two scenarios.)

The early evaluation of the VAT-account experience shows that, on the one hand, it has increased business's compliance costs by effectively freezing some of its cash assets in a sort of escrow account long before the VAT liability has become payable. On the other hand, the VAT account arrangement has failed to offset these higher compliance costs by faster unconditional VAT refunds. The fact that the classical missing-trader scheme is still feasible under the arrangement means that tax audits for the purposes of VAT refunds are not an exception and, indeed, often result in denial of refund despite payments made to a VAT account. On balance, while it has not put an end to fraud, the VAT account has only given the administration greater discretion to decide when to do a tax audit and when not to—when to recognise tax credit and when to deny it.

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.

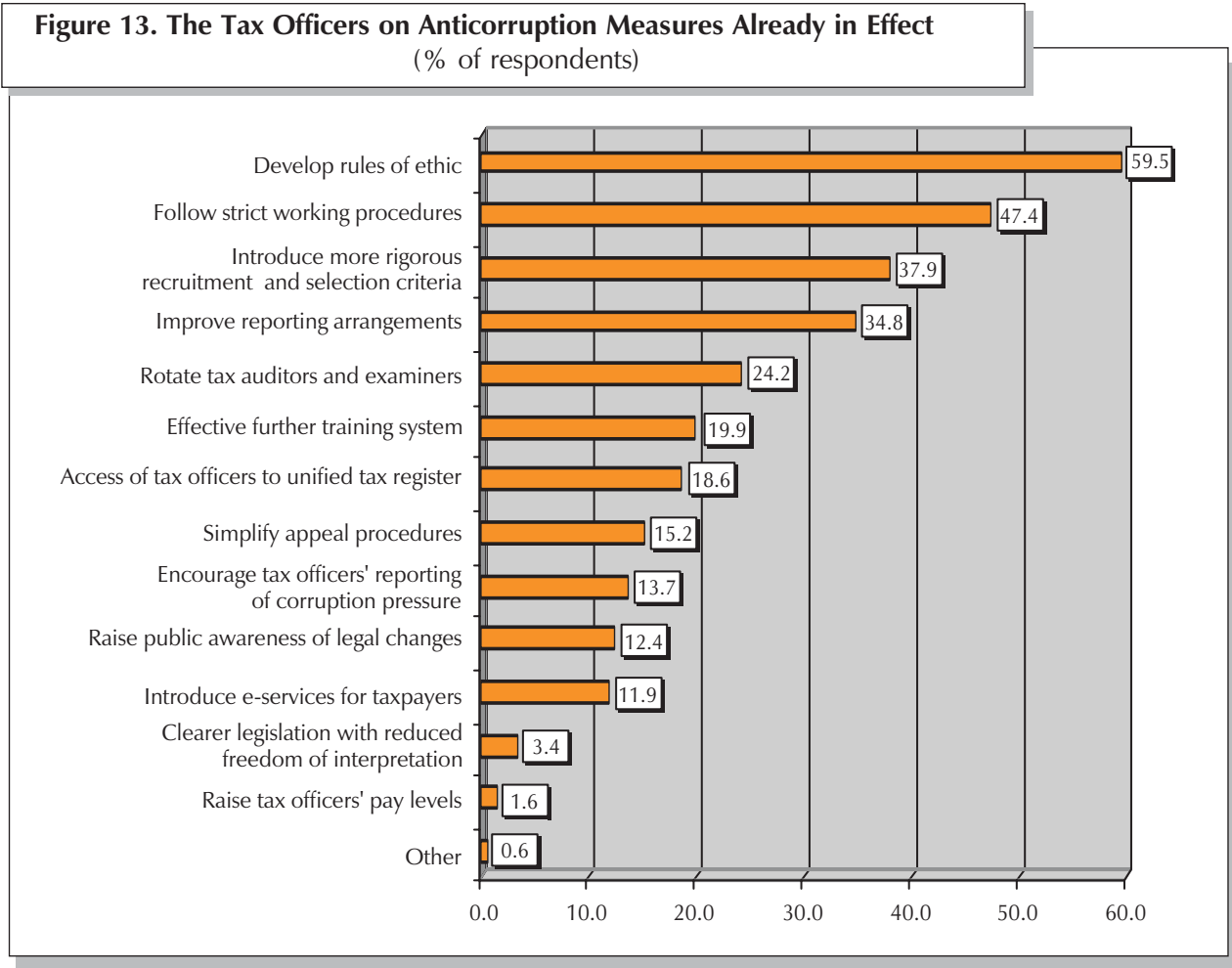
service as ways to prevent corruption (Table 11). According to them again, the main areas in which relative anticorruption progress has been achieved include: the adoption of ethical norms; the strengthening of control and transparency in operational processes; and the improvements in the staff recruitment 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.



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*

Min. Pay (BGN)	„What should your minimum pay level be for corruption motives to be brought to a minimum?“									
	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: Vitoshka Research, April 2004, base 699, and the author's own calculations.

³⁴ See more in Пауев [Pashev] (2005).

imum. 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 leadership³⁵; 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 cent³⁶ (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-unfriendly 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 prejudice 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.

⁴¹ See. *ЦНА* [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	Rate					
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 *tkte-a-tkte*; 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 VП-2 and VП-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; *Пауев* [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 *Пауев* [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 *Витосха 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 strong 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 non-existent 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 as 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.

6. ANTICORRUPTION EFFECTIVENESS INDICATORS

The limited feasibility of direct measurements of corruption is a major challenge to anticorruption policy. Acts of corruption detected and punished show only the tip of the iceberg. Surveys try to capture personal experience, but personal involvement in tax-related bribery often implies rather grave offences and admitting that in a survey becomes a sensitive matter, especially in a face-to-face interview. As a result, measurements of corruption mostly rely on perception or opinion or hearsay, with all the inherent risk of hitting wide off the mark of reality.

Still, even *perceived* corruption is important for anticorruption policymaking. Economic behaviour is determined by expected rather than actual costs and benefits; and investors' decisions on how much and where to invest are indeed conditioned by their perceptions of corruption levels and the related risks and costs.⁶¹ The same, more or less, goes for the choice they make to give or not to give bribes. It is conditioned by taxpayers' expected cost and benefit of evasion, and their perceived probability of getting caught and punished, rather than by the administration's actual effectiveness or integrity, or the severity of the law. Therefore, close to reality or otherwise, taxpayers' opinions are important for understanding demand-side corruption drivers and making the appropriate policy decisions.

The indicator matrix presented here for the assessment of corruption levels and the strength of corruption drivers and factors derives from the analysis made in the preceding five chapters of the forms and mechanisms of corruption, and of the ways of fighting it. It is also based on leading theoretical work and practical experience in the monitoring and measurement of corruption in transition and developing countries, and on the corruption survey of the Bulgarian tax administration. Of course, the matrix makes no claim to being a perfect, or even exhaustive, diagnostic tool. Rather, it proposes an open framework to help focus diagnostic efforts on a more balanced cost-benefit analysis from the perspective of either party to a corrupt transaction. Its advantages are threefold:

The conventional approach places the emphasis on the cost of corruption to business. But it can hardly explain the sustained high corruption levels in transition economies. Corruption in the tax administration can be made much better sense of if bribery forced on taxpayers is distinguished from bribery as the price of a corrupt service from which the briber's gain exceeds its price. In this latter case, bribery is a transactional bilateral relationship from which both parties stand to gain at the expense of any and

⁶¹ It is often argued that the results of corruption monitoring themselves create perceptions and work as a self-fulfilling prophecy. Doubtful as it is that observed behaviour generates more of the same, this argument effectively proposes that an economy would stand a greater chance of investment and growth were (foreign) investors kept in the dark about corruption levels in it. But, measured or otherwise, corruption can hardly remain hidden. Besides, the uncertainty created by no corruption monitoring can be a much stronger investment deterrent than the darkest picture revealed by monitoring.

all third parties, i.e., the other taxpayers and the Treasury. Thus, the winner-loser (or victim) paradigm, applicable to business's corruption costs, does not fit corruption predicated on tax fraud and other tax-related offences. Not infrequently, tax corruption is initiated by taxpayers in pursuit of some undue advantage. This is why, if the state of play in tax corruption is to be assessed properly, analytical efforts must cover the members of the tax administration, as well as the business community. The proposed matrix tries to capture both the demand-side and the supply-side costs and benefits related to corrupt services.

In addition, the matrix is an attempt to extend the diagnostic framework toward 'harder', other than opinion or experience-related, data derived from the administration's management information systems and other statistical sources. Indeed, personal experience is an indispensable element in the corruption monitoring system; most surveys include questions about bribes given or taken and their size, or else, phrased more euphemistically, about the respondent's experience of corruption pressure. However, the results that these yield should be approached with some qualifications, and especially so, where, instead of a criminal offender and a victim, there are two criminal offenders both of whom stand to gain from the act of corruption.⁶² If each of the two potential parties to corruption is asked about its experience of corruption pressure from the other, the sensitivity of the question about personal involvement might be overcome in the interest of a more objective assessment of the spread of corruption. The matrix proposed here includes both of these questions addressed to both of these parties. Still, these are 'soft' data, and the matrix does include also indicators based on data from the administration's management information system. Their retrieval and processing can be done by means of widely available IT resources. In the matrix, they are grouped together in a separate column by measurement and diagnosis parameter of corruption in the tax administration.

Last but not least, the proposed indicators make it possible to measure not only corruption levels but also, corruption drivers. To the choice of anticorruption policy measures, the latter are more relevant than corruption levels and much more indeed, than assessed discrepancies between perceived and actual corruption levels.

Corruption is usually quantified in two dimensions: (a) spread and incidence; and (b) average value of corrupt transactions. Of these, spread can be measured by the proportions of taxpayers and tax officers involved in corruption; and incidence basically means the rate at which bribes change hands or, more neutrally, the rate at which corruption pressure occurs.

As to the value of a corrupt transaction, i.e., the amount of money changing hands, it is a fundamental corruption-level indicator in the conventional approach, which regards bribes as a cost of doing business. It is measured either in absolute terms or as

⁶² In addition to perceived corruption levels, *Coalition 2000* corruption indices include data on corruption pressure experienced by the respondents and on their personal involvement in corrupt acts (see the survey methodology in *Coalition 2000* (1998)). As both the giving and the taking of bribes, and any action conducive to either, are punishable under the Bulgarian legislation, the data on bribes given and taken, and their size, obtained from face-to-face interviews, are rather an indication of time dynamics than an accurate measure of corruption levels. A number of international surveys try to get around the unease factor by formulating the question about personal involvement in terms of 'firms similar to yours' or 'your industry/sector', rather than asking directly about the respondent's own behaviour (e.g., the indices of Global Competitiveness Report or Transparency International).

a proportion of gross sales or profit.⁶³ Numbers can be put to this indicator based on either taxpayers' or tax officers' perceptions and personal experiences. However, using it to account for the level of corruption requires a number of qualifications which follow directly from the understanding of tax corruption as a transaction between two interested and willing parties. In the traditional understanding of bribery as a cost of doing business, rising bribe levels are interpreted as a sign of worsening. This interpretation ignores both the causes and the likely effects of such a development. As already noted here, higher bribe levels could be the reflection of a successful anticorruption policy. That corruption deterrents and anticorruption incentives have become more effective on the supply side means, among other things, higher probability of detection and higher contingent loss to the corrupt tax officer. Accordingly, this will have the effect of raising the lower bribe threshold under which such an officer would not take the risk of being caught. In a nutshell, higher average bribe levels could mean a rise in the risk premium which suppliers of corrupt services build into the price. On the other hand, it could mean bigger amounts involved in tax fraud or more severe punishments or more effective tax audits. Depending on demand and supply elasticities, as bribes keep rising, they might limit the spread of corruption by pushing it toward the higher income brackets or higher-value fraud, where—and this is the silver lining of such a scenario—corruption-risk management and control are as a rule more effective.

Also, as the cost of tax-related corruption rises (in terms of bribe levels and/or loss contingent on detection), corruption may altogether diminish in the field of taxation and target higher-yield sectors, such as public procurement. By raising bribe levels, tax corruption may price itself out of the market—as the bribe burden becomes comparable to that of penalties lawfully imposed for non-compliance and takes on a similar force of deterrent. Moreover, unlike lawful penalties, from which a corrupt auditor can expect no personal gain, comparable bribes may mean a stronger incentive to such an auditor to hunt down the very last penny of tax money lost to fraudsters, i.e., higher bribes may in fact result in higher detection of non-compliance. Of course, this paradox is not to be taken literally in the sense that, where they have failed by more severe penalties and better organised audits, the tax authorities should hope to succeed by relying on the corrupt motivation of some of their own. It is only meant as another argument in support of the view that, of themselves, bribe levels are not a good indicator of, either, taxpayers' corruption-related costs—if measured in isolation from their corruption-related benefits—or corruption levels, if the spread and incidence of corrupt practices are ignored. An indicator defined at a higher level of synthesis would be more useful, i.e., one measuring corruption costs in relation to corruption benefits, such as bribe to tax or penalty evaded.

In addition to measuring the overall level of corruption in the tax administration in terms of the number and value of corrupt transactions, the proposed diagnostic framework focuses on the structure of corruption by accounting for kinds of service received in exchange for a bribe, and also, the horizontal and vertical spread of corruption risk throughout the administration.

The matrix also includes indicators reflecting the causes of corruption among tax officers. In keeping with the conceptual framework outlined in Chapter One, it makes

⁶³ *Coalition 2000* uses absolute terms, and the World Bank has opted for relative terms in its Business Environment and Enterprise Performance Surveys (BEEPS) of transition countries. See *Gray et al* (2004).

a distinction between corrupt behaviour driven by tax evasion motives and corrupt behaviour provoked by excessive bureaucratic costs or yielding to extortion pressure from members of the administration. The probability that a taxpayer may choose to evade taxes, and the related probability of such a choice leading to bribery, are conditioned by the extent of the tax burden and by taxpayers' perceived risk of detection and punishment. These factors are quantified based on effective tax rates and ceilings, estimates of the size of tax evasion, and respondents' perception of the tax burden and of the likely consequences of detection. The cost of tax evasion (to the taxpayer) is a function of the probability of detection and of the expected bribe amount contingent on detection (if the tax officer is not report it). On the other hand, the data on tax assessments successfully appealed provide a partial indication of the extent to which bribery results from legal deficiencies or corruption pressure from tax officers.

The intensity of the drivers behind the second large group of corrupt services, i.e., those related to voluntary tax compliance, is measured by various indicators of compliance cost and the effect of service level standards. Important in this regard is the transaction cost of corruption, i.e., how much it takes over and above the bribe itself to negotiate a corrupt deal. That, in turn, depends on the degree of institutionalisation of corruption, i.e., how easy it is for a taxpayer to target the right officer for the right service, how clear they are about what they are getting in return and how certain they are that the tax officer will deliver.

Corruption drivers and motives within the administration have been identified primarily on the basis of tax officers surveys. The emphasis has been on institutional drivers and on the effectiveness of anticorruption incentives and deterrents. Related to these is the respondents' perception of the fairness and effectiveness of human resource management, and in particular, the two components of tax officers' compensation: base salary and pay bonuses. So far as deterrents are concerned, their effectiveness has been assessed from the respondents' perceived cost of detection. That, in turn, is a function of the perceived probability of effective inquiry/investigation, the expected severity of punishment, other expected consequences short of effective punishment, and risk tolerance.

In response to the rising interest in ethical factors, they too have been included in the diagnostic framework. The relevant findings could be used by the administration in a training needs assessment.

A significant advantage of surveying tax officers' corrupt attitudes is that it yields first-hand information about the institutional weaknesses which encourage and make bribery possible—ranging from legal deficiencies to problems stemming from the working environment and work processes in the administration.

Table 14. Indicator Matrix of Anticorruption Effectiveness

Object of Measurement	Indicator	Statistics & MIS ('Hard' Data)	Surveys ('Soft' Data)		Reference Data	
			Taxpayers' Perceptions/Personal Experiences	Tax Officers' Perceptions/Personal Experiences		
A. Level & Structure						
Level	% Involvement (Businesses)		<ul style="list-style-type: none"> • % businesses paying bribes^a to tax officers (on scale of 1–5^b) 	<ul style="list-style-type: none"> • # businesses paying bribes to tax officers (on scale of 1–5) 	# taxpayers sanctioned ^c	
	% Involvement (Tax Officers)		<ul style="list-style-type: none"> • % tax officers taking bribes (on scale of 1–5) 	<ul style="list-style-type: none"> • % tax officers taking bribes (on scale of 1–5) 	# tax officers sanctioned ^d	
	Incidence of Bribery		<ul style="list-style-type: none"> • How often a firm like yours might offer bribes, gifts and other favours to tax officers? (on scale of 1–5) 	<ul style="list-style-type: none"> • How often businesses offer bribes, gifts and other favours to tax officers? (on scale of 1–5) 		
	Bribe Size		<ul style="list-style-type: none"> • What is the average size of bribes paid? (on scale of 1–5^e) 	<ul style="list-style-type: none"> • What is the average size of bribes paid? (on scale of 1–5^e) 		
	Personal Experience		<ul style="list-style-type: none"> • How often last year did you have to offer some consideration to a tax official in connection with your duties as taxpayer in the form of bribe/gift/favour/entertainment? (on scale of 1–5 each) 	<ul style="list-style-type: none"> • How often last year were you offered some consideration in connection with your duties as tax officer in the form of bribe/gift/favour/entertainment? (on scale of 1–5 each) 		
Level	Personal Experience		<ul style="list-style-type: none"> • Did your bribe expenses change last year (from the previous one): (a) in absolute terms; (b) as a share of sales? – – Yes, went up; – Yes, went down; – No change on either basis 	<ul style="list-style-type: none"> • Has bribery changed from last year in terms of: (a) # businesses paying bribes; (b) incidence /size? – – Yes, went up; – Yes, went down; – No change on either basis 		

^a Bribes includes cash and/or in-kind consideration, such as gifts, favours, 'free lunches', etc.

^b Scale of 1-5 approximates the following cases:

Rate	1	2	3	4	5	DK/NA
How often?	Never	Rarely	Sometimes	Often	Always	
How many?	Few	< 1/2	≈ 1/2	> 1/2	Almost all	

^c Indicates both corruption level and detection rate, and being ambiguous, has been included for reference only.

^d Indicates both corruption level and detection rate, and being ambiguous, has been included for reference only.

^e For cross-country comparisons, the scale may be based on minimum wage or the average wage for the tax administration wage, e.g.: < 1/5; < 1/2; < 1; < 3; > 3.

Object of Measurement	Indicator	Statistics & MIS ('Hard' Data)	Surveys ('Soft' Data)		Reference Data
			Taxpayers' Perceptions/Personal Experiences	Tax Officers' Perceptions/Personal Experiences	
Structure			<ul style="list-style-type: none"> • What services are most often bribes paid for (rank them): evasion of non-compliance fines, etc. sanctions; speedier procedure (including VAT refund); undue tax relief (exemptions, allowances, tax credit); information about (action against) competitors? 	<ul style="list-style-type: none"> • What services do tax payers most often pay bribes for (rank them): evasion of non-compliance fines, etc. sanctions; speedier procedure (including VAT refund); undue tax relief (exemptions, allowances, tax credit); information about (action against) competitors? 	
Horizontal & Vertical Patterns			<ul style="list-style-type: none"> • Assess the degree of penetration of corruption by functional area in terms of: <ul style="list-style-type: none"> – Employees involved; – Bribe sizes; – Frequency of bribes Assess the degree of penetration of corruption by administrative level in terms of: <ul style="list-style-type: none"> – Employees involved – Bribe sizes; – Frequency of bribes 	<ul style="list-style-type: none"> • Assess the degree of penetration of corruption by functional area in terms of: <ul style="list-style-type: none"> – Employees involved; – Bribe sizes; – Frequency of bribes • Assess the degree of penetration of corruption by administrative level in terms of: <ul style="list-style-type: none"> – Employees involved; – Bribe sizes; – Frequency of bribes 	

Object of Measurement	Indicator	Statistics & MIS ('Hard' Data)	Surveys ('Soft' Data)		Reference Data
			Taxpayers' Perceptions/Personal Experiences	Tax Officers' Perceptions/Personal Experiences	
Corruption Related to Tax Fraud, etc. Tax Offences	Tax Burden	Tax Burden Indicators: Marginal & Effective Tax rates	<ul style="list-style-type: none"> • What do you think of the rates of PIT, CIT, VAT, SS, excise duties, property and other local taxes?— <ul style="list-style-type: none"> – Not a problem; – Some problem; – Severe problem • How often last year did your firm have to pay a bribe to evade non-compliance sanctions on account of flawed regulations or to evade taxes? (on scale of 1–5) • Which tax is most often evaded?— <ul style="list-style-type: none"> – PIT; – CIT; – VAT; – Excise; – Property; – Other 	<ul style="list-style-type: none"> • What do you think of the rates of PIT, CIT, VAT, SS, excise duties, property and other local taxes?— <ul style="list-style-type: none"> – Not a problem; – Some problem; – Severe problem • Which tax is most often evaded?— <ul style="list-style-type: none"> – PIT; – CIT; – VAT; – Excise; – Property; – Other 	Compliance Gap ^f
			Evasion Cost	Schedule of Penalties	
	Bribe Sizes	<ul style="list-style-type: none"> • What is the average bribe size as a proportion of non-compliance amount detected?— <ul style="list-style-type: none"> – Less than one-fifth; – One-third; – Half or more, as much as asked; – DK/DN; – Other 		<ul style="list-style-type: none"> • What is the average bribe size as a proportion of non-compliance amount detected?— <ul style="list-style-type: none"> – Less than one-fifth; – One-third; – Half or more, as much as asked; – DK/DN; – Other 	

^f May reflect both excessive tax burden or compliance costs, or taxpayers' income-maximising behaviour of taxpayers, and being ambiguous, has been included for reference only.

Object of Measurement	Indicator	Statistics & MIS ('Hard' Data)	Surveys ('Soft' Data)		Reference Data
			Taxpayers' Perceptions/Personal Experiences	Tax Officers' Perceptions/Personal Experiences	
Corruption Related to Tax Fraud, etc. Tax Offences	# Evasion Cases Detected	# Correction Assessments	<ul style="list-style-type: none"> In your opinion, what percentage of tax-fraud cases is detected by tax officers? Of those detected, what percentage is actually punished, i.e. penalties are not evaded by bribes? 	<ul style="list-style-type: none"> In your opinion, what percentage of tax-fraud is detected by tax officers? Of those detected, what percentage is actually punished, i.e. penalties are not evaded by bribes? 	
	Detection Probability & Cost	Size of Correction Assessments	<ul style="list-style-type: none"> In your opinion, which companies evade more taxes (as a percentage of tax liability)?- <ul style="list-style-type: none"> Small; Large; Other; DK/NA Do you believe that the probability of detection depends on the size of the fraud? Have you last year been audited or examined for non-compliance? Have you last year evaded non-compliance penalties by paying a bribe? 	<ul style="list-style-type: none"> In your opinion, which companies evade more taxes (as a percentage of tax liability)?- <ul style="list-style-type: none"> Small; Large; Other; DK/NA Do you believe that the probability of detection depends on the size of the fraud? 	
	Probability of Successful Appeal	# Appeals before the Administration # Appeals Overruled by Administration # Court Appeals # Appeals Overruled by Courts	<ul style="list-style-type: none"> Have you last year appealed any correction assessment? If so, was your appeal successful? - <ul style="list-style-type: none"> Yes; No; Still pending 		

Object of Measurement	Indicator	Statistics & MIS ('Hard' Data)	Surveys ('Soft' Data)		Reference Data
			Taxpayers' Perceptions/Personal Experiences	Tax Officers' Perceptions/Personal Experiences	
Risk Tolerance			<ul style="list-style-type: none"> Do you have insurance on your home or other real estate? If you were given a choice between evasion and avoidance resulting in the same amount of tax savings, but in evasion you would face a 50:50 probability of detection and penalty, while in avoidance you would have to pay the tax consultant a fee equal to half the evasion penalty, which one would you choose?— <ul style="list-style-type: none"> Evasion; Avoidance; Neither; DK/NA 		
Service-Related Corruption (faster service delivery, etc. compliance facilities)		<p>Existing Service Level Standards</p> <p>Compliance with Standards Monitored & Reported</p>	<ul style="list-style-type: none"> How often last year did your firm have to pay a bribe for faster service, tax rebates, etc.? (on scale of 1–5) Has the Administration adopted Service Level Standards? What do you think of the efficiency of the tax administration? (on scale of 1, <i>Simple and stable regulations, and low compliance costs</i>, to 5, <i>Inefficient, high compliance costs</i>) What average proportion of work time is spent by: (a) the firm's owner/manager; (b) the firm's accounting and other staff on ensuring compliance under: <ul style="list-style-type: none"> PTA; CITA; VATA; SS regulations; Excise duty regulations; PTA; Other? 	<ul style="list-style-type: none"> Has your Administration adopted Service Level Standards? If so, is compliance with the Standards monitored, assessed and reported publicly? How often last year did you encounter the following in taxpayers? (on scale of 1–5)— <ul style="list-style-type: none"> Dissatisfaction with service; Ignorance of their rights and duties; Excessive expectations; A-bribe-can-buy-anything attitude 	'Time Tax' data from business environment surveys
Institutionalisation of Corruption Bribe Effectiveness			<ul style="list-style-type: none"> Are there fixed rates of irregular payment for tax-compliance services and are they common knowledge in your industry? How reliable is a bribe? Do tax officers deliver on their part of the deal? 		

Object of Measurement	Indicator	Statistics & MIS ('Hard' Data)	Surveys ('Soft' Data)		Reference Data
			Taxpayers' Perceptions/Personal Experiences	Tax Officers' Perceptions/Personal Experiences	
	Perceived Corruption Costs (Economic Cost of Corruption)			<ul style="list-style-type: none"> Rank the three most likely negative effects of corruption 	
C. Supply-Side Drivers & Opportunities					
HRM Effectiveness & Fairness	Pay-Bonus & Performance-Appraisal System as related to Career & Pay Development, Selection & Training	Staff Turnover Rate Educational Levels Absenteeism		<ul style="list-style-type: none"> Assess the fairness and effectiveness of the following HRM components: <ul style="list-style-type: none"> – Compensation; – Bonuses; – Performance appraisal; – Performance appraisal impact on career and compensation development; – Recruitment & Selection; – Training 	
	Detection Probability Detection Cost Risk Tolerance Moral Inhibitions	# Corruption Complaint Inquiries # Disciplinary Actions Taken Existing Code of Ethic		<ul style="list-style-type: none"> If you were caught taking bribes, what would be the most likely punishment? If you lost your job, what would be your chances of employment in the private sector? Do you have insurance on your home or other real estate? Rank the three most likely negative effects of corruption 	
Institutional Environment				<ul style="list-style-type: none"> What are your administration's worst problems? What are the main causes of corruption in your administration? What measures would minimise corruption in your administration? 	

CONCLUSION. POLICY IMPLICATIONS

Tax corruption remains a major obstacle to free competition based on a level playing field and clear, predictable rules of the game. This is why fighting tax corruption is among the main priorities of economic policy aimed at improving the business environment and the economy's competitiveness, and at encouraging investment and growth.

This study has attempted to provide albeit partial answers to the following three questions: Why do tax officers take bribes? How exactly do they go about taking bribes? What can the administration and civil society do to ensure that tax officers take less bribes?

The answer to the first question seems obvious. The educated answer derived from the welfare economics is identical to the one suggested by intuition:—To live a better life and consume more. Of course, this is only that part of the story which focuses on individual motives. Equally important are a number of supplementary answers:—Because they can; because they can get away with it; because everybody takes bribes (other public servants, doctors, judges, teachers, co-workers); etc. Each of these adds something to complete the picture, but they also raise further questions the answers to which imply different policy recommendations.

There are several practical implications of the above analytical approach. First, it focuses anticorruption measures on personal motives and institutional drivers. So far, the fight against corruption has tended to rely, almost exclusively, on deterrents: criminal liability, internal control, and moral inhibitions (enshrined in codes of ethic). However, necessary as they are, deterrents are not sufficient. Besides, so far as moral inhibitions are concerned, they set a rather long timeframe for policy: the evolution of values and mindsets is a lengthy process; it can hardly be achieved within a single administration and without a parallel impact on economic drivers and incentives. Of course, the codification of legal liability and moral responsibility is the first necessary step which defines the limits of corruption, of what is acceptable, and sets the mechanisms of public scrutiny in motion. But this first step can only go that far if it is not accompanied with measures addressing personal financial motives and the institutional drivers of corruption.

Stronger internal control also has an important preventive role. Increasing the risk of retribution, it reduces the subjective well-being derived from bribery and acts as a deterrent. Here again, however, limitations arise from the lack of direct impact on the economic motives. If corruption has spread throughout the administration, for reasons other than mere internal control weaknesses, what is the guarantee that the administration's own internal policing elements have been, and will remain, unaffected by it?

Against this background, the study has identified several main action lines which may yield visible results in the medium run.

First and foremost, there is a significant potential for curbing **taxpayer service-related corruption**. A relatively high proportion of bribery seeks to overcome bureaucratic hurdles and obtain faster service. The main solution in this area is to limit personal contacts between tax officers and taxpayers by greater reliance on e-services and one-stop-shop delivery. Most importantly, service level standards should be adopted prescribing quality of service and delivery times. While the administration would commit publicly to such standards, individual tax officers' failure to comply with them would not result in administrative liability but would nonetheless send the right signals throughout the organisation to identify weak links in the delivery chain and the necessary structural measures.

Of course, the Bulgarian tax administration's main challenge is **corruption related to fraud and other tax offences** which, like elsewhere in the world, exceeds service-related corruption in spread and level. Here, the chances of success stem from the fact that tax corruption is relatively concentrated within two functional areas: Tax Audit and Operational Control. This allows to concentrate accordingly the available resources in terms of internal control and supplementary financial incentives.

The precise targeting of the anticorruption impact also allows to identify the most effective countermeasures. As shown by this study, these should address personal motives and deterrents but also, the elements of the legal framework and the operational setup which make corruption possible in the first place. The following policy guidelines have been identified:

First. The reverse correlation between pay levels and the level of corruption has been confirmed by a number of empirical studies. The tax officers themselves identify low salaries as their number-one problem and strongest corruption driver. However, this study has concluded that practically very little can be done to remedy the situation. Theory, and international practice for that matter, has not established any particular pay level at which officers would have sufficient financial comfort and no use for any bribe money. Raising base salaries may lead to a reduction in the number of bribes but more likely, to an increase in their average size. The survey of Bulgarian tax officers about the pay level which would minimise their vulnerability to corruption has revealed a wide gap between that level and their actual current incomes, and accordingly, between required and available resources.

Therefore, rather than raising base salaries across the board, a more workable solution would be to focus on the performance-based component of gross pay, reflecting and rewarding each tax officer's contribution to the success of anticorruption policies and higher collection rates. To this end, the existing pay bonus scheme should be revised and streamlined to make it more transparent, reduce its top-down discretionary component and shift its emphasis from rewarding zealous administrative coercion to rewarding excellence in tax compliance management based on a more straightforward linkage with individual performance appraisal.

The issue of salaries is not just about their absolute levels. It is equally important, in terms of corruption drivers, to focus on the perceived fairness of the compensation package, i.e. its size relative to that of colleagues and superiors. The fairness and impartiality of recruitment and selection, performance appraisal, career development and compensation is what gives employees the assurance that their performance will be judged on merit; that their position and salary will not be jeopardised by changes of leadership; that no one will be unduly favoured to the detriment of others.

Second. The business community, the administration, and the analysts are unanimous that corruption is largely driven by gaps in the tax and financial-reporting legislation, plus its rising complexity, which allow broad freedom of interpretation and compromise the uniformity of application. A simpler legal framework, together with reduced tax rates and a broader tax base (fewer exemptions and exceptions), would go a long way to narrowing the opportunities for tax corruption. At-source taxation would have a similar effect. Although such measures are among the priorities of the National Anticorruption Strategy and its implementing programmes, practical progress has been modest at best. The tax and financial-reporting legislation is in bad need of an anticorruption overhaul in the light of judicial and administrative practices and in particular, the experience of GTD's Methodology and Appeal, and Inspectorate. Once the problematic legal provisions have been identified and discussed with the associations of business, a plan for their improvement must be developed, responsibilities clearly assigned and progress reported publicly.

Third. The improvement of operational processes holds a considerable anticorruption potential. In addition to the clear separation of functions and responsibilities between structural levels and functional areas, there is a need for an effective information system to manage document flows and pinpoint the weak spots in the operational setup. Most importantly in this regard, new tax audit and examination targeting, performance, and reporting methods should be introduced based on state-of-the-art risk assessment and monitoring of individual tax officers' control and audit effectiveness.

Fourth. Despite the achievements in recent years, there is still a lot to be done on deterrents. The structure of penalties for tax offences and corruption could benefit from further streamlining. The existing arrangement concerning tax evasion allows broad administrative discretion and effectively encourages large-scale non-compliance, as the penalties are regressive above the upper fine limits. A lot could be gained in deterrence if the severity of punishment were more closely correlated with the gravity of offence.

Deterrence is also seriously compromised by inadequate anticorruption enforcement. An important measure in this regard would be the development of a corruption-risk assessment system based on tax officers' personal wealth registers and their control and audit effectiveness. The thrust of these efforts should be in countering VAT fraud.

On the other hand, the tax officers should be properly trained, with an emphasis on their rights and responsibilities in taxpayer service delivery, the safeguards ensuring their own security, the limits of acceptable conduct, and the disciplinary and penal consequences of their involvement in corrupt practices. Crucial in this regard is the administration's internal communication and consultation effort: every member of the administration at each structural level should be involved in the discussion on anticorruption strategies and should have access to information about their effectiveness based on a set of indicators.

In the short run, enforcement effectiveness could gain a lot from improved cooperation among administrative entities and between the administration and the associations of business. At present, the investigation and prosecution of tax offences, and of corruption predicated on them, suffers from the involvement of too many government agencies with little separation of responsibilities and coordination among them. Rather than adding to their number (e.g., a Tax Police), the existing agencies' objectives, efficiency and effectiveness should be assessed and measures should be taken on that basis to

integrate or consolidate them. This would result in information-support and risk-management synergies; and any budget savings could be allocated to supplementary financial incentives for law-enforcement and revenue-administration staff.

Industry and other business associations should be more actively involved in fighting unfair competitive practices based on tax fraud and corruption. Although compliant taxpayers stand to lose the most from such practices and are best placed to know about the shady dealings in their respective lines of business, they still appear to be on the wrong side of the front-line in the fight against corruption.

Fifth. The fight against corruption needs an effective progress monitoring and evaluation system. The indicator matrix presented in Chapter Six includes both 'soft' sociological data and 'hard' data from official statistics and the administration's management information system. Thereby, the matrix provides not just an estimate of corruption levels but also, a measurement of the strength of corruption drivers from the perspective of business and of the administration.

The above policy priorities make no claims to originality or even, exhaustiveness. The efforts to curb tax corruption have not started today, nor have they started from scratch. Considerable progress has been made along most of the action lines discussed here. Criminal and administrative liability for corrupt practices has been provided, and control and enforcement functions have been set up. The foundation has been laid of a system of supplementary financial incentives, and recruitment and selection, performance appraisal, promotion and compensation have been based on modern standards. A state-of-the-art information-support system will be introduced shortly, without which an effective anticorruption stance is impossible. The new National Revenue Agency will bring together the collection of taxes and social security contributions, and will consolidate the existing data in the interest of more effective control and audit, and better public service. This adds up to a solid basis for a more precise targeting of impacts and further progress.

This study has not intended to offer any magical solution that would virtually eradicate corruption from the tax administration. Rather, it has highlighted certain areas which have so far attracted relatively little attention and in which a little extra effort could yield a considerable anticorruption effect in the medium run. Above all, of course, the administration must have a clear vision of what it aims to achieve, and how, in the time remaining until Bulgaria's EU accession.

Finally, two words of caution concerning expectations: The first one is against unfounded pessimism, which stems from the view that fighting corruption takes time because success in it depends on the evolution of values. However, in Bulgaria, like in other transition countries, widespread tax corruption has not struck such deep roots in society's system of values, much as, for that matter, the principles of market economy have not yet struck such roots either. The current situation is rather the result of a 'corruption shock', and the current level of corruption is not the 'equilibrium' level reached already in a number of advanced market economies. This corruption shock of transition has largely been caused by the collapse of the old institutions and values, and the absence of new ones to replace them, and by the ambitions of emerging economic elites to capture the State. So, there is a good chance that tax corruption will be brought relatively quickly under control, before it has struck any deeper cultural roots or a high-level equilibrium.

Similarly, the second word of caution should be against unfounded optimism, given that both parties to an act of corruption stand to gain from it. In this regard, the emphasis should continue to shift from legal deterrents and moral inhibitions to anticorruption incentives and the removal of adverse institutional drivers. In addition, the effectiveness of these measures must be monitored, analysed and made public, so that adjustments could be made in the course of implementation.

As there are no 'comprehensive' or 'radical' solutions to the corruption problem in the tax administration, the risk of choosing a certain course of action, which may prove badly wrong, is no bigger than the chance of overnight success. What could be worse than long-term failure is doing nothing today, and what is decidedly better than any 'magical' Strategy or Action Plan (to say nothing of adding more institutions on top of existing ones) is even the smallest practical step that effectively curbs corruption.

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APPENDICES

Appendix 1. Criminal and Administrative Liability Provisions for Tax Offences and Corruption

CRIMINAL CODE

General Part

Art. 93. The words and expressions below have been used in this Code in the following context:

...

14. (New, SG 62/97; amend., SG 21/00) „Taxes large in size“ are those exceeding three thousand levs, and „taxes particularly large in size“ are those exceeding twelve thousand levs;

From Chapter VII. OFFENCES AGAINST THE FINANCIAL, TAX AND INSURANCE SYSTEMS

Art. 255. (Amend., SG 28/82; SG 89/86; repealed, SG 10/93; new, SG 62/97, in force from November 5, 97)

(1) Who avoids the payment of tax liabilities in large amount by not presenting declaration required by virtue of a law, or confirms untruth or conceals a truth in a filed declaration, shall be punished by imprisonment of up to three years and a fine of up to five hundred levs.

(2) If, until the conclusion of the court investigation in the first instance court the tax liability which is not declared and not paid, together with the due interest, is paid to the budget the punishment shall be a fine of up to two thousand levs.

Art. 256. (Repealed, SG 10/93; New, SG 62/97) Who, with the purpose of frustrating the establishment of tax liabilities of particularly large size, keeps accountancy or uses accountancy documents of untrue contents, shall be punished by imprisonment of one to five years and a fine of one thousand to five thousand levs.

Art. 257. (Repealed, SG 10/93; New, SG 62/97; in force from November 5, 97)

(1) If the acts under art. 255 and 256 have concealed tax liabilities of particularly large size or if they have been committed with the participation of an official of the tax administration or of a certified expert accountant the punishment shall be imprisonment of two to ten years and a fine of five thousand to twenty thousand levs.

(2) In minor cases under art. 255 and 256 the punishment shall be a fine of the double amount of the concealed tax liabilities , imposed through administrative channels.

(3) If, until the conclusion of the court investigation in the first instance court the tax liability which has not been declared and paid, together with the due interest, are paid to the budget the punishment shall be imprisonment of up to three years and a fine of up to ten thousand levs.

Art. 258. (Amend., SG 28/82; repealed SG 10/93; new, SG 62/97) (1) Who unlawfully obstructs a tax body to fulfil his legal obligation shall be punished by imprisonment of up to three years and a fine of one thousand to two thousand levs.

Art. 301. (1) Any official, who requests, or accepts a gift, or any benefit, which he is not due, or accepts an offer, or a promise for a gift or benefit, in order to perform, or fail to perform an act within his/her duties, or because he/she has performed, or failed to perform such an act, shall be punished for bribery by imprisonment for up to 6 years and a fine to 5000 levs.

(2) If an official has committed an act under Para 1, in order to breach, or because has breached his/her duties, where such a breach does not constitute a crime, he/she shall be punished by imprisonment of up

to 8 years, and a fine of up to 10000 levs.

(3) If an official has committed an act under Para 1, in order to commit, or because has committed another crime in connection with his/her duties, the punishment shall be imprisonment of up to 10 years, and a fine of up to 15000 levs.

(4) (Amend., SG 89/86) In the cases under the preceding paras the court shall also rule revoking of right according to art. 37, item 6 and 7.

(5) The punishment under Para 1 shall be imposed to a foreign official, who requests, or accepts bribe, or accepts an offer, or promise for a bribe.

Art. 302. For a bribery made:

1. by a person who occupies a responsible official position, including a judge, juror, prosecutor or investigator;
2. through extortion through embezzlement;
3. (amend., SG 28/82) repeatedly and
4. in large size, the punishment shall be:
 - (a) (suppl., SG 89/86; amend., SG 51/00) in the cases of art. 301, para 1 and 2 - imprisonment of three to ten years, a fine of up to twenty thousand levs and revoking of rights according to art. 37, item 6 and 7;
 - (b) (amend., SG 89/86) in the cases of art. 301, para 3 - imprisonment of three to fifteen years, a fine of up to twenty-five thousand levs and confiscation of up to one seconds of the property of the culprit, whereas the court shall also rule revoking of rights according to art. 37, item 6 and 7.

Art. 302a. (New, SG 89/86) For a bribe of particularly large size, representing a particularly serious case, the punishment shall be imprisonment of ten to thirty years, a fine of up to thirty thousand levs, confiscation of the whole or a part of the property of the culprit and revoking of rights according to art. 37, item 6 and 7.

Art. 303. Having regard for the differences in the preceding articles, an official and a foreign official shall also be punished and where with their consent, the gift or material benefit have been proposed, promised, or given to a third person.

Art. 304. (1) Any person who proposes, promises or makes a gift or any other material benefit to an official so as to perform or fail to perform an official act in his/her official duties, or on account of having performed or failed to perform any such duty of service shall be punished by imprisonment of a term of up to six years, and a fine of up to five thousand levs shall be imposed."

(2) If in connection with a bribe, the official has breached his/her duties, the punishment shall be imprisonment of up to eight years, and a fine of up to seven thousand levs shall be imposed, if the breach does constitute a crime of a graver punishment".

(3) Punishment under Par. 1 shall also be imposed to any person who offers, promises, or gives a bribe to foreign official.

Art. 304a. (New, SG 51/00) (1) Any person who offers, promises, or gives a bribe to a high-ranking official, including a judge, juror, prosecutor or investigator shall be punished by imprisonment of up to ten years and a fine of up to fifteen thousand levs.

(2) The punishment under para 1 shall also be imposed to those who promise or offer a bribe to a foreign official.

(3) An official who requests or agrees to receive a bribe shall be punished by imprisonment of up to five years.

Art. 304(b) (1) Any person who requests or accepts a gift or any benefit, to which he/she is not entitled, or accepts an offer, or promise for a gift, or benefit in order to exercise influence while taking a decision by a foreign official in reference to his/her job, shall be punished by imprisonment of up to 6 years, or a fine up to 5000 levs.

(2) Any person, who offers, promises or gives a gift or any benefit not due to another person, which claims that he/she can exercise influence under Para. 1 shall be punished by imprisonment of up to 3 years, or a fine of up to 3000 levs.

Art. 305. (1) The punishments for bribery under the previous articles shall be imposed on an arbiter, or an expert witness, appointed by the court, institution, enterprise, or an organization, after having performed such acts in reference to their activity, as well as to that person, who offers, promises, or gives such a bribe.

(2) The punishments for bribery under the previous articles shall be imposed also to a defender or an attorney, while performing such acts in order to help to be decided in favour of the counter party, or to the detriment of the demandant a criminal, or civil case, as well as to that person, who offers, promises or gives such a bribe.

Art. 305a. (New, SG 28/82) Any person who acts as a mediator to the offences under the preceding articles and if this act does not constitute a graver crime shall be punished by imprisonment of up to three years and a fine of up to five thousand levs.

Art. 306. Any person who has offered, promised or given a bribe, if he/she has been extorted by an official, arbiter or expert witness to do so and if he/she has immediately and voluntarily communicated the above circumstances to the competent authorities shall not be punished.

Art. 307. (Amend., SG 51/00) Who intentionally creates circumstances or conditions in order to provoke offering, giving or receiving of a bribe with a purpose of doing harm to those who gives or receives the bribe shall be punished for provoking a bribe by imprisonment of up to three years.

Art. 307a. (New, SG 28/82) The subject of the crime under this Section shall be seized in favour of the state, and if it is missing its equivalence shall be adjudicated.

From Chapter IX. DOCUMENTARY OFFENCES

Art. 308. (1) Who draws an untrue official document or forges the contents of an official document with the purpose of being used shall be punished for forging a document by imprisonment of up to three years.

(2) (New, SG 26/2004) Where the subject of the offence under paragraph 1 are Bulgarian or foreign personal identity documents or educational or qualification certificates, or driving licences or vehicle registration certificates, or visa stickers, or any other such document as certifies legal capacity or personal identification or registration data, the punishment shall be imprisonment not to exceed eight years.

(3) (New, SG 26/2004) Where the offence under paragraph 1, having subject under paragraph 2, has been committed for material gain, the punishment shall be imprisonment not to exceed 10 years. Any such material gain, where received, shall be confiscated, and where missing or disposed of, the offender shall pay to the State the equivalent thereof.

(4) (New, SG 28/1982, former paragraph 2 as amended SG 26/2004) In minor cases, the punishment shall be:

1. under paragraph 1, imprisonment not to exceed six months or correctional labour;
2. under paragraph 2, imprisonment not to exceed two years;
3. under paragraph 3, imprisonment not to exceed three years,

(5) (New, SG 26/2004) Any action in preparation for an offence under paragraph 1 shall entail imprisonment no to exceed one year. Any action in preparation for an offence under paragraphs 2 and 3, or any collusion for the purposes of any such offence, shall entail imprisonment no to exceed six years.

(6) (New, SG 26/2004) No such party to collusion shall receive any punishment who, prior to the completion of any counterfeit or forged official document (if such is the purpose of collusion) or prior to the circulation of any such document (if such is the purpose of collusion), desists from such offence and reports it to the authorities.

(7) (New, SG 26/2004) Whoever holds in possession or conceals any physical items or materials or tools, which he knows or suspects to be intended for, or to have served, the purpose of counterfeiting or forging any document under paragraph 2 or 3, shall be punished by imprisonment not to exceed six years.

Art. 309. (1) Who alone or through another draws an untrue private document or forges the contents of a private document and uses it in order to prove the existence or non-existence, or termination or amendment of a certain right or obligation or some legal relation shall be punished for document forgery by imprisonment of up to two years.

(2) If the crime has as a subject securities the punishment shall be imprisonment of up to three years.

(3) (Amended, SG 10/1993) In minor cases, the punishment under any of the preceding paragraphs shall be correctional labour or a fine not to exceed BGN 300.00.

Art. 310. (1) (Amended, SG 26/2004) Where an offence under 308(1) or 309(1) or (2) is committed by an official servant in such servant's official capacity, such offence shall entail imprisonment not to exceed five years, and under 308(2) or (3), imprisonment not to exceed 12 years and, in the court's discretion, forfeiture of the right under 37(1.6).

(2) (New, SG 28/82) In minor cases the punishment shall be imprisonment of up to one year or corrective labour.

Art. 311. (1) An official who, within the scope of his duties, draws an official document certifying untrue circumstances or statements with the purpose of using this document as a proof of these circumstances or statements shall be punished by imprisonment of up to five years, whereas the court can also rule revoking of right according to art. 37, item 6.

(2) In minor cases the punishment shall be imprisonment of up to one year or corrective labour.

Art. 312. (1) A physician who provides somebody with a false certificate for the status of his health when he is not acting as an official shall be punished by imprisonment of up to two years or by corrective labour.

(2) Under the same circumstances a veterinarian who issues a document of untrue contents for the health status of an animal shall be punished by imprisonment of up to one year or by corrective labour.

Art. 313. (Amend., SG 28/82) (1) (Amend., SG 10/93) Who confirms a falsehood or conceals a truth in a written declaration or message sent electronically which, by virtue of a law, edict or decree of the Council of Ministers, are presented to a body of the authority for certifying the genuineness of certain circumstances shall be punished by imprisonment of up to three years or by a fine of five to thirty levs.

(2) (New, SG 10/93; amend., SG 50/95) If the act under para 1 has been committed with the purpose of evading payment of due taxes the punishment shall be imprisonment of one to six years or a fine of twenty to two hundred and fifty levs.

(3) (Prev., para 2 - Amend., SG 10/93) The punishment under para 1 shall also be imposed on those who confirm a falsehood or conceals a truth in a private document or message sent electronically, which, by an explicit provision of a law, edict or decree of the Council of Ministers, are specially obliged to certify the truth, and he uses this document as a proof of falsely certified circumstances or statements.

(4) (New, SG 62/97) Who, in connection with public offering of securities by a prospectus or a survey of the economic status uses untrue favouring data or withholds unfavourable ones, which are of substantial importance for taking a decision for acquiring securities, shall be punished by imprisonment of up to three years and a fine of up to five hundred levs.

Art. 313a. (New, SG 89/86; amend., SG 99/89; repealed., prev. Art. 313b, New SG 54/92 - SG 10/93) (1) Who, in a declaration under art. 4, para 2 of the Law for the property of the Bulgarian Communist Party, the Bulgarian Agrarian People's Union, the Fatherland Front, the Dimitrov Communist Youth Union, the Union of the active fighters against fascism and capitalism and the Bulgarian Trade Unions confirms a falsehood or conceals a truth with the purpose of frustrating entirely or partially the seizing of the illegally possessed state property shall be punished by imprisonment of three to eight years.

(2) Who, upon request, refuses to present a declaration according to art. 4, para 2 of the law under para 1 shall be punished by imprisonment of two to six years.

(3) In the cases under para 1 and 2 the court can also rule revoking of rights according to art. 37, para 1, item 6 and 7.

(4) The perpetrator under para 1 and 2 shall not be punished if, while discovering the truth would accuse himself of a crime, or his spouse, the descendants, ascendants, brothers or sisters.

Art. 313b. (New, SG 41/01) Who conceals a truth or confirms a falsehood in a written declaration he presents by virtue of the Law for the access to the documents of the former State Security and the former Intelligence Department of the Chief Staff shall be punished by imprisonment of one to three years or by a fine of five thousand to thirty thousand levs.

Art. 314. Who deliberately becomes an instrument of introducing false circumstances or statements in an

official document drawn by the established order on the grounds of a declaration of an individual shall be punished by imprisonment of up to two years or by corrective labour.

Art. 315. (1) Who draws a document by filling out a list bearing the signature of the issuer, with contents which do not coincide with the will of the signed, shall be punished according to the differences under art. 308 and 309.

(2) Punished, in compliance with the same differences, shall be those who through a fraud persuades another to sign a document with contents which do not coincide with the will of the signed.

Art. 316. The punishment stipulated by the preceding Art.s of the present chapter shall also be imposed on those who deliberately avails himself of false or forged document, of a document with untrue contents or of a document under the preceding Art. if he cannot be charged with criminal liability for the drawing itself.

Art. 317. Who illegally avails himself of a document, knowing that the issuer has signed it without an intention of taking responsibility by it, shall be punished by imprisonment of up to two years or by corrective labour.

Art. 318. (Amend., SG 28/82; SG 10/93) Who illegally uses an official document, issued to another person, with the purpose of misleading a body of the authority or a representative of the public shall be punished by imprisonment of up to two years or by corrective labour or by a fine of up to six levs.

Art. 319. Who destroys, conceals or damages a document of another or not belonging to him explicitly with the purpose of causing a damage to another or to provide for himself or for another a benefit shall be punished by imprisonment of up to three years or by corrective labour.

From Chapter IXa (New, SG 92/2002) COMPUTER CRIMES

Art. 319a. (1) Any person who performs irregular access to the computer resources, copies or uses computer data without authorization, where such is required, shall be punished by a fine of up to 3000 levs.

(2) If the act under Para. 1 has been committed two or more persons, agreed in advance upon the commitment of such an act the punishment shall be imprisonment of up to one year and a fine of up to 3000 levs shall be imposed.

(3) If the act under Para. 1 has been committed for a second time the punishment shall be imprisonment of up to tree years and a fine of up to 5000 levs shall be imposed.

(4) If the acts under Para. 1-3 have been committed in reference to information comprising state secret the punishment shall be imprisonment from one to tree years if it is not subject to heavier punishment.

(5) If the act under Para. 1 has caused grave consequences the punishment shall be imprisonment from one to eight years.

Art. 319b. (1) Any person who without permission of the person who administrates or uses a computer, adds, alters, deletes or destroys computer programme or data in non trivial cases, shall be punished by imprisonment and a fine of up to 2000 levs.

(2) If the act under Para. 1 has caused substantial damages or other grave consequences have occurred the punishment shall be imprisonment of up to two years and a fine of up to 3000 levs.

(3) If the act under Para. 1 has been committed whit the purpose of property benefit, the punishment shall be imprisonment from one to tree years and a fine of up to 5000 levs shall be imposed.

Art. 319c. (1) Any person who commits an act under Art.319b in reference to data provided under a law, electronically or on a magnet disc shall be punished by imprisonment of up to two years and a fine of up to 3000 levs.

(2) If the act under Para. 1 has been committed with the purpose to frustrate the performance of an obligation the punishment shall be imprisonment of up to tree years and a fine of up to 5000 levs.

Art. 319d.(1) Any person who implants computer virus in a computer or in a IT network, shall be punished by a fine of up to 3000 levs.

(2) If as a result of the act under Para. 1 substantial damage have occurred or the act has been committed

for the second time, the punishment shall be imprisonment of up to tree years and a fine of up to 1000 levs.

Art. 319e. (1) Any person who disseminates computer or system passwords and as a result personal data or state secret has been disclosed, shall be punished by imprisonment of up to one year.

(2) For an act under Para. 1 committed with mercenary intent, and if trough it substantial damages have been caused the punishment shall bi imprisonment of up to tree years.

Art. 319f. Any person who while providing information services breaches the provisions of Art. 6, Para. 2, item 5 of the Law on the Electronic Document and the Electronic Signature, shall be punished by a fine of up to 5000 levs, if he/she is not subject to a heavier punishment.

...

CODE OF TAX PROCEDURE

...

Article 245. The tax administration officials may not:

1. (amended and supplemented, SG No. 42/2003) perform as sole proprietors, unlimited liability partners in commercial partnerships, commercial representatives or authorized commercial entities;
2. participate in surveillance and management Boards of commercial partnerships, cooperatives and other organizations, except with the permission in writing of the General Director of the tax administration or his/her designee;
3. (amended, SG No. 42/2003) conclude additional employment contracts with other employers or work outside the system of the tax administration, except with the permission in writing of the General Director of the tax administration or his/her designee.

...

Article 250 (Amended, SG No. 45/2002, supplemented SG No. 42/2003)

The persons referred to in Article 12, Article 12a, as well as all persons legally having access to confidential information, who disclose, provide, publish, use or spread in any way confidential facts and circumstances, if no subject to a heavier punishment, shall be penalized from 3,000 to 20,000 BGN, dismissed for disciplinary reasons and deprived of the right to occupy the relevant position for a period of 1 to 3 years.

...

Article 253. (1) (Amended and supplemented, SG No. 45/2002) Any tax administration official, failing to issue a certificate for the presence or absence of tax liabilities, at the request of the tax subject, shall be penalized up to 250 BGN. In cases of a repeated offence the tax administration authority shall be penalized by up to 500 BGN.

...

Article 255. (1) (Supplmented, SG No. 45/2002) Any tax administration official, responsible for acceptance of tax returns, who refuses to accept a duly signed tax return, including such filed by an authorized person, shall be penalized with up to 250 BGN, and in cases of a repeated offence the tax administration authority shall be penalized up to 500 BGN.

(2) The penalty under Paragraph 1 shall be imposed to any tax administration official who fails to enter the filed return into the corresponding ledger of the Tax Administration Directorate (for incoming documents), as well as in cases when no document is issued to certify the filing of the return.

Article 256. (Supplmented, SG No. 45/2002) Any tax administration authority, who fails to timely inform the tax subject about any omissions and discrepancies inthe return, or makes an untimely assessment of the tax liabilities, when so required by law, as well as in cases when he/she does not send the notification for tax due within the legally determined deadlines, shall be penalized with up to 250 BGN. In cases of a repeated offence the tax administration authority shall be penalized by up to 500 BGN.

...

Article 258. (Supplmented, SG No. 45/2002) Any tax administration authority, performing a tax audit

without having an assignment to do so, or continuing the audit after the specified deadline, unless the deadline has been suitably extended, shall be penalized with from 250 to 500 BGN, and in cases of a repeated offence the penalty shall be from 500 to 1,000 BGN.

...

Article 261. (1) (Supplemented, SG No. 45/2002) Any tax administration authority who fails to initiate procedures for issuing a tax administration decision or does not issue a decision on an appeal filed by a tax subject within the legally determined deadlines, shall be penalized from 250 to 500 BGN, and in cases of a repeated offence the penalty shall be from 500 to 1,000 BGN.

(2) The penalty referred to in Paragraph 1 shall apply for any tax administration authority who has refused, without reasonable grounds, to allow an offsetting or refund of overpaid taxes and undue amounts, subject to refund on other grounds, as well as in cases when he/she has allowed a delay of the tax procedure and this fact has been established by a superior tax administration authority under this Code.

Article 262. (Amended, SG No. 45/2002) Any tax administration authority who has allowed the preliminary execution of a tax administration decision to be suspended, without securing collateral, shall be penalized from 250 to 500 BGN, and in cases of a repeated offence the penalty shall be from 500 to 1,000 BGN.

Article 263. (Amended, SG No. 45/2002) Any tax administration authority, who fails to invite the debtor to voluntarily comply, after the legally determined deadlines for payment have expired, shall be penalized up to 50 BGN, and in cases of a repeated offence the penalty shall be up to 100 BGN.

Appendix 2. Anticorruption Policies of the Tax Administration: Strategy & Programmes

NATIONAL ANTICORRUPTION STRATEGY (Decision 671/01.10.2001) (Excerpts)

1.2. Improvement of the Financial and Fiscal Control

Financial discipline, transparency and responsibilities of the institutions should be completely ensured based on the Internal State Financial Control Act and in compliance with the new economic and social environment. This can be achieved through improvement of the forms of liability such as increased fines in cases of administrative liability and extended applicability of full financial liability for unlawfully inflicted damages. There is also a need for changes in the tax legislation aimed at:

- Clearer regulation of the powers of tax authorities and simplification of the taxation process;
- Increase in incentives for officials contributing to a greater exposing of tax evasions;
- Introduction of a public register of the income of tax administration officials;
- Improving the efficiency of interaction between State Financial Control, the National Audit Office, tax administrations, National Social Insurance Institute, General Labor Inspectorate Agency, the Ministry of the Interior authorities, and the judiciary, through the adoption of joint instructions for prevention and combating corruption;
- Feasibility study on Establishing an integrated information system for control authorities and the law-enforcement agencies in compliance with the laws regulating the protection of personal data;
- Improving the internal financial control offices within the various agencies and organizations.

Responsible: Minister of Finance, Council of Ministers

2002-2003 IMPLEMENTATION PROGRAMME OF THE NATIONAL ANTICORRUPTION STRATEGY (Decision 84/13.02.2002) (Excerpts)

Programme Objectives

Harmonise national tax strategy and policies with the tax policies of the single EU market:

- Narrow the gap between effective and legal arrangements by developing processes and systems to encourage improvements in tax compliance.
- Improve taxpayer service; increase transparency in the tax administration.
- Enhance the effectiveness of internal public financial control in fiscal loss prevention, detection and recovery, and in the detection and investigation of corrupt practices.

Main Initiatives and Tasks

1.2.1. The following should be reviewed, and appropriate amendments to them drafted:

- Acts of Parliament conducive to corruption pressure (VATA, CITA, Customs Act, PITA, Public Procurement Act, PIFCA, etc.).
- Under the Value Added Tax Act and the Excise Duties Act, synchronise provisions allowing control authorities to present as court evidence any documents requested and received through official channels from neighbouring countries.
- Propose amendments to CCP and CTP concerning financial embezzlement proceedings, with a view to providing a time-limit for the completion of court cases relating to financial embezzlement. In addition, provide severe penalties in cases of court files being lost with material effect on the outcome of such proceedings.

Responsible for the above: Minister of Finance; Minister of Public Administration.
Deadline: 31 July 2002.

1.2.2. Develop and implement measures to:

- Reorganise the existing control arrangement to limit corruption opportunities for public internal financial control officers.
- Improve implementation mechanisms to follow up on audit reports issued by the Audit Office, as an important factor in preventing fiscal loss, financial irregularity, and corruption at auditees.

- Widen the use of unannounced examinations to uncover fiscal loss and financial irregularity, and prevent the introduction of any bureaucratic conditions conducive to cover-up.

Responsible for the above: Minister of Finance.
The deadline: 31 July 2002.

1.2.3. Under the Minister of Finance, create a Council of the Heads of Inspectorate Departments as the coordinating body among the appropriate Agencies and Directorates in their respective antifraud and anticorruption efforts.

- Develop and adopt common criteria for the identification of corruption and financial fraud, and define countermeasures to be applied by all Agencies and Directorates concerned.

Responsible for the above: Minister of Finance.
Deadline: 31 December 2002.

1.2.4. Modify the reporting arrangements and structure of the existing Inspectorate Departments under the General Tax Directorate:

- Create a single Inspectorate entity of the General Tax Directorate.

Responsible for the above: Minister of Finance.
Deadline: 31 March 2002.

1.2.5. Modernise the systems for: supplementary financial incentives, performance appraisal, compensation, training, and career development of tax officers.

Responsible for the above: Minister of Finance.
Deadline: 30 June 2002.

1.2.6. Consider possibilities for the simplification of tax procedures and the introduction of conspiracy criteria regarding the actions of tax authorities. Introduce rules to ensure alternative current review of tax authorities' actions already in the course of proceedings.

Responsible for the above: Minister of Finance.
Deadline: 31 December 2002.

1.2.7. Introduce controlled-access register of tax officers' personal wealth.

Responsible for the above: Minister of Finance.
Deadline: 31 December 2002.

1.2.8. Develop special rules to safeguard tax officers' security in conflict situations arising in connection with the discharge of their duties.

- Tax officers should be treated with respect.
- Any contempt of a tax officer in his or her official capacity must be sanctioned.
- Tax officers themselves must be sanctioned for any lack of respect for a taxpayer.

Responsible for the above: Minister of Finance.
Deadline: 31 August 2002.

1.2.9. Introduce rules to award pay bonuses to tax officers and auditors whose correction assessments have been sustained in court appeals.

Responsible for the above: Minister of Finance.
Deadline: 28 February 2002.

2004-2005 IMPLEMENTATION PROGRAMME OF THE NATIONAL ANTICORRUPTION STRATEGY

(Excerpts)

4. Development of the Anticorruption Potential of the National Control System

Programme Objectives

- *Raising the efficiency of the state internal financial control in preventing, revealing and compensating of damages, and enhancing its role to reveal and provide evidence for corrupt behavior;*

- Improvement of the tax and financial control;
- Raising the efficiency of the specialized services involved in the discovery and prevention of corrupt acts;
- Application of the strategy of collaboration and community in the audit and tax policy in the European Union Single Market;
- Improvement of the services to taxpayers, raising the transparency in the tax administration's activities;
- Improvement of the coordination and interaction between the controlling structures of the Executive Power, the Chamber of Accounts, and the judicial system structures.

Main Initiatives and Tasks

4.1. Development and implementation of measures for the expansion of the possibilities of the Agency „Financial Intelligence Bureau“ in respect to receiving and examining of signals of corrupt acts, and the existence of higher risks for corruption.

*Responsible for the above: Minister of Finance
Deadline: 31.01.2004 – for announcement
30.12.2004 – for holding the initiatives*

4.2. Development and implementation of measures for anticorruption control, based on the possibilities for information exchange and control, formed within the framework of establishing a system of bylaws for organizations subject to the Law on Measures against Money Laundering, and the Rules for Enforcement of the Law on Measures against Money Laundering.

*Responsible for the above: Minister of Finance
Deadline: 31.03.2004 – for adoption of the measures
31.03.2005 – for implementation of the measures*

4.3. Establishment of systems for financial management and external audit.

*Responsible for the above: the National Audit Office Chairperson
Deadline: 31.03.2004 – for adoption of a project*

4.4. Raising the administrative capacity, to protect the financial interests of the Community against frauds and irregularities.

*Responsible for the above: Minister of Interior and Minister of Finance
Deadline: 30.10.2004 – for the project*

4.5. Establishment of a Service for Fiscal Investigations.

*Responsible for the above: Minister of Finance
Deadline: 30.11.2004*

4.6. Organizational and functional final establishment and reinforcement of the National Agency of Revenues.

*Responsible for the above: Minister of Finance
Deadline: 30.12.2004*

4.7. Finalization of the reconstruction of department „Inspectorate and Internal Security“ within the Tax Administration.

*Responsible for the above: Minister of Finance
Deadline: 31.01.2004*

4.8. Updating the programs for training the employees at the Bulgarian Tax Administration in Anticorruption practices.

*Responsible for the above: Minister of Finance
Deadline: 31.03.2004*

4.9. Development and testing of a unified information system for the National Agency of Revenues.

*Responsible for the above: Minister of Finance
Deadline: 30.12.2004*

4.10. Definition of the channels of interaction between the Anticorruption Coordination Commission and the Coordination Council for Combating Violations, infringing the financial interests of the European Communities, established by Decree No. 18 of the Council of Ministers adopted on February 04, 2003.

*Responsible for the above: Chairperson of the ACC and Minister of Finance
Deadline: 31.03.2004*

4.11. Carrying out of training of experts from the controlling institutions in the application of the new Law on Public Procurements.

*Responsible for the above: Chairperson of the ACC and Minister of Finance
Deadline: 30.07.2004*

4.12. Development and implementation of a common information system for the national controlling structures (the National Audit Office, the Agency of Public Internal Financial Control, the Tax Administration, the Agency of Revenues, the Ministry of Interior, the Agency „Financial Intelligence Bureau“, the ACCC, etc.)

*Responsible for the above: Chairperson of the ACC and Minister of Finance
Deadline: 31.03.2005*

4.13. Development of a project for the improvement of the coordination and interaction between the national structures exercising controlling functions (the Chamber of Accounts, the Agency of Public Internal Financial Control, the Tax Administration, the Agency of Revenues, the Ministry of Interior, the Agency „Financial Intelligence Bureau“, the ACCC, etc.), when examining signals concerning corruption and the danger of higher risks for corruption.

*Responsible for the above: Chairperson of the ACCC and Minister of Finance
Deadline: 31.03.2004*

2004-2005 IMPLEMENTATION PROGRAMME OF THE NATIONAL ANTICORRUPTION STRATEGY PROGRAMME IMPLEMENTATION REPORT FROM THE ANTICORRUPTION COORDINATION COMMITTEE (Excerpts)

Ministry of Finance

In pursuance of its tasks under the Programme for the Implementation of the National Anticorruption Strategy, the Ministry has taken the following action during the January–October 2004 period:

The tax administration and the National Revenue Agency developed, and are in the process of implementing, a number of internal training programmes funded by the World Bank and the US Treasury. These focus on professional capacity strengthening and officers' ethical conduct. In 2004, the tax administration consolidated its territorial directorates with a view to providing better service to the public and the Treasury. The appropriate staff training programmes underway were developed jointly with the National Social Security Institute.

The Financial Intelligence Agency has performed on its tasks under the Programme by the development and continued updating of its web site (www.fia.minfin.bg). The website contributes to the further improvement of relations with the entities of the Agency's concern (by posting internal rules and other information of current interest).

Pursuant to the Money-Laundering Act and the Detailed Rules for its implementation, and the Financial Intelligence Agency is the recipient of relevant information, concerning also money laundering predicated on corruption.

The constant internal control, performed by the Agency's Inspectorate Directorate, the assignment of concrete responsibility to the Agency's staff in their communication with persons of concern, and the observance of strict reporting requirements, together with the increasingly broad application of electronic intelligence-gathering resources (the Agency's website, which carries the supervision provisions relating to the implementation of the Money-Laundering Act; the introduction of an electronic reporting system for commercial banks)—are all elements which contribute to the prevention of corrupt practices. Another such important element is the cooperation between the Agency and the other government agencies which

have a duty to provide information to it pursuant to the 2003 amendments to the Money-Laundering Act (OG, 31/04.04.2003). The same holds for the increasingly close cooperation between the Agency and all the other law enforcement authorities engaged in fighting money laundering, which has been the product of the EU/PHARE, *Combating Money-Laundering*, Twinning Project which concluded on 1 November 2004. Rigorous control and corruption countermeasures have also supported the Agency's international exchange arrangements.

Pursuant to an Order issued by the Minister of Finance in June 2004, the Inspectorate Departments of the Regional Tax Directorates in Sofia, Plovdiv, Varna, Bourgas, and Veliko Turnovo have been abolished and replaced with the appropriate sections of GTD's Inspectorate Department. The relevant new job descriptions and structure for the Inspectorate Department are and development.

The tax administration developed *Ethical Norms of Tax Officers' Conduct*. These were approved by the General Tax Director and the Executive Director of the National Revenue Agency. Each officer of the tax administration was given a copy of the Norms and acknowledged receipt by signature. A total of 150,000 leaflets concerning the newly-adopted Norms were printed for the administration's clients and circulated locally. The relevant training programme for the administration's staff for 2004–2005 has been developed.

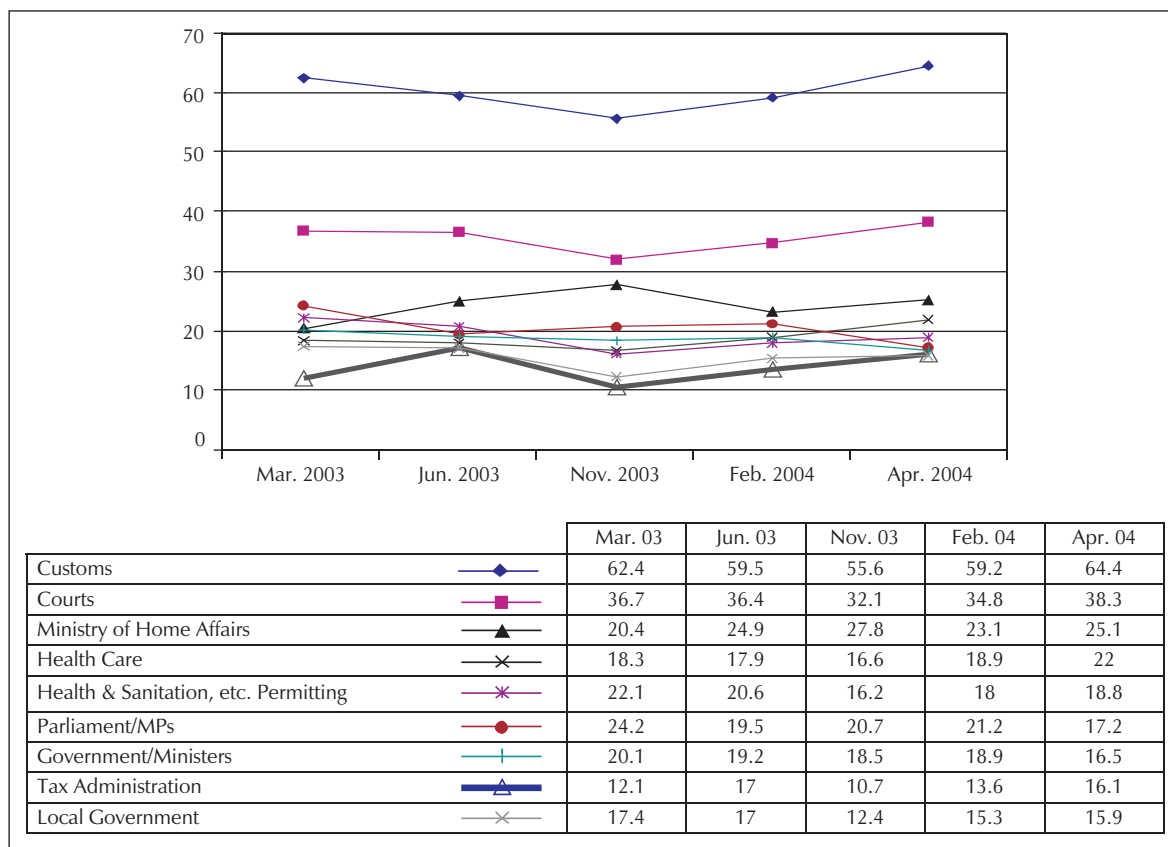
A number of actions were taken for the purposes of the further institutional build-up at the National Revenue Agency, with World Bank funding support and human-resource support from the Agency and the tax administration. The projects will be ongoing in 2005. For the purposes of a smoother migration to the National Revenue Agency, the tax administration is consolidating its territorial directorate.

The Financial Intelligence Agency works in close cooperation with the Customs Agency and receives information on all cash amounts crossing the border. On the other hand, a single information system for all control and law-enforcement agencies (Audit Office, Public Internal Financial Control Agency, the tax administration, National Revenue Agency, Ministry of Home Affairs, Financial Intelligence Agency, the Anticorruption Coordination Committee) is yet to be implemented. The Financial Intelligence Agency and the General Tax Directorate have been improving their cooperation with the other government agencies by operation guidelines, joint participation in conference and training events, in the active involvement of a number of government authorities in the Twinning Project at the Financial Intelligence Agency.

Appendix 3. Spread and Level of Tax Corruption on a Comparison Basis

3.1. Institutional Comparisons

(% of responses by institution to: „In your view, where in Bulgaria is corruption widest-spread?"; up to 3 responses)



Source: Coalition 2000 CMS, April 2004, Business Sector. Base: 478.

3.2. Professional Group Comparisons

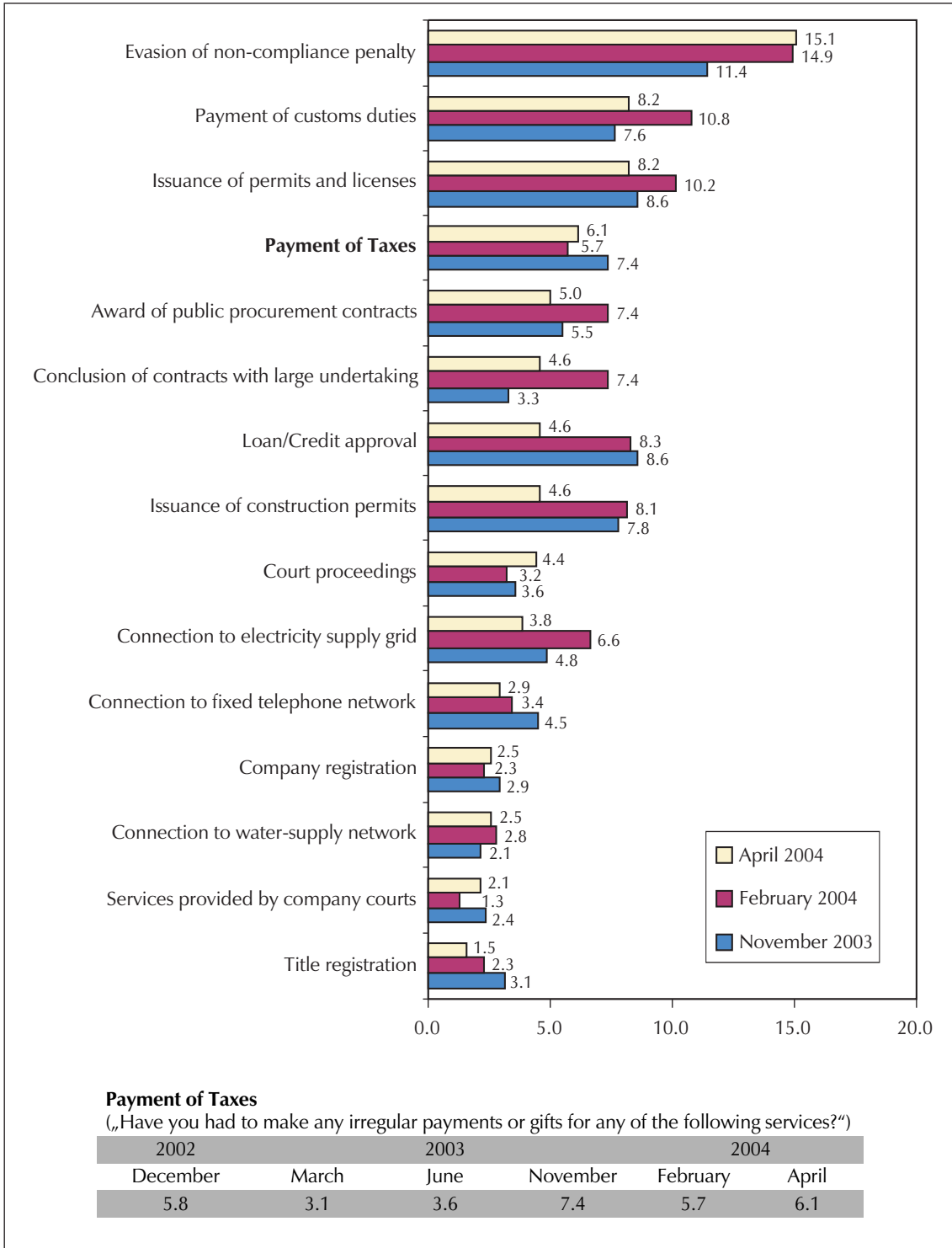
(% of „Almost all or most are involved in corruption“ responses by group to: „How widespread is corruption among the following?“)

	2000	2002	2003			2004	
	Oct.	Dec.	Mar.	Jun.	Nov.	Feb.	Apr.
Customs Officers	80.0	80.3	73.6	74.9	80.3	82.4	81.1
Police Officers	57.7	59.8	53.5	62.7	62.5	64.5	56.0
Politicians/Political Party Leaders	64.5	59.6	55.3	57.5	62.7	64.3	54.4
Judges	53.4	57.4	47.7	50.4	53.4	53.7	52.7
Members of Parliament	60.2	60.8	53.9	54.3	58.7	58.2	51.4
Tax Officers	58.8	62.7	50.3	58	62.9	58.0	51.1
Public Prosecutors	49.3	56.5	49	50.2	52.0	52.0	51.0
Physicians	38.2	53.1	46.8	45.4	53.4	54.8	50.2
Lawyers	52.0	53.0	47.0	50.3	49.4	52.0	50.0
Local Servants	49.3	54.2	43.2	49.6	47.5	50.1	47.1
Mayors/Local Councillors	36.9	54	47.4	52.9	54.9	54.6	47.1
Government Ministers	60.2	54.5	42.1	51.4	55.6	56.1	45.4
Criminal Investigators	43.2	52.2	43.6	47.5	46.8	44.4	44.0
Government Ministry Officials	60.0	57.8	43.2	49.1	46.8	50.1	41.6

Source: Coalition 2000 CMS, April 2004, Business Sector. Base: 478.

3.3. Service Comparisons

(% of businesses which admit having paid bribes in the past year for any of the following services)



Source: Coalition 2000 CMS, April 2004, Business Sector. Base: 478.

3.4. Average Bribe-Size Comparisons

(a) compared with other services (% of businesses which admit having paid bribes by bribe size reported)

Service	Average Bribe Size (BGN)				
	< 250	250–500	501–1,000	1,001–5,000	> 5000
Award of public procurement contract	13.3	13.3	13.3	40.0	20.0
Issuance of building permit	18.8	25	37.5	6.3	12.5
Payment of customs duties	35.3	20.6	35.3	8.8	–
Court proceedings	27.8	38.9	22.2	11.1	–
Title registration	16.7	66.7	16.7	–	–
Payment of Taxes	56.5	39.1	–	–	4.3
Issuance of permits and licences	68.8	28.1	–	–	3.1

Source: Coalition 2000 CMS, April 2004, Business Sector. Base: of 478, those who admit having paid.

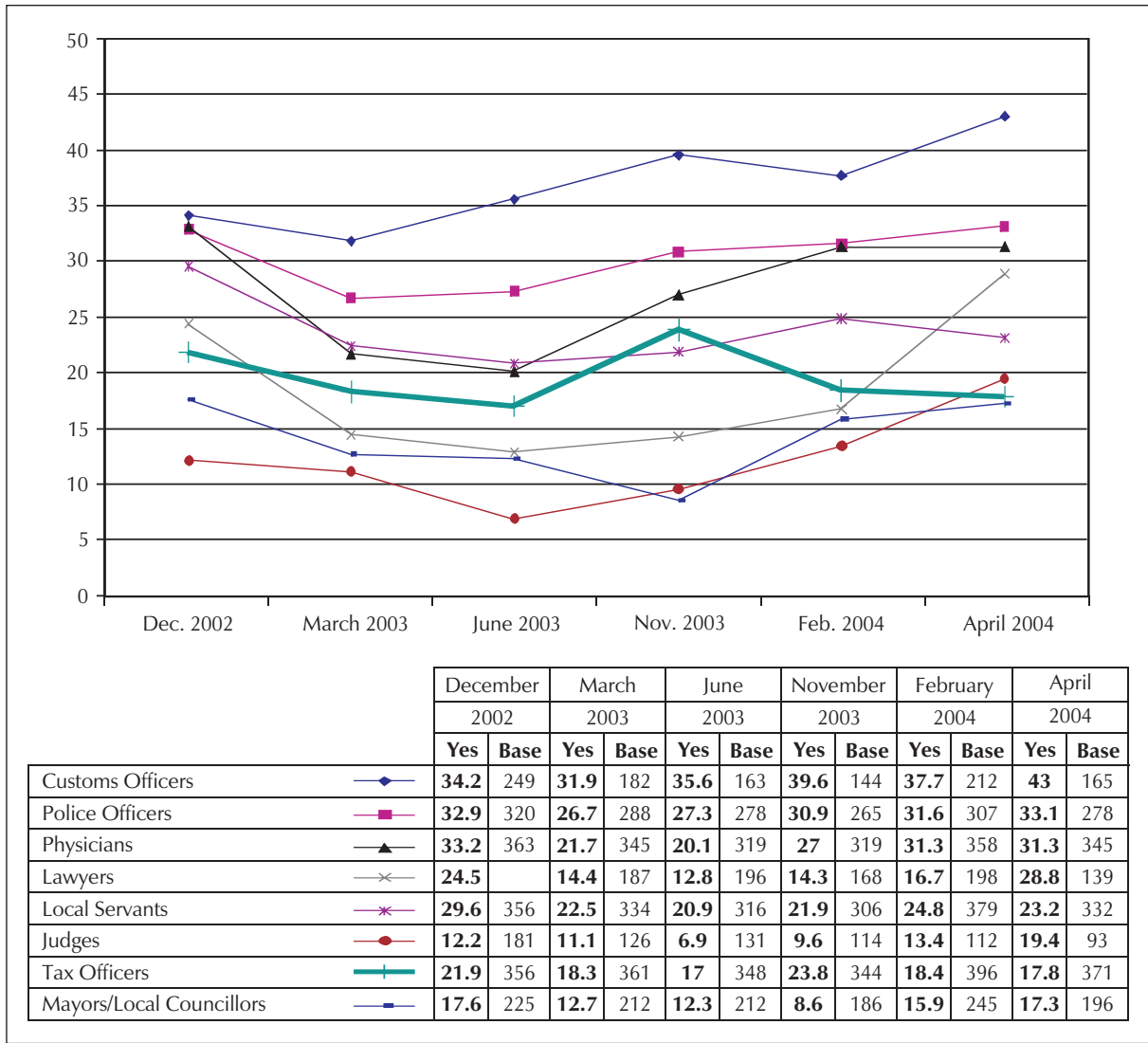
(b) over time „On average, what size irregular payment/gift value have you had to pay for tax-related services?“ (% of those who admit having paid)

BGN	Dec. 02	Mar. 03	Jun. 03	Nov. 03	Feb. 04	Apr. 04
< 250	58.3	72.7	50.0	74.2	94.1	56.5
251–500	29.2	18.2	41.7	19.4	5.9	39.1
501–1,000	12.5	–	8.3	6.5	–	–
1,001–5,000	–	9.1	–	–	–	–
> 5,000	–	–	–	–	–	4.3

Source: Coalition 2000 CMS, April 2004, Business Sector.

3.5 Corruption Pressure by Professional Group Comparisons

(% of businesses of which irregular payments, gifts or favours were asked by the following)



„If, last year, anything (e.g., money, gift or favour) was asked of you in consideration for a solution to a problem of yours, it was asked by:–“
 (% of respondents who had had contacts with the group concerned)

Source: Coalition 2000 CMS, April 2004, Business Sector.

Appendix 4. International Corruption Indices on Corruption in Bulgaria

Bulgaria features in a number of international ratings and indices of corruption, of economic freedom, of the quality of the business and institutional environment, and of investment risk, the most authoritative of which are listed in the box below. Even though most of them are interrelated,⁷⁰ the overall picture derived from them is inconclusive.

- **Transparency International.** *The Corruption Perceptions Index (CPI)* has been published annually since 1995, and has included Bulgaria since 1998. In 2003, CPI covered 133 countries. It assesses perceived corruption levels in the *public sphere* and defines corruption as the misuse of public powers for personal gain, including bribery, irregular payments in public procurement, misappropriation, etc.
- **World Economic Forum.** The *Global Competitiveness Report* publishes annual competitiveness ratings of economies, including two indices based on business surveys and statistics: the *Growth Competitiveness Index (GCI)*, developed by Geoffrey Sax's team, and the *Business Competitiveness Index (BCI)* developed by Michael Porter's team. One of GCI's three components is the index of public institutions, which has a corruption subcomponent. The latest Report covers 102 countries. Among other things, it features a tax-burden indicator.
- **The World Bank** surveys businesses about the business environment, including questions about the incidence of bribery and the extent to which corruption is perceived as a business barrier. Bulgaria was included in the sample of the *World Business Environment Survey (WBES)* in 2001, and in the two transition-countries regional *Business Environment and Enterprise Performance Surveys (BEEPS)* in 1999 and 2002. These have provided the empirical basis for the World Bank's two surveys of corruption in transition countries. In addition to business's corruption perceptions, the World Bank uses annual indicators based on expert assessments of the institutional environment—*Country Performance and Institutional Assessment (CPIA)*—which, however, remain unpublished.
- **Freedom House** has, since 1998, published annual expert assessments of the democratisation process in 27 transition countries, which include a corruption index.
- **The Heritage Foundation** has, since 1995, published its *Index of Economic Freedom* for 161 countries based on its expert assessments. Among the 10 components of the index are tax burden and regulatory burden.
- **The Fraser Institute** has, since 1997, published an annual report on economic freedom in 123 countries. Its business environment indices, including corruption and tax burden, are derived from the World Economic Forum's ratings.
- **Investment risk ratings.** The leading agencies which publish investment ratings include: The Economic Intelligence Unit (100 countries); World Market Research Centre (196 countries); Global Insight (117 countries); Political Risk Services (140 countries); etc. Most of these are based on expert assessment of the various kinds of investment risk, including: political, economic, regulatory, taxation, operational, etc. All ratings include a corruption indicator as a component of the operational risk assessment.

⁷⁰ For example, Transparency International's index for Bulgaria is a composite of several others, including Random House's, which, for its part, relies for countries' corruption ratings on Transparency International's index. Fraser Institute's index is fully derived from the corruption component of the World Economic Forum's Global Competitiveness Report. The WMRC index relies on Global Insight data, etc.

For example, according to the corruption index in the 2003 Global Competitiveness Report,⁷¹ Bulgaria ranked 35th of 102 countries, i.e., below the undoubted regional leaders Estonia (27), Hungary (28), and Slovenia (32), but on a par with Lithuania (34) and ahead of Slovakia (40), the Czech Republic (41), Italy (47), Poland (53), and Romania (90). In all fairness however, that was a setback by six places from Bulgaria's 2002 ranking: 27th of the 80 countries included in GCR.

For its part, the World Bank's 2004 Report⁷² presents a rather different regional comparison based on the 1999 and the 2002 BEEPS. In it, the scale of corruption is derived from the extent to which it is perceived by business as a barrier, and the scale of administrative corruption is assessed on the basis of businesses' estimates of bribe incidence and size in their respective industries (size being measured as a proportion of annual sales). The findings for Bulgaria are rather worse than the average for the Region—of the new EU Member States and accession countries, only Romania and, partially, Slovakia having performed worse than Bulgaria. In terms of *bribe incidence*, Bulgaria is behind all new EU Member State, excepting Slovakia, and behind all Balkan countries, excepting Romania and Albania. On this indicator, Bulgaria also ranks behind some former Soviet Republics, such as Armenia, Uzbekistan, and Azerbaijan, which incidentally, are perceived by business as having scored remarkable progress in curbing corruption between 1999 and 2002. During that period, Bulgaria had seen no change. In terms of *businesses' corruption costs*, Bulgaria has performed worse than all new EU Member States, all Balkan countries, excepting Romania and Albania, and also worse than Armenia, Russia, Uzbekistan, and Belarus.

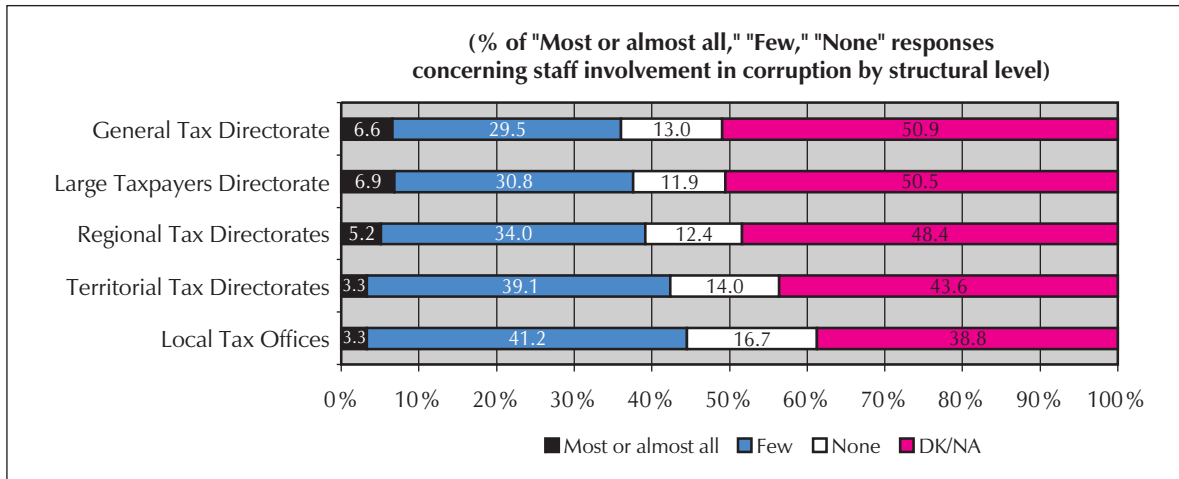
Freedom House's 2000 corruption index also ranked Bulgaria behind all new EU Member States, but first in the Balkans and ahead of all the former Soviet Republics, and as having registered a steady positive trend.

⁷¹ The corruption index, together with the law and contract enforcement index, makes up the index of public institutions. The latter is one of the three components (weighted equally), including the technological development index and the macro-environment index, of the economic competitiveness index, i.e., GCI. The corruption index reflects the incidence of irregular payments in export and import; tax collection; connection to network services, such as telephone, water supply, and electricity; public procurement; loan approval; public governance; administration of justice; and also, corruption related to embezzlement of public funds, policymaking and lawmaking, the funding of political parties, and money laundering.

⁷² Gray *et al* (2004).

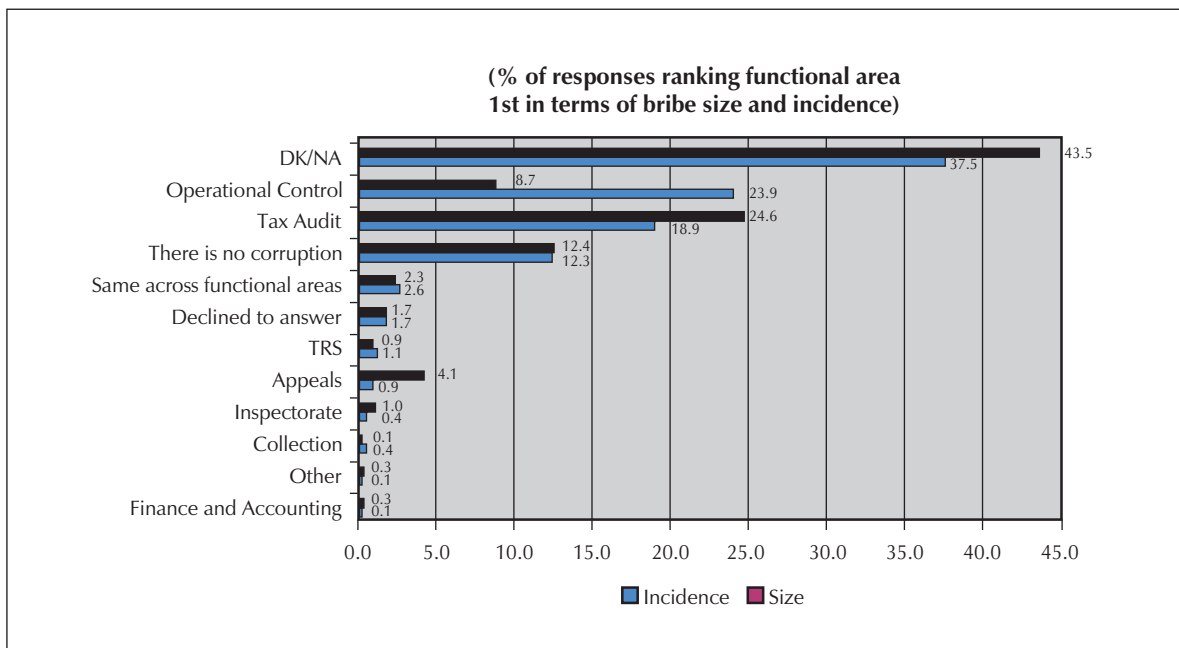
Appendix 5. Spread of Corruption in the Tax Administration by Structural Level and Functional Area

5.1. Perceived Spread of Corruption by Structural Level



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

5.2. Perceived Spread of Corruption by Functional Area



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

5.3. Perceived Level & Spread of Corruption by Respondents' Functional Area

„Where is corruption biggest?“					
<i>Responses</i>	<i>% of responses by respondent's own functional area</i>				
	<i>TRS</i>	<i>Tax Audit</i>	<i>OC</i>	<i>Collection</i>	<i>FA</i>
Tax Audit	30.6	14.2	28.4	33.3	22.7
Operational Control (OC)	8.3	12.5	0.0	11.1	9.1
Appeals	0.3	9.9	0.0	7.4	2.3
Same across areas	1.7	3.4	3.0	0.0	0.0
There is no corruption	13.9	10.3	16.4	11.1	9.1
Other	2.5	3.1	1.5	3.8	0.0
DK/NA	42.7	46.6	50.7	33.3	56.8
	100.0	100.0	100.0	100.0	100.0
Base	288	232	67	27	44

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

„Where is corruption most common?“					
<i>Responses</i>	<i>% of responses by respondent's own functional area</i>				
	<i>TRS</i>	<i>Tax Audit</i>	<i>OC</i>	<i>Collection</i>	<i>FA</i>
Operational Control (OC)	20.8	35.3	1.5	22.2	13.6
Tax Audit	26.4	5.6	29.9	33.3	20.5
Other	1.8	6.1	1.5	0.0	2.3
Same across areas	1.7	3.4	4.5	0.0	0.0
There is no corruption	13.5	10.8	14.9	11.1	9.1
DK/NA	35.8	38.8	47.8	33.3	54.5
	100.0	100.0	100.0	100.0	100.0
Base	288	232	67	27	44

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

Appendix 6. Spread of Corrupt Tendencies by Age-Group and Length of Service

(a) „Are younger or older officers more likely to exert corruption pressure?“

Responses	Age		< 35		35–50		> 50		NA	Total	
	#	%	#	%	#	%	#	%	#	#	%
Younger	13	5.8	41	13.7	26	23.4	5		85	12.2	
Older	29	12.9	19	6.3	8	7.2	5		61	8.7	
Makes no difference	155	69.2	199	66.3	63	56.8	46		463	66.2	
Other	4	1.8	4	1.3	0	0.0	1		9	1.3	
DK/NA	23	10.3	37	12.3	14	12.6	7		81	11.6	
TOTAL	224	100.0	300	100.0	111	100.0	64		699	100.0	

(b) „Are younger or older officers more likely to yield to corruption pressure?“

Responses	Age		< 35		35–50		> 50		NA	Total	
	#	%	#	%	#	%	#	%	#	#	%
Younger	15	6.7	58	19.3	39	35.1	10		122	17.5	
Older	20	8.9	7	2.3	2	1.8	3		32	4.6	
Makes no difference	170	75.9	201	67.0	59	53.2	43		473	67.7	
Other	3	1.3	4	1.3	0	0.0	0		7	1.0	
DK/NA	16	7.1	30	10.0	11	9.9	8		65	9.3	
TOTAL	224	100.0	300	100.0	111	100.0	64		699	100.0	

(c) „Are shorter or longer-serving officers more likely to exert corruption pressure?“

Responses	Service yrs.		< 3		3–10		> 10		NA	Total	
	#	%	#	%	#	%	#	%	#	#	%
Shorter-serving	2	4.1	26	6.7	43	16.9	1		72	10.3	
Longer-serving	14	28.6	63	16.3	22	8.7	1		100	14.3	
Makes no difference	21	42.9	259	66.9	155	61.0	3		438	62.7	
Other	1	2.0	4	1.0	4	1.6	0		9	1.3	
DK/NA	11	22.4	35	9.0	30	11.8	4		80	11.4	
TOTAL	49	100	387	100	254	100.0	9		699	100.0	

(d) „Are shorter or longer-serving officers more likely to yield to corruption pressure?“

Responses	Service yrs.		< 3		3–10		> 10		NA	Total	
	#	%	#	%	#	%	#	%	#	#	%
Shorter-serving	4	8.2	43	11.1	55	21.7	1		103	14.7	
Longer-serving	12	24.5	47	12.1	17	6.7	1		77	11.0	
Makes no difference	23	46.9	268	69.3	152	59.8	3		446	63.8	
Other	1	2.0	3	0.8	3	1.2	0		7	1.0	
DK/NA	9	18.4	26	6.7	27	10.6	4		66	9.4	
TOTAL	49	100	387	100	254	100.0	9		699	100.0	

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