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The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation.

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Editorial

The Complex and Critical Relationship Between Tax and Corruption

Tax and corruption are global phenomena. No society is immune from corruption,¹ and within any society taxation plays a pivotal role in relation to such activity – which can be both positive and negative. Positively the tax system can provide the kind of regulatory framework and institutional foundations which can help to eradicate or constrain corrupt practices. On the negative side, corruption reduces tax compliance.² Even perceptions of corruption, whether ‘grand’ or ‘petty’, seriously undermine taxpayers’ intentions to report actual income or sales.³ The relationship between tax and corruption is therefore both complex and critical.

Two events with the common theme of ‘Tax and Corruption’, held in Australia in April 2017 and in South Africa in October 2017, explored this complex and critical relationship. In Sydney, in a symposium convened by UNSW Sydney, hosted by KPMG and sponsored by the Asian Development Bank Institute, the focus of 26 presentations was on tax and corruption in the Asia-Pacific region. In Johannesburg, in a symposium sponsored by the South African Institute of Chartered Accountants and convened by the University of Pretoria, UNSW Sydney and the University of Western Australia, the focus shifted to Africa in the 21 presentations made there. But, despite the regional variations, the two events canvassed many of the same themes and came to many of the same conclusions – affirming the view that whilst there will always be country-specific aspects, the issues raised by the relationship between tax and corruption are more than often global and are never simple.

Both events were interdisciplinary, involving tax specialists, lawyers, accountants and economists, and both were attended by between 30 and 40 invited delegates from all over the world, including representatives from academia, the tax profession, international organisations, the business community, civil society and senior tax administrators and policy makers. The symposia, each lasting two days, were designed to provide a safe environment in which research, thoughts and ideas relating to the problems of tax and corruption, and possible solutions or ways forward to tackle some of the problems, could be freely debated. Both followed broadly similar formats.

A selection of the 47 papers from the two events have been refereed and the ensuing ten articles, revised in the light of symposium feedback and referees’ comments, are now published in this Special Issue of the *eJournal* on Tax and Corruption. As Guest

¹ Transparency International, ‘Corruption Perceptions Index 2015’ <<http://www.transparency.org/cpi2015>>.

² James Alm, Jorge Martinez-Vazquez and Chandler McClellan, ‘Corruption and Firm Tax Evasion’ (2016) 124 *Journal of Economic Behavior and Organization* 146, 146.

³ Arifin Rosid, Chris Evans and Binh Tran-Nam, ‘Do Perceptions of Corruption Influence Personal Income Taxpayer Reporting Behaviour? Evidence from Indonesia’ (2016) 14(2) *eJournal of Tax Research* 387.

Editor I am grateful to all the participants at the two symposia, and to all the referees, for their invaluable thoughts and comments. I particularly appreciate the insightful summations made by my colleagues at the two symposia: Adjunct Professor Grant Wardell-Johnson of KPMG at the Sydney symposium; Professor Jim Alm from Tulane University at the Johannesburg symposium; and Professor Richard Krever, now at University of Western Australia, present at both of the symposia. I also appreciate the time and effort invested by the authors of the articles assembled here.

The two opening articles are designed to set the scene for the articles that follow in this Issue. They provide contrasting perspectives on the relationships between tax and corruption. Vito Tanzi, the former Director of the Fiscal Affairs Department of the International Monetary Fund, explores the thesis that tax evasion is facilitated by corruption and that corruption in turn is facilitated by tax complexity. His article, 'Corruption, complexity and tax evasion', argues, and provides evidence to support the argument, that tax systems have become far more complex than they need to be, with a resulting impact upon corruption and evasion. In contrast, Jim Alm of Tulane University and Yongzheng Liu of Renmin University of China, examine three specific questions in their article 'Corruption, taxation and tax evasion'. First, on a general level, what are the causes and consequences of corruption? Second, on a more specific level, what is the relationship between corruption and taxation? Third, on an even more specific level, what is the relationship between corruption, taxation, and tax evasion? They conclude with a discussion of how this evidence can be used to control corruption, making use of a different, if related, body of work on tax evasion.

Both of these articles explore the relationship between tax and corruption from broad macro-economic and social perspectives, and this theme continues with the article by Anja Baum, Sanjeev Gupta, Elijah Kimani and Sampawende Jules Tapsoba from the International Monetary Fund and Princeton University. In 'Corruption, taxes and compliance' the four authors re-visit the effects of corruption on the state's capacity to raise revenue, concluding that corruption is negatively correlated with overall tax revenue and most of its components, largely influenced by the way corruption interacts with tax compliance. The following article by Bernd Schlenther of the African Tax Administration Forum also considers, in the African context, the impact of corruption on tax revenues, tax compliance and economic development.

Articles selected from the papers presented at both the Sydney and Johannesburg events are also devoted to the challenges and possible solutions for specific countries in the two regions in which the symposia were held. Hence country-specific articles on tax and corruption in China (Nolan Sharkey and James Fraser), Indonesia (Christine Tjen and Chris Evans), New Zealand (Lisa Marriott), South Africa (Boela (AP) Swanepoel and Jacolize Meiring) and Vietnam (Ngoc Anh Nguyen, Quang Hung Doan and Binh Tran-Nam) feature in the following part of this Special Issue. These articles provide a general overview and analysis of the problems of corruption in the Asian-Pacific and African tax environments and consider international and national legislative and strategic frameworks governing corruption. The topic of corruption in revenue agencies is also a recurrent theme. Many of the articles focus on general and more specific responses designed to combat corruption, ranging from transparency and disclosure (including whistle-blowing) through to the many aspects of policy, legislative and administrative or institutional reform and governance designed to tackle corruption in the tax environment. Hence 'Is sunlight the best disinfectant' is the compelling title of the article about tax and corruption in New Zealand by Lisa

Marriott. The article appropriately reminds us that corruption cannot simply be labelled as a developing country issue – developed countries have their own issues and problems too.

Finally, an article by Heidi Zummo, Bronwyn McCredie and Kerrie Sadiq explores the relationship between aggressive tax planning and mandatory corporate tax disclosure. Although the article is less focused upon corruption than the others in this Special Issue, it nonetheless touches upon many of the themes that are prevalent throughout, including the importance of transparency – and the contribution transparency can make to increased public confidence in the integrity of rules, systems and institutions.

A large number and variety of additional themes emerge from the articles (and from the symposia that underpinned the articles). Inter alia it can be noted that corruption has many faces and many definitions, and that significant work is being done on the drivers and the effects of corruption in the tax world. But despite the growing research on corruption, that research is difficult, due largely to data and measurement issues. Moreover, a lot of the research is very case, context or country-specific, with the result that any solutions are also often likely to be case, context or country-specific.

There are a number of other lessons that emerge from the articles (and the papers and presentations at the symposia). For example, it is clear that corruption is widespread, linked to tax evasion, often driven by greed, but also by poor governance/institutions and monopoly power in such institutions. Other factors include a lack of transparency, complicated and/or discretionary tax systems, poor enforcement, perceptions of unfairness in taxation and services, poor government services, low government wages, and a lack of integrity/ethics/morality. The point is also strongly made that responsibility does not simply lie with public officials: business is not blameless since corruption is generally a two-sided transaction. Corruption is shown to have clear (and usually detrimental) effects on innovation, fiscal citizenship and tax compliance.

As noted earlier, much of the content of the articles focuses on potential means by which corruption in the tax environment can be addressed. Very clearly corruption can be reduced by a host of possible strategies. Some which emerge include: increasing enforcement; instilling integrity/ethics/morality in government officials – and their business counterparts; increasing transparency, along with the power to act on transparency; establishing anti-corruption bodies and laws; changing human resource management practices; reducing tax compliance costs; eliminating or restricting discretionary practices in taxation – ensuring revenue authorities are precise on what is allowed and what is not allowed, even if this increases tax complexity; focusing on ‘basic’ implementation of taxes on domestic taxpayers; educating the ‘next generation’ of citizens and tax administrators (accepting that many of the current generation may be lost); improving institutions and building capacity; having the political will to address corruption; and protecting the ‘whistle-blower’.

Although it is obvious from this array of quality research articles that much more is now known about corruption than when the explosion of corruption research began in the 1990s, there is nonetheless a feeling that the articles (as well as the papers, presentations and discussions at the symposia) often merely confirm what we already know (or think we know). Arguably it is more important to establish the new things that can be learned and to establish the areas on which those interested can change their minds. It is also critical that further research needs to be undertaken to address some of the ‘unknowns’ that emerge. These include:

1. there is the widespread perception that corruption is widespread, but exactly how much corruption is there? That is, can country-level estimates of the extent of corruption be calculated?
2. there is the widespread perception that corruption has many (harmful) effects, but exactly how large are these effects of corruption?
3. there have been many suggested anti-corruption policies, but do any or all of the many proposed and enacted anti-corruption strategies actually work?
4. the focus is typically on anti-corruption policies in the public sector, but what about policies that might work via the private sector?
5. many have said that it is essential to instill ‘integrity/ethics/morality’ to reduce corruption, but what are the specific actions that can be taken to do this, so that people will ‘do the right thing’?
6. we want to think that there are ‘best practices’ that should be enacted, but can we expect that policies that work in one country will always work elsewhere?

Perhaps this was the most valuable outcome of the two symposia and the current set of articles – the identification of areas where much more research is needed. And clearly such research needs to provide the empirical data upon which future evidence-based strategies can be developed, potentially involving a host of methodologies including the judicious use of field experiments, laboratory experiments, administrative data and other approaches. The articles in this Special Issue of the *eJournal* may represent the current state of play on the topic of tax and corruption, but they also remind us how much more there is to know.

Chris Evans, UNSW Sydney and University of Pretoria

December 2017

Corruption, complexity and tax evasion

Vito Tanzi¹

Abstract

Tax evasion is facilitated by corruption and corruption is facilitated by tax complexity. This article argues and presents evidence that tax systems have become far more complex than they need to be. Complexity is not inevitable. It is the result of lobbying and of trying to achieve far too many objectives with tax systems.

Keywords: corruption, complexity, evasion, simplicity, revenue losses, equity, development

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1. INTRODUCTION

Corruption is an old human activity and references to it go back thousands of years. In the distant past, corruption had not always been considered an illegitimate or undesirable activity and some modern societies continue to be relatively indifferent, or at least more tolerant, of corruption than others. During the high days of the Roman Republic, when a modern legal system started to be created, corruption came to be seen as an undesirable and illegitimate activity. Centuries later, Dante, the great Italian, medieval poet, in his literary masterpiece, *Inferno*, placed corrupt people in the deepest and most painful levels of Hell. The term comes from the Latin verb ‘to break’, because it is assumed that corruption breaks some widely accepted norms. The term entered the English language at about Dante’s time, in the 13th-14th centuries. A few centuries later, the US Constitution made corruption, together with treason, one of two explicitly mentioned crimes that could lead to the impeachment of a president.

Over the years there have been different definitions of corruption, some more morally based and some more legally-based. The concept of corruption, defined as *the act of breaking an accepted social or legal norm*, must inevitably recognise that different societies may respect different norms, and that some norms are not legally defined. Therefore, an act that may be considered corrupt in one society may be seen as normal, expected, and tolerated in another. This is especially the case when the act reflects relations with, or assistance provided to, friends and family members, or with other members of close communities. In some societies, for example, exchanges of favours, that may hide bribes, are considered normal. As a consequence, some forms of corruption take the form of, or start as, favours (Tanzi, 1995a).

In recent years there has been the problem of the rise of what could be called *legally tolerated corruption*, that is, behaviour that many may consider questionable, or even illegitimate, but that is not explicitly forbidden by a specific law or regulation. Examples of legal corruption have come from the financial market, from some forms of tax avoidance, and, in some mineral exporting, poor countries, from some questionable acts on the part of policy-makers.

The role that culture plays in human relations is important in understanding why corruption continues to be more common in some parts of the world than in others (Tanzi, 1995a). For this reason, much time was spent in defining corruption in international meetings during the decade of the 1990s, when corruption became a significant global issue due to globalisation. At that time, it had become necessary for lawyers from international organisations and from countries’ governments, to agree on a legally and widely agreed definition of corruption. That definition would apply to all actors operating in a world that was becoming progressively more globalised, and when multinational enterprises and individuals were increasingly operating in places that had different cultures and legal systems.

Tax evasion is a slightly more recent sin or activity than corruption. The term also first appeared in the late Middle Ages and was linked with the taxing activity of the governments of ‘city-states’. It refers to illegitimate actions on the part of taxpayers directed at evading the payment of due taxes. A modern day visitor to Venice can still see, at the entrance of the Ducal Palace in Piazza San Marco, an old, carved stone that, centuries ago, had invited Venetian citizens to report those who were hiding corrupt or taxable activities from the Republic of Venice.

Both corruption and tax evasion, however defined, are, therefore, not just modern activities. For many centuries they have generally not been condoned. Some experts have, at times, tried to justify them on various grounds, generally related to presumably bad laws and to the bad behaviour of governments and policy-makers. Some have argued that oppressive taxes and rigid regulations may lead to and justify tax- or regulation-evading reactions by citizens. Very low wages may also justify some acceptance of bribes, and regulations that are too strict may justify ignoring them.

As government activities grew over the years, and as they required higher tax revenue, more public spending and more government regulations, both corruption and tax evasion seemed to grow and to become more widespread. Tax evasion had attracted some attention of economists for some time but, until the decade of the 1990s, corruption had attracted less attention by them. Until that time, references to corruption had come mainly from political scientists and historians (see Massie, 1980, pp. 781-789), or even from opera composers --see Puccini's *Manon Lescaut* and *Tosca*--, not from economists. However, since the early 1990s corruption has been receiving much more attention from economists than in earlier years (see Abed and Gupta, 2002).

This article discusses reasons for these developments. It argues that they are likely to rest on both the growing public activities of governments and, especially, the growing complexity of modern government operations including in tax systems.

2. ON TAX EVASION AND CORRUPTION

After World War II, there were two major developments, worldwide, that called for higher tax revenue in both rich and poor countries. Rich countries were abandoning the more *laissez faire*, or low government spending, policies of the past, and started on a path that would transform many of them, within a couple decades, into modern welfare states. Or, at least, they would create new and expensive government programs, even in countries that would not become classic welfare states, as for example the US, Australia and some others.

To finance the higher public spending, the rich countries' governments needed additional revenue. The needed resources came, first, from a greater use of income taxes and from many assorted, small taxes; successively, they increasingly came from the newly introduced value added taxes, or from some other general sales taxes. Income taxes and value added taxes became the two major contributors, in the second half of the 20th century, to the rise in tax revenue in industrial countries. These two taxes explain much of the rise in tax revenue.

During the 20th century the average tax level in the industrialised countries increased, from around 10 per cent of GDP at the beginning of the century, to over 30 per cent of GDP by the end of the century. In several European countries, the tax level even came to exceed 40 per cent of GDP. In most OECD countries, the growth in tax levels came to a stop in the new millennium. More recently pressures have built pushing for tax reductions in several countries.

After World War II, many poor, developing countries had come out of their former colonial status and had become politically independent. Their governments were soon

confronted by statistical evidence, made available mostly by the statistical offices of the United Nations and the newly-created Bretton Woods institutions (the World Bank and IMF) that quantified the rather obvious conclusions that these countries were much poorer than the rich countries. Therefore, they badly needed to adopt policies that would make their economies grow, to begin a process of convergence with the rich countries' living standards.

Development economics had then become an important field of economics and many development economists had concluded that the governments of the developing countries should play a leading role in the economic development of those countries. At that time there was a lot of confidence in what good governments could do for their economies. Most economists were convinced that economic growth could not be expected to originate spontaneously from the actions of private sectors that, at that time, were far from modern.

The development strategy recommended by many economists was: (a) the developing countries needed to accumulate more capital; (b) the governments had to raise the countries' tax burdens, to have more resources available; (c) they should keep government *current* spending low; and (d) they should use the budget surpluses thus generated to build badly needed public infrastructure and to accumulate capital in other ways.

At that time, popular economists' models (Harrod and Domar-type models) considered capital accumulation as the key ingredient to generate economic growth. The *capital-output ratios* and the *tax levels* became the two development statistics that attracted much attention, and taxation was seen as central in the promotion of economic development. Most developing countries were urged to increase their tax levels with appropriate tax reforms and with foreign technical assistance. Foreign aid could add to governments' available resources.

Econometrically-based estimates of the *tax potential* of countries became important policy inputs. Tax rates were pushed up and new taxes were introduced, to raise the tax levels. However, because of tax evasion (and the opposition to high taxes by those citizens who had greater taxable capacity and more political power), assisted or facilitated by corrupt tax administrations, tax revenue generally increased to a far lesser extent than hoped. Corruption also entered into investment decisions, making capital less productive (Tanzi and Davoodi, 1998).

3. FACTORS CONTRIBUTING TO TAX EVASION AND TO CORRUPTION

Some real world examples of tax evasion in particular developing countries may help give a feel for the importance of the problem. Examples from two important Latin American countries, Argentina and Peru, will be used (they are borrowed from two books: Tanzi, 2007a, pp. 30-33, and Tanzi, 2010, ch. 8). Similar examples could have been taken from Asian countries.

In Argentina, by 1975-76, the share of tax revenue in GDP had fallen sharply, to well below the already-low level that it had averaged in the preceding years. Several factors, relevant to our discussion, had contributed to that fall. At that time the role that high and increasing inflation, combined with delays in the payment of due taxes to the governments, in reducing real tax revenue was also at play. That particular factor, that

came to be described in the economic literature as the ‘Tanzi effect’, will be ignored in the discussion that follows, because it is not relevant in these non-inflationary times (Tanzi, 1977).

Of note first, the tax administration of Argentina

had become a relaxed place where many employees received full-time (though much compressed real) salaries but worked for only few hours a day. Many... had private practices where they spent much of their working day advising the same taxpayers they were supposed to be administering [in their official jobs], on how to reduce their tax liabilities. Some were corrupt and, for a bribe, would take care of the tax problems of particular taxpayers. They would use their power in the selections of audits, in the determination of fines, in the intentional misplacing of relevant files, in selecting taxpayers for inspections, in estimating the incomes or the sales of taxpayers and so on. Some... would accommodate requests from politicians to go easy on some taxpayers... As one employee put it: you interpret the law for friends and apply it rigidly for others (Tanzi, 2007a, p. 31).

The above paragraph conveys much information on factors that can contribute to tax evasion, and on the role of corruption and other factors to encourage, facilitate or make possible tax evasion. The cited volume on Argentina also contains information on strategies that taxpayers used to evade taxes (faking invoices, not reporting incomes, and so on), in an economy that was still closed and where *global tax evasion* was not yet playing the major role that it would come to play in many countries in later years (Tanzi, 2007a, pp. 32-33). One exception was the actions of some rich Argentines who deposited their money in US banks where, as deposits made by ‘non resident aliens’, the interest earned on the money deposited was not taxed by the US government and was not reported to the Argentine tax administration. In those years tens of billions of US dollars, belonging to Argentine citizens, were deposited in US banks.

In the Peruvian case (Tanzi, 2010, ch. 8), Alberto Fujimori, a shy, agricultural economist of Japanese background, who, in a surprising election, had been elected president of Peru in 1990, had invited the IMF to assist his country with the collection of taxes. At that time the tax level in Peru had fallen to about 7 per cent of the country’s GDP, and Peru was in arrears in the payment of salaries to public employees, and in the servicing of its foreign debts. The main reason for the drastic revenue fall was that the tax administration had become totally dysfunctional and corrupt, during the years of the leftist, populist, government of Alan García.

The tax mission that the IMF sent to Peru to study the problem, after a few days of work, reached the conclusion that the Peruvian tax administration was just too corrupt to be reformed. Drastic surgery was needed. As this conclusion has been described:

It was necessary to shut down the existing tax administration, sending home most of its employees, and to create a new one, from scratch. The new administration would have a salary structure comparable with that of the Central Bank, but the new employees would not enjoy tenure in their jobs. They could be fired at any sign of corruption, or of incompetence (Tanzi, 2010, p. 94).

A new administration, staffed mainly with carefully selected recent college graduates, was created. 'Within a short time, the situation began improving significantly, [tax revenue went up], and the new administration...was able to move into a new building' (Tanzi, 2010, p. 95). An incentive system was created that allowed the tax administration to keep a certain share of the total revenue collected, to allow it to pay bonuses for top performers. Some of the managers of the new tax administration came from the central bank.

The above descriptions, of specific experiences of two Latin American countries, make it possible to identify and to comment on factors that play, or can play, important roles in the tax evasion of most countries. Some of these factors are:

1. *The role of administrative controls.* All public institutions need some effective controls, to operate efficiently. There is no 'invisible hand' that can make them operate without controls. In institutions with weak or no controls, the employees spend less hours working than the official office hours suggest that they should. Furthermore, while at work, many work at a slow pace. Extended coffee breaks, frequent visits to restrooms, long lunches, and frequent absences from the offices, because of faked illness or other excuses, and, while in the offices, trivial conversations with colleagues and other actions can take a toll on efficiency and productivity.
2. *Inefficiency and absenteeism,* that inevitably affect performance. Recently, in Italy, there have been many reported cases of employees who, in the morning, checked in to their offices and, as in Argentina in the 1970s, disappeared for a good part of the day. *Job tenure* had made it difficult for the government to fire those who got caught. In some cases employees had established reciprocal arrangements with colleagues, who would electronically 'card in' their arrival.
3. The 'presence' of '*ghost workers*', workers who receive salaries but never show up for work, or may not even exist. Poor accountability, political corruption, and slack controls make possible the payment of salaries to *virtual* employees. In both of the above-described situations the need for controls *internal* to the institutions, and also for controls by *external* government-wide institutions (such as general accountability offices, or courts of accounts) are important. In recent years, in several countries, this issue has attracted more attention than in the past.
4. *Salary levels.* This factor has received empirical support in some studies. When salaries are low, there may be a greater temptation (or even need) for some employees to accept bribes, or to engage in other illegitimate activities that generate some incomes to them. This had happened in both Argentina and Peru. Low salaries, combined with job tenure, are factors likely to create bad incentives.
5. *Government salaries kept low,* on the very assumption that the workers are receiving bribes that increase their incomes. The reasoning is that, because of the bribes, the government does not need to pay higher salaries. This attitude ends up legitimising corruption and justifying the acceptance of bribes.
6. *A salary structure* that prevents some necessary and justified *differentiations* in salaries, between individuals with greater ability, initiative and responsibilities

and others. When the salary structures become too flat, they are likely to lead to poorer performances and to other difficulties, especially when the better trained and the top performers have the option of quitting and working for private and often foreign corporations, at higher salaries. This drainage of talent has become a more common problem in recent years in many developing countries, because globalisation has brought potential foreign employers to countries.

7. *The impact of rigid job tenure.* When individuals cannot be fired, at times even for incompetence or for some corrupt acts, job tenure ends up encouraging those acts. Labour unions generally defend job tenure, and some job security for public employees is important, to prevent politically motivated or abusive firing. In recent years, some countries have traded the freedom to fire unproductive or corrupt workers against higher salaries, as Peru did in the 1990s.
8. *The cultural dimension.* It was mentioned in section 1 above that *corruption has a cultural dimension*. In some forms, as with the exchange of favours or with the assistance to relatives, corruption is more condoned in some cultures than in others (Tanzi, 1995a). For this reason it may tend to be a greater problem at the subnational government level, because of the greater proximity to each other of individuals who know one another, or who are related. Corruption can also take forms that are more difficult to notice. For example, how quickly, or how favourably, an employee responds to a request from a citizen, who needs a particular government authorisation may depend on personal connections with that citizen.
9. *The role of contagion.* Corruption may be more contagious in some cultures than in others. When some employees engage in corrupt acts, others may be more likely to denounce them, or conversely to imitate them. This may depend on cultures and possibly on tradition. Therefore, specific rules and active controls against some actions may be more necessary in some countries than in others.
10. Some economists have ignored or removed the cultural or moral element from acts of corruption or other crimes and have described individual decisions on whether or not to commit a crime as depending mainly on *the probabilities of getting caught and on the expected penalties expected* if caught (see Becker, 1968, and Allingham & Sandmo, 1972; see also Chalfin & McCrary, 2017 for a review of related literature). While the above factors are clearly important, the moral attitude of individuals *vis-à-vis* some illegitimate, or illegal, actions must also play a role and should not be removed from these decisions.
11. *Unnecessary discretion in some actions*, such as the choice by tax administrators in the selection of taxpayers for audits, in the determination of the size of some fines, in the granting of tax incentives, and so on. Discretion in some actions can encourage acts of corruption. The granting of incentives has been a problem in several countries, especially in Asia. Discretion should be limited, and administrative decisions should be based, as much as possible, on specific and precise rules. When that is not possible, there should be more strict, *ex post*, controls. However, total absence of discretion may not be desirable and might create other problems, because some situations require judgment and discretion.

12. *Relations between tax administration and politicians.* Political influence on tax administrations remains a major problem in many countries, especially in developing countries. The insulation of tax administrators from the interference of politicians is thus essential to prevent corruption and tax evasion. There has been a lot of attention over the years to the need for the political independence of central banks, but not enough about the need for the political independence of tax administrations.
13. The *absence of incentives*, in addition to the general level of salaries, for encouraging efficient performances of employees. The criteria for hiring, promotions and salary increases are obviously important. Policies that end up rewarding good and bad performances equally are more likely to lead to corruption.
14. *The appointment* in high-level administrative positions of *politically connected individuals* with the power to channel to themselves the handling of some corrupt, but politically supported, acts. This happened in Peru, in the later years of the Fujimori administration, when a corrupt colonel was appointed as a deputy head of the tax administration. Political acts of corruption were channelled through this individual. In time they created new, great difficulties for the Fujimori government, and for Fujimori himself (Tanzi, 2000, p. 120).
15. Finally, in some countries, *corrupt policy-makers* who may take actions, especially connected with the export of mineral resources, or the granting of attractive tax incentives to foreign corporations, that benefit the policy-makers and not the countries overall. The media have reported on some of these cases in particular countries. This form of political corruption is more difficult to deal with because, in some sense, corruption has become legal.

The above list is long but, probably, it is not complete. The importance of the abovementioned factors is likely to vary from country to country. Therefore, they should not be given equal weight when assessing their importance in the incidence of corruption and tax evasion in different countries. Not all of these factors have received the attention by economists that they merit. They largely describe institutional weaknesses. Many institutional quality indexes now available from the World Bank and from other institutions show significant correlation between economic growth and those indexes. One of them is control of corruption.

4. ON TAX COMPLEXITY AND ITS IMPACT

There is now a lot of anecdotal evidence that indicates that corruption in tax administrations and tax evasion and tax avoidance by taxpayers are facilitated by the *complexity* that has come to characterise tax systems and, to some extent, tax administrations in recent decades. Some tax systems have become so complex that few individuals can find their way in that obscure jungle that has been created by thousands of pages of tax laws and tax regulations (Tanzi, 2013).

As a general topic for analysis and research, complexity has been attracting increasing attention by scientists, by experts in particular areas, and by economists (see, *inter alia*, Weaver, 1948; Waldrop, 1992, 1994; Cohen & Stewart, 1994; Casti, 1994; Heyndels and Smolders, 1995; Wilson, 1999; Weinberg, 2001; Tanzi, 2007b; Mitchell, 2009;

Walpole, 2015). As Wilson (1999, p. 96) put it, '[c]omplexity theory was born in the 1970s, gathered momentum in the 1980s, and was enveloped in controversy by the mid-1990s'.

Mechanical, biological, ecological, social, or government systems can be *simple*, *complicated* or *complex*. The working of a simple system is easy to understand and its results are generally predictable. *Complication* is the inevitable consequence of pursuing technically difficult tasks, such as going to the Moon, producing an atomic power plant, or building a modern jetliner or smartphone. The system can be made less complicated by reducing the number of parts but this is often not possible. *Complicated systems* need many parts, and each part (say a battery) has some potential to fail, thus exposing the whole system to potential disasters (Tanzi, 2007). However, the failures are specific and attributable to the parts. Apart from them, the internal working of a complicated system should be understandable to the experts who have built it and its functioning should be predictable by them. It should not be subject to randomness except the occasional failure of a part.

A *complex system* is, in some essential ways, different from a *complicated* one. Complexity implies that a system is hard to understand and to deal with. It may also be less stable. As Wilson (1999, p. 96) again put it, '[t]he greatest challenge today, not just in cell biology and ecology but in all science, is the accurate and complete description of complex systems'. When a system is *complex*, and not just complicated, its internal working and the way its parts are related to one another become less predictable, thus raising great and, in the view of some scientists, impossible to meet challenges to science.

As noted above, some technical systems inevitably need to be complicated, such as modern jetliners or those required to go to the Moon or to other planets. They require the inputs of highly-trained specialists and very precisely calibrated mechanical parts. Some systems, however, such as biological or ecological systems, and some government systems, such as tax systems, can be either complicated or complex. In some of these systems the mechanical parts are replaced by a human element, and humans can be inefficient, corrupt and irrational. When systems become complex, they become less understandable and, especially, less predictable, in their workings and in their consequences.

In recent decades the tax systems of many countries have clearly become complex, leading to the questions of whether complexity is a necessary evil for them or whether it could have been largely avoided by different tax designs (Walpole, 2015). The tax systems of some countries have become so complex that, in some actual experiments, requests for clarifications or advice, on how to deal with a specific tax issue, directed to different tax offices *of the same tax administration*, have received widely different replies. Furthermore, rather than interpreting some tax laws, and running the risk of making serious and punishable mistakes, many taxpayers now prefer to pay tax advisers to prepare their tax returns. Assistance in tax preparation has become a big business in several countries. The greater the complexity the greater the tax assistance business has become.

Complexity is not limited to tax systems but is a characteristic that describes many systems in which humans and not just mechanical parts play significant roles. In a forthcoming book, this author has argued that the growth of public sector operations over the past century - a growth that was accompanied by higher and more complex

taxes, higher public spending, many new government programs, and an increasing involvement by governments in the functioning of the countries' economies and in the activities of citizens - has created a great deal of complexity in public sectors, and a fertile field for corruption, tax evasion or tax avoidance, or abuses in some government programs (Tanzi, 2018a forthcoming).

To what extent tax systems have become fertile for corruption and for tax evasion is likely to depend not only on the tax laws and on the administrative arrangements, and on how effective the controls are within the tax administrations, but also on cultural characteristics of countries. Given particular laws, administrative arrangements and controls, some cultures seem to be more likely to condone or to tolerate corruption and tax evasion than others (Tanzi, 1995a).

Complexity is often associated with the size of operations. Most human activities and institutions are more easily controllable when they are small. As they grow in size and in scope, they tend to become less controllable, and principal-agent problems grow within them. Take as a simple example the case of a small, family-owned and successful restaurant. Its success may convince its owners that it would be a good idea to expand it. They consequently rent a larger premises, hire additional staff, add new dishes to the menu, and try to adjust the menu to the culinary tastes of the expanded and more diverse patronage.

The larger scale of the operation is likely to change its character and to bring difficulties that had been absent before. The incentives of the newly hired staff would be different. Principal-agent problems would be likely to develop. Some employees would be less dedicated and less responsible than were those of the smaller restaurant, and so on. The newly hired chefs may be less competent and may have greater difficulties satisfying the more varied tastes of the larger clientele. Organisational problems will require more controls and the adoption of clearer incentives, including greater use of penalties and rewards for the employees. In any case, uncertainty of outcome is likely to increase.

The solutions adopted to deal with the new problems are often not of a sufficient standard to cope with them, because of the greater complexity that size has created. And *the greater complexity has made the outcome less predictable*. The use of franchises or corporatisation, along the lines of McDonald's, and standardisation of the product sold, may reduce the difficulties in some activities and the uncertainty. In these circumstances the operation reproduces itself without adding complexity, as in a cloning operation.

Consider, next, tax systems and their administrations. Many years ago tax systems were simpler, and tax administrations were small. The latter had to deal with simple and often 'presumptive' or 'forfeit' taxes. The taxes were not based on accounting concepts but on cadastral values of land or buildings, on the frontage of houses, on the number of windows, on how much grain was taken to the mills to be processed, on the right to sell goods in the local market, or, simply, on the physical space that a shop occupied.

These simpler taxes, that required little discretion by tax administrators, were imposed on the taxpayers with *the sole objective of collecting revenue*. They largely satisfied a criterion that had been given great importance by the first Nobel Prize winner in economics, Jan Tinbergen: that each policy objective should be pursued by one instrument. In the past the only objective of taxation had been *to get revenue*. Like Mao's famed tunics, the taxes used largely ignored the circumstances, or the sizes, of

the individual taxpayers. Like poll taxes, ‘one size fitted all’, because there was only one objective to satisfy, that of generating revenue. Simplicity drove the operation.

Over the last century, governments’ needs for tax revenue increased and, furthermore, governments started to pursue other objectives, in addition to collecting revenue. As the need for more revenue increased, and the objectives pursued became progressively more numerous, new and more complex tax laws were introduced; equity and many other government objectives became important policy goals. The new taxes were increasingly based on accounting concepts (income taxes, value added taxes, wealth taxes) rather than on the presumptive or forfeit criteria of the past. New criteria were used for determining how much income tax a specific taxpayer should pay. Increasingly, the criteria took into account ability to pay, source of income, age of taxpayer, occupation, family status, size of family, use of income, and an increasingly large number of other considerations and social goals. The tax systems abandoned the Mao’s tunic principle and, at least in intention, attempted to fit an exquisitely-tailored Armani suit to each taxpayer.

The more governments relied on tax systems to pursue an increasing number of social and economic objectives, the more complex the tax systems became and the greater were the opportunities created for some taxpayers to ‘game the system’. The reactions of taxpayers became less predictable. Increasingly this gaming was attempted with the assistance of ‘tax planners’, clever tax consultants, and, occasionally, in some countries, corrupt tax administrators. As a random item of information, the Italian Corte dei Conti (Accountability Office) recently estimated that in Italy there are now about 800 different tax ‘incentives’, presumably pursuing 800 different policy objectives through the tax system. In Brazil, the federal budget of 2016 contained thousands of objectives to be promoted by it.

In many countries, the *level* of taxation became part of the problem, but it is important to realise that it may not have been the main factor in contributing to the tax complexity. Some countries have been able to collect high levels of tax while significantly limiting the tax complexity (Denmark, Sweden and some others). They have done this by limiting special treatments, tax expenditures and many incentives and focusing on the objective of tax collection with some attention to vertical equity.

Some other countries, especially but not only Eastern European countries, introduced *flat rate income taxes* with the specific objectives of limiting complexity and the impact of higher tax rates on incentives. By so doing, these countries abandoned the important objective of *vertical equity in taxation* and other potential objectives that many governments have considered important in today’s world. The introduction of *dual income taxes* in the 1990s by the Scandinavian countries was also, to some extent, an attempt at keeping their tax systems from becoming more complex (see Sørensen, 1998).

Taxes can still be progressive in tax systems that are relatively simple, as in *dual income tax systems*. However those systems must retain some features of Mao’s tunics. They must avoid most of the special treatments connected with income sources, personal conditions, and other objectives that most governments pursue with *tax incentives*, *tax expenditures*, *tax deductions* and so on. In other words they must ignore all or most particular conditions of taxpayers, except the income level. The dual income taxes manage to do that to some extent, especially for taxes on capital incomes.

Value added taxes can also be kept simple by having a single rate applied to as broad a tax base as possible. This is the secret for administrative simplicity, and for obtaining high revenue with lower tax rates. However, in the pursuit of equity, many governments have continued to use multiple rates for different products, under the often mistaken belief that, by so doing, they achieve greater equity. Various empirical studies of value added taxes have shown that this is a fiscal illusion. Often, the favourable tax treatment of what are considered ‘necessities’ ends up benefiting the higher income groups more than those at lower income levels. It also makes the tax system more complex and promotes tax evasion, because it is harder to keep track of the sale of specific categories of products and services than of total sales. The OECD has recently estimated that Bolivia, which uses a single VAT rate on a very broad base, collected close to 100 per cent of the tax potential while Mexico, which used multiple rates in the same period, including a zero rate for some goods and services, collected only 25 per cent of the potential (OECD, 2017, p. 36).

The pursuit by governments of higher tax levels, and especially of multiple social or economic objectives, has led to complex tax systems that, in some countries, have encouraged or facilitated tax evasion and administrative corruption. Tax experts should have been more insistent in recommending that simplicity remain an important policy objective in taxation and in other social programs. It may be worthwhile to cite the views expressed over recent decades by some tax experts, on the problem of complexity in several countries, as had been reported in Tanzi (2013).

Writing about the problem of complexity in Australia’s tax system, McKerchar (2007, p. 192) stated:

The Australian federal tax system is widely regarded as one of the most complex tax systems in the world ... There is ... scope to inflate ... claims for deductions or to exploit the ambiguities created by complex laws and instructional material.

Evans and coauthors have also more recently written on the complexity of the Australian tax system: see Evans, Lignier & Tran-Nam (2016).

On the UK tax system in 1978, Kay and King (1978, p. 246) wrote:

No one would design such a system on purpose and nobody did. Only a historical explanation of how it came about can be offered as a justification ... of how seemingly individually rational decisions can have absurd effects in aggregate.

They often result in complexity.

The Economist of 16 April 2005 cited a New Zealand report to ministers that had concluded that the New Zealand Tax Code ‘instills anger, frustration, confusion, alienation’.

When Eugenio Scalfaro was President of Italy, he declared that the Italian tax system could only have been ‘designed by lunatics’. If anything, continuous tinkering and attempts to make it fairer and less exposed to evasion have made that system even more complex.

In the US, the members appointed to an Advisory Panel on Tax Reform in 2005 underlined that '[t]ax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs and can lead to an inefficient use of resources' (statement by the members of the President's Advisory Panel on Tax Reform, April 2005, p. 5). When the US income tax was introduced in 1913, it required 400 pages of laws and regulations. At that time some members of the US Supreme Court, which had to approve the new law, had already criticised it for its complexity. During the first 25 years of its existence the number of pages grew to 504. However, by 2006 the law and related regulations had reached the extraordinary number of 66,498 pages (Edwards, 2006). In recent years the number of pages has continued to grow at a rapid pace.

Inevitably, complexity creates space for corruption, and opportunities for tax evasion and tax avoidance. It also encourages the growing army of lobbyists to push for small tax changes advantageous to their clients, causing tax systems to become increasingly more complex. Complexity increases the costs of administering tax systems and of complying with the many tax obligations. These administrative and compliance costs are important 'dead weights' on countries' economies. A useful survey of many empirical studies by Evans (2003) concluded that compliance costs can range between 2 and 10 per cent of tax revenue, and up to 2.5 per cent of GDP. Furthermore, they tend to be highly regressive. Additional estimates on these costs are available in Tanzi (2013) and in Evans, Lignier and Tran-Nam (2016). These high compliance costs are often the direct consequence of complexity.

In addition to raising compliance costs, complexity also contributes to instability, as mentioned in the report of the President's Advisory Council on Tax Reform (2005), and makes the impact of tax systems less predictable.

5. THE GLOBAL DIMENSION

So far the discussion in this article has ignored the impact that globalisation has been having on the complexity of tax systems and on the related behaviour by both governments in various countries and taxpayers. Both governments and taxpayers now operate in an open world and must take into account the possible impact (positive or negative) on them that comes from the tax systems of other countries. Countries can try to exploit the possibilities created by 'tax competition' and may even engage in 'tax wars'.

While in the past tax evasion and related corruption had been connected mainly to *domestic* activities (often offered by the underground economy, by informal activities, and by inefficient or corrupt tax administrations), these behaviours have now increasingly gone global, at least for important taxpayers, such as corporations and 'high net worth individuals' (HNWIs) (see Tanzi, 2012; Tanzi, 2018b forthcoming).

Globalisation has opened new doors and new opportunities: for countries' governments, to modify their tax systems, to better adapt them to an open world; and for individuals and corporations who operate or can operate globally, to exploit the new tax avoiding possibilities created by globalisation and a global financial system. Some governments now attempt to export some of their tax burdens, and to import to their own countries tax bases from the rest of the world. Both corporations and HNWIs attempt to reduce

their tax payments, by transferring profits or incomes to low or zero-tax jurisdictions, and by reducing their tax bases reported in high tax-rate countries.

In recent years globalisation has been attracting growing attention, and so has its impact on tax systems. That impact has been associated with increasing tax evasion, growing tax complexity, and growing evidence of corruption or other undesirable behaviour by the tax officials of some countries (see, *inter alia*, Tanzi, 1995b, 2012; Pogge & Mehta, 2016). In May 2016 the World Bank organised an important conference on ‘global tax wars’. The OECD and the IMF have also been concerned with these developments.

By facilitating increasing multicountry and global economic activities of corporations and HNWIs, globalisation has made tax collection more difficult than it previously had been. It has created new opportunities for tax evasion, for tax-related corruption, and for opportunities for some countries to take advantage of the existing global tax arrangements. In today’s world, multinational corporations and HNWIs operating globally must deal with, and can try to exploit, tax evasion opportunities that global economic operations offer. Governments can no longer ignore the impact that the tax systems of *other countries* can have on their own countries.

Corporations have discovered that ‘global chains of production’ and the use of inputs (physical, financial and intellectual) obtained from other countries can offer them opportunities to use ‘transfer prices’, ‘thin capitalisation’, ‘patent boxes’, secret or non-transparent arrangements with governments of ‘tax havens’ or of ‘quasi tax havens’ (e.g., Ireland, Luxembourg, the Netherlands, Switzerland, Singapore, and even the UK and the US), to reduce their global tax obligations, through tax avoidance or explicit tax evasion.

A fast-growing industry of tax advisers, accounting and law firms (such as Mossack Fonseca in Panama) and other tax ‘facilitators’ is available and willing to provide valuable assistance to both corporations and HNWIs on how to reduce their tax payments (see, *inter alia*, Palan, Murphy, & Chavagneux, 2010; Burgis, 2016; Pogge & Mehta, 2016; Murphy, 2013).

The information that, in April 2016, came from the ‘Panama Papers’ confirmed and provided interesting details to what was already known. It showed that a wide and often obscure (or ‘shadow’) global financial system, with the assistance of many banks and other financial institutions and complicit government authorities, can offer rich individuals opportunities to hide from tax collectors a large share of their income and wealth. This is often done by creating *anonymous* corporations, which become the legal owner of much of the world’s wealth, or in various other ways (see Zucman, 2015, for estimates of hidden wealth).

There is not space in this article to describe in detail some of the strategies that enterprises and individuals are using to evade taxes. Available estimates of global tax evasion run into the hundreds of billions of US dollars. Pogge and Mehta (2016) offer additional information and estimates of annual revenue losses to governments. A recent paper by IMF economists has estimated losses of up to USD 600 billion (Crivelli, de Mooij & Keen, 2016). On 27 March 2017, Oxfam reported that ‘European banks posted at least EUR 628 million profits in tax havens where they employ nobody’ (Oxfam, 2017). It is clear, however, that these are more educated guesses than true estimates.

One important and uncontroversial aspect of these global tax avoiding operations is that they overwhelmingly benefit high net worth individuals and not average workers. Therefore, they must have contributed to the growing inequality in the distribution of income that has been reported in many countries in recent decades.

6. CONCLUDING REMARKS

This paper has discussed *domestic* and *global* factors that, by making tax systems more complex, contribute to tax evasion and to tax-related corruption. Similar arguments could have been made regarding the global financial system. That system has also become too complex for anyone to fully understand. In addition to having become highly complex, the global financial system is also influenced, perhaps more than tax systems, by the irrational behaviour of those who participate in it, as some recent literature has argued. To some extent, complexity has also characterised some government spending programs (see Tanzi, 2007b; Tanzi, 2018a forthcoming). In important economic areas, complexity must have contributed to creating more uncertainty and more randomness in policy outcomes, raising the prospects of occasional unpleasant economic surprises, as was the financial crisis of 2007 and later years.

This article has stressed that tax systems do not necessarily need to be complex (see also Walpole, 2015). Their complexity is a consequence of the roles that governments have increasingly wished to play, in their economies and in the lives of their citizens, over past decades. The more objectives governments try to pursue and to promote, and the more they rely on tax systems to do that, the more complex tax systems become, and the more corruption, tax evasion and high compliance and administrative costs result. Thus, the pursuit of many social objectives comes with a cost that may become too high when that pursuit leads to a high level of complexity.

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Corruption, taxation, and tax evasion

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Abstract

In this article, we examine the relationships between corruption, taxation, and tax evasion. We examine three specific questions. First, on a general level, what do simple empirical analyses suggest about some of the causes and the consequences of corruption? Second, on a more specific level, what do similar empirical analyses indicate about the relationship between corruption and taxation? Third, on an even more specific level, what is the relationship between corruption, taxation, and tax evasion? We conclude with a discussion of how this evidence can be used to control corruption, making use of a different if related body of work on tax evasion.

Keywords: Corruption, tax evasion, behavioural economics, controlled field experiments, laboratory experiments

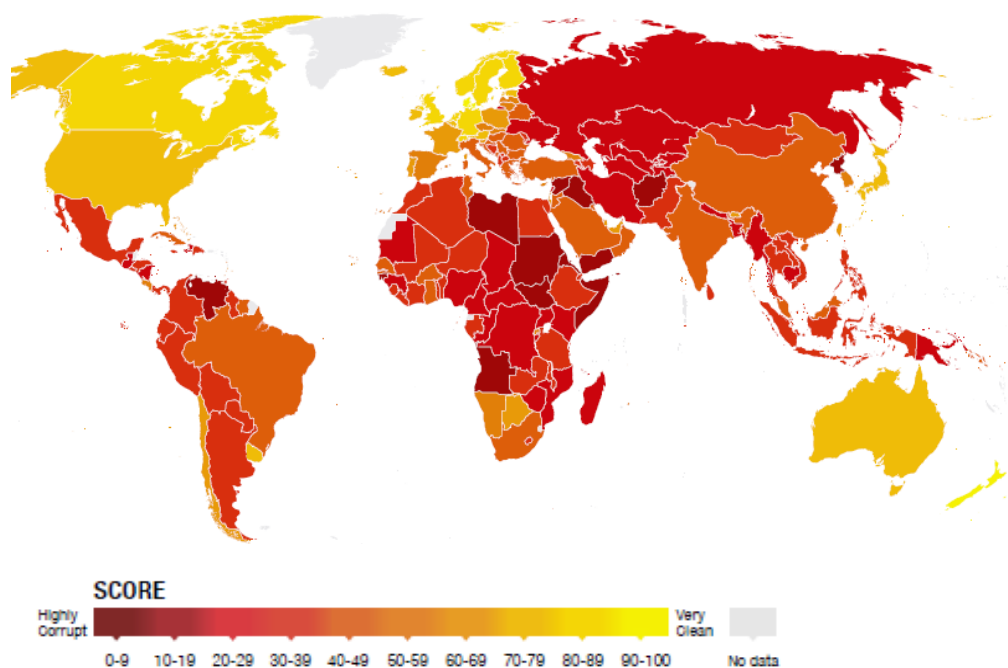
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1. INTRODUCTION

It is commonplace but nevertheless true to assert that corruption plagues virtually all countries, developing and developed alike. ‘Corruption’ is typically defined as the use of public office for private gain in ways that violate declared rules. Corruption can range from ‘grand corruption’ (e.g., corruption at the highest levels of government) to ‘petty corruption’ (e.g., small scale corruption between the public and government officials), and the methods of corruption include such activities as bribery, embezzlement, theft, fraud, extortion, blackmail, collusion, and abuse of discretion (International Monetary Fund, 2016). The available evidence, even if somewhat imprecise, indicates that corruption is widespread. See Figure 1 for a map of the world that presents estimates of the extent of corruption for 2016 using the Corruption Perception Index (CPI) of Transparency International, where darker colours represent higher levels of corruption. See also Table 1 in Appendix 1, which presents country averages for the period 1995-2009 using the International Country Risk Guide (ICRG) Index of The Political Risk Services (PRS) Group, scaled from 0 (for a country that has very little corruption) to 1 (for a country that is highly corrupt).

Figure 1: Corruption Around the World, CPI (2016)



Source: Transparency International (2017).

Corruption is important for many reasons (Rose-Ackerman, 1975). Its existence creates misallocations in resource use, with possible effects on investment, unemployment, and economic growth. Its presence requires that government expend resources to detect it, to measure its magnitude, and to penalise its practitioners. Corruption alters the distribution of income in arbitrary, unpredictable, and unfair ways, thereby affecting the poverty and inequality in a country. It may contribute to feelings of unjust treatment and disrespect for the law. More broadly, corruption reduces the ability of government to provide for its citizens, with especially pernicious effects on those individuals most dependent on government services.

In this article we examine several questions about corruption. First, on a general level, what do simple empirical analyses suggest about some of the causes and the consequences of corruption? Second, on a more specific level, what do similar empirical analyses indicate about the relationship between corruption and taxation? Third, on an even more specific level, what is the relationship between corruption, taxation, and tax evasion?

We attempt to answer these questions. Starting with the first question, we look at some simple empirics that attempt to explain the causes and consequences of corruption. On the second question, we look in detail at the relationship between corruption and taxation, again using some simple empirics. We conclude with an examination of the third question, in which we present a detailed case study based on some of our own previous empirical work in which we analyse how corruption, taxation, and tax evasion of a firm are linked; that is, how does corruption affect a firm's tax evasion decision when bribery is an option for the firm?

On the simple empirics, we find many relationships between corruption and various indicators, based on simple correlations between corruption and these indicators. On the relationship between corruption and taxation, we again find many significant correlations. On the linkages between corruption, taxation, and tax evasion, we find that corruption is a statistically and economically significant causal determinant of tax evasion. Specifically, we find that engaging in bribery reduces reported sales of a firm by 4 to 10 percentage points, and that each percentage point of sales paid in bribes reduces reported sales by about 2 percentage points. We also find strong empirical evidence that audits matter; that is, more audits reduce firm tax evasion.

In the next section, we discuss some general aspects of corruption: What is corruption, how is it measured, and what does theory say about the causes and consequences of corruption? We then present in section 3 some simple empirics on corruption (e.g., its causes and consequences), followed by a similar analysis in section 4 on the ways in which corruption and taxation interact, and finally followed in section 5 by a detailed case study on the interactions between corruption, taxation, and tax evasion. We conclude in section 6 with a discussion of how this evidence can be used to control corruption, making use of a different if related body of work on tax evasion.

2. A BRIEF REVIEW OF SOME CONCEPTS ON CORRUPTION

In this section we review some basic concepts on corruption: its definition, its measurement (including empirical work based on its measurement), and the 'theory' of corruption.³

2.1 Definition

There are several competing definitions of 'corruption', but the most widely used one defines corruption as the use of public office for private gain in ways that violate declared rules (International Monetary Fund, 2016). Corrupt can range from 'grand corruption' (e.g., corruption at the highest levels of government) to 'petty corruption' (e.g., small scale corruption between the public and government officials). It can also

³ See Banerjee, Hanna and Mullainathan (2013) for a recent survey on corruption. For earlier but still relevant surveys, see Bardhan (1997), Rose-Ackerman (1999), Jain (2001) and Aidt (2003).

occur as political corruption, police corruption, or judicial corruption. Specific activities include bribery, embezzlement, theft, fraud, extortion, blackmail, collusion, and abuse of discretion (e.g., favouritism, nepotism, clientelism). For example, common forms of petty corruption are activities like: demanding a bribe to issue a government licence, to award a contract, or to give a subsidy or incentive; stealing directly from the government treasury; selling government commodities at black market prices; hiring family members or friends in government positions; and simply shirking one's official duties. Grand corruption typically involves theft, fraud, or collusion by high government officials, often leading to the transfer of massive amounts of money to overseas accounts. At its essence, corruption involves the trade of activities that should not be for sale.

2.2 Measurement

Evidence on corruption is very hard to find, for obvious reasons. After all, corruption is illegal, and individuals have strong incentives to conceal their corrupt activities, given financial and other penalties that are imposed on individuals who are found engaging in corrupt activities. Even so, recent research has utilised a range of innovative approaches to examine corruption.

Many efforts to measure corruption have been based on 'perception surveys', in which various types of individuals (e.g., villagers, business people, 'experts') are asked their 'perception' of the extent of corruption and the results are compiled in an index. The best known of these perception surveys has been conducted by Transparency International, with its CPI. There are also other perception surveys that have been generated by The PRS Group (International Country Risk Guide, or ICRG, Index), The World Bank (Business Environment and Enterprise Performance Survey, or BEEPS, Index), or the Worldwide Government Indicators Index. These indices differ in the details of their construction, but they are all based in some way on perceptions of corruption. Note that these indices do not generate estimates of the amount of corruption in a country. Rather, they generate rankings of countries based on perceptions of the extent of corruption in the countries. Figure 1 (CPI) and Table 1 (ICRG Index) are based upon these perception surveys.

More recently, researchers have become increasingly creative in generating estimates of corruption in specific settings.⁴ These methods have involved direct estimates of bribes based on specific field observations or records, so-called 'subtraction' estimates in which comparisons are made of officially recorded transactions versus actually received amounts or of records of exports/imports of the exporting country versus the importing country, estimates based on market inferences, and even official government corruption audits. Such methods produce estimates of the extent of corruption in these settings; they do not of course generate estimates of corruption beyond their specific circumstances.

All of these approaches have limitations. Indeed, there are to our knowledge no reliable country-level estimates of the magnitude of corruption.⁵ This is not to say that it is not

⁴ See Olken and Pande (2012) for a survey on empirical work on corruption, especially the use of controlled field experiments to examine corruption. Also, see Abbink and Serra (2012) for a survey of laboratory experiments on corruption.

⁵ For example, a frequently cited estimate of the worldwide costs of corruption by the International Monetary Fund (2016) is that the annual costs of bribery alone are USD 1.5-2.0 billion, or 2 per cent of global GDP. However, this estimate is simply an 'extrapolation' of an earlier estimate by Kaufmann

in principle possible to generate such estimates. However, to date such estimates do not exist.

2.3 Theory

There are many approaches to modelling corruption (Jain, 2001). Almost all models are based on the assumption that individuals are rational, controlled, and self-interested: an individual engages in corruption if the expected benefits of successful corruption are greater than the expected costs of detection and punishment. This framework draws heavily upon the tax evasion framework of Allingham and Sandmo (1972), which in turn is largely derived from the economics-of-crime model of Becker (1968).⁶

A simple and illustrative example is based on Becker and Stigler (1974). Consider a government official who is paid a public sector wage of W_G . If the official does not engage in any corrupt acts, his or her income is simply W_G . However, the official may engage in corrupt acts C each of which generates benefits B per act. If caught with probability p , the official will be fired, lose the public sector wage W_G , face a fine F , and be forced to pursue private sector employment that pays a private sector wage of W_P . The official's income I_C if caught equals $[W_P - F]$. If not caught with probability $(1-p)$, the income I_N of the government official equals $[C \times B + W_G]$. The official chooses the number of corrupt acts C to maximise expected income $\mathcal{E}I$ (or, in a more extended version, expected utility $\mathcal{E}U$):

$$\mathcal{E}I = p [W_P - F] + (1-p) [C \times B + W_G].$$

where \mathcal{E} is the expectation operator. This simple framework suggests that a government official will only engage in corrupt activities if expected income $\mathcal{E}I$ with corrupt acts is greater than the certain public sector wage W_G with no corrupt acts:

$$\mathcal{E}I = p [W_P - F] + (1-p) [C \times B + W_G] > W_G.$$

It is straightforward to show that the official will be more likely to engage in corrupt activities the lower is the probability of being caught, the smaller is the fine if caught, the lower is the public sector wage, the larger is the private sector wage, and the larger is the benefit from the corrupt act. Indeed, this framework forms the basis for many anti-corruption strategies, which rely on reducing the financial benefits of corrupt acts by increasing the likelihood of detection, increasing the penalty, and making public sector employment more attractive.

However, this framework is too simple because it does not always recognise that with corruption there is someone who is offering the bribe, there is someone who is accepting the bribe, and there is 'someone' (e.g., the government or the public) who has an interest in the transaction. A more sophisticated framework is needed, one that incorporates interactions between all of the 'players'. There is now work that models corruption as a 'game' between the players.

This framework is also too simple because it does not recognise that an individual may not behave as assumed by the underlying framework. The individual may have a utility function that differs from the standard one in terms of what is valued and how it is

(2005), which in turn is based on surveys (including online surveys), estimates of the 'shadow economy', and estimates of 'money laundering', all of which are subject to much uncertainty.

⁶See Shleifer and Vishny (1993) for an especially influential approach to modelling corruption.

valued. Also, the individual may be motivated not simply by self-interest (narrowly defined) but by group notions like social norms, trust, intrinsic motivation, fairness, reciprocity, tax morale, and also by individual notions stemming in part from group factors like guilt, morality, and altruism.

These limitations may be addressed by extending the analysis of corruption to incorporate behavioural economics, in two broad (and somewhat overlapping) dimensions. One extension keeps its focus on *individual* factors, utilising non-expected utility theories in the analysis of individual behaviour. The other extension emphasises *group* considerations, recognising that individuals are influenced by the social context in which, and the process by which, decisions are made; that is, the individual may be motivated by factors that go well beyond financial self-interest to include a wide range of additional factors that indicate that one's own individual behaviour is strongly influenced by the behaviour of the group to which one identifies. Theoretical extensions that rely upon behavioural economics are now starting to be applied to the analysis of corruption, although these efforts are still in their early stages.

3. SOME SIMPLE EMPIRICS ON THE CAUSES AND CONSEQUENCES OF CORRUPTION

In this section, we examine two questions. First, what are some of the *causes* of corruption? Second, what are some of the *consequences* of corruption?⁷

In each case we present mainly suggestive evidence, based on simple correlations between corruption (the ICRG index) and various indicators. Our data come from 120 countries for the period 1995 to 2009, and we use average values of variables to reduce short-run variations and to allow us to examine the long-run relationships. We focus on cross-country regressions using these averages. To be clear, these simple correlations do not establish a causal relationship between (say) GDP per capita and corruption because we do not control in these regressions for other variables and because we also do not control for possible endogeneity issues. Even so, our simple results are almost always consistent with more sophisticated analyses that establish more clearly a causal relationship between the variables. We have also examined the robustness of our results to the use of different perception surveys (e.g., CPI, BEEPS Index), and we find that our results are generally unaffected. Table 2 in the Appendix presents some definitions and sources for the variables that we use, although we do not present all of the results for all of the possible correlations.

3.1 Some *causes* of corruption

Corruption is widely thought to be caused by many factors. Figure 2, also in the Appendix, presents the results of simple linear regressions in which a cause (e.g., GDP per capita) is associated with corruption, as measured by the ICRG Index. The individual charts demonstrate that:

1. a higher GDP per capita is associated with less corruption;
2. a more open economy is associated with less corruption;

⁷ See Dimant and Tosato (2017) for a recent survey on empirical work on corruption. For an earlier survey, see Treisman (2000).

3. a more urbanised economy is associated with less corruption;
4. a greater level of education is associated with less corruption;
5. greater internet use is associated with less corruption;
6. a larger government is associated with less corruption;
7. there is a consistent relationship between the composition of government spending and corruption, with the exceptions that more social protection spending is associated with less corruption and that more defence spending is associated with more corruption;
8. a more decentralised government is associated with less corruption;
9. a more stable government is weakly associated with less corruption;
10. a higher quality of government bureaucracy is associated with less corruption;
11. stronger government regulations and enforcement are associated with less corruption;
12. stronger anti-corruption measures are associated with less corruption;
13. more political rights are associated with less corruption;
14. more press freedom is associated with less corruption;
15. more economic freedom is associated with less corruption;
16. more ethnic diversity is associated with more corruption

Also, a country with a British colonial heritage has more corruption, and a country with a presidential system has more corruption.

Again, it is important to emphasise that these results demonstrate only a correlation, positive or negative, between the variables and not necessarily a causal relationship. It is also important to note the ‘outliers’ in these results; that is, even when there is a strong correlation between the variables, there may be many specific country examples in which the correlation does not in fact hold.

3.2 Some *consequences* of corruption

Figure 3 in the Appendix presents the results of simple linear regressions in which corruption is associated with some consequence (e.g., FDI). As with Figure 2, these results are mainly suggestive. They do not establish a causal relationship between corruption and (say) economic growth because we do not control in these regressions for other variables and we also do not control for possible endogeneity issues.

The individual charts demonstrate that:

1. corruption is negatively if weakly associated with fixed capital formation;
2. corruption is negatively associated with FDI;
3. corruption is positively if weakly associated with unemployment;

4. corruption is positively if weakly associated with economic growth;
5. corruption is positively associated with income inequality;
6. corruption is positively associated with the poverty rate.

The only somewhat surprising result is the positive association between corruption and growth. A more common result is for corruption to be negatively associated with economic growth (Mauro, 1995; Fisman & Svensson, 2007); however, there are also several studies that find a positive relationship between corruption and growth (Egger & Winner, 2005; Aidt, Dutta & Sena, 2008).

4. SOME SIMPLE EMPIRICS ON THE RELATIONSHIP BETWEEN CORRUPTION AND TAXATION

As for the possible relationships between corruption and taxation, we examine whether the level of taxation or the specific form of taxation affects – or is affected by – corruption.⁸ Again, we present mainly suggestive evidence, based on simple correlations between corruption and various tax indicators. These results are presented in Figure 4 in the Appendix. The individual charts demonstrate that:

1. a government with more total revenues is associated with less corruption;
2. a government with more total tax revenues is associated with less corruption;
3. a larger deficit is weakly associated with less corruption;
4. greater reliance on direct taxes is associated with less corruption;
5. greater tax complexity is associated with more corruption;
6. greater reliance on resource taxes is associated with more corruption;
7. greater reliance on corporate income taxes is associated with less corruption;
8. greater reliance on personal income taxes is associated with less corruption;
9. greater reliance on sales taxes is associated with less corruption;
10. greater reliance on property taxes is associated with less corruption;
11. higher ‘tax morale’ is weakly associated with less corruption’
12. corruption is positively associated with the size of the ‘shadow economy’.

For the most part, these results are expected.

5. CORRUPTION, TAXATION, AND TAX EVASION

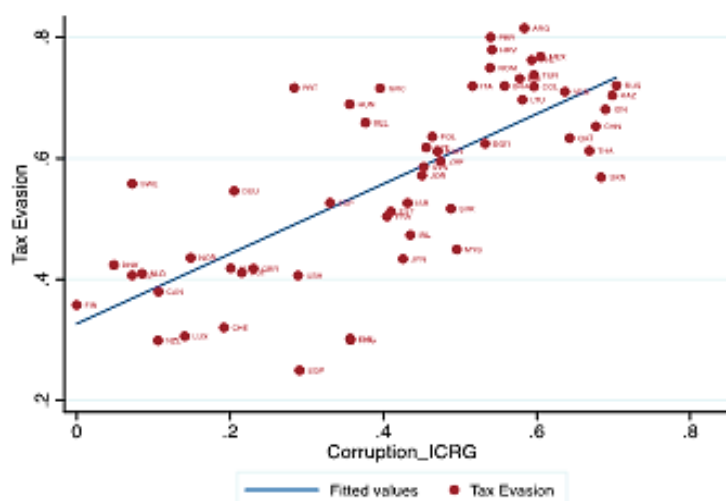
In this section, we attempt to bring together the interrelationships between corruption, taxation, and tax evasion. Figure 5 suggests that there is a strong and positive

⁸ Again, see Dimant and Tosato (2017) for a recent survey on empirical work on corruption.

relationship between tax evasion and corruption, but the relationship in Figure 5 is based only on a simple correlation between the two variables. Here we examine this relationship in more detail by presenting a recent case study based on some of our own previous work (Alm, Martinez-Vazquez & McClellan, 2016), which examines in a rigorous manner the relationship between corruption, taxation, and tax evasion. This case study provides compelling empirical evidence that corruption is a causal determinant of firm tax evasion. The case study also provides strong evidence that more audits decrease firm tax evasion and that more stringent tax regulations and higher tax rates generally increase evasion.

Figure 5: Tax Evasion and Corruption

**Tax evasion (index from 0-1, with 1 the highest level of tax evasion):
Corruption is positively associated with tax evasion.**



In Alm, Martinez-Vazquez and McClellan (2016), we examine whether the potential for corruption (e.g., bribery of tax officials) affects a firm's tax reporting (e.g., tax evasion) decision. Specifically, we empirically estimate the relationship between firm reporting when bribery of tax officials is an option. See Alm, Martinez-Vazquez and McClellan (2016) for a detailed discussion of methods, data, and results.

We examine this relationship with firm-level data for multiple countries and years and using both Instrumental Variable (IV) and Propensity Score Matching (PSM) approaches. We combine data from the World Enterprise Survey (WES) and the Business Environment and Enterprise Performance Survey (BEEPS), giving 8,000 firms across 33 countries for years 2000-2009.

We are interested in the impact of corruption on a firm's tax reporting decision. Our main dependent variable is a firm-level measure of firm tax evasion, or *PercentageReportedSales*. This variable is derived from a BEEPS question in which each firm is asked, 'What percentage of total annual sales would you estimate the typical firm in your area of business reports for tax purposes?' The response is a self-reported measure of firm tax evasion. However, it is a measure of what the respondent firm

believes a ‘typical’ firm reports, not the firm itself, so it is hoped that the resulting measure is unbiased and accurate.

The various explanatory variables include a dummy variable for whether the ‘typical’ firm bribed government officials to deal with taxes (*BribeforTaxes*), another variable for total firm bribes of the ‘typical’ firm as a percentage of sales (*BribesasPercentageofSales*), a dummy variable for whether the respondent firm was audited (*Audit*), variables to measure whether taxes or regulations were an obstacle to doing business (*RegulationsasObstacle*, *TaxRatesasObstacle*), firm sales (*Sales*), and various firm-level control variables (*X*).

Our main empirical specification is then:

$$\begin{aligned} \text{PercentageReportedSales}_i = & \beta_0 + \beta_1 \text{BribeforTaxes}_i + \beta_2 \text{BribesasPercentageofSales}_i \\ & + \beta_3 \text{Audit}_i + \beta_4 \text{TaxRegulationsasObstacle}_i + \beta_5 \text{TaxRatesasObstacle}_i \\ & + \beta_6 \ln(\text{Sales}_i) + \beta_7 X_i + \varepsilon_i \end{aligned}$$

where ε is an error term. We are mainly interested in the coefficients on *BribeforTaxes* (β_1) and *BribesasPercentageofSales* (β_2). We are also interested in the impacts of *Audit* (β_3) and of taxes (*TaxRegulationsasObstacle* (β_4), *TaxRatesasObstacle* (β_5)).

Estimation of this specification is made challenging by the likelihood that corruption and tax evasion are jointly determined; that is, the possibility of corruption may induce a firm to engage in tax evasion, but the possibility of tax evasion creates opportunities for a firm to bribe tax officials. We deal with this endogeneity by using two alternative approaches.

In an IV approach, we use instrumental variables to control for potential endogeneity. The variable *BribeforTaxes* is instrumented by the firm’s other bribery activities since a ‘culture of corruption’ likely leads to a high correlation across bribery activities but it also seems likely that bribes for other non-tax-related activities do not affect tax reporting. Also, the variable *BribesasPercentageofSales* is instrumented by a firm’s time spent on regulations since more red tape gives officials more bargaining power but it seems likely that red tape is unrelated to tax reporting. In a second PSM approach, we attempt to ‘match’ firms that engage in bribery (e.g., ‘treated firms’) with similar firms that do not engage in bribery (e.g., ‘control firms’), based on observable characteristics of the firms. A simple comparison of *PercentageReportedSales* for treated versus control firms then measures the impact of bribery activities on firm tax evasion.

Some IV results are presented in Table 3 in the Appendix and Figure 6. Table 3 shows some selected IV estimation results, which indicate a strong negative relationship between *PercentageReportedSales* and the two measures of bribery (*BribeforTaxes* and *BribesasPercentageofSales*). Figure 6 presents the IV coefficient estimates for *BribeforTaxes* (shown as *bribe_tax*) and *BribesasPercentageofSales* (shown as *bribe_per*) for a wide range of alternative specifications of the IV estimations. In virtually all cases, the estimated coefficient on the measure of bribery is negative and significant. Table 3 also indicates that audits have a positive (if insignificant) impact on reporting, and that more stringent tax regulations and higher tax rates generally reduce reporting.

Table 4 presents the PSM estimation results, which indicate that the treated group reports lower *PercentageReportedSales* than the control group by amounts that range from -4.402 percentage points to -6.466 percentage points, depending upon the specific

way in which treated firms are matched with control firms. Regardless of the specific form of matching, firms that engage in bribery also engage in more tax evasion.

Figure 6: IV Estimation Results

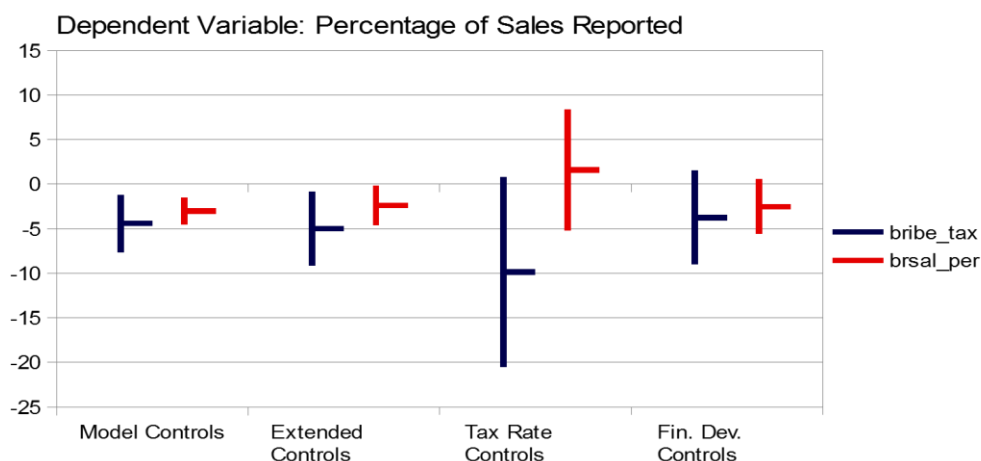


Table 4: PSM Estimation Results

	Unmatched	Nearest Neighbour	Kernel – Gaussian	Kernel – Epanechnikov
Treated	86.225	86.225	86.225	86.304
Controls	92.691	90.628	90.807	90.706
Difference	-6.466	-4.402	-4.581	-4.402
Standard Error	0.369	0.735	0.493	0.545
t-statistic	-17.5	-5.99	-9.29	-8.07
On-Support	8,855	8,855	8,855	8,831

Overall, the results clearly indicate that corruption is a statistically and economically significant determinant of tax evasion. Specifically, the results show that engaging in bribery reduces reported sales by 4 to 10 percentage points. The results also show that larger bribes lead to more evasion: each percentage point of sales paid in bribes reduces reported sales by about 2 percentage points. Finally, the results demonstrate that both tax regulations and tax rates affect these decisions, as do audit rates, in largely expected ways.⁹

⁹ Note that we (Alm, Liu & Zhang, 2017) have also conducted an additional case study in which we examine a related but nevertheless different issue: Do financial constraints faced by a firm increase the likelihood that the firm will evade its taxes? The premise is that a firm that faces financial constraints is less able to access financial markets to fund its various activities. As a response, the firm may turn to tax evasion as a source of internally generated funds. Further, a firm that engages in tax evasion may seek to reduce its chances of detection and punishment by bribing tax officials, so we also examine the potential impact of financial constraints on bribery as a possible channel for the effects of financial constraints. Simple correlations using firm-level data for 15,000 firms in 27 countries across multiple years (2002, 2005) from the World Enterprise Survey and the Business Environment and Enterprise Performance survey indicate a clear negative relationship between the firm's reporting decision (measured as percentage reported sales) and two measures of financial constraints (difficulty of access to external finance and cost of external finance). However, these simple correlations do not control for other possible influences on the firm's reporting, including a possible endogenous relationship between reporting and financial constraints. Accordingly, we apply Instrumental Variable (IV) estimation methods to these data.

6. DEVISING POLICIES TO REDUCE CORRUPTION

What does all of this work suggest about devising government policies to improve compliance?

There are many standard remedies for combating corruption, all of which follow from the basic and simple economics-of-crime model:

1. increase the costs of corruption by toughening the laws and their enforcement (e.g., increase penalties on corrupt activities, increase the likelihood of getting caught);
2. improve the incentives of officials to not engage in corrupt activities (e.g., increase public sector wages);
3. reduce the range and value of activities that can be exploited by corrupt officials (e.g., increase bureaucratic competition, improve transparency, increase information, reduce discretion).

Indeed, there is some evidence that these policies often (if not always) reduce corruption (United Nations Office on Drugs and Crime, 2004).

Even so, we believe that there are lessons from the *tax evasion* literature that are also relevant for *corruption*; that is, there are lessons for how to reduce tax evasion that are also relevant for how to reduce corruption. Although work on corruption is distinct from work on tax evasion, there are some clear overlaps in these literatures. In both cases, measurement is difficult, even if increasingly creative approaches are now being developed and used. In both cases, theoretical analysis started by a simple extension of the economics-of-crime approach, even if more recent work has extended considerably this framework. In both cases, policy responses have largely focused on detection and punishment as the primary policy tools, even if there is now a growing recognition that additional tools are needed. Even so, we believe that the tax evasion literature has advanced somewhat farther than the corruption literature in its measurement, theory, and policies. Accordingly, we believe that there are lessons from the tax evasion literature that can help inform the corruption literature.¹⁰

Indeed, our reading of the tax evasion literature suggests that people are motivated by many factors in their decisions, some of which are financial but many of which go far beyond the expected benefits and costs of evasion. More precisely, we believe that this evidence suggests that there are three ‘paradigms’ for a tax administration that wishes to reduce tax evasion (Alm & Torgler, 2011). These paradigms start with a government compliance strategy based on detection and punishment. However, these paradigms also go well beyond a tax evasion strategy that emphasises only enforcement to include a range of additional policies for which there is now emerging much theoretical and empirical support.

Overall, we find that more financially constrained firms are more likely to be involved in tax evasion activities, largely because evasion helps them deal with financing issues created by financial market constraints; these effects are heterogeneous across firm ownerships, firm age, firm size, and industries. We also find that firm reporting increases with additional audits. Finally, we find that financial market constraints seem to operate by increasing bribe activities in exchange for tax evasion opportunities. See Alm, Liu and Zhang (2017) for a detailed discussion of methods, data, and results.

¹⁰ See Alm (2017) for a recent and comprehensive discussion of what motivates tax compliance.

Under a first paradigm – what has been termed the traditional ‘*Enforcement Paradigm*’ – the emphasis is exclusively on repression of illegal behaviour through frequent audits and stiff penalties. This has been the conventional paradigm of tax administrations throughout history, and it fits well the standard portfolio model of tax evasion based upon the economics-of-crime theory.¹¹

However, research on tax evasion also suggests a second paradigm, one that acknowledges the role of enforcement but also recognises the role of tax administration as a facilitator and a provider of services to taxpayer-citizens, in order to assist taxpayers in every step of their filing returns and paying taxes. This new ‘*Service Paradigm*’ fits squarely with the perspective that emphasises the role of government-provided services as a consideration in the individual tax compliance decision. Indeed, the most recent literature on tax administration reform has emphasised this new paradigm for tax administration, as a facilitator and a provider of services to taxpayer-citizens, and many recent administrative reforms around the world have embraced this new paradigm with great success.

A third paradigm is also suggested by recent work on tax evasion, especially the emerging work that sees the taxpayer as a member of a larger group, as a social creature whose behaviour depends upon his or her own moral values (and those of others) and also upon his or her perception of the quality, credibility, and reliability of the tax administration. This third paradigm is called a ‘*Trust Paradigm*’. It is consistent with the role of various behavioural economics factors like social norms broadly defined in the compliance decision. It is based on the notion that individuals are more likely to respond either to enforcement or to services if they believe that the government generally and the tax administration specifically are honest, and if they believe that other individuals are similarly motivated; that is, ‘trust’ in the authorities – and in other individuals – can have a positive impact on compliance.

Given this discussion, strategies which may be designed to control tax evasion fall into three main categories, each consistent with one of the three paradigms: increase the likelihood and the threat of punishment, improve the provision of tax services, and change the tax culture. Specifically, these strategies entail the more detailed considerations set out below.

First, there is scope for an improvement in policies to increase detection and punishment (e.g., the Enforcement Paradigm). Traditionally, there are three main aspects of tax administration: taxpayer registration, taxpayer audit, and collections. Improvements in each of these areas are feasible, all of which would enhance detection and punishment. These policies include such obvious actions as increasing the number of audits, improving the quality of the audits (and of the auditors), using more systematic audit selection methods (e.g., ‘scoring’ methods), improving information-sharing across governments, increasing penalties for tax cheating, applying these penalties often and consistently, publicising tax evasion convictions in the media as an alternative type of non-financial penalty, relying more heavily on source-withholding whenever possible, facilitating payments through the banking system, granting

¹¹ Note that there is some evidence that higher audit rates may sometimes backfire, leading to lower post-audit compliance by individuals, sometimes termed a ‘bomb-crater effect’; a similar finding has been found for corporate taxpayers (DeBacker et al., 2015). One explanation for this effect is that deterrence may ‘crowd out’ an individual’s ‘intrinsic motivation’ to pay taxes (Frey, 1997). Another explanation is that individuals may update their subjective audit probabilities following an audit (Mittone, Panebianco & Santoro, 2017).

additional power for collecting delinquent accounts, and increasing taxpayer registration and identification via better use of third-party information. These are all standard methods for increasing enforcement, and are consistent with a paradigm that views the taxpayer as a potential criminal who must be deterred from cheating.

Second, there is scope for an improvement in the services of the tax administration by becoming more 'consumer-friendly', along the lines of the Service Paradigm. Such policies include promoting taxpayer education, providing taxpayer services to assist taxpayers in filing returns and paying taxes, improving phone advice service, improving the tax agency website, simplifying taxes and tax forms, and simplifying the payment of taxes. The basic thrust of these actions is to treat the taxpayer more as a client than as a potential criminal.

Third, there may be scope for a government-induced change in the culture of paying taxes, consistent with the Trust Paradigm, by using the mass media to reinforce tax compliance as the ethical form of behaviour, publicising cheaters, emphasising the link between payment of taxes and the receipt of government services, targeting certain groups (e.g., new firms or employees) in order to introduce from the start the notion that paying taxes is 'the right thing to do', enlisting other organisations to promote compliance, avoiding actions that lead individuals to think cheating is 'okay' (e.g., a tax amnesty), addressing perceived inequities in the ways people feel that they are treated, and promoting a tax administrator – and a taxpayer – 'code of ethics'. It is this third paradigm that is, we believe, an essential but largely neglected strategy for improving compliance.

In short, there should be a 'full house' of strategies to address the 'full house' of tax evasion motivations.

How does this work on controlling *tax evasion* relate to government policies to control *corruption*? We believe that the lessons from tax compliance apply directly, even if differently, to corruption. Specifically, we believe that these three paradigms offer significant guidance for anti-corruption strategies.

First, detection and punishment must be present (the *Enforcement Paradigm*). However, with corruption there are two sides to any 'transaction'. As a result, enforcement must be applied both to the individual accepting the bribe and to the individual offering the bribe. Other aspects of enforcement (e.g., increasing audit rates, increasing penalties) also apply. In short, the role of the private sector in abetting corruption must be considered in enforcement policies.

Second, government should improve its provision of services, including improving the incentives for government officials to provide higher quality services (the *Service Paradigm*). Doing so will again affect both the demand-side and supply-side of corruption. There are many standard public administration practices that can be applied to these efforts.

Third, the government must change the social norm of corruption, again on both sides of the transaction (the *Trust Paradigm*). This is probably the most difficult of government's full house of anti-corruption strategies, largely because the evidence on successful efforts to change norms is suggestive and promising but far from definitive.

In sum, we believe that the tax evasion paradigms provide a useful framework for thinking about the causes, the consequences, and the control of corruption: there should be a ‘full house’ of strategies to address the ‘full house’ of corruption motivations.

Even so, the actual evidence supporting these paradigms is not always compelling, either in the tax evasion domain or in the corruption domain. Clearly, additional research is required on the potential impacts of these three paradigms, which leads to our final and concluding comments on some suggestions on the direction in which future research on corruption should move.

We believe that there are three areas in which additional work is most obviously needed. First, there have been many suggested anti-corruption policies, but do any/all of the many proposed/enacted anti-corruption strategies *actually* work? Second, the focus has typically been on anti-corruption policies in the *public sector*, but what policies might work via the *private sector*? Third, it is common to say that it is essential to instil in public officials notions of ‘integrity’ or ‘ethics’ or ‘morality’ in order to reduce corruption, but what are *specific* actions that can be taken to do this, so that people will ‘do the right thing’?

Answering these questions will require empirical strategies of some sophistication, including strategies that address both identification of causal effects (e.g., internal validity) and generalisation of specific results to other settings (e.g., external validity). The use of controlled field experiments and laboratory experiments seems especially well-suited to these challenges, as does empirical work that uses administrative data of the most up-to-date vintage.

Devising research programs to answer these – and other – questions will help in the design of useful public policy advice on corruption. Such advice is unlikely to apply in all settings but it should be helpful in the specific setting that informed the research design.

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8. APPENDIX

Table 1: Corruption Around the World, ICRG Index (Country Averages for 1995-2009)

Rank	Country	ICRG Index
1	Congo, Democratic Republic	0.848
2	Zimbabwe	0.821
3	Niger	0.819
4	Sudan	0.812
5	Myanmar	0.803
6	Lebanon	0.789
7	Paraguay	0.752
8	Moldova	0.726
9	Armenia	0.726
10	Bangladesh	0.715
11	Russia	0.704
12	Togo	0.703
13	Kazakhstan	0.699
14	Azerbaijan	0.697
15	Indonesia	0.689
16	Ukraine	0.684
17	Papua New Guinea	0.682
18	Algeria	0.679
19	Serbia	0.678
20	China, People's Republic	0.677
21	Kenya	0.676
22	Egypt	0.671
23	Pakistan	0.670
24	Thailand	0.669
25	United Arab Emirates	0.667
26	Ethiopia	0.667
27	Panama	0.667
28	Albania	0.655
29	Honduras	0.652
30	Uganda	0.649
31	Qatar	0.643
32	Vietnam	0.637
33	Burkina Faso	0.637
34	Venezuela	0.637
35	Jamaica	0.634
36	Sierra Leone	0.629
37	Ghana	0.620
38	Latvia	0.619
39	Mali	0.616
40	Cote d'Ivoire	0.611
41	Mexico	0.605
42	Cameroon	0.601
43	Colombia	0.596
44	Turkey	0.596
45	Philippines	0.593
46	Bolivia	0.584
47	Tunisia	0.584
48	Argentina	0.584
49	Trinidad and Tobago	0.582
50	Lithuania	0.581
51	Namibia	0.579
52	India	0.578
53	Guatemala	0.575
54	Belarus	0.573
55	Bahrain	0.572
56	Kuwait	0.569
57	Brazil	0.558
58	Oman	0.545
59	Croatia	0.542
60	Senegal	0.542
61	Peru	0.540
62	Romania	0.539

Rank	Country	ICRG Index
63	Zambia	0.539
64	Syrian Arab Republic	0.538
65	Mongolia	0.535
66	Bulgaria	0.533
67	Dominican Republic	0.524
68	Congo, Republic	0.523
69	Gambia	0.522
70	Italy	0.516
71	Iran	0.512
72	Guinea	0.512
73	Ecuador	0.509
74	Morocco	0.507
75	Uruguay	0.500
76	Malaysia	0.496
77	El Salvador	0.489
78	Slovak Republic	0.488
79	Botswana	0.475
80	South Africa	0.475
81	Korea	0.471
82	Poland	0.464
83	Sri Lanka	0.459
84	Czech Republic	0.456
85	Slovenia	0.453
86	Jordan	0.450
87	Nicaragua	0.438
88	Ireland	0.435
89	Israel	0.432
90	Japan	0.426
91	Estonia	0.410
92	France	0.405
93	Costa Rica	0.403
94	Malta	0.399
95	Greece	0.396
96	Belgium	0.376
97	Hong Kong	0.357
98	Chile	0.357
99	Hungary	0.356
100	Madagascar	0.337
101	Bahamas	0.333
102	Spain	0.330
103	Singapore	0.291
104	United States	0.289
105	Cyprus	0.288
106	Portugal	0.284
107	United Kingdom	0.231
108	Austria	0.215
109	Germany	0.205
110	Australia	0.201
111	Switzerland	0.192
112	Norway	0.149
113	Luxembourg	0.141
114	Canada	0.107
115	New Zealand	0.106
116	Netherlands	0.085
117	Iceland	0.072
118	Sweden	0.072
119	Denmark	0.049
120	Finland	0.000

Source: Calculations by authors from The Political Risk Services (PRS) Group International Country Risk Guide (ICRG) Index (2016). The ICRG Index is the average value of the corruption index over the period 1995-2009 of each country's ICRG Index.

Table 2: Variable Definitions and Sources

Variables	Description	Source	Years
Corruption_ICRG	Corruption index, originally ranging from 0 to 6, with 6 indicating the lowest corruption and rescaled to take values between 0 and 1 with 0 indicating the least corruption	International Country Risk Guide (ICRG)	1995-2008
Tax Mix	Direct (personal and corporate income tax, payroll tax, social security contributions) to indirect (property tax, general taxes on goods and services, excise taxes, custom duties) tax ratio	Government Finance Statistics (GFS), OECD Revenue Statistics	1995-2009
Tax Complexity	Time to prepare, file and pay corporate, sales, labour, and other taxes	World Bank Doing Business	2006-2009
Natural Resource Tax	Share of reported tax revenue that is from natural resource sources, most often corporate taxation of resource firms in GDP (%)	ICTD UNU-WIDER Government Revenue Dataset	1995-2009
Corporate Income Tax	Share of corporate income tax in GDP (%)	GFS	1995-2009
Personal Income Tax	Share of personal income tax in GDP (%)	GFS	1995-2009
Property Tax	Share of property tax in GDP (%)	GFS	1995-2009
Sales Tax	Share of general sales tax in GDP (%)	GFS	1995-2009
Top Statutory CIT Rate	Top statutory tax rate of corporate income tax (%)	World Tax Indicators	1995-2003
Top Statutory PIT Rate	Top statutory tax rate of personal income tax, (%)	World Tax Indicators	1995-2005
VAT Tax Rate	Standard statutory VAT rate (%)	World Tax Indicators	1995-2009
Total Revenue/GDP	Share total revenue in GDP (%)	GFS	1995-2009
Total Tax Revenue/GDP	Share total tax revenue in GDP (%)	GFS	1995-2009
Deficit	[Total expenditure-Total revenue]/GDP (%)	GFS	1995-2009
Public Services	Share of general public services expenditures in total expenditure (%)	GFS	1995-2009
Environment	Share of environmental expenditures in total expenditure (%)	GFS	1995-2009
Safety	Share of public order and safety expenditures in total expenditure (%)	GFS	1995-2009
Economic Affairs	Share of economic affairs expenditures in total expenditure (%)	GFS	1995-2009
Housing	Share of housing expenditures in total expenditure (%)	GFS	1995-2009
Health	Share of health expenditures in total expenditure (%)	GFS	1995-2009
Recreation	Share of recreational, cultural and religious affairs expenditures in total expenditure (%)	GFS	1995-2009
Education	Share of educational expenditure in total expenditure (%)	GFS	1995-2009

Variables	Description	Source	Years
Social Protection	Share of social protection expenditure in total expenditure (%)	GFS	1995-2009
Defence	Share of defence expenditure in total expenditure (%)	GFS	1995-2009
Government Size	Share of government expenditure in GDP (%)	GFS	1995-2009
Decentralisation	Subnational share of total government spending (%)	World Bank's Decentralization Indicators	1995-2009
Government Stability	Index of government stability, ranging from 0 to 12, with 12 indicating the highest levels of stability	ICRG	1995-2008
Bureaucracy Quality	Index of bureaucracy quality, ranging from 0 to 4, with 4 indicating the highest levels of quality	ICRG	1995-2008
Regulations	Index of law and order, ranging from 0 to 6, with 6 indicating the highest levels of law enforcement	ICRG	1995-2008
Anti-Corruption	This category examines a country's anti-corruption laws, the country's anti-corruption agency, citizen access to justice, and law enforcement accountability		2006-2009
Rule-based Governance	Index of the extent to which private economic activity is facilitated by an effective legal system and rule-based governance structure in which rights are reliably respected and enforced		2005-2009
Tax Morale	Respondents' view on whether the cheating on tax can always be justified or never be justified, and rescaled to take values between 0 and 1 with 0 indicating least tax morale		1995-2008
Political Right	Index of political right, originally ranging from 1 to 7, with 1 indicating the highest levels of political right, and rescaled to take values between 0 and 1 with 0 indicating least political right	Freedom House	1995-2009
Press Freedom	Score of freedom of the Press, originally ranging from 5 to 100, with 5 indicating the highest levels of freedom, and rescaled to take values between 0 and 1 with 0 indicating least freedom	Freedom House	1995-2009
Economic Freedom	Economic Freedom Index	Freedom House	1995-2009
GDP Per Capita	GDP per capita (log)	World Development Indicators (WDI)	1995-2009

Variables	Description	Source	Years
Ethnic Diversity	Probability that two random selected individuals within the country belong to the same religious and ethnic group, a continuous variable between 0 and 1	Quality of Government Dataset (QGD)	1995-2009
Legal origin	Dummy variable equal to 1 if legal origin of English Common Law, 0 otherwise	QGD	1995-2009
Colonial dummy	Dummy variable equal to 1 If country was a British colony, 0 otherwise	QGD	1995-2009
Political System	Dummy variable equal to 1 if country is presidential, 0 otherwise	QGD	1995-2009
Openness	Imports of goods and services (% of GDP)	WDI	1995-2009
Urbanisation	Urban population as percent of total population (%)	WDI	1995-2009
Internet	Number of Internet users per 100 people (log)	WDI	1995-2009
Education	Years of schooling of 25 years old and over people (years)	Barro and Lee (2013)	1995-2009
Economic Growth	GDP growth rate (%)	WDI	1995-2009
Fixed Capital Formation	Gross fixed capital formation (% of GDP)	WDI	1995-2009
Foreign Direct Investment	Foreign direct investment, net inflows (% of GDP)	WDI	1995-2009
Unemployment	Unemployment rate (%)	WDI	1995-2009
Income Inequality	Gini coefficient	UNU-WDIER World Income Inequality Database	1995-2006
Poverty	Poverty headcount ratio at national poverty lines (% of population)	WDI	1995-2009
Tax Evasion	Tax evasion index, originally ranging from 0 to 10, with 10 indicating the lowest tax evasion, and rescaled to take values between 0 and 1 with 0 indicated the lowest tax evasion	IMD World Competitiveness Yearbook 2017	1997-2009
Shadow Economy	Shadow economy as percentage of official GDP (average)	Buehn and Schneider (2012)	1995-2007

Table 3: IV Estimation Results

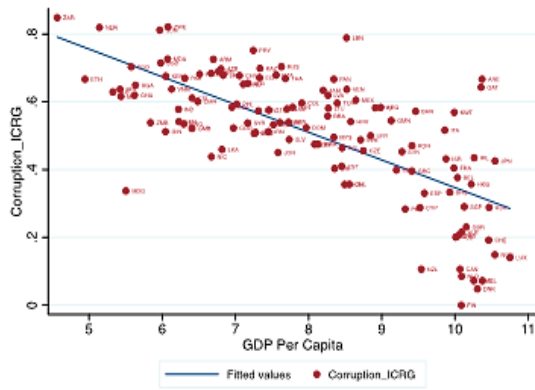
Variable	(1) Percent Reported Sales	(2) Percent Reported Sales
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Bribe for Taxes	-3.609** (1.741)	-4.973** (2.132)
Bribe as Percentage of Sales	-3.623*** (0.821)	-2.386** (1.135)
Audit	0.435 (0.760)	0.575 (0.404)
Tax Regulations as Obstacle	0.006 (0.360)	-0.438* (0.237)
Tax Rates as Obstacle	-0.606** (0.308)	0.020 (0.230)
ln(Sales)	0.606*** (0.189)	0.632*** (0.120)
Years Operating		0.000 (0.008)
Listed		0.324 (1.370)
Closed		-1.308 (0.998)
Sole Proprietorship		-4.401*** (1.003)
Partnership		-3.075*** (1.023)
Public Sector		0.367 (1.761)
Foreign Private		1.683*** (0.537)
State		-0.713 (1.685)
Constant	92.084*** (1.890)	97.842*** (2.312)
Observations	7758	7749
R-squared	0.012	0.130
Underidentification Statistic LM	15.573	47.720
LM Statistic P-Value	0.001	0.000
Weak Identification Statistic F	10.580	11.900
Hansen's J	3.656	2.091
Hansen's P-value	0.1608	0.351
Industry Fixed Effects?		X
Country Fixed Effects?		X
Year Fixed Effects?		X

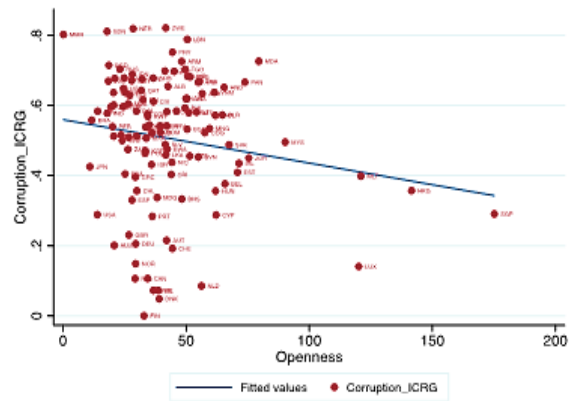
Notes: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$. Robust standard errors are in parentheses. Differences in observation numbers across specifications are due to incomplete data in the added controls at the country level.

Figure 2: Some Causes of Corruption

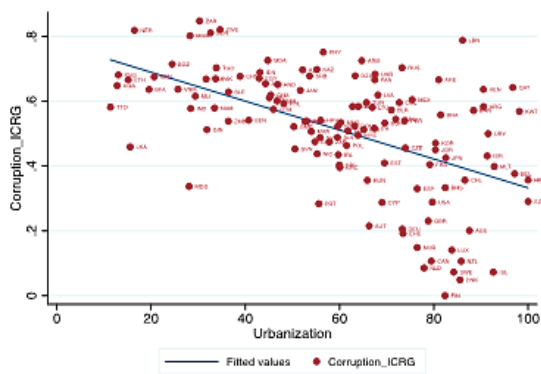
GDP per capita (as log):
A higher GDP per capita is associated with less corruption.



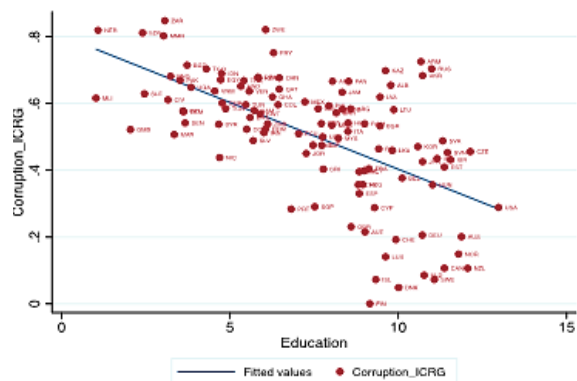
Openness (imports as percent of GDP):
A more open economy is associated with less corruption.



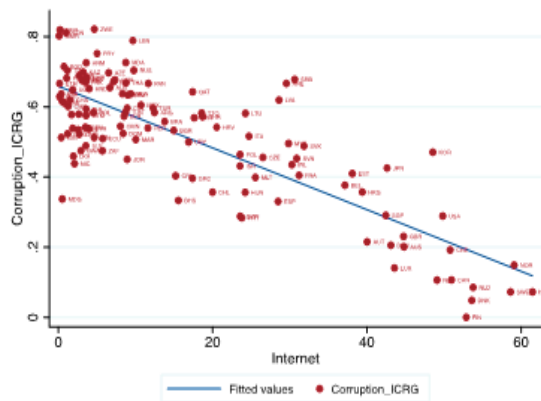
Urbanization (urban population as percent of total population):
More urbanization is associated with less corruption.



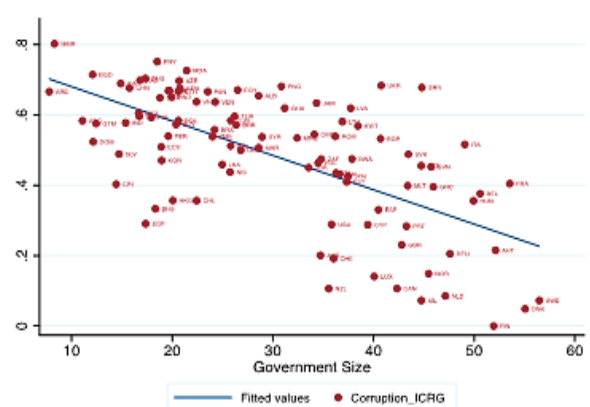
Education (years of schooling for people 25 years and older):
A greater level of education is associated with less corruption.



Internet use (log of internet users per 100 people):
Greater internet use is associated with less corruption.

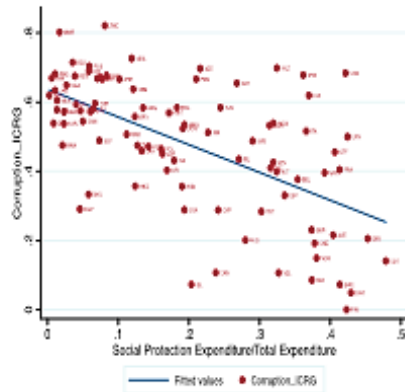


Size of government (government spending as percent of GDP):
A larger government is associated with less corruption.

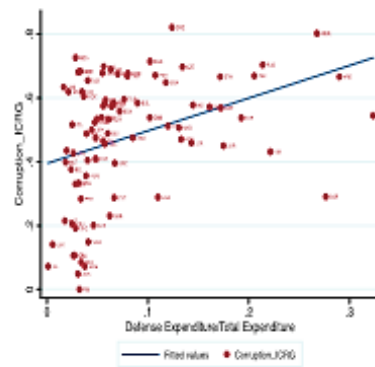


Composition of government spending (government spending by category as proportion of total government spending, for public services, environment, public order, economic affairs, housing, health, recreation/culture/religion, education, social protection, defense):
There are no consistent results.

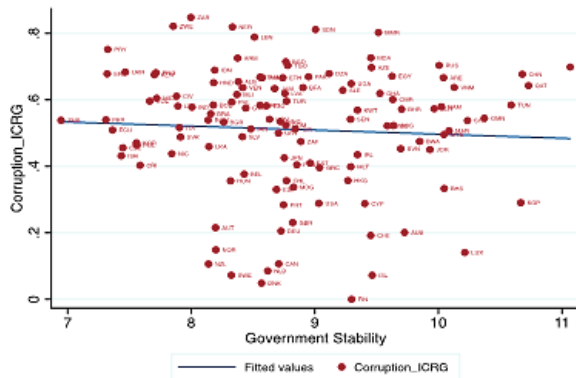
More social protection spending is associated with less corruption.



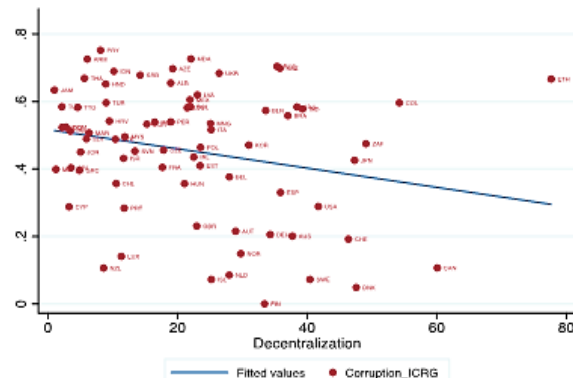
More defense spending is associated with more corruption.



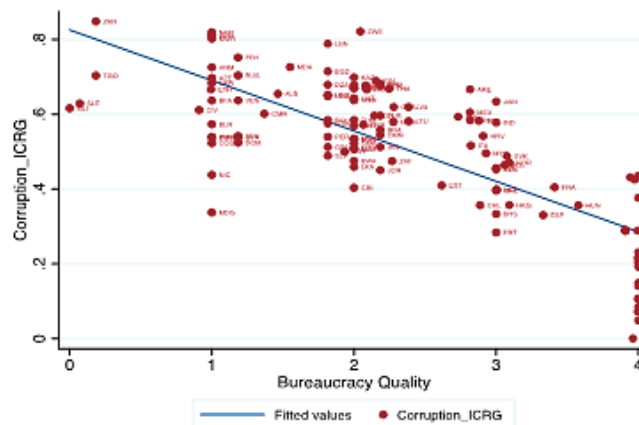
Government stability (index from 0-12, with 12 the highest stability):
A more stable government is weakly associated with less corruption.



Decentralization (subnational government spending as percent of GDP):
A more decentralized government is associated with less corruption.

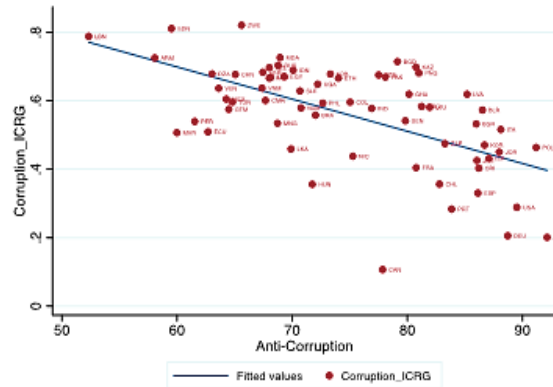
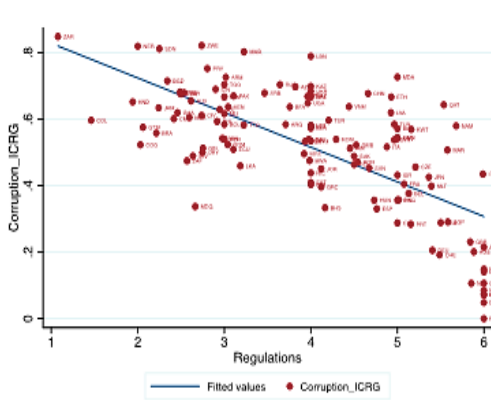


Quality of government bureaucracy (index from 0-4, with the highest quality):
A higher quality of government bureaucracy is associated with less corruption.



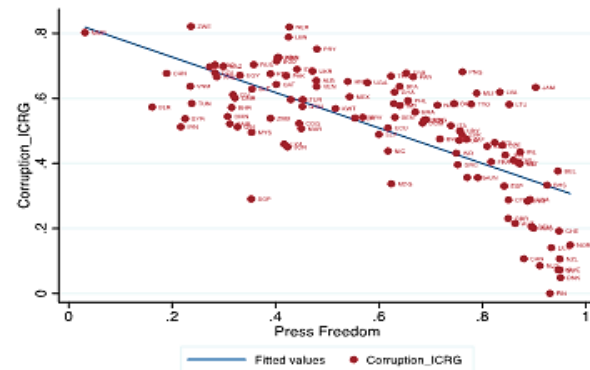
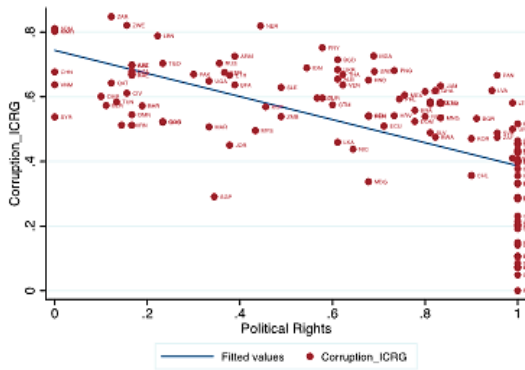
**Strength of government regulations and enforcement (index from 0-6, with 6 the strongest):
Stronger government regulations and enforcement are associated with less corruption.**

**Anti-corruption measures (index from 0-1, with 1 the strongest):
Stronger anti-corruption measures are associated with less corruption.**



**Political rights (index from 0-1, with 1 the highest level of political rights):
More political rights are associated with less corruption.**

**Press freedom (index from 0-1, with 1 the most press freedom):
More press freedom is associated with less corruption.**



**Economic freedom (index from 0-100, with 100 the most economic freedom):
More economic freedom is associated with less corruption.**

**Ethnic diversity (index from 0-1, with 1 the highest ethnic diversity):
More ethnic diversity is associated with more corruption.**

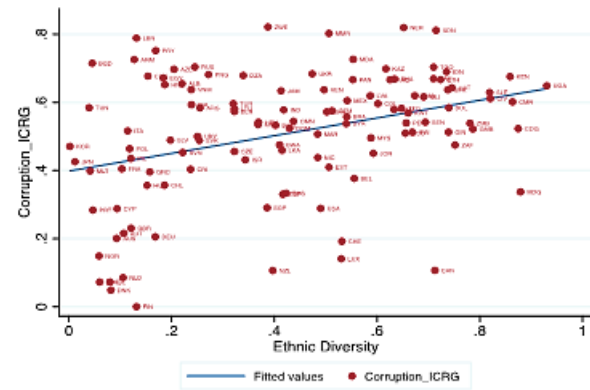
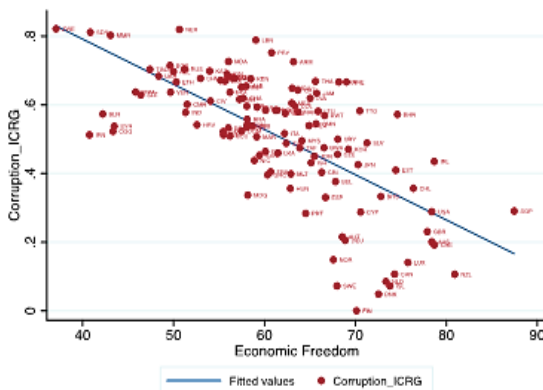
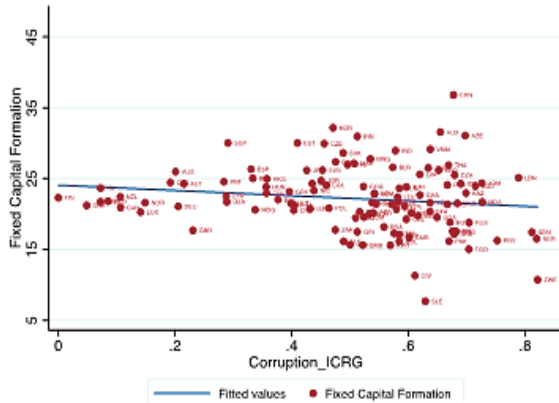
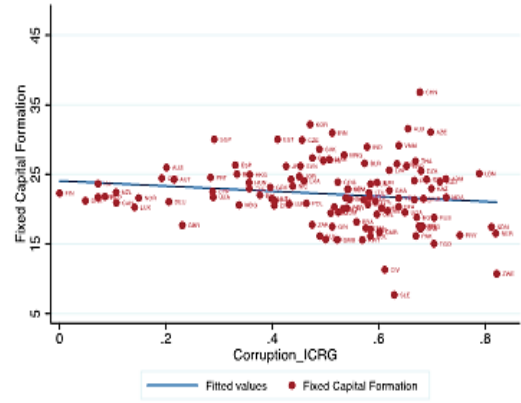


Figure 3: Some Consequences of Corruption

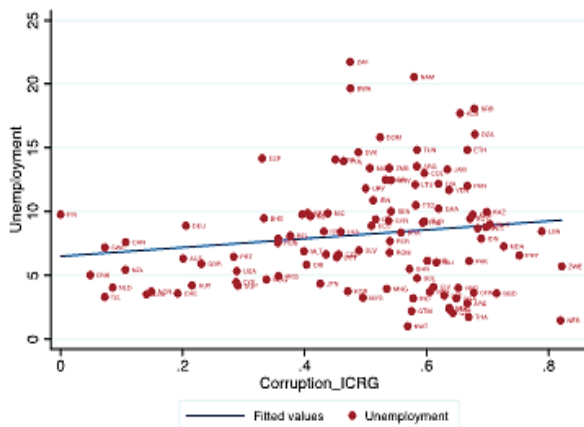
Fixed capital formation (gross fixed capital formation as percent of GDP):
Corruption is negatively if weakly associated with fixed capital formation.



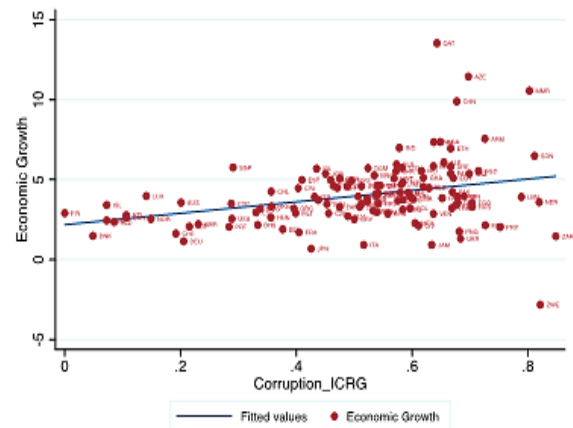
Fixed capital formation (gross fixed capital formation as percent of GDP):
Corruption is negatively if weakly associated with fixed capital formation.



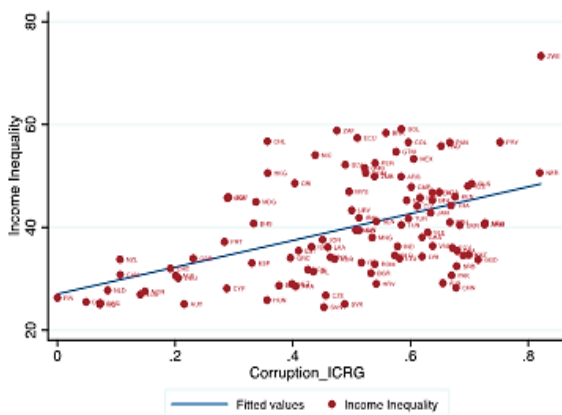
Unemployment (unemployment rate):
Corruption is positively if weakly associated with unemployment.



Economic growth (percentage growth rate of GDP per capita):
Corruption is positively if weakly associated with economic growth.



Income inequality (Gini coefficient):
Corruption is positively associated with income inequality.



Poverty (percent of population below national poverty line):
Corruption is positively associated with the poverty rate.

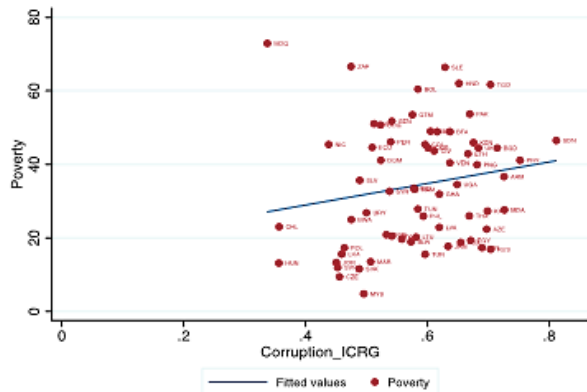
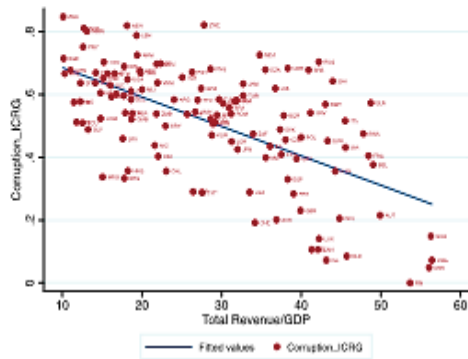


Figure 4: Some Simple Relationships between Corruption and Taxation

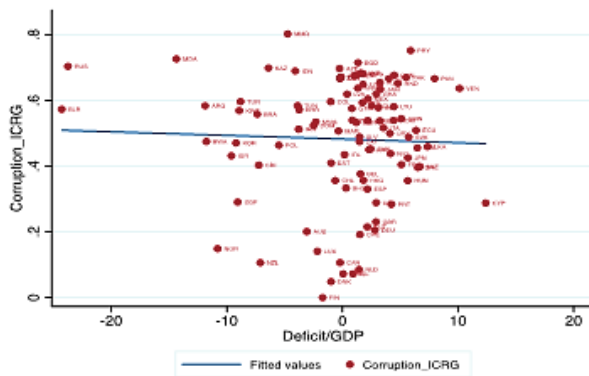
Revenue level (total revenues as percent of GDP):
 More total revenues are associated with less corruption.



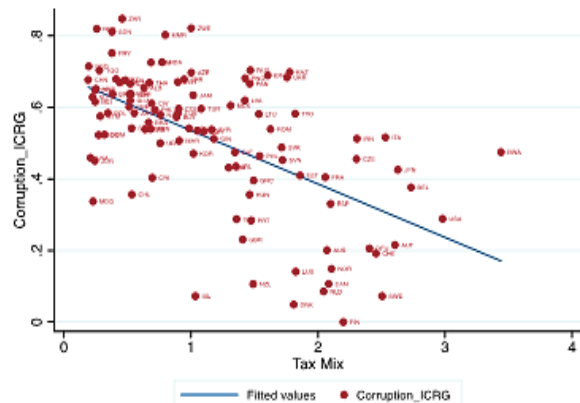
Tax level (total tax revenues as percent of GDP):
 More total tax revenues are associated with less corruption.



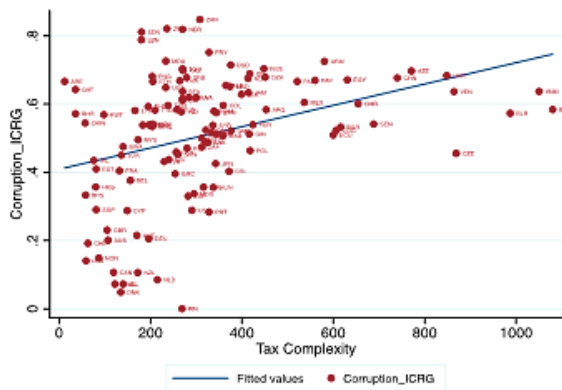
Deficit (deficit as percent of GDP):
 A larger deficit is weakly associated with less corruption.



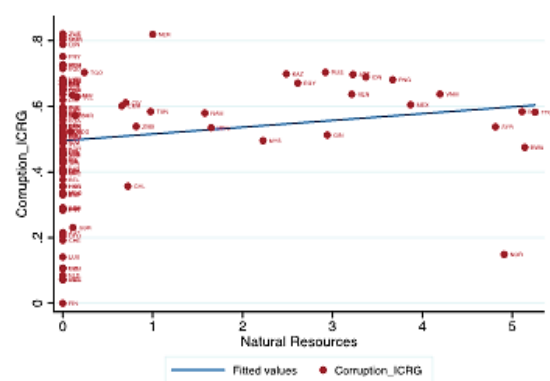
Tax mix (ratio of direct to indirect taxes):
 Greater reliance on direct taxes is associated with less corruption.



Tax complexity (time to prepare, file, and pay taxes):
 Greater tax complexity is associated with more corruption.

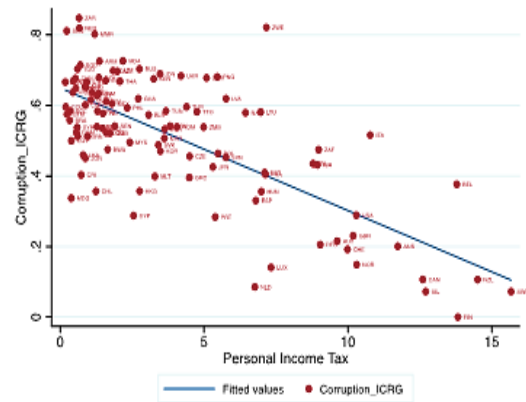
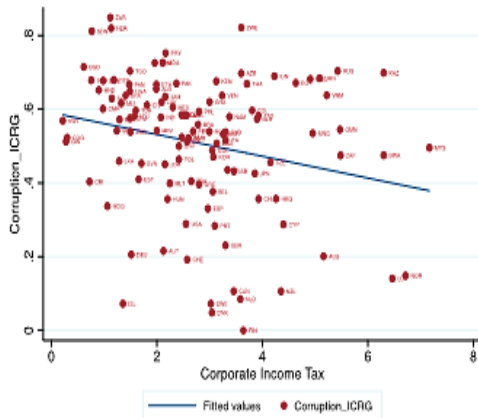


Resource taxes (resource taxes as percent of GDP):
 Greater reliance on resource taxes is associated with more corruption.



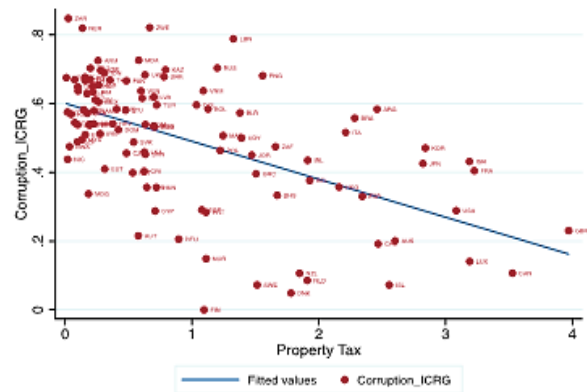
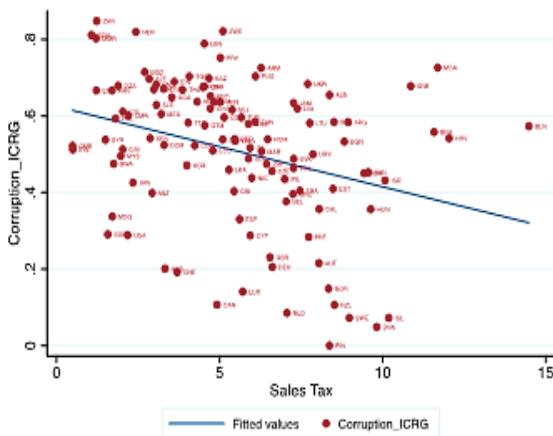
Corporate income taxes (corporate income taxes as percent of GDP):
 Greater reliance on corporate income taxes is associated with less corruption.

Personal income taxes (personal income taxes as percent of GDP):
 Greater reliance on personal income taxes is associated with less corruption.



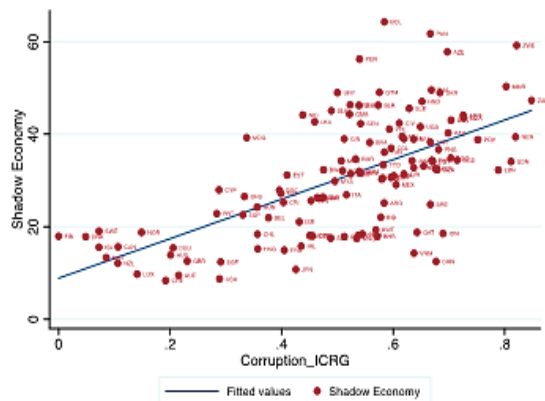
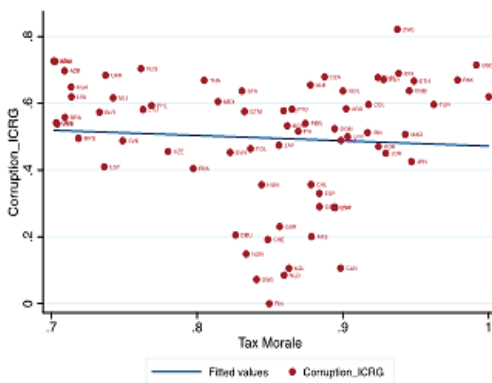
Sales taxes (sales taxes as percent of GDP):
 Greater reliance on sales taxes is associated with less corruption.

Property taxes (property taxes as percent of GDP):
 Greater reliance on property taxes is associated with less corruption.



“Tax morale” (index from 0-1, with 1 the highest level of tax morale):
 Higher tax morale is weakly associated with less corruption.

Shadow economy (shadow economy as percent of GDP):
 Corruption is positively associated with the size of the shadow economy.



Corruption, taxes and compliance

Anja Baum,¹ Sanjeev Gupta,² Elijah Kimani³ and Sampawende Jules Tapsoba⁴

Abstract

This article revisits the effects of corruption on the state's capacity to raise revenue, building on the existing empirical literature using new and more disaggregated data. We use a comprehensive dataset for 147 countries spanning 1995-2014, compiled by the International Monetary Fund. The study finds that—consistent with the existing literature—corruption is negatively associated with overall tax revenue, and most of its components. This relationship is predominantly influenced by the way corruption interacts with tax compliance. The establishment of large taxpayer offices within revenue administrations improves tax compliance by dampening the perception of corruption, thereby boosting revenue.

Keywords: taxation, compliance, corruption

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1. INTRODUCTION

States that do not raise adequate revenues are unable to build institutions to support economic development (Besley & Persson, 2014). In a recent study, Gaspar, Jaramillo, and Wingender (2016) show that once the tax-to-GDP ratio reaches around 15 per cent, GDP per capita increases sharply, a threshold that several developing countries have not yet crossed. Determinants for why revenue mobilisation might be lagging are many, and the literature repeatedly and increasingly identifies corruption as one of the factors.

In this article, we revisit the effects of corruption on the state's capacity to raise revenue, building on the existing empirical literature with new and more disaggregated data. We use a comprehensive dataset for 147 countries spanning 1995-2014, compiled by the International Monetary Fund (IMF). The data are disaggregated by revenue type: taxes on personal and corporate income, social security, property, goods and services, and international trade. The robustness of these results is then tested against another data source. In this regard, this article is the first to make use of data generated by two IMF tools to benchmark countries' tax performance, the Revenue Administration–Fiscal Information Tool (RA-FIT) and to assess actual tax collection *vis-à-vis* the potential, the IMF's Revenue Administration Gap Program (RA-GAP).

Another novelty of this study is the analysis of the impact of establishing public institutions designed to improve tax compliance. For the first time, a comprehensive dataset for the establishment of 'specialised' taxpayer offices—both large and medium-sized—within revenue administrations and anti-corruption agencies is compiled. It has been argued that establishing such institutions should be part of an anti-corruption strategy (IMF, 2016).

We find that, consistent with the existing literature, corruption is negatively associated with overall tax revenue, and most of its components. This relationship is predominantly influenced by the way corruption interacts with tax compliance. Building on this relationship, we assess the possibility of improving tax compliance via strengthening institutions, specifically those focusing on taxpayer segmentation. When properly implemented, segmentation by taxpayers could lead to better focus on managing the unique compliance risks presented by the respective segments, thereby reducing the perception of corruption and increasing taxpayer compliance. Our results indicate that this is indeed the case.

The rest of the article is structured as follows. Section 2 briefly reviews the existing literature. Section 4 describes a series of key stylised facts. The dataset is presented in section 3. The empirical methodology and the results are discussed in sections 5 and 6. Section 7 concludes.

2. LITERATURE REVIEW

Over the previous decades, there has been a prolific literature—both theoretical and empirical—on the relationship between corruption and taxation. This literature finds, first, that widespread corruption harms the culture of compliance, thereby increasing tax evasion (Aghion et al., 2016). Tax exemptions perceived to be the result of a bribe undermine the trust in government and the compliance with tax laws (Dreher &

Herzfeld, 2005); Second, corruption fosters the development of the informal sector, and therefore erodes the potential tax base (Schneider, 2005; Schneider & Denste, 2000).

Many papers have studied the direct influence of corruption on revenue performance (see Table 1), and most find a negative relationship between corruption and tax revenue. Sen Gupta (2007) finds that, among other factors (such as per capita GDP, the ratio of agriculture to GDP, trade openness and foreign aid), corruption is a significant determinant of a country's revenue performance. More recently, Besley and Persson (2014) discuss why developing countries tax so little, examining considerations such as the economic structure of these economies, political factors (including strength of institutions, fragmented politics, and a lack of transparency due to weak news media), and sociological and cultural influences (such as a weak sense of national identity and a poor norm for compliance). The authors find a strong negative correlation between corruption and the tax revenue-to-GDP ratio. They attribute this correlation to corrupt systems of government that face resistance to increasing taxes.

However, due to data limitations, few empirical studies have considered the effect of corruption on different tax types. These studies suggest that indirect taxes requiring frequent interactions between tax authorities and individuals are more prone to corruption (Hwang, 2002, Attila, Chambsa & Combes, 2009; Thornton, 2008; Imam & Jacobs, 2014). For example, taxes on international trade, which are an important source of revenue for developing countries, are negatively and statistically significantly affected by corruption. Furthermore, corruption tends to increase the share of international trade taxes to total tax revenues. Similarly, the impact of corruption on taxation of goods and services (such as value added tax (VAT) and excise) is found to be statistically significant (Attila et al., 2009; Thornton, 2008; Imam & Jacobs, 2014). Estimates for direct taxes are mixed: both personal and corporate income taxes are found to be insignificantly impacted by corruption by Attila et al. (2009) and Thornton (2008), and only Imam and Jacobs (2014) find a negative impact on corporate taxes in the Middle East. Though these papers attempt to solve the endogeneity issue (see the empirical analysis and discussion in section 5 below), they remain focused on regions where tax collection has historically been weaker.

Table 1: Literature Summary of Panel Estimation Techniques for the Impact of Corruption on Public Revenue

	Period	Countries	Corruption Indices	Estimation method	Dependent Variables*	Corruption Impact	Control Variables	Instruments for Corruption
Ghura (2002)	1985 – 1996	39 SSA countries	International Country Risk Guide (ICRG)	Feasible instrumental variable generalised least squares (IV-GLS)	Total government revenue	(-)	Per capita GDP (/) Agriculture (-) Openness (+) CPI (-) Dummy for non-oil mining (+) Dummy for oil producer (+) REER (nl) Structural Reforms (+) Human capital (+)	Contemporaneous, squared, and lagged values of population, population growth, urbanisation rate, and the remaining as exogenous treated regressors
Hwang (2002)	1979 – 1995	41-66 countries	5 indices; Business International (80-83, Levine-Loayza-Beck (1999) data set that is averaged over 1982 – 1995, 3 indices based on Transparency International (TI)	OLS, FE 2SLS and SURE for four years (1980, 1985, 1990 and 1995)	Total revenue excluding grants Tax revenue Trade revenue (measured as a share to government revenue)	(-) (-) (-)	Real GDP per capita in 1979-80 (nl) Import volume in 1979 (/) Government consumption in 1980 (+)	Percent of population professing protestant faith, a dummy for a former British colony or UK, and an index of ethnolinguistic fractionalisation
Sen Gupta (2007)	1980 – 2004	105 countries	ICRG Index	Fixed, random effect panel and GMM type estimations	Total revenue excluding grants	(/)	Per capita GDP in PPP (+) Agriculture, value-added (% of GDP) (-) Imports (% of GDP) Aid (% of GNI) (+) Debt (% of GNI_ (nl) Goods and services tax (-) Total income tax (+) Trade tax (nl) Highest marginal tax rate, individual rate (%) (nl) Highest marginal tax rate, corporate rate (%) (nl) Average tariff (nl) Political stability (-) Economic stability (-) Law and order (nl) Government stability (nl) Dummies for landlocked and resource-rich countries	Not discussed for FE/RE model. GMM: Lagged levels of the dependent variable and the predetermined variables and differences of strictly exogenous variables

	Period	Countries	Corruption Indices	Estimation method	Dependent Variables*	Corruption Impact	Control Variables	Instruments for Corruption
Thornton (2008)	1984 – 2001	53 Middle East and African countries	World Bank's control of corruption index	OLS and 2SLS	Tax revenue Personal income tax Corporate income tax Social security Payroll tax Property tax Goods and service tax Trade taxes	(-) (nl) (nl) (-) (nl) (/) (/) (-)	Per capita GDP (+) Dummies for Middle East and North Africa (/)	Openness, black market foreign exchange premium, index of ethnic fractionalisation, and a dummy for oil-rich countries
Attila et al. (2008)	1980 – 2002	125 countries	ICRG Index	OLS and IV-GMM	Tax revenue VAT (as a share to tax revenue) Income tax (as a share to tax revenue) Tariff income (as a share to tax revenue)	(-) (-) (nl) (+)	GDP per capita (/) Trade openness (+) Inflation (-) Money supply M2 (-) Child mortality rate (/) Primary school completion rate (/) Primary school enrolment ratio (/) Secondary enrolment ratio (/) Years of primary education (/) Dummies for regions	Ethnolinguistic fragmentation, legal origins (French and British), distance from the equator and urbanisation rate
Imam and Jacobs (2014)	1990 – 2003	12 Middle East countries	ICRG Index	System-GMM	Tax revenue Total income tax Personal income tax Corporate income tax Social security Payroll tax Property tax Excise tax Goods and service tax Trade taxes Import duties Export taxes	(nl) (nl) (nl) (-) (nl) (-) (nl) (-) (nl) (-) (-) (-)	Per capita GDP (/) Agriculture (-) Openness (/) CPI (/)	GMM type instruments

Note: *Ratio to GDP, unless otherwise indicated.

Impact: (nl) no significant impact; (+) significantly positive; (-) significantly negative; (/) depends on the specification/ambiguous.

Much of the negative correlation between tax revenue and corruption comes from the effect corruption has on tax compliance, which constitutes the second focus of this article. A revenue administration reform that aims at compliance improvements is the establishment of specialised taxpayer offices, focusing on taxpayers with different characteristics and different risks to revenue. Such segmentation, primarily but not only by size, enables the distinct compliance risks various types of taxpayers pose to be addressed most effectively. For example, IMF (2015) lists effective monitoring of large taxpayers as one way to address compliance deficits. This specialisation may be reinforced by segmentation into economic sector to improve knowledge of personnel on sector-specific issues (e.g., for extractive industries, financial institutions, or telecommunications companies). By building specialised tax offices with the specialist skills to service distinct taxpayer segments, compliance and service can be enhanced, perceptions of corruption reduced and tax yield raised. Focusing on the largest taxpayers can be an important signal to the taxpaying public of the government's commitment to enforcing the tax laws, thereby lowering the perception of corruption.

There is some anecdotal evidence that large taxpayer offices (LTOs) improve compliance, and thus increase tax revenue (Imam & Jacobs, 2014). Ebrill et al. (2001) show that countries with LTOs have generally performed better in terms of VAT revenue collection than those without one. Ebeke, Mansour and Rota Graziosi (2016), on the other hand, find that LTOs have no significant direct impact on tax revenues, but are a precondition for other revenue-increasing tax policy and administrative measures, such as those relating to VAT. They employ a propensity score matching (PSM) method on a group of sub-Saharan African countries. We build on the PSM methodology, extending the LTO dataset to more than 100 countries, while also adding data for medium and small taxpayer offices (grouped with the acronym MTO here), as well as anti-corruption agencies (ACAs).

3. DATASET

We predominantly rely on the World Revenue Longitudinal Database (WoRLD),⁵ which has been put together at the IMF and comprises data on total revenue, taxes on individual income, corporate income, goods and services, and international trade, as well as social security contributions. The dataset is compiled from multiple sources and covers 147 countries (both advanced and developing) between 1995 and 2014.⁶ We conduct a robustness check with revenue data compiled by the International Centre for Tax and Development (ICTD), whose results are presented in Appendix 3.⁷ All the revenue data are presented as a percentage of nominal gross domestic product (GDP).

⁵ <http://data.imf.org/?sk=77413F1D-1525-450A-A23A-47AEED40FE78>.

⁶ The sources are IMF country reports, Government Finance Statistics (GFS), World Economic Outlook (WEO) and the Organisation for Economic Co-operation and Development (OECD).

⁷ The ICTD Government Revenue Dataset (GRD) combines data from several international sources to compile a comprehensive database. The data includes 50 revenue indicators and global coverage. There are some methodological and source differences between the ICTD data and WoRLD, making it a strong candidate for robustness checks.

In addition to the WoRLD database, we use data from the IMF's Revenue Administration Gap Program (RA-GAP) and the Revenue Administration–Fiscal Information Tool (RA-FIT).⁸ The RA-GAP program has been applied to 23 countries to evaluate the difference between potential and actual collection of VAT between 2003 and 2013. RA-FIT is a web-based data gathering tool used to establish a baseline for revenue administration performance, to facilitate comparative study and benchmarking. There are over 140 countries included in this tool with hundreds of variables on revenue collection services, revenue authority staffing, tax base registration, dispute resolution, auditing and verification, among others. The surveys have been conducted over the past five years and country specific data are currently not publicly available.

The dates of establishment of LTOs, MTOs and ACAs are identified for more than 100 countries, making it the largest information set on LTOs and MTOs currently available. The data draws on information from IMF teams working on these countries and their reports, as well as country officials, websites of revenue authorities or finance ministries, and other online sources. In addition, we cross-checked the results with dates presented for subsets of countries in Baer (2002), Fossat and Bua (2013), and Ebeke et al. (2016). Appendix 4 summarises the results. Overall, we collect dates (or verify their non-existence) for 109 LTOs, 62 MTOs and 77 ACAs.

We primarily use two corruption measures throughout this article, the Corruption Perception Index by Transparency International (TI) and the World Bank's Control of Corruption Index. Both indices measure the perception of corruption, defined as the misuse of public power for private benefit, and cover about 180 countries. The two indicators differ in the sources used and specific questions asked to survey participants. Both are primarily perception-based, which has been criticised across the literature since actual and perceived levels of corruption might differ significantly. In the absence of measures for actual levels of corruption, and given that tax evasion might be equally impacted by the perception of corruption, the indices here are taken as proxies for actual corruption. In addition, while highly correlated, the indices have been subject to methodological changes over time (for example, the TI Corruption Perception Index underwent a significant change in 2012). For this reason, both indicators are used to verify the robustness of the results. The corruption variables have been rescaled to indicate that higher values are associated with greater corruption.

4. STYLISTED FACTS

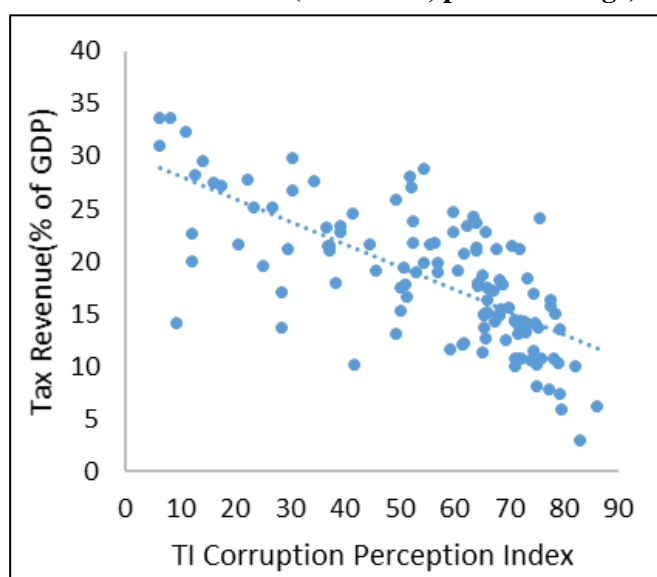
At the outset, we look at the correlation between corruption, tax revenue, and compliance indicators. Total tax revenue is negatively correlated with the

⁸ For details on RA-GAP see Hutton (2017). For an example, see: <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/South-Africa-Technical-Assistance-Report-Revenue-Administration-Gap-Analysis-Program-The-43069>; and for details on RA-FIT see Lemgruber, Masters and Cleary (2015) and <https://www.imf.org/external/np/seminars/eng/2013/asiatax/pdfs/masters.pdf>.

Transparency International Corruption index (Figure 1),⁹ which implies that increased corruption is associated with lower levels of the tax-to-GDP ratio.

A disaggregation of data into individual income and corporate income taxes shows that the former is more strongly negatively correlated with corruption (Figure 2, Panels A and B). Large corporate enterprises often fall under the supervision of LTOs and are part of the formal sector, in contrast to smaller enterprises, which could partly explain this result. Furthermore, the scope for discretion tends to be more pronounced in the case of personal income tax (Besley & Persson, 2014). For individual income tax, the perception of corruption lowers the willingness of individual taxpayers to comply fully with tax laws because of the perception that their taxes will be misused by the authorities.

Figure 1: Total Tax Revenue (1995-2014, period average)

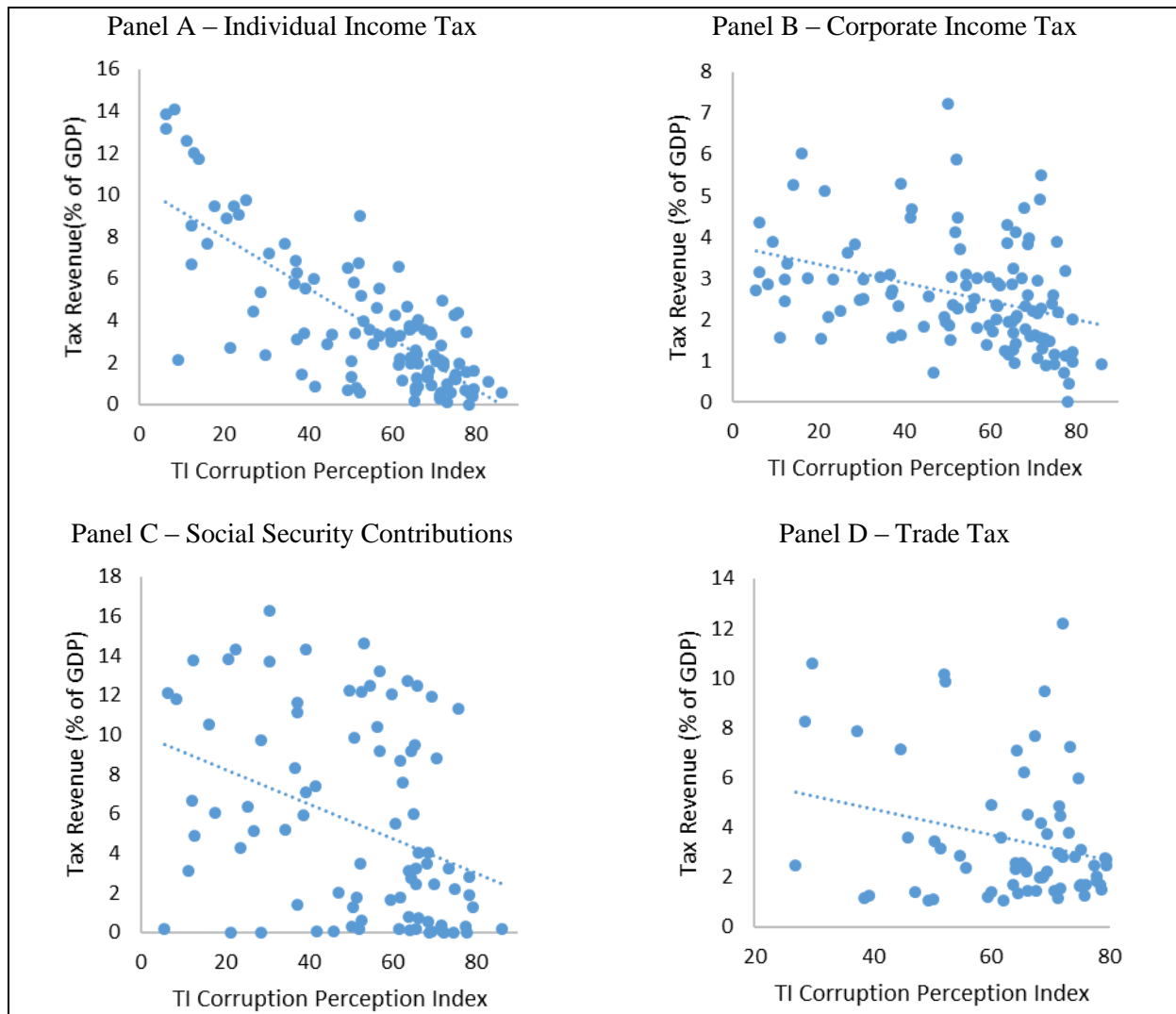


Sources: Transparency International, IMF WoRLD Database.

Panel C in Figure 2 shows a negative correlation between corruption and social security contributions. This is likely attributable to a characteristic of the informal sector in many countries, leading individuals and small and medium-sized enterprises to not meet their social security obligations. For international trade (Figure 2, Panel D), the negative correlation with corruption reflects the delays that traders face at the border and bribes they are asked to pay to clear their goods.

Ideally, one would like to go beyond the correlation between tax revenue and corruption by analysing compliance for different taxes. Data on the VAT's C-efficiency ratio offers such an analysis. The C-efficiency ratio compares the actual VAT revenue with its potential when a uniform tax rate is applied to all consumption. A shortfall in the former (i.e., a ratio less than 1) is influenced by both VAT design and compliance. Data for 108 countries shows that there is a strong correlation between a lower C-efficiency and a higher perception of corruption (Figure 3, Panel A).

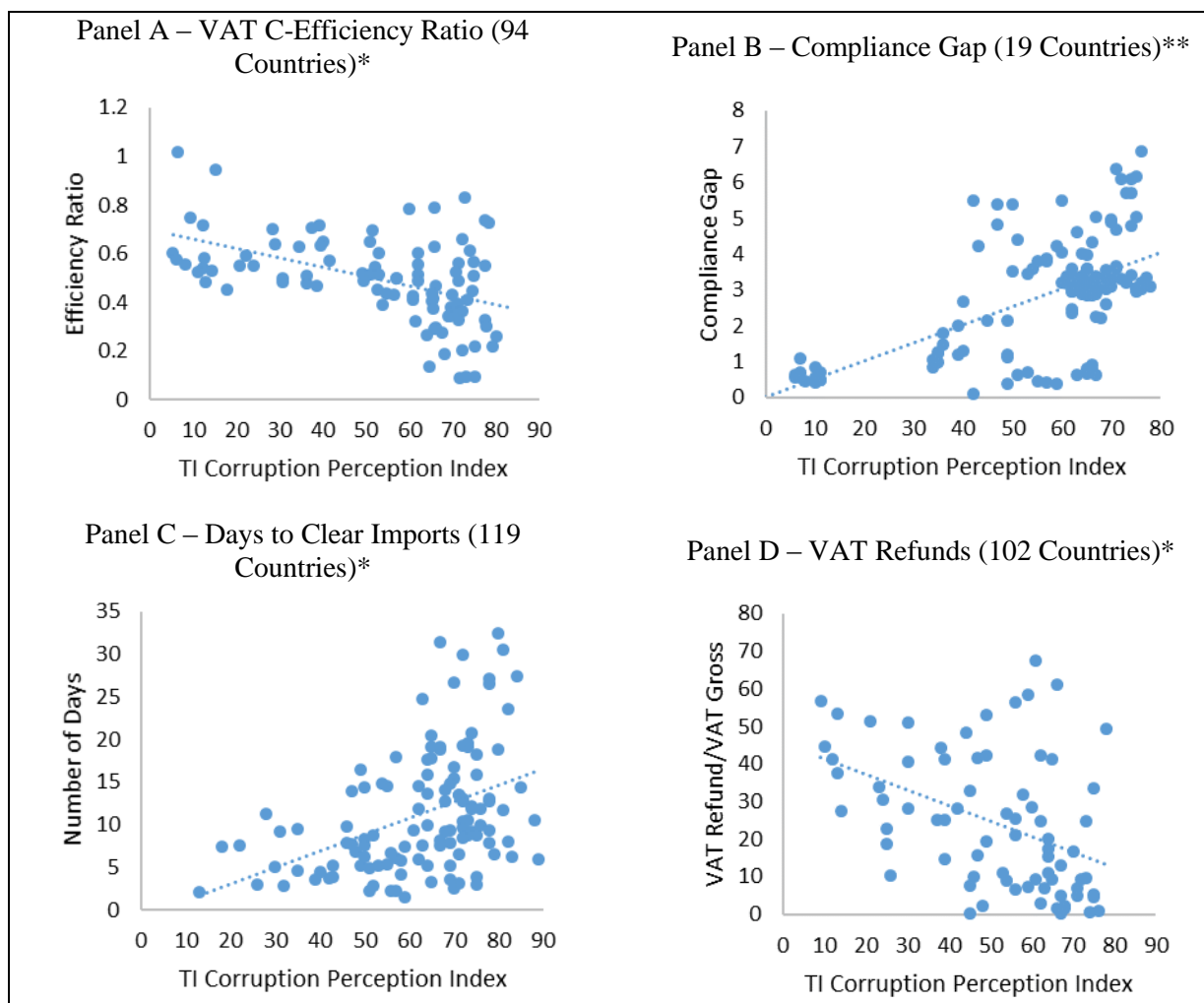
⁹ Similar results are found when the World Bank Control of Corruption index is used.

Figure 2: Tax Revenue Components and Corruption (1995-2014, period average)

Sources: Transparency International, IMF Staff Estimates.

As noted above, the RA-GAP program has generated data on the VAT compliance gap for 23 countries. When plotted against the level of perceived corruption (Figure 3, Panel B), we find a positive relationship, that is, the higher the level of perceived corruption, the larger is the VAT compliance gap. In addition, Panel C of Figure 3 shows that for countries with higher perceived corruption, more days are required to clear imports through customs, as importers go through unofficial channels to get their items released. Finally, we find the relationship between corruption and VAT refunds to be negative (Figure 3, Panel D) — a result that confirms problems with getting VAT refunds in more corrupt countries.

Figure 3: Tax Compliance and Corruption



*: Data spans 1995-2014, and points represent the period average for each country.

** : Data represents between 4 and 8 observations in the years 2004-2013 for each country.

Sources: Transparency International, IMF RA-GAP, IMF RA-FIT, IMF Staff Estimates.

5. REVISITING THE IMPACT OF CORRUPTION ON TAX REVENUE

5.1 Empirical methodology – panel techniques

This empirical section assesses the effect of corruption on tax revenue. The following equation is estimated:

$$y_{it} = \alpha_i + \lambda_t + \beta * Corruption_{it} + \sum_n^k(\theta_k * X_{it}^k) + \epsilon_{it} \quad (1)$$

where y_{it} is the tax revenue-to-GDP ratio for a country i at time t , and $Corruption_{it}$ represents a measure of corruption. The regressor X_{it}^k represents a set of k control variables, which, following the literature (Baunsgaard & Keen, 2010), include proxies

of the development level, the size of the tax base, the degree of openness, and the macroeconomic environment. α_i and λ_t represent a full set of country and time fixed effects, respectively. ϵ_{it} is the error term. For our controls, we use trade openness, which is the value of the total imports and exports as a percentage of GDP, as well as inflation, the share of agriculture in the economy, and GDP per capita in purchasing power parity terms.¹⁰

Estimating equation (1) is challenging because of potential reverse causality between corruption and taxation. High taxation could encourage tax evasion and low tax capacity could favour corrupt behaviour. To address this endogeneity issue, the literature has applied different instrumental variable approaches (Ghura, 2002; Hwang, 2002; Attila et al., 2009; Thornton, 2008). In its IV-GLS procedure, the study by Ghura (2002) uses the contemporaneous, squared, and lagged values of population, population growth, and the urbanisation rate as instruments. In Hwang (2002), corruption is instrumented with three variables: the percent of population professing Protestant faith, a dummy for being a former British colony, and an index of ethnolinguistic fragmentation. Attila et al. (2009) favour ethnolinguistic fragmentation, legal origins (French and British), distance from the equator, and the urbanisation rate as instruments. Thornton (2008) uses openness, the black-market exchange rate premium, ethnic fragmentation, and a dummy for oil producers instead. In this study, we follow Hwang (2002), Attila et al. (2009), and Thornton (2008) by using the ethnolinguistic fragmentation index (Taylor & Hudson, 1972), and adding an index capturing religious fragmentation (Mauro, 1995), both employing the argument that more fragmented countries tend to have more dishonest bureaucracies.

An additional challenge is the possibility that some omitted variables may be correlated with both corruption and tax collection. To mitigate the omitted variable bias, the literature has used the within fixed effects estimator to control for country-specific factors. However, this technique expunges the heterogeneity in the corruption variable and the instrument variables, which exhibit significant country-specific components (see Appendix 1). Accounting for both endogeneity and fixed effects would have been preferable, but the lack of idiosyncratic heterogeneity in the corruption index led to weak results.

For the reasons mentioned above, we apply pooled instrumental variable (IV) estimations. Pooled methods do not control for fixed effects and assume that the unobserved heterogeneity is uncorrelated with the covariates. This approach helps prevent the collinearity bias between the corruption indexes, the IV variables, and the country fixed effects. All estimates correct for autocorrelation and heteroscedasticity. Given the estimation weaknesses, the below results should be interpreted as controlled correlations, rather than clear causation of corruption to revenue.

5.2 Results

5.2.1 Baseline specifications

The pooled IV results are reported in Table 2, columns (1) and (2), and the corresponding first-stage results are discussed in Appendix 2. In line with the existing literature, the relationship between corruption and tax revenue in per cent of GDP is

¹⁰ This data is obtained from the World Bank Development Indicators covering the years 1995 to 2014.

negative and significant. The estimated coefficients are significant at least at the 5 per cent level, indicating that an increase of one standard deviation (SD) in corruption perception—which corresponds to a differential between relatively highly corrupt and relatively less corrupt countries¹¹—would correspond to an on average 12 percentage point lower tax revenue-to-GDP ratio.

Most control variables have the expected signs, comparable to the findings in Sen Gupta (2007). The coefficient associated with openness is positive, but only significant when the advanced economies dummy is added in the baseline specifications. Inflation has a positive impact on the tax-to-GDP ratio (inflation, when unanticipated, increases tax revenue). The increase in nominal income pushes people into higher tax brackets. There is a negative and significant relationship between the share of agriculture and revenue performance in the baseline specification. This confirms that the agricultural sector may be difficult to tax, especially if it is dominated by subsistence farmers. The coefficient associated with the log of per capita GDP is positive and significant in the baseline specification. This is in line with other studies that have found that the capacity to collect and pay taxes increases with the level of development. The effect of the log of per capita GDP on tax revenue is non-linear because the coefficient associated with the squared term is negative and significant.

We use the generalised method of moments (GMM) estimator to test for robustness of our results. Unfortunately, GMM does not lead to consistent estimates with our dataset. The number of instruments outweigh the cross-sectional dimension, and the model is over-identified, with the probability for the Sargan-Hansen test being well above the accepted thresholds in the literature.¹² In summary, our baseline estimates confirm the evidence that corruption undermines tax collection.

5.2.2 *Advanced economies versus developing economies*

We further check whether the negative relationship between corruption and tax revenue varies between advanced and developing economies (the latter including both low-income and emerging markets). We introduce additively and multiplicatively (with the corruption index) a dummy variable taking the value of 1 if the country is an advanced economy, and 0 otherwise. The results are shown in Table 2, columns (3) and (4). The adverse effect of corruption on tax collection is larger in advanced economies relative to the average impact for all countries in the sample. The coefficients associated with corruption are negative, and statistically significant at the 1 per cent level. The coefficients of the interactive terms are significantly negative. This result is a novelty to the existing literature and implies that any given change in the level of corruption is more detrimental in advanced economies, likely because of the lower overall level of corruption in these countries.

¹¹ For example, the average Corruption Perception Index is 26.3 for advanced, 62.5 for emerging, and 74 for low income economies.

¹² After following Roodman's (2009) strategy, we found that the probability of the Hansen J-statistic test equals 1 in most cases. The issue is even more pronounced when examining various tax categories.

Table 2: The Effect of Corruption on Tax Revenue

VARIABLES	IV (All Countries)		IV Advanced Economies (AEs)	
TI Corruption Perception Index (CPI)	-0.1246*** (0.000)		-0.2175*** (0.023)	
World Bank Control of Corruption Index (CCI)		-0.1218*** (0.009)		-0.1664*** (0.022)
CPI*AEs Dummy			-0.7051*** (-0.203)	
CCI*AEs Dummy				-0.1921*** (0.072)
AE Dummy			1.2848*** (0.411)	0.2395** (0.109)
Trade Openness	-0.0010 (0.005)	0.0014 (0.005)	0.0257** (0.010)	0.0144** (0.007)
Inflation	0.0163*** (0.003)	0.0156*** (0.003)	0.0054 (0.006)	0.0084** (0.004)
Share of Agriculture	-0.1548*** (0.034)	-0.1035*** (0.033)	0.2041* (0.107)	0.1021 (0.076)
PPP/PC	0.3398*** (0.033)	0.3589*** (0.032)	-0.0009 (0.141)	0.1733* (0.089)
PPP/PC ²	-0.0220*** (0.002)	-0.0226*** (0.002)	-0.0007 (0.009)	-0.0108* (0.006)
Constant	-0.7247*** (0.121)	-1.1921*** (0.134)	0.8267 (0.544)	-0.4796 (0.350)
Observations	1,934	1,934	1,934	1,934
Cragg-Donald	94.50	106.3	3.877	2.536

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

5.2.3 Tax components

Next, we turn to the relationship between corruption and the components of tax revenue. We split overall tax revenue into personal and corporate income tax, social security, property tax, taxes on domestic goods and services, and international trade taxes. This approach should help understand how the adverse effects of corruption impact specific taxes and avoid misleading conclusions that can arise from broad aggregates, especially if tax components move in offsetting directions. We re-estimate equation (1) for each tax item using the pooled IV methodology described above.

The results are shown in Table 3, where all taxes are specified as a ratio to GDP. The personal income tax (PIT), VAT, social security contributions, and trade taxes all confirm the negative relationship with corruption. The associated coefficients are negative and statistically significant at the 1 per cent level.

The negative relationship with PIT suggests that corruption works through informality, which favours tax evasion. An increase of one SD in corruption perception or control of corruption would decrease the PIT ratio by 0.2 percentage points per year. The impact of corruption on goods and services is felt most strongly via its impact on the VAT—the tax with most revenue potential. An increase of one SD in corruption perception would decrease the VAT ratio by 0.2 percentage points per year. Excise taxes tend to be unaffected. Social security contributions (SSCs), on the other hand, correlate strongly with the perception of corruption—an increase of one SD in corruption would decrease SSCs by 0.5 percentage points per year. International trade tax revenue would decrease by 0.2 percentage points per year. While the importance of international trade taxes is declining for many developing countries, they remain a crucial source of revenue in fragile states.

Surprisingly, the relationship between corruption and corporate income tax (CIT) is positive. An increase of one SD in corruption perception is associated with an increase in the CIT ratio by 0.1 percentage points per year. Given the deterrent effect of corruption on taxes prone to informality, there seems to be a substitution in favour of the tax burden on the formal sector. Finally, we do not find any impact on property taxes, which typically have a relatively small share in overall revenue. Furthermore, property taxes are usually levied at the subnational level where compliance may be weak, particularly in developing countries. The results remain broadly robust to the use of an alternative ICTD database (see Appendix 3).

Table 3: The Effect of Corruption on Tax Revenue Components

	Corruption Index	Tax Type	Coefficient	Significance	Observations	Cragg-Donald
WoRLD data	Transparency International Corruption Perception Index	Total Income	-0.0227***	(0.000)	1,562	43.30
		Individual Income	-0.0363***	(0.000)	1,309	22.68
		Corporate Income	0.0136***	(0.000)	1,388	34.55
		Tax on Trade	-0.0408***	(0.000)	1,347	44.17
		Tax on Goods and Services	-0.0272***	(0.000)	1,531	43.05
		Excise Tax	-0.0045	(0.000)	1,451	40.45
		VAT	-0.0340***	(0.000)	1,310	38.14
		Property Tax	-0.0023	(0.000)	1,388	37.62
		Social Security Contributions	-0.0997***	(0.023)	1,076	23.23
	World Bank Control of Corruption Index	Total Income	-0.0236***	(0.005)	1,562	47.84
		Individual Income	-0.0386***	(0.006)	1,309	27.18
		Corporate Income	0.0143***	(0.004)	1,388	40.35
		Tax on Trade	-0.0384***	(0.010)	1,347	46.11
		Tax on Goods and Services	-0.0319***	(0.004)	1,531	45.79
		Excise Tax	-0.0097***	(0.003)	1,451	39.33
		VAT	-0.0373***	(0.004)	1,310	40.22
Property Tax	-0.0016	(0.002)	1,388	39.87		
Social Security Contributions	-0.1049***	(0.014)	1,076	23.44		

Notes: Robust standard errors in parentheses, *** significance at the 1 per cent level, ** significance at the 5 per cent level, * significance at the 10 per cent level.

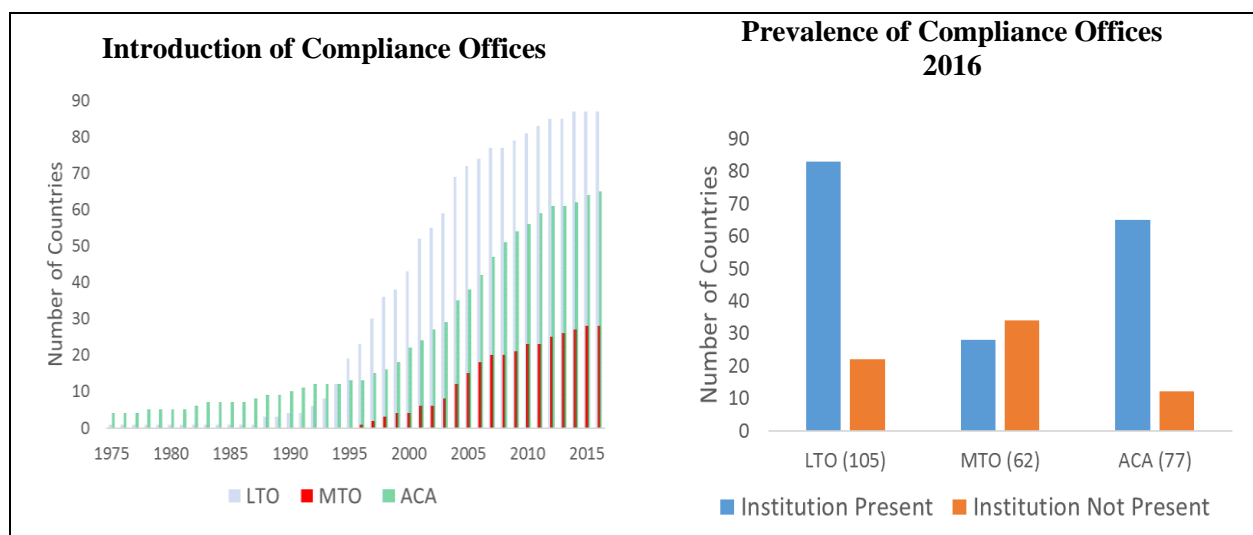
6. IMPROVING COMPLIANCE – THE IMPACT OF INSTITUTIONS

In this section, we analyse the impact of specific public institutions—such as LTOs—on compliance. These institutions are expected to have a dampening effect on corruption and a positive influence on tax revenue. We collect dates of establishment

on LTOs, MTOs and ACAs, which are detailed in Appendix 4. The resulting database on LTOs and MTOs is the largest of its kind, and will be useful for future impact analysis of fiscal and public institutions on economic performance.

The first wave of establishment of LTOs can be observed during the mid- to late 1990s, and currently only a minority of countries have not opted to establish them.

Figure 5: Effectiveness of Compliance Offices



Notes: chart only shows observations for which date of establishment could be identified, or where it is certain that institutions do not exist.

6.1 Propensity score matching technique

The dates of establishment of taxpayer offices or ACAs are the foundation of the propensity-score matching (PSM) methodology developed by Rosenbaum and Rubin (1983), which is applied here to analyse the impact of these institutions on corruption and tax revenues. PSM is a statistical matching technique that attempts to estimate the effect of a treatment, policy, or other intervention by accounting for the covariates that predict receiving the treatment. In our case, the treatment is the establishment of a specific institution (LTO, MTO, or ACA) to counter corruption and improve revenue performance. Ebeke et al. (2016) applied this methodology to study the impact of LTOs, VAT and semi-autonomous revenue authorities on tax revenue in 41 sub-Saharan African countries, an approach that is applied here in a difference-in-difference specification.

The reason for using difference-in-difference methodology *vis-à-vis* panel estimation is that it is difficult to control for endogeneity and the resulting bias in the latter approach. The bias arises because the apparent difference in outcomes between countries with and without units may depend on characteristics that determine whether a unit was established in the first place, and therefore the outcome could be dependent on these characteristics rather than on the establishment (treatment) per se. Given the absence of suitable instruments to capture the institution's establishment, we refrain from using standard panel estimation. PSM avoids the common endogeneity issue by using explanatory variables to find observations across countries when they were equally likely to establish the respective institution, by means of propensity scores.

The impact of an institution on the dependent variable is then compared across countries with similar propensity scores.

Propensity scores are estimated with a Probit model, using a set of independent variables that are close to those in the previous section 5.1 model – a dummy variable for the state of development, the share of agriculture, real per capita GDP, openness, and population – as well as a variable for time. Both the general income category (AE, EM or LIDC), as well as the income level within these groups impacts the likelihood of establishment of institutions, specifically LTOs and ACAs. For example, many of the poorest LIDCs share the characteristic of below-average LIDC tax ratios and higher levels of perceived corruption. All controls, except for population, are significant in explaining the likelihood of establishment of these institutions. In an expanded baseline, we add CPI inflation, latitude, a dummy variable for oil exporters, total tax revenue as a share to GDP, and the ratio of external debt to GDP. The latter two controls in particular are likely to influence decisions to increase efforts to mobilise revenue or reduce corruption for economic and fiscal stabilisation purposes.

Once the propensity scores are estimated, the observations are matched with three different matching estimators – Stratification, Kernel, and local linear regression matching. We enforce common support for the estimation, i.e., treatment observations with propensity scores higher r than the highest t propensity score in the non-treated pool are left unmatched.¹³

The average treatment effect (ATE) – the impact from the establishment of the units on variables of interest, compared to countries without the units – is analysed based on the identified matches. We use a difference-in-difference approach specified as follows:

$$\begin{aligned} ATE &= E(D_{t+x} - D_{t-x} | T = 1) = E((Y_{t+x}^{T=1} - Y_{t+x}^{T=0}) - (Y_{t-x}^{T=1} - Y_{t-x}^{T=0}) | T = 1) \\ &= E(Y_{t+x}^{T=1} - Y_{t-x}^{T=1} | T = 1) - (Y_{t+x}^{T=0} - Y_{t-x}^{T=0} | T = 1) \end{aligned} \quad (2)$$

where $T = 1$ if an institution is established, and $T = 0$ otherwise. The first term on the lower right hand side refers to the differences in outcomes before (or at) and after the treatment for the treated group. The second term uses the differences in outcomes for the control group to eliminate the bias. This specification eliminates the bias arising from common time trends in the dependent variables. It further eliminates issues resulting from the likely case that countries without the respective institutions have a higher tax revenue ratio or higher corruption to begin with. For example, if we used the revenue ratio in absolute terms and not in difference levels as a dependent variable, the results would simply compare the revenue-to-GDP ratios between countries with and without institutions. If countries that establish the institutions have lower tax ratios on average, the ATE will suggest that LTOs lead to lower tax revenue mobilisation. Instead, taking the difference-in-difference approach changes the interpretation of the ATE to ‘how much did the tax revenue ratio increase after the establishment of an LTO compared to countries that have not done so’.

¹³ The distributions of the propensity scores for treated and control groups are visually inspected with kernel density plots for each of the presented estimates, which are almost identical to one another after matching for all presented results below.

6.2 Results

The PSM baseline results are shown in Table 4, with the dependent variables specified as follows: (i) for corruption we use the change in the Corruption Perception Index three years after and one year before establishment of an institution; (ii) for revenue the difference between tax revenue two years after and the year of establishment is used.¹⁴ In the baseline, treatment (establishment) is noted as one occurrence only, and all years after the establishment year are dropped. All years before establishment are kept, except for three (for corruption) or two (for revenue) years before the year of establishment to avoid an overlap in the dependent variable.

Column 1 of Table 4 shows that LTOs have a statistically significant impact on the perception of corruption (significance levels are based on the bootstrap *T*-statistics).¹⁵ This impact is negative, with an average treatment effect (ATE) of about -3; i.e., the perception of corruption significantly declines (or increases significantly less) during the three years after the establishment of the LTO compared to other countries. On the other hand, the impact of both anti-corruption units and MTOs on the Corruption Perception Index is insignificant. For ACAs, the result is in line with the notion that the establishment of anti-corruption units alone is likely to be insufficient to lower corruption, unless they are given wide-ranging independence and power to pursue relevant cases. It further provides empirical support to those who have argued that ACAs are a mere additional bureaucratic step in a corrupt environment that is used to support corrupt activities (for example, bribes to avoid prosecution).

Table 4 further shows a statistically significant and positive impact of the establishment of LTOs on tax revenue, with an average treatment effect of about 0.6 per cent of GDP: i.e., following the establishment of an LTO, tax revenue increases on average by 0.6 per cent of GDP more (or declines less) over two years compared to countries that have not established an LTO. At the same time, the impact of the establishment of MTOs and ACAs, while positive, is insignificant. These results suggest that the establishment of LTOs has led to improvements in how compliance of this key segment is managed – via targeted taxpayer service and improved enforcement programs. This may not be the case with respect to MTOs. The establishment of MTOs is a relatively new concept, and while offices have been set up in several countries, tailored compliance programs for this segment have, on average, not yet been implemented to the same degree as for LTOs. In addition, MTOs are often regionally organised and managed, with decentralisation making targeted program implementation and supervision more challenging.¹⁶

¹⁴ The impact on corruption perception is likely to be realised with delay. However, where signal effects are strong, perception might change in the year of establishment itself. In contrast, the effects of LTOs on revenue are unlikely to be realised in the first year of establishment, given a natural learning process. However, the results hold for the LTO impact on tax revenue also if tax revenue is specified like the Corruption Perception Index.

¹⁵ The Kernel and log-linear regression methods estimate the propensity scores after excluding all observations for which the dependent variable is not available (using the `psmatch2` command in Stata). The stratification method first estimates the propensity scores, and in a separate step estimates the ATE (using the `pscore` command in Stata). Consequently, the treatment observations are different across these methods.

¹⁶ A third argument is that shareholders of larger corporates have an interest in a no-corruption policy in the companies they are invested in, while smaller taxpayers and firms often directly interact with the tax authorities.

Table 4: Impact of Institutions on Corruption and Tax Revenue – Baseline

Dependent Variable	Corruption Perception Index: (T+3) - (T-1)			Tax Revenue Change: (T+2) - T		
Treatment Variable	LTO	MTO	ACA	LTO	MTO	ACA
Control Variables	State of development, share of agriculture, real per capita GDP, openness, population, year					
Kernel Method						
Observations Treatment Group	32	12	41	52	20	33
Observations Control Group	286	432	534	492	601	534
ATE	-2.87**	0.53	-0.94	0.006**	0.000	0.001
T-Statistic	-2.77	0.3	-0.88	2.29	0.11	0.45
Bootstrap T-Statistic	-2.49	0.25	-1.05	2.38	0.1	0.42
Log linear regression matching						
Observations Treatment Group	32	12	41	52	20	33
Observations Control Group	286	432	534	492	601	451
ATE	-2.77***	0.45	-0.78	0.006**	0	0.002
T-Statistic	-1.97	0.2	-0.51	1.65	0.10	0.42
Bootstrap T-Statistic	-2.63	0.26	-0.67	2.02	0.18	0.52
Stratification Method						
Observations Treatment Group	61	23	41	61	23	41
Observations Control Group	1467	1900	2096	1467	1900	2096
ATE	-3.07***	0.448	-0.709	0.007**	0.001	0.002
T-Statistic	-4.116	0.358	-0.818	2.79	0.24	0.53
Bootstrap T-Statistic	-2.899	0.338	-0.787	2.35	0.21	0.48

Notes: IMF estimates, *** significance at the 1 per cent level, ** significance at the 5 per cent level, * significance at the 10 per cent level.

The impact of LTOs on revenue and corruption might seem contrary to the notion that increased perception of corruption has a positive impact on CIT revenues. However, the cross-country regression describes a structural comparison of how revenue levels and revenue structure compare at different levels of perceived corruption. On average, countries with higher perceived corruption have higher CIT revenues. The establishment of LTOs could lead to a shorter-term reduction in the level of perceived corruption, as well as to an increase in CIT and other tax revenue, without altering this structural comparison.

Since the treatment effects of MTOs and ACAs on corruption and tax revenue remain largely insignificant for the remainder of specifications below, results for them are not shown.

Table 5: Impact of LTOs on Tax Revenue – Robustness

Dependent Variable	Corruption Perception Index: (T+3) - (T-1)			Tax Revenue Change: (T+2) - T		
Robustness Test	Expanded Baseline	No Fragile States	Full Sample	Expanded Baseline	No Fragile States	Full Sample
Treatment Variable	LTO	LTO	LTO	LTO	LTO	LTO
Control Variables	Baseline + CPI inflation, latitude, dummy for oil exporters, total tax revenue as a share to GDP, the ratio of external debt to GDP	Baseline	Baseline	Baseline + CPI inflation, latitude, dummy for oil exporters, total tax revenue as a share to GDP, the ratio of external debt to GDP	Baseline	Baseline
Kernel Method						
Observations Treatment Group	28	29	384	46	41	528
Observations Control Group	208	286	259	339	455	448
ATE	-2.1*	-3.33***	-2.35***	0.007***	0.006**	0.004**
T-Statistic	-1.72	-3.06	-3.10	1.95	2.00	1.56
Bootstrap T-Statistic	-1.66	-2.72	-4.3	2.93	1.93	2.15
Log linear regression matching						
Observations Treatment Group	28	29	384	40	41	528
Observations Control Group	208	286	259	414	455	448
ATE	-2.13**	-3.32***	-2.25***	0.004	0.005*	0.004**
T-Statistic	-1.550	-2.700	-2.650	1.010	1.360	1.510
Bootstrap T-Statistic	-2.01	-3.39	-3.24	1.46	1.89	2.28
Stratification Method						
Observations Treatment Group	57	51	840	46	51	840
Observations Control Group	1157	1797	1681	967	1797	1681
ATE	-2.61**	-3.16***	-1.66***	0.007**	0.005*	0.004
T-Statistic	-3.287	-4.11	-5.215	2.654	2.12	1.85
Bootstrap T-Statistic	-2.305	-3.201	-2.645	2.518	1.659	1.135

Notes: IMF estimates, *** significance at the 1 per cent level, ** significance at the 5 per cent level, * significance at the 10 per cent level.

We conduct several robustness tests in Table 5. First, we expand the set of independent variables to include CPI inflation, a control for latitude, a dummy variable for oil exporters, total tax revenue as a share to GDP, and the ratio of external debt to GDP. The second specification deletes all fragile states from the baseline estimation on the assumption that their institutions are weaker than other countries. Finally, and with fragile states included, the last test refrains from dropping the observations after an institution is established, increasing the number of observations with an LTO in place significantly. The results are consistent across all specifications. The perception of corruption declines and revenue increases significantly when fragile states are excluded, and the results seem to hold for the entire sample, suggesting that after LTOs are established, revenue continues to increase faster than in countries without LTOs.¹⁷

¹⁷ Ideally, we would like to disaggregate the revenue data into its components, and analyse the institutions' impact by level of development. Unfortunately, these analyses lead to a significant loss of observations in the treatment group, rendering this analysis infeasible.

7. POLICY CONCLUSIONS

This article revisits the relationship between perceived corruption and taxation, by using a recently available revenue dataset. It finds that corruption has a considerable impact on aggregate revenue performance— with a loss of revenue of as much as 0.6 per cent of GDP annually. The effect is felt even on taxes with most revenue potential, such as the VAT. Taxes on income and international trade as well as social security contributions are equally adversely affected. It seems that the effect of corruption on revenue performance is mediated through poor compliance as suggested by a strong correlation between VAT compliance and perceived corruption. Corruption takes a toll on the functioning of the VAT; the higher the perceived corruption, the slower the speed at which VAT refunds are given.

The article further examines the effect of institutions designed to reduce corruption and improve tax compliance. In this regard, it assesses the impact of over 100 LTOs, MTOs and ACAs across different country groups and regions. It finds that LTOs do indeed reduce perceived corruption. They further seem to enhance revenue performance, with countries with LTOs outperforming revenue generation of countries without LTOs by as much as 0.6 per cent of GDP. The effect of MTOs and ACAs on corruption and revenue performance is not statistically significant.

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9. APPENDICES

9.1 Appendix 1

Table 1: Variance Decomposition of Corruption, Instruments, and Tax Revenues-to-GDP

Variables	Fraction of variance due to country fixed effects in %
Corruption Index	
TI Perception Index	95.77
WB Control of Corruption	97.47
Instruments	
Ethnolinguistic fragmentation	100.00
Religion Fragmentation	100.00
Tax Revenue	
WoRLD	93.99
ICTD	95.27

Notes: Values show the percentage of the variable that is explained by country fixed effects.

9.2 Appendix 2

All instruments are highly significant in explaining the corruption index. Ethnolinguistic fragmentation has a positive and significant impact on corruption, whereas religious fragmentation has a negative and significant effect. The partial R² of the excluded instruments is between 0.26 and 0.28. Moreover, the *F*-statistics of the first stage are significant at 1 per cent.

Table: First Stage

Variables*	TI Perception Index	WB Control of Corruption
Ethnolinguistic Fragmentation	18.3044*** (1.421)	0.9831*** (0.070)
Religion Fragmentation	-9.8781*** (1.320)	-0.4166*** (0.063)
Observations	1,934	1,934
R-squared	0.672	0.663
Partial R-squared	0.262	0.275
F(2, 1931) = 424.40		
Prob > F= 0.0000		

*Controls included

Robust standard errors in parentheses

***p<0.01, **p<0.05, *p<0.1

9.3 Appendix 3:

Table: Results with ICTD Data

	Corruption Index	Tax Type	Coefficeint	Significance	Observations	Cragg-Donald
ICTD Data	Transparency International Corruption Perception Index	Total Income	-0.0249***	(0.000)	981	43.45
		Individual Income	-0.0136	(0.000)	913	16.98
		Corporate Income	0.0023	(0.000)	866	18.92
		Tax on Trade	-0.0272***	(0.000)	1,033	42.65
		Tax on Goods and Services	-0.0363***	(0.000)	1,065	29.82
		Excise Tax	-0.0045*	(0.000)	981	26.64
		Indirect Taxes	-0.0748***	(0.023)	1,031	38.83
		Direct Taxes	-0.0385***	(0.000)	1,036	40.97
		Property Tax	-0.0045**	(0.000)	944	26.94
		Social Security Contributions	-0.0612***	(0.023)	1,014	30.14
	World Bank Control of Corruption Index	Total Income	-0.0259***	(0.005)	981	49.61
		Individual Income	-0.0182**	(0.009)	913	18.12
		Corporate Income	0.0065	(0.004)	866	20.48
		Tax on Trade	-0.0273***	(0.010)	1,033	52.41
		Tax on Goods and Services	-0.0520***	(0.008)	1,065	32.25
		Excise Tax	-0.0126***	(0.003)	981	31.63
		Indirect Taxes	-0.0886***	(0.011)	1,031	45.02
		Direct Taxes	-0.0390***	(0.006)	1,036	47.34
		Property Tax	-0.0029	(0.002)	944	31.87
		Social Security Contributions	-0.0583***	(0.011)	1,014	37.84

9.4 Appendix 4:

Table: LTO, MTO and ACA Establishment Dates

Country	LTO	Since	MTO	Since	Anti-Corruption Agency	Since
Afghanistan	Y	2005	Y	2010	Y	2008
Albania	Y	1998	N		N	
Algeria	Y	2001				
Anguilla	N					
Antigua and Barbuda	N					
Argentina	Y	1997	Y	1997	Y	1999
Armenia	Y	2002	N		Y	2004
Austria					Y	2010
Australia	Y	1994				
Azerbaijan	Y	2003			Y	2005
Bangladesh	Y	2003	N		Y	2004
Barbados	N		N		N	
Belarus	N		N		Y	1991
Benin	Y	1995	Y	1996	Y	2008
Bhutan					Y	2005
Bolivia	Y	1988				
Bosnia and Herzegovina	Y	2004	N		Y	2009
Botswana	Y	2012				

Country	LTO	Since	MTO	Since	Anti-Corruption Agency	Since
Brazil	Y	2010	N		N	
Bulgaria	Y	1997	N		N	
Burkina Faso	Y	2004	Y	2004	Y	2007
Burundi	Y	2003	Y	2009	N	
Cambodia	Y	1995				
Cameroon	Y	2004	Y	2006	Y	2000
Central African Republic	Y	1998	Y	1998		
Chad	Y	1997	N			
China	N		N		Y	1978
Colombia	Y	1988				
Comoros	Y	1994				
Congo, Republic of	Y	1997				
Cook Islands	N					
Côte d'Ivoire	Y	1997	Y	2014	Y	2015
Croatia	Y	2005	N		Y	2001
Cyprus	Y	2014	N		Y	2003
Djibouti	Y	2001	Y	2001		
Dominica	N					
Congo, Democratic Republic of the	Y	2003	Y	2005		
Ecuador	Y	1994	N		Y	2007
Estonia	N					
Ethiopia	Y	2001			Y	2001
Fiji	N					
Gabon	Y	2007				
Georgia	Y (a)	1996	N		Y	2012
Ghana	Y	2009	Y	2013	Y	1992
Greece	Y	2011	N		Y	2011
Grenada	N					
Guatemala	Y	2007	N		N	
Guinea	Y	1996	Y	2001	Y	2016
Guinea-Bissau	Y	2004	Y	2004	Y	1995
Haiti	Y	1996	Y	2012	Y	2004
Honduras	Y	2004			Y	1928
Hong Kong SAR	N					
Hungary	Y	1996				
Iceland	N					
India					Y	1964

Country	LTO	Since	MTO	Since	Anti-Corruption Agency	Since
Indonesia	Y	2002	Y	2006	Y	2002
Iraq	N (b)		N		Y	2004
Iran	Y	2001				
Jamaica	Y	2009	N		Y	2000
Jordan	Y	2004	Y	2004	Y	2006
Kenya	Y (c)	2006	N		Y	1997
Kenya	Y (c)	1998				
Korea	N				Y	2008
Kosovo	Y	2001	N		Y	2007
Lao PDR	Y	1998				
Latvia	Y	1995			Y	2003
Lebanon	Y	2005	N		N	
Liberia					Y	2008
Lithuania					Y	1997
Luxembourg	N					
Madagascar	Y	1997	Y	2003	Y	2004
Malawi	Y	2007	N		Y	1998
Malaysia					Y	2009
Mali	Y	1997			N	
Malta	N					
Mauritania	Y	2000	Y	2007		
Mauritius					Y	2002
Mexico	Y	1999	Y	1999	N	
Moldova	Y	2011	N		Y	2002
Mongolia	Y	2000	N		Y	2007
Morocco	Y	2000				
Myanmar	Y	2014	Y	2015	Y	2014
Namibia					Y	2006
Netherlands	Y	1990				
New Zealand	Y	1994			Y	1990
Nicaragua	Y	1993				
Niger	Y	1998	Y	2003		
Nigeria	N		N		Y	2000
Pakistan	Y	2004	N		Y	1999
Papua New Guinea	N				Y	2011
Paraguay	Y	1993				
Peru	Y	1992				
Philippines	Y	2000	N		Y	1987

Country	LTO	Since	MTO	Since	Anti-Corruption Agency	Since
Poland					Y	2006
Portugal	Y	2012	N		N	
Romania	Y	2004	Y	2007	Y	2005
Russia	Y	1998			Y	2011
Saint Lucia	N					
Saint Vincent and the Grenadines	N					
Senegal	Y	2001	Y	2012	Y	2004
Serbia	Y	2002	N		Y	2009
Sierra Leone					Y	2000
Singapore					Y	1952
Slovenia					Y	2010
Somalia	N		N		N	
South Africa	Y	2001				
Spain	Y	1995	N		Y	1982
Sri Lanka	Y	1995				
Sudan	Y	2004	Y	2005	Y	2012
Switzerland	N					
Tanzania	Y	2001	Y	2005	Y	1974
Togo	Y	1995	Y	2006		
Turkey	Y	2006	N		N	
Uganda	Y (d)	2004	Y	2009	Y	1988
Uganda	Y (d)	1999				
Ukraine	Y	2000	N		Y	2015
Uruguay	Y	1992				
United Kingdom					Y	1983
United States	Y	1975				
Venezuela	Y	1995				
Vietnam	Y	2010	N		Y	2006
Yemen	Y	2001	Y	2010	Y	2007

Notes: (a) Georgia - LTO dismantled in 2010; (b) Iraq - an LTO does exist, but it is staffed with 4 people only. We therefore classify it as not functional; (c) Kenya - two dates are presented, because LTO was formed as an operations unit in 1998 to provide one-stop shop services in the administration of income tax and VAT matters affecting large taxpayers. The LTO was developed into a fully-fledged department in the year 2006 with the sole purpose of administering domestic tax matters affecting large taxpayers. Both dates are kept due to a likely impact from both reforms; (d) Uganda - LTO closed in 2001 and re-opened in 2004.

9.5 Appendix 5:

Table: Summary Statistics

Variable	Observations	Mean	Standard Deviation	Minimum	Maximum
Total Tax - WoRLD	1934	19.06776	8.04348	0.70334	58.11479
Total Income Tax - WoRLD	1562	7.57159	5.18073	0.00253	33.195
Individual Income Tax - WoRLD	1309	4.89952	4.61933	0.001	27.674
Corporate Income Tax - WoRLD	1388	3.02241	2.41465	0.000555	25.50648
Trade Taxes - WoRLD	1347	1.96975	3.21967	0.001	39.90194
Excise Taxes - WoRLD	1451	2.29456	1.44299	0.00042	21.88961
Tax on goods and services - WoRLD	1531	6.09664	2.89537	0.00242	25.87794
VAT Tax - WoRLD	1310	6.17329	2.34868	1.34E-07	19.20702
Property Tax - WoRLD	1388	1.00759	1.01473	6.12E-07	7.299
Social Security Contribution - WoRLD	1076	6.59905	5.07973	4.42E-06	18.042
Corruption Perception Index - TI	1934	55.8348	22.65745	0	92
Control of Corruption - WB	1934	-0.1120269	1.082339	-2.59	1.64
PPP Per Capita	1934	9.104392	1.176914	6.097523	11.916
Share of Agriculture	1934	12.29981	11.88534	0.03447	58.20515
Inflation	1934	-3.195819	1.065253	-9.782633	1.178743
Ethnic Fragmentation	1934	0.4220083	0.2551487	0	0.9302
Religion Fragmentation	1934	0.4274414	0.2360986	0.0035	0.8603
Trade Openness	1934	84.9161	49.21485	15.58034	439.6567
Corruption Index - ICRG	1651	0.5241551	0.2138007	0	1
Compliance Gap % of GDP	109	2.798532	1.664916	0.38	6.88
C-Efficiency	1213	0.5020849	0.1863975	0.0611281	1.193815

The impact of corruption on tax revenues, tax compliance and economic development: Prevailing trends and mitigation actions in Africa

Bernd Schlenther¹

Abstract

The impact of corruption on development is well-documented and a multitude of international instruments and domestic laws are in place to address corruption. Despite these initiatives, the prevailing trend across Africa is that socio-economic decisions by government are informed by the interests of patronage networks that are further advanced through institutional weaknesses. The pervasiveness of these conditions has a severe impact on domestic resource mobilisation because it complicates enforcement efforts on the part of tax authorities. Over and above increasing their own efficiencies, tax authorities are thus under pressure to identify and implement mitigating actions to address the impact of corruption in conjunction with other stakeholders.

Keywords: Africa, corruption, fraud, regulation, tax evasion

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1. INTRODUCTION

The global cost of bribery alone is estimated to range from USD 1.5 to USD 2 trillion per year (Lagarde, 2017). Indirect effects of corruption are often far-reaching and include reductions in the delivery of public services, increased poverty and difficulties in achieving social welfare to the benefit of nations (African Tax Administration Forum, 2017, p. 100). Corruption also impacts negatively on the administration of the tax system where tax officials accept or solicit bribes in exchange for lowering tax assessments. As such, corruption within tax administrations is a serious concern for many jurisdictions and can involve practices such as paying bribes in exchange for understating liability and avoiding registration, or extorting taxpayers through threats of over-assessment. According to the International Monetary Fund, the resulting damage to tax compliance, revenue collections and respect for the wider tax system can be chronic, and the ‘effects in shaping its real incidence profound’ (International Monetary Fund, 2015, p. 17).

The questions this article seeks to address are: (i) what are the prevailing corruption trends in Africa? (ii) what is the impact of these trends on domestic resource mobilisation? and (iii) are regulatory frameworks and preventative measures effective in addressing corruption? In answering these questions, 10 African countries have been randomly selected and analysed against the backdrop of the Transparency International Corruption Perception Index (CPI). The analysis takes into account the CPI country ratings assigned over a four-year period, prominent media reports on corruption, and the regulatory framework the selected countries have in place to combat corruption. In addition, preventative measures available to countries are highlighted and consideration is given to cultural aspects that fuel corruption.

The article shows that corruption impacts negatively on the operating environment in which tax administrations collect revenue in that compliance levels decline and tax evasion increases. The analysis in this article suggests that in order to improve the operating environment, African governments should promote transparency and accountability, encourage and protect whistleblowers and promote leadership in the service of citizens. Without these steps, institutions dominated by patronage networks will fail to detect flows of funds that escape taxation, either through corruption, money laundering, tax evasion or avoidance strategies.

The article is organised as follows: section 2 addresses some definitional aspects of corruption and tax evasion and explores the linkages between the two concepts. Section 3 explores prevailing trends of corruption in randomly selected African countries whilst sections 4 and 5 provide an overview of regulatory and preventative measures available to countries to address corruption. Section 6 concludes.

2. THE RELATIONSHIP BETWEEN TAX EVASION AND CORRUPTION

In 1963 Nicholas Kaldor asked the question, ‘when will underdeveloped countries learn to tax?’, and his answer was that there is sufficient capacity in economic and administrative terms for such countries to tax more – whether a country did so, therefore, was primarily dependent on its political institutions (Kaldor, 1963, quoted in Bird, Martinez-Vazquez & Torgler, 2008, p. 56). The main reason why developing countries do not tax more may be that it is not in the interest of those in power who

control political institutions to do so. It can therefore be argued that good governance of institutions may result in a higher tax effort. Bird, Martinez-Vazquez and Torgler (2008, pp. 58-66) find that an ‘encompassing and legitimate state is an essential precondition’ to an adequate tax system and ‘[i]f taxpayers perceive that their interests (preferences) are properly represented in political institutions’, they will be more willing to contribute to the state through taxes.

Corruption, when applied in a civil service context, is defined variously as: (i) the ‘unauthorised trading of one’s entrusted authority’ (Graycar, 2015); (ii) ‘dishonest or illegal behaviour especially by powerful people’;² (iii) the ‘abuse of entrusted power for private gain’;³ or (iv) an act done with intent to give some advantage inconsistent with official duty and the rights of others.⁴ Through its fourth *African Governance Report*, the United Nations Economic Commission for Africa (UNECA) challenges the traditionally narrow definition of corruption⁵ as placing too much emphasis on public officials, while neglecting tendencies of corruption that are widespread in the private sector. UNECA emphasises that it is important for policy-makers to understand the significance and implications of viewing corruption as a broader phenomenon wherein ‘private agents share significant responsibility, and where many unethical acts, which can be regarded as corrupt, may not necessarily be illegal or located within the public sector’ (United Nations Economic Commission for Africa, 2016, p. viii).

Tax evasion refers to illegal acts taken by individuals or companies to reduce their tax obligations that are legally due (Thuronyi, 2003, p. 154; Cordes, Ebel & Gravelle, 2005, p. 401).⁶ The potential for both tax avoidance and evasion to arise is created with the negotiation of contracts where companies, seeking favourable terms in contractual arrangements, offer some benefit or payment to public officials. If the corrupt act that led to the conclusion of the favourable terms is not detected, the taxpayer entity can benefit in perpetuity from structured transactions based on a

² Merriam-Webster Dictionary.

³ Transparency International: <<https://www.transparency.org/what-is-corruption>>.

⁴ Duhaime’s Law Dictionary: <<http://www.duhaime.org/LegalDictionary/C/Corruption.aspx>>.

⁵ That is, ‘abuse of public office for private gain’.

⁶ Tax evasion or tax fraud is a criminal offence and is punishable by criminal sanction. Specifically, what behaviour constitutes tax evasion depends on the criminal laws of each country. According to De Koker (2011, para. 19.1), ‘tax evasion is characterized by fraud and deceit’. It refers to all those activities deliberately undertaken by a taxpayer to free him or herself from the tax that the law charges upon the taxpayer’s income, such as the falsification of returns, books and accounts and the conclusion of sham transactions. Alm, Martinez-Vazquez and McClellan (2016, p. 147) list the following: underreporting income, overstating deductions, exemptions or credits, failing to file appropriate tax returns; underreporting sales or engaging in barter to avoid taxes. Tax avoidance refers to any activity aimed at reduction of tax that is not criminal in nature or that involves a situation where the taxpayer has arranged his or her affairs in such a legal manner that the taxpayer has either reduced his or her income or has no income on which tax is payable (Thuronyi, 2003, p. 152). Thuronyi points out that the term is used to connote tax minimisation behaviour that skirts the limits of the law or that is in fact legally ineffective in reducing the taxpayer’s liability. Tax avoidance involves situations where ‘[t]he taxpayer will typically have structured a transaction that qualifies for favorable tax treatment under the literal language of the statute. The taxpayer may argue that the statutory language is clear and entitles him to the treatment sought’. The counter argument is that ‘what the taxpayer is trying to do may be inconsistent with fairness in taxation, and [courts] may therefore be inclined to disallow the benefits if there is a sound legal basis to do so’ (Thuronyi, 2003, pp. 150-151). Thuronyi also points out that tax law often treats transaction differently that are similar in economic terms. Taxable transactions are legally defined events. By manipulating the transactions that they engage in, taxpayers can legally reduce the tax that they are required to pay which exploits the legal definition of taxable income based on legal categories.

purportedly ‘legal’ contract. Alm, Martinez-Vazquez and McClellan (2016, pp. 161-162) find that ‘[c]orruption enables tax evasion by making it easier for taxpayers to hide their income, while tax evasion can contribute to corruption by creating additional opportunities for corruption to thrive’; in addition, ‘larger bribes result in higher levels of evasion’, thus supporting the argument that ‘tax compliance is dependent on the quality and honesty of the tax enforcers’.

Although corruption and outright tax evasion are distinct concepts, various studies show that they are interrelated and together bring about lower tax revenues and compliance levels and a range of economic and fiscal distortions (Attila, 2008, p. 3 and references there cited). Attila describes three mechanisms that link corruption and tax evasion: first, corruption decreases public revenues available for ‘productive public investments in areas such as roads, health and education’; secondly, through distortions in the tax structure corruption reduces growth; and, thirdly, as a possible countervailing impact, ‘by allowing economic agents, in particular private companies to reduce their fiscal burden’, an indirect ‘positive effect’ growth may be found if the unpaid revenue is utilised in productive investment spending (Attila, 2008, p. 3). It has been noted, however, that corruption also imposes costs on the private sector by weakening competitiveness and crowding out local small and medium sized companies in favour of the state-owned sector (Centro de Integridade Pública, 2016, pp. 1-2) and leading to the imposition of higher rates of tax under an eroded tax base (Asher, 2001). Corruption also deters foreign direct investment because major investors’ are subject to anti-corruption codes at various governmental and international levels (Centro de Integridade Pública, 2016, pp. 1-2).

In the above context, Djumashev (2007, p. 5) identifies two distortions created by corruption: (a) corrupt tax officers ‘conceal tax evasion for the bribes paid by detected tax evaders’; and (b) corrupt officials ‘abuse the authority given to them by attaching excessive red tape [that has no productive value to companies] to the public services they are supposed to provide’. In effect a share of the profits private companies is diverted from the lawful channels of the economy by means of this quasi-tax the level of which becomes greater as the quality of the public sector institutions declines.

The willingness of companies to evade taxes may vary in accordance with tax officials’ willingness to accept bribes (Alm, Martinez-Vazquez & McClellan 2016, p. 146). According to the World Bank, the causes of corruption are always related to the country context in which the corruption takes place and is particularly also linked to the imposition of government policies that generate economic rents. The model proposed by the World Bank envisages opportunity for corruption as a function of the size of the rents under a the control of a ‘public official’,⁷ the discretion that official has in allocating those rents, and the accountability imposed on that official (World

⁷ The *United Nations Convention against Corruption* (UNCAC), provides that the term ‘Public official’ means: ‘(i) any person holding a legislative, executive, administrative or judicial office of a State Party, whether appointed or elected, whether permanent or temporary, whether paid or unpaid, irrespective of that person’s seniority; (ii) any other person who performs a public function, including for a public agency or public enterprise, or provides a public service, as defined in the domestic law of the State Party and as applied in the pertinent area of law of that State Party; (iii) any other person defined as a “public official” in the domestic law of a State Party. However, for the purpose of some specific measures contained in chapter II of this Convention, “public official” may mean any person who performs a public function or provides a public service as defined in the domestic law of the State Party and as applied in the pertinent area of law of that State Party’. *United Nations Convention against Corruption*, opened for signature 9-11 December 2003, 2349 UN Treaty Series 41, entered into force 14 December 2005, art 2(a).

Bank, 1997, ch. 2; for a recent study finding an impact of mining on local corruption in Africa, see Knutsen et al., 2017). This abuse can take a variety of forms including asking bribes for the issuing of licences of any kind, in awarding contracts or in granting exemptions, diverting funds from the fiscus, by selling government property at black market prices or manipulating tender processes in favour of politically connected persons or entities, and also creates an uncontrolled environment for smuggling and diversion of revenues from the treasury to other ministries.⁸

Corruption, like tax evasion, also promotes distrust in the government, and creates equity costs by imposition of additional tax burdens that are arbitrary and capricious (Asher, 2001, p. 5). Although traditional analysis generally refers to petty corruption, grand corruption and state capture (Graycar, 2015, p. 88), six categories of corruption have also more particularly been identified in the literature that include: administrative corruption, grand corruption, political corruption, petty corruption, patronage/paternalism and being a 'team player' (Purohit, 2007, p. 285). Because of the complexity in defining corruption, Graycar (2015, p. 88) proposes the use of an analysis framework to understand what events lead to corruption in the public sector. This framework is used to analyse different behaviours that manifest through different activities, within different sectors of industry and in different places (countries/regions). Accordingly, in the next section of this article, examination of reported corrupt activities in 10 African countries will show that the predominant forms of corruption, such as state capture, are driven by high-level politicians, mainly through the natural resources sector and through abuse of procurement processes.

3. WHAT ARE THE PREVAILING TRENDS? THE GOOD, THE BAD AND THE UGLY

While as discussed in the previous section, corruption in a country's revenue administration can have severe and widespread repercussions, because it is difficult to measure hidden and often unrecorded activity, a precise measure is not possible (United Nations Economic Commission for Africa, 2016, p. 60; Lagarde, 2017). As a result, various methodologies are employed to derive indications of the scale of corruption, which apart from reports in the media include: perception-based indices (such as the Transparency International Corruption Perceptions Index⁹); surveys of involved parties such as bribe payers; estimates from direct observation (e.g., record-keeping by bribe payers and surveillance by law enforcement); estimation by subtraction; and estimates from market interference (e.g., if a major shareholder is a politician, company share value increases) and through official audits (Olken & Pande, 2012, pp. 5-12).

⁸ In Zimbabwe, for example, the collection of revenue in the diamond fields is controlled by the minerals department. Production in the Marange fields started in 2006, and estimates of its potential ranged from 25 to 36 million carats per year, with total gross revenue of USD 1-2 billion, which could be sustained for 14 years (IMF, 2012, p. 42). However, the 2013 national budget for Zimbabwe shows that Treasury only received USD 41 million from diamond mining in 2012 (Ministry of Finance, Zimbabwe, 2012, p. 231).

⁹ Critics of the Corruption Perception Index point out that it only provides a simplified view of corruption and that it disregards the involvement of Western countries involved in large-scale corruption in other jurisdictions (Åkesson & Orjuela, 2017, p. 3). Bauman (2016, p. 467) finds, in the case of Tunisia, that the Corruption Perception Index methodology primarily reflects the needs of foreign investors and that it 'fails to show how the production of the CPI is embedded in a wider global political economy'.

A random selection of 10 African countries' levels of corruption as measured by the Corruption Perceptions Index over a four-year period shows that the prevailing trend in Africa is that corruption is increasing (see Table 1). Of the 10 countries selected, seven showed increased levels of corruption, one remained unchanged and two showed slight improvement. The level of corruption in low-scoring countries (i.e., high corruption), such as Angola, is described as rampant corruption; the archetypal captured state. In higher scoring countries (lower corruption), such as South Africa, it is described as pervasive, even systemic. Some key questions following from this data are, for instance, what forms of corruption drive this prevalence and are there measures in place to address corruption?

Table 1: Transparency International Corruption Perception Index 2016

Country	2016	2015	2014	2013	Global Rank ¹⁰	Change
Angola	18	15	19	23	164	↓
Botswana	60	63	63	64	35	↓
DRC	21	22	22	22	156	↓
Kenya	26	25	25	27	145	↓
Malawi	31	31	33	37	120	↓
Mozambique	27	31	31	30	142	↓
Nigeria	28	26	27	25	136	↑
South Africa	45	44	44	42	64	↑
Tunisia	41	38	40	41	75	↔
Uganda	25	25	26	26	151	↓

Source: Transparency International, Corruption Perceptions Index 2016.

A media search of these 10 African countries shows an apparent prevalent trend of vast amounts of money being channelled to ministers and senior government officials through corrupt practices. There are also some examples of good practices that have emerged on the continent as illustrated below.

3.1 Angola

Literature describes Angola as a country that suffers from both a resource curse and a form of neopaternalism in which there is little distinction between private and public sector (Arko-Cobbah & Olivier, 2016, p. 163). When the civil war ended in Angola in 2002, large-scale corruption, already in existence during the war, was fuelled by post-war economic growth. Politicians and heads of the armed forces enriched themselves through trade in arms, oil and diamonds. Sonangol, the Angolan oil concessionaire, came to function as a parallel state coffer ensuring the prosperity of the elite (Åkesson & Orjuela, 2017, p. 8). Roy (2016, p. 8) finds that in post war Angola, control over resources (especially rough diamonds) was assured through exclusionary strategies

¹⁰ Ranking is done on a scale of 0 (highly corrupt) to 100 (very clean).

that rest on corrupt practices in the extraction of resources and the consequent distribution of cost and benefits associated with it.

For the period 2002 to 2015, USD 28 billion remains ‘unaccounted for’ from government budgets, with 35 per cent of money spent on road construction alone having disappeared. For the same period, Angolan companies and individuals reportedly invested USD 189 billion in foreign jurisdictions through often ‘opaque transactions’ (Onishi, 2017, citing research by the Catholic University of Angola’s Center for Studies and Scientific Research). In 2015, Angola’s Vice President, Manuel Vicente, was charged with corruption and money laundering in relation to his role as CEO of the national oil company, Sonangol and alleged payments of bribes to a Portuguese magistrate and prosecutor (Shaban, 2017).

3.2 Botswana

Botswana has featured consistently as the top performing country in Africa from an anti-corruption perspective as reflected in the Corruption Perceptions Index. Its success is ascribed to the implementation of ethics and anti-corruption initiatives that are supported by the country’s leaders. According to Mphendu and Holtzhausen (2016, p. 237), the Botswana experience is instructive to other countries because it holds important lessons about ‘the value of socially rooted leadership’. Most of the success of anti-corruption reforms in Botswana is attributable to political will that is supported by a dedicated anti-corruption agency that has been able to translate political talk into action (Mphendu & Holtzhausen, 2016, p. 237). However, the country still faces challenges such as a ‘lack of transparency, deeply entrenched patronage networks, conflicts of interest and nepotism, together with concerns over judicial independence’ (Badham-Jones, 2014). According to Ulrikson (2017, p. 88) this translates into redistributive policies that largely promote the interests of the political elite while the loyal rural poor only receive supplementary benefits in the form of ‘minimal social transfers and negligible taxation’. Nevertheless, Botswana highlights a different experience to many other African countries and this aspect highlights the need to consider corruption in the context of a country’s historical, political and economic situation (Warf, 2017, p. 27).

3.3 The Democratic Republic of Congo (DRC)

The DRC is described as a country where ‘institutional rules and regulations to guide the allocation and utilization of the country’s natural resources either do not exist or they have been enfeebled by years of conflict and bad governance’ (Kongolo & Zamberia, 2016 p. 183). According to these authors, unregulated extractive activity has fuelled conflict and a failure by the government to create an environment whereby the citizens of the country benefit from resource extraction (2016, p. 202).

The DRC is reportedly losing one-fifth of all of mining revenues to corruption and mismanagement (Al Jazeera, 2017, citing research by Global Witness). According to Global Witness, an estimated USD 750 million in revenue paid to the Congolese revenue authority and the state-owned mining company (Gécamines) vanished between 2013 and 2015. Reportedly some of these funds were distributed among corrupt networks linked to the DRC president (Al Jazeera, 2017).

3.4 Kenya

Corruption in Kenya is described as ‘endemic’ and ‘pervasive, dominating the provision of public services, the formation of contracts and, of course, political life’ (Hope, 2017, p. 62). According to Hope (2017, p. 63), corruption persists in Kenya primarily because those in power benefit from corruption and the existing governance institutions lack both the will and capacity to stop them from doing so. For example, the office of the president was drawn into allegations of misappropriation of funds amounting to USD 50 million that were intended for use for free maternity care in hospitals across the country. Reportedly, an electronic payment system at the Ministry of Health was manipulated to make double payments to vendors and to divert funds to individuals and private companies that are associated with the president (Osiro [2016]). According to Hope (2017, p. 63), the main reason for high levels of corruption is the deliberate undermining of the basic institutions that underpin and support the rule of law and good governance.

3.5 Malawi

In August 2017, Malawi police announced that an arrest warrant for former president, Joyce Banda, was issued for her suspected involvement in the 2013 ‘Cashgate’ scandal (Masina, 2017). At the centre of the scandal was a computer-based financial information storage system that was exploited by officials to divert funds from the *fiscus*. Reportedly, an estimated USD 250 million may have been lost to this fraud scheme where payments for services that were never rendered, were made. (Harawa, 2014).

In 2017, a former cabinet minister was charged with abuse of office for his role in ‘Maizagate’ by facilitating a maize procurement contract for the purchase of maize from Zambia, involving reported kickbacks of over USD 100,000 (Masina, 2017; Reuters, 2017b).¹¹

‘Cashgate’ led to the suspension of foreign aid and consequently the Malawian government has been struggling to implement badly needed infrastructure and modernisation projects. With up to 40 per cent of Malawi’s annual budget being funded by donors (Harawe, 2017), domestic resource mobilisation has become an imperative for the country.

3.6 Mozambique

The estimated average annual cost of corruption (based on a sample of 36 cases) over a 10-year period (2004-2014), is estimated at USD 4.9 billion which is equivalent to around 30 per cent of the country’s 2014 GDP and 60 per cent of the 2015 budget (Centro de Integridade Pública, 2016, p. 1). Estimates also show that the annual value of bribes paid in the customs area alone amounted to USD 108 million, with a significant secondary impact of corruption on revenue (through a loss of tax revenue) estimated at 11.6 per cent and the economy (the loss of over 17 per cent of the value added to the Mozambican economy) (Centro de Integridade Pública, 2016, pp. 1-2).

Whilst Mozambique has implemented anti-corruption laws, Levy and Williams (2014, p. 237) point out that for these to succeed, a supporting legal and practical framework

¹¹ Reportedly, import documents show that the government of Malawi had been overcharged by USD 345 per ton, instead of the real worth of the consignment, estimated at USD 215.

is needed that not only prosecutes and sanctions corrupt practices, but also ‘attempts to change culturally entrenched attitudes, reduce the opportunities for abuse and increase the likelihood that offences are detected and punished’. Also, like Malawi, the scale of corruption affects donor programs and transparency in the budgeting process has, for example, emerged as a key aspect for measuring accountability in how donor funding is spent (Schmitt, 2017, p. 246).

3.7 Nigeria

Nigeria has been the victim of many examples of grand corruption (Anaedozie, 2016). For example, in 2014 it was reported that USD 20 billion was not remitted to the federal government by the Nigerian National Petroleum Corporation (NNPC). Between 2011 and 2015, the NNPC reportedly withheld an estimated USD 25 billion in public funds and reportedly allowed them to be siphoned off to a variety of private interests (Ugbuaja, 2017, p. 14).

In order to change its fortunes as one of the most corrupt countries on the African continent, the Chief Justice of Nigeria has revealed plans in 2017 to establish special courts for the sole purpose to hear and promptly resolve corruption and financial crime cases (Inyang, 2017). Another measure aimed at addressing corruption is an Audit Bill which aims to guarantee the independence of the office of the Auditor-General and enhance transparency and accountability across all levels of the Federal Government (Nwachukwu, 2017, p. 6). It is also noteworthy that Nigeria’s Federal Inland Revenue Service (FIRS), has instituted an Anti-Corruption and Transparency Unit to watch for corrupt practices (African Tax Administration Forum, 2017, p. 106).

Nigeria is also attempting to diversify its economy in an effort improve domestic resource mobilisation. By focusing on agriculture that is more decentralised than the oil industry, the government is attempting to lift a large section of its population out of poverty. Because agriculture is driven by private enterprise of citizens as opposed to narrow self-interest pursuits of many government officials, it may be less prone to corruption (Ugbuaja, 2017, p. 15).

3.8 South Africa

Despite the vast range of laws in place to discourage and punish corruption, media reports indicate that government officials, audit and advisory firms and large multinational corporations appear ambivalent to such laws and continue to engage in arrangements that are not only illegal but morally reprehensible. Illustrative of this point are recent activities of a big four auditing and advisory firm in South Africa. Amidst political infighting and factionalism within South Africa’s ruling party and allegations of state capture by the Guptas, a family described as being very close to the country’s president, KPMG South Africa found itself drawn into this political cauldron through: (a) a commission to conduct an investigation for the South African Revenue Service (SARS), and (b) by its association with a Gupta-related entity (KMPG SA, 2017).

With regard to the first issue, the company found itself in a position where it produced an ‘investigative’ report with specific recommendations which was not as a result of its own work. In other words, it rubber stamped a narrative that was compiled by another firm of attorneys (amaBhungane & Scorpio, 2017a). This KMPG endorsed narrative, was mainly used to discredit and replace a serving finance minister. The

collateral damage of these actions was the South African economy (rocked by a steep depreciation in currency value and credit downgrades) and democracy, described by Poplak (2017) as giving rise to ‘the wholesale destruction of the democratic experiment in the service of unfettered rent-seeking’. De Vos (2017) correctly makes the point:

It [KPMG] provided its alleged integrity and auditing skills to endorse (and give credibility to) legal ‘findings’ it had not investigated, had no skills to assess, and had no way of knowing whether they were correct. Like many other South African companies, it decided to please its powerful client with deep pockets, instead of acting in an ethical and legally appropriate manner. Greed trumped any sense of right and wrong.

On the second issue, KPMG provided tax advisory services to a Gupta-controlled entity that was implicated in the abuse of taxpayer funds.¹² In short, wedding expenses (for hosting a wedding of a Gupta family member) were covered by Linkway Trading (a Gupta entity) which were reimbursed by Accurate Investment, purportedly an unrelated entity based in Dubai. The media flagged two issues in this regard: (a) no explanation was offered in the audited financial statements as to reasons why a ‘supposedly unrelated third party in Dubai’ would pay for the Guptas’ USD 2.3 million (ZAR 30 million) wedding bill;¹³ and (b) no reason was provided as to why a wedding was deemed a bona fide business expense (amaBhungane & Scorpio 2017a). It has been noted that the net effect of this ‘accounting sleight-of-hand’ was that the wedding was effectively paid for by taxpayers from funds diverted from the Free State government (through an ‘empowerment project’ involving another Gupta-related entity) (amaBhungane & Scorpio, 2017b). Reportedly, the Gupta family paid no income tax on this windfall and any income was offset against Linkway Trading’s expenses, resulting in it receiving zero taxable income from its Free State windfall.

While the above example illustrates complicity of private and public sector corruption, instances of grand corruption keep emerging in South Africa that may bring into question the ‘improved’ Corruption Perception Index rating assigned to the country.¹⁴

3.9 Tunisia

Government failure to address corruption in the face of rising inequality has led to increased public demand for responsive and accountable government. In Tunisia it triggered social unrest and gave rise to the Arab Spring (United Nations Development Programme, 2014, p. 13). Murphy and Alba (2017, p. 4) describe this political change

¹² Its senior partners reportedly also had a close relationship with the Gupta family as evidenced by their reported attendance at a lavish wedding (amaBhungane & Scorpio, 2017a, 2017b).

¹³ The items for which Linkway invoiced Accurate reportedly ranged from ZAR 13,086 for chocolate truffles to ZAR 2.3-million for scarves, ZAR 247,848 for fireworks and ZAR 13.9-million for ‘event services’. Inclusive of VAT, Linkway’s bill totalled a perfectly round ZAR 30 million (rounded numbers being an established audit risk indicator). It was further noted that ‘this invoice is the equivalent of USD 3,333,400’ (amaBhungane & Scorpio 2017b). According to the report, a junior auditor found that these [wedding-related] costs were most probably not incurred in the production of Linkway’s income.

¹⁴ For example, alleged misappropriation of an estimated ZAR1 billion in public funds by the State Security Agency (SSA), fraud and corruption in the Passenger Rail Agency of South Africa (PRASA) estimated at ZAR 2.5 billion, fraud and corruption in the energy parastatal (ESKOM) in excess of ZAR 2 billion and alleged corruption and procurement irregularities in the South African Information and Technology Agency (SITA) and the South African Police Service (SAPS) amounting to an estimated ZAR 6.1 billion.

as an ‘overthrow of a pro-Western kleptocratic autocracy and the persistence of economic relationships between international capital and Tunisian economic operators developed in obscurity during the former regime’.

In 2017, Tunisia's parliament approved a law that protects officials accused of corruption during the rule of former President Zine El-Abidine Ben Ali from 1987 to 2011. This triggered a range of protests by activists and the opposition (Reuters, 2017a). The government argues that the measure can ensure that business people are able to inject their fraudulently obtained riches back into the local economy. According to estimates, USD 3 billion could reportedly find its way into the legally-taxed economy (Al Jazeera, 2017). It can be argued that while this approach may secure short-term revenue, it may have a damaging impact on state building that is dependent upon governments’ ability to constructively interact with their societies. Le Billon (2014, p. 770) observes that there is a close link between inequality, mistrust and corruption and that unequal power relations may ‘reinforce particularised or in-group trust within privileged circles, which in turn exacerbates corruption’.

3.10 Uganda

Corruption in Uganda is systemic and cuts across many sectors. (Van Uhm & Moreto, 2017, p. 14). For example, the Ugandan Ministry of Energy and Mineral Development, mandated to oversee the mining sector,¹⁵ is frequently the subject of allegations of mismanagement and corruption in relation to the payment of mining and prospecting royalties. The Office of the Auditor General reportedly found that the Ministry assessed royalties and awarded exports for 93 kilograms of gold worth 11.82 billion Ugandan shillings (USD 113 million). However, corroborative reports from the Customs and Excise Department of the Ugandan Revenue Authority indicated that 5,316 kilograms of gold, valued at close to 700 billion shillings (USD 6 billion), were in fact exported (Wambi, 2017). Thus, a deficit of approximately USD 5.8 billion needs to be explained.

Another sector affected by corruption is the trade in wildlife as reflected in the appointment of a commission of enquiry into the mismanagement of a USD 27 million World Bank loan that was meant to improve wildlife conservation (Van Uhm & Moreto, 2017, p. 15). According to the United Nations Office on Drugs and Crime (2016, p. 97), corruption plays a significant role in wildlife crime since officials can ‘transform contraband into legal product with a single piece of documentation’. Cakaj and Lezhnur (2017, p. 16) state that in addition to corruption, pressure on those in leadership of the Ugandan Wildlife Authority Conservation ensure that illegal permits are handed out or that a blind eye is turned to wildlife crime.

3.11 Summary

The prevailing trend identified from the media reports and literature discussed above shows that predominant forms of corruption such as grand corruption and state capture are driven by high level politicians, mainly through the natural resources sector and through abuse of procurement processes. The next section looks at the regulatory anti-corruption frameworks and preventative measures available to these countries to mitigate the impact of corruption on domestic resource mobilisation.

¹⁵ Including issuing of exploration and mining licences and enforcement of the mineral sector regulations.

4. REGULATORY FRAMEWORK TO ADDRESS CORRUPTION

Corruption is classified as a category of transnational crimes¹⁶ and the emergence of the international framework against corruption has been described as being the result of convergence of a combination of values (moral and religious) and interests (economic and development), with the negotiation of international anti-corruption instruments involving highly political processes representing a response of traditional normative values and the interests of global players to corruption (Terracino, 2012, p. 3). On the African continent, this is reflected by the *Southern African Development Community Protocol Against Corruption*¹⁷ and the *ECOWAS Protocol on the Fight against Corruption*,¹⁸ and by the *African Union Convention on Preventing and Combating Corruption*.¹⁹ The *United Nations Convention against Corruption* is the most recent and significant international law instrument against corruption (Terracino, 2012, pp. 19, 51). The latter includes provisions on the recovery of stolen assets and establishes various measures for international cooperation for the purpose of detecting the transfer of proceeds of crime, determining the ownership of assets as well as their confiscation, return and disposal (Terracino, 2012, p.52).

Under the *United Nations Convention against Corruption*, it is mandatory to criminalise bribery and embezzlement in domestic law whilst the criminalisation of the specified second group of acts²⁰ is not mandatory, but preferred (Terracino, 2012, p. 82). The Southern African Development Community (SADC) Protocol deals with both primary and secondary acts whilst the ECOWAS Protocol covers the same but without the inclusion of ‘abuse of function’. The immediate concern flowing from this is, according to Terracino (2012, p. 82), that where other acts than the prescribed ones are not accepted by countries party to the *United Nations Convention against Corruption*, their acceptance as corrupt acts at the international level is not clear and can complicate judicial processes.

Among other international instruments, the OECD Anti-Bribery Convention establishes legally binding standards to criminalise bribery of foreign public officials in international business transactions and is focused on the supply side of bribery transactions.²¹ The US Foreign Account Tax Compliance Act (FATCA) targets non-compliance by US taxpayers using foreign accounts. FATCA requires foreign

¹⁶ Other crimes in this category include drug trafficking, human trafficking and the financing of terrorism.

¹⁷ *Southern African Development Community Protocol Against Corruption*, signed 14 August 2001 (entered into force 6 August 2003).

¹⁸ *Economic Community of West African States Protocol on the Fight Against Corruption*, signed 21 December 2001. This Protocol was noted in 2016 as having entered into force with the then recent ratifications of Niger and Senegal: National Anti-Corruption Institutions in West Africa (NACIWA), General Assembly Resolutions, 13-15 July 2016,

<https://www.unodc.org/documents/westandcentralafrica/NACIWA_General_Assembly_Resolutions_Cotonou_EN_FINAL.pdf>.

¹⁹ *African Union Convention on Preventing and Combating Corruption*, adopted 11 July 2003 (entered into force 5 August 2006). An additional feature to the AU Convention is a monitoring role constituted as the African Peer Review Mechanism (APRM) which is a mutually agreed instrument to which member states can voluntarily accede as a means of self-monitoring as to whether they are in conformity with the agreed political, economic and corporate governance values.

²⁰ Trading in influence, abuse of functions and illicit enrichment.

²¹ *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, signed on 17 December 1997 (entered into force 15 February 1999). From an African perspective, the Ratification Status of the Convention (as of May 2017) reflects only South Africa as signatory.

financial institutions (FFIs) to report to the US Internal Revenue Service information about financial accounts held by US taxpayers, or by foreign entities in which US taxpayers hold a substantial ownership interest.

Domestic legislation in some countries places emphasis on the briber, for example, the UK Bribery Act of 2010 sets out two offences that are specifically aimed at commercial bribery. Section 6 creates an offence relating to bribery of foreign public officials for the purpose of obtaining or retaining business or an advantage in conducting business. Section 7 establishes a new form of corporate liability for failing to prevent bribery on behalf of a commercial organisation.²² The statutory formulation of the UK Bribery Act abandons the agent/principal relationship²³ in favour of a model based on an intention to induce improper conduct.

By introducing similar legislation, African countries can better position themselves to address cross border corrupt activities, but also, to give policy effect to UNECA's concern that a wider interpretation of corruption is necessary to deal with "private agents." Looking at the selected countries, all have anti-corruption laws in place as reflected hereunder.

²² This is in addition to the two general offences that cover the 'offering, promising or giving of a bribe (active bribery) and the requesting, agreeing to receive or accepting of a bribe (passive bribery)' through sections 1 and 2 of the Act.

²³ The agent/principal model defined bribery as the betrayal of a loyalty to an identified person, and by eliminating the need for an identified person, the standard was lowered to 'the betrayal of a duty' in general.

Table 2: Anti-Corruption Instruments and Legislation in African Countries

Country	Anti-Corruption Instruments and Legislation
Angola	Law on the Criminalization of Infractions Related to Money Laundering (CIML); Public Probity Law 2010; Public Contracting Law; Decree 48/06; Law on Access to Administrative Documents; Penal code 1886 and the Law of Crimes against the Economy criminalise active and passive corruption 2002; In 1996, the Law of the High Authority Against Corruption was passed for the creation of an anti-corruption body (yet to be established).
Botswana	Directorate on Corruption and Economic Crimes (1994); National Anti-Corruption Strategy; Proceeds and Instruments of Crime Act 2014; Section 99 of Penal Code of 1964.
DRC	Public Finance Management Act, Constitution 2006; Code of Ethics for Public Officials; Anti-Corruption Act; DRC Financial Intelligence Unit.
Kenya	Kenya Anti-Corruption Commission (KACC); Constitution of 2010; Ethics and Anti-Corruption Commission Act 2011; Leadership and Integrity Act 2012; Anti-Corruption and Economic Crimes Act 2003 and the Public Officer Ethics Act 2003.
Malawi	Anti-Corruption Bureau (ACB), established in 1995 under the Corrupt Practices Act 1995; National Anti-Corruption Strategy 2009;
Mozambique	Central Office for Combating Corruption (Gabinete Central de Combate à Corrupção, GCCC). The GCCC was established within the Attorney General's Office and replaced the anti-corruption unit established in 2003; The Penal Code; Law No. 6/2004, of 17 June, Anti-corruption Act; Law No. 14/2012, of 8 February, amending the Law No 22/2007, of 1 August, Organic Law of the Attorney-General's Office and the Statute of Prosecutors; Law No. 16/2012, of 14 August, Law of Public Probity; Law No. 1/79, of 11 January, punishing crimes for misappropriation of State's funds; Law No. 15/2012, of 14 August, Witnesses Protection Act; and Law No. 7/2012, of 5 February, Anti- Money Laundering Act.
Nigeria	EFCC Est. Act 2004; Independent Corrupt Practices & Other Related Offences Act 2000; Advance Fee Fraud and Other Related Offences Act 2006; Money Laundering (Prohibition) (Amendment) Act 2012; Miscellaneous Offences Act; Code of Conduct Act; Nigerian Extractive Industries Transparency Initiative Act; Freedom of Information Act 2011; Fiscal Responsibilities Act 2010; Penal Code Laws of Federation of Nigeria 2004; Criminal Code Law of Federation of Nigeria 2004; Banks and Other Financial Institutions (Amendment) Act 1991; Failed Banks (Recovery of Debts) and Financial Malpractices in Banks (Amendment) Act 1994.
South Africa	Special Investigations Unit (SIU) established in terms of the Special Investigating Units and Special Tribunal Act, Act No 74 of 1996 (SIU Act); Public Finance Management Act of 1999; Prevention of Organized Crime Act 121 of 1998; Constitution of the Republic of South Africa; Municipal financial Management Act 56 of 2003; Financial Intelligence Centre Act 38 of 2001; Prevention and combating of Corrupt Activities Act 12 of 2004; Prevention of Corruption Act 1988
Tunisia	Constitution 2014; Good Governance and Anti-Corruption Agency: Instance de la Bonne Gouvernance et de la Lutte Contre la Corruption (established under article 125 of Constitution); Penal Code ; Anti-money laundering legislation : Law 2003-75.
Uganda	National Anti-corruption Strategy; Constitution of the Republic of Uganda 1995 Inspectorate of Government Act, 2002; Leadership Code Act, 2002; Anti-Corruption Act, 2010; Whistle-blowers Protection Act, 2010.

Source: World Bank, 'Anti-Corruption Agencies', <<https://www.acauthorities.org/cross-country>>; Badham-Jones (2014); United Nations Development Programme (UNDP) (2014).

5. PREVENTATIVE MEASURES

Various preventative measures are available to reduce the incidence of corruption. Where these measures are combined as part of the regulatory framework, a greater impact in reducing corruption may be possible.

5.1 Increased transparency

In recent times, a number of mass ‘public interest’ disclosures by whistleblowers has highlighted tax and corporate practices which are characterised by aggressive tax avoidance and use of corporate structures to hide profits. The ‘Luxembourg Leaks’ (Luxleaks), ‘Panama Papers’ and ‘Paradise Papers’ are probably the best known. The effect of the scandals has been a re-ignition of the debate on international tax reform to counter practices contributing to all forms of illicit financial flows, including corruption.

The UN *Convention against Corruption* also emphasises the importance of transparency in public administration. Under Article 10 of the *Convention*, Parties are required to undertake the measures that are necessary to enhance transparency in public administration, which includes aspects such as the organisation, functioning and decision-making processes. The measures may include

adopting procedures or regulations allowing members of the general public to obtain, where appropriate, information on the organization, functioning and decision-making processes of its public administration and, with due regard for the protection of privacy and personal data, on decisions and legal acts that concern members of the public; (b) simplifying administrative procedures, where appropriate, in order to facilitate public access to the competent decision-making authorities; and (c) publishing information, which may include periodic reports on the risks of corruption in its public administration.

In many instances corruption is fuelled in part by either the indifference or resignation (or both) of the population. By raising public awareness, transparency supports measures to combat corruption and, importantly, increases public pressure on the government to fully address the problem of corruption (Terracino, 2012, p. 136). Because whistleblowing hinges on public awareness and understanding, tax administrations in Africa are finding innovative ways of drawing attention to the importance of public disclosure. For example, in Swaziland, the revenue authority’s Internal Affairs Division launched a campaign under the slogan, ‘I refuse to be silent’, that is intended to ‘raise public awareness and encourage people to come forward with any suspicions of corruption or fraud cases through a toll-free number that they can call any time’ (African Tax Administration Forum 2017, p. 108) In Uganda, 30 per cent of the revenue administration investigation unit’s cases in financial year 2015/16 were brought to its notice by whistleblowers (African Tax Administration Forum, 2017, p. 107).

5.2 Bilateral and multilateral treaties

Bilateral and multilateral treaties provide mechanisms to police interactions between countries because bilateral investment treaties (BITs), for example, permit countries that want to host foreign investment to attract financing by agreeing to certain constraints to safeguard the rule of law and encourage investment (Campbell, 2016, p.

540). Campbell (2016, p. 541) also points out that a failure on the part of an investing country's BITs to put any real pressure on nations to institute internal reforms (e.g., human rights considerations or corporate social responsibility) represents a lost opportunity to assist the host country and to mitigate risks for investing entities because well-designed BITs have the ability to promote the rule of law through international arbitration and other conditions. Such conditions may 'motivate developing host countries to improve domestic administrative practices and laws to avoid future disputes' and for countries to better deal with negative externalities caused by foreign involvement (Campbell, 2016, p. 546).

5.3 Establishment of anti-corruption bodies

Institutional responses to corruption have also come in the form of anti-corruption bodies whereby states attempt to enhance their institutional capacity to prevent corruption. The typical role assumed by these bodies is implementing and/or overseeing and coordinating the implementation of anti-corruption policies. Implementation of anti-corruption policies is, however, dependent on institutional cohesion (i.e., all government departments 'buying in' and supporting the initiative) since the responsibility for implementation of the various individual components of the anti-corruption policy lies with the particular sector or government agency (Terracino, 2012, p. 138). Terracino (2012, pp. 138-139), further points out that functional and financial independence should be established in law (rather than by executive decree) to ensure that the entity is able to carry out its functions without undue interference (such as reductions in its budget). Campbell (2016, p. 537) argues that an important reason why corruption persists in countries such as Nigeria and South Africa, is 'the inability of these countries to establish monitoring bodies that are both effective and independent'; it is noted that 'comprehensive domestic solutions to the problem of corruption seem a long way off' in that 'true government reforms' will be unsuccessful until nations such as China join Western countries in policing their companies operating in Africa. Corruption-related recovery is low in South Africa despite the existence of a multitude of enforcement bodies (Financial Action Task Force, 2009; Campbell, 2016).

In the South African context, Pillay (2017, p. 11) identifies the following impediments to address corruption, namely 'political interference, lack of capacity, and the non-existence of coordination, synergy and cooperation'. These impediments are common across the continent and countries can benefit from a 'whole of government approach' that draws different agencies' strategies and resources together to allow for better alignment of activities that support common objectives. Murphy and Albu (2017, p. 2) caution that anti-corruption policies should, however, not be developed in the 'absence of an open acknowledgement of divergent institutional, socio-economic and political interests of both their developers and the regulated subjects'.

5.4 Implementation of a risk management framework

An important element in corruption mitigation is a formal process by which government departments can take ownership of their anti-corruption activities and assess levels of implementation of anti-corruption measures. In tracking the successful implementation of anti-corruption mechanisms, the following aspects are important:

1. if the country acceded to the UN *Convention against Corruption*, have the relevant Articles been passed into domestic law?

2. to what extent are corruption cases pursued and what is the quality of judicial rulings; in other words, were there instances of judicial abuse – either procedurally or substantively?
3. what is the monetary value of corruption-related freezing, seizure and confiscation of assets?
4. are anti-corruption bodies fully operational?
5. how functionally effective are financial investigation units within the larger criminal justice system in assisting prosecutions linked to public sector corruption through mutual legal assistance and joint investigations?
6. how many requests are made to other jurisdictions for mutual cooperation in handling transnational corruption cases?
7. to what extent are prevention measures pursued, e.g., public information activities that contribute to refusal to tolerate corruption, as well as public education programs?
8. have departments established appropriate transparency-based systems for procurement that promote competition and objective criteria in decision-making? Are these effective in deterring corruption?
9. is a system of oversight in place and are risk management best practices applied to ensure a proper control framework?²⁴

Buscaglia (2011, pp. 471-473) finds that countries experiencing significant reductions in perceptions of high-level corruption and reductions of irregularities in the handling of case files have had successful reforms in a range of areas, such as: (i) creating uniform and comprehensive case management and tracking systems together with transparent rules for assignment of cases; (ii) administrative reforms in the public service (personnel, budget, performance-based indicators; rewards, and career paths for law enforcement officers); (iii) inter-agency cooperation through improved coordination and specialisation; (iv) implementation of a ‘task team’ approach to treating cases of corruption, and (v) in many cases, implementation of forfeiture of assets linked to high-level political corruption.

Given the generally limited financial and human resources of tax administrations, tax education and integrity efforts should include engagement with all relevant stakeholders to allow for more and better opportunities to get through to taxpayers. Such engagement can also be effective in influencing compliance behaviour and reducing the incidence of corruption and fraud. It is therefore critical that tax authorities effectively engage with local leaders, politicians, tax advisors, business associations, clearing agencies, policy-makers and local police (African Tax Administration Forum, 2017, p. 170).

5.5 Implementation of an anti-money laundering framework

The links between corruption, tax evasion and money laundering are well-established (Financial Action Task Force, 2011, p. 6; see also Article 14 of the UN *Convention against Corruption*). Money laundering provides the mechanism to hide both the

²⁴ As envisaged under Article 9 of UN *Convention against Corruption*.

proceeds of tax evasion and corrupt acts and also the sources of these funds. A comprehensive anti-corruption strategy therefore requires a properly functioning anti-money laundering regime where predicate offences, such as tax evasion, are clearly recognised.

5.6 Implementation of a legislative and regulatory environment for revenue collection

The OECD very relevantly points out that the lack of a clearly defined legal and regulatory framework may constitute a major driver of corruption (OECD 2014, p. 67). The problem is exacerbated through the absence of a well-functioning tax administration. In this context, the *African Tax Outlook* (African Tax Administration Forum, 2017, p. 100) also highlights that ‘manual registration, filing and payment procedures involve person-to-person interaction between tax officials and taxpayers’ that can create opportunities for corruption. The IMF (International Monetary Fund, 2015, p. 35) advises that in view of the cost of corruption in revenue administrations in terms of both short-term revenue losses and long-term erosion of compliance, a range of risk mitigation measures are required including simple, transparent and to the extent possible automated procedures, strong information systems and high-profile prosecutions.

Escaping from the costly and harmful ‘equilibrium’ of high corruption and low tax revenue is difficult and both a strong political will and whole-of-government approach are essential if anti-corruption efforts are to have any chance of success (International Monetary Fund, 2015, pp. 35-36). Tax design issues that may create opportunity for corruption also need to be considered. In this regard, the IMF cautions against the use of presumptive taxes based on physical assessments, because they tend to be complex and prone to corruption (International Monetary Fund, 2015, p. 58). In this context, for firms below the value-added tax (VAT) threshold, a simple turnover tax that is levied at one or two rates differentiated across sectors can serve as a basic form of income tax.

Some key areas identified by the OECD (2014, p. 67) that can mitigate tax evasion and corruption, and that have taken up across the African continent include:

1. promoting the use of tax information exchange agreements as an instrument for fighting cross-border tax evasion in developing countries;
2. fully implementing international standards on exchange of information, expansion of a network of information exchange agreements between OECD and developing countries, and exploring possible automatic exchange of information;
3. increased efforts to build capacity in developing countries to enable exchange of information;
4. expansion of networks of treaties with relevant countries and jurisdictions through instruments such as the Multilateral Convention on information exchange;
5. strengthening institutions and systems to prevent and combat tax evasion. For tax and customs administrations, post clearance audit and risk management capacities are critical to: (a) identifying false invoicing; (b) assessing the risk;

- (c) auditing the transactions and entities involved; and (d) reporting the results in detail;
6. strengthening the ability to detect and pursue criminal activity by adoption of a ‘whole-of-government’ approach to fighting tax and other financial crimes.

Country by Country Reporting²⁵ is useful in providing tax administrations with a means to risk assess multinational enterprises through provision of data on the overall allocation of profits within the group across multiple jurisdictions, and whether a bias exists towards low-tax jurisdictions or whether intragroup trading reflects trade mispricing practices.

5.7 Implementation of beneficial ownership requirements

A wide range of business activities are conducted through corporate entities and other types of legal structures such as companies, trusts, partnerships and foundations, and while these corporate vehicles play an essential and legitimate role in the global economy, they can also be used in some circumstances for illicit purposes such as corruption and tax evasion (Financial Action Task Force, 2014, p. 3).

The Financial Action Task Force (2014, p. 3) highlights that a meaningful reduction of various abuses of corporate vehicles could be brought about if there was information available to authorities regarding the legal owner and the beneficial owner of such vehicles, the different sources of their assets, and its business activities. Beneficial ownership information facilitates better identification of perpetrators of predicate crimes and ‘following the money’ through identification of assets and accounts held through corporate vehicles, particularly in cross-border situations (Financial Action Task Force, 2014, p. 3). There are, however, significant challenges involved in implementing beneficial ownership information measures. Many African countries do not have automated company registers in place nor are there interfaces between public institutions and revenue bodies which can ensure better integration of data. Therefore it may take considerable time for many African countries to develop, implement and have beneficial ownership requirements available for the purposes of domestic law enforcement and international exchange.

5.8 Addressing the cultural aspects that fuel corruption

According to the *African Tax Outlook*, tax and customs rank third after government procurement and land administration on the corruption scale (African Tax Administration Forum, 2017, p. 24). While disciplining of corrupt staff is recommended, and stringent pre-screening and vetting when recruiting carried out, the African Tax Administration Forum (2017, pp. 104, 106) considers that upstream action should, however, take precedence in that revenue authorities should build integrity and anti-corruption into corporate culture and require their staff to work and behave in accordance with ethical standards. Anti-corruption and integrity have become key agenda items for meetings year round of, for example, the Botswana and Burundi revenue authorities; in addition, employees ‘should be financially literate and

²⁵ Under the OECD’s Base Erosion and Profit Shifting (BEPS) Action 13, a template is provided for the means by which multinational enterprises (MNEs) must report annually and for each tax jurisdiction in which they do business: OECD, *Country by Country Reporting*, <<http://www.oecd.org/tax/beps/country-by-country-reporting.htm>>.

trained to recognise and respond to fraud, conflicts of interest and integrity dilemmas' (African Tax Administration Forum, 2017, p. 106).

Apart from the above conceptual management principles, however, cultural attitudes to political institutions and actors are also highly relevant, and, in many African countries, the service-based nature of political leadership as enshrined in democracy in theory is replaced by a 'serve me' mentality in practice (see, for example, Antwi, 2017). This observation reflects the general unwillingness or protracted time it takes – if at all – for such countries to prosecute corrupt leaders. For example, while the South African President was charged with corruption in 2008, it took nearly a decade for the Appeal High Court to confirm that the charges are legitimate.²⁶ Similarly, in Kenya charges against ministers for signing overpriced or fake contracts for equipment that amounted to as much 16 per cent of the annual budget, were brought in 2005 but prosecutions only launched in 2015 (The Economist, 2015). Antwi may to a large extent be correct when he points out that 'today, the average African politician knows that the worst punishment he/she might ever receive for corruption, is a couple of weeks of bad press' (Antwi, 2017).

6. CONCLUSION

African countries are faced with a huge challenge to reduce endemic corruption. Reflecting on her campaign of 2006 to eradicate corruption, the outgoing president of Liberia, President Ellen Johnson Sirleaf, stated in her final state of the nation address that corruption had been too firmly entrenched in Liberian society for her administration to eliminate it (Foxnews 2017). It is, however, clear from the example set by Botswana, that political will is the starting point for any country's anti-corruption drive. In the absence of political will, all the anti-corruption instruments are blunted and will not produce the results that the programs are designed to achieve, such as prosecution of high level officials, repatriation of assets and the protection of whistle blowers.

Corruption is damaging to the social contract because it weakens the legitimacy of the state and results in low tax compliance levels. Tax policy is an important tool for good governance and good governance is also a measure to prevent and combat corruption. The presence of corruption negates or skews the objectives of the tax regime because corrupt politicians approve contracts that allow for unreasonable exemptions, thus affecting the taxation of profits. Over and above institutional improvements, it is important that African countries promote transparency and accountability, encourage and protect whistle blowers and promote leadership in the service of citizens. These are critical steps needed because weak institutions dominated by patronage networks, can fail to detect outflows that escape taxation, either through corruption, money laundering, tax evasion or avoidance strategies.

²⁶ See 'SA President Zuma must face corruption charges, court rules', *BBC News*, 13 October 2017, <<http://www.bbc.com/news/world-41607511>>.

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Causes and consequences of corruption in tax administration: An Indonesian case study

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Abstract

This article uses an Indonesian case study (the Gayus case) to explore critical issues in the relationship between tax and corruption. More particularly, it considers the causes and impact of corruption at tax administrative levels in Indonesia, and identifies and evaluates strategies the Indonesian revenue authority (the Directorate General of Taxation, or DGT) has adopted, or can adopt, to ensure opportunities for such corrupt activity are mitigated or eliminated. The article adopts a qualitative approach, utilising archival analysis supplemented by interviews and correspondence with key parties involved. After a broad introduction which outlines the nature, types and impact of corruption in revenue authorities, the article identifies the principles that typically underpin anti-corruption strategies in revenue authorities in developing countries, together with examples of some of the anti-corruption strategies employed. It then considers the nature of the corrupt activity exemplified by the Gayus case in Indonesia, how it arose, and how it came to light. This is followed by a consideration of the impact upon the organisation, how the DGT dealt with it and what changes came about as a result in terms of anti-corruption strategies subsequently adopted and now operating in the DGT. The article concludes with a section on the lessons learned and prospects for the future, both in Indonesia and elsewhere in the Asia-Pacific region.

Keywords: tax, tax administration, corruption, compliance

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1. INTRODUCTION

No society is immune from corruption,³ and within any society taxation plays a pivotal role in relation to such activity – which can be both positive and negative. Positively the tax system can provide the kind of regulatory framework and institutional foundations which can help to eradicate or constrain corrupt practices. On the negative side, corruption reduces tax compliance.⁴ Even perceptions of corruption, whether ‘grand’ or ‘petty’, seriously undermine taxpayers’ intention to report actual income.⁵

The relationship between tax and corruption is complex and it is also critical, and nowhere is this more the case than in the role a revenue authority plays in its administration of the tax system. A revenue authority acting with integrity, effectively and transparently administering the many facets of the system from taxpayer registration through to final tax collection and acquittal, will underpin good governance in any society. Conversely, where the revenue authority is distrusted, fails to carry out its duties in an impartial manner, and does not follow legal and socially accepted norms, then the social, economic and legal fabric will be fragile at best. ‘No tax is better than its administration, so tax administration matters – a lot’.⁶ And an essential objective of tax administration is to ensure the maximum possible compliance by taxpayers of all types with their taxation obligations. Unfortunately, in many developing countries, tax administration is ‘usually weak and characterised by extensive evasion, corruption and coercion. In many cases overall tax levels are low, and large sectors of the informal economy escape the tax net entirely’.⁷

As noted by the International Monetary Fund (IMF), ‘defining corruption in a comprehensive way is difficult both because corrupt behaviour varies and because it is generally concealed from public view’.⁸ The generally accepted definition adopted by the IMF – ‘the abuse of public office for private gain’ – is entirely relevant for the focus of this article, involving corruption in a revenue authority. It emphasises the point made by Soreide that ‘at its core, corruption is trade in decisions that should not be for sale’.⁹ That ‘trade’ can take a variety of forms and encompass a ‘range of acts, allocations and bargains....[including] “extortion”, “bribery”, “collusion” and “negligence”’.¹⁰

³ Transparency International, ‘Corruption Perceptions Index 2015’ <<http://www.transparency.org/cpi2015>>

⁴ James Alm, Jorge Martinez-Vazquez and Chandler McClellan, ‘Corruption and Firm Tax Evasion’ (2016) 124 *Journal of Economic Behavior and Organization* 146, 146.

⁵ Arifin Rosid, Chris Evans and Binh Tran-Nam, ‘Do Perceptions of Corruption Influence Personal Income Taxpayer Reporting Behaviour? Evidence from Indonesia’ (2016) 14(2) *eJournal of Tax Research* 387.

⁶ Roy Bahl and Richard Bird, ‘Tax Policy in Developing Countries: Looking Back – and Forward’ (2008) 61(2) *National Tax Journal* 279, 296.

⁷ Deborah Brautigam, ‘Introduction: Taxation and State-Building in Developing Countries’ in Deborah Brautigam, Odd-Helge Fjeldstad and Mick Moore (eds), *Taxation and State-Building in Developing Countries: Capacity and Consent* (Cambridge University Press, 2008) 1, 3.

⁸ IMF, ‘Corruption: Costs and Mitigating Strategies’ (IMF Staff Discussion Note SDN/16/05, May 2016) 3.

⁹ Tina Søreide, *Corruption and Criminal Justice: Bridging Economic and Legal Perspectives* (Edward Elgar, 2016) 17.

¹⁰ *Ibid* 14.

The costs of corruption are substantial. The IMF, noting that these costs are difficult to measure, nonetheless suggests that the annual costs of bribery alone¹¹ in developing and advanced economies are in the order of USD 1.5 trillion to 2 trillion (or roughly 2 per cent of GDP).¹² The same report goes on to note that corruption has a number of other manifest and direct implications for taxation. *Inter alia* it can: weaken the state's capacity to tax, leading to lower revenue collections; create disincentives for taxpayers to pay taxes; reduce the impetus for the state to collect taxes; and undermine spending programs.¹³

This article uses an Indonesian case study as a framework to explore critical issues in this relationship between tax and corruption. More particularly, it considers the causes and impact of corruption at tax administrative levels in Indonesia, and identifies and evaluates strategies the Indonesian revenue authority (the Directorate General of Taxation, or DGT) has adopted, or can adopt, to ensure opportunities for such corrupt activity are mitigated or eliminated. This is done in the context of an evaluation of a major tax office corruption scandal that has occurred in recent years in Indonesia: the Gayus case.¹⁴

The article adopts a qualitative approach, utilising archival analysis supplemented with interviews and correspondence with key players involved. After this introduction, section 2 identifies the principles that typically underpin anti-corruption strategies in revenue authorities in developing countries, together with examples of some of the anti-corruption strategies employed. The article then considers (section 3) the nature of the corrupt activity exemplified by the Gayus case in Indonesia, how it arose, and how it came to light. This is followed (in section 4) by a consideration of the impact upon the organisation, how the DGT dealt with it and what changes came about as a result in terms of anti-corruption strategies subsequently adopted and now operating in the DGT. The article concludes (section 5) with a section on the lessons learned and prospects for the future, both in Indonesia and elsewhere in the Asia-Pacific region.

2. PRINCIPLES AND STRATEGIES¹⁵

The integrity of its staff and systems is a vital component of any effective revenue administration, and yet – as Bahl and Bird point out – corruption and taxation have always been associated in history – and not just in developing countries.¹⁶ It would be naïve to believe that corruption is not a serious issue in most developing economies – indeed Uche and Ugwoke noted in 2003 in relation to Nigeria, for example, that '[t]he major threat to the effective administration of VAT in Nigeria ... is the widespread

¹¹ As noted earlier, bribery is only one aspect of the possible forms of corruption.

¹² IMF, 'Corruption: Costs and Mitigating Strategies', above n 8, 5.

¹³ *Ibid* 6-7.

¹⁴ Gayus Halomoan Partahanan Tambunan, a relatively low-ranking DGT official.

¹⁵ Parts of this section are based upon material originally contained in Margaret Mc Kerchar and Chris Evans, 'Sustaining Growth in Developing Economies through Improved Taxpayer Compliance: Challenges for Policy Makers and Revenue Authorities' (2009) 7(2) *eJournal of Tax Research* 171.

¹⁶ Bahl and Bird, above n 6, 291, citing Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World* (Simon and Schuster, 1986).

corruption and indiscipline which are deeply entrenched in all aspects of the country's social and economic life'.¹⁷

Corruption may be systematic – involving groups of employees acting together in a corrupt fashion and often led by senior staff – or individual; and may or may not involve external 'clients'. Examples are not difficult to cite: charging for services that should be free; diverting cash; making false repayment claims; losing files; and receiving payments to complete tax returns or bribes to favourably settle audits. And corruption is not limited simply to tax activities – it can also include abuses of power such as theft or private use of goods like office equipment; fraudulent subsistence and travel allowance claims; and stealing time to pursue outside interests and/or employment.¹⁸

The consequences of corruption are obvious. It is a cancer that destroys the organisation itself and undermines all other aspects of society. It erodes confidence in the tax system and encourages evasion. It increases the costs of doing business and distorts the level playing field that should be available. And to the extent that there is a political limit as to the amount of tax that people will bear in developing countries (and that there is therefore a substitution effect between taxation and corruption), it reduces the amount of formal tax that can be collected.¹⁹

A comprehensive literature already exists on how to design and implement effective anti-corruption strategies in revenue authorities.²⁰ This section of the article merely highlights some key aspects from that literature in order to provide the context for the analysis of the Gayus case in Indonesia, explored in section 3. It begins by looking at a series of high level priorities and principles that the literature suggests are critical in attempting to tackle corruption in what Johnston terms 'fragile situations'.²¹ This is followed by a brief consideration of some of the key strategies that the literature has suggested may be appropriate (though they are very context-specific and are not always successful) in tackling corruption in revenue authorities.

¹⁷ Chibuike Uche and Onuora Ugwoke, 'The Law and Practice of Value Added Tax in Nigeria' (2003) 57(6) *Bulletin for International Taxation* 265, 272.

¹⁸ David Child, 'Key Steps to Address Corruption in Tax and Customs' (U4 Brief No. 15, Chr. Michelsen Institute, May 2008) <<https://www.cmi.no/publications/3041-key-steps-to-address-corruption-in-tax-and-customs>> accessed 4 April 2017.

¹⁹ Bahl and Bird, above n 6, 291.

²⁰ See, for example, Nick Devas, Simon Delay and Michael Hubbard, 'Revenue Authorities: Are They the Right Vehicle for Improved Tax Administration?' (2001) 21 *Public Administration and Development* 211; Anwar Shah (ed.), *Performance Accountability and Combating Corruption* (World Bank, 2007) (especially ch. 9: Mahesh Purohit, 'Corruption in Tax Administration', 285); Aminur Rahman, 'Tackling Corruption through Tax Administration Reform' (*In Practice* Business Taxation Note 48312, World Bank, April 2009); McKerchar and Evans, above n 15; OECD, *Bribery and Corruption Awareness Handbook for Tax Examiners and Tax Auditors* (2013); Maira Martini, 'Approaches to Curbing Corruption in Tax Administration in Africa' (U4 Anti-Corruption Resource Centre Expert Answer, Transparency International and Chr. Michelsen Institute, 25 June 2014); Richard Bird, 'Improving Tax Administration in Developing Countries' (2015) 1(1) *Journal of Tax Administration* 23; IMF, 'Corruption: Costs and Mitigating Strategies', above n 8.

²¹ Michael Johnston, 'First, Do No Harm – Then, Build Trust: Anti-Corruption Strategies in Fragile Situations' (World Development Report 2011 Background Paper, World Bank, September 2010).

2.1 Priorities and principles

Johnston identifies two key priorities that must underpin any form of anti-corruption strategy. The first is ‘do no harm’ and the second is ‘build trust’.²²

The first priority (‘Do no harm’) means avoiding premature or poorly thought-out reforms that can do more harm than good – notably steps that overwhelm a society’s capacity to absorb aid and put it to effective use, and that risk pushing fragile situations and societies into particular kinds of corruption that are severely disruptive. The second imperative (‘Build trust’) is essential if complex, collective-action problems are to be minimized, and if reform is to draw broad-based report.²³

These are sensible points, to which the IMF is able to add a number of other broad principles, as follows:²⁴

1. an effective strategy requires a holistic and multifaceted approach, albeit one that is appropriately prioritised and sequenced, depending upon country-specific circumstances. Hence an effective anti-corruption strategy is likely to involve not only credible sanctions but also a recognition that the kind of behavioural change sought must be grounded in a core system of social values. Moreover, any such approach is likely to entail short, medium and long term instruments and strategies;²⁵
2. perceptions and expectations (whether of internal or external stakeholders) must be carefully managed according to the implementation horizon of many anti-corruption reforms. Certain strategies, such as anti-corruption laws, can be very quickly implemented; but credibility, and sustainability, will only be achieved where they are supported, or appropriately enforced, by effective social values and institutions, which inevitably require more time to develop. In addition, and as noted by Johnston, where expectations are too low, essential support for reform and for the local leaders and groups that must undertake it will be absent or difficult to sustain. But conversely, high expectations can be equally problematic;²⁶
3. reforms of a preventative nature (as opposed to reforms directly addressing corrupt activity) can be equally effective. Hence reforms addressing transparency, or enhancing the rule of law – which will have an indirect effect on corruption – may be just as effective as more direct measures (such as setting up an anti-corruption commission); and
4. there are significant challenges to measuring corruption and the success of anti-corruption strategies.²⁷ But such challenges should not be a reason for inaction, merely a recognised impediment built into the process of reform.

²² Ibid 2-3.

²³ Ibid 1.

²⁴ IMF, ‘Corruption: Costs and Mitigating Strategies’, above n 8, 15.

²⁵ Rahman, above n 20, 2-3.

²⁶ Johnston, above n 21, 6-7.

²⁷ See, for example, Fredrik Galtung, ‘Measuring the Immeasurable: Boundaries and Functions of (Macro) Corruption Indices’ in Charles Sampford, Arthur Shacklock, Carmel Connors and Fredrik Galtung (eds), *Measuring Corruption* (Ashgate, 2006) 101; Francisco-Javier Urra, ‘Assessing Corruption: An Analytical

2.2 Key strategies

Tax corruption depends, ultimately, on the willingness of tax officials on the one hand, and taxpayers or their intermediaries on the other, to engage in corrupt activity. As noted by Rahman, the key drivers of tax corruption are often based upon opportunities afforded by tax officials.²⁸ For example, in many countries, offering a bribe is the only way to make progress with tax matters (as in obtaining relevant documentation or progressing an appeal) or avoid harassment from tax officials. Rahman further notes that the underlying factors that can facilitate this willingness to engage in corrupt behaviour by tax officials include: complex and unclear tax laws and procedures; non-transparent hiring and reward mechanisms; a low level of skills; a lack of professional ethics and integrity; low pay and a lack of incentives; conflicts of interest; the ‘get-rich-quick’ syndrome; and insufficient checks and balances within the administration.²⁹ But the willingness of tax officials to act corruptly is often simply a response to an opportunity proffered by the taxpayer or agent. For example, businesses are often willing to pay a bribe if it reduces the tax cost and/or saves time in tax disputes.

Obviously, therefore, any strategies which directly impact upon the opportunity or willingness of the parties to engage in corrupt activities will be worthy of consideration. Many such strategies are now briefly considered.

2.2.1 *Corruption risk mapping*

The preparation of ‘Corruption Risk Maps’, designed to guide procedural changes to reduce opportunities of corruption, is a useful starting point for any revenue agency determined to tackle problems of corruption. In Columbia this strategy was successfully employed, based upon an initial systematic study of important business processes, to address the vulnerable points in the systems and identify optimal strategies for dealing with each.³⁰

2.2.2 *Human resource management*

The development and implementation of a transparent, fair and effective human resource management policy, involving all aspects of recruitment, performance appraisal, career development and remuneration is a vital aspect of any medium to long term reform process.³¹ Staff need to be carefully recruited on merit-based selection principles, and remunerated at levels which are at least broadly comparable to equivalent positions in banking and the accounting profession, have access to carefully developed in-house and external training possibilities and have realistic opportunities for career and income progression.

Review of Corruption Measurement and Its Problems: Perception, Error and Utility’ (Edmund A Walsh School of Foreign Service, Georgetown University, Washington, DC, May 2007); Carmen R Apaza, ‘Measuring Governance and Corruption through the Worldwide Governance Indicators: Critiques, Responses, and Ongoing Scholarly Discussion’ (2009) 42(1) *PS: Political Science & Politics* 139.

²⁸ Rahman, above n 20, 2.

²⁹ Ibid.

³⁰ Jit Gill, ‘The Nuts and Bolts of Revenue Administration Reform’ (World Bank, January 2003) 13 <<http://siteresources.worldbank.org/INTTPA/Resources/NutsBolts.pdf>> accessed 4 April 2017.

³¹ Rahman, above n 20, 3.

2.2.3 *Ethical policies and practices*

Staff must be aware of the importance of integrity at both the personal and organisational levels, and policy and practice must reflect this. It is not sufficient merely to introduce ethical 'Codes of Conduct', sets of internal disciplinary rules and instruments such as 'Taxpayers' Charters'; they also need to be shown to be 'living' documents that inform everyday activity and decision-making. Other practical measures include asset declarations for all staff, and the availability of avenues for whistleblowing (including protection from disclosure after the event). Collier et al., in an Indonesian context, identified that the establishment of peer learning groups in the workplace considerably enhanced and reinforced ethical behaviour and reduced corruption in a revenue authority when allied to internal training on the topic. The groups comprised a small number of trainees who maintained contact and reinforced communities of ethical practice in a variety of ways, including face to face meetings, and SMS and email groups, during and after the delivery of the training.³²

2.2.4 *Internal controls and deterrence*

Strong internal controls are an essential part of any strategy designed to address corruption in a revenue authority. Child notes that managers must be proactive and conduct desk and office inspections, and design procedures and systems that deter integrity lapses and make them easier to spot.³³ Other examples include restricting access by taxpayers to designated taxpayer service areas so that they cannot access other revenue authority work spaces; restricting access by employees to scanned copies of original records to prevent tampering; creating audit trails of administrative decisions and changes made to taxpayer current accounts; and separating the functions of assessing and collection in order to reduce opportunities for corruption and collusion.³⁴

In addition, an effective internal investigation force, combined with severe penalties (including dismissal and prosecution) for malfeasance and a strong likelihood of detection, will inevitably reduce the incidence of corruption. 'To the extent corruption follows an economic calculus, the expected value of the outcome of taking a bribe may be heavily influenced by the chances of getting caught and being heavily penalized'.³⁵

2.2.5 *Statutory changes*

Statutory changes to increase transparency, remove discretion and simplify the law can make a significant contribution to the enhancement of the integrity of the operation of the revenue authority. Where the structure of a particular tax is as transparent as possible, and obligations and liabilities are clearly stated, taxpayers will be less likely to be cheated. Bahl and Bird note that '[n]othing good can come of a situation in which tax administrators and tax payers negotiate over how large the tax liability should be. One problem in the practice of income taxation in developing

³² Kate Collier, Ali Rokhman, Sherria Ayuandini and Panca Kurniawan, 'Using "Workplace Learning Groups" - A Peer-Learning Approach — in the Indonesian Tax Office to Encourage Workplace Learning and Support Cultural Change within the Organisation' (Paper presented at the *Researching Work and Learning Conference 5*, Cape Town, South Africa, December 2007).

³³ Child, above n 18.

³⁴ Gill, above n 30, 13.

³⁵ Bahl and Bird, above n 6, 291.

countries is that, apart from withheld taxes, tax liabilities are, in fact, often negotiated'.³⁶ In similar vein, Awasthi and Bayraktur have produced empirical findings which support the existence of a significant link between measures of tax corruption and tax simplicity, such that a less complex tax system is shown to be associated with lower corruption in tax administration.³⁷

2.2.6 *Autonomous revenue authorities*

In recent years many developing countries have established their tax departments into autonomous or semi-autonomous revenue authorities ('ARAs'). It has been a noticeable worldwide trend, with some suggestions that the World Bank has, upon occasions, 'been a persuasive salesman'.³⁸ The defining feature of an ARA is some degree of autonomy whereby the revenue collection function is removed, either partly or wholly, from the Ministry of Finance. The management of the ARA therefore has significant independence in financial, personnel and operational matters, but is accountable for delivering agreed results, with continuation of appointment and renewal of contract for top management dependent upon revenue administration performance.³⁹ These independent revenue agencies, it is argued, are thus more able to provide better pay and other incentives to their staff while also imposing greater accountability for performance and reducing opportunities for corruption.⁴⁰ Taliercio argues that if one compares the pre- and post- reform state of affairs in countries where ARAs have been introduced, there is improvement in most cases along most dimensions of performance.⁴¹

Others are more circumspect. Gallagher notes that the jury is still out,⁴² while Fjeldstad and Moore suggest that many of the perceived advantages may have been short term and identify a number of conceptual and practical problems with ARAs that suggest they are not always the panacea that the World Bank may have suggested.⁴³ Whatever the true overall picture, it is certainly the case, as argued by Rahman, that 'autonomy minimizes the chances of the administration's involvement in political corruption and client favouritism'.⁴⁴

2.2.7 *Organisational options*

Regardless of whether the revenue authority is constituted as an autonomous or semi-autonomous body, the way in which it is internally organised can have a significant impact upon the effectiveness of the tax administration and its capacity to combat corruption.⁴⁵ Traditionally, three separate models for the organisation of revenue

³⁶ Ibid.

³⁷ Rajul Awasthi and Nihal Bayraktur, 'Can Tax Simplification Help Lower Tax Corruption?' (World Bank Policy Research Working Paper 6988, July 2014).

³⁸ Odd-Helge Fjeldstad and Michael Moore, 'Tax Reform and State-Building in a Globalised World' in Deborah Brautigam, Odd-Helge Fjeldstad and Michael Moore (eds), *Taxation and State-Building in Developing Countries: Capacity and Consent* (Cambridge University Press, 2008) 235, 249.

³⁹ Gill, above n 30.

⁴⁰ Mark Gallagher, 'Benchmarking Tax Systems' (2005) 25(2) *Public Administration and Development* 125, 130.

⁴¹ Robert Taliercio, 'Designing Performance: The Semi-Autonomous Revenue Authority Model in Africa and Latin America' (World Bank Policy Research Working Paper 3423, October 2004).

⁴² Gallagher, above n 40, 133.

⁴³ Fjeldstad and Moore, 'Tax Reform and State-Building in a Globalised World', above n 38, 249-255.

⁴⁴ Rahman, above n 20, 4.

⁴⁵ Charles Vehorn and John Brondolo, 'Organizational Options for Tax Administration' (Paper presented at the 1999 Institute of Public Finance Conference, Zagreb, June 1999).

authorities have been suggested both in the broader organisational theory literature⁴⁶ and in more specific literature relating to tax administration:⁴⁷

1. product-based, relating to the type of tax (income tax, VAT, etc.) administered by the revenue authority;
2. functional, relating to the different administrative functions performed by revenue authorities such as processing tax returns, or auditing, or collecting taxes; and
3. client-based, relating to the different types of taxpayer according to criteria such as scale of operation (large, small, etc.), form of ownership or industrial/economic sector.

Developing countries have tended to move away from product-based structures built upon different types of tax to those which are based upon function, although often with elements of a client-based market segmentation approach also in evidence (for example, the introduction of large taxpayers units focusing upon the large companies which are often responsible for a disproportionate amount of revenue collections; or the introduction of industry-based organisational structures).⁴⁸ In this way they have been able to secure the advantages of improved accountability and control, enhanced compliance, better administrative efficiency, reduced corruption and more customised taxpayer service.

2.2.8 *Minimise taxpayer/revenue agency interaction*

The higher the level of contact and interaction between tax officials and taxpayers, the greater the scope for corruption and collusion. Therefore minimising that contact through the use of self-assessment, withholding taxes and the like can be an effective strategy. Gill identifies examples from Latvia and Russia where work processes were modified to reduce interaction between tax officials and taxpayers,⁴⁹ and Bahl and Bird note that VAT and payroll taxes tend to score relatively highly in this respect.⁵⁰

2.2.9 *Reduce compliance costs*

Compliance costs for taxpayers in developing countries are four to five times higher than those in developed countries.⁵¹ This therefore suggests that reducing compliance costs 'lowers the amount of bribe a (rational) taxpayer might be willing to pay to avoid the declaration and payment process'.⁵²

2.2.10 *Other strategies*

Other strategies mentioned by Rahman include greater institutional use of e-services and automation; simplified and standardised procedures; and taxpayer outreach and

⁴⁶ For example, B J Hodge, William Anthony and Lawrence Gales, *Organization Theory: A Strategic Approach* (Prentice Hall, 5th ed., 1996).

⁴⁷ Vehorn and Brondolo, above n 45.

⁴⁸ Ibid 21; Gallagher, above n 40, 133; Fjeldstad and Moore, 'Tax Reform and State-Building in a Globalised World', above n 38, 248.

⁴⁹ Gill, above n 30, 13.

⁵⁰ Bahl and Bird, above n 6, 291.

⁵¹ Chris Evans, 'Studying the Studies: An Overview of Recent Research into Taxation Operating Costs' (2003) 1(1) *eJournal of Tax Research* 64.

⁵² Bahl and Bird, above n 6, 291.

education.⁵³ One strategy that does not appear to have been successful in combating corruption is the privatisation or outsourcing of the tax collection function. Tax farming (the process where the right to collect tax is auctioned off to a private agent in exchange for a fixed sum payable in advance) and tax sharing (whereby private agents collect taxes, with the right to keep a share of the total collection) have often been introduced with the objective of reducing administrative costs and increasing the level and reliability of collections.⁵⁴ The examples of outsourcing of some local authority tax collection in Tanzania and Uganda suggest that they may sometimes have succeeded in increasing revenue collections, but that the levels of corruption have also increased.⁵⁵

3. THE GAYUS CASE

The Gayus case stands out – in terms of media coverage and organisational impact – as one of the more infamous and significant tax corruption cases in Indonesia in recent years. Gayus Tambunan was an official in the Indonesian DGT in the period up to 2009, where his role was Tax Objection and Appeal Reviewer.⁵⁶ As a civil servant Group IIIA, his net income in the year ended 31 December 2009 was IDR 9,263,600 per month (AUD 926.36); it was subsequently established that he had around IDR 28 billion (AUD 2,800,000) in his bank accounts in that year.

Gayus' name first emerged into the public spotlight in July 2009 when he was mentioned as a potential money laundering suspect by police involved in the investigation of the so-called judicial mafia. This suspicion had come from the Center for Financial Transaction Reporting and Analysis (PPATK), which had identified substantial bank accounts belonging to Gayus in Bank Panin and Bank BCA. The police then conducted an investigation into the case and on 7 October 2009, investigators from the Criminal Police Headquarters sent a Notice of Commencement of Investigation to Gayus, formally identifying him as a suspect. In the file sent by police investigators to the prosecutor's office, Gayus was alleged to be involved in corruption, money laundering, and embezzlement. His assets were initially frozen, but surprisingly unfrozen in November 2009. Even more surprisingly he was initially cleared by a local court of various charges laid against him in March 2010.

Later in 2010, however, fresh charges were laid, and Gayus was indicted on the following counts:

⁵³ Rahman, above n 20, 2-3.

⁵⁴ Anuradha Joshi and Joseph Aye, 'Associational Taxation: A Pathway into the Informal Sector' in Deborah Brautigam, Odd-Helge Fjeldstad and Michael Moore (eds), *Taxation and State-Building in Developing Countries: Capacity and Consent* (Cambridge University Press, 2008) 183, 190.

⁵⁵ Godfrey Bahiigwa, Frank Ellis, Odd-Helge Fjeldstad and Vegard Iversen, 'Uganda Rural Taxation Study', Report commissioned by Department for International Development (UK) Uganda, Economic Policy Research Centre, Kampala, 2004; Daniel Kobb, 'Corruption in Tanzania: An Application of Tax Farming' (Mimeo, Tanga Tanzania and KKonsult USA, 2004).

⁵⁶ The literature refers to him variously as a 'fairly low level tax official' (Howard Dick, 'Statistics, Half-Truths and Anti-Corruption Strategies' in Tim Lindsey and Helen Pausacker (eds), *Is Indonesia as Corrupt as Most People Believe and Is It Getting Worse?* (Centre for Indonesian Law, Islam and Society Policy Paper, Melbourne Law School, 2013) 5, 13), a 'relatively low ranking tax official' (Ross H McLeod, 'Survey of Recent Developments' (2011) 47(1) *Bulletin of Indonesian Economic Studies* 7, 8), and 'a middle level [of] DGT official' (Yustinus Prastowo, 'New Perspectives of Comprehensive Reform: Integrating Corruption Eradication and Tax Optimization Agenda' (Paper presented at the Tax and Corruption Symposium, Sydney, 12 and 13 April 2017) 3).

1. *first*, that Gayus, as a Reviewer in the Objections and Appeals Directorate of the DGT, together with four other DGT officials (a fellow Reviewer from the same Directorate, the Head of Section and the Deputy Director of the Tax Reduction and Objection Division and the Director of the Objection and Appeal Division) committed or participated in an unlawful act, to enrich themselves or another person or a corporation, detrimental to the country's finances, in handling a tax objection filed by a small corporate taxpayer related to that taxpayer's tax liabilities;
2. *second*, that Gayus, together with another person, at various times between August 2009 and November 2009, attempted to bribe investigators from the Civil Service Criminal Investigation Police Headquarters to persuade them to use their positions of power and authority to cease their investigation of his financial transactions;
3. *third*, that Gayus attempted to bribe a judge with the intention of influencing his trial case, so that he would escape a prison sentence or so that his sentence would be reduced; and
4. *fourth*, that Gayus in September 2009 at the office of the Criminal Investigation Police Headquarters and Manhattan Hotel (South Jakarta) gave false information in relation to the ongoing investigation.

Based on the above indictments, Gayus was found guilty and sentenced to seven years in prison, together with a fine of IDR 300 million. In addition, and unsurprisingly, Gayus was served with a dishonourable discharge from his DGT employment on the basis that he had violated the employment code of conduct.

There are a number of rather unsettling and somewhat unsavoury aspects of the Gayus case. The corrupt activity in the case appears to have been corruption by greed rather than corruption by need, particularly given that the Ministry of Finance of the Republic of Indonesia had increased the salary rates for their staff compared to other civil servants in years prior to 2009. Furthermore, the Gayus case became a major issue in Indonesia because, at that time, the DGT was in a period of modernisation and was particularly trying to increase the level of trust from taxpayers. This case, according to interviews with key personnel from the DGT,⁵⁷ had an adverse impact upon that process and, because of the heightened media interest,⁵⁸ significantly decreased the level of trust from taxpayers and reduced the ability of the DGT to achieve tax revenue targets that had been set for it.

It is also disturbing that Gayus was apparently able to leave prison on scores of occasions, on at least one of which he had travelled overseas on a false passport.⁵⁹ Moreover, he testified that he had received millions of dollars in bribes and fees from over 150 individual and corporate taxpayers, including three large companies

⁵⁷ Harry Gumelar, Director of Internal Compliance and Apparatus Transformation Directorate, interviewed 25 January 2017.

⁵⁸ See, for example, articles in the *Jakarta Globe*, 19 January 2011, 20 January 2011 and 5 February 2011; and in the *Jakarta Post*, 29 January 2011.

⁵⁹ It is noted, for example, that he 'bribed his way out of prison for short trips to Singapore, Kula Lumpur, Macau and famously to watch the tennis in Bali': Dick, above n 56, 13, citing Alice Budisatrijo 'Indonesian Taxman Gayus Tambunan Jailed for Corruption', *BBC News*, 19 January 2011 <<http://www.bbc.com/news/world-asia-pacific-12224782>>.

associated with the Golkar party chief, Aburizal Bakrie (though subsequently he recanted this aspect of his testimony).⁶⁰

But perhaps the most worrying aspect of the Gayus case is that the nature of the case, and the manner in which it unfolded, played directly into a narrative that has led the Indonesian public to suspect that there is a very large gap between policy rhetoric and action, and that the much-vaunted anti-corruption campaign being conducted in Indonesia at the time was largely ineffective and its impact overstated.⁶¹ Gayus was a relatively 'small fish' so far as corrupt activity was concerned, and the monetary penalty imposed was a very small proportion (only around 1 per cent) of the amount of bribes that were apparently extracted. Despite the very obvious involvement of powerful and wealthy taxpayers who had been involved in the corrupt activity, as well as very high ranking police officers and members of the judiciary, none of these 'big fish' involved in the same web of corruption as Gayus were ever prosecuted or sanctioned.⁶²

4. IMPACT UPON THE DIRECTORATE GENERAL OF TAXATION

In general, corruption within the DGT is influenced by several factors, often relating to opportunity (as noted in section 2). More particularly, interviews and correspondence with a senior DGT official suggest that corrupt activity within the DGT is driven by:⁶³

1. the non-compliance of taxpayers in fulfilling their obligations as required by the provisions. As a result, when the Account Representative (the relevant tax official) asks them to pay their tax liability, the taxpayer instead seeks to negotiate a lower amount, usually also offering a bribe, rather than pay the full amount of tax due;
2. in the audit process, where under-declarations or evidence of other forms of evasion are established, then the taxpayer attempts to negotiate a lower tax liability, again by offering a bribe, than the amount of the true tax assessment; and
3. taxpayers negotiating (with proffered financial inducements) with tax collectors and bailiffs to postpone or cancel the impounding of their assets as a result of the tax collection process.

It is, perhaps, slightly surprising that corrupt activity within the DGT would still be driven by the first and the third of these points. They would certainly have been primary drivers in the periods prior to the modernisation of the DGT but it would be expected that they would be less prevalent in more recent times. In the case of the first point, this is partly because taxpayers under supervision of a particular Account Representative are regularly rotated by the DGT. Arguably, therefore, the risk would be 'too high' for a 'rational' tax officer to undertake such blatantly corrupt activity.

⁶⁰ McLeod, above n 56, 8.

⁶¹ Ibid 7.

⁶² Ibid 8.

⁶³ Harry Gumelar, Director of Internal Compliance and Apparatus Transformation Directorate, interviewed 25 January 2017, supplemented by private correspondence dated 31 March 2017.

With respect to the third point, it also appears somewhat unlikely that tax collectors and bailiffs would be capable of postponing or cancelling the seizure of assets without being detected given the implementation of new real time and comprehensive information systems such as the DGT Information System (Sistem Informasi Direktorat Jenderal Pajak or SIDJP). Nonetheless, it is clear from interviews and correspondence that the DGT sees all three areas as potential points of vulnerability.

The anti-corruption strategy in operation in relation to the Indonesian DGT has, in recent years, involved both external and internal monitoring and control. The principal external driving agency since 2003 has been the Corruption Eradication Commission (Komisi Pemberantasan Korupsi or KPK). Its main functions are to investigate alleged corruption and, if sufficient evidence exists, to prosecute those suspected of engaging in it.⁶⁴ Dick suggests that, since 2004, it has been ‘the brightest star in Indonesia’s anti-corruption firmament’, having been remarkably successful, investigating and prosecuting ‘big fish’ such as ministers, parliamentarians, senior public servants, provincial chiefs, district heads and mayors across the country.⁶⁵ He also notes, however, that this success may be chimerical: that the KPK’s activities have been in the nature of ‘sustainable harvesting’. ‘In other words, as one “big fish” is reeled in, another takes its place. Sustainable harvesting is a good thing environmentally but not as a corruption eradication strategy. It does not reduce the rate of harvesting’.⁶⁶

It is probably reasonable to conclude that a low-level official such as Gayus would have been ‘flying under the radar’ of the external monitoring agency (the KPK), notwithstanding allegations that ‘big fish’ were possibly involved. As a result, the Gayus case probably did not have any serious implications for the external monitoring of corruption within the DGT. The KPK was not, in any obvious way, impacted by the Gayus case, and has continued its strategy of pursuing the perpetrators of ‘grand corruption’ rather than turning its attention to corrupt activity in the lower levels of the DGT.⁶⁷

The Gayus case, and cases like it such as that involving Dhana Widyatmika, another tax official,⁶⁸ and many other tax officials,⁶⁹ may not have resulted in the prosecution of any of the bigger fish involved in corrupt activities, nor any significant change in the manner in which external monitoring of the DGT takes place by agencies such as the KPK. But it has certainly had an impact upon the manner in which anti-corruption activity has subsequently been conducted within the DGT.

⁶⁴ Simon Butt, ‘Indonesia’s Anti-Corruption Courts: Are They as Bad as Most People Say and Are They Getting Better?’ in Tim Lindsey and Helen Pausacker (eds), *Is Indonesia as Corrupt as Most People Believe and Is It Getting Worse?* (Centre for Indonesian Law, Islam and Society Policy Paper, Melbourne Law School, 2013) 17.

⁶⁵ Dick, above n 56, 12.

⁶⁶ Ibid.

⁶⁷ This is the case despite suggestions from commentators that the KPK should target its resources and efforts more strategically on the goal of consolidating islands of integrity within the state apparatus – and particularly the Supreme Court, the Attorney General’s Office, and the DGT: see Dick, above n 56, 12.

⁶⁸ See Joko Sriwidodo, ‘The Implementation of Gijzeling in Solving Tax Corruption Cases in Indonesia’ (2016) 4(1) *Scientific Research Journal* 50.

⁶⁹ See Yustinus Prastowo, ‘New Perspectives of Comprehensive Reform: Integrating Corruption Eradication and Tax Optimization Agenda’ (Paper presented at the Tax and Corruption Symposium, Sydney, 12 and 13 April 2017) for a list of other DGT officials involved in bribery and other forms of corruption in recent years.

Based on the information gathered from DGT, the organisation does not distinguish between different forms of corruption (such as 'large' and 'small'); all irregularities or violations that are related to corruption (fraud) involving DGT officials now receive a 'zero tolerance' approach. Thus, legal action will ensue, providing strict penalties up to and including formal dismissal and prosecution. The Government of Indonesia has set penalties for disciplinary offences committed by civil servants.⁷⁰ These regulations contain categories and classifications of punishment for various offences, with disciplinary outcomes based upon the impact of the offence upon the work unit, institution and/or country. The case of Gayus, as the final outcome attests, clearly fell at the more egregious end of the scale of offences.

As a result of the Gayus case, many internal changes have occurred since 2012. For the purposes of this article, two major changes are now considered: in the first place there has been a significant change in internal organisation related to internal corruption monitoring and control; and secondly there have been developments in broader anti-corruption strategies conducted within the DGT.

4.1 Optimising the role of the Directorate of Internal Compliance and Apparatus Transformation

One prime example of change since Gayus is the change in the role of the Directorate of Internal Compliance and Apparatus Transformation (DICAT) within the DGT's organisational structure. The role of the DICAT is to formulate and implement policies and technical standardisation in internal compliance and apparatus transformation. Since the Gayus case, the DGT has optimised the role of this Directorate, especially through its Internal Compliance and Internal Investigation Unit. This unit operates as a formidable line of defence in order to supervise the implementation of the Code of Conduct through a variety of techniques, including random surprise inspections, surveillance, and others.⁷¹

The DGT has established this internal compliance unit to carry out the following functions: internal control monitoring; risk management monitoring; monitoring the code of conduct and disciplinary compliance; monitoring the follow-up of internal control results; and formulating recommendations on business process improvement.

This internal compliance regime within the DGT consists of both a preventative system and a reactive system. The preventative system entails compliance examination, monitoring of the DGT's Employee Code of Conduct, administration of the whistleblowing system, the obligation to submit the Civil Servant Wealth Report, risk management, and a Corporate Value Internalisation Program. In contrast, the reactive part of the system is conducted by an Internal Investigation Sub Directorate and embraces the following actions:

1. collecting materials and information on complaints received;
2. making recommendations to immediate supervisors to examine the disciplinary offences committed by employees; and
3. conducting 'red-handed operations' if there is valid information that will

⁷⁰ The Discipline of Civil Servants, Indonesian Government Regulation No 53 Year 2010, 6 June 2010.

⁷¹ Directorate General of Taxation (DGT), *Annual Report 2015: The Guidance Year of Taxpayers' Compliance: Building a Culture of Tax Compliance* (2015).

occur in order to discipline violation transactions.

4.2 Developments in the anti-corruption strategy within the DGT

Great emphasis is now placed on the DGT Code of Conduct,⁷² which consists of nine key obligations for employees and eight prohibitions (see Table 1). To facilitate the understanding and implementation of the code, the DGT has issued the Director General of Taxes Circular Letter No SE-33/PJ/2007 regarding Guidelines for Implementing DGT Code of Conduct. Initially, the code of conduct is implemented by each employee signing a Statement Letter of Willingness to Comply with DGT Code of Conduct. Although this existed prior to the Gayus case, greater emphasis has been placed upon adherence to the code since 2010.

Table 1: Employee Code of Conduct

Employee Obligations
1. Respect other people's religions, faith, and cultures
2. Work in a professional, transparent, and accountable manner
3. Secure DGT data and information
4. Provide best service to taxpayers, fellow employees, or other stakeholders
5. Obey official orders
6. Be responsible in using DGT properties
7. Abide by official working hours and rules
8. Become a role model for the community in fulfilling tax obligations
9. Behave, dress, and speak in a polite manner
Employee Prohibitions
1. Act in a discriminatory way in performing tasks
2. Become an active member or partisan of political parties
3. Abuse power
4. Misuse office facilities
5. Accept any gift in any form, either directly or indirectly, from taxpayers, fellow employees, or other stakeholders, which leads to the employee being suspected of abusing power
6. Misuse tax data and information
7. Perform actions which may lead to data disruption, destruction or alteration in the DGT information system
8. Break the norms of decency that can damage public image and dignity of DGT

Source: DGT (2017)⁷³

The DGT has adopted a three-line defence concept to monitor the correct implementation and operation of its code of conduct. The first line of defence lies with workplace supervisors who are specifically obliged to ensure that their subordinates strictly adhere to the code of conduct. The second line comprises the work carried out by the Internal Compliance Unit (see section 4.1 above) through surprise inspection, surveillance, and other mechanisms. Finally, a last line of defence

⁷² Regulated by Minister of Finance Regulation No 1/PM.3/2007.

⁷³ Private correspondence with DGT dated 31 March 2017, supported with Minister of Finance Regulation No 1/PM.3/2007.

is provided by the Inspectorate General of the Ministry of Finance which is particularly responsible for identifying violations of the code of conduct where fraud is indicated.

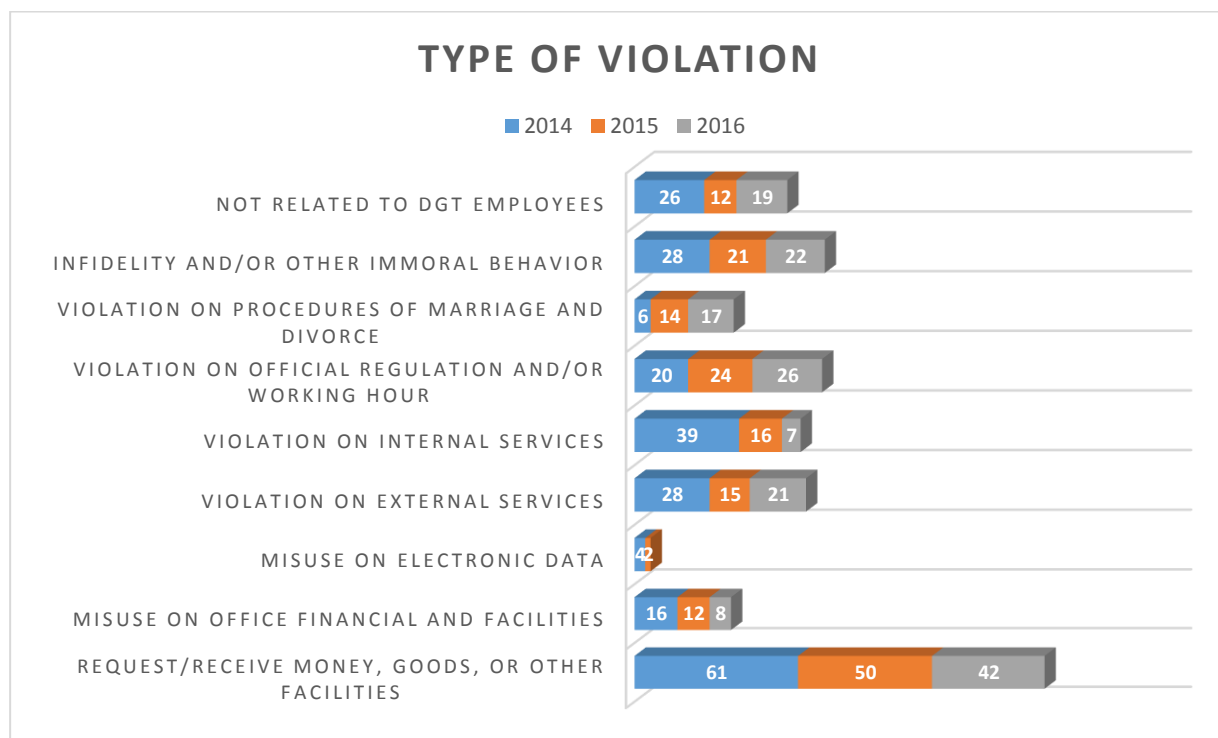
One further development since 2012 is the introduction of a comprehensive whistleblowing system to help provide early detection of violations of the code of conduct of employees. Currently, reports on the violation of the DGT code of conduct can be submitted in a variety of relatively easy and accessible ways, including through Help Desks and Call Centres, on a dedicated whistleblowing telephone hotline, and by fax, email and written letter. The number of violations reported in the period 2007 to 2016 is reported in Figure 1. It is interesting to note the spike in reports in the two years immediately following 2011, around the period when the Gayus case was receiving intense media publicity.

Figure 1: Number of Violation Reports



Source: DGT (2017)

Figure 2 identifies the types of violation report for the years 2014 to 2016.

Figure 2: Type of Violation Reports

Source: DGT (2017)

It is noticeable in Figure 2 that ‘bribery’ (requests for money, goods or other) is by far the largest category in each of the three years, but also encouraging that the trend is positive over the period, with very nearly a one-third decline in such reports in 2016 compared to 2014. A similar positive trend, albeit on significantly lower absolute figures, is evident in relation to the abuse/misuse of office finances and other facilities.

5. LESSONS LEARNED AND FUTURE PROSPECTS

In part the positive trends identified in the preceding section may reflect the development of a culture within the DGT that is more resistant than has hitherto been the case to the temptations of corruption. To demonstrate resistance to any sort of corruption, collusion, and nepotism, and to build resilience, the DGT has held various activities to nurture and foster an anti-corruption culture and spirit among its employees. For example, the commemoration of World Anti-Corruption Day was conducted by organising an anti-corruption poster-making contest, an anti-corruption exhibition, and an Anti-Corruption and Integrity Initiative Appraisal (Penilaian Inisiatif Integritas dan Anti Korupsi/PIIAK) program. In addition, the DGT organised an anti-corruption talk show, featuring anti-corruption activists, with the theme ‘United in Delivering Corruption-Free Transformation’ as a highlight of World Anti-Corruption Day 2015. The theme was raised with the expectation that the DGT employees would be united in helping to foster the DGT as an institution free from negative influences such as corruption, so that its work for Indonesia could be optimised.

Interviews recently conducted with DGT officials and others with a close knowledge of the DGT certainly suggest that there may have been a cultural shift with a positive change in the behaviour of DGT officials.⁷⁴ Noticeably they suggest, on a purely anecdotal basis, that corrupt activity has tended to decrease. In part this may be because officials are afraid to engage in corrupt activities because there is stronger penalty enforcement undertaken by the triple line internal defence mentioned in section 4.2 above (immediate supervisors, the DGT Internal Compliance Unit and the Inspectorate General of the Ministry of Finance) as well as external monitoring and control exercised by the KPK (the Corruption Eradication Committee). In addition, however, and based on the interviews, there appears to be a change in corporate culture, such that, whereas in the past it used to be common to find examples of 'collective corruption', in contrast, nowadays, a person acting in a corrupt fashion would more likely to be seen as an outlier or 'strange person'.⁷⁵

But there is also a recognition that this is an ongoing process where vigilance must be maintained. As noted by Dick, corruption in Indonesia is no small problem; among the G20 nations, Indonesia's perceived level of corruption is the worst except for Russia.⁷⁶ As such, the DGT recognises that it must continue to implement a series of carefully designed internal compliance programs with the aim of building integrity and trust in the system. To this end it is currently undertaking three initiatives as follows:

The 'know your employee' initiative

The DGT intends to make an initiative to 'Know Your Employee' a critical part of its culture. Direct supervisors will be expected to have a good understanding of their subordinates, based upon their performance and activities during working hours, as well as their lifestyles away from the office.

The role model program

This program is designed to create a culture where DGT leaders become role models, in terms of commitment and implementation of the values of the Ministry of Finance and the Employee Code of Conduct. With the commitment and role models of leadership, it is expected to motivate employees to continue to uphold and implement the values of the Ministry of Finance and Employee Code of Conduct.

The DGT care initiative

This is the development of a culture that should be emphasised within the DGT where officials are expected always to have a caring attitude towards the image of the DGT by not hesitating to remind fellow employees to always uphold the DGT Employee Code of Conduct and Discipline of Civil Servants and report those employees who show indications of violations, either to their immediate supervisor or through the whistleblowing system. This is designed to encourage a cultural change to one where an attitude of 'I will not let anyone spoil the DGT' becomes part of the

⁷⁴ Interviews conducted with Harry Gumelar from the Directorate Internal Compliance and Human Resource Transformation of the DGT; and with Yohanes (Tax academic and consultant); and Darussalam (Tax consultant and member of the Tax Reform team), on 25 January 2017.

⁷⁵ Based on the interview with Yohanes. As a former DGT official he may be in a good position to compare the 'old condition' and the 'current condition' of the DGT.

⁷⁶ Dick, above n 56, 14.

implementation of the Finance Ministry Core Values, particularly values related to integrity and professionalism.

Such initiatives, of course, may be judged to be effective, in the longer term, in helping to eradicate or mitigate the worst ravages of corruption within the DGT and helping to build trust between the taxpaying population of Indonesia and its tax officials. But – useful as they may eventually prove to be – they can only ever be a small part of the overall anti-corruption strategy. Many other instruments/levers and policy prescriptions will also be required. For example, as suggested by one of the interviewees, simplification of tax regulations is desperately needed so that the number of tax disputes can be reduced.⁷⁷ A reduction in the number of tax disputes inevitably removes a key set of opportunities for corruption and collusion.

Providing certainty in outcomes under tax laws and avoiding discretion wherever possible is also absolutely vital in reducing opportunities for corrupt behaviour by tax officials, taxpayers and their intermediaries. Sadly, it is therefore disappointing to end this article on a negative note. According to a government regulation issued in 2010⁷⁸ business enterprises that can persuade the relevant tax official that they are ‘pioneers’ – defined as those having ‘extensive linkages, providing high value-added and externalities, introducing new technology and having strategic value to the economy’ – may be granted unspecified special (discretionary) income tax treatment.⁷⁹ Whilst ever such discretions exist, surrounded by ill-defined and nebulous concepts, opportunities for corrupt behaviour by tax officials will continue to flourish.

This combination of complex tax laws (particularly when it comes to the process of tax dispute resolution as in the Gayus case), the discretionary power of tax officials (as was evident in the more recent Handang Sukarno case⁸⁰) and a general lack of adequate monitoring and supervision (notwithstanding the improvements noted above) is a toxic mix that is not easily tackled. Until it is, it will, sadly, continue to promote corrupt activity and bedevil the operation of the Indonesian tax system, and the role of the DGT in that system, for many years to come.

⁷⁷ Darussalam (Tax consultant and member of the Tax Reform team), interviewed on 25 January 2017.

⁷⁸ Number 94/2010. Article 29 is particularly open to abuse.

⁷⁹ McLeod, above n 56, 18-19.

⁸⁰ Handang Sukarno was the Head of the Sub-Directorate of Preliminary Audit in the DGT who was recently the centre of a corruption scandal in Indonesia.

Tax and corruption: Is sunlight the best disinfectant? A New Zealand case study

Lisa Marriott¹

Abstract

Recent events such as the release of the ‘Panama Papers’ to the public in April 2016 have increasingly focused the international community on the connection between tax systems and corruption. Countries benefit in multiple ways from the perception of low levels of corruption. Thus, greater focus is visible in many jurisdictions on increasing regulation to address corrupt activity. This article questions whether international pressure or national concerns are more likely to generate regulatory change in relation to the role of the tax system in facilitating corrupt activities. An historical institutionalist framework is used for analytical purposes. New Zealand is used as a case study to examine this issue as New Zealand is a country typically perceived to have low levels of corruption. This article explores two activities: the tax treatment of facilitation payments made to overseas public officials; and the tax treatment and disclosure requirements of foreign trusts. Facilitation payments made to overseas public officials are deductible for tax purposes in New Zealand. Current practice is showing no sign of change, despite perceptions that this practice denotes a permissive attitude towards corruption and is no longer tolerated in most other comparable tax jurisdictions. The tax treatment and disclosure requirements of foreign trusts together with the link between tax and corruption in New Zealand was highlighted with the release of the Panama Papers. This event generated international media interest with the suggestion that New Zealand was acting as a tax haven. The Panama Papers release resulted in an immediate inquiry, rapid production of a report with multiple recommended changes to extant practice and government agreement to act on all recommendations. The article concludes that sunlight is indeed the best disinfectant for addressing corrupt activities. However, protecting a country’s international reputation is likely to be a greater catalyst in achieving change than a country’s domestic concerns.

Keywords: taxation of foreign trusts, facilitation payments, New Zealand

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1. INTRODUCTION

It has been said that sunlight is the best disinfectant.² This study examines the impact of public scrutiny, and international and domestic concerns, in achieving regulatory change in relation to tax activities connected to corruption. There have been many high-profile cases of perceived tax corruption in recent times. For example, the release of the colloquially termed ‘Panama Papers’ in early 2016 highlighted how offshore entities were facilitating a range of illegal activities, including tax evasion.

This article uses New Zealand as a case study. New Zealand benefits from the widely held belief that it is a country with little corruption. This belief has some evidential backing: New Zealand ranks positively in most corruption measures. For many years Transparency International has ranked New Zealand among the least corrupt countries due to low levels of corruption in the public sector and transparent processes. However, other indices, such as the Financial Secrecy Index, rank New Zealand around the middle of 102 countries.³ In addition, political scandals⁴ and cases of public sector bribery⁵ have been visible in recent times. Moreover, New Zealand has been criticised for what is perceived as a permissive attitude towards some areas of corruption.⁶ Two of the activities that have attracted this criticism are explored in this article: the tax treatment of facilitation payments to overseas public officials (referred to as the facilitation payments issue); and the tax treatment and disclosure requirements of foreign trusts (referred to as the foreign trusts issue).

Globally, New Zealand is now an outlier with its tax treatment of facilitation payments. New Zealand legislation allows for facilitation payments to be deductible for tax purposes under certain circumstances. While historically this was not uncommon in other jurisdictions, most countries have now removed the tax deductibility of facilitation payments. However, New Zealand not only allows for facilitation payments to be tax deductible, it does not monitor how the deduction is used. The OECD and the United Nations have been critical of both facilitation payments and countries that allow them as tax deductions.⁷ However, this criticism has attracted little media attention and the issue of deductibility of facilitation payments has not been addressed.

New Zealand has also attracted criticism for its treatment of foreign trusts. The particular issue is that New Zealand taxes on the basis of the location of the settlor of a trust, rather than the trustee, which is the more common method of taxation in other countries. The consequence of this approach is that foreign trusts are not taxed in New Zealand, which is aligned with New Zealand’s principle of not taxing the foreign

² Attributed to Justice Louis D Brandeis. In the context of this article, the quote is included to suggest that increased transparency will assist with reduced corruption.

³ Tax Justice Network, ‘Financial Secrecy Index – 2015 results’ <<http://www.financialsecrecyindex.com/introduction/fsi-2015-results>>.

⁴ See, for example, Daniel Zirker and Patrick Barrett, ‘Corruption vs. Corruption Scandals in New Zealand: Bridging a Wide Gulf?’ (2017) 69(1) *Political Science* 35.

⁵ Patrick Barrett and Daniel Zirker, ‘New Zealand’s Panama Connection: Financial Services, Facilitation Payments, and A Legal Slippery Slope’ (2017) 3 *International Review of Transparency and Integrity* 1.

⁶ See, for example, OECD, *OECD Working Group on Bribery Annual Report 2014* (OECD Publishing, 2014) 60 <<http://www.oecd.org/tax/crime/oecdworkinggrouponbribery-annualreport.htm>>.

⁷ OECD, *Recommendation of the Council for Further Combating Bribery of Foreign Public Officials in International Business Transactions*, Adopted by the Council on 26 November 2009, para VI; United Nations Office on Drugs and Crime in Cooperation with PricewaterhouseCoopers, *Anti-Corruption Policies and Measures of the Fortune Global 500* (United Nations, 2015).

sourced income of non-residents. The issue exists in relation to New Zealand's disclosures, or historical absence thereof, which limit the capacity for most countries' tax authorities to have knowledge of the presence of the foreign trust. This supports the view that, while New Zealand is not facilitating tax evasion in its own country, it is effectively facilitating tax evasion in other jurisdictions. New Zealand's involvement in the international 'Panama Papers' scandal resulted in significant regulatory change in New Zealand, with a rapid inquiry led by one of New Zealand's most well-known tax commentators, with all recommendations subsequently agreed to by the government.

The tax treatment of facilitation payments and of foreign trusts in both cases posed threats to New Zealand's global reputation as a country with low levels of corruption. However, different responses resulted when each of the activities was brought into the public domain. Thus, the focus of this study is on the process of achieving change in the area of tax and corruption.

This article is structured as follows. Section 2 provides a brief background on corruption and the benefits gained when countries are perceived as having low levels of corruption. This section also outlines the relevant provisions of two international conventions that are targeted towards reducing corruption. A brief outline of historical institutionalism, the theoretical framework used for analytical purposes, is provided in section 3. Section 4 describes the New Zealand case study, including how New Zealand is perceived from a corruption perspective, and the two tax activities that are the primary focus of this study: the tax treatment of facilitation payments; and the treatment of foreign trusts. Section 5 outlines New Zealand's responses to possible threats to its reputation as a country with low levels of corruption. Section 6 outlines the lessons that may be learned from New Zealand's recent experience, with an analysis informed by an historical institutionalism lens. The study concludes in section 7.

2. BACKGROUND

There are many advantages gained by a country with a reputation as an honest location to do business. Correlations between low levels of corruption and higher levels of economic growth have been demonstrated. Research has shown that as a country's wealth increases, a country's corruption decreases⁸ and more developed economies have lower levels of corruption.⁹ It is generally agreed that the costs of capital are lower in a less corrupt country. This is captured by the International Monetary Fund (IMF) which observes the significant negative impact of corruption on channels that affect growth: corruption 'breeds public distrust in government and weakens the state's capacity to perform its core functions'.¹⁰ The IMF also notes that, depending on how pervasive corruption is, it can impact on multiple drivers of growth 'such as

⁸ Seini O'Connor and Ronald Fischer, 'Predicting Societal Corruption Across Time: Values, Wealth, or Institutions?' (2012) 43(4) *Journal of Cross-Cultural Psychology* 644.

⁹ Daniel Treisman, 'The Causes of Corruption: A Cross-National Study' (2000) 76(3) *Journal of Public Economics* 399.

¹⁰ International Monetary Fund, 'Corruption: Costs and Mitigating Strategies' (IMF Staff Discussion Note SDN/16/05, 11 May 2016) 5.

macro-financial stability, public and private investment, human capital accumulation, and total factor productivity'.¹¹

It is worth observing the link between perceptions of high levels of corruption and taxation. Studies have linked high levels of corruption to reductions in tax revenue collection.¹² Other studies have demonstrated links between low levels of tax collection and a weak compliance culture.¹³ This can result from a reduced willingness of taxpayers to pay tax when they perceive that others are not paying tax or it can result from reluctance to pay tax where it is perceived that taxes are poorly used in a corrupt state environment. Further impacts from corruption include:

1. lower revenue collection, undermining spending programs;
2. large fiscal deficits and increased debt accumulation;
3. undermining the independence of the central bank in implementing sound monetary policy;
4. discouraging financial development;
5. weak financial oversight and stability;
6. undermining recovery of debts or enforcement of claims;
7. increasing the cost and lowering the quality of public investment;
8. reducing private investment;
9. political instability;
10. harming countries' access to international credit markets; and
11. reducing productivity and reforms.¹⁴

The costs associated with corruption are significant. The IMF estimates the cost of bribery alone at USD 1.5-2 trillion per annum, which is approximately 2 per cent of global GDP.¹⁵ However, alongside the traditional financial costs associated with corruption are the non-financial costs, such as damage to a jurisdiction's reputation when it is considered to be corrupt. Therefore, perhaps it is not surprising that many countries have been quick to adopt more robust regulatory measures to prevent, detect and punish corruption.

There are two primary international conventions associated with bribery and corruption. The first of these was introduced in 1997 by the OECD - the OECD Convention on Combating Bribery ('*OECD Convention*').¹⁶ All OECD member countries have adopted the Convention, along with eight non-member countries. The aim of the OECD Convention is to ensure that countries adopt a shared responsibility

¹¹ Ibid.

¹² Timothy Besley and Torsten Persson, 'Why Do Developing Countries Tax So Little?' (2014) 28(4) *Journal of Economic Perspectives* 99.

¹³ International Monetary Fund, above n 10.

¹⁴ Ibid 5-13.

¹⁵ Ibid 5.

¹⁶ *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, signed on 17 December 1997, OECD (entered into force 15 February 1999).

for addressing corruption in international business transactions. Article 1 of the Convention requires countries to take measures ‘as may be necessary’ to establish a criminal offence under that country’s law for any person

intentionally to offer, promise or give any undue pecuniary or other advantage, whether directly or through intermediaries, to a foreign public official, for that official or for a third party, in order that the official act or refrain from acting in relation to the performance of official duties, in order to obtain or retain business or other improper advantage in the conduct of international business.¹⁷

The OECD Convention establishes legally binding standards that create an offence where foreign public officials are bribed in international business transactions. While the OECD cannot enforce the adoption of specific legislation in nation states, it does monitor and report on progress subsequent to countries ratifying the Convention. Since its introduction there have been three phases of monitoring nation states against the Convention.

The OECD view on tax deductibility of ‘bribes’ has changed since the introduction of the Convention. In early publications the OECD recommended that ‘those Parties that do not disallow the deductibility of bribes to foreign public officials re-examine such treatment with the intention of denying this deductibility’.¹⁸ The Recommendation of the Council on Tax Measures for Further Combating Bribery of Foreign Public Officials in International Business Transactions, published in 2009, has now moved to recommend that ‘member countries and other Parties to the OECD Anti-Bribery Convention explicitly disallow the tax deductibility of bribes to foreign public officials, for all tax purposes in an effective manner’.¹⁹ Moreover, OECD guidance on facilitation payments recommends that member countries

undertake to periodically review their policies and approach on small facilitation payments in order to effectively combat the phenomenon; [and] encourage companies to prohibit or discourage the use of small facilitation payments in internal company controls, ethics and compliance programmes or measures, recognising that such payments are generally illegal in the countries where they are made, and must in all cases be accurately accounted for in such companies’ books and financial records.²⁰

The OECD Convention continues to state that it urges ‘all countries to raise awareness of their public officials on their domestic bribery and solicitation laws with a view to stopping the solicitation and acceptance of small facilitation payments’.²¹ Thus, the signal from the OECD is that facilitation payments are not acceptable in the ordinary course of doing business.

¹⁷ Ibid art 1, para 1.

¹⁸ OECD Working Group on Bribery in International Business Transactions, ‘Review of the OECD Instruments on Combating Bribery of Foreign Public Officials in International Business Transactions Ten Years after Adoption’ (Consultation Paper, January 2008).

¹⁹ OECD, *Recommendation of the Council on Tax Measures for Further Combating Bribery of Foreign Public Officials in International Business Transactions*, (2009)64, 25 May 2009.

²⁰ OECD, *Recommendation of the Council for Further Combating Bribery of Foreign Public Officials in International Business Transactions*, above n 7, para VI.

²¹ Ibid para VII.

A further relevant Convention, the UN Convention against Corruption ('*UN Convention*'), was introduced by the UN in 2003. The aim of the UN Convention is

to promote and strengthen measures to prevent and combat corruption more efficiently and effectively; to promote, facilitate and support international cooperation and technical assistance in the prevention of and fight against corruption, including in asset recovery; to promote integrity, accountability and proper management of public affairs and public property.²²

The UN Convention has since been signed by 140 countries.²³ In a similar way to the OECD Convention, the UN Convention requires State Parties to adopt legislative and other measures to establish criminal liability for offering bribes to foreign public officials.²⁴ Like the OECD Convention, the UN Convention also covers the issue of tax deductibility of expenses that constitute bribes and facilitation payments. In relation to bribes the UN Convention states that 'each State Party shall disallow the tax deductibility of expenses that constitute bribes ... and, where appropriate, other expenses incurred in furtherance of corrupt conduct'.²⁵ In relation to facilitation payments, the UN position is noted in other policy documents:

[S]o-called 'facilitation payments', a form of bribery made with the purpose of expediting or facilitating the performance by a public official for a routine action, is a problem that many companies have to deal with. The United Nations Convention against Corruption prohibits facilitation payments.²⁶

The UN and OECD Conventions do not make specific comment on the use of trust structures to facilitate corrupt activity. However, the Base Erosion and Profit Shifting (BEPS) program currently being undertaken by the OECD is targeted at tax planning strategies that 'exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity'.²⁷ The OECD observes that, while some schemes are illegal, 'most are not', which 'undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level'.²⁸

3. HISTORICAL INSTITUTIONALISM

An historical institutionalist (HI) lens informs the analysis in this article. HI is used for analytical purposes, as it allows for the interaction between history, political institutions, public policies and societal preferences to be considered in understanding

²² *United Nations Convention against Corruption*, opened for signature 9-11 December 2003, 2349 UNTS 41 (entered into force 14 December 2005) art 1.

²³ United Nations Office on Drugs and Crime, 'United Nations Convention against Corruption, Signature and Ratification Status as of 21 September 2016' <<https://www.unodc.org/unodc/en/treaties/CAC/signatories.html>>.

²⁴ *United Nations Convention against Corruption* art 16.

²⁵ *Ibid* art 12, para 4.

²⁶ United Nations Office on Drugs and Crime in Cooperation with PricewaterhouseCoopers, *Anti-Corruption Policies and Measures of the Fortune Global 500*, above n 7.

²⁷ OECD, 'Base Erosion and Profit Shifting', <<http://www.oecd.org/tax/beps-about.htm>>.

²⁸ *Ibid*.

actual policy choices made.²⁹ Moreover, HI originally arose from a desire to explain variation, which is the objective of this study.³⁰ HI highlights a number of influencing factors within the political domain that contribute towards the different actions adopted in each of the scenarios discussed in this study.

HI is pluralist in its methodological approach, which allows for the multiple competing perspectives to be drawn out. HI supports macro-level analysis and seeks to focus on the interactions between multiple institutions and processes. The focus of HI on 'relations between politics, state and society'³¹ draws out the politically nuanced scenarios discussed herein. It is a feature of HI that it focuses on a small number of cases that have some commonality,³² which is relevant for the current study. HI can also assist with emphasising the historical impact of policies and institutions on future policy development³³ which is also relevant to this research.

HI has a number of components that assist with analysis of the two activities investigated in this study. Those that are particularly relevant are:

1. *Path dependency*, which is the idea that extant policy has a continuing or constraining influence over policy into the future.³⁴ At least in part, path dependency relates to the political risk associated with introducing new policy. HI provides for policy to evolve, with the caveat that a high level of political pressure is required to do so.³⁵ Reference back to the 'historical' component of HI is needed to track how ideas become embedded in practice. HI suggests that the concept of increasing returns links to path dependency, as policy directions become more difficult to change when they have moved steadily in one direction over time. This then requires a 'critical juncture' to achieve change.
2. *Critical junctures* are defined by Collier and Collier as major transitions in institutional life that shape politics and policy formation into the future; frequently 'the critical juncture is intertwined with other processes of change'.³⁶ The Panama Papers discovery may be considered as a critical juncture: it was a large event that resulted in meaningful societal impact. Moreover, the event resulted in significant policy change.
3. *Punctuated equilibria*, within the context of HI, involve the expectation that a policy will continue in a state of equilibrium, as determined by decisions made at its origin, or past point of punctuation. However, equilibria are not

²⁹ Sven Steinmo, 'Historical Institutionalism and Experimental Methods' in Orfeo Fioretos, Tulia G Falleti and Adam Sheingate (eds), *The Oxford Handbook of Historical Institutionalism* (Oxford University Press, 2016) 107.

³⁰ Ibid.

³¹ Ellen M Immergut, 'The Theoretical Core of the New Institutionalism' (1998) 26(1) *Politics & Society* 5, 17.

³² Kathleen Thelen, 'Historical Institutionalism in Comparative Politics' (1999) 2 *Annual Review of Political Science* 369.

³³ Jacob Torfing, 'Path-Dependent Danish Welfare Reforms: The Contribution of the New Institutionalisms to Understanding Evolutionary Change' (2001) 24(4) *Scandinavian Political Studies* 277.

³⁴ B Guy Peters, *Institutional Theory in Political Science* (Pinter, 1999) 63.

³⁵ Ibid 65.

³⁶ Ruth Collier and David Collier, *Shaping the Political Arena: Critical Junctures, the Labor Movement, and Regime Dynamics in Latin America* (Princeton University Press, 1991) 27.

permanent and are capable of change.³⁷ Punctuated equilibria highlight that new policies evolve during periods of crisis, with stasis visible during other periods.

4. *Power* is highlighted by HI in emphasising the uneven distribution of power among interest groups. The ‘institutional’ component of HI shows how institutions allocate power to some interests in the decision-making process. Studies have shown how policies may facilitate the organisation of interests through emphasising the legitimacy of particular claims.³⁸
5. *Ideas* are inevitably multiple and competing in tax policy. However, interests and ideas can interact, generating incentives that support certain behaviours and making ‘the expression of political views more or less viable for certain groups’, thereby impacting on the power held within certain institutions.³⁹ Perhaps the most important argument is the institutionalisation of certain behaviours, which constrains the potential for new ideas to be conveyed.⁴⁰ However, ideas can also help to communicate both the need for change and the form that this change should take. Ideas may also help in communicating the need for change and how this change can be structured. Blyth asserts that ‘change can reconstitute those interests by providing alternative narratives through which uncertain situations can be understood’.⁴¹ One example of a dominating idea in the New Zealand context is the ‘broad-base, low-rate’ approach that is generally adopted in relation to tax policy.

Historical institutionalism is used in this study to highlight the influences on the policy approaches adopted in the two case studies examined in this research. Specifically, the HI approach is used as a framework in section 6 to analyse the path dependency arrangements, punctuated equilibria, power and ideas that are visible in the two case studies discussed in sections 4 and 5.

4. CASE STUDY: NEW ZEALAND

New Zealand is typically perceived to be a country with low levels of corruption. This is supported by high rankings on many of the well-known surveys on corruption. Perhaps the most well-known measure of corruption is the Transparency International Corruption Perception Index (CPI). This is a global survey that measures the perceived level of public sector corruption across multiple countries. Corruption is measured on a scale from 0 to 100, where 0 is highly corrupt and 100 is not corrupt. Measures for New Zealand over the past five CPI rankings are outlined in Table 1. New Zealand is typically highly ranked by this measure and, while it fell from top position in 2014 and 2015, it returned to be equal first (with Denmark and Finland) in 2016.

³⁷ Peters, above n 34, 68

³⁸ Immergut, above n 31, 22.

³⁹ Peter A Hall, ‘The Movement from Keynesianism to Monetarism: Institutional Analysis and British Economic Policy in the 1970s’ in Sven Steinmo, Kathleen Thelen and Frank Longstreth (eds), *Structuring Politics: Historical Institutionalism in Comparative Analysis* (Cambridge University Press, 1992) 90, 91.

⁴⁰ Ibid.

⁴¹ Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge University Press, 2002) 38.

Table 1: Corruption Perception Index Rankings and Scores: 2011-2015⁴²

	2012	2013	2014	2015	2016
CPI (ranking)	1= (from 176 countries)	1= (from 177 countries)	2 (from 175 countries)	4 (from 168 countries)	1= (from 176 countries)
CPI (score)	90/100	91 / 100	91 / 100	88/100	90/100

It is worth observing that the Transparency International ranking is a perceptions-based index focused on the public sector, rather than an index measuring actual behaviours across a range of sectors, such as the private sector or not-for-profit organisations. An example of what is arguably a more comprehensive survey is the World Justice Project Rule of Law Index. The most recent survey was undertaken in 2016 and covers 113 countries and jurisdictions from over 100,000 household and other expert surveys that assess how the rule of law is experienced by the general public worldwide.⁴³ The scores in the Index are built from assessments of 1,000 local respondents per country as well as local legal experts.

Indicators in the Rule of Law Index are grouped by eight factors, which are outlined in Table 2. In the most recent Index, New Zealand scored 0.83 overall on a scale of 0-1, where 1 is the strongest adherence to the rule of law. This placed New Zealand at position 8 behind Denmark, Norway, Finland, Sweden, the Netherlands, Germany and Australia. The specific positions held by New Zealand are outlined in Table 2. Order and security, civil justice and criminal justice are the categories where New Zealand is weakest.

Table 2: Rule of Law Index Rankings for New Zealand (2016)⁴⁴

	Score	Global Ranking	Regional Ranking
Constraints on government power	0.86	6	1/15
Absence of corruption	0.90	6	2/15 (behind Singapore)
Open government	0.84	6	1/15
Fundamental rights	0.82	10	1/15
Order and security	0.86	15	5/15 (behind Singapore, Japan, Hong Kong and Australia)
Regulatory enforcement	0.82	8	2/15 (behind Singapore)
Civil justice	0.78	11	4/15 (behind Singapore, Japan and the Republic of Korea)
Criminal justice	0.75	13	4/15 (behind Singapore, Hong Kong and Australia)

Reference to a more recently developed ranking places New Zealand in a less favourable position. The Tax Justice Network launched their Financial Secrecy Index in November 2015. This Index provides a ranking of 102 jurisdictions according to

⁴² Transparency International, 'Corruption Perceptions Index 2016'

<http://www.transparency.org/news/feature/corruption_perceptions_index_2016#table>.

⁴³ World Justice Project, 'WJP Rule of Law Index 2016' <<http://worldjusticeproject.org/rule-of-law-index>>.

⁴⁴ Ibid.

the ‘secrecy and the scale of their offshore financial activities’.⁴⁵ The Tax Justice Network describe this ranking as ‘politically neutral’ and ‘a tool for understanding global financial secrecy, tax havens or secrecy jurisdictions’.⁴⁶ The term secrecy jurisdiction is used as an alternative to the term tax haven. New Zealand is ranked at position 54 on this Index, which is around the middle of the 102 countries included. The index covers measures such as how secretive the country is, how large its offshore financial services are and responses to 15 key financial secrecy indicators. In relation to the key financial secrecy indicators, New Zealand scores poorly on some transparency measures, in particular:

1. recorded company ownership, as New Zealand does not maintain company ownership details in official records;
2. public company accounts, as New Zealand does not require that company accounts be available on the public record; and
3. country-by-country reporting, as New Zealand does not require public country-by-country reporting by companies.⁴⁷

Of the 15 key financial secrecy indicators, only three score at the highest level and these three are related to efficiency of tax and financial regulation, and the network of bilateral treaties providing for information exchange on request.

Table 3 provides the Transparency International ranking (from 168 countries) and the World Justice Project ranking (from 113 countries) of the countries that are New Zealand’s top ten trading partners. Table 3 shows that many of the top trading partners are ranked highly. However, some, such as New Zealand’s top trading partner – China – are not. Other countries such as Malaysia and Thailand are also noted as countries with high levels of corruption.

Table 3: New Zealand’s Top Ten Trading Partners Rankings’ on Corruption Indices

Country	Trading Position	CPI Ranking (2016) ⁴⁸	Rule of Law Index Ranking (2016) ⁴⁹
China	1	83= / 168	80 / 113
Australia	2	13 / 168	11 / 113
US	3	16 / 168	18 / 113
Japan	4	18 / 168	15 / 113
Republic of Korea	5	37= / 168	19 / 113
Singapore	6	8 / 168	9 / 113
UK	7	10= / 168	10 / 113
Germany	8	10= / 168	6 / 113
Malaysia	9	54 / 168	56 / 113
Thailand	10	76= / 168	64 / 113

⁴⁵ Tax Justice Network, above n 3.

⁴⁶ Ibid.

⁴⁷ Tax Justice Network, ‘Report on New Zealand 2015’
<<http://www.financialsecrecyindex.com/PDF/NewZealand.pdf>>.

⁴⁸ Transparency International, above n 42.

⁴⁹ World Justice Project, above n 43.

A case study method is adopted in this study. The case study method is appropriate when the researcher has no control over the events being examined. Moreover, case studies typically examine phenomenon occurring within a real-life context.⁵⁰ The cases selected in this study are chosen as they reflect the underlying problem of potential damage to New Zealand's reputation as an honest jurisdiction in which to do business. Historical and current documents form the primary data source for the analysis, which is guided theoretically by historical institutionalism.

Notwithstanding the sometimes inconsistent results in rankings outlined above and the two case studies discussed in this article, New Zealand should not, as a general rule, be considered a corrupt country. The two case studies that are the topic of this research are selected due to their nature as outliers in a country that is typically considered as incorrupt. The following sub-sections outline these two tax case studies, both of which have attracted national and international criticism: the tax treatment of facilitation payments; and the tax treatment of foreign trusts.

4.1 Tax treatment of facilitation payments and bribes

Under s DB 45(1) of the *Income Tax Act 2007* (NZ) ('*Income Tax Act*'), bribes are not an allowable deduction. However, this is not extended to all bribes; instead, it is bribes given or offered within circumstances specified in ss 101, 102(2), 103(2), 104(2), 105(2), 105C or 105D(1) of the *Crimes Act 1961* (NZ) ('*Crimes Act*'). Moreover, s DB 45(1) does not apply in circumstances specified in s 105C(3) of the *Crimes Act*.

Before examining the specific sections of the *Crimes Act* two observations are necessary. The first is that s DB 45 overrides the General Permission of the *Income Tax Act*. The General Permission is s DA 1, which provides the general rule for deductibility of expenditures or losses, ie, that expenditures or losses must have a nexus with the derivation of income in order to meet the general test for deductibility. The second is the definition of a bribe, which is provided in s 99 of the *Crimes Act* as 'any money, valuable consideration, office, or employment, or any benefit, whether direct or indirect'.

In theory, a bribe is different from a facilitation payment, as a bribe is made to change or ascertain an unknown outcome, whereas a facilitation payment is made to confirm or accelerate a known outcome. However, the boundary between a bribe and a facilitation payment is not always clear. The Serious Fraud Office in the United Kingdom takes the position that 'a facilitation payment is a type of bribe and should be seen as such'.⁵¹ This approach is also visible in organisations such as the United Nations and the OECD.

The activities that the *Crimes Act* denies a deduction for are as follows:

1. bribery of a judicial officer (s 101);
2. bribery of a Minister of the Crown (s 102(2));
3. bribery of a Member of Parliament (s 103(2));

⁵⁰ Robert K Yin, *Case Study Research: Design and Methods* (Thousand Oaks, 2nd ed, 1994).

⁵¹ Serious Fraud Office (UK), 'Facilitation Payments' <<http://www.sfo.gov.uk/bribery--corruption/the-bribery-act/facilitation-payments.aspx>>.

4. bribery of a law enforcement officer (s 104(2));
5. bribery of an official (s 105(2));
6. bribery of a foreign public official (s 105C);
7. bribery outside New Zealand of a foreign public official (s 105D(1)).

The issues around the tax deductibility of bribes are twofold. First, it is only in the abovementioned activities that a bribe is *not* tax deductible. The second issue around tax deductibility of bribes is in relation to the bribery of a foreign public official under s 105C of the *Crimes Act* and in particular s 105C(3) which provides for the section to *not* apply when the act is ‘committed for the sole or primary purpose of ensuring or expediting the performance by a foreign public official of a routine government action; and the value of the benefit is small’.

No guidance is provided on what is ‘small’, ie, whether it is a small specific value, such as \$100 or \$1,000, or whether it is small relative to some financial measure within the organisation, such as 1 per cent of income or 1 per cent of net profit after tax. Thus, there is potentially wide scope for interpretation of ‘small’ within different organisations. No guidance is provided by the Inland Revenue on this issue, nor is there any monitoring by Inland Revenue on the use of this particular deduction by New Zealand entities.⁵²

Some examples are provided of what a ‘routine government action’ is not, rather than what it is. The s 105C definition of routine government action is that it

does not include any decision about whether to award new business; or whether to continue existing business with any particular person or body; or the terms of new business or existing business; or any action that is outside the scope of the ordinary duties of that official; or any action that provides an undue material benefit to a person who makes a payment; or an undue material disadvantage to any other person.

Reference to ‘ensuring’ or ‘expediting’ performance gives this expenditure the characteristics of a facilitation payment, rather than a bribe. The primary argument raised in support of retention of the tax deductibility of facilitation payments is that these are necessary to ensure that New Zealand businesses remain internationally competitive if they are trading in countries where facilitation payments or bribes are common practice. However, as there are few countries now that retain the practice of allowing tax deductible facilitation payments and/or bribes, this argument is significantly weaker than it was some decades earlier when the practice was more common (only Australia, Canada, the USA and the Republic of Korea retain the option for such a deduction).

The OECD and UN Conventions, together with the expected behaviours from signatories to these Conventions, were outlined in section 2. New Zealand has attracted criticism from both of these international organisations for an approach to addressing corruption which is perceived to be lax. In particular, the OECD has noted

⁵² Information received by author from the Inland Revenue Department, requested under the *Official Information Act 1982* (NZ).

serious concerns about the lack of enforcement of the foreign bribery offence. Since becoming a Party to the Convention in 2001, New Zealand has not prosecuted any foreign bribery cases. Only four foreign bribery allegations have surfaced. New Zealand opened its first investigations into two of these allegations in July 2013.⁵³

Of further relevance to this study is the critique in the most recent OECD report on implementing the OECD Convention.⁵⁴ The report identifies that while New Zealand has adopted legislative provisions that deny the tax deductibility of bribes, there are weaknesses in the legislation. The report notes that ‘the lead examiners are seriously concerned that, 7 years after its phase 2 evaluation, New Zealand has not addressed any of the weaknesses identified in its regime of non-deductibility of bribes’.⁵⁵

4.2 Foreign trusts

The foreign trust issue came to light in New Zealand with the release of what have become known as the ‘Panama Papers’.⁵⁶ The Panama Papers are believed to comprise around 11.5 million fraudulently obtained confidential documents from a Panama-based law and trust services firm, Mossack Fonseca.⁵⁷ New Zealand was referenced in the documents and the New Zealand media were quick to associate a range of corrupt practices with Mossack Fonseca to New Zealand. The scandal was deepened with the identification of the involvement of the personal lawyers of the then Prime Minister, John Key, in lobbying to stop an Inland Revenue review of the rules associated with New Zealand foreign trusts.⁵⁸

4.2.1 *The tax treatment of foreign trusts in New Zealand*

In New Zealand, the tax residence of the settlor determines the tax treatment of the trust and whether the trust’s foreign sourced income is taxable in New Zealand. This is outlined in s HC 10 of the *Income Tax Act*: ‘a trust is a foreign trust in relation to a distribution if no settlor is resident in New Zealand at any time in the period that starts on the later of 17 December 1987 and the date on which a settlement was first made on the trust’. Where the trust has a New Zealand resident settlor, the trustee is responsible for including New Zealand and foreign-sourced income in their taxable income, regardless of the tax residency of the trustee. A trust will cease to be a

⁵³ OECD, *OECD Working Group on Bribery Annual Report 2014*, above n 6, 60.

⁵⁴ OECD, ‘Phase 3 Report on Implementing the OECD Anti-Bribery Convention in New Zealand’ (October 2013).

⁵⁵ Ibid 103.

⁵⁶ It is acknowledged that the abuse of New Zealand foreign trusts for potential illegal activity had been highlighted years before the Panama Papers were revealed. See Gareth Vaughan, Denise McNabb and Richard Smith, ‘New Zealand Foreign Trusts: the Scandals, the Reforms, and Some Throat-Clearing From the EU’, *Naked Capitalism* (4 August 2016) <<http://www.nakedcapitalism.com/2016/08/new-zealand-foreign-trusts-the-scandals-the-reforms-and-throat-clearing-from-the-eu.html>>, for a range of references to sources raising issues relating to New Zealand foreign trusts.

⁵⁷ Government Inquiry into Foreign Trust Disclosure Rules (constituted by John Shewan), *Government Inquiry into Foreign Trust Disclosure Rules: Report* (June 2016). A total of 752 lines relating to New Zealand are reported from a total 559,602 across all the documents (ibid 18).

⁵⁸ See, for example, Matt Nippert, ‘The Antipodes email: John Key, his lawyer and foreign trusts’, *New Zealand Herald* (29 April 2016) <http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11630367>.

foreign trust if it makes any distribution after a settlor becomes a New Zealand resident, or if a New Zealand resident makes a settlement on the trust.⁵⁹

The relevant legislation is ss CW 54 and HC 26(1) of the *Income Tax Act*. Under ss CW 54 and HC 26(1), where foreign-sourced amounts are derived by a trustee who is resident in New Zealand, these amounts are exempt income if no settlor of the trust is a New Zealand resident in the income year. This exemption applies only to trustees, that is, if beneficiaries are New Zealand resident, then income received by beneficiaries is taxed. Where income is sourced in New Zealand it is also taxed as income in the hands of the trustee. Thus, the New Zealand approach to taxing offshore trusts is driven by the principle that non-residents are not taxed on non-New Zealand sourced income. However, it is also possible that this income may be free from tax in the foreign settlor's jurisdiction as a result of New Zealand's approach to taxing foreign trusts.⁶⁰

New Zealand's foreign trust rules were introduced in 1988, together with other international tax reforms. The rules depart from typical international practice of taxing on the basis of the residence of the trustee.⁶¹ It is acknowledged that the difference between the generally accepted international approach and the approach adopted in New Zealand creates an arbitrage opportunity. The rule is designed to protect the New Zealand tax base by restricting the ability of New Zealand residents to place assets in a trust that is managed offshore with non-resident trustees in order to avoid New Zealand income tax on the income of the trust.⁶²

New Zealand's approach is premised on the idea that while trustees have legal ownership of the assets, the settlor has the economic power, as the settlor establishes the trust, transfers assets to the trust, appoints the trustees, determines who the beneficiaries are and specifies the terms of the trust deed.⁶³ It has been suggested that one of the objectives of New Zealand's approach to the tax treatment of trusts is to assist New Zealand in developing an international financial services industry.⁶⁴ However, the primary objective was to protect against the use of non-resident trusts by New Zealanders to protect income from New Zealand income tax.

Inland Revenue do not report separately the value of fees collected from foreign trusts; instead they report this in an amount that includes employment income for third party employees and principals for foreign trust provider entities. This is estimated at approximately NZD 24 million per annum.⁶⁵ Also disclosed is the tax collected on fee income, goods and services tax, and pay-as-you-earn paid on behalf of third party

⁵⁹ For a more in-depth discussion on the tax treatment of trusts see Mark Brabazon, 'Trust Residence, Grantor Taxation and the Settlor Regime in New Zealand' (2016) 22(4) *New Zealand Journal of Taxation Law and Policy* 346; Michael Littlewood, 'Foreign Trusts, the Panama Papers and the Shewan Report' [2017] 1 *New Zealand Law Review* 59.

⁶⁰ *Ibid.*

⁶¹ Inland Revenue and New Zealand Treasury, *Tax Policy Report: Foreign Trusts Rules*, Report No T2014/2190/IR2014/620 (2014) <<http://www.treasury.govt.nz/publications/reviews-consultation/foreign-trust-disclosure-rules>>.

⁶² OliverShaw Limited, Submission to the Government Inquiry into Foreign Trust Disclosure Rules, May 2016.

⁶³ Inland Revenue and New Zealand Treasury, above n 61.

⁶⁴ Jeremy Beckham and Craig Elliffe, 'The Inconvenient Problem with New Zealand's Foreign Trust Regime' (2012) 18(2) *New Zealand Journal of Taxation Law and Policy* 1.

⁶⁵ *Ibid.*

employees and principals for foreign trust providers of NZD 3 million per annum.⁶⁶ Therefore, the presence of foreign trusts does not provide a significant contribution either to the broader economy of New Zealand or to the tax base. Foreign trust registrations since 2006 in New Zealand total 11,671 as at 31 May 2016.⁶⁷

4.2.2 *Tax havens in New Zealand?*

There is a well-established industry in New Zealand facilitating non-New Zealand residents to establish and maintain foreign trusts in New Zealand. The industry adopts a position that it exists to support the New Zealand financial services industry. However, the tax treatment of foreign trusts has generated criticism of what is perceived as New Zealand's status as a tax haven in relation to foreign trusts.⁶⁸ The Inland Revenue / New Zealand Treasury response to this criticism is that secrecy is required in order for a country to be considered as a tax haven and as New Zealand has reasonable disclosure requirements, it is not possible for New Zealand to be a tax haven. However, this is a somewhat narrower qualification of the more widely accepted definition of what comprises a tax haven. Moreover, whether some aspects of New Zealand's disclosure regime are 'reasonable' is open to challenge. The more typically accepted view is that a tax haven has four key factors:

1. no or nominal tax on the relevant income;
2. lack of effective exchange of information;
3. lack of transparency; and
4. no substantial activities.⁶⁹

The first criterion, of no or nominal tax on relevant income, is not viewed as sufficient in isolation to classify a country as a tax haven. Thus, the New Zealand claim that 'tax havens are all about secrecy'⁷⁰ is a somewhat convenient claim that avoids the issue that tax may be avoided on income from foreign trusts due to the mismatch of treatment under New Zealand tax rules and other jurisdictions' tax rules. The New Zealand approach to taxing trusts is unlikely to result in any loss to the New Zealand tax base. However, this is not the same as there being no loss to any tax base and it is possible that the New Zealand approach facilitates point (1) of the tax haven definition above, which is no or nominal tax on the relevant income. It is also notable that despite the claims from New Zealand bureaucrats that it is not a tax haven, this does not detract from the fact that New Zealand is perceived this way.⁷¹

While most commentators do not refer to New Zealand as a tax haven, some of the language used suggests that it is not far away from being such an entity. Examples include:

⁶⁶ Ibid.

⁶⁷ Government Inquiry into Foreign Trust Disclosure Rules, above n 57, para 4.24.

⁶⁸ See, for example, Mark Bennett, 'Implications of the Panama Papers for the New Zealand Foreign Trust Regime' (2015) 21 *New Zealand Association of Comparative Law Yearbook* 27.

⁶⁹ OECD, 'Countering Offshore Tax Evasion: Some questions and answers on the project' (2009) <<https://www.oecd.org/ctp/harmful/42469606.pdf>>.

⁷⁰ Inland Revenue and New Zealand Treasury, above n 61, 2.

⁷¹ Beckham and Elliffe, above n 64, note sources identifying New Zealand as one of the top ten tax havens in the world.

1. the New Zealand Law Commission describing New Zealand as an ‘attractive haven’ for offshore trusts;⁷²
2. Littlewood suggesting the New Zealand tax system is structured in such a way that provides for the country to be ‘used as a tax haven’;⁷³
3. Deborah Russell proposing that ‘New Zealand is not a tax haven in general, but in respect of these foreign trusts, it operates as a tax haven’.⁷⁴

The submission from Littlewood to the Government Inquiry into Foreign Trust Disclosure Rules (Shewan Inquiry) also comments on the issue of whether New Zealand is a tax haven. Littlewood writes:

[I]f a ‘tax haven’ is defined as meaning ‘a jurisdiction that does not tax incomes’, then plainly New Zealand is not a tax haven. A more meaningful definition, however, is that a tax haven is ‘a jurisdiction that allows itself to be used by non-residents as a means of avoiding the tax that they would otherwise have to pay in their home countries’. By this definition, New Zealand is plainly a tax haven.⁷⁵

Thus, the question of whether New Zealand is a tax haven will be determined by the definition adopted of a tax haven. While it is evident that no New Zealand tax is avoided by the tax rules adopted for foreign trusts in New Zealand, the extent to which the New Zealand regime facilitates tax avoidance in other jurisdictions remains unclear. Moreover, it is unclear if a country is a tax haven when they facilitate tax avoidance in another jurisdiction.

On the issue of secrecy, while the New Zealand regime did not hold itself out as offering secrecy, this was effectively achieved due to the disclosure requirements. Issues highlighted in submissions to the Shewan Inquiry include the difficulty associated with detecting and preventing abuse of the rules as the limited disclosure requirements result in difficulty for tax authorities in other countries to identify New Zealand foreign trusts and for Inland Revenue to provide information on these trusts. The foreign jurisdiction requires knowledge of the New Zealand foreign trust in order to request information on the trust, but Inland Revenue may not hold information on the residency of the settlor of that trust.

It is generally accepted that New Zealand’s approach to foreign trusts does not impact on New Zealand’s tax revenue. This is reasonable, as New Zealand has never set out to tax the non-New Zealand sourced revenue of non-residents. However, it has also been claimed that no ‘substantive evidence [has] been produced to suggest that New Zealand foreign trusts have been used to facilitate evasion of other countries’ taxes’.⁷⁶

⁷² Law Commission, *Review of Trust Law in New Zealand: Introductory Issues Paper* (2010) 20 <<http://www.lawcom.govt.nz/sites/default/files/projectAvailableFormats/NZLC%20IP19.pdf>>.

⁷³ Michael Littlewood, ‘Using New Zealand as a Tax Haven: How Is It Done? Could It Be Stopped? Should It Be Stopped?’ (Working Paper No 1 of 2016, 11 April 2016) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2761993>.

⁷⁴ Deborah Russell, Submission to the Government Inquiry into Foreign Trust Disclosure Rules, May 2016.

⁷⁵ Michael Littlewood, Submission to the Government Inquiry into Foreign Trust Disclosure Rules, May 2016.

⁷⁶ OliverShaw Limited, above n62. Similar observations are visible in other submissions.

This may, at least in part, result from inadequate disclosure requirements that limit the opportunity for other jurisdictions to have knowledge of the presence of these trusts.

Littlewood observes that despite the generally agreed position that New Zealand's tax revenue is not diminished with its approach to foreign trusts, there are likely to be less obvious losses made in the form of damage to New Zealand's reputation. Indeed, Littlewood suggests the approach of New Zealand is

simply wrong in principle for a country to allow itself to be used to undermine other countries' tax systems – especially if it does so deliberately. Further, whilst there are plenty of other tax havens in the world, it would seem that there are no other members of the OECD that permit this particular form of tax avoidance.⁷⁷

Littlewood makes the point that if New Zealand changed its foreign trust regime, then those trusts currently taking advantage of New Zealand's approach would need to resort to other, potentially less 'safe', countries to achieve the same result.

4.2.3 *Disclosure requirements*

Until 2006, there were no ongoing disclosure requirements for foreign trusts.⁷⁸ New Zealand introduced additional disclosure requirements for Australian trusts in 2006. Section 59B of the *Tax Administration Act 1994* (NZ) requires a resident foreign trustee for a foreign trust to disclose (to the Commissioner of Inland Revenue): the name or other identifying particulars of the foreign trust; the name and contact details of the resident foreign trustees; whether a settlor is resident in Australia; and certain other particulars if the resident foreign trustee claims to be a qualifying resident foreign trustee. It is notable that this section does not require identification of the details or residence of the settlor, with the exception of when the residence is Australia.⁷⁹ However, no additional information disclosure is mandated; only that the residence is in Australia together with the aforementioned requirements relating to the name of the trust and resident foreign trustees.

Where the settlor is resident anywhere other than Australia, the trustee is not obliged to supply anything other than the name or other identifying particulars that relate to the foreign trust; for example, the date of the settlement on the trust. The requirement for the trustee to advise Inland Revenue of the name or other identifying particulars of the trust is provided only on initial registration and no annual updating is required.⁸⁰

Documentation from Inland Revenue and the New Zealand Treasury in 2014 notes concerns about

the adequacy of our disclosure and record-keeping requirements – particularly in light of expanding obligations to exchange information now and in the future as a result of FATCA [Foreign Account Tax Compliance Act], AEOI [automatic exchange of information], and the multilateral agreement for exchange of information and assistance.⁸¹

⁷⁷ Littlewood, 'Using New Zealand as a Tax Haven', above n 73, 4.

⁷⁸ Government Inquiry into Foreign Trust Disclosure Rules, above n 57, 14.

⁷⁹ *Tax Administration Act 1994* (NZ) s 59B(1)(c).

⁸⁰ Littlewood, above n 75, 19.

⁸¹ Inland Revenue and New Zealand Treasury, above n 61, 2.

The same document notes a concern about New Zealand's ability to 'realistically bring the regime up to the appropriate standard in a way that is enforceable and ensures compliance'.⁸² The disclosure rules were highlighted in submissions as being particularly problematic. For example, Littlewood writes: 'if the New Zealand government would prefer not to allow the country to be used as a tax haven, the remedy would be straightforward. All that would be required would be to strengthen the disclosure requirements'.⁸³

As noted by a respondent to the Shewan Inquiry, the 2006 response to the Australian request for greater disclosure suggests that a problem did exist with the disclosure regime of the time: '[t]he fact that the Australian government negotiated a special deal with New Zealand suggests that Australians were using New Zealand foreign trusts inappropriately'.⁸⁴ It is also notable that since this time, there have been very few Australian trusts registered in New Zealand.⁸⁵ It is also relevant that the Australian *Income Tax Assessment Act 1936* contains provisions that limit Australian residents from using New Zealand trusts to avoid Australian taxation.⁸⁶

4.2.4 Submissions to the Shewan Inquiry

There were a total of 22 submissions to the Shewan Inquiry that were publicly released. The Shewan Inquiry report refers to 23 submissions, but one (from Amicorp New Zealand Limited) was not released. Amicorp New Zealand is part of Amicorp group who describe themselves as one of the top ten trust companies in the world.⁸⁷ On the New Zealand webpage, New Zealand foreign trusts are described as

an effective estate planning vehicle increasingly used as an alternative to trusts from zero tax jurisdictions as NZ is considered a high tax jurisdiction and a white list country. If properly established, it offers excellent tax efficiency and can be easily combined with other investment structures in high tax jurisdictions.⁸⁸

The terms of reference for the Shewan Inquiry relate to:

1. New Zealand's existing foreign trust disclosure rules, including enforcement of the rules, exchange of information with foreign jurisdictions and practices for complying with the rules;
2. whether the existing foreign trust disclosure rules and enforcement of the rules are sufficient to maintain New Zealand's reputation, taking into account New Zealand's commitment to the OECD base erosion and profit shifting action plan, the global standard for automatic exchange of information, the tax treaty network, anti-money laundering and countering financing of terrorism laws and other related regimes; and

⁸² Inland Revenue and New Zealand Treasury, above n 61, 2.

⁸³ Littlewood, above n 75, 18.

⁸⁴ Russell, above n 74.

⁸⁵ Government Inquiry into Foreign Trust Disclosure Rules, above n 57.

⁸⁶ Chartered Accountants' Australia New Zealand, Submission to the Government Inquiry into Foreign Trust Disclosure Rules, May 2016.

⁸⁷ Amicorp Group <<http://www.amicorp.com/amicorp-group/index>>.

⁸⁸ Ibid.

3. options for enhancements to New Zealand's foreign trust disclosure rules.⁸⁹

Not all responses addressed all components of the terms of reference. Nine of the 19 responses to the first point above responded that they believed the current policy settings were fit for purpose, with one submitter choosing not to make their own response and instead concurring with another submitter in this respect. A further submitter did not comment on the extant rules, and instead noted the potential benefits to New Zealand from the presence of foreign trusts.

The other responders adopted a range of positions that reflected dissatisfaction with the current policy settings. These ranged from suggesting the current scheme is 'fundamentally flawed'⁹⁰ to suggesting that the current New Zealand tax law facilitates tax evasion in the trusts home country⁹¹ or that loopholes were created as a result of New Zealand's tax law.⁹² Multiple submissions observed that it was not New Zealand potentially losing tax revenue from the current tax policy settings relating to foreign trusts.

In relation to disclosure, most submitters were in agreement that there was a need for greater disclosure. Most submitters felt that the current rules were inadequate (10) or that the introduction of Automatic Exchange of Information would act to resolve current disclosure issues. Only one submitter to this question expressed the view that adequate controls and processes were in place.

The third issue relates to anti-money laundering and countering foreign terrorism. The majority of submitters did not expressly comment on this particular issue, with those that did generally agreeing that the rules were adequate or that there was insufficient evidence of failure of the current scheme. Only two respondents suggested that the current rules were inadequate.⁹³

An additional issue that arose frequently in submitters' responses was the need to protect New Zealand's reputation as a jurisdiction with low levels of corruption and good regulation. Some suggested that New Zealand's reputation had been damaged as a result of the treatment of foreign trusts, while others were more concerned that the future of New Zealand's reputation was not damaged by an inadequate response to the Panama Papers.

5. THE NEW ZEALAND RESPONSE

Two different responses to the two different issues raised in the previous section are visible in New Zealand. There has been little reaction to criticism of New Zealand's tax treatment of facilitation payments, indicating path dependency. By way of contrast, there has been significant and prompt reaction to New Zealand's involvement in the Panama Papers saga, indicating a critical juncture and changes in prevailing ideas. The different responses are outlined in the following sub-sections.

⁸⁹ New Zealand Gazette, *Establishment of the Government Inquiry into Foreign Trust Disclosure Rules*, Notice No 2016-go2253, 19 April 2016 <<https://gazette.govt.nz/notice/id/2016-go2253>>.

⁹⁰ Simon Boyce, Submission to the Government Inquiry into Foreign Trust Disclosure Rules, May 2016.

⁹¹ Littlewood, above n 75.

⁹² Russell, above n 74.

⁹³ Chartered Accountants' Australia New Zealand, above n 86, and Transparency International, Submission to the Government Inquiry into Foreign Trust Disclosure Rules, May 2016.

5.1 Tax treatment of facilitation payments

In November 2014, the New Zealand government introduced the Organised Crime and Anti-corruption Legislation Bill with the expressed aim of strengthening the law to combat organised crime and corruption.⁹⁴ The Bill was passed into law in November 2015, by way of 15 amendment Acts. The changes were intended to introduce an all-of-government response to addressing various components of organised crime. Components addressed include attending to gaps in the current anti-corruption framework, increasing penalties for bribery and corruption and multiple amendments to offences such as human trafficking, identity related offences and money laundering offences.⁹⁵

The legislative changes allowed New Zealand to ratify the UN Convention, and enable implementation of the *Agreement between the Government of the United States of America and the Government of New Zealand on Enhancing Cooperation in Preventing and Combating Crime*.⁹⁶ It further extends New Zealand's compliance with a range of other international conventions.

The Bill also resulted in changes to the *Income Tax Act* in relation to the acceptance of a bribe by a foreign public official. However, the legislative changes did not result in any changes likely to result in different behaviours or different interpretations of the legislation, with the issues outlined in the previous section still remaining.

There were 23 (written and oral) submissions to the Law and Order Select Committee on the Organised Crime and Anti-corruption Legislation Bill, most of which were concerned with issues such as the timing of implementation and information sharing provisions. Of the 20 written submissions to the Select Committee on the Bill, two submissions directly commented on facilitation payments. They also made reference to New Zealand's reputation as follows:

At stake is New Zealand's reputation as one of the least corrupt countries in the world. By taking a strong stance on facilitation payments, and providing clarity to all New Zealand organisations trading and operating abroad, the government will also send a clear and important message to the international community that honest transactions are expected when working with New Zealand Inc. and New Zealand companies;⁹⁷

and

A facilitation payment is still a bribe no matter how low the amount and such payments inculcate a culture of corruption. Given New Zealand's leadership in the field of ethics and integrity, and also its deserved global

⁹⁴ Explanatory Note, Organised Crime and Anti-corruption Legislation Bill 2014 (NZ) <<http://www.parliament.nz>>.

⁹⁵ Ministry of Justice (NZ), 'Organised Crime and Anti-Corruption Legislation Bill – Initial Briefing' (5 February 2015) <https://www.parliament.nz/resource/en-NZ/51SCLO_ADV_00DBHOH_BILL56502_1_A420384/57a531cdb1c2734fed0ec6b756e7b11ee5067f72>.

⁹⁶ *Agreement between the Government of the United States of America and the Government of New Zealand on Enhancing Cooperation in Preventing and Combating Crime*, signed on 22 March 2013 (not yet in force), <<http://www.treaties.mfat.govt.nz/search/details/p/54/590>>.

⁹⁷ Transparency International, Submission to the Law and Order Select Committee on the Organised Crime and Anti-corruption Bill, February 2015, 6.

reputation for anti-corruption, it seems anomalous that we would wish to leave such a loophole.⁹⁸

Two other submissions made reference to potential damage to New Zealand's reputation. However, this was not in relation to the tax issue and instead applied to organised crime.⁹⁹

The submission from the New Zealand chapter of Transparency International raised two issues.¹⁰⁰ The first was the suggestion that the Bill should more fully clarify that facilitation payments are bribes. Arguments for this included that this would align New Zealand with other jurisdictions that have adopted this approach, and that 'a bribe is a bribe if it is a large payment or a small payment'.¹⁰¹ The submission makes the point that the UN Convention prohibits all bribes to government officials, regardless of their size. The second point raised is the observation in the Transparency International submission that 'if a facilitation payment were a due advantage it would be regulated by law, classified as a fee/expense, be budgeted and be recorded for legitimate tax or transaction cost treatment'.¹⁰² This statement captures a key issue. Legitimate business expenditure will meet the requirements of s DA 1 of the *Income Tax Act*. The payment will have the necessary nexus with income and there will be no question of its deductibility status for tax purposes. Section DB 45 of the *Income Tax Act* is only necessary where payments fall outside what is typically considered to be legitimate business expenditure.

5.2 Foreign trusts

By way of contrast with New Zealand's response to criticisms pertaining to the tax treatment of facilitation payments, the government response to New Zealand's involvement in the Panama Papers is markedly different. The issue first came to light via the media in early 2016 and by April 2016 the Shewan Inquiry (John Shewan being one of New Zealand most well-known tax professionals) was underway. The report was specified to be due by 30 June 2016, less than four months after the Panama Papers were first released.

The Shewan Inquiry attracted a similar number of submissions, 23, to those to the Law and Order Select Committee on the Organised Crime and Anti-corruption Legislation Bill. However, these were focused on the tax issues, and New Zealand's global reputation. The Shewan Inquiry report includes 20 recommendations under the headings of:

1. registration process (6);
2. strengthened disclosure on registration (3);
3. ongoing tax obligations (4);
4. registration and annual filing fee (1);

⁹⁸ Michael Macaulay, Submission to the Law and Order Select Committee on the Organised Crime and Anti-corruption Bill, February 2015, 1.

⁹⁹ New Zealand Bankers' Association, Submission to the Law and Order Select Committee on the Organised Crime and Anti-corruption Bill, February 2015.

¹⁰⁰ Transparency International, above n 97.

¹⁰¹ Transparency International, above n 97, 5.

¹⁰² Transparency International, above n 97, 10.

5. expansion of scope and application of anti-money laundering rules (3);
6. suspicious transaction reporting (2); and
7. information sharing (1).

The Government's response¹⁰³ was to agree with all the recommendations, although the 'way in which a small number are implemented will be tweaked'.¹⁰⁴ In the media release accompanying the Government's response to the recommendations, it was noted that 'the Shewan Inquiry's recommendations are sensible and well-reasoned and by acting on all of them, we will ensure that our foreign trust disclosure rules are strengthened and New Zealand's reputation is protected'.¹⁰⁵ It was also stated that the Government intends to move quickly to implement the recommendations.

The Inquiry questions directed respondents to address reputation, with the question, '[a]re the existing foreign trust disclosure rules adequate to ensure New Zealand's reputation as a country that co-operates with other jurisdictions to deter abusive tax practices is maintained?' Therefore, it is not surprising that the majority of the submissions addressed the issue of New Zealand's reputation, with only four submissions not touching on the issue of either damage to, or the importance of, New Zealand's reputation. However, two contrasting positions are evident from these submissions. The first is visible in the submission from the New Zealand Council of Trade Unions as outlined below:

New Zealand's influence in such forums depends on its reputation. We cannot credibly call on other countries to help us prevent tax abuse in New Zealand if we are at the same time aiding and abetting the gouging of their revenue bases. In addition, tolerating such abuse undermines trust in New Zealand's legal and administrative systems. Accepting such abuse on the basis that it makes money for a small group of lawyers and accountants gives the impression that our principles and morality are for sale. That is bad for New Zealand's social cohesion and in the long run bad for us economically because it discourages good business practices, longer term investment and longer term thinking.¹⁰⁶

This is the position adopted by most of the Inquiry respondents and may be contrasted with the submission from OliverShaw:

There thus seems little foundation in any assertions that New Zealand's international reputation has been damaged by the operations of New Zealand foreign trusts. Certainly no evidence has been produced to demonstrate how this has led to damage to New Zealand except perhaps to the extent that some more ill-considered New Zealand media coverage has impacted

¹⁰³ New Zealand Government, *Government Inquiry into Foreign Trust Disclosure Rules: Government's Response* (July 2016) <<http://taxpolicy.ird.govt.nz/sites/default/files/news/2016-07-13-inquiry-response.pdf>>.

¹⁰⁴ Inland Revenue, 'Government's Response to Shewan Inquiry Recommendations' (Media Statement, 13 July 2016).

¹⁰⁵ *Ibid.*

¹⁰⁶ New Zealand Council of Trade Unions, *Submission to the Government Inquiry into Foreign Trust Disclosure Rules*, May 2016, para 2.8.

negatively on the reputation of New Zealand foreign trusts to be a safe haven for the family wealth of non-residents.¹⁰⁷

5.3 Summary

This section has outlined the New Zealand responses to the visibility given to the tax treatment of foreign trusts and the tax treatment of facilitation payments. A response that is perhaps best described as inadequate is present in relation to the tax treatment of facilitation payments with, in effect, no resulting changes that would impact on extant outcomes. This may be contrasted with the timely and comprehensive response associated with the tax treatment of foreign trusts, where the outcomes are likely to be significantly different as a result of reforms implemented.

6. LESSONS LEARNED

The two activities discussed in this article are not the only activities likely to impact on New Zealand's international reputation as a country with low corruption. They are chosen here as they have both recently attracted criticism. Moreover, they are of interest as, while both have the potential to negatively impact on New Zealand's global reputation, the two activities resulted in different governmental responses: one activity continues largely unchanged while the other has been the subject of a government Inquiry and the subsequent acceptance of multiple policy changes. There are a number of observations that may be made from the outcomes of the two issues, which are outlined over the following sections. These observations are informed by the HI lens outlined in section 3.

6.1 Path dependency and critical junctures

As noted in section 3, policy is expected to evolve. However, in many cases, a high level of political pressure is needed to generate significant policy change. This is particularly the case in tax policy. Periods of stasis are evident for both the tax treatment of facilitation payments and the tax treatment of foreign trusts. However, a critical juncture is only visible in the case of the trust activity, whereas the tax treatment of facilitation payments continues on the path dependent trajectory.

Both activities considered in this study were likely to impact negatively on New Zealand's reputation as a country with low levels of corruption. The facilitation payments issue generated criticism from international organisations, but did not receive the same profile as the trusts issue, and also did not generate the same level of public interest as the foreign trust concern. By way of contrast, the international attention created by the Panama Papers issue, and New Zealand's inclusion as a participating country in questionable activity, was significantly higher. While it is not always evident when an event may be considered to be a critical juncture, one indication is that it becomes difficult to return to a point where other alternatives are available once a particular option is selected.¹⁰⁸ This is the situation in the case of the foreign trusts issue, as it will be difficult for New Zealand to reverse agreed actions, particularly in relation to increasing information disclosure.

¹⁰⁷ OliverShaw Limited, above n 62.

¹⁰⁸ James Mahoney, 'Path Dependence in Historical Sociology' (2000) 29(4) *Theory and Society* 507.

New Zealand's potential reputational damage was highly visible in the foreign trusts issue. There were multiple references to New Zealand's reputation in submissions to the Shewan Inquiry. Indeed the Shewan Inquiry reported New Zealand's 'compliant' rating in the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes in the 2013 Peer Review Report and that New Zealand 'takes pride in its reputation as a country that cooperates with other jurisdictions to deter abusive tax practices'. The Shewan Inquiry report goes on to state that '[t]he Inquiry was informed by the Government that maintenance of that reputation is important'.¹⁰⁹ The potential reputation damage from the high level of visibility associated with the Panama Papers generated the sufficient critical juncture to result in a high-level inquiry and subsequent policy change. The concern with damage to New Zealand's reputation was present from the time the Panama Papers issue was first raised, and continued to be visible in the terms of reference, submissions to the Inquiry, the report and the government responses to the report. However, the events surrounding the facilitation payment issue were diluted and did not have the same profile or impact as the Panama Papers, thereby not appearing to raise the same level of potential damage to New Zealand's reputation.

6.2 Punctuated equilibria

Punctuated equilibria are demonstrated with minimal change over an extended period of time, followed by a period of rapid and significant change, with eventual reversion to new stable policy. Punctuated equilibria are visible in relation to foreign trusts, with the change of policy direction in response to the publicity associated with the Panama Papers scandal. However, again this is not visible with facilitation payments. There was not a sufficiently large or powerful issue to generate the change in policy direction for facilitation payments, unlike the foreign trusts issue.

Under HI, factors that explain why a set of arrangements is created may be quite distinct from those that explain why it has endured over time; for example, punctuated equilibrium indicates that new structures may evolve during times of crisis, with periods of stasis prominent during other periods. A country operating as a tax haven poses an international threat, as compared to allowing tax deductions for facilitation payments, which will only impact on that own nation state's tax revenue. Thus, the two tax issues ultimately have different impacts: the tax treatment of foreign trusts has the potential to impact on the tax revenue of multiple other jurisdictions, likely exerting higher levels of pressure for change. As globalisation impacts increasingly on tax policy, it is perhaps inevitable that an individual nation state's tax policy that is detrimental, or potentially detrimental, to another nation state's tax policy will see the first-mentioned such state come under pressure to accede to a more commonly adopted policy direction.¹¹⁰

6.3 Power

The two tax issues discussed in this article were presented differently to the public. Submissions for the facilitation payments issue were sought within a number of other broad issues. In contrast, the tax treatment of foreign trusts was presented as an

¹⁰⁹ Government Inquiry into Foreign Trust Disclosure Rules, above n 57, para 2.3.

¹¹⁰ The growing demand for increased transparency in fiscal arrangements is noted in Pravir Tesiram and Stephen Law, 'Proposed Reforms to New Zealand Foreign Trust Rules' (2017) 23(2) *Trusts & Trustees* 179.

isolated, and specific, issue. The inclusion of one issue within a group of larger issues appears to have diluted the impact of interest groups who may otherwise have focused on the issue of facilitation payments. Submissions were expected to cover multiple issues, of which facilitation payments and the tax deductibility thereof, were not the most important to many of the interest groups. This is reflected in the fact that only two of the submissions commented on the facilitation payment issue.

Steinmo observes that the balance of power may change over time, which is also a factor that can help explain the different treatments afforded to the two activities discussed herein.¹¹¹ The OECD has been involved in international tax policy for decades; for example, the OECD Model Tax Convention has been in place for over 60 years. The general trend is for tax policy among OECD countries to become more aligned, with projects such as the OECD's BEPS project likely to significantly impact on nation states' tax policies.

It is notable that the policy issue that did generate change – the tax treatment of foreign trusts – was agreed to have no negative impact on the New Zealand tax base. By way of contrast, the tax policy issue that did not generate change – the tax deductibility of facilitation payments – is likely to negatively impact on the New Zealand tax base. While it would appear that the facilitation payments made to overseas public officials are intended to be 'small', there is no knowledge of the amount of such payments that are made, and therefore it is not possible to quantify their tax impact. However, it may not be unreasonable to posit that their presence is valuable to New Zealand businesses due to their retention despite disapproval from international bodies. It is suggested that if they had little or no value to New Zealand enterprise, then it would be a straightforward and practical solution to repeal their tax deductible status. Moreover, as noted in section 5.1, legitimate business expenditure will meet the requirements of s DA 1 of the *Income Tax Act*, and the statutory nexus between the expenditure and the income earning process will be present, thereby negating the need for s DB 45.

Power is also evident in the terms of reference for the Inquiry for the foreign trusts issue. Reference to the title of the Inquiry provides an indication of this: 'Government Inquiry into Foreign Trust Disclosure Rules'. The Inquiry is thereby restricted to disclosure rules and minimises the potential for the fundamental issues around New Zealand's approach to taxing foreign trusts to be addressed.

6.4 Ideas

The primary driver of the difference in responses appears to be concern with New Zealand's reputation. Respondents to the Law and Order Select Committee on the Organised Crime and Anti-corruption Legislation Bill were not strongly focused on the tax elements of the Bill. Instead, it was the anti-money laundering and organised crime components that attracted the majority of the submission commentary. This is likely to be, at least in part, because the tax issues were 'hidden' within a number of other changes. By way of contrast, in the case of the Shewan Inquiry the focus was clearly on the tax issues and there was no potential for the issues to be diluted within a broader range of issues. However, what was evident in the submissions is that the questions directed focus to be on the disclosure rules, rather than the wider issues of

¹¹¹ Sven Steinmo, 'The Evolution of Policy Ideas: Tax Policy in the 20th Century' (2003) 5(2) *British Journal of Politics and International Relations* 206.

whether New Zealand was acting as a tax haven. Notwithstanding this comment, addressing the disclosure rules effectively would be likely to end any accusation that New Zealand was facilitating tax evasion in other jurisdictions.

The role of New Zealand as a ‘good global citizen’ arose in many submissions to the Shewan Inquiry.¹¹² One view was that ‘it is certainly not up to, or even possible, for New Zealand to attempt through its tax laws to compensate for what we may see as deficiencies of the tax policies of other countries’.¹¹³ However, the issue was less about deficiencies of tax policy in other countries and more about insufficient disclosure to allow other countries to enforce their tax laws. This was represented in other submissions, for example that ‘it is not New Zealand’s role to be the prime enforcer of other countries’ tax systems ... However, New Zealand should be in a position to provide reasonable assistance to other countries with the enforcement of their laws when requested...’.¹¹⁴ Thus, there is a conflict between New Zealand’s laws and how these will impact in other jurisdictions. The incompatibility between New Zealand taxing on the basis of residence of the settlor, while much of the rest of the world taxes on the basis of the residence of the trustees, was not disputed. The issue was whether this was a concern that New Zealand should be addressing. In general, the view was that New Zealand’s tax treatment was aligned with overall principles of taxation and ‘tax differences (and mismatches) should not normally be a specific concern to be addressed’.¹¹⁵

The KPMG submission to the Shewan report notes the global trend for countries to provide support for each other in preventing behaviours such as tax evasion and illegal money flows.¹¹⁶ The greater focus on the international impact of New Zealand’s behaviour was evident in relation to the foreign trusts issue. By way of contrast, there was no suggestion that the tax deductibility of facilitation payments in New Zealand would impact on another jurisdiction.

The OECD is increasing efforts in relation to automatic exchange of information, resulting from increasing globalisation and cross-border activities. New Zealand’s response to the foreign trusts issue shows willingness to cooperate with other tax jurisdictions, thereby protecting its reputation as an honest country. The OECD observes the importance of automatic exchange of information in bringing national tax administrations in line with the globalised economy.¹¹⁷ The common reporting standard (the global framework for the collection, reporting, and exchange of financial account information about entities and individuals outside their tax resident jurisdiction) has been introduced into New Zealand law.¹¹⁸ From 1 July 2017, under automatic exchange of information, non-exempt New Zealand financial institutions will need to collect and report information to Inland Revenue on accounts held by or

¹¹² See also discussion on neighbourliness in Huigenia Ostik, ‘Neighbourliness and New Zealand’s Foreign Trust Regime’ [2017] 2 *New Zealand Law Review* 285.

¹¹³ OliverShaw Limited, above n 62, 4.

¹¹⁴ PricewaterhouseCoopers, Submission to the Government Inquiry into Foreign Trust Disclosure Rules, May 2016, 2.

¹¹⁵ KPMG, Submission to the Government Inquiry into Foreign Trust Disclosure Rules, May 2016, 7.

¹¹⁶ *Ibid.*

¹¹⁷ *Ibid.*

¹¹⁸ Inland Revenue, ‘Automatic Exchange of Information and the Common Reporting Standard’ (2017) <<http://www.ird.govt.nz/international/exchange/crs/aeoi-crs/>>.

(in certain circumstances) controlled by non-residents. This information may then be shared with other tax jurisdictions in specific countries.¹¹⁹

Some ideas have a greater ‘fit’ in a particular political economic or social environment – such as automatic exchange of information. Thus, ideas are not limited to previous policy choices and, as is visible in the treatment of trusts in New Zealand, ideas may include new policy options. Steinmo suggests that ideas may change over time when new information is received that challenges the status quo; where there are inconsistencies in extant beliefs; where the context changes; or where individuals may be persuaded that a different approach is preferable.¹²⁰ All of these are visible in relation to the foreign trusts issue. Many are also present in relation to the facilitation payments issue, with the notable exception of the last point, which is persuading individuals that a different approach is preferable.

Ideas can be used to validate certain approaches in policy debates. This is visible in both scenarios. In relation to facilitation payments, ideas were used to justify no action. Extant policy arrangements, including the requirements for deductibility that the value of the benefit was small and it was to a foreign public official for a routine government action, have been used to justify their retention, despite the OECD highlighting their undesirable nature. By way of contrast, in relation to foreign trusts, ideas such as automatic exchange of information and protecting the New Zealand reputation for low corruption were used to support change.

7. CONCLUSION

Analysis of governmental responses to two different areas relating to corruption in New Zealand highlights some key activities that appear to have impacted on the outcomes of reviews into two activities relating to tax and corruption. Historical institutionalism helps to highlight the changes that resulted from the two different policy scenarios outlined in this case study. While both had the potential to impact negatively on New Zealand’s reputation as a country with low levels of corruption, only the tax treatment of New Zealand foreign trusts was sufficiently serious to generate significant policy change. The critical juncture generated by the Panama Papers appears to have assisted with creating a sufficient crisis to generate a more significant policy response. The potential reputation damage to New Zealand’s image of low levels of corruption was greater in relation to the foreign trusts issue, due to the reach of the crisis and its potential to negatively impact on New Zealand’s global reputation as an incorrupt jurisdiction. The communication of the foreign trusts issue as a stand-alone ‘problem’ may be contrasted with the inclusion of the tax treatment of facilitation payments within a broader set of issues, which reduced the visibility of the issue in the way it was communicated, and the submissions and their responses.

The dominating global ideas relating to automatic exchange of information appear to have had a strong impact on both the submissions to the Shewan Inquiry and on the recommendations from that Inquiry. Greater international media interest in the subject, rather than solely national media reporting, appears to have impacted on the speed of

¹¹⁹ Inland Revenue, ‘Automatic Exchange of Financial Account Information - Information for Financial Institutions’ (2016) <<http://taxpolicy.ird.govt.nz/publications/2016-other-aeoi-fact-sheet/overview>>. First exchanges are likely to occur in 2018.

¹²⁰ Steinmo, ‘The Evolution of Policy Ideas’, above n 111.

decision-making and action in relation to the foreign trusts issue. This is despite the fact that any negative financial impact for New Zealand is likely to result from the tax deductibility of facilitation payments, rather than the tax treatment of foreign trusts.

The limitations associated with this study are acknowledged. There is limited ability to generalise from a case study. Moreover, a case study approach using New Zealand, which is a country with low levels of corruption, may have limited application to other countries where corruption is embedded within the culture of that location. The study also only examines two examples where New Zealand has been tainted with corruption. Future research could examine other tax examples or extend into other regulatory and disclosure regimes within New Zealand.

The study leads to the suggestion that concern for New Zealand's reputation is likely to be the catalyst for future changes, rather than a desire to be a good global tax citizen. While these two factors may be connected, submissions to the Shewan Inquiry showed little concern for other jurisdictions' tax revenue collection, but greater disquiet relating to the potential impact on New Zealand's reputation in the event that no action was taken.

Tax corruption and private sector development in Vietnam*

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Abstract

This article aims to examine the impact of tax corruption on private sector development in Vietnam. It is motivated by two separate but related considerations. First, despite the seriousness of the phenomenon of corruption, there is a paucity of rigorous empirical research of corruption, particularly tax corruption, in Vietnam. Secondly, ineffective control of corruption is viewed as a cause of Vietnam's recent total factor productivity (TFP) slowdown or its poor industrial policy, both of which may hamper Vietnam's progress as a low middle-income country. Without some understanding on the impact of tax corruption on the economy, it may not be possible to devise the most effective anti-corruption policy and measures. After a brief literature review that focuses on tax corruption, various conceptual issues relating to tax corruption are discussed and clarified. The extent of petty tax corruption in Vietnam is then discussed, followed by a review of findings and implications of recent studies on how tax corruption impacts on private sector development in Vietnam. Despite perceptions and evidence of widespread petty tax corruption, Vietnam ranks very highly both in terms of tax collection and tax effort. Not unexpectedly, the impact of tax corruption is mixed in the sense that empirical evidence lends credence to both 'sanding the wheels' and 'greasing the wheels' hypotheses. Finally, some broad policy recommendations for combating tax corruption are offered.

Keywords: tax corruption, unofficial/informal payments, private sector, Vietnam

JEL Classification: H20, H26, H29

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1. INTRODUCTION AND CONTEXT

Vietnam's transition from an inward-looking, centrally-planned economy to an outward-looking, market-based economy formally commenced in 1986 although substantial, irreversible changes only took place in 1989 (World Bank, 1993, pp. i-ii). After three decades of economic reform, Vietnam has achieved certain commendable outcomes, especially in terms of economic growth, poverty reduction and macroeconomic stability. From being one of the 30 poorest countries in the world in the early 1990s,⁴ Vietnam has recently become a middle-income country (World Bank, 2013a) thanks to its steady growth rate since economic reform.⁵ Overall, it is an emerging transition country with a sizeable population⁶ and a dynamic economy with expanding international and investment trade ties.⁷

Despite these achievements, Vietnam has been facing a number of social, economic and political challenges such as productivity slowdown, widening income and wealth inequality, diminished environmental sustainability and, perhaps most seriously, corruption. While the phenomenon of corruption is widespread across countries and over time, it has been perceived by many different stakeholders as one of the most critical issues facing Vietnam at present (World Bank and Government Inspectorate of Vietnam, 2012). More specifically, the Communist Party of Vietnam has long identified corruption as a threat to its political legitimacy (Communist Party of Vietnam, 2006). Yet, despite a strong anti-corruption legal framework since 2005, very limited results have been achieved (Transparency International, 2017a).

In the above context, the principal aim of this article is to examine the impact of tax corruption on private sector development in Vietnam. The article is motivated by two separate but related considerations. First, despite the seriousness of the phenomenon of corruption, there is a paucity of rigorous empirical research of corruption in Vietnam. Further, there are hardly any studies that specifically focus on tax corruption although some studies nevertheless touch on some aspects of tax corruption. Secondly, there is an increasing concern in Vietnam that the country may fall into the 'middle income trap'. In this sense, many researchers have blamed ineffective control of corruption as a cause of Vietnam's recent total factor productivity (TFP) slowdown (see, for example, Vu, 2016) or its poor industrial policy (Ohno, 2016, p. 35). Without some understanding of the impact of tax corruption on the economy, it may not be possible to devise the most effective anti-corruption policy and measures.

The scope of this article is limited to tax corruption that involves at least one tax official. Illegal business practices involving firms only (e.g., one business issuing fake value added tax (VAT) invoices to another business) do not constitute tax corruption

⁴ In terms of GDP per capita in purchasing power parity (PPP) dollar terms, Vietnam was ranked among the 30 poorest countries in the world in 1990 when estimates of its GDP per capita in PPP dollars first became available; see various issues of the United Nations Development Programme (UNDP) *Human Development Report*.

⁵ Vietnam's GDP grew at an average annual rate of 7.2 per cent in the first decade of the 21st century (World Bank, 2012).

⁶ Vietnam's population in 2015 was estimated at about 93.4 million, making it the 14th most populous country in the world (United Nations, 2015, p. 17, Table 5.1).

⁷ Vietnam's trade-to-GDP ratio decreased from 157.4 per cent in 2008 to 130.7 per cent in 2009 but then rebounded to 147.6 per cent and 164.8 per cent in 2010 and 2011, respectively (World Bank, 2013b).

for the purposes of this article. Furthermore, due to data limitations, the empirical examination is confined to petty tax corruption, i.e., relatively small ‘unofficial/informal’ payments (bribes) made to tax officials during the process of assessing and collecting tax revenue in Vietnam. The article focuses on the impact of petty tax corruption on the private sector, which is widely considered to be the engine of growth and development in Vietnam in the long run.⁸ Finally, the development of the private sector is studied in terms of four dimensions: innovation, investment, employment and per capita income.

The remainder of this article is organised as follows. Section 2 presents a brief literature review on tax corruption, including some recognised Vietnamese studies (available in English). In section 3, various conceptual issues relating to tax corruption are discussed and clarified in order to prepare the ground for the discussion that follows. These include definition and types of tax corruption, its measurement, and its causes and consequences, mainly from a Vietnamese perspective. Section 4 reviews the extent of tax corruption in Vietnam while section 5 presents an overview of private sector development in Vietnam, and then discusses the implications of empirical findings on how tax corruption impacts on private sector development in Vietnam. Despite the perception and evidence of widespread petty tax corruption, Vietnam ranks very highly both in terms of tax collection and tax effort. Not unexpectedly, the impact of tax corruption on private sector development is mixed in the sense that empirical evidence lends credence to both the ‘sanding the wheels’ and ‘greasing the wheels’ hypotheses. The final section offers some summary remarks and proposes various recommendations for mitigating tax corruption in Vietnam.

2. BRIEF LITERATURE REVIEW ON TAX CORRUPTION

The economic literature on corruption is long-standing and very substantial (see, for example, Leff, 1964; Mauro, 1995; Tanzi and Davoodi, 2000; Kaufmann, Kraay & Mastruzzi, 2011). A significant proportion of this literature is devoted to economic growth and development. In this context, two opposing hypotheses, namely that corruption ‘sands the wheels’ and ‘greases the wheels’ of growth, have been theoretically established and empirically tested. The results obtained to date from these empirical tests have been mixed (see the reviews in this field by Méon and Weill, 2009, and Nguyen, Nguyen and Tran-Nam, 2016). Since the literature on corruption in general has been well discussed elsewhere (see, for example, Rosid, 2017) and in view of the focus of this article, it suffices to focus on the literature on tax corruption.

By definition, tax corruption is a strict subset of corruption. Furthermore, tax corruption is necessarily intertwined with tax evasion (and tax avoidance to a lesser extent) because taxpayers who bribe are often motivated by tax evasion/avoidance and tax officials who receive bribes will find it necessary to hide their receipt of illegally

⁸ The term ‘private sector’ is employed in this article to mean the non-state sector. In Vietnam, the non-state sector is divided into the private (i.e., domestic private) sector and the Foreign Direct Investment (FDI, i.e., international private) sector.

obtained income. Thus, tax corruption involves a very important intersection of corruption and tax evasion.

There are several strands of research on tax corruption that can be identified in the general literature on tax corruption. These areas are: (i) determinants of tax corruption; (ii) impact of corruption on tax compliance including firm tax evasion; and (iii) strategies to reduce tax corruption. Each of these strands will be briefly considered in turn.

2.1 Determinants of tax corruption

Richardson (2006a) examined the influence of culture (proxied by power distance,⁹ individualism, uncertainty avoidance and masculinity) on petty tax corruption (irregular payments or bribes). Based on sample data of 47 countries drawn from the World Economic Forum's *Global Competitiveness Reports* 2002-04 and other sources, and after controlling for economic development (bureaucratic compensation), size of government and democracy, it was found that the higher the level of power distance and uncertainty avoidance, the higher is the level of petty tax corruption in a country. While those findings are plausible, the potential endogeneity between tax corruption and uncertainty avoidance casts some doubts on the strict applicability of the OLS estimation employed by that author.

In a similar study, Richardson (2006b) studied the influences of the level of tax evasion, tax law complexity and level of self-assessment on petty tax corruption. Based on sample data of 48 countries drawn from a wide range of sources (mainly the *Global Competitiveness Reports* 2002-04), and after controlling for the three economic and political variables mentioned above plus the top marginal individual income tax rate, it was found that the lower the level of tax evasion and tax law complexity, and the higher the level of self-assessment, the lower is the level of petty corruption. Again, while the results are sensible, it is unclear to what extent the potential endogeneity between petty tax corruption and tax evasion undermines the OLS estimation results obtained.

2.2 Impact of corruption on tax compliance

There is a series of studies examining the impact of corruption on tax compliance. This relationship has been found to be negative in practically all cases. For example, using an international cross-section of 30 developed and developing countries, Pincur and Riahi-Belkaoui (2006) showed that individual tax compliance internationally is negatively related to the control of corruption. Similarly, based on a sample of over 5,000 firms from 22 former Soviet Bloc transition economies (extracted from the World Bank and European Bank for Reconstruction and Development's 2005 Business Environment and Enterprise Performance Survey (BEEPS)), Alon and Hageman (2013) found that a higher level of corruption is associated with a lower level of firm tax compliance. Utilising micro-level data from the Afrobarometer Survey Wave 5 (covering 35 African countries, mostly from the sub-Saharan region, during the years 2011-13), Jahnke (2015) demonstrated that personal experiences of petty corruption not only directly lower tax morale (willingness to pay taxes) but also

⁹ Power distance refers to how paternalistic the relationship between superiors and subordinates is. The more paternalistic, the higher is the power distance.

indirectly affect tax morale via reduced trust in the tax collection agency. While these studies used corruption overall as a determinant, it seems plausible that the same results would hold when corruption is substituted by tax corruption.

More recent studies of corruption and firm tax evasion have explicitly recognised the interaction between corruption and tax evasion. Based on firm-level data obtained from the World Enterprise Survey and BEEPS covering 8,000 observations and 32 countries, Alm, Martinez-Vazquez and McClellan (2016) applied the instrumental variable method to control for the potential endogeneity of corruption and tax evasion. As a robustness check, the method of propensity score matching was also employed. Their results indicated that it is corruption that largely drives tax evasion, in that: (i) requests for bribes reduce reported taxable sales, and (ii) larger bribes result in higher levels of tax evasion. In a theoretical study of business culture and tax evasion, Çule and Fulton (2009) constructed a coordination game to show that multiple equilibria can exist. In an unfavourable equilibrium (high cheating and corruption), increases in auditing or penalties may have perverse impacts and increase tax evasion. An externality between firms and tax inspectors is the source of this perverse effect: more tax evasion by firms is good for bribe-taking inspectors and more bribe-taking inspectors are good for tax evading firms.

2.3 Strategies to combat tax corruption

In terms of combating tax corruption, the literature is not consistent in its findings and implications. For example, in an early contribution, Flatters and MacLeod (1995, p. 397) proposed that '[s]ome tolerance of corruption can be part of an efficient collection system, especially when there are constraints on government wages or effort is required to learn payers' tax liabilities'. In contrast, Fjeldstad and Tungodden (2003) put forward an opposite argument on three grounds. First, while an increase in corruption may raise tax revenue in the short run, the opposite result generally holds in the long run. Secondly, the value of reducing corruption exceeds that of reduced tax evasion and higher revenue. Thirdly, eliminating corruption should be viewed as an end, not a means, in itself.

Turning to Vietnam, the literature on corruption has only recently emerged due to the sensitivity of the issue and lack of systematic data until about a decade ago. As a result, there has been very little research on corruption, let alone tax corruption, in Vietnam. An interesting study that deserves mention is that by Rand and Tarp (2012) who investigated the determinants of bribes and changes in bribe-paying behaviour by Vietnamese firms. Applying a pooled probit model and a fixed-effect linear probability model to firm-level data obtained from the United Nations University's 2005 and 2007 Vietnam Small and Medium Enterprises Surveys (VSMES) covering 1,659 firms in 10 provinces, Rand and Tarp (2012) found that: (i) bribe incidence among SMEs in Vietnam is closely related to firm-level differences in sunk costs and ability to pay; (ii) the magnitude of bribes is higher for firms that get preferential tax benefits and government contracts, and (iii) there is evidence indicating a decline in firm-level corruption from 2005 to 2007.

During 2013-14 the UK Department for International Development (DFID) sponsored an anti-corruption research program in Vietnam (see Tromme, 2016). The program involved a series of empirical studies utilising a variety of research methods and data sources. These studies examined the impact of corruption on economic growth (Nguyen, Nguyen & Tran-Nam, 2016), provincial development (Dang, 2016), firm

innovation (Nguyen, Doan, Nguyen & Tran-Nam, 2016), firm strategy (Nguyen, Ho, Le & Nguyen, 2016) and household business sector (Dang et al., 2016). They were published in a special issue of *Crime, Law and Social Change* in 2016 and have remained the most comprehensive, up to date and authoritative set of studies on corruption in Vietnam. While most of these studies are concerned with general corruption, the findings can plausibly carry over to tax corruption. In the only study that focused on tax corruption, Dang et al. (2016) found that: (i) bribes result from both extortion and collusion, and (ii) bribe payments are often perceived as a normal cost of doing business.

3. CONCEPTUAL ISSUES

Before proceeding further, it is useful to clarify key concepts and theoretical relationships. To this end, we shall in turn discuss the meaning, measurement, causes and consequences of tax corruption.

3.1 Definition and types of tax corruption

Like needs and poverty, corruption is a social concept so that its meaning is not only relative but also context dependent. What is considered as corruption at a particular place and time in a particular context may not be regarded so at a different place and time or in a different context. The meaning of corruption is comprehensively reviewed in Rosid (2017, ch. 3). While corruption can be defined in various ways, there is nevertheless a near-universal agreement on two essential characteristics of corruption, namely: (i) illegal/illegitimate use/exercise (or misuse/abuse) of public office/power, and (ii) private/personal gains/benefits. Note that, especially in the context of developing/transition economies, these benefits consist of not only financial but also non-financial rewards. Not surprisingly, corruption often goes hand in hand with nepotism and cronyism in these countries.

For a variety of purposes, it is necessary to adopt a formal definition of tax corruption. To this end, tax corruption is defined as the ‘behaviour on the part of tax officials to improperly and unlawfully enrich themselves, or those close to them, by the misuse of the public power entrusted to them’ (Li, 1997, p. 475). This definition seems to be precise yet sufficiently broad to capture the various characteristics of tax corruption discussed above. More importantly, it explicitly mentions the benefits to people who are close to the corrupted tax officials. This is most relevant in countries such as China or Vietnam where the traditional culture encourages sharing, especially among members of the extended family or local community.¹⁰

In terms of the operation of the tax system, one may, in principle, distinguish between tax policy corruption, tax administration corruption and tax dispute resolution corruption. Tax policy corruption represents an example of the classification of ‘political’ corruption by Transparency International. This refers to ‘a manipulation of policies, institutions and rules of procedure in the allocation of resources and financing by political decision makers, who abuse their position to sustain their power,

¹⁰ There is a Vietnamese saying that ‘One mandarin helps the whole clan’ (*Một người làm quan cả họ được nhờ*).

status, and wealth' (Transparency International, 2017b). However, it is generally not possible to find evidence of tax policy corruption in practice. This is especially true for Vietnam in view of the consensual-based decision-making process at the national level (Lucius, 2009, p. 13). Vietnam is a civil law country in which the courts play a very insignificant role in resolving tax disputes so the scope for tax dispute resolution corruption is negligible. Thus, in practice, all empirical studies of tax corruption necessarily focus only on tax administration corruption. Thus in this article, from this point on, tax corruption refers to tax administration corruption, unless otherwise stated.

In terms of scale, tax corruption can be divided into petty and grand (United Nations Development Programme, 2008, p. 6). Petty tax corruption refers to the bribes (known in Vietnam as informal or unofficial payments) received by relatively low-level tax officials (tax inspectors/auditors) in their interaction with taxpayers (individuals and firms). Grand tax corruption, on the other hand, refers to the abuse of public power by high-level tax officials, such as directors or senior staff, for their personal gains. Grand tax corruption occurs much less frequently but involves much larger sums of money than petty tax corruption. In view of the lack of concrete data on grand tax corruption in Vietnam, tax corruption in this article from now on will refer to petty tax administration corruption, unless otherwise stated.

In terms of process, petty tax corruption can be further classified into extortion and collusion. In the case of collusion, the bribery is often suggested by the taxpayer and the amount is normally arrived at after a process of negotiation, whether explicitly or implicitly. In the case of extortion, it is the tax official who first makes the demand for the bribe. In both cases, the amount of the bribe tends to be proportional to the amount of taxation that is in dispute.

In the literature, the bribe-taking behaviour of tax officials is supposed to be conducted in an isolated and independent manner, and the bribes normally take the form of cash or gifts. In Vietnam, there is a range of anecdotal evidence that tax corruption appears (or at least is perceived) to be widespread, loosely organised and taking many forms. More specifically, tax-related bribes often go hand in hand with nepotism and favouritism (i.e., appointment of inappropriate candidates due to their family ties or close relationships with the Communist Party of Vietnam, etc.)

Because of the many forms of tax corruption in Vietnam, it can still take place in isolation. In terms of interaction between tax officials and taxpayers, tax corruption can be further divided into the following categories:

1. one tax official in isolation: embezzlement, inappropriate appointment/promotion of tax officials (due to bribery, family ties, political connection, etc) or revealing sensitive tax information to the wrong party;
2. one or more tax officials and one taxpayer: bribery (cash, gift, renting or buying assets below market prices, paying for private expenses such as meals or tours) or recruitment/promotion of persons related to the tax official(s) in the taxpayer's business;
3. two or more officials: excessive gifts to curry preferential treatments (e.g., appointment of relatives, own promotion) from superiors or an informal scheme of bribe-sharing between tax officials.

It is noted that while the above classification also applies to general corruption, the frequency and scale of bribery are most severe in the case tax corruption, at least in the context of Vietnam.

3.2 Measurement of tax corruption

For any given specific definition of tax corruption, exact measurement of tax corruption is impossible for a number of obvious reasons. First, due to its secret and illegal nature, direct and systematic observations of tax corruption are not possible. Secondly, as discussed previously, tax corruption has several different dimensions and it may not be possible to combine these aspects into a single measurement or index. Thus, it is very problematic to arrive at a set of measures of tax corruption which are comparable across countries and consistent over time.

Broadly speaking, there are two different approaches in measuring tax corruption, namely objective measurement and subjective measurement. An objective measurement of tax corruption may include, for example, the frequency and the amount of bribery that a taxpayer makes to tax officials. Such information can in principle be collected from taxpayers through the means of a questionnaire- or interview-based survey. In addition to the conventional data problems arising from survey research, it is unclear whether respondents truthfully reveal the full extent of their bribery behaviours. An objective measurement of tax corruption can be further categorised into an absolute measure (e.g., the average dollar value of the tax-related bribes) or a relative measure (e.g., the ratio of bribe payments to official tax liability or the ratio of bribe payments to firm's total costs or profits).

A subjective measurement of tax corruption seeks to obtain (normally informed) views/perceptions of relevant stakeholders such as tax officials, business entities, institutional agencies (including donors) and individuals through questionnaire-based surveys. This is by far the most widely-used approach in gauging the level of tax corruption in countries around the world, including Vietnam.

Objective and subjective measurements of tax corruption discussed above constitute direct measures of tax corruption. An additional means to assess the extent of tax corruption is to rely on a set of indirect measures, which can be either objective or subjective. For example, it is well known that tax corruption often occurs as a result of the interaction between tax officials (inspectors and auditors) and taxpayers. Thus, in the case of tax corruption, indirect measures may include the Paying Taxes indicators compiled by the World Bank. Similarly, aggregate measures such as tax collection (tax revenue/GDP) or tax effort (to be further discussed later, in section 4.3 below) can also be loosely used as indirect, macro measures of tax corruption.

3.3 Causes of tax corruption

There is a variety of general and specific causes of tax corruption in Vietnam. Since most of the general causes have been well-discussed in the literature, it suffices to mention them only briefly here.

3.3.1 General causes:

1. political: lack of transparency, accountability and genuine will to fight corruption;

2. institutional: lack of a competent public sector; no objective measure of public sector performance; job-buying practice in the public sector;
3. cultural: sharing within the extended family of local community; compromising and paternalistic culture;
4. economic: low wages in the public sector (no public servant can survive on his/her official salary!).

3.3.2 *Specific causes:*

1. tax law complexity: tax law can be interpreted in different ways (under the civil code approach, Vietnam's tax law cannot cover all cases that may arise in practical situations);
2. tax discretions: tax officials have many discretions (e.g., assessing turnover for the purposes of presumption taxes);
3. tax administration: no self-assessment, frequent site visits to business taxpayers, no effective system of independent tax dispute resolution;
4. business practice: poor tax and accounting record-keeping;
5. business motive: desire to pay as little tax as possible.

3.4 **Consequences of tax corruption**

Tax corruption gives rise to a number of harmful consequences on social welfare and economic development (see, for example, Purohit, 2007). First, and most apparently, tax corruption causes a loss in the tax revenue collected. This revenue leakage is particularly damaging to developing and transition economies which rely heavily on tax revenue for the provision of much needed public goods and services for economic development such as health and education.

Secondly, and also quite obviously, tax corruption causes distortion in the allocation of resources, including the allocation of talents. Together with other forms of corruption, it reduces the efficiency of both the private and public sectors, and decreases the inflows of foreign direct investment. At the firm level, the costs and benefits of corruption are not always unambiguous. While firms may enjoy some short-term benefits from tax corruption, it erodes their long-term business integrity and strategic capability. All of these lead to lower economic growth and development in the long run.

Thirdly, and less apparently, tax corruption reduces the policy equity of the tax system. This is because those who enjoy the benefits of tax corruption tend to be higher-income individuals. Their undeclared, illegal income from bribery reduces the distributive function of the income tax system, which in turn contributes to increasing income inequality in the society. This is particularly serious in transition economies such as Vietnam where there has been a steadily widening gap in the distribution of household income.

Fourthly, perception of tax corruption may have an adverse effect on the tax morale of taxpayers (see Rosid, 2017). This in turn weakens voluntary tax compliance which is fundamental to the success of any modern tax system.

Finally, perception of tax corruption itself reinforces the public's perception of general corruption which is a serious threat to the political legitimacy of the government, including in one-party countries such as Vietnam.

4. EXTENT OF TAX CORRUPTION IN VIETNAM

There is a range of primary evidence, both anecdotal and documented, that Vietnam has remained confronted with widespread tax corruption. In this section, we start by presenting evidence of general corruption in Vietnam. It is then followed by evidence of tax corruption. Finally, we discuss Vietnam's tax collection and tax effort. Somewhat surprisingly, despite evidence of prevalent tax corruption, Vietnam has been performing well in terms of both tax collection and tax effort.

4.1 Extent of general corruption in Vietnam

Vietnam performs consistently poorly in terms of international measures of general corruption such as the Corruption Perceptions Index (CPI). During the period 2011 to 2016, Vietnam's CPI level improved slightly from 29 to 33 (0 is highly corrupt and 100 is highly clean) but its ranking slightly worsened from 112 out of 184 to 113 out of 176 (Transparency International, 2017a, 2017c). The Global Corruption Barometer Report (involving about 22,000 people living in 16 countries from 2015 to 2017) confirms Vietnam's poor standing. Along with Malaysia, Vietnam was the worst performing country in the Asia Pacific region (Transparency International, 2017d, p. 27). In particular, the government was rated poorly in its efforts to fight corruption and bribery was very high.

While the World Bank's Worldwide Governance Indicators support the above findings, an improvement in Vietnam's control of corruption has been detected. The control of corruption indicator increased steadily from 25 in 2005 to 33 in 2010 and to 39 in 2015 (on a 0 to 100 scale, with higher values corresponding to better outcomes; World Bank, 2017a).

There is also some domestic evidence of the seriousness of general corruption derived from the 2012 survey sponsored by the World Bank and Government Inspectorate of Vietnam. Some interesting results are summarised below (World Bank and Government Inspectorate of Vietnam, 2012, pp. 30, 35 and 84 respectively):

1. after costs of living, corruption is perceived as the second most serious issue according to public officials, business and individuals;
2. at the national level, high-income individuals consider corruption to be more serious than average or low-income individuals;
3. to pressure businesses to make unofficial payments, public officials' three most common practices are intentionally prolonging time, giving no clear guidance/finding faults, and sticking to ambiguous regulations.

4.2 Extent of tax corruption in Vietnam

4.2.1 Indirect measure: Paying Taxes indicators

As previously argued, Paying Taxes indicators derived from the World Bank's *Doing Business* Report can serve as an indirect measure of tax corruption because there is potentially a positive association between tax compliance burden (including dealing with tax inspectors' site visits) and petty tax corruption. In the 2015 calendar year, paying taxes in Vietnam (540 hours) took more than 2.5 times longer than it did in the average of the East Asia and Pacific (198 hours) (World Bank, 2017b).¹¹ Similarly, the number of tax payments in Vietnam in 2015 (31 times) also far exceeded the average of the East Asia and Pacific Region (22.9 times).

4.2.2 Direct, subjective measure: perception of tax corruption in Vietnam

Relevant results from the 2012 survey sponsored by the World Bank and Government Inspectorate of Vietnam are summarised below:

1. in terms of perception of the prevalence of corruption, out of 22 sectors, customs and taxation rank 3rd and 9th respectively, according to public officials, businesses and individuals (World Bank and Government Inspectorate of Vietnam, 2012, p. 38);
2. out of 22 sectors, customs and taxation rank as the 4th and 6th most corrupt sectors respectively, according to public officials, businesses and individuals (2012, p. 39). This represents some improvement since customs and taxation ranked as the 2nd and 4th most corrupt sectors respectively in the 2005 Survey (2012, p. 82);
3. tax officials are identified by businesses as the public officials creating the most difficulties and the ones that have been given the most unofficial payments and gifts (2012, pp. 44-45);
4. in the taxation sector, unofficial payments are actively suggested by businesses (almost 90 per cent of all cases) and only in about 10 per cent of cases are the unofficial payments demanded (2012, p. 46);
5. the probability that individuals coming in contact with tax officials must pay a large bribe is only 0.5 per cent (not surprising in view of the small role played by the income tax in Vietnam) (2012, p. 52);
6. in the case of individuals making unofficial payments to tax officials, 83 per cent are voluntary (2012, p. 55).

4.2.3 Direct, objective measure of tax corruption in Vietnam

1. The Vietnam Chamber of Commerce and Industry (VCCI) conducted a national survey of more than 2,500 registered businesses in 2015. The survey indicates that 32 per cent of registered businesses in Vietnam had to make

¹¹ This refers to the number of hours that a medium-size company must spend to pay (or withhold) all taxes and mandatory contributions in a given year.

unofficial payments and 40 per cent believed that their businesses would be poorly treated without bribery (VCCI, 2015);

2. similar but more detailed data on tax corruption are also available from the Vietnam Provincial Competitiveness Index (PCI) and Surveys of Small and Medium Manufacturing Enterprises in Vietnam which have been conducted at regular time intervals. These data more or less confirm the picture painted above.

4.3 Vietnam's tax collection and tax effort

For completeness, we now consider Vietnam's tax collection and tax effort. Tax collection is conventionally defined as the ratio of actual tax revenue to GDP. Tax effort is defined as the ratio of tax collection to taxable capacity where taxable capacity refers to the predicted tax collection ratio that can be estimated by regression analysis, taking into account a country's specific, time-varying macroeconomic, demographic and institutional features (Le, Moreno-Dodson & Bayraktar, 2012, p. 3).

Using tax collection and tax effort allows us to rank countries into four separate groups: (i) low tax collection (below the median value of the sample), low tax effort (below 1); (ii) high tax collection, low tax effort; (iii) low tax collection, high tax effort, and (iv) high tax collection, high tax effort. *A priori*, a country with widespread tax corruption is expected to belong to the low tax effort group. Similarly, a country at a low level of economic development is expected to belong to the low tax collection group. Thus, Vietnam would be expected to belong to the low tax collection, low tax effort group.

Surprisingly, however, Vietnam in fact belongs to the high tax collection, high tax effort group (Le et al., 2012, p. 25). Its average tax collection during the period of analysis from 1994 to 2009 was above 18.31 per cent (median value of the tax collection in the sample). That Vietnam has a high tax collection, relative to its GDP per capita, is well known. In fact, Vietnam is known to have one of the highest tax collection ratios in the region.

What is much less known is Vietnam's tax effort. During 1994-2009, Vietnam's average tax effort index was 1.31, the highest in East Asia and the 16th highest in the world (Le et al., 2012, pp. 19-20). Vietnam's remarkable tax effort may lend credence to the argument put forward by Flatters and MacLeod (1995, p. 397) that, at least in the short run, an efficient collection system can be consistent with petty corruption, particularly when there are constraints on government wages or effort is required to learn businesses' tax liabilities.

5. IMPACT OF TAX CORRUPTION ON PRIVATE SECTOR DEVELOPMENT IN VIETNAM

In this section we first provide an overview of private sector development in Vietnam and how private businesses in Vietnam deal with their domestic tax obligations. We then review how and why business taxpayers in Vietnam bribe tax inspectors, and how tax corruption affects the development of the private sector in Vietnam using four dimensions of analysis, namely innovation, investment, employment and per capita income.

5.1 Private sector development in Vietnam

Following its reunification in 1975 Vietnam officially adopted a central planning economic regime throughout the country. Such a policy choice, coupled with other external difficulties, produced disrupting economic failure in Vietnam. This necessitated the introduction of *Doi Moi* (economic renovation) in 1986, which saw the emergence of the private sector in 1989: agriculture was decollectivised, private land use rights established, the majority of prices and the financial sector liberalised, many restrictions on private sector activity eliminated and trade and investment opened up (see, for example, Tran-Nam, 1999).

The most significant legal development for the private sector in Vietnam was the promulgation of the Enterprise Law which came into effect from 1 January 2000. This law replaced the old Private Enterprise Law and Company Law to establish a more favourable business environment for the private sector development. As a result, the number of new businesses has since increased very rapidly. For example, the average number of newly registered enterprises per day during the period 2000-05 was 3.75 times higher than that of the 1991-99 period. This rising trend has accelerated further in recent years. There were 14,453 newly established enterprises in 2000 and this number was estimated to be more than seven times larger in 2010 with 103,170 new businesses (Business Insides, 2011).

Because of its rapid growth and contribution to the economy, Vietnam's private sector is considered to hold the key to Vietnam's future economic success. Estimates of the contribution of the private sector (called the non-state sector) to GDP in Vietnam vary from source to source. According to the Organisation for Economic Co-operation and Development (OECD, 2014), private enterprises accounted for more than 50 per cent of GDP and created 60 per cent of all new jobs in 2013. Despite its growing importance, the private sector in Vietnam remains relatively underdeveloped and faces major constraints. Some of the main problems are briefly discussed below.

First, private enterprises do not compete on an equal footing with state-owned enterprises (SOEs), especially in terms of access to land and credit. Secondly, most of private enterprises are of small and medium size. For example, in 2005 more than 85 per cent of private enterprises had less than VND 1 billion (about USD 45,000) in total capital. According to the criteria specified in the new Decree 56/2001/ND-CP,¹² about 96 per cent of private enterprises are SMEs although the scale of their operation has been expanded in recent years. Thirdly, as a consequence of being small and having little protection from the government, private enterprises are more likely to become vulnerable to global economic changes. A study by Le (2009) suggested that the 2009 global economic slowdown affected 57.5 per cent of SMEs in Vietnam while only 40.4 per cent of large firms were affected.

¹² This decree defines the size of a business (micro, small, medium or large) according to total capital (the priority criterion except for the micro category) or average annual number of employees. The threshold definitions vary according to the industrial sector (primary, manufacturing and service). For all sectors, a business which employs 10 workers or less is said to be micro. For the primary/manufacturing sectors, a business is said to be small (medium) if it has a total capital of VND 20 billion or less (between more than VND 20 billion and VND 100 billion), or it employs between more than 10 to 200 (between more than 200 and 300) workers. For the service sector, a business is said to be small (medium) if it has a total capital of VND 10 billion or less (between more than VND 10 billion and VND 50 billion), or it employs between more than 10 to 50 (more than 50 and 100) workers.

In spite of the above constraints, the private sector is an engine of innovation and hence productivity and efficiency. In particular, estimates by global management consulting firm McKinsey found that with one additional unit of capital the private sector in Vietnam produces three times the additional revenue compared to SOEs (reported in Kim, 2014). In recent years, Vietnam's efficiency and productivity has stagnated and, as a result, its annual GDP growth has slowed to around 5 per cent. It is argued by many researchers that Vietnam's total factor productivity slowdown has been primarily caused by resource misallocation within its economy and there would be a very substantial productivity improvement if these distortions were removed (Doan et al., 2016, p. 105).

5.2 Paying taxes in Vietnam

There are about 10 different types of formal taxes in Vietnam (see PricewaterhouseCoopers, 2017). However, the main taxes that are relevant to businesses are value-added tax (VAT), corporate income tax, excise tax (known in Vietnam as special consumption tax), and import and export taxes. In terms of reporting frequency and burden, VAT and corporate income tax are by far the most significant business taxes in Vietnam.

Businesses in Vietnam are generally required to register with the tax administration (the General Department of Taxation (GDT) or its city and local offices) within 10 working days of their formal establishment. Each registered business will be supplied with a business tax registration certificate and a unique tax code. Businesses then have to report their estimated tax obligations by filing certain forms at a certain frequency depending on each tax type (VAT, corporate income tax, excise tax, import and export taxes).¹³ There is also a regulation on tax payment deadlines according to which enterprises have to pay their taxes arising from the period that corresponds to the frequency of tax payment. Otherwise, they must pay an additional penalty for being late in paying tax dues.

Large enterprises are required to report and pay their VAT liabilities on a monthly basis while SMEs do so on a quarterly basis. There are two ways of calculating VAT, namely, the conventional credit-invoice method and the direct method. Under the direct method, VAT tax liability is calculated by multiplying business turnover by a VAT rate which varies from industry to industry. The direct method is only available for newly established enterprises or enterprises with turnover below VND 1 billion (or USD 45,000).

In contrast to VAT, corporate income tax in Vietnam is reported and paid to the tax authorities on a quarterly basis. Prior to 2014, enterprises were required to file the tax declaration form quarterly in detail and pay that monetary amount. However, since the fourth quarter of 2014, enterprises only have had to estimate their corporate income tax liabilities and pay that amount without any additional declaration. Besides the requirement of estimating and paying corporate income tax in each quarter, the regulation on corporate income tax also requires that the total of estimated taxes should be no less than 20 per cent of total actual tax from the same period. Otherwise,

¹³ For household businesses, the tax authority will assign them a presumptive amount of tax liability and every household business is required to pay this assigned tax obligation.

the enterprises will have to pay the difference and an additional amount of penalty for the late payment of the difference.

As expected, the large business sector has played a key role in tax payment in Vietnam. However, an examination of tax revenue share by business size from 2000 to 2015 reveals three interesting trends.¹⁴ First, the contribution of the large business sector to total tax revenue has declined from about two-thirds (about 66 per cent) in the early 2000s to about 54 per cent in 2015. Secondly, the contribution of the medium business sector to total tax revenue has remained largely static at about 21 per cent over the 2000-15 period. Thirdly, during the same time period, the total tax revenue shares of the micro and small business sectors have more than doubled: from 1.8 to 3.7 per cent for the micro business sector and from 9.9 to 21 per cent for the small business sector.

As discussed previously, *Paying Taxes* indicators suggest that a mid-size firm in Vietnam typically makes many tax payments to the tax authorities annually and also requires many hours to complete its tax affairs. Further, a Vietnam Enterprise Survey conducted by the World Bank (2017c) in 2015 reveals that a very high proportion of businesses (42.7 per cent) are visited by or required to meet with tax officials. The number of visits would be directly proportional to the required frequency of tax reporting. Such interactions between business taxpayers and tax auditors can often give rise to petty tax bribes.

To the best of the authors' knowledge, there is no publicly announced anti-tax corruption policy in place despite the perception of widespread petty tax bribes.¹⁵ There may be two reasons for such a lack of specific policies. First, as discussed in section 4.3, Vietnam has been doing reasonably well in terms of both tax collection and tax efforts at the national level. Secondly, Vietnam's current business culture seems to exhibit a high degree of tolerance, or even acceptance, of petty tax bribes. This point will be further discussed in the remainder of this section.

5.3 How and why business taxpayers bribe tax inspectors

In this section, we briefly report the findings of Dang et al. (2016) and Nguyen, Ho, Le and Nguyen (2016).

The study by Dang et al. (2016) utilised a qualitative research method. Primary data were collected using a questionnaire-based survey. A random and proportional sampling was applied resulting in an effective sample of 525 household businesses in eight regions of Vietnam (out of 4.09 million household businesses in 2013).

Their key findings on tax corruption are as follows:

1. while the respondents complained that tax officials use their prerogative and authority with a view to demanding more tax payments, bribes often result

¹⁴ The tax revenue share calculations are based on the annual enterprise surveys conducted by Vietnam's General Statistics Office (GSO, 2016) from 2010 to 2015. The surveys employ a combination of samples to collect data on different groups of enterprises. In the most recent survey (2015), about 455,300 enterprises were covered.

¹⁵ There may be General Department of Taxation internal guidelines or practices for anti-tax corruption but the authors are not privy to this kind of information.

from a process of negotiation and collusion rather than extortion. About 70 per cent of the respondents indicated that they always or often colluded with tax inspectors for mutual benefits. Correspondingly, only 11 per cent of the respondents agreed that tax inspectors often harass them for unofficial payments whereas 43 per cent of the respondents disagreed with it;

2. the scale of corruption is petty. About 67 per cent of the respondents stated that the average amount of unofficial payment per inspection visit is one million VND or less (about 45 USD at the April 2017 exchange rate);
3. tax officials, at the commune and district levels, only received 20 per cent and 25 per cent positive ratings from the respondents, respectively;
4. tax corruption is often perceived as a normal cost of doing business. More than 80 per cent of the respondents did not believe that reporting corruption would result in any action whereas 13 per cent admitted their guilt (so that a bribe would be the lesser penalty than a fine).

The theoretical framework of the study of Nguyen, Ho, Le and Nguyen (2016) was based on the institutional theory, rent-seeking approach and resource-based view. It utilised a mixed-modes research method in which the quantitative analysis involved formal hypothesis-testing using regression analyses. Data were derived from firm-level data for 2009-11 drawn from the Provincial Competitiveness Index, conducted by the Vietnam Competitiveness Initiatives and the VCCI, and the annual enterprise survey, conducted by the General Statistics Office of Vietnam.

Their main findings on costs and benefits of tax corruption are:

1. institutional view: firms engage in corrupt activities only to follow the 'rules of the game'. There is a positive relationship between the probability that a firm makes unofficial payments and: (a) the unofficial payments made by other firms in the district; (b) the firm's belief that other firms make unofficial payments, and (c) the firm's belief that negotiations with tax officials are important;
2. institutional view: the hypothesis that unofficial payments are positively associated with transactional benefits of young firms cannot be supported. There is some evidence that unofficial payments seem to increase with the number of visits and the length of each visit for young firms;
3. rent-seeking view: unofficial payments are positively related to growth for firms operating in restricted areas;
4. resource-based view: unofficial payments have a negative relationship with firm efficiency. This harmful effect is normally hidden and not well recognised by firms.

5.4 Firm innovation

In the study by Nguyen, Doan, Nguyen and Tran-Nam (2016), three aspects of innovation were recognised: new product, new process and modification of an existing product. The research utilised a quantitative analysis that involved instrumental variable regression analyses to deal with the endogeneity problem. Secondary data were derived from firm-level data for 2005-11 drawn from the Surveys of Small and

Medium Manufacturing Enterprises, conducted jointly by Vietnam's Central Institute for Economic Management and the Danish International Development Agency.

Key findings on firm innovation:

1. the findings support the 'greasing-the-wheels' hypothesis of corruption;
2. unofficial payments appear to have a positive and significant effect on general innovation, product innovation, product improvement and, especially, process innovation. While the findings are controversial, it is consistent with the 'greasing-the-wheels' hypothesis of corruption and other previous studies. In the absence of formal and transparent institutions, unofficial payments can provide the certainty needed by businesses to innovate.

5.5 Firm performance

The study by Dang (2016) examined three dimensions of firm performance: investment, employment and per capita income. His research analysis was quantitative, involving a Hausman–Taylor estimation method to deal with the endogeneity problem. His data were taken firm-level data 2006–12 drawn from the annual enterprise survey, conducted by the GSO, and the Vietnam Household Living Standard Surveys, conducted by the GSO with technical assistance from the World Bank.

His key findings on firm performance can be summarised as follows:

1. the findings support the 'sanding-the-wheels' hypothesis of corruption. The prevalence and burden of corruption have negative and significant impacts on investment, employment and household income. Thus, tax corruption can substantially undermine the socioeconomic development of the provinces;
2. a 1 per cent drop in the prevalence of corruption would increase private investment by 3.7 per cent, private employment by 1 per cent and per capita income by 1.5 per cent;
3. a 1 per cent drop in the burden of corruption would increase private investment by 6.4 per cent, private employment by 1.8 per cent and per capita income by 2.3 per cent.

Overall, the empirical findings of the above studies suggest that the impact of tax corruption on private sector is indeed mixed as both the 'sanding-the-wheels' and 'greasing-the-wheels' hypotheses can be supported in different contexts. The presence of the vicious circle of tax corruption, and taxpayers' myopic view on the short-term benefits of engaging in tax corruption are serious challenges to policy-makers who are genuinely committed to fighting corruption.

6. MOVING FORWARD: SOME POLICY RECOMMENDATIONS

The present article has attempted to make a contribution to the under-researched field of tax corruption in general and tax corruption in Vietnam in particular. It has discussed the meaning and types, measurement, causes and consequences of tax corruption, presented the evidence on the extent of tax corruption and reviewed the

findings on impact of tax corruption on private sector development, primarily in the Vietnamese context.

The evidence suggests that Vietnam faces a serious tax corruption problem. Petty tax corruption is prevalent, resilient and damaging. Yet the fight against tax corruption to develop a healthier tax culture is such a difficult one for two key reasons. First, at the macro level, Vietnam appears to do very well in terms of tax collection and tax effort. Thus, there is little incentive for tax authorities and tax administrators to move away from the current practice. Secondly, from the business perspective, corruption has created a vicious circle. Firms may lose sight of their business integrity and long-term strategic capacity because of their myopic, perceived benefits of petty bribes that provide some short-term certainties in the presence of inefficient governance.

To effectively fight tax corruption in Vietnam, a suite of both generic and specific reform measures are urgently needed. Like other transition countries, Vietnam needs to push forward with its structural reform. The generic structural reform consists of several dimensions such as marketisation, rule of law and democratisation. These are clearly beyond the scope of both tax policy-makers and administrators, so they will not be further elaborated upon here.

Tax-specific proposals are within the control of tax policy-makers and administrators. In the long term, tax culture is continuously evolving so there should be a deliberate program of education of taxpayers, especially business taxpayers, and the training of tax collectors/inspectors. Needless to say, such an education and training program should be accompanied by a gradual reform of the salary structure of the public sector.

The short and medium-term proposals basically call for the modernisation and simplification of the Vietnamese tax system. The proposed reform measures are set out as follows:

1. first, Vietnam's tax law should be made more certain and unambiguous so that tax inspectors have fewer discretions in interpreting the tax law. The tax law should also be simplified in order to eliminate an important source of corruption. There should also be a greater effort in applying self-assessment in accordance with international practice;
2. secondly, the tax administration process should be simplified so that there are fewer site visits by tax inspectors and so that businesses can comply with their tax obligations more easily. In particular, there should be a more vigorous push for a greater application of digital technology to minimise face-to-face interactions between business taxpayers and tax inspectors;
3. thirdly, entrance to the General Department of Taxation should be based more rigorously on transparent, merit-based examinations. As a supplement, there should be more regular rotation of staff (from one department to another, or from one sector to another, or from one district to another);
4. fourthly, consideration should be given to establishment of a more accessible mechanism of independent tax dispute resolution through which taxpayers who disagree with the GDT can voice their disputes;

5. fifthly and finally, the GDT should consider introducing a formal measure of its productivity as a way to monitor and improve its operation and performance.

The above proposed measures can only work if there is a parallel effort to break the vicious circle of tax corruption among business taxpayers. This typically requires a carrot and stick approach. As mentioned previously, an important component of such a strategy is a thoughtful program to educate both tax officials and taxpayers about the benefits of a healthier tax culture. High-profile prosecutions of a few corrupted tax officials would also be helpful in turning the tax paying culture around. Another helpful development, which may not be entirely within the control of the GDT, is for the Ministry of Finance to guide and assist the progress and growth of a wave of capable and law-abiding tax practitioners in Vietnam.

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Applying foreign anti-corruption law in the Chinese tax context: Conceptual difficulties and challenges

Nolan Sharkey¹ and James Fraser

Abstract

At the core of the international effort to combat corruption is the ‘home country’ anti-corruption legislation that penalises companies in their home state for engaging in corruption extraterritorially. This article examines the application of Australia’s foreign bribery legislation to the Chinese tax context. The legal test for Australia’s extraterritorial bribery legislation rests heavily upon a finding that an extra-legal advantage gained, or benefit provided, is ‘illegitimate’. While the assumption that formal law is aligned with legitimacy is reasonable in many contexts and practical in the application of the law, a focus on legality does not align well with legitimacy in China. In China, vague laws are created by the central government in order to facilitate flexible and localised implementation. In a system where formal legal institutions are underdeveloped, informal rules are significant in guiding the actions of local officials. Australia ought to consider the nature of the relationships between China’s central and local governments prior to implementing its extraterritorial jurisdiction. Upon doing so, it will become apparent that a strictly ‘legal’ analysis is an inappropriate yardstick by which to gauge the legitimacy of an official’s behaviour.

Keywords: Local state corporatism; China; corruption; bribery; Chinese tax law; rule of law in China; vague and flexible law; rule of mandates; informal rules; legitimately due; competitive advantage; regionally decentralised authoritarianism; local experimentation

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1. INTRODUCTION

Corruption and bribery are regarded as highly undesirable and damaging phenomena. This is particularly thought to be the case in developing countries with weak institutions and, often, weak rule of law. As a result of concerns about bribery and corruption in developing countries there has been an international effort to curb them since the 1960s. This has been particularly aimed at preventing large multinational businesses from the developed world from engaging in bribery and facilitating corruption in the developing world. At the core of this international effort is the 'home country' anti-corruption legislation that penalises companies in their home state for engaging in corruption extraterritorially.

A country's taxation institutions are a key area of concern in the above context as they represent one of the major interfaces between the private and public sectors. Favourable tax treatment may provide a significant competitive advantage to a taxpayer while unfavourable tax treatment may impede success. Many countries have chosen to intervene in their economies through the use of taxation to encourage and discourage particular economic activities. Where this is the case, there is greater scope for the administrative process surrounding taxation to be corrupted.

The issue of corruption in China has received significant attention. Media, anecdotal and scholarly sources have focused attention on how business outcomes in China may be shaped by relationships and favours. This focus has grown since November 2012 when the Chinese Communist Party embarked on a heavily publicised Anti-Corruption Campaign under the leadership of Chinese President Xi Jinping.² However, it may be suggested that various phenomena observed in Chinese administration and government are difficult to typify as corruption according to concepts adopted in anti-corruption law and the academic literature dealing with the concept.

China's tax institutions and administration are significantly tied to the above discussion. China's tax is well known for a raft of variable treatments under the law through incentives and administrative practice. It is also well known that relationships and negotiation can shape taxation outcomes for businesses in China. Therefore the possibility of corruption in China's taxation is worthy of academic discussion. In addition, taxation in China allows for a general examination of the problems that arise in typifying many phenomena in China as being 'corrupt', notwithstanding their prima facie appearance as such.

Understanding whether Chinese tax practices are corrupt is important for understanding Chinese economic development. It is also important to countries like Australia that have significant economic interaction with China. While the Chinese central government attempts to rein in corruption, China continues to become an important trading partner of Australia.³ Australia's foreign bribery legislation operates to prohibit Australian firms from bribing Chinese public officials. In order to facilitate

² On 26 June 2015 President Xi Jinping emphasised the fundamental role of China's legal and regulatory institutions in ensuring the campaign's success: Dingding Chen, 'China's Anti-Corruption Campaign Enters Phase Two', *The Diplomat*, 2 July 2015 <<http://thediplomat.com/2015/07/chinas-anti-corruption-campaign-enters-phase-two>>.

³ For commentary on the Australian Government's White Paper, *Australia in the Asian Century* (2012), see Ken Henry, 'Australia in the Asian Century' (East Asian Bureau of Economic Research Working Paper No. 101, Australian National University, April 2015).

ongoing trade relations, it is important that Australian firms are able to understand with certainty the nature of these prohibitions.

This article uses the application of Australian foreign bribery legislation to the Chinese tax context to highlight the difficulties with typifying Chinese institutions as corrupt in general. In addition to this significant finding, the article achieves a subsidiary practical outcome of demonstrating the risks and issues Australian firms face in doing business in China. The article also provides information of a practical nature in relation to China's taxing institutions.

Finally it must be noted that this article does not seek to justify truly corrupt practices on the basis that they are part of the manner in which things work in China. Rather the goal is to show conceptual difficulties in defining something as corrupt in the Chinese institutional environment. True corruption cannot be dealt with effectively if the environmental circumstances mean that it is not correctly identified by relevant laws.

2. THE TAXATION ENVIRONMENT IN CHINA

While China has enacted tax laws and regulations, these are far from conclusive in determining taxation outcomes for businesses.⁴ Despite dealing with complex taxation concepts, the laws are brief.⁵ For example, China's *Enterprise Income Tax Law* of 2007 ('EITL') introduced the concept of a Controlled Foreign Company (CFC). This is a complex legal concept as 'control' needs to be carefully defined to determine when it can be found in the myriad legal and economic relationships possible in relation to corporate groups. The fact that China uses the concept of 'enterprise' instead of 'company' further complicates the control concept in comparison to a country such as Australia that relies on the company concept. Notwithstanding this, China's law devotes only a few articles to defining its CFC rules while Australia devotes numerous pages. This brevity of law is typical in Chinese taxation.⁶

In addition to the brevity of the law, China's laws use vague concepts that increase the scope for administrative discretion. Notably, items 'may' be exempted from tax or be subject to a reduced rate,⁷ and 'reasonable' amounts incurred may be deducted.⁸ In addition the Detailed Implementing Regulations of the EITL refer to 'certain prescribed criteria' and have numerous 'etc.'s.⁹ Such language adds to the conceptual uncertainty already inherent in words such as 'control', 'environmental protection' and 'new technology'.

⁴ Nolan Sharkey, 'Enterprise Income Tax in China: Simplicity to Complexity through Institutional Context' in Patricia Blazey and Kay-Wah Chan (eds), *Commercial Law of the People's Republic of China* (Thomson Reuters, 2012) 337.

⁵ Nolan Sharkey, 'China's New Enterprise Income Tax Law: Continuity and Change' (2007) 30(3) *University of New South Wales Law Journal* 833.

⁶ *Ibid.*

⁷ Enterprise Income Tax Law of the People's Republic of China, adopted by the Fifth Session of the Tenth National People's Congress of the People's Republic of China on 16 March 2007 art 27.

⁸ EITL art 8.

⁹ See Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law, promulgated on 1 January 2008 ('Detailed Implementing Regulations'), ch 4.

The lack of certainty inherent in Chinese written law is resolved through the interaction between taxpayers and tax officers.¹⁰ Courts are so rarely used that they cannot be considered a materially meaningful element in the current Chinese tax institutional context.¹¹ The interactions between a taxpayer and their tax office are decentralised. Taxpayers interact with the tax office in their relevant city or lower administrative level as opposed to the provincial or national level. This form of interaction provides significant certainty in administration but also results in a variety of outcomes across time and location.¹² The variety is inevitable given the decentralised decision-making and lack of interaction between offices in different locations. The lack of cooperation between tax offices across different locations is the product of a competitive localised orientation that is partly related to tax office local performance measures and partly related to formal and informal ties to the local economy and its administrators. The overall tax office administrative hierarchy requires such decentralised local decision-making in order to function.¹³

The Chinese tax institutional context outlined above necessitates a significant degree of interaction between administrators and taxpayers. Tax outcomes will be significantly impacted by these interactions.¹⁴ The role of written law, regulations and other normative documents in this process may be significant but is far less significant than it is in a country such as Australia. The law may frame the decision-making process but the lack of detail in the law means that a variety of outcomes are possible within this frame. In determining outcomes, decision-makers in China do not necessarily prioritise the principles implicit in the written law. A range of other factors can influence the decision-making process. The most significant of these factors is local economic management and development. This factor operates in an environment where local economies compete against one another for economic opportunity.¹⁵

Local economic interests are complicated by the fact that high-ranked administrators are often enmeshed in local business networks. As a result there can be a relationship between local economic interests and the private economic interests of high-ranked officials. These officials are not necessarily tax officers. However, the enmeshed nature of local governmental interests means that high level local officials can influence the decision-making of various bureaucratic departments at the local level including the State Administration of Taxation and the Local Tax Bureau. Ultimately, there is a significant blurring of the boundary between the local private economy and

¹⁰ Nolan Sharkey and Ian Murray, 'The Rule of Law and Leadership in Substitution and in Conflict: Social Psychological and Legal Perspectives on Chinese Tax Administration' (2015) 30(3) *Australian Tax Forum* 595.

¹¹ Wei Cui, 'What is the "Law" in Chinese Tax Administration?' (2011) 19(1) *Asia Pacific Law Review* 73.

¹² Nolan Sharkey, 'Localization of Central Taxation in China' in Nolan Sharkey (ed.), *Taxation in ASEAN and China: Local Institutions, Regionalism, Global Systems and Economic Development* (Routledge, 2012) 62.

¹³ Barbara Krug, Ze Zhu and Hans Hendrichske, 'China's Emerging Tax Regime: Devolution, Fiscal Federalism, or Tax Farming?' (Paper presented at the Annual Meeting of European Public Choice Society, University of Durham, 31 March 2005).

¹⁴ Sharkey and Murray, above n 11.

¹⁵ Sharkey, 'Localization of Central Taxation in China', above n 13.

the local state. At the same time, the local state plays a significant role in governing China.¹⁶

Thus a taxpayer company such as a foreign investment enterprise may be granted highly favourable taxation treatment based on a range of factors discussed above. On the other hand, highly unfavourable taxation treatment may also be imposed on other taxpayers in ostensibly similar circumstances. In some circumstances the range of treatment may be argued to fall within the vague limits of the law. However, it has been documented that the treatment may clearly depart from the principles inherent in the law and only be justified on a significantly strained interpretation of certain words, if at all.¹⁷ It would not be remarkable for treatment to be granted that simply departs from the law. For example, an enterprise that is not in any way using advanced technology may be granted an incentive aimed exclusively at those using advanced technology. Recourse to default and deemed assessments allows significant scope for administrators to simply determine a total tax burden for particular taxpayers.¹⁸ Finally, in cases where taxpayers are not generally granted the full benefit of a particular provision of the law, a taxpayer may be favoured by being granted it. For example, the law on Value Added Tax allows for the full refund of input credits on exported goods but this is not routinely given in China. Therefore a taxpayer can be favoured by being afforded the legal treatment.

It can be concluded that Chinese tax treatment varies significantly within the vague boundaries of the law and, at times, departs from these. Whether a taxpayer is granted the most favourable taxation treatment is influenced by a range of factors that includes, most significantly, competitive local economic development and management. At the same time, local government is heavily enmeshed in the local economy and it can be difficult to separate the private interests of local officials and their networks from the economic interests of the local state per se. A foreign investor's investment may be desirable because it involves a venture that will significantly benefit the local economy. For example, the foreign investor may employ people who need employment. Alternatively it may be desirable because it will partner with a local company or entrepreneur. This may be because the partnership facilitates the development of local skills and technology or because the local firm needs economic support to survive or thrive. Finally, the foreign taxpayer may simply provide some form of direct benefit to a decision-maker or influential local person. For example, a cash payment, the granting of an interest in the company or the employment of a particular person in a significant role may be made.

¹⁶ Krug, Zhu and Hendrischke, above n 14; Nolan Sharkey, 'Tax Evasion and Administration Realities in the People's Republic of China: Some Initial Findings from Discussions with Tax Officers in Fujian Province' in Margaret McKerchar and Michael Walpole (eds), *Further Global Challenges in Tax Administration* (Fiscal Publications, 2006) 175. Also Nolan Sharkey, 'Default Tax Assessments in Different Institutional Environments: An Australia/China Comparison of Rule of Law Implications' in G V Chang (ed.), *Tax Strategies in Economic Substance and Protection of Taxpayers' Rights* (Angle Publishing Co., Ltd., China, 2012) 631; Sharkey, 'Localization of Central Taxation in China', above n 13.

¹⁷ Sharkey, 'Localization of Central Taxation in China', above n 13.

¹⁸ Sharkey, 'Default Tax Assessments', above n 17.

3. CORRUPTION: THE AUSTRALIAN LAW

The context described above certainly indicates at least significant potential for corruption. However, it also indicates a lack of clarity in respect of where and when corruption can be clearly identified. This results in both typification problems and evidentiary issues. These can be explored in the context of both the practical operation of an anti-corruption law and from a normative perspective. The analysis below considers the Australian anti-foreign bribery law and the perspectives of other literature. This other literature both informs the understanding of the practical law and calls into question the operation of the law in China.

On 17 December 1999, the *Convention on Combating Bribery of Foreign Officials in International Business Transactions*¹⁹ entered into force in Australia.²⁰ Article 1(1) of the *Convention on Foreign Bribery* requires that Australia criminalise the act of bribery under Australian law.²¹ The *Criminal Code Amendment (Bribery of Foreign Officials) Act 1999* (Cth) ('Amendment Act') was enacted in response to the obligations created by the Convention. The Amendment Act operates to insert the offence of foreign bribery into the *Criminal Code Act 1995* (Cth) ('the Act'). Section 70.2 of the Act provides that:

1. A person is guilty of an offence if:
 - a. the person:
 - i. provides a benefit to another person; or
 - ii. causes a benefit to be provided to another person; or
 - iii. offers to provide, or promises to provide, a benefit to another person; or
 - iv. causes an offer of the provision of a benefit, or a promise of the provision of a benefit, to be made to another person; and
 - b. the benefit is not legitimately due to the other person; and
 - c. the first-mentioned person does so with the intention of influencing a foreign public official (who may be the other person) in the exercise of the official's duties as a foreign public official in order to:
 - i. obtain or retain business; or
 - ii. obtain or retain a business advantage that is not legitimately due to the recipient, or intended recipient, of the business advantage (who may be the first-mentioned person).

¹⁹ *Convention on Combating Bribery of Foreign Officials in International Business Transactions*, signed on 17 December 1997, OECD [1999] ATS 21 (entered into force 15 February 1999) ('*Convention on Foreign Bribery*').

²⁰ *Convention on Foreign Bribery*; Catherine Barker, 'Australia's Implementation of the OECD Anti-Bribery Convention' (Background Note, Department of Parliamentary Services, 7 February 2012).

²¹ *Convention on Foreign Bribery* art 1(1): Australia is required to 'take such measures as may be necessary to establish that the act of bribing a foreign official is an offence under Australian law'.

The offence refers to the provision of an ‘*advantage that is not legitimately due*’ as well as benefits that are ‘*not legitimately due*’.²² The concept of ‘*illegitimate advantage*’ is equivalent to the notion of an ‘*improper advantage*’ set out in Article 1(1) of the Convention.²³

Section 70.2 can be simplified into the following components:

1. to provide a benefit that is not legitimately due;
2. to influence a public official;
3. to obtain an advantage that is not legitimately due.

3.1 Defences to section 70.2

The meaning of an ‘advantage that is not legitimately due’ within section 70.2 is informed by the broader statutory context. As such, sections 70.3 and 70.4 may assist in the interpretation of section 70.2.²⁴ These are briefly considered below.

3.1.1 Section 70.3: lawful conduct defence

Section 70.3 provides that a person will not be guilty of an offence under section 70.2 where the impugned conduct is lawful in the country in which the foreign official operates.²⁵ The scope of this defence has been significantly narrowed in response to the 2007 UN Oil-for-food Program debacle.²⁶ Prior to 2007, the defence could be raised in any situation where the impugned conduct did not offend a written law of the foreign country.²⁷ The defence has since been restricted to situations in which the conduct is explicitly permitted by a written law.²⁸

The inclusion of the ‘lawful conduct’ defence amounts to an act of deference to the legal systems of foreign jurisdictions. Section 70.2 of the Act involves the exercise of Australia’s extraterritorial jurisdiction. The Australian Parliament has signalled its intention to respect the legal institutions of other sovereign nations through the inclusion of section 70.3. This parliamentary intention (of deference) should inform statutory construction of the term ‘advantage that is not legitimately due’.

3.1.2 Section 70.4: facilitation payment defence

Section 70.4 sets out a defence in relation to facilitation payments. The defence absolves criminal responsibility if ‘the person’s conduct was engaged in for the sole or dominant purpose of expediting or securing the performance of a routine government action of a minor nature’.²⁹ Central to this defence is the concept of a ‘routine government action’. A ‘routine government action’ is defined to include actions that are ‘ordinarily and commonly performed’ by a foreign official.³⁰ The meaning of a routine action is restricted by section 70.4(2)(b) of the Act. Notably, administrative

²² *Criminal Code Act 1995* (Cth) s 70.2(1)(c)(iii) (‘*Criminal Code*’).

²³ *Convention on Foreign Bribery* art 1(1).

²⁴ *Criminal Code* ss 70.3, 70.4.

²⁵ *Criminal Code* s 70.3.

²⁶ Barker, above n 21, 7.

²⁷ *Ibid.*

²⁸ *Ibid.*

²⁹ *Criminal Code* s 70.4(1)(b).

³⁰ See *Criminal Code* s 70.4(2)(a).

decisions relating to the ‘terms of business’ are excluded from the meaning of a ‘routine government action’.³¹ Therefore such decisions are excluded despite the fact that foreign officials ‘ordinarily and commonly’ make decisions of this nature.³² It would therefore appear that this defence would generally not be available in relation to tax treatment.

3.2 The meaning of legitimacy

A critical aspect of the statute is the provision of a ‘business advantage that is not legitimately due’.³³ The Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 indicates that the term ‘not legitimately due’ should be given its ordinary meaning.³⁴ Ordinarily, an act that is illegal will be considered to be illegitimate. In determining the ‘legitimacy’ of a benefit, ‘official tolerance’ to the provision of a benefit must be disregarded.³⁵ The Explanatory Memorandum goes further to require a ‘legal basis for receiving the advantage’, and proscribes ‘conduct which is in breach of a statutory requirement’.³⁶ The narrow interpretation adopted by the Explanatory Memorandum to the Bill is supported by the Commentaries relating to the *Convention on Foreign Bribery*.³⁷ Finally it has been argued that the perception that the benefit is ‘customary or necessary in the situation’ must also be disregarded.³⁸ The rationale behind this narrow interpretation is that any ‘allowance for cultural norms would undermine the offence’.³⁹

3.3 The ordinary meaning of ‘legitimately due’ in the context of academic discourses on corruption

The Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 indicates that the term ‘not legitimately due’ should be given its ordinary meaning.⁴⁰ In view of the context, it is appropriate to have regard to a wider understanding of corruption in determining what ‘legitimately due’ means. Corruption is the subject of considerable debate among scholars.⁴¹ Various approaches

³¹ *Criminal Code* s 70.4(2)(c)(iii).

³² See *Criminal Code* s 70.4(2)(a) and the interaction with s 70.4(2)(c)(iii).

³³ *Criminal Code* s 70.4(2)(c)(iii).

³⁴ David Hume and Geoff Healy, ‘Bribery and Corruption: Key Issues for Australian Companies Operating Overseas’ (2011) 34(3) *University of New South Wales Law Journal* 747, 752, citing Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 (Cth).

³⁵ Hume and Healy above n 35, 752.

³⁶ Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 [34].

³⁷ Hume and Healy, above n 35, 752, citing *Commentaries on the Convention on Combating Bribery of Foreign Officials in International Business Transactions* (adopted by the parties 21 November 1997) [5]; Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 [34].

³⁸ Hume and Healy, above n 35, 752; These observations were made by Hume and Healy in relation to the benefit provided to the public official in section 70.2(1)(b) of the *Criminal Code*. As the same terminology is employed (‘not legitimately due’) in section 70.2(1)(c)(ii) of the *Criminal Code*, these observations are also applicable in relation to the conduct of the officials themselves.

³⁹ Hume and Healy, above n 35, 752, citing Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 [33].

⁴⁰ Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999[25].

⁴¹ Wolfgang Muno, ‘Clientist Corruption Networks: Conceptual and Empirical Approaches’ in Tobias Debiel and Andrea Gawrich (eds), *(Dys-)Functionalities of Corruption: Comparative Perspectives and Methodological Pluralism* (2013(Supp 1), *Zeitschrift für Vergleichende Politikwissenschaft*) 34, 34.

have been proposed in an attempt to understand the meaning of corruption. Three broad approaches to understanding corruption have been identified, namely: cause-based corruption; consequence-based corruption; and norms-based corruption.⁴²

3.3.1 *Cause-based approach*

The cause-based approach to corruption adopts a market-centric analysis. The approach draws on the concept of economic rationality to explain why an official acts in a corrupt manner. Public officials are charged with allocating scarce public resources. As demand for public services increases, officials respond by raising their 'price'. Within this paradigm, corruption is caused by an imbalance of demand and supply for government services.⁴³ The limitations of the 'market-centred' analysis are twofold:

1. the approach fails to encapsulate broader instances of corruption that do not involve resource allocation; and
2. the approach fails to describe the intrinsic quality of the corrupt act itself. That is, it describes 'why' corruption exists rather than 'what' it actually is.

3.3.2 *Consequence-based approach*

Corruption may be understood by reference to the way that it affects the public interest.⁴⁴ This is known as the 'consequence-based' approach. Again, this approach fails to describe the intrinsic quality of the act itself.⁴⁵ In simple terms, it describes 'why we are concerned' about corruption rather than 'what' corruption is.

The consequence-based approach characterises an act as 'corrupt' if it is adverse to the 'public interest'. The main limitation of this approach is the lack of clarity surrounding the meaning of 'public interest'. The term 'public interest' presupposes the existence of common interests within a community. What may be dysfunctional for one section of the community may be functional for another. Additionally, an act may have the quality of being functional in some ways, but not so in other ways.⁴⁶ The 'consequence-based' approach would appear to encapsulate what Fan and Grossman describe as the 'economic definition' of corruption. The economic definition of corruption 'equates corruption with purely unproductive rent-seeking activities'.⁴⁷

3.3.3 *Norms-based approach*

The norms-based approach to corruption focuses on an official's deviation from a set of formal norms.⁴⁸ The approach is formally expressed as 'the use of public office to pursue private gain in ways that violate laws and other formal rules'.⁴⁹ The violation

⁴² Rance Lee, 'Bureaucratic Corruption in Asia: The Problem of Incongruence Between Legal Norms and Folk Norms' in Ledivina Cariño (ed.), *Bureaucratic Corruption in Asia: Causes, Consequences and Controls* (NMC Press, 1986) 70.

⁴³ Lee, above n 43, 71.

⁴⁴ Tugrul Gurgur and Anwar Shah, 'Localization and Corruption: Panacea or Pandora's Box?' (World Bank Policy Research Working Paper 3486, January 2005) 1.

⁴⁵ Lee, above n 43, 71.

⁴⁶ *Ibid* 71.

⁴⁷ Chengze Fan and Herschel Grossman, 'Incentives and Corruption in Chinese Economic Reform' (2001) 4(3) *Journal of Economic Policy Reform* 195, 199.

⁴⁸ Lee, above n 43, 71.

⁴⁹ Fan and Grossman, above n 48, 198.

of norms must be motivated by private interest.⁵⁰ This approach is also known as the legal definition of corruption. Academic commentary on the norms-based approach tends to focus on formal legal norms. This preference relates to the contemporary dominance of government.⁵¹ The ‘norms-based’ approach to corruption has gained acceptance from the academic community.⁵²

The Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 indicates that section 70.2 of the Act must be interpreted in accordance with the norms-based approach to corruption.⁵³ The Explanatory Memorandum specifically requires that there be a ‘legal basis for receiving the advantage’ and that an advantage will be illegitimate where it involves ‘conduct which is in breach of a statutory requirement’.⁵⁴ The law also proscribes the consideration of ‘cultural norms’. However, the Explanatory Memorandum does contemplate consideration of the nature of the legal institutions in which the law is to be extraterritorially applied.⁵⁵

3.4 Applying the Australian statute to the Chinese taxation context

Considering the Australian law in the Chinese taxation context, it can be seen that there is clear potential for it to apply. It has been noted that tax treatment that is highly preferential and arguably exceeds the written law may be provided in exchange for a benefit. However, the application of the law is significantly complicated by the Chinese institutional context and that which may be considered ‘legitimately due’ within it. The concept of ‘legitimately due’ is at the very core of the Australian statute and the concept of corruption. However, what constitutes ‘legitimate’ behaviour in China may not be readily determined. The nature of China’s legal system informs the meaning of a ‘legitimate’ act in the administrative context. Local officials apply a lattice of flexible, unclear and, at times, contradictory laws, policies, notices and regulations in their decision-making. In the absence of a rule of law system, formal legality is a difficult and arguably inappropriate benchmark by which to gauge the legitimacy of a local official’s actions.

It must be noted that the analysis that this article provides in relation to what should be considered ‘legitimate’ in China is for the purposes of Australian law. The *Convention on Foreign Bribery* that guided the drafting of the Australian law and creates Australia’s obligations in international law uses a different concept, namely ‘appropriateness’. Therefore at a strict level, this article’s analysis is relevant only to the understanding of the Australian law. It is clear, however, that the Convention’s use of ‘appropriateness’ does not simply resolve the issues considered in relation to deciding what is legitimate in the Chinese context. This is because ‘appropriateness’ needs to be determined in accordance with some standard in the same way that ‘legitimacy’ does. Therefore the analysis in this article will have significant relevance to any analysis of the *Convention on Foreign Bribery* as well as other countries’ laws that implement it. However further research would be needed in relation to the

⁵⁰ Lee, above n 43, 71.

⁵¹ Lee, above n 43, 72.

⁵² Fan and Grossman, above n 48, 198; Lee, above n 43, 72.

⁵³ Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 [34].

⁵⁴ *Ibid.*

different approaches to reach concluded views on the operation of those regimes in China.

3.5 China's unclear legal system

Australia's foreign bribery legislation assumes the existence of a rule of law system.⁵⁶ Within a taxation context, a rule of law system allows for the rights and obligations of a taxpayer to be readily ascertained.⁵⁷ As such, obligations are assumed to be 'prospective, open and clear'.⁵⁸ Australia's rule of law system operates to restrain the power of its administrative bodies. In doing so, the system limits the capacity of an administrator to consider the individual circumstances of a taxpayer.⁵⁹

3.5.1 Law

China's tax system operates differently from the type of system found in Australia. The requirements of China's tax laws are unclear. Central government law employs simple, yet ambiguous language.⁶⁰ The brevity and simplicity of the legislation results in an inability to comprehensively explain complex issues.⁶¹ Consequently, significant questions remain unanswered in China's tax legislation.⁶²

Unclear legislation is a policy choice of China's central government.⁶³ Vague laws are created by the central government to facilitate flexible localised implementation.⁶⁴ As a result, uniform taxation treatment is not found in China's decentralised reality despite the existence of a uniform central statute.⁶⁵ Local circumstances vary significantly between regions. Vague laws allow local governments to tailor the implementation of what would otherwise be a rigid, uniform system to suit the needs of their locality. This flexibility is appropriate in China as local officials are best placed to tailor local policy to achieve their economic goals.⁶⁶

3.5.2 Directives

Guidance documents are issued by Chinese authorities in order to supplement the otherwise extremely brief and vague legislative provisions.⁶⁷ At times the supplementary documents fail to clarify the 'legal' position and actually cause further uncertainty.⁶⁸ Normative directions are issued across various levels of government, from different local regions.⁶⁹ Whether a document is applicable to an individual taxpayer will depend upon the locality from which it was issued and from which level

⁵⁶ Ibid.

⁵⁷ Sharkey and Murray, above n 11, 606.

⁵⁸ Ibid, citing: Joseph Raz, 'The Rule of Law and its Virtue' (1977) 93 *Law Quarterly Review* 195, 198-202.

⁵⁹ Sharkey and Murray, above n 11, 612.

⁶⁰ Ibid 613-4.

⁶¹ Ibid.

⁶² Ibid 613.

⁶³ Ibid 615.

⁶⁴ Ibid 615.

⁶⁵ Ibid 624.

⁶⁶ Mayling Birney, 'Decentralization and Veiled Corruption under China's "Rule of Mandates"' (2014) 53 *World Development* 55, 56.

⁶⁷ Nolan Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence in Chinese Law: The Institutional and Treaty Implications' (2014) 68(11) *Bulletin for International Taxation* 617, 618.

⁶⁸ Sharkey and Murray, above n 11, 613-4, citing Cui, above n 12.

⁶⁹ Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence', above n 68, 618.

of government it emanates. Furthermore, the validity of a normative document may be unclear where it operates to contradict the original law.⁷⁰

Due to the variable economic environments of each locality, regionally-based pronouncements may conflict with one another.⁷¹ For example, as one district experiences economic overheating in its housing market and attempts to stifle demand, another may be suffering from falling house prices. In these circumstances, contradictory interpretations of a body of real estate law would be issued by regional governments.⁷² It follows that the brevity of the 'nationally applicable' legislation may be considered a policy choice of the central government. Ambiguous national law invites discretion, and hence the application of flexible policy. Significant discretion is afforded to localities due to the information asymmetry that exists in relation to a locality's implementation challenges.⁷³ Ultimately, guidance documents fail to fully clarify the central government's expectations of a local official.

In the specific context of China's Enterprise Income Tax Law, numerous normative or guidance documents exist. These have created a confused hybrid of administrative-legislative direction. How do these documents interact and what determines their priority? Again, the Chinese approach to resolving these tensions diverges from that of Australia's.

In Australia's legal system, conflicts are resolved through the distinction between those directions that constitute 'law' and those of merely 'administrative' opinion.⁷⁴ Similar to China's normative documents, Australia's taxation bodies provide 'rulings' that set out how the tax office has interpreted a set of laws.

In Western Australia, the Commissioner of State Revenue routinely publishes 'Commissioner's Practices' and 'Rulings' in relation to 'decisions' under the *Duties Act 2008* (WA).⁷⁵ These 'rulings' do not operate to change the law of Western Australia. All rulings are subject to administrative review at the State Administrative Tribunal.⁷⁶

Pronouncements of administrative bodies in China operate differently to those of Australia's executive bodies. Taxation decisions issued by a local Chinese official, even if 'legally wrong', will not be subject to judicial review.⁷⁷ In this context, the relevance of determining the proper legal interpretation of a set of legal instruments is of very little practical relevance.⁷⁸ Ultimately, there is not a meaningful separation between China's legislative and executive power. This creates an environment in which it can be argued that all determinations of the local official are at least of a *quasi* if not *de facto* legislative nature.

In a system where formal legal institutions are underdeveloped, informal rules are significant in guiding the actions of officials. These informal rules may be in the form

⁷⁰ Sharkey and Murray, above n 11, 613-4.

⁷¹ Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence', above n 68, 618.

⁷² Ibid.

⁷³ Birney, above n 67, 56.

⁷⁴ Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence', above n 68, 618.

⁷⁵ See *Taxation Administration Act 2003* (WA).

⁷⁶ The State Administrative Tribunal is a statutory body under the *State Administrative Tribunal Act 2004* (WA) s 7.

⁷⁷ Sharkey, 'The Correctness of the Chinese Position of Enterprise Residence', above n 68, 618.

⁷⁸ Sharkey and Murray, above n 11, 613-4.

of normative documents as outlined above but more generally arise in the context of complex social relationship networks and hierarchies. Social institutions play a far more significant role in comparison to formal institutions in China than is the case in Australia. Social institutions and relations significantly govern human behaviour in this context.⁷⁹ Governmental actors are often ‘circumspect’ in their approach to official central tax law.⁸⁰ Gong and Zhou have observed the instructive nature of informal rules in Chinese governance.⁸¹ Informal rules operate as ‘codes, routines, and norms’ that constitute customary patterns of behaviour of a local official.⁸²

It is notable that China’s academic literature defines corruption to include both formal and informal norms.⁸³ The inclusion of informal norms allows for the notion of ‘corruption’ to more accurately reflect behaviour that deviates from public expectations. This perception accords with the distinction drawn by Ostrom between ‘rules-in-form’ and ‘rules-in-use’. Ostrom observes that many ‘rules-in-form’ fail to affect the behaviour of an official.⁸⁴ In order to determine the ‘presence of an institution’, Ostrom argues, the focus should be on ‘rules-in-use rather than rules-in-form’.⁸⁵ This would suggest that a country’s ‘rules-in-use’ accurately describe the nature of a country’s institutions. China’s ‘rules-in-use’ are of a predominantly informal nature.

3.5.3 Rule of mandates

China’s administrative governance structure may be appropriately typified as a ‘rule of mandates’ system.⁸⁶ The ‘rule of mandates’ system subverts the traditional understanding of an administrator’s role. Rather than being tasked with the implementation of stringent laws, officials are asked to pursue broad and often conflicting policy objectives.⁸⁷ Unlike a system governed by laws, not all mandates must be implemented. Mandates are ‘directives that are hierarchically ranked against each other’.⁸⁸ Officials must prioritise mandates that are of relatively greater importance to the central government. Laws that coexist within this system must be implemented only if their implementation is ‘compatible’ with prioritised mandates.⁸⁹ In China, the appropriate exercise of an official’s discretion may involve the non-application or contravention of formal law. Mandates are expressed in broad terms and fail to expansively set out their expectations.⁹⁰ The mandates speak only to the central government’s desired *outcomes* for a locality, rather than stipulating the

⁷⁹ Ibid 624.

⁸⁰ Ibid 616.

⁸¹ Ting Gong and Na Zhou, ‘Corruption and Marketization: Formal and Informal Rules in Chinese Public Procurement’ (2015) 9(1) *Regulation and Governance* 63, 65.

⁸² Ibid.

⁸³ Eight of 24 studies examined by Ko and Weng, see: Kilkon Ko and Cuifen Weng, ‘Critical Review of Conceptual Definitions of Chinese Corruption: A Formal–Legal Perspective’ (2011) 20(70) *Journal of Contemporary China* 359, 363.

⁸⁴ Gong and Zhou, above n 82, 65, citing Elinor Ostrom, *Understanding Institutional Diversity* (Princeton University Press, 2005) 138.

⁸⁵ Gong and Zhou, above n 82, 65.

⁸⁶ Birney above n 67, 55.

⁸⁷ Ibid 57.

⁸⁸ Ibid 55.

⁸⁹ Ibid 55.

⁹⁰ Ibid 56.

processes that must be followed to achieve them.⁹¹ In other words, only modest direction is provided to officials.

The above characteristics pose significant problems for an objective inquiry into whether an official has provided an ‘illegitimate advantage’. For example, is a tax incentive granted in contradiction to the formal law an illegitimate advantage? In this circumstance the ‘legitimacy’ of the local official’s action is unclear. Here, the local official has subordinated their mandate to collect central government revenue in favour of their mandate to stimulate the local economy. Whether this advantage is ‘legitimately due’ depends on whether the central government prioritises local growth over their own fiscal revenue streams. As the mandates themselves are often not publicly disclosed, substantial evidentiary difficulties arise in making this determination.⁹²

The situation is further complicated by China’s inter-regional differences. The flexible ‘mandate’ system allows broad central government policy to be pursued effectively across vastly different regions. Local officials are best placed to tailor local policy to achieve these overarching goals.⁹³ A decision to ignore a law or policy may be appropriate in Region A but not in Region B. This speaks to the argument in favour of a ‘relative’ standard for legitimacy and, consequently, corruption in China.⁹⁴ The ‘legitimacy’ of an official’s act is dependent not only on the way it interacts with conflicting central policy, but also on the unique needs of a locality.

3.6 Determining legitimacy in China by focusing on formal law

As a result of the above institutional factors generally, the Chinese institutional environment cannot be typified as a rule of law system.⁹⁵ The role of informal rules and social institutions in government has been noted. It is questionable whether these rules have become so pronounced that they can be used as a yardstick to measure what constitutes an ‘illegitimate advantage’ in China. The Explanatory Memorandum to the Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 requires that the customary nature of a benefit be disregarded.⁹⁶ However, this narrow construction fails to acknowledge that customs and social institutions fall within the wider notion of a country’s legal framework.⁹⁷

In principle, these informal rules should not be disregarded as mere ‘cultural norms’ under the Explanatory Memorandum.⁹⁸ The rationale that an ‘allowance for cultural norms would undermine the offence’ fails to appreciate the importance of informal rules in the Chinese context.⁹⁹ In China, informal rules are a constituent part of the administrative institution. The ‘rule of mandates’ system presents significant challenges to the legalistic approach adopted by Australia’s foreign bribery legislation. Within this context, legality based upon central government statute is an inappropriate benchmark to measure the ‘legitimacy’ of an official’s actions.¹⁰⁰ What in Australia is

⁹¹ Ibid.

⁹² Ibid.

⁹³ Ibid.

⁹⁴ Ibid.

⁹⁵ Sharkey and Murray, above n 11, 613-4.

⁹⁶ Hume and Healy, above n 35, 752.

⁹⁷ Sharkey and Murray, above n 11, 604.

⁹⁸ *Criminal Code Amendment Explanatory Memorandum* [33].

⁹⁹ Ibid.

¹⁰⁰ Cf. Ibid [34].

an *absolute* legal standard to assess ‘legitimacy’, becomes a *relative* standard in China.¹⁰¹ The critical question is ‘why’ rather than ‘whether’ an official has violated a law.¹⁰²

Australia’s foreign bribery legislation fails to contemplate the above context as well as China’s unique central-local legal relations. A simple formalistic application of Australia’s legislation to China’s unique system will produce arbitrary or meaningless results. Ultimately, in the absence of a rule of law system, formal legality is an inappropriate benchmark by which to gauge whether an advantage is legitimately due to a third party. It follows that the receipt of an ‘illegal’ tax advantage by an Australian private enterprise operating in China should not constitute conclusive evidence of criminal liability under the *Criminal Code Act 1995*.

3.7 Determining legitimacy by focusing on the administrative decision-maker

In view of the difficulties inherent in determining legitimacy in China by focusing on formal law, an alternative approach is to focus on the administrative decision-maker. However, such an exercise also presents significant difficulties in China. The role of a local administrator in China differs from the equivalent official’s role in Australia.¹⁰³ Local officials in China adopt a dual identity. They are simultaneously a state political agent to the central government and a local economic principal of their locality.¹⁰⁴ In their role as an economic principal, the provision of formally illegal tax treatment may be legitimately within the scope of their duty.

Under the principal-agent model, corruption is said to occur where an agent has betrayed the interests of their principal.¹⁰⁵ In equity, this occurs where the agent fails to fulfil their fiduciary obligation to act in the best interests of their principal. The principal-agent model of corruption assumes that the agent is in control of, but does not own, a valuable resource. As a result, the agent operates as a trustee to the principal with respect to that resource.¹⁰⁶ The principal for a Chinese official is not, however, as readily identifiable as may first be thought. Within the Chinese institutional context it is inaccurate to typify local officials as mere agents of the central government. The duality of an official’s role affects the inquiry here as to whether derogating from the law is *prima facie* illegitimate. The proper identification of a local official’s principal is required in order to determine whether an act is within that principal’s best interests.

China’s system of contemporary government is best understood through comparison to its system of local governance prior to the 1978 reform. Historically, the role of local government was confined to the implementation of central government policy directives.¹⁰⁷ Local governments were effectively a conduit to the centre. Any deviation from their role as agents of the State was strictly forbidden.¹⁰⁸ Local

¹⁰¹ Birney, above n 67, 57.

¹⁰² Ibid 55.

¹⁰³ Jean Oi, ‘The Role of the Local State in China’s Transitional Economy’ (1995) 144 *The China Quarterly* 1132, 1136; Feng Wang, *Boundaries and Categories: Rising Inequality in Post-Socialist Urban China* (Stanford University Press, 2008) 140.

¹⁰⁴ Ting Gong, ‘Corruption and Local Governance: The Double Identity of Chinese Local Governments in Market Reform’ (2006) 19(1) *The Pacific Review* 85, 86.

¹⁰⁵ This model is used to explain the economic definition of corruption. See Munro, above n 42, 35.

¹⁰⁶ Munro, above n 42, 36.

¹⁰⁷ Gong, above n 105, 87.

¹⁰⁸ Ibid.

administrative discretion was eliminated in order to strengthen the Chinese Communist Party's grasp over the localities.¹⁰⁹ The State maintained a system of vertical leadership (*chui zhi ling dao*) that ensured that all decisions were made at the top. Local officials functioned as mere agents of a paternalistic state.¹¹⁰ Prior to the reform, if a local official did the equivalent of providing an illegal tax advantage to a foreign firm they would have been accused of localism.¹¹¹

After 1978, the State began to devolve central power to local arms of government.¹¹² The motivation for the diffusion of central power was to provide fiscal incentives for local governments to pursue economic growth.¹¹³ Prior to 1994 local regions benefited from a decentralised tax revenue system.¹¹⁴ Additionally, local officials were provided freedom to approve private investment projects within their region.¹¹⁵ As such, local officials were transformed from being *unproductive* political entrepreneurs into *productive* economic entrepreneurs.¹¹⁶ This reform process led to the creation of China's system of local state corporatism.¹¹⁷ Under this system, corporations and local officials are expected to operate together as one corporate whole.¹¹⁸

Local officials may consider it appropriate, having regard to the interests of their locality, to make decisions that are inconsistent with the State's legal framework. Published formal law may impede regional growth when local opportunities are fully accounted for. In their role as local economic principals, local officials are able to enhance regional growth through assisting private enterprise to navigate burdensome rules. One such example is the act of providing a formally illegal tax advantage to foreign firms. Under Jean Oi's concept of 'local state corporatism', this action is an appropriate commercial decision between partners working towards a common objective.¹¹⁹

On the face of it, local officials have a conflict of interest between the central government and local regions.¹²⁰ On the one hand they are tasked with implementing the law and policy of the central government, while on the other, they are responsible for the promotion of regional growth.¹²¹ By focusing only on local economic growth,

¹⁰⁹ Ibid 88.

¹¹⁰ Ibid 87-88.

¹¹¹ Localism in China is known as '*difang zhuyi*': Jae Ho Chung, *Central Control and Local Discretion in China: Leadership and Implementation during Post-Mao Decollectivization* (Oxford University Press, 2000); Gong, above n 105, 88.

¹¹² Gong, above n 105, 88.

¹¹³ Ibid.

¹¹⁴ Since 1994, a process of fiscal recentralisation has occurred to reign in local government power. Nonetheless, the decentralised governance system and corresponding growth incentives that were kick-started in 1978 remain firmly in place today: Jean Oi et al, 'Shifting Fiscal Control to Limit Cadre Power in China's Townships and Villages' (2012) 211 *The China Quarterly* 649, 650.

¹¹⁵ Gong, above n 105, 88.

¹¹⁶ Fan and Grossman, above n 48, 197.

¹¹⁷ See also comments in relation to 'socialist development state' and 'state entrepreneurialism'. Each expression emphasises the active role of local government in facilitating economic growth: Chunyu Wang, Jingzhong Ye and Jennifer Franco, 'Local State Corporatism or Neo-Guanxilism? Observations from the County Level of Government in China' (2014) 23(87) *Journal of Contemporary China* 498, 500; Fan and Grossman, above n 48, 198.

¹¹⁸ Oi, above n 104, 1132; Fan and Grossman, above n 48, 198.

¹¹⁹ Oi, above n 104, 1132.

¹²⁰ Gong, above n 105, 87.

¹²¹ Ibid 86.

the loyalty of the local official to the central government appears to be impugned.¹²² It could be questioned whether this factor may inform a test of illegitimacy in the Chinese context. However, the apparent conflict in interest is not as clear as it may appear to be at first glance.¹²³ It is submitted that what appears to be a conflict between local and central governments is more correctly regarded as a policy conflict throughout the State and stems from the overall administrative model implemented from the centre in China.

Localised economic governance and administration is in fact central policy. Centrally-imposed performance assessment mechanisms are structured to encourage officials to act as local economic principals. The focus is not on whether an official has strictly imposed central laws.¹²⁴ Instead, it is on whether an official has been able to improve the financial wellbeing of their jurisdiction.¹²⁵ Specifically, local government performance is assessed on the basis of their 'economic output, revenue growth and improvement in living standards'.¹²⁶ Local officials may determine that a low technology enterprise that employs people is desirable within their jurisdiction despite the central move to only incentivise advanced technology enterprise. In response the local government may grant such an enterprise favourable taxation treatment regardless of formal law and central policy.¹²⁷ However, in doing so they are actually carrying out their ultimate duty to the State.¹²⁸ This context reconciles with the rule of mandates system outlined above.¹²⁹ In this context it cannot be argued that a local economic prioritisation in decision-making in and of itself makes a decision illegitimate.

Finally it should be noted that various studies have indicated that local government in China has been forced by central budget restraints to resort to entrepreneurial activities and extra-legal revenue raising to fund the responsibilities imposed on them by the centre.¹³⁰ Some areas that have been studied are land expropriation,¹³¹ off-budgetary funds and off-budgetary enterprises.¹³² While such activity lacks transparency and may be argued to be conducive of corruption,¹³³ the role of the Chinese central policy in creating the situation makes calling it illegitimate simplistic and inaccurate.

¹²² Ibid 87.

¹²³ Cf. observations by Gong that the system indicates a 'divergence of local economic interests from those of the center': Gong, above n 105, 94 (our emphasis).

¹²⁴ Ibid 93, citing Fanghua Zhang, 'The Effective Control over Irregular Behavior of Local Governments in the Transitional Period' [*Zhuanxing shiqi defang zhenfu feizhengdang xingwei de youxiao kongzhi*] (2002) 1 *Shanghai Social Science Academy Academic Quarterly* 67.

¹²⁵ Gong, above n 105, 93.

¹²⁶ Ibid.

¹²⁷ Sharkey and Murray, above n 11, 615.

¹²⁸ The creation of Special Economic Zones in China involved the provision of tax concessions in a bid to attract enterprises to operate in the given region. See Maria Edin, 'Local State Corporatism and Private Business' (2003) 30(3-4) *Journal of Peasant Studies* 278, 287.

¹²⁹ Birney, above n 67, 56.

¹³⁰ Oi et al, above n 115, 654.

¹³¹ Ibid 653; Daniel Rosen and Beibei Bao, 'China's Fiscal and Tax Reforms: A Critical Move on the Chessboard' Rhodium Group Note, 11 July 2014, <<http://rhg.com/notes/chinas-fiscal-and-tax-reforms-a-critical-move-on-the-chessboard>>.

¹³² Gong, above n 105, 94.

¹³³ Ibid 95.

4. CENTRAL ADMINISTRATIVE POLICY AND LEGITIMACY

Corruption is traditionally understood to have debilitating effects for the economic development of a country.¹³⁴ However, in many aspects of China's society, extra-legal decision-making (say, formal illegitimacy) is developmental and facilitates economic growth.¹³⁵ Chinese officials disregard formal law to facilitate the creation of an efficient market system. In addition, they adopt an informal, consultative approach to governance in order to generate market certainty for investors.¹³⁶

The form of local governance has developed within the context of institutional deficiencies of China's socialist-market economy.¹³⁷ Local officials draw on *Guanxi* networks to navigate China's hybrid system and expedite business activity.¹³⁸ During the transition period this has allowed for the creation of a 'shadow-economy' to facilitate a more efficient allocation of resources.¹³⁹ With the strengthening of formal institutions, the demand for formal illegitimacy should 'erode'.¹⁴⁰ Formal illegitimacy in China will cease to be 'functional' when the transformation to a market system is complete.¹⁴¹ In order to understand extra-legal decision-making as being 'functional', the institutional deficiencies of China's formal institutions must first be acknowledged. China's informal administrative system allows for an official to tailor the regulatory climate of the local region to the needs of an individual foreign investor.¹⁴² The functional nature of an official's flexible approach calls for the corrupt quality of their actions to be re-examined.

4.1 Central corruption policy impacting legitimacy

During China's transition it has been observed that local officials have been allowed to benefit from the private sector as a form of compensation and performance measure.¹⁴³ In support of their argument, academics Fan and Grossman explain that the private sector is in a better position to reward performance than the 'distant' central government.¹⁴⁴ The performance of officials has not been related to their nominal salary.¹⁴⁵ It can therefore be argued that the central government has made

¹³⁴ Tobias Debiel and Andrea Gawrich (eds), *(Dys-)Functionalities of Corruption: Comparative Perspectives and Methodological Pluralism* (2013(Supp 1), *Zeitschrift für Vergleichende Politikwissenschaft*) 1.

¹³⁵ Charles Wolf Jr, 'Developmental Corruption in China' (2013) 177 *Policy Review* 99, 100-1, referring to Andrew Wedeman, *Double Paradox: Rapid Growth and Rising Corruption in China* (Cornell University Press, 2012).

¹³⁶ Sharkey and Murray, above n 11.

¹³⁷ For commentary on China's socialist-market system, see John Wong, *Understanding China's Socialist Market Economy* (Times Academic Press, 1993).

¹³⁸ For academic commentary relating to the relationship between corruption and *guanxi* practice, see Jacob Harding, 'Corruption or *Guanxi*? Differentiating between the Legitimate, Unethical, and Corrupt Activities of Chinese Government Officials' (2014) 31(2) *UCLA Pacific Basin Law Journal* 127; Ling Li, 'Performing Bribery in China: Guanxi-Practice, Corruption with a Human Face' (2011) 20(68) *Journal of Contemporary China* 1.

¹³⁹ Markus Taube, 'Relational Corruption in the PR China: Institutional Foundations and Its (Dys)Functionality for Economic Development and Growth' in Tobias Debiel and Andrea Gawrich (eds), *(Dys-)Functionalities of Corruption: Comparative Perspectives and Methodological Pluralism* (2013(Supp 1), *Zeitschrift für Vergleichende Politikwissenschaft*) 89.

¹⁴⁰ *Ibid.*

¹⁴¹ *Ibid.*

¹⁴² Sharkey and Murray, above n 11, 621-2.

¹⁴³ Fan and Grossman, above n 48.

¹⁴⁴ *Ibid.* 200.

¹⁴⁵ *Ibid.* 202.

instrumental use of such compensation, has acquiesced to the situation and ultimately institutionalised it.¹⁴⁶

The context is further complicated by the fact that the central government has historically used anti-corruption policy as a macroeconomic management tool. Rather than implementing uniform anti-corruption measures, corruption campaigns have historically been employed by the central government in order to stifle inflation.¹⁴⁷ Such selective enforcement of anti-corruption laws suggests a disinterest in the inherent quality of the behaviour that is proscribed. During an anti-corruption campaign, local officials face the prospect of criminal punishment rather than mere internal disciplinary action.¹⁴⁸ Each of the four major anti-corruption campaigns between 1981 and 1997 coincided with the introduction of macroeconomic austerity policies.¹⁴⁹ The former General Secretary of the Chinese Communist Party has acknowledged that in order to ‘cool down the feverish economy’ the central government ‘must combat corruption’.¹⁵⁰ During periods of political calm, the central government has been tolerant of corrupt activity.¹⁵¹ The use of corruption as a macroeconomic policy instrument diverts the focus from the inherent quality of the proscribed act itself.

The above factors add further to the difficulty in characterising the actions and decisions of officials as illegitimate in the Chinese context.

4.2 Experimentation, subsequent control and legitimacy

The role of regulation and law in China has been significantly different to its role in other places. A final significant aspect in this regard is the manner in which regulation can be experimental and officials can be retrospectively rewarded for departing from the rules. This is again highly significant for defining a departure from formal law, currently or historically, as illegitimate.

Since the start of the transitional period, the central government has created incentives for experimental governance through its system of ‘regionally decentralised authoritarianism’.¹⁵² China’s regionally decentralised authoritarian system encourages local officials to compete with neighbouring regions to achieve efficient outcomes for China’s economy.¹⁵³ This process is known as experimental governance.¹⁵⁴ Within this system, China’s ‘M-form’ central-local relationship provides local government with significant autonomy to innovate.¹⁵⁵ The ‘M-form’ relationship can be contrasted to

¹⁴⁶ Ibid 201.

¹⁴⁷ Elizabeth Quade, ‘The Logic of Anticorruption Enforcement Campaigns in Contemporary China’ (2007) 16(50) *Journal of Contemporary China* 65, 65.

¹⁴⁸ Ibid 67, citing Melanie Manion, *Corruption by Design* (Harvard University Press, 2004) 168.

¹⁴⁹ Fubing Su and Dali Yang, ‘Political Institutions, Provincial Interests, and Resource Allocation in Reformist China’ (2000) 9(24) *Journal of Contemporary China* 215; cf. Quade, above n 148, 69.

¹⁵⁰ Quade, above n 148, 70, citing Bruce Gilley, *Tiger on the Brink: Jiang Zemin and China’s New Elite* (University of California Press, 1998) 207.

¹⁵¹ Su and Yang, above n 150, referring to ‘special interests and lobbying’.

¹⁵² James Kai-sing Kung, Chenggang Xu and Feizhou Zhou, ‘From Industrialization to Urbanization: The Social Consequences of Changing Fiscal Incentives on Local Governments’ Behavior’ in David Kennedy and Joseph Stiglitz (eds), *Law and Economics with Chinese Characteristics: Institutions for Promoting Development in the Twenty-First Century* (Oxford University Press, 2013) 491, 494.

¹⁵³ Ibid.

¹⁵⁴ Yingyi Qian and Chenggang Xu, ‘Why China’s Economic Reforms Differ: The M-Form Hierarchy and Entry/Expansion of the Non-State Sector’ (1993) 1(2) *Economics of Transition* 135.

¹⁵⁵ Taube, above n 140, citing Qian and Xu, above n 155.

the former Soviet Union's 'U-form' system of governance.¹⁵⁶ Within a 'U-form' system, local regions are interdependent.¹⁵⁷ In an interdependent system, the costs of an unsuccessful regional reform will be borne by the system as a whole. It follows that 'U-form' governance allows only for 'top-down' rather than 'bottom-up' economic reform. That is, economic reform initiatives can be initiated by the central government only.¹⁵⁸ By way of contrast, China's 'M-form' system of governance 'gives a green light for local experimentation'.¹⁵⁹

During China's economic reform, local experimental governance allowed the Chinese Communist Party to pursue market reform without political ramifications. Movement towards a capitalist market economy was in conflict with the traditional communist ideals of the Party. Through 'bottom-up' reform, the central government was able to maintain its Marxist ideals while reaping economic gains from a newly developed market system. Former Chinese Communist Party chairman Deng Xiaoping described the local experimental process as 'groping for stones to cross the river' (*mozhe shitou guohe*).¹⁶⁰ Through the use of this idiom, Deng Xiaoping appears to have been actively encouraging otherwise unsanctioned experimental methods of incremental reform.

An early example of local experimental reform was the development of Township and Village Enterprises ('TVEs'). In 1988 Deng Xiaoping hailed the advent of TVEs, acknowledging that the Chinese Communist Party was initially unaware of their development.¹⁶¹ These innovations were 'in principle illegal' as they departed from the established institutional framework.¹⁶² Another example of 'bottom-up' local government innovation was the development of the 1980s foreign exchange swap market.¹⁶³ As with TVEs, due to their success, local foreign exchange swap markets were retrospectively legalised.¹⁶⁴

Notably, only successful reform experiments were given the retrospective approval of central government.¹⁶⁵ Failed reform attempts were considered 'corrupt' derogations from the lawful administration of a locality. This aligns with contemporary observations that the central government will allow for significant exploitation of a local official's position only in so far as it leads to successful economic reform.¹⁶⁶

As part of the experimental process, local governments were vulnerable to allegations of corruption and lived in fear of the central government.¹⁶⁷ Selective tolerance of an official's 'corrupt' actions meant that local officials had no choice but to remain politically loyal to the State.¹⁶⁸

¹⁵⁶ Qian and Xu, above n 155, 137.

¹⁵⁷ Ibid.

¹⁵⁸ Ibid.

¹⁵⁹ Ibid 154.

¹⁶⁰ Ibid, see associated footnote at 161.

¹⁶¹ Ibid, citing *Zhongguo xiangzhen Qiye*, 1989.

¹⁶² Taube, above n 140, 101.

¹⁶³ Ibid 102.

¹⁶⁴ Ibid 103.

¹⁶⁵ Qian and Xu, above n 155, 154.

¹⁶⁶ Nolan Sharkey, *Social Institutions and Tax Design: The Case of Income Tax and Chinese Society* (PhD Thesis, The University of New South Wales, 2010) 185.

¹⁶⁷ Fan and Grossman, above n 48, 202, citing Susan Shirk, *The Political Logic of Economic Reform in China* (University of California Press, 1993) 144.

¹⁶⁸ Fan and Grossman, above n 48, 202.

Experimentation and associated selective regulation has a significant bearing on how the substantive legitimacy of an official's actions should be judged. Again it can be seen that formal law and regulation in China has not been held sacrosanct and economically successful departures from law have been tolerated, rewarded and embraced. In this context extra-legal decisions on economic laws such as taxation cannot be assumed to be illegitimate.

5. CONCLUSION

The legal test for Australia's foreign bribery law rests heavily upon a finding that an extra-legal advantage gained or benefit provided is illegitimate. Reference to the Explanatory Memorandum Criminal Code Amendment (Bribery of Foreign Public Officials) Bill 1999 as well as other surrounding material indicates that legitimacy should be given its ordinary meaning. However, much of the same commentary appears to indicate that legitimacy should be gauged by reference to the application of formal law. While the assumption that formal law is aligned with legitimacy is reasonable in many contexts and practical in the application of the law, a focus on legality does not align well with legitimacy in China.

Australia must consider the nature of the relationship between China's central and local government prior to implementing its extraterritorial jurisdiction in relation to China. Upon doing so, it will become apparent that a strictly 'legal' analysis is an inappropriate yardstick by which to gauge the legitimacy of an official's behaviour. The application of Australia's foreign bribery legislation must be appropriate for the Chinese context. Failure to do so will render criminal convictions under Australia's foreign bribery legislation arbitrary and inequitable. Law and regulation have not been used for the same purposes in China as they are used elsewhere. Officials are expected to apply laws flexibly in view of competing priorities and successful experimental departures from the law have been rewarded in China. Local economic success is a key priority, as is successful local government that does not place administrative strain on the central government. A central reliance on local corporatism understands that a reward system for economic success operates in China that is not determined from the centre. In this sense, anti-corruption campaigns might be understood less as an attack on this institutionalised system than as macroeconomic and political management tools.

While China's institutional and rule of law situation is changing, a transformation to a strict legal system is far from complete or even near. This is particularly apparent in taxation in China, a matter which goes to the heart of economic administration. In addition, action taken in response to corruption and similar issues are often historically focused. Therefore the actions of firms and administrators must be understood within their context of the time. There are, of course, truly illegitimate actions in China and the lack of a formal benchmark to judge them creates significant practical issues for the law. However, these practical issues should not create an allowance for injustice to occur.

Morality associated with fraud, corruption and tax evasion in South Africa

Boela (AP) Swanepoel¹ and Jacolize Meiring²

Abstract

The word ‘moral’ is explained in the Collins English Dictionary as ‘adhering to conventionally accepted standards of conduct, based on a sense of right and wrong according to conscience’. The aim of this article is to gauge the morality associated with fraud, corruption and tax evasion in general in South Africa. This study also discusses the impact that morality may have on the occurrence and prevention of fraud, corruption and tax evasion. A questionnaire was employed to investigate the morality issues associated with fraud, corruption and tax evasion in South Africa. The results show that there are certain morality issues associated with fraud, corruption and tax evasion in general, but that an increase in morality may have a positive impact on the occurrence and prevention of these economic crimes.

Keywords: corruption, economic crime, fraud, morality, tax evasion, South Africa

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1. INTRODUCTION

Economic crime has managed to infiltrate virtually all spheres of life in South Africa. The public and private sectors not only testify to the existence of this economic challenge, but also bear the scars of the impact of economic crime in general. Economic crimes such as fraud, corruption, money laundering, and tax evasion may generally have distinct financial and moral consequences.

Due to fraud that goes undetected, corporations pay less tax (Geis, 2007, p. 104). To this end, Beesley (2008, p. 116) contends that the elimination or even the reduction of economic crimes will assist a tax administration in its efforts to increase the tax base and ensure that all taxes are paid. However, economic crimes may never be eliminated because such crime offenders have little or no regard for their victims and only focus on the financial rewards of these crimes. Nevertheless, a proactive risk management plan in the form of preventative measures and corporate ethics could act as an effective countermeasure to manage the levels of economic crimes in general.

Certain factors contribute to the prevalence of fraud and corruption, including changes in social norms, market deregulation consequences, and the democratisation of finance (Bishop & Hydoski, 2009, p. 5). Fraud, corruption, aggressive tax avoidance and tax evasion also seem to disregard set boundaries such as state borders, legal compliance structures, and revenue authorities (Visser, McIntosh & Middleton, 2006, p. 75). The public and private sectors are subject to constant threat from fraud or corruption attempts by fraudsters operating from inside or outside an organisation, testing their defence and control structures for possible weaknesses. Fraud and corruption cannot be eliminated, but they can be reduced (Wells, 2003a, p. 36).

Many new laws have been written and promulgated in the South African Parliament in an attempt to address fraud and corruption. These include the *Prevention of Organised Crime Act 121 of 1998*, the *Prevention of Organised Crime Amendment Act 24 of 1999*, the *Protected Disclosures Act 26 of 2000*, the *Financial Intelligence Centre Act 38 of 2001*, the *Prevention and Combating of Corrupt Activities Act 12 of 2004*, and the *Protection of Constitutional Democracy against Terrorist and Related Activities Act 33 of 2004*. Unfortunately, laws alone might not be enough to curb fraud and corruption. Many organisations have come to realise that a crucial connection between ethics and organisational success exists (Van Vuuren, 2002, p. 21). Hughes, Kaidonis and Anderson (2008, p. 28) suggest that ethics might be the magic product that many companies could employ to build customer, investor, and employee loyalty. Even though it may take years for a company to build up a good reputation, it can be lost in a matter of seconds. Silverstone and Sheetz (2007, p. 68) state that '[o]ne of the more important controls over the accounting system has to be the ethical conduct of management'. The actions taken by management thus influence the actions of those below them (Coenen, 2008, p. 178).

Each person has a moral code that serves as a foundation for daily ethical decisions (Wells, 2003b, p. 5). Certain characteristics such as honesty, fairness, kindness, courtesy and respect are universal aspects of people's moral codes (Wells, 2003b, p. 5). Many people find themselves sacrificing short-term rewards for long-term goals and are even willing to sacrifice their sense of morality if they can obtain an immediate benefit from a transaction (Wells, 2003b, p. 5).

Morality and ethical conduct, therefore, are paramount in complementing current legal efforts to curb fraud and corruption in the public and private sectors. This article sets out to investigate the possible moral issues associated with fraud, corruption and tax evasion in South Africa.

The remainder of this article is organised as follows: in section 2, the relevant literature on the morality associated with fraud, corruption and specifically tax evasion is discussed. This is followed in section 3 by a short description of the research methodology. In section 4, the empirical findings of this article are reported and discussed, followed finally in section 5 by a summary of the key findings and conclusion, as well as the implications of this research for the public and private sectors.

2. LITERATURE REVIEW

The Collins English Dictionary explains the word '*moral*' as 'being concerned with or relating to human behaviour, especially the distinction between good and bad or right and wrong behaviour'. The word '*moral*' is further explained as 'adhering to conventionally accepted standards of conduct, based on a sense of right and wrong according to conscience'. Synonyms for the word '*moral*' include good, right, principled, pure, decent, proper, noble, ethical, honourable, honest, righteous, blameless and incorruptible.

When an issue is recognised as involving ethical considerations, the ethical components should be evaluated (Fleischman, Valentine & Finn, 2007, p. 115). Moral judgment is exercised when determining whether actions are morally right or wrong, and can be affected by personal values (Hobson, Mellon & Stevens, 2011, p. 87). Bell et al. (2011, p. 1) observe that personal history and social traditions may become part of a person's philosophical and behavioural responses.

Burt (2009, p. 12) states that greed appears to have clouded the moral fibre of society. Unethical decision-making and behaviour within organisations have received increasing attention over the last decade in the popular press, especially with regard to moral turpitude (Bell et al., 2011, p. 2). In light of this, business ethics is described as a 'process of promoting moral principles and standards to guide business behaviour' (Rezaee, 2009, pp. 64-65). The violation of ethics, trust and responsibility may be at the heart of economic crimes (Rezaee & Riley, 2010, p. 26). For this reason, ethical behaviour is the bedrock of every successful society, individual, company or organisation (Hughes et al., 2008, p. 30). By implementing and dealing with ethics at all levels in the public and private sector, and by setting the tone at the top levels, the temptation to commit economic crimes may be handled appropriately in conjunction with prevailing law enforcement and legislation.

Jones and Rhoades-Catanach (2011, p. 576) state that 'non-compliance with the tax laws can result in monetary penalties, and, in extreme cases, criminal prosecution'. Enforcement therefore influences compliance as an individual pays taxes out of fear of the economic consequences of detection and punishment (Alm & Torgler, 2011, p. 637). However, tax compliance is not only impacted by the opportunity to evade taxes, but also tax rates, and the probability of detection (Torgler, 2006, p. 101). Tax compliance is an intricate decision that is motivated by a host of factors, including

those that are non-economic in nature (Torgler, 2006, p. 101; Cummings et al., 2009, p. 456). Alm and Torgler (2011, p. 638) observe that a taxpayer will comply as long as the taxpayer believes that compliance is the 'right thing to do'. Tax morality therefore impacts tax compliance.

The most difficult issue to deal with is probably whether there are any moral limits to the steps or procedures a taxpayer may take to reduce tax. To act as an ethical person, one should be capable of taking a stand regarding an important and difficult problem in one's life (such as being tax compliant) and be able to justify and explain one's stance regarding the dilemma being faced and the course of action to be followed to handle the problem (for example an adverse tax position) (Brooks & Dunn, 2012, p. 132). A decline in ethics 'is largely cultural and appears to be closely associated with a failing system of morality' (Stephens, Vance & Pettegrew, 2012, p. 17). In a study conducted by Murphy (2004, p. 318), it was found that the overall level of morality in terms of paying tax is much lower for taxpayers that have an aggressive tax agent.

From the sources consulted, it is obvious that ethics are essential in preventing the occurrence of economic crime. The promotion and implementation of steps to prevent economic crime and promote sound management may positively affect the reduction of economic crime. It can therefore be said that the negative impacts of economic crime can be influenced by addressing the moral orientation of people and promoting ethical conduct in all spheres of life.

3. RESEARCH METHODOLOGY

A typical South African society or community is composed of people working in various spheres of the economy, being either self-employed, employed in the public or private sectors, or retired. People, in general, interact with other people, being from either the same or a different society or community. This interaction may occur in the fields of education (pre-school, primary school, secondary school and tertiary training), sport, arts, business, government, culture and church or religion. Most people who are part of a society or community interact by way of one or more of the abovementioned fields of involvement.

Within a society or community, all of the laws promulgated by the South African Parliament, and subsequently gazetted, would apply. However, not all members of a society or community would adhere to or comply with all the applicable laws and regulations. This may cause members of a society or community to come to the fore and deal with or promote the morality issues associated with certain non-compliance by other members of their society or communities. In order to research the morality issues associated with fraud, corruption and tax evasion in this study, a questionnaire was provided to respondents who were involved in their community or society. The purpose of the questionnaire was to establish the perceptions and observations of the respondents regarding morality issues associated with fraud, corruption and tax evasion in general.

3.1 Measurement instrument and respondent profiles

The data for this research project were obtained through a questionnaire provided to 185 members of societies and communities in South Africa that fulfil some sort of leadership role. The internet, as well as telephone directories were used to identify

possible respondents at random for this research project. The respondents were contacted by telephone to explain the purpose of the research and to enquire whether the prospective respondent would be willing to participate. If a respondent agreed to participate, the questionnaire was sent via either electronic mail or fax to the respondent. All of the completed questionnaires that were returned were analysed using specialised statistical software.

The questionnaire comprised 20 questions and the terms 'fraud', 'corruption', 'tax evasion' and 'South African Revenue Service (SARS)' were explained to respondents in the 'General information' section. The 20 questions were not directly related to each other, but the questionnaire was designed in such a manner that it grouped related questions under the relevant sub-headings. The main objectives for this questionnaire were to determine a preferable framework for people in general to direct their actions or decisions, the involvement of the church, community and society in moral issues, people's attitudes regarding morality issues, people's moral values, morality in taxpayers' conduct, morality in tax evasion, morality in tax planning, and the main reasons for perpetrating tax evasion, fraud and corruption. By analysing the research results, the research objectives were addressed. The questionnaire is set out in the annexure to this article.

The respondents were selected to represent the fields of education, sports, arts, business, government, culture, church and religion in general. To this end, the respondents had to indicate their position and respective roles in their society/community, for example, a legal practitioner indicated that he was a church cell group leader, and a pharmacist indicated that she was a mother and wife. The reason for this approach was to obtain the widest possible spectrum of respondents from various spheres of societal involvement. If the respondents were to come from the business environment only, this would have provided responses from a business perspective alone. By selecting respondents from various spheres of involvement, this research provides a more holistic view of the morality issues associated with fraud, corruption and tax evasion in general.

A total of 185 people agreed to participate and were provided the questionnaire to complete. Only 140 completed questionnaires were received, indicating a 76 per cent response rate. The 140 respondents comprised 52 per cent males and 48 per cent females, with Gauteng having the highest representation with 68 respondents. Table 1 provides a demographic overview of the respondents by province and gender.

Table 1: Demographic Detail of Respondents

<i>Province</i>	<i>Males</i>	<i>Females</i>	<i>Total</i>	
	<i>N</i>	<i>N</i>	<i>N</i>	<i>%</i>
Eastern Cape	3	1	4	2.9
Free State	3	2	5	3.6
Gauteng	39	29	68	48.6
Kwazulu-Natal	5	3	8	5.7
Limpopo	2	2	4	2.9
Mpumalanga	2	1	3	2.1
Northern Cape	1	2	3	2.1
North-West	2	1	3	2.1
Western Cape	16	26	42	30.0
Total	73	67	140	100.0

The 140 respondents represented 68 different professional positions in their society/community. The different professional positions included accountants, auditors, business owners, care workers, church ministers, engineers, financial advisors, journalists, lecturers, medical and dental practitioners, pharmacists, psychologists, sales representatives, personal assistants, students, school teachers and public health workers. The 140 respondents represented 48 different leadership roles in their respective society/community. These included administration roles at various levels, care and spiritual leadership, chairpersons of homeowner associations, church deacons and elders, counselling services, involvement in community sport development and training, the management of community projects, leading and uplifting disadvantaged people, the management of a mission office, pastoral work, public service, private practice, the rendering of professional services, being a school psychologist, and teaching.

3.2 Statistical methods

The integrity of the results obtained with the questionnaires was statistically analysed by considering frequencies and distributional statistics. Distributional analysis furthermore provided insight into the importance of moral issues regarding the morality associated with fraud, corruption and tax evasion in general in South Africa.

Pearson Chi-Square tests were employed to test for meaningful associations between some of the questions in the questionnaire. The Chi-Square test is used to test for a statistically significant association or dependence between two variables. It is important to note that the Chi-Square test only indicates whether two variables are dependent (or related), it does not say anything about the magnitude of the dependency (Welman, Kruger & Mitchell, 2005, p. 229). Statistical significance is determined by considering the respective *p*-values, where a *p*-value of below 0.01 indicates statistical significance at a 1 per cent level.

4. EMPIRICAL RESULTS AND FINDINGS

This study aims to establish people's perceptions of their own moral values regarding fraud, corruption and tax evasion. As such, the following is considered regarding morality associated with fraud, corruption and tax evasion:

1. a preferable framework for people to direct their actions or decisions;
2. the involvement of the church, community and society in moral issues;
3. people's attributes in terms of morality issues;
4. people's moral values;
5. morality in taxpayers' conduct;
6. morality in tax evasion;
7. morality in tax planning; and
8. reasons for perpetrating tax evasion, fraud and corruption.

Each of these is discussed in the following section by considering the responses to various questions in the questionnaire.

4.1 A preferable framework for people to direct their actions or decisions

An individual may act in a manner befitting his own moral ontology and when such an individual is faced with new and challenging decisions, he or she may seek counsel from other more knowledgeable persons (Beattie, 2010, p. 92). The first question required the respondents to indicate a preferable framework to direct people's actions or decisions in the absence of an effective law or a lack of adequate law enforcement. The following is a summary of the main responses:

1. the values of the community should be of such a nature that its members would realise the purpose of taxation and that a moral obligation should be the main motivational instrument in this regard;
2. companies should utilise a strategy for the training of employees in the essence of business ethics regarding corporate governance;
3. if there were no legal system in place, the preferable system would be one based on what the general community finds acceptable – each person needs to do what is considered reasonable by one's own culture and values;
4. companies should have standard operating procedures, which entail written procedures clearly identifying and guiding people in the correct way of conducting their business (actions and decisions).

Based on the responses given, leaders could formulate their own value system with reference to the values of the community and educate their followers or employees in the essence of business ethics.

4.2 Involvement of the church, community and society in morality issues

Churches, community and society play a significant role in forming public opinion on various issues. With the globalisation of world economies, and the arrival of the internet and electronic communication such as email, Skype, Twitter, Facebook and YouTube, the role of churches, community and society as shapers of values may have changed.

The involvement of the church, community and society in morality issues is addressed in the answers given for the two questions listed in Table 2.

Table 2: Church/Community/Society versus Fraud, Corruption and Tax Evasion

Question	Yes		No		Uncertain		Total	
	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>
Do you think that the church/community/society in general can play a role in modern society in condemning tax evasion and promoting tax morality?	122	87%	13	9%	5	4%	140	100%
Do you think that the church/community/society should take a more open or firm public stance against fraud, corruption and tax evasion?	123	88%	10	7%	7	5%	140	100%

Despite the elements of today's modern era, 87 per cent of the respondents indicated that churches, community and society could play a role in modern society in condemning tax evasion and promoting tax morality. Only 9 per cent of the respondents had an opposing viewpoint. The church/community/society therefore has an important role to play when voicing an opinion about what is deemed unacceptable by the community, and may influence people's perspective on such an issue. However, churches and the community can assist in promoting morality far beyond just tax matters, for example, in terms of respect for the law, respecting other people's rights, and behaving in an orderly manner in public.

Surprisingly, 88 per cent of the respondents indicated that churches, community and society should take a more open or firm public stance against fraud, corruption and tax evasion. Only 7 per cent of the respondents held an opposing viewpoint. All of these transgressions have one goal in common and that is to enrich the perpetrator and to deprive the victim of certain benefits, money or revenue. Law enforcement is the primary vehicle for dealing with fraud, corruption and tax evasion. However, law enforcement alone may not be enough to combat these economic crimes, and therefore the assistance of churches, the community and society is required.

4.3 People's attributes in morality issues

With the realisation of the new democratic South Africa, the Constitution of 1996 was drafted and promulgated as law in 1996. Chapter 2 of the Constitution contains the Bill of Rights, which is applicable to all South Africans. It was against the backdrop of the Constitution that three questions were posed to the respondents regarding people's attributes in terms of morality issues; their responses are indicated in Table 3.

Table 3: People's Attributes in Morality Issues

Question	Yes		No		Uncertain		Total	
	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>
Do you think that people are more aware of their human rights than of their responsibility to comply with tax laws and regulations?	117	83%	15	11%	8	6%	140	100%
Do you think that a change in taxpayers' attitude towards SARS and the government may positively affect eliminating tax evasion, fraud, corruption and strengthen tax morality?	121	86%	10	7%	9	7%	140	100%
Do you think that materialism; greed and self-enrichment have become more important to people than old-fashioned moral values?	120	85%	8	6%	12	9%	140	100%

The majority of the respondents (83 per cent) were of the opinion that people are more aware of their human rights than of their responsibility to comply with tax laws and tax regulations. Only 11 per cent of the respondents did not agree with this statement. This corresponds with an observation made by Bondeson (2006, p. 5) that there has been a renewed focus on human rights in recent years.

Eighty-six per cent of the respondents were of the opinion that a change in taxpayers' attitudes towards SARS and the government may positively affect eliminating tax evasion, fraud, and corruption, and could strengthen tax morality. Only 7 per cent of the respondents had an opposing viewpoint. This result may emphasise the general attitude displayed by taxpayers towards SARS and the government.

Eighty-five per cent of the respondents indicated that materialism, greed and self-enrichment have become more important than old-fashioned moral values. Only 6 per cent of the respondents had an opposing opinion. The majority of the respondents therefore had the view that many people have indeed experienced a shift in their value systems. Materialism, greed and self-enrichment have, for many people, replaced their original value system.

The role that churches, community and society could play in curbing fraud, corruption and tax evasion should not be underestimated. Many people still regard the opinion of their churches, community or society on various issues as important.

4.4 People's moral values

People pursue their own interests and most often choose the option that most likely yields the greatest benefit to them (Larmore, 2008, p. 92). Tax laws and regulations govern the payment of tax and the taxpayer is therefore legally bound to comply with the applicable tax laws and regulations. Tax morality is and will always be a contentious issue. The respondents' answers to the three questions relating to people's moral values are set out in Table 4.

Table 4: People's Moral Values

Question	Yes		No		Uncertain		Total	
	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>
Do you think that it is morally justifiable not to comply with tax rules and regulations in order to save an amount of taxation because, for example, the taxpayer might disapprove of the present government?	13	9%	119	85%	8	6%	140	100%
Do you think that tax morality should be governed by tax rules and tax regulations?	108	77%	27	19%	5	4%	140	100%
Do you think that fraud, corruption and tax evasion can be minimised by addressing the moral values of people?	111	79%	19	14%	10	7%	140	100%

Only 9 per cent of the respondents indicated that it is morally justifiable not to comply with tax rules and regulations in order to save an amount of taxation. However, 85 per cent of the respondents indicated that it would not be morally justifiable to not comply with tax laws in order to save an amount of taxation because the taxpayer may, for example, disapprove of the present government. Taxpayers would therefore not be prepared to fail to comply with tax laws should they disapprove of any particular issue of note.

The majority of the respondents (77 per cent) were also of the opinion that tax morality should rather be governed by tax rules and regulations than by something else such as personal, spiritual, religious or another set of moral values. However, 19 per cent of the respondents had an opposing opinion on this issue. When a taxpayer is not tax compliant, it would be much easier to address such non-compliance if it were governed by a tax law rather than by some personal, spiritual, religious or other set of moral values. This is the case because not all people may have the same moral values, but the law applies equally to every person. A society or a community could probably

function without any moral values and only rely on official laws and regulations to maintain law and order.

It is noteworthy that 79 per cent of the respondents indicated that fraud, corruption and tax evasion could be minimised by dealing with the moral values of people. To the contrary, 14 per cent of the respondents opposed this statement. The respondents were in consensus that moral values can play a role in dealing with fraud, corruption and tax evasion in general. People with established moral values align their conduct accordingly. Attempts to limit fraud, corruption and tax evasion should therefore involve educating members of the community regarding moral value systems.

4.5 Morality in taxpayer conduct

Morality in taxpayer conduct was measured by considering the responses to four questions in the questionnaire. The respondents' answers are indicated in Table 5.

Table 5: Morality in Taxpayer Conduct

Question	Yes		No		Uncertain		Total	
	N	% of Total	N	% of Total	N	% of Total	N	% of Total
Do you think that if a taxpayer has been dishonest in the past when declaring his/her income for tax purposes, the taxpayer should notify SARS and declare the correct income for previous years?	99	71%	16	11%	25	18%	140	100%
Do you think that continued tax dishonesty/tax evasion may cause taxpayers to experience health or psychological problems?	91	65%	25	18%	24	17%	140	100%
Do you think that if one taxpayer becomes aware of another taxpayer's tax dishonesty or tax evasion, he/she should report the fact to SARS?	84	60%	34	24%	22	16%	140	100%
Do you think that tax laws and regulations should primarily guide a taxpayer's actions?	103	74%	31	22%	6	4%	140	100%

Only 11 per cent of the respondents indicated that SARS should not be notified of tax dishonesty in previous tax years. A further 18 per cent of the respondents indicated that they were uncertain regarding this issue. However, 71 per cent of the respondents answered affirmatively about notifying SARS of tax dishonesty in previous tax years. It may be fair to conclude that those respondents who indicated that SARS should be

notified about tax dishonesty in previous tax years had a certain level of tax morality. However, it would be unfair to conclude that those respondents that replied negatively had little or no tax morality as other external factors may have influenced the respondents' views on tax compliance. It is nevertheless noteworthy that 71 per cent of the respondents believed that SARS should be notified of tax dishonesty in previous tax years. Alexander (2007, p. 285) observed that people make choices about what they value, and would learn to behave morally. Morality is therefore a choice and not a law, and cannot be enforced on anyone.

Only some of the respondents in this research project had a medical or psychological background. Thus, the opinions expressed by the majority of the respondents relating to the issue of whether continued tax dishonesty/tax evasion may cause taxpayers to experience health or psychological problems were based on their own perceptions of this issue. Sixty-five per cent of the respondents replied in the affirmative to this question, while 18 per cent of respondents did not agree with the probability that continued tax dishonesty/tax evasion may cause taxpayers to experience health or psychological problems. A further 17 per cent of the respondents were uncertain on this issue. A person displaying sound morality and adhering to or complying with tax laws and regulations need not be concerned with the consequences of non-adherence or non-compliance.

Sixty per cent of the respondents indicated that when one taxpayer becomes aware of another taxpayer's tax dishonesty or tax evasion, it should be reported to SARS. Twenty-four per cent of the respondents indicated the opposite, while 16 per cent of the respondents were uncertain about this issue. The fact that the majority of the respondents indicated that they would report tax dishonesty or tax evasion to SARS may be of note. People want to know what actions are praiseworthy, blameworthy or morally neutral (Alexander, 2007, p. 268). In this regard, Hare (2007, p. 242) observes that sometimes morality requires sacrifices, however, people attempting morally good behaviour are happier. Reporting another taxpayer to SARS for tax dishonesty could become a moral issue.

The majority of the respondents (74 per cent) indicated that tax laws and regulations should primarily guide a taxpayer's actions. A significant number of the respondents (22 per cent) had an opposing viewpoint, which indicates that other possibilities might also exist to guide taxpayers' actions, apart from tax laws and regulations. The majority of the respondents were, however, of the opinion that taxpayer' actions should primarily be guided by tax laws and regulations rather than something else. Tax law can be successfully enforced on all taxpayers as it sets the tax boundaries. However, tax laws and regulations could be supported by general values in a community.

4.6 Morality in tax evasion

The question could be asked whether a person could feel remorse when committing an offence or transgressing a specific legal or regulatory requirement. The respondents were challenged with four questions relating to morality in tax evasions, the responses to which are indicated in Table 6.

Table 6: Morality in Tax Evasion

Question	Yes		No		Uncertain		Total	
	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>
If I perceive the current tax system to be unfair or unjust, could that be sufficient grounds for tax evasion?	8	6%	124	88%	8	6%	140	100%
Do you think that tax evaders have any concerns about their tax evasive actions?	47	34%	63	45%	30	21%	140	100%
Do you think that people comply with tax rules and regulations because they respect the law?	94	67%	15	11%	31	22%	140	100%
Do you think that by adding more severe penalties and other punitive measures against tax evasion, fraud and corruption, the current levels of these transgressions would decrease?	73	52%	51	37%	16	11%	140	100%

Most of the respondents (88 per cent) indicated that if a person perceives the current tax system to be unfair or unjust, it would not be sufficient grounds for tax evasion. However, 6 per cent of the respondents indicated that tax evasion could be an option if the current tax system is perceived to be unfair or unjust. The fact that such a large percentage of the respondents answered 'no' to the posed question emphasises the strong moral orientation of these respondents. It can be said that even if they were to perceive the current tax system to be unfair or unjust, they would still adhere to the tax laws and regulations by refraining from tax evasion. Bondeson (2006, p. 5) debates whether 'justice is the law of the ruling society, or something that is related to man's feelings of justice'. Bondeson's conclusion on justice was that the law should be the primary vehicle for addressing justice, but that a person's own conviction may complement justice from a legal perspective (Bondeson, 2006, p. 5).

Only 34 per cent of the respondents indicated that tax evaders might have concerns about their evasive actions, while 45 per cent of the respondents indicated that evaders have no concerns about their tax evasive actions. The remaining respondents (21 per cent) were uncertain about this issue. The respondents that remained uncertain could have had a significant impact on the affirmative or opposing viewpoints expressed by the respondents. The fact that 45 per cent of the respondents indicated that tax evaders have no concerns about their tax evasive actions might imply that such tax evaders may continue with their tax evasion activities until being detected.

The majority of the respondents (67 per cent) were of the opinion that people comply with tax laws and regulations because they respect the law. A considerable number of the respondents (22 per cent) were uncertain about this issue, while 11 per cent of the respondents indicated that people might comply with tax laws and regulations for different reasons.

Only 52 per cent of the respondents indicated that by levelling more severe penalties and other punitive measures against tax evasion, fraud and corruption would the current levels of these transgressions decrease. It is anticipated that by imposing more severe penalties and other punitive measures against tax evasion, fraud and corruption, it might have a positive effect on the levels of these transgressions. However, 37 per cent of the respondents believed that more stringent measures against tax evasion, fraud and corruption would have no impact on these transgressions. These respondents may therefore have affirmed their faith in existing punitive measures to deal with the aforementioned transgressions. It might also be interpreted as an indication of the effectiveness of existing measures and procedures to address tax evasion, fraud and corruption in general.

The general view of the respondents was that there are enough punitive measures in place to deal with fraud, corruption or tax evasion. Introducing additional penalties or punitive measures may, actually, affect law-abiding citizens more than offenders. Current measures in place may be sufficient, but should possibly be enforced more rigorously.

4.7 Morality in tax planning

With almost every transaction that a taxpayer concludes, taxation of some sort could come into play and would have to be considered by the taxpayer. One of the goals of taxation is the raising of revenue; tax law is used to achieve this goal (Dennis-Escoffier & Fortin, 2007, p. 3). In this regard, a taxpayer has the right to plan his or her tax affairs within the parameters of the tax laws in order to pay the least possible taxes. The respondents' answers to the questions relating to morality in tax planning are reflected in Table 7.

Table 7: Morality in Tax Planning

Question	Yes		No		Uncertain		Total	
	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>	<i>N</i>	<i>% of Total</i>
Do you think that taxpayers should pay their tax without any form of tax planning?	5	4%	129	92%	6	4%	140	100%
Do you think that tax planning, when it becomes aggressive (tax planning becomes tax evasion), may become a moral issue?	117	83%	19	14%	4	3%	140	100%

For 92 per cent of the respondents, the payment of tax without any form of tax planning would not be acceptable. Only 4 per cent of the respondents indicated that they would pay their taxes without any form of tax planning.

Furthermore, 83 per cent of the respondents indicated that tax planning might become a moral issue when it becomes aggressive. This emphasises the responsibility of taxpayers in exercising their right to implement tax planning within the ambit of the law. A total of 14 per cent of the respondents were of the opinion that when tax planning does become aggressive, it will not be a moral issue. This could imply that some people therefore employ or use aggressive tax planning to handle an adverse tax

position without considering it immoral and therefore could be willing to use tax evasion to address an adverse tax position to their satisfaction.

4.8 Reasons for perpetrating tax evasion, fraud and corruption

There must be something that triggers the need for tax evasion and the perpetration of fraud and corruption. In this regard, Hare (2007, p. 96) observes that a person has a natural inclination to seek an advantage despite their regard for justice.

The respondents were prompted to indicate why they thought people conducted tax evasion in general or committed fraud and corruption. They also had to supply a short justification in this regard. The following is a summary of some of most the notable justifications supplied by the respondents:

1. the respondents believed that people might distrust the government as they see no attempt to indicate how money is utilised, and may start paying tax in terms of what they perceive as service delivery;
2. the respondents held the opinion that there are excessive taxes in South Africa and a number of people are trying to reduce a large burden that could easily lead to tax evasion in all possible ways;
3. the respondents contended that fraud and corruption are part of an immoral and lawless society that is unaware of the impact of their actions or is not held responsible for its crimes. In this regard, they also observed that it has become acceptable in society to be dishonest, and that a lack or absence of control systems creates opportunities for irregularities without punishment;
4. the respondents observed that given the climate of bribery, poor public service delivery and corruption in government, there may be a growing feeling among the middle and upper classes that being honest is foolish and that they are merely giving money to incompetent officials who may squander or abuse the funds.

To curb tax evasion, fraud and corruption, taxpayers therefore need to see that government utilises tax money in a responsible manner and that law enforcement is adequate and effective. Government should furthermore address misconduct in its ranks and communicate effectively with taxpayers.

4.9 Association between morality issues

A Pearson Chi-Square test was carried out to examine whether there was a statistically significant association between the categorical questions focusing on the impact of the stance of the church/community/society and people's moral values, morality in tax evasion, morality in taxpayers' conduct and people's attributes in terms of morality issues. The null hypothesis of independence is rejected when the *p*-value is smaller than 0.01, therefore indicating a statistically significant association between two categorical variables at a 99 per cent level of confidence.

Only five of the questions in the questionnaire revealed a statistically significant association with the involvement of the church/community/society, while 11 questions revealed no statistically significant association, as displayed in Table 8. Only those questions that revealed a statistical association with the involvement of the church/community/society are the focus of the remainder of this section.

Table 8: Associations between Moral Issues and the Church/Community/Society

Comparison between questions		Chi-square value	DF	P-value	Result
Base question: Do you think the churches/community/ society should take a more open or firm public stance against fraud, corruption and tax evasion?					
1	If I perceive the current tax system to be unfair or unjust, could that be sufficient grounds for tax evasion?	5.929	4	0.2045	Insignificant
2	Do you think a taxpayer should pay his/her tax without any form of tax planning?	2.324	4	0.6763	Insignificant
3	Do you think that tax planning, when it becomes aggressive, (tax planning become tax evasion), may become a moral issue?	2.635	4	0.6206	Insignificant
4	Do you think it is morally justifiable not to comply with tax rules and regulations in order to save an amount of taxation because, for example, the taxpayer might disapprove of the present government?	18.963	4	0.0008	Significant
5	Do you think that people are more aware of their human rights than of their responsibility to comply with tax laws and tax regulations?	4.314	4	0.3652	Insignificant
6	Do you think that tax morality should be governed by tax rules and tax regulations, or rather by a personal, spiritual, religious or other set of moral values?	3.188	4	0.5269	Insignificant
7	Do you think that when a taxpayer has been dishonest in the past when declaring his/her income for tax purposes, the taxpayer should notify SARS and declare the correct income for previous tax years?	2.507	4	0.6433	Insignificant
8	Do you think that continued tax dishonesty/tax evasion may cause taxpayers to experience health or psychological problems?	3.119	4	0.5382	Insignificant
9	Do you think if one taxpayer becomes aware of another taxpayer's tax dishonesty or tax evasion, he/she should report that fact to SARS?	8.145	4	0.0864	Insignificant
10	Do you think that a change in taxpayers' attitudes towards SARS and the government may positively affect eliminating tax evasion, fraud, corruption, and strengthen tax morality?	1.467	4	0.8325	Insignificant
11	Do you think that tax evaders have any concerns about their tax evasive actions?	25.363	4	0.0001	Significant
12	Do you think that tax laws and regulations should primarily guide a taxpayer's actions?	1.982	4	0.7391	Insignificant
13	Do you think that fraud, corruption and tax evasion can be minimised by addressing the moral values of people?	10.968	4	0.0069	Significant

Comparison between questions		Chi-square value	DF	P-value	Result
Base question: Do you think the churches/community/ society should take a more open or firm public stance against fraud, corruption and tax evasion?					
14	Do you think that materialism; greed and self-enrichment have become more important to people than old-fashioned moral values?	15.882	4	0.0032	Significant
15	Do you think that people comply with tax rules and regulations because they respect the law or simply because they are afraid of being caught for perpetrating non-compliance?	3.195	4	0.5258	Insignificant
16	Do you think that by adding more severe penalties and other punitive measures against tax evasion, fraud and corruption, the current levels of these transgressions would decrease?	17.467	4	0.0016	Significant

The null hypothesis of no association relating to comparison 4 in Table 8 may be rejected at a 1 per cent level of significance ($\chi^2(4) \approx 18.963$; $p=0.0008$). The results therefore reveal that there seems to be a statistically significant association between people's moral values concerning non-compliance with tax rules and regulations and a firmer public stance against fraud, corruption, and tax evasion by churches/community/society. In other words, even though some people's moral viewpoint may cause them to choose not to comply with tax rules and regulations in order to save an amount of taxation, it is nevertheless considered that the involvement of the church/community/society in taking a firmer and more open stance on the matter could possibly curb fraud, corruption and tax evasion as the church/community/society is still viewed by many people to resemble the moral compass of the broad community/society.

The null hypothesis of no association relating to comparison 11 in Table 8 may be rejected at a 1 per cent level of significance ($\chi^2(4) \approx 25.363$; $p=0.0001$). The results therefore reveal that there seems to be a statistically significant association between people's moral values about the fact that tax evaders may have any concerns about their tax evasive actions and a firmer public stance against fraud, corruption and tax evasion by churches/community/society. Even though some tax evaders may have no concern about their evasive tax actions, the involvement of the church/community/society in taking a firmer and more open stance on the matter could possibly curb fraud, corruption, and tax evasion. If people are associated with or linked to the church/community/society, they may well align their own moral conduct accordingly.

The null hypothesis of no association relating to comparison 13 in Table 8 may be rejected at a 1 per cent level of significance ($\chi^2(4) \approx 10.968$; $p=0.0069$). The results therefore reveal that there seems to be a statistically significant association between people's moral values about the fact that fraud, corruption and tax evasion can be minimised by addressing the moral values of people and a firmer public stance against fraud, corruption and tax evasion by churches/community/society. Even though some people may still perpetrate fraud, corruption or tax evasion once their moral values have been addressed, the involvement of the church/community/society in taking a

firmer and more open stance on the matter could possibly curb fraud, corruption, and tax evasion as the church/community/society is still viewed by many people to resemble the moral compass of the broad community/society.

The null hypothesis of no association relating to comparison 14 in Table 8 may be rejected at a 1 per cent level of significance ($\chi^2 (4) \approx 15.882$; $p=0.0032$). The results therefore reveal that there seems to be a statistically significant association between people's moral values about the fact that materialism, greed and self-enrichment have become more important to people than old-fashioned moral values and a firmer public stance against fraud corruptions and tax evasion by churches/community/society. Even though some people may place a higher value on materialism, greed and self-enrichment than old-fashioned moral values, the involvement of the church/community/society in taking a firmer and more open stance on the matter could possibly curb fraud, corruption and tax evasion.

The null hypothesis of no association relating to comparison 16 in Table 8 may be rejected at a 1 per cent level of significance ($\chi^2 (4) \approx 17.467$; $p=0.0016$). The results therefore reveal that there seems to be a statistically significant association between people's moral values concerning the fact that adding more severe penalties and other punitive measures against tax evasion, fraud and corruption would decrease the current levels of these transgressions, as well as a firmer public stance against fraud, corruption and tax evasion by churches/community/society. Even though some people may still commit tax evasion, fraud and corruption in any event, the addition of more severe penalties and other punitive measures against these transgressions, the involvement of the church/community/society in taking a firmer, and more open stance on the matter could possibly curb fraud, corruption and tax evasion as the church/community/society is still viewed by many people to resemble the moral compass of the broad community/society.

4.10 Summary

The following conclusions can be drawn based on the analysis in this section:

1. a preferable framework for people to direct their actions and decisions could be that the values of the community should be of such a nature that its members would realise the purpose of taxation. Also, a moral obligation should be the main motivational instrument in this regard (section 4.1);
2. the majority of the respondents were of the opinion that the involvement of the church, community and society in morality issues should be promoted as a measure to prevent the perpetration of fraud, corruption and tax evasion (section 4.2);
3. people's attributes in terms of morality issues should not be overshadowed by people's human rights when it comes to compliance with tax laws and regulations. The majority of the respondents also indicated that a change in taxpayers' attitudes towards SARS and the government might positively affect eliminating tax evasion, fraud, corruption, and may strengthen tax morality. However, they also indicated that materialism, greed and self-enrichment have become more important to people than moral values (section 4.3);
4. people's moral values cannot be adjusted to save any amount of taxation, and tax morality should be governed by tax rules and regulations. Moreover,

fraud, corruption and tax evasion could be minimised by addressing the moral values of people (section 4.4);

5. the majority of the respondents were of the opinion that the morality in taxpayer conduct should be to act fairly towards SARS in declaring the correct income for past tax years and the current tax year, to rectify any misdeclaration in this regard, and to report any known tax evasion to SARS (section 4.5);
6. there cannot be any morality in tax evasion. Tax evasion remains immoral regardless of the reason for it (section 4.6);
7. the majority of the respondents were of the opinion that taxpayers are entitled to use tax planning, but that tax planning may become a moral issue when it becomes aggressive, leading to immoral behaviour such as tax evasion (section 4.7);
8. of note were the main reasons identified by the respondents for committing economic crimes. Financial stress, economic pressures, needs, greed or simply the thrill and opportunity were some of most the notable justifications (section 4.8).

The Chi-Square test dependency results in section 4.9 indicate a highly significant association between the church/community/society playing a role in society by taking a firmer public stance against fraud corruptions and tax evasion, and:

1. taxpayers' non-compliance with tax rules and regulations in order to save an amount of taxation;
2. whether tax evaders have any concerns about their tax evasive actions;
3. whether fraud, corruption and tax evasion can be minimised by addressing the moral values of people;
4. whether materialism, greed and self-enrichment have become more important to people than old-fashioned moral values;
5. that adding more severe penalties and other punitive measures against tax evasion, fraud and corruption could reduce the current levels of these transgressions.

4.11 Limitations and possible future research

The sample of 185 respondents selected for this research project may create certain limitations due to the research methodology followed in this project. The sample may not be completely representative of a typical South African society or community. Care has been taken to include the widest possible spectrum of community leaders and persons in key roles. This study included people involved in the field of education (pre-school, primary school, secondary school and tertiary institutions), sport, art, business, government, culture, church, and religion in an attempt to make this research as representative as possible. It would have been impossible to identify all prospective respondents fulfilling some sort of leadership role in society and communities in South Africa and to involve them in this research project due to the magnitude and financial implications of such a project.

This study focused only on the morality issues associated with fraud, corruption and tax evasion in general in South Africa. There are additional drivers of the perpetration of economic crimes and the prevention, detection and addressing of economic crimes. This area could prove to be a topic for future research. From the analysis conducted, it was evident that there is a high level of uncertainty regarding questions related to morality in taxpayers' conduct and questions related to morality in tax evasion. The respondents that were uncertain cannot be labelled as being immoral simply because they were uncertain regarding a specific moral issue related to taxpayers' conduct and tax evasion. The respondents may have chosen this option merely because they were in no position to predict the outcome of a scenario as morality if not cast in legislation or formal regulations. The high level of uncertainty in the responses to some of the questions is intriguing and therefore provides scope for future research.

5. CONCLUSION AND IMPLICATIONS FOR THE PUBLIC AND PRIVATE SECTORS

The focus of this study was the moral issues associated with fraud, corruption and tax evasion in general. The representative composition of 140 members of society and communities in South Africa, who were respondents in this study, provides support for the research findings, which represent authoritative views, conclusions and recommendations.

This study has produced results that strongly confirm the need for sound moral values in a society or community. This study furthermore provides strong support for a necessary change in the attitude of taxpayers towards SARS and the government. Based on the responses to the questionnaire, various significant aspects of the morality associated with fraud, corruption and tax evasion were revealed, considering the issues identified from the reviewed literature. The literature consulted for this research suggests that ethics might be the magic product that many companies could employ to build customer, investor and employee loyalty because there seems to be a crucial connection between ethics and success in business. The literature consulted also suggests that if a person has a sound moral development, that person can be expected to display sound moral behaviour.

The valuable contribution of this study to the existing body of knowledge is best demonstrated by the fact that it may be practically applied by SARS or correctional services in addressing morality issues associated with economic crimes. Morality is not something that can be regulated by legislation, nor can it be enforced on the public by any government or legislator. The building blocks of morality include justice, principles, morals, honour, integrity, goodness, honesty, decency, courtesy, kindness and fairness. These building blocks should be transferred from parents to their children and continuously reinforced by society/community. Schools, tertiary institutions, churches, community leaders, persons in key community roles and employers can play a vital role in establishing and improving the moral conduct of the members of a community in their interaction with other people, government, and commerce and industry. If people start to implement morality in all spheres of life, it may have a positive impact on the occurrence of fraud, corruption and tax evasion in general and for this reason, morality should be promoted at a grassroots level, as well as at the highest level of corporate governance in South Africa.

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7. APPENDIX

7.1 Questionnaire

General information

The purpose of this questionnaire is to investigate the general perception of leaders in communities regarding the moral issues associated with fraud, corruption and tax evasion in South Africa. Similar studies and research have been undertaken around the globe. It is therefore important to research the moral issues associated with fraud, corruption and tax evasion in the South African context.

Selected community leaders from different social, political and religious perspectives will be interviewed personally to complement this questionnaire.

The input of each respondent is very important for the purpose of this research project. The participation of each respondent is highly valued and will make a difference.

The information supplied by you will be treated as **strictly confidential**. Your responses together with those of other respondents will be used to obtain a complete view.

Any additional comments may be written on a separate sheet of paper, if insufficient space has been provided in the questionnaire.

Please answer every question in the space provided in each question by marking the applicable section with an "X" or write down your answer where required.

For the purpose of this research, the concepts of fraud, corruption, tax evasion and SARS will mean the following:

1. Fraud - The Collins English Dictionary & Thesaurus (2006:474) describes fraud as deliberate deception, trickery, or cheating intended to gain an advantage.
2. Corruption – The Collins English Dictionary & Thesaurus (2006:260) describes corruption as the act of corrupting or a state of being corrupt. It may include depravity, dishonesty like bribery or even an altered form of a word. To be corrupt a person should be open to or be involved in bribery or other dishonest practices.
3. Tax evasion – Stiglingh *et al* (2009:657) describes tax evasion as the illegal activities deliberately undertaken by a taxpayer to free himself from a tax burden. One example of simple tax evasion would occur where taxpayers omit income from their annual tax returns.
4. SARS – South African Revenue Service.

Please indicate your position and role in your community, for example pastor, priest, minister, imam, teacher, lecturer, doctor etc.

Position in your community: _____

Role in your community: _____

Question 1			
In the absence of an effective law or a lack of adequate law enforcement, what should be the preferable framework for people to direct their actions or decisions? Please justify your answer.			
Question 2	YES	NO	UNCERTAIN
If I perceive the current tax system to be unfair or unjust, could that be sufficient grounds for tax evasion?			
Question 3	YES	NO	UNCERTAIN
Do you think a taxpayer should pay their tax without any form of tax planning?			
Question 4	YES	NO	UNCERTAIN
Do you think that tax planning, when it becomes aggressive (tax planning becomes tax evasion), may become a moral issue?			
Question 5	YES	NO	UNCERTAIN
Do you think it is morally justifiable not to comply with tax rules and regulations in order to save an amount of taxation because, for example, the taxpayer might disapprove of the present government?			
Question 6	YES	NO	UNCERTAIN
Do you think that people are more aware of their human rights than of their responsibility to comply with tax laws and tax regulations?			
Question 7	YES	NO	UNCERTAIN
Do you think that tax morality should be governed by tax rules and tax regulations, or rather by a personal, spiritual, religious or other set of moral values? Please supply a short justification.			

Question 8	YES	NO	UNCERTAIN
Do you think that when a taxpayer has been dishonest in the past when declaring his/her income for tax purposes, the taxpayer should notify SARS and declare the correct income for previous tax years?			
Question 9	YES	NO	UNCERTAIN
Do you think that continued tax dishonesty/tax evasion may cause taxpayers to experience health or psychological problems? Please supply a short justification.			
Question 10	YES	NO	UNCERTAIN
Do you think if one taxpayer becomes aware of another taxpayer's tax dishonesty or tax evasion, he/she should report that fact to SARS?			
Question 11	YES	NO	UNCERTAIN
Do you think that the church/community/society in general can play a role in modern society in condemning tax evasion and promoting tax morality? Please supply a short justification.			
Question 12	YES	NO	UNCERTAIN
Do you think that a change in taxpayers' attitudes towards SARS and the government may positively affect eliminating tax evasion, fraud, corruption, and strengthen tax morality? Please supply a short justification.			
Question 13			
Why do you think people embark on tax evasion in general or commit fraud and corruption? Please supply a short justification.			
Question 14	YES	NO	UNCERTAIN
Do you think that tax evaders have any concerns about their tax evasive actions?			

Question 15	YES	NO	UNCERTAIN
Do you think the churches/community/society should take a more open or firm public stance against fraud, corruption and tax evasion? Please supply a short justification.			
Question 16	YES	NO	UNCERTAIN
Do you think that tax laws and regulations should primarily guide a taxpayer's actions? Please supply a short justification.			
Question 17	YES	NO	UNCERTAIN
Do you think that fraud, corruption and tax evasion can be minimised by addressing the moral values of people? Please supply a short justification.			
Question 18	YES	NO	UNCERTAIN
Do you think that materialism; greed and self-enrichment have become more important to people than old-fashioned moral values? Please supply a short justification.			
Question 19	YES	NO	UNCERTAIN
Do you think that people comply with tax rules and regulations because they respect the law or simply because they are afraid of being caught for perpetrating non-compliance?			
Question 20	YES	NO	UNCERTAIN
Do you think that by adding more severe penalties and other punitive measures against tax evasion, fraud and corruption, the current levels of these transgressions would decrease? Please supply a short justification.			

THANK YOU FOR YOUR VALUABLE TIME AND INPUT IN COMPLETING THIS QUESTIONNAIRE. YOU HAVE MADE A GREAT CONTRIBUTION TO THE OUTCOME OF THIS RESEARCH.

Addressing aggressive tax planning through mandatory corporate tax disclosures: An exploratory case study

Heidi Zummo,¹ Bronwyn McCredie² and Kerrie Sadiq³

Abstract

Secrecy and aggressive tax planning are arguably interdependent. As such, when secrecy is reduced via mandatory tax disclosures there is likely to be a consequential reduction in aggressive tax planning. However, to reduce secrecy, legislative interventions, as opposed to voluntary frameworks such as corporate social responsibility (CSR) reporting guidelines, are generally required. In this article, we argue that aggressive tax planning can be addressed through public disclosures by revenue authorities of certain taxpayer information collected from annual corporate tax returns. Further, we propose that it is a combination of primary tax disclosures by revenue authorities and the subsequent responses of corporate taxpayers subject to the disclosure legislation which may increase public confidence in the integrity of rules, systems and institutions. This article briefly considers the concept of aggressive tax planning in the context of the OECD/G20 base erosion and profit shifting program of reform and then examines the concept of mandatory corporate tax disclosures by revenue authorities. It also provides a theoretical framework for an investigation into taxpayer responses. The second part of the article adopts a case study approach to test the hypothesis that corporate taxpayers react to mandatory disclosure requirements by increasing their disclosures and by adopting impression management strategies to legitimise their image and identity. Using the introduction of the *Tax Laws Amendment (2013 Measures No. 2) Act 2013* as the critical event point, we investigate whether there has been an increase in tax communications by corporate taxpayers since the introduction of the legislation and then undertake an analysis to identify the types of strategies used in these disclosures. Also investigated is whether there is a relationship between a company's level of CSR and their tax communications. Overall, we conclude that a combination of primary tax disclosures by revenue authorities and the subsequent responses of corporate taxpayers subject to the disclosure legislation is likely to increase public confidence in the integrity of rules, systems and institutions.

Keywords: Aggressive tax planning, corporate tax avoidance, tax secrecy, disclosures, corporate taxpayers, corporate social responsibility

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1. INTRODUCTION

Secrecy and aggressive tax planning are interdependent. As such, when secrecy is reduced via mandatory tax disclosures there is likely to be a consequential reduction in aggressive tax planning. However, to reduce secrecy, legislative interventions, as opposed to voluntary frameworks such as corporate social responsibility (CSR) reporting guidelines, are generally required. In response to current initiatives by the OECD, several mandatory tax disclosure reform measures have recently been adopted by national jurisdictions. Specifically, many jurisdictions have introduced legislation to enact the Automatic Exchange of Information – Common Reporting Standard framework and the Base Erosion and Profit Shifting – Country-by-Country Reporting recommendations. To date, these reforms require the disclosure of tax-related information to revenue authorities on a confidential basis. In this article, we argue that aggressive tax planning can also be addressed through public disclosures by revenue authorities of certain taxpayer information collected from annual corporate tax returns. Further, we propose that it is a combination of primary tax disclosures by revenue authorities and the subsequent responses of corporate taxpayers subject to the disclosure legislation, which may increase public confidence in the integrity of rules, systems and institutions.

Following this introduction, section 2 of this article briefly considers the concept of aggressive tax planning in the context of the OECD/G20 base erosion and profit shifting program of reform. Section 3 then examines the concept of mandatory corporate tax disclosures by revenue authorities. Utilising the Australian approach, one of the first jurisdictions to provide a contemporary example of mandatory disclosure of taxpayer information by a revenue authority, a possible legislative model is considered, namely, the regime contained in the *Tax Laws Amendment (2013 Measures No. 2) Act 2013* (Cth) (2013 Act) which received Royal Assent on 29 June 2013 requiring the Commissioner of Taxation to publish certain information about the tax affairs of large corporate taxpayers. Section 4 of the article then provides a theoretical framework for an investigation into taxpayer responses. Based on impression management theory, we argue that corporate taxpayers are likely to respond to mandatory disclosures by revenue authorities after they review how the public perceives them. The corporate taxpayer will then use impression management strategies in the communication of tax-related information to control and legitimise their image and identity. We argue that, ultimately, this leads to corporate taxpayers voluntarily disclosing more information about their tax planning strategies. That is, as corporate tax positions become more transparent and available for public evaluation through mandatory disclosure, there is an increase in the frequency of voluntary communication by corporations about their tax position.

In section 5 of this article, we adopt a case study approach to test the hypothesis that corporate taxpayers react to mandatory disclosure requirements by increasing their disclosures and by adopting impression management strategies to legitimise their image and identity. Using the introduction of the 2013 Act as the critical event point, we investigate whether there has been an increase in tax communications by corporate taxpayers since the introduction of the legislation and then identify the types of strategies used in these disclosures. We also investigate whether there is a relationship between a company's level of CSR and its tax communications. Statistical testing is adopted to assess any increases in tax communications and the tax and CSR relationship, while content analysis is used to determine the impression management

techniques used by corporate taxpayers. Measurable results are obtained to illustrate changes in the level of tax communication since the critical incident point. The use of impression management strategies by corporations in their tax communications is also confirmed. Further, the results demonstrate a relationship between CSR and tax communications. Overall, we conclude that a combination of primary tax disclosures by revenue authorities and the subsequent responses of corporate taxpayers subject to the disclosure legislation is likely to increase public confidence in the integrity of rules, systems and institutions.

2. AGGRESSIVE TAX PLANNING BY CORPORATE TAXPAYERS

In the last few years, a great deal has been written about corporate tax avoidance, tax evasion and aggressive tax practices. Even more has been done to address these practices, both through international bodies such as the OECD and at national levels by revenue authorities. Currently, the technical umbrella term capturing corporate tax behaviour deemed inappropriate is ‘base erosion and profit shifting’ (BEPS). In this article it is also suggested that such behaviour is an abuse of public interest which undermines ‘public confidence in the integrity of rules, systems and institutions that promote the public interest’ (Tax Justice Network, 2017). This suggests that corporations have a responsibility not just to shareholders but to the general population of a society.

The adoption of aggressive tax strategies by corporate taxpayers for the private financial gain of corporate shareholders may be legal but such strategies are often considered devoid of ethical considerations. Often, it is argued that corporations cannot be expected to voluntarily pay more tax than is legally required (Freedman, 2006). However, from a moral and ethical perspective, corporations engaging in aggressive tax planning strategies to reduce their corporate tax rate are employing undesirable corporate behaviour (Avi-Yonah, 2008, 2014; Hoi, Wu & Hao, 2013; Sikka, 2010; Lanis & Richardson, 2012). The conflict between these legal and moral viewpoints arises amidst the corporation’s obligation to shareholders to create profit and to society to contribute to the public purse. Companies that act solely in the interest of their shareholders by increasing profits via tax minimising activities are ignoring the impact of their behaviour on broader society. So, as corporate profits increase and government revenues decrease, governments, media, and the public are focusing on the tax behaviour of large corporations (PricewaterhouseCoopers, 2016). It is this behaviour that arguably may amount to aggressive tax planning and which we argue can, at least in part, be addressed through mandatory disclosure regimes.

It is also often argued that corporations should be expected to act as individuals constrained by ethical and moral behaviour (Avi-Yonah, 2008, 2014). Avi-Yonah asserts through the real entity theory that corporations should be seen as individual citizens and thus are expected to pay taxes and not engage in overtly aggressive tax avoidance arrangements. This article seeks to apply Avi-Yonah’s (2008, 2014) concept of a corporate conscience to examine the relationship between tax and CSR. The motivation for adopting these notions comes from prior research which links these constructs (Hoi, Wu & Hao, 2013, Huseynov & Klamm, 2012; Lanis & Richardson, 2012, 2013; Sikka, 2010; Zeng, 2016) and an aim of seeking to test the assertion that corporations that engage in tax minimising arrangements not only affect the revenue

stream to government treasuries, but impact on the supply of public goods and benefits to society.

The payment of taxes is a fundamental way in which corporations engage in contributing to the 'lifblood of the social contract' (Christensen & Murphy, 2004). For this reason, society's attention to tax transparency is building, particularly at a time when government austerity measures are being imposed. The financial reporting of corporations is being scrutinised due to public interest in how and whether corporations contribute to the society in which they make their profit. Prior to the global focus on tax, CSR had evolved as the public's measure of corporate promises of ethical and moral behaviour (Sikka, 2010). This article proposes that the increase in corporate tax transparency has motivated corporations to incorporate disclosures on tax within CSR disclosures. Consequently, we also seek to determine whether this proposed change is related to their level of CSR engagement.

3. CURRENT CORPORATE TAX DISCLOSURES

In February 2013, the Australian Government announced its intention to increase transparency within the country's corporate tax system. The rationale for doing so was that improvements in tax transparency encourage corporations to pay their 'fair share' of tax, to dissuade taxpayers from the use of aggressive tax minimisation arrangements and to provoke public debate on corporate tax policy (Bradbury, 2013). Following this announcement, the Australian Government introduced the 2013 Act which incorporated a new requirement into the *Taxation Administration Act 1953* for the Commissioner of Taxation to publish annual corporate tax transparency information. Specifically, new section 3C of the *Taxation Administration Act 1953* provides that where an Australian public or foreign owned company returns a total income of AUD 100 million or more for an income year, the Commissioner is required to publish the entity's name and ABN, total income, taxable income, and tax payable, as reported in its company tax return. The Commissioner is also required to disclose the same information for Australian-owned resident private companies with total income of AUD 200 million or more, entities that have petroleum resource rent tax (PRRT) payable and entities that had minerals resource rent tax (MRRT) payable for the years it was in place. Under a further provision introduced in 2015, similar reporting obligations now also apply in respect of 'significant global entities' with effect from 1 July 2016 (generally, multinational entities with annual global income of AUD 1 billion or more) (section 3CA of the *Taxation Administration Act 1953*, introduced by *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*).

Australia has a self-assessment system which requires voluntary compliance. The overarching rationale for the introduction of the disclosure requirements was the fact that a system which relies on voluntary compliance requires strong public confidence (Explanatory Memorandum to the Tax Laws Amendment (2013 Measures No. 2) Bill, p. 75). This suggests that the purpose of the disclosure requirement aligns with the notion that aggressive tax planning undermines public confidence and that increased transparency is an option to address this. The Explanatory Memorandum (p. 76) provides four objectives to the disclosure requirement, which also support the notion of greater public confidence and increased transparency:

The first objective of these amendments is to discourage large corporate tax entities from engaging in aggressive tax avoidance practices.

The second objective of these amendments is to provide more information to inform public debate about tax policy, particularly in relation to the corporate tax system.

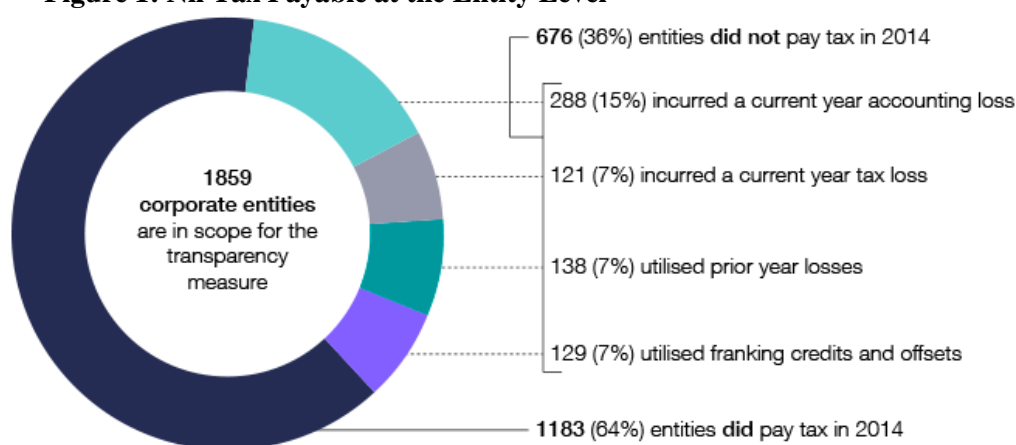
The third objective is to enable better public disclosure of aggregate tax revenue collections, even when the identity of particular taxpayers (other than natural persons) could potentially be deduced.

The fourth objective is to allow improved sharing of relevant tax information between Government agencies.

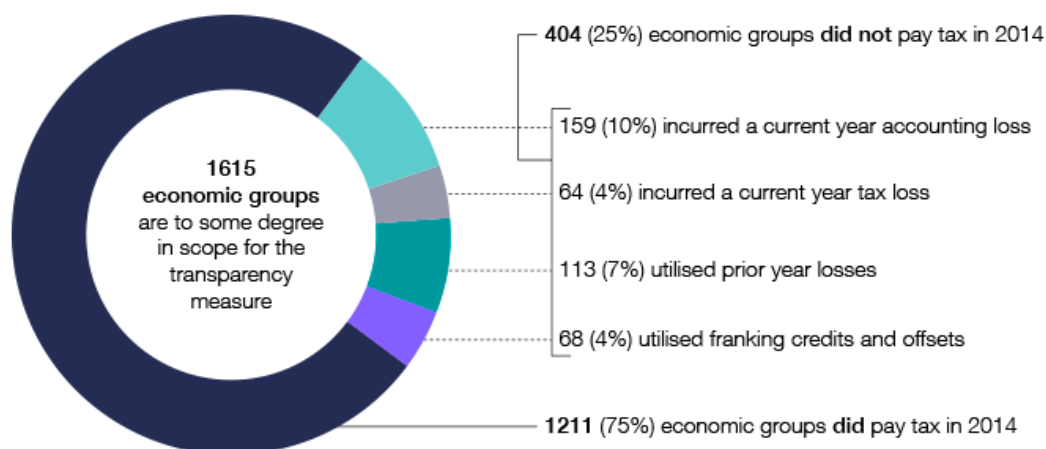
The first publication of Australian public and foreign owned company information, entitled *The Report of Entity Tax Information* (Australian Taxation Office, 2015) and detailing information about the 2013-14 income tax year, was released on 17 December 2015. A second publication detailing the same information for the 2014-15 income tax year was released on 6 December 2016 (Australian Taxation Office, 2016) and a third publication detailing information for the 2015-16 income tax year was released on 7 December 2017 (Australian Taxation Office, 2017). For the purposes of this study, we use the first report released as the event point. This report disclosed what was previously considered sensitive tax information relating to approximately 1,500 of Australia's top public companies including their total income; taxable income; and tax paid (Australian Tax Office, 2015). The report is published directly on the Australian Government website and available through a link on the ATO website for evaluation by all interested stakeholders. The report uses information contained in the tax returns of the relevant entities, but does not release further information beyond what is provided in the report. Consequently, as stated by the ATO, the report itself does not indicate whether an entity is paying a high or low rate of tax; this can only be assessed by calculating effective tax rates, which requires additional information.

The ATO also published an analysis of the data of 1,859 corporate tax entities on its website which included 321 large Australian private companies. Of relevance is the information around nil tax payable at both entity and economic group level.

Figure 1: Nil Tax Payable at the Entity Level



Source: <https://www.ato.gov.au/Business/Large-business/In-detail/Tax-transparency/Corporate-tax-transparency-report-for-the-2013-14-income-year/>.

Figure 2: Nil Tax Payable at the Economic Group Level

Source: <https://www.ato.gov.au/Business/Large-business/In-detail/Tax-transparency/Corporate-tax-transparency-report-for-the-2013-14-income-year/>.

The publication of this report has led to scrutiny by stakeholders of tax strategies used by corporations in Australia. Consequently, the introduction of this legislation has been chosen as the event point for this study. The legislation has resulted in the publication of a unique report, following which corporate responses to increased transparency of their corporate tax practices can be investigated. This study investigates how these corporations have responded to their tax strategies becoming more transparent.

While the study uses the 2013 Act as its event point, other initiatives cannot be dismissed. Adding to the Australian Government's commitment to tax reform and increased transparency has been an Australian Senate inquiry into corporate tax avoidance, announced in 2014. The Senate Economics References Committee Inquiry into Corporate Tax Avoidance was tasked with understanding corporate tax strategies used by large corporations, and making them more transparent. High-level executives of multinational corporations, such as Apple, Google, News Corp, and Microsoft, have been 'grilled' by the Senate inquiry to explain their tax affairs in Australia (Om, 2015). The Senate inquiry has been extended eight times since its inception with the committee due to report by 30 May 2018.⁴ An interim report delivered in August 2015, headed 'You cannot tax what you cannot see' (Parliament of Australia, Senate Economics References Committee, 2015), and a subsequent report released in April 2016 'Gaming the system' (Parliament of Australia, Senate Economics References Committee, 2016), are aptly named, referring to the difficulty in unravelling the international tax arrangements used by corporations in Australia.

Australia continues to move forward with measures to reform and increase the transparency of its corporate tax system both at a domestic and international level. It has committed to increased transparency of corporate tax information through the sharing of tax data under the Automatic Exchange of Information – Common Reporting Standard framework and has adopted the Base Erosion and Profit Shifting –

⁴ See https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporatetax45th (accessed on 12 December 2017).

Country-by-Country Reporting recommendations as developed by the OECD. Further, it has introduced measures such as the Diverted Profits Tax and Multinational Anti-Avoidance Laws. Australia has also undertaken work around a new voluntary Tax Transparency Code, harsher penalties for breaches, new protections for whistleblowers and support for a new Tax Avoidance Taskforce within the ATO, to enforce and police these measures (Morrison, 2016). These actions indicate a significant shift in Australia's view on how its tax system should function.

With increased transparency, the Senate investigation, and new tax rules (summarised in Table 1), the challenge for corporations is to make sure their tax position is properly understood (PricewaterhouseCoopers, 2016, p. 2).

Table 1: Timeline of Change in Tax Focus During Test Period

2008	Global Financial Crisis hits economies worldwide: Governments are encouraged to adopt austerity measures and focus on budget expenditures and revenue in aid to control rising fiscal deficits.
2 April 2009	<i>G20 London Summit</i> : Global leaders announce focus on overhaul on global tax architecture, targeting tax minimising strategies and increasing transparency of international tax systems.
18 June 2012	<i>G20 Los Cabos Summit</i> : G20 Leaders restate the need to prevent BEPS and endorse the work of the OECD.
September 2012	Australia's transfer pricing rules changed to reflect the OECD Transfer Pricing Guidelines.
4 February 2013	Australian Government announces intention to amend tax laws to increase the transparency of the corporate tax system.
June 2013	OECD releases 15-point BEPS Action Plan to be delivered by end of 2015.
3 April 2013	Discussion paper released by Australian Government regarding corporations being required to disclose tax information to the public.
24 April 2013	Discussion paper closed to submissions regarding corporations being required to disclose tax information to the public.
29 May 2013	Tax Laws Amendment (2013 Measures No. 2) Bill introduced to the Australia Parliament, with requirements for the Commissioner of Taxation to publish information about the tax affairs of large corporate taxpayers.
28 June 2013	Tax Laws Amendment (2013 Measures No. 2) Bill passed by the Australian Parliament.
30 June 2014	Australia and the United States intergovernmental agreement to implement the US Foreign Account Tax Compliance Act (FATCA) in Australia.
December 2014	Australia takes over G20 Presidency with focus on leading global efforts to combat multinational tax avoidance.
September 2014	Australian Treasurer releases ministerial statement on G20-OECD tax transparency. Common Reporting Standard for the automatic exchange of financial accounting information will come into effect in 2017 to address tax evasive practices.
26 September 2014	Tax Justice Network and United Voice publish 'Who pays for our Common Wealth? Tax practices of the ASX 200' report on the effective tax rates of Australia's top 200 companies.
2 October 2014	The Senate Economics References Committee inquiry into Corporate Tax Avoidance proceeds.
15 November 2014	<i>G20 Brisbane Summit</i> : Australia hosts G20 leaders.
April 2015	Australia and the United Kingdom form a joint working group to develop initiatives to tackle diverted profits by multinational organisations.
May 2015	Australian Government announces, in 2015-16 Budget, action on four key BEPS Actions and provides the ATO with \$87.6 million to continue the International Structuring and Profit Shifting program.
16 September 2015	<i>The Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015</i> : introduced into Parliament. The bill contains multinational anti-avoidance law, stronger penalties to combat tax avoidance and profit shifting, and country-by-country reporting.
5 October 2015	OECD releases final BEPS recommendations.
11 December 2015	<i>The Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015</i> : receives Royal Assent.
17 December 2015	Release of first <i>Report of Entity Tax Information</i> by the ATO detailing 1500 public corporations' total income, taxable income and tax paid for the 2013/14 financial year.

Source: Australian Tax Office, 2016; Bradbury, 2013; OECD, 2016; G20 Australia, 2014; Parliament of Australia, Senate Economics References Committee, 2015; United Voice, 2016.

4. IMPRESSION MANAGEMENT THEORY

In this section we provide a theoretical framework to investigate taxpayer responses to the introduction of the 2013 Act. We use impression management theory, developed by Erving Goffman and published in *The Presentation of Self in Everyday Life* (1959), which examines how individuals represent themselves strategically to others in the hope of being perceived favourably (the *performance*) and extend it to corporations. First, the techniques and strategies are discussed, followed by an explanation of his dramaturgy framework.

4.1 Techniques and strategies

Goffman (1959, p. 35) explains that to achieve favour an individual will ‘tend to incorporate and exemplify the officially accredited values of the society’. Based on this theory, this article uses impression management strategies to analyse the tax communications (*performances*) of Australian corporations prior to and post the 2013 Act. That is, we examine the volume and content of pre- and post-tax communications to determine, first, the impact of legislated transparency in the corporate tax system, and second, the impression management strategies employed by corporations to influence and align public perceptions of the corporation with accepted societal values (Hooghiemstra, 2000). To accomplish this, we use impression management theory, as it has been extended, to consider organisations in the same vein as the individual (Hooghiemstra, 2000; Tata and Prasad, 2015); that is, corporations act strategically to influence an *audience’s* perception of them (Elsbach, Sutton & Principe, 1998). We acknowledge the concerns of Bolino et al. (2008), that looking at impression management from an organisational level can be difficult as the *actor* is not constant. For example, there are a variety of individuals (the *actors*), from CEOs to public relations personnel, engaging in scripting and presenting the *performances* to the *audience*. However, this article aims to interpret the *performances* as an overall projection of the desired corporate image and identity. In accordance with Goffman’s (1959) concept of ‘front stage performances’ (which is discussed in section 4.2 below), this article assumes that all *actors* are reading from a similar script with complementing goals on what the *performance* is required to illustrate to the *audience*.

To analyse the tax communications, two impression management strategies that address the methods used by the *actors* to promote the desired corporate image and identity, and to project and react to *audience* perceptions, have been adapted from Bolino et al. (2008). First, we consider assertive strategies in which corporations ‘proactively manage impressions of themselves’, and second, defensive strategies where corporations ‘reactively manage impressions of themselves’. Assertive impression management strategies encompass three techniques used in the *performance*: ingratiation, self-promotion, and exemplification. Bolino et al. (2008) indicate that these techniques aim to maximise and advertise the positive perceptions and attributes of a corporation. Similarly, they reflect Goffman’s (1959) aspect of self-presentation in which the *actor* tries to control the impression presented to the *audience*. Defensive impression management strategies contain the techniques of excuses and justifications. These techniques are used to restore and enhance the legitimacy of a corporation and to minimise negative attributes seen by the *audience*, for example a negligible corporate effective tax rate.

Table 2 provides a summary of the assertive and defensive impression management strategies along with a brief explanation of the techniques that are used to investigate corporate tax communications (*performances*).

Table 2: Definitions of Impression Management Strategies

<u>Assertive Behaviours</u>	
Ingratiation	A corporation trying to gain <i>audience</i> approval through trying to appear likeable.
Self-Promotion	Communication of abilities and accomplishments to the <i>audience</i> to appear competent and compliant.
Exemplification	Communication of doing more or better, than what is required, in attempt to appear dedicated and superior.
<u>Defensive Behaviours</u>	
Excuses	Denial of any negative behaviour or outcomes.
Justifications	Accepting responsibility for negative implications but providing reasons that there are external causes for actions.

Source: adapted from Jones (1964) and Bolino et al. (2008).

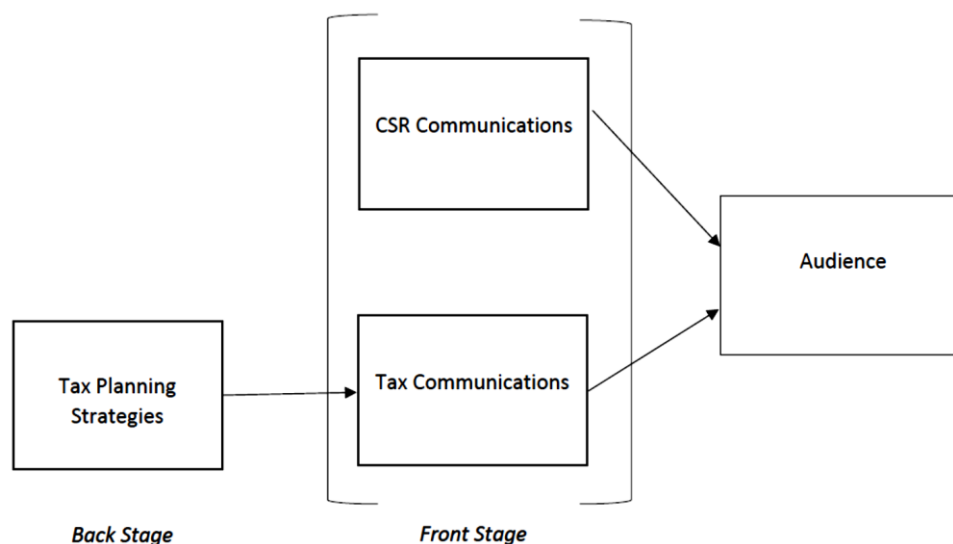
4.2 Dramaturgy

To complement impression management theory, Goffman (1959) proposed a dramaturgical framework to explain the positioning of *performances*. This dramaturgy describes and compares *front stage performances*, which include ‘the stage props, appropriate expressions, and attitudes that allow a *performer* to conjure up a desired self-image’ (Fine & Manning, 2003, p. 46), to *back stage* functions, where the *actors* may ‘knowingly contradict the impressions that had carefully been publicly presented’ (Fine & Manning, 2003, p. 46). Such positioning of performances is no more apparent than when corporations publish Corporate Social Responsibility (CSR) reports that espouse their commitment to aiding society on the *front stage*, whilst potentially engaging in tax-minimising strategies covertly in the *back*, ‘away from the glare of public scrutiny’ (Sikka, 2010, p. 156).

Studies examining corporate disclosures suggest that a CSR report is the medium by which corporations communicate their moral and ethical positions to society (Hooghiemstra, 2000; Tata & Prasad, 2015). As such, if we apply the dramaturgical framework, CSR reports serve as the main *performance* piece presented by corporations on the *front stage* to communicate their desired self-image to their *audience*. Historically, the CSR report has focused on three dimensions: social, environmental, and corporate governance performances. However, the recent focus on tax transparency, which in Australia includes the 2013 Act and the subsequent publication of the *Report of Entity Tax Information* (Australian Tax Office, 2016), has drawn public attention to the issue of corporate taxation. We therefore argue that *performances* regarding tax have transitioned from a back stage function to the *front stage* (alongside societal, environmental, and corporate governance concerns), with corporations purposefully altering their presentation of tax information in an effort to

justify their actions to their *audience*, as illustrated in Figure 3. To coin a phrase, the curtain has been lifted and tax performances are now on the billing.

Figure 3: The Proposed Change of Performances on the Front Stage in a Dramaturgical Context



This article tests the proposition that tax communications have moved to the front stage by examining the relationship between the level of tax communications and CSR. If these two variables exhibit a significant positive relationship this supports our argument and provides evidence of a fourth dimension in CSR reporting, that of tax.

5. AN AUSTRALIAN CASE STUDY

The purpose of this case study is to determine how corporations have responded to changes in the Australian tax landscape, specifically the increase in corporate tax transparency. First, this section investigates whether there has been a significant increase in the volume of corporate tax communications in response to transparency legislation in the corporate tax system, namely the 2013 Act and the subsequent publication of the *Report of Entity Tax Information* (Australian Tax Office, 2016). Second, it examines the content of those corporate tax communications, including an analysis of the impression management strategies employed. This analysis highlights how corporations have responded to greater public scrutiny about tax and their methods for legitimising their image and identity. Third, it investigates whether there is a relationship between the level of corporate tax communications and, given its positioning as the *front stage performance*, a corporation's CSR performance.

5.1 Data

The corporations examined in this article, that is, the *dramatists* of the corporate tax communications, are the constituents of the S&P/ASX 200 index. This sample was chosen as these corporations are conspicuous enough to compel a public *performance* via tax communications. The constituent data was obtained from the Thomson Reuters Tick History database of the Securities Industry Research Centre of Asia-

Pacific (SIRCA) for the 2012/13 and 2014/15 financial years. This sample period captures data prior to and post the introduction of the 2013 Act. The year the Act was introduced (2013/14) was omitted to avoid any contemporaneous issues.

Corporate tax communications, defined as those communications that include the term ‘tax’, were obtained from reports published on corporate websites (predominantly within the annual and CSR reports) for the sample period. These communications were analysed for content, with those communications that discussed the corporation’s effective tax rate or their position on tax deemed relevant; whilst those that discussed general tax information (e.g., explanatory notes to the financial statements) were deemed irrelevant and trimmed from the sample.

CSR *performance* data was collected from the Thomson Reuters ASSET 4 database, which provides scores on all three dimensions of CSR: social, environmental and corporate governance; along with an equally-weighted composite. These scores transparently and objectively measure a corporation’s CSR performance based on 70 key *performance* indicators across more than 400 data points. A sample of these metrics is provided in Table 3.

Table 3: Examples of Metrics Used to Calculate CSR Dimension Scores

Social	Environmental	Corporate Governance
Accidents Total	Carbon Offsets/Credits	Anti-Takeover Devices
Average Training Hours	CO2 Equivalents Emission Total	Audit Committee Independence
Day Care Services	Energy Use Total	Board Cultural Diversity
Donations Total	Environmental R&D Expenditures	Board Member Compensation
Flexible Working Schemes	Environmental Supply Chain Management	CEO-Chairman Separation
Health & Safety Policy	Green Buildings	CSR Sustainability External Audit
Human Rights Policy	Hazardous Waste	Female on Board
Lost Time Injury Rate	Policy Energy Efficiency	GRI Report Guidelines
Policy Child Labour	Policy Water Efficiency	Highest Remuneration Package
Trade Union Representation	Renewable Energy Use	Shareholders Vote on Executive Pay
Women Employees	Waste Total	Veto Power or Golden Share

To allow comparability, the constituent lists over the three years were trimmed to include only those corporations that were constituents of the S&P/ASX200 index over the full three-year period and only those corporations that had complementary CSR performance data. This trimming resulted in a final sample of 161 corporations. A full list of the corporations included in the sample is provided in Appendix 1.

5.2 Research question 1

To assess the impact of legislated transparency in the corporate tax system, our first research question is:

RQ1: *Has there been a significant increase in the volume of corporate tax communications (performances) since the introduction of the 2013 Act in Australia in June 2013?*

Consistent with Goffman's impression management theory (1959), whereby individuals (corporations) act strategically to influence an *audience's* perception of them, we hypothesise that legislated transparency in the corporate tax system has increased the volume of corporate tax communications. To test this hypothesis and contrast the number of tax communications made by each of the constituents of the S&P/ASX 200 index (trimmed sample), prior to and post the introduction of the 2013 Act (the 2012-13 and 2014-15 financial years respectively), descriptive statistics and a paired samples *t*-test were calculated.

The number of corporate tax communications for each year are presented in total and by report type in Table 4 below. These statistics indicate that the number of tax communications increased across the sample period, from 69 in 2012-13 to 86 in 2014-15.

Table 4: Corporate Tax Communications across the Sample Period

	2012/13 Financial Year	2014/15 Financial Year
Number of tax communications		
Total Tax Communications	69	86
Annual Report	49	58
CSR Report	20	28

Trimmed sample: 161 companies

This increase was found to be statistically significant in the paired samples *t*-test (*t*-statistic 3.09, significant at 1 per cent), supporting our hypothesis that legislated transparency in the corporate tax system has increased the volume of corporate tax communications.

Further analysis to determine the source of the additional tax communications, via paired samples *t*-tests, required the sample to be partitioned into tax communications that originated from the annual report and those that originated from the CSR report across the sample period. The results of these tests, reported in Table 5, demonstrate that the additional tax communications originated from increased disclosures in both the annual report (*t*-statistic 2.29, significant at 5 per cent), and CSR report (*t*-statistic 2.01, significant at 5 per cent). We therefore conclude that there has been a significant increase in corporate tax communications presented in the annual and CSR reports since the introduction of the 2013 Act.

Table 5: Changes to Corporate Tax Communications across the Sample Period

	2012/13 Financial Year	2014/15 Financial Year
Paired samples <i>t</i>-tests		
Average tax communication per company	0.5839	0.8012
<i>t</i> -statistic	3.09**	
Average tax communication per company in annual report	0.3727	0.4969
<i>t</i> -statistic	2.29*	
Average tax communication per company in CSR report	0.2112	0.3043
<i>t</i> -statistic	2.01*	

Trimmed sample: 161 companies

Note: *, ** denotes significance at 5% and 1% respectively.

5.3 Research question 2

To determine how corporations have responded to greater public scrutiny about tax and their methods for legitimising their image and identity, our second research question is:

RQ 2: *What impression management techniques and strategies are employed by corporations to influence and align public perceptions of the corporation with accepted societal values about tax?*

To determine the impression management techniques and strategies employed by corporations in their communications about tax, the content of the 155 tax communications, reported earlier in Table 4, were analysed. This analysis involved categorising each communication into one or more of the impression management strategies adapted from Bolino et al (2008): assertive strategies which encompass ingratiation, self-promotion, and exemplification techniques; and defensive strategies which encompass excuse and justification techniques. An example of this categorisation is provided below in Table 6.

Table 6: Categorisation of Tax Communications

Raw Data	Impression Management Technique	Impression Management Strategy
<i>'The effective tax rate of 29.4% was higher than 28.0% for FY14 primarily due to a reduction in adjustments relating to prior years.'</i> (AGL, 2015 Annual Report)	Justification (Accepting responsibility for negative implications but provide reasons there are external causes for actions)	Defensive

The results of these analyses are presented in Table 7 for all tax communications and separately, for tax communications by report type. The results presented in Panel A

are based on impression management techniques, whilst the results presented in Panel B are based on impression management strategies. The reason for this format is to highlight the specific techniques or strategies that are prevalent in certain types of corporate reporting.

Table 7: Impression Management Techniques and Strategies in Tax Communications

Impression Management Technique or Strategy	Tax communications in Annual report		Tax communications in CSR report		All tax communications	
	Number	%	Number	%	Number	%
Panel A: Impression management techniques						
Ingratiation	15	10.71%	11	13.25%	26	11.66%
Self-Promotion	23	16.43%	33	39.76%	56	25.11%
Exemplification	3	2.14%	33	39.76%	36	16.14%
Excuses	22	15.71%	2	2.41%	24	10.76%
Justifications	77	55.00%	4	4.82%	81	36.32%
Panel B: Impression management strategy						
Assertive	41	29.29%	77	92.77%	118	52.91%
Defensive	99	70.71%	6	7.23%	105	47.09%

Sample: 155 tax communications

As shown in Table 7, the dominant impression management techniques employed by corporations are justifications (36.32 per cent) and self-promotion (25.11 per cent). When these techniques are differentiated based on report type, justifications (55.00 per cent) are shown to be dominant in the annual report, whilst self-promotion (39.76 per cent) and exemplification (39.76 per cent) are shown to be dominant in the CSR report. As a consequence, the impression management strategies adopted by each report type are distinct; a defensive strategy in the annual report (70.71 per cent) and an assertive strategy in the CSR report (92.77 per cent). Collectively however, both assertive (52.91 per cent) and defensive strategies (47.09 per cent) are relatively evenly represented.

These results suggest that corporations strategically use both assertive and defensive impression management techniques to influence and align their public perception with accepted societal values about tax. The tax communications provided in annual reports are reactive, used to protect corporate legitimacy by justifying their practices (van Halderen et al., 2013), whilst tax communications provided in the CSR report are proactive, used to boost corporate accomplishments and achievements and to identify their contribution to the public good.

Further analysis was then conducted via paired samples *t* tests to determine whether the additional tax communications reported in section 5.2 above were associated with a specific impression management technique and/or strategy. The results of this analysis are reported in Table 8.

Table 8: Changes in Impression Management Techniques and Strategies across the Sample Period

Impression Management Technique or Strategy	Tax communications in Annual report			Tax communications in CSR report			All tax communications		
	2012/13	2014/15	t-stat	2012/13	2014/15	t-stat	2012/13	2014/15	t-stat
Panel A: Impression management techniques									
Ingratiation	6	9	-1.13	4	7	-1.00	10	16	-1.61
Self-Promotion	10	13	-0.77	12	21	-2.77**	22	34	-2.39**
Exemplification	1	2	-0.58	15	18	-0.83	16	20	-1.07
Excuses	11	11	0.00	1	1	0.00	12	12	0.00
Justifications	32	45	-2.29*	2	2	0.00	34	47	-2.16*
Panel B: Impression management strategy									
Assertive	17	24	-1.30	31	46	-2.21*	48	70	-2.68**
Defensive	43	56	-1.76*	3	3	0.00	46	59	-1.70*

Sample: 155 tax communications

Note: *, ** denotes significance at 5% and 1% respectively.

These results show a statistically significant increase (*t*-statistic 2.29, significant at 5 per cent) in the number of tax communications that employ a defensive (justification) impression management strategy (technique) in the annual report; and a statistically significant increase (*t*-statistic 2.77, significant at 1 per cent) in the number of tax communications that employ an assertive (self-promotion) impression management strategy (technique) in the CSR report. This suggests that corporations, in response to legislated transparency in the corporate tax system, have increased the volume of their tax communications in order to legitimise their tax practices and promote their alignment with accepted societal values about tax.

5.4 Research question 3

To determine whether tax has become a fourth dimension in CSR reporting, moving from a *back stage* function to the *front stage* alongside societal, environmental, and corporate governance concerns, our third research question is:

RQ 3: *Is there a relationship between the level of corporate tax communications and the level of CSR?*

Applying Goffman's dramaturgical framework to corporate communications, we hypothesise that a positive relationship exists between the level of tax communications and the level of CSR. That is, corporations which use CSR reports as a performance piece to communicate their desired self-image to their audience to allay social, environmental and corporate governance concerns, now synonymously disclose information about their tax position.

To test this hypothesis the following ordinary least squares (OLS) regression model was employed:

$$Y_{\text{Tax communication}}^{\text{FY}} = \alpha + \beta_{\text{CSR performance score}}^{\text{FY}} + \varepsilon \quad (1)$$

where $Y_{\text{Tax communication}}^{\text{FY}}$ represents the number of tax communications and $\beta_{\text{CSR performance score}}^{\text{FY}}$ represents the equally-weighted composite CSR score of each of the constituents of the S&P/ASX 200 (trimmed sample) for the 2012-13 and 2014-15 financial years.

This regression was then re-run substituting the equally weighted composite CSR score for each CSR dimensions score: social, environmental, and corporate governance. This was done to determine whether one dimension, or all, subsumed the influence of tax.

Table 9: Relationship between the Level of Tax Communications and CSR

CSR Performance score	A	$\beta_{\text{CSR performance score}}$
Equally weighted composite score	-0.2003	0.0150
T-statistic	(-1.58)	(7.71)**
Social score	-0.1075	0.0152
T-statistic	(-0.95)	(7.96)**
Environmental score	0.0606	0.0129
T-statistic	-0.59	(7.12)**
Corporate governance score	-0.3097	0.0135
T-statistic	(-1.33)	(4.42)**

Sample: 310 observations

Note: *, ** denotes significance at 5% and 1% respectively.

The regression results reported in Table 9 indicate that there is a significant positive relationship between the level of corporate tax communications and the level of CSR. Specifically, using the equally-weighted composite score as a proxy for the level of CSR, this analysis demonstrates that a 1 unit increase in a corporation's CSR score will lead to a 1.50 per cent increase in the number of tax communications disclosed by the company. This relationship is significant at the 1 per cent level and persists irrespective of the proxy used to measure the level of CSR, which suggests that tax is all-pervasive and now situated on the *front stage*.

5.5 Summary of case study findings

Consistent with Goffman's impression management theory (1959), whereby individuals, or in this case corporations, act strategically to influence an *audience's* perception of them, legislated transparency in the corporate tax system has significantly increased the volume of corporate tax communications. When the sample was partitioned by report type, both annual and CSR reports were shown to contain a significant increase in the number of tax communications since the introduction of the *Tax Laws Amendment (2013 Measures No. 2) Act 2013*. This result, when analysed using an impression management framework, was found to arise from both defensive and assertive impression management strategies respectively.

Further analysis of the impression management strategies employed by corporations in their tax communications shows, in aggregate, that assertive and defensive impression management strategies are equally represented. However, when these tax

communications or *performances* are partitioned by impression management techniques and report type, corporations are shown to predominantly use justifications, a defensive impression management technique, when communicating about tax in the annual report and self-promotion and exemplification, both assertive impression management techniques, when communicating about tax in the CSR report. It is also demonstrated that corporations have been both reactionary and proactive, with the number of tax communications that employ a defensive and assertive impression management strategy respectively, significantly increasing. This suggests that corporations are using impression management strategies to influence (Elsbach et al., 1998) and control (Spear & Roper, 2013) the *audiences'* view of the corporation in an attempt to legitimise and promote their tax practices (van Halderen et al., 2013).

Finally, we report a significant positive relationship between the level of corporate tax communications and the level of CSR. This suggests that tax has become a fourth dimension in CSR reporting, moving from a *back stage* function to the *front stage*.

6. CONCLUSION

Consistent with the OECD/G20 BEPS program, this article considered certain legal activities to constitute aggressive tax planning strategies because they were devoid of ethical considerations. We then argued that aggressive tax planning can be reduced through mandatory tax disclosures imposed not on the taxpayers themselves, but on the revenue authorities. It was hypothesised that these primary tax disclosures by a revenue authority, and the resulting corporate taxpayer response, are likely to increase public confidence in the integrity of rules, systems and institutions.

To test taxpayer reaction to mandatory disclosure requirements by a revenue authority, this study aimed to find out how corporations responded to the *Tax Laws Amendment (2013 Measures No. 2) Act 2013*. This change in the Australian tax landscape, including tax reforms and increased corporate tax transparency, reflected an increased focus on corporate tax contributions and how they impact societal functions. The study found that corporations have responded by increasing their communications about tax to the *audience*, with the use of control and legitimisation strategies to project a desired corporate image and identity. It also found that corporations, which provide CSR *performances*, were complementing this with tax disclosures to address concerns about their moral and ethical standing. Consequently, this study shows that tax is now on the *front stage*, in accordance with Goffman's (1959) dramaturgical theory, for *audience* review.

The publication, *Report of Entity Tax Information by the ATO* (Australian Tax Office, 2016), allows *audiences* to compare what corporations say and what they do, via an external impartial marker. The results support the objectives of the Australian Government in the implementation of their transparency legislation, which was to provoke public debate on corporate tax policy (Bradbury, 2013). Further, this study demonstrated that the specific objectives of providing more information to inform public debate, and to enable better public disclosure of tax information, are being achieved. With tax now on the *front stage*, corporations have noted that they need to increase communications about tax to the Australian public in an effort to ensure their tax operations are seen as legitimate.

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8. APPENDIX: FULL LIST OF COMPANIES IN SAMPLE

Company	RIC	GICS Sector
Abacus Property Group Stapled	ABP	Real Estate
Acrux Limited	ACR	Pharmaceuticals, Biotechnology & Life Sciences
Adelaide Brighton Ltd.	ABC	Materials
AGL Energy Limited	AGL	Utilities
Als Limited	ALQ	Industrials
Alumina Limited	AWC	Materials
Ancor Limited	AMC	Materials
AMP Limited	AMP	Financials
Ansell Limited	ANN	Health Care
APA Group Stapled	APA	Utilities
Ardent Leisure Group Stapled	AAD	Consumer Discretionary
Aristocrat Leisure Limited	ALL	Consumer Discretionary
Arrium	ARI	Materials
ASX Limited	ASX	Financials
Atlas Iron Limited	AGO	Materials
Aurizon Holdings Limited	AZJ	Industrials
Ausnet Services Limited	AST	Utilities
Australia And New Zealand Banking Group Limited	ANZ	Financials
Australian Worldwide Exploration	AWE	Energy
Automotive Holdings Group Limited	AHG	Consumer Discretionary
Bank of Queensland Limited	BOQ	Financials
Beach Energy Limited	BPT	Energy
Beadell Resources	BDR	Materials
Bendigo And Adelaide Bank Limited	BEN	Financials
BHP Billiton Limited	BHP	Materials
BlueScope Steel Limited	BSL	Materials
Boral Limited	BLD	Materials
Bradken Limited	BKN	Industrials

Company	RIC	GICS Sector
Brambles Limited	BXB	Industrials
Breville Group Limited	BRG	Consumer Discretionary
Buru Energy Limited	BRU	Energy
BWP Trust	BWP	Real Estate
Cabcharge Australia Limited	CAB	Industrials
Caltex Australia Limited	CTX	Energy
Cardno Limited	CDD	Industrials
Carsales.com Limited	CAR	Information Technology
Challenger Limited	CGF	Financials
Charter Hall Group Forus	CHC	Real Estate
Charter Hall Retail REIT	CQR	Real Estate
CIMIC Group Limited	CIM	Industrials
Cleanaway Waste Management Ltd	CWY	Industrials
Coca-Cola Amatil Limited	CCL	Consumer Staples
Cochlear Limited	COH	Health Care
Commonwealth Bank of Australia	CBA	Financials
Computershare Limited	CPU	Information Technology
Crown Resorts Limited	CWN	Consumer Discretionary
CSL Limited	CSL	HealthCare
CSR Limited	CSR	Materials
Dexus Property Group Stapled	DXS	Real Estate
Domino's Pizza Enterprises Limited	DMP	Consumer Discretionary
Downer EDI Limited	DOW	Industrials
Drillsearch	DLS	Energy
Duet Group Forus	DUE	Utilities
Dulux Group	DLX	Materials
Echo Entertainment Group	EGP	Consumer Discretionary
Evolution Mining Limited	EVN	Materials
Fairfax Media Limited	FXJ	Consumer Discretionary
Federation Centres/Vicinity Centres	VCX	Real Estate
Fletcher Building Limited	FBU	Materials
Flexigroup Limited	FXL	Financials
Flight Centre Travel Group Limited	FLT	Consumer Discretionary
Fortescue Metals Group LTD	FMG	Materials
G.u.d. Holdings Limited	GUD	Consumer Discretionary
G8 EDUCATION LIMITED	GEM	Consumer Discretionary
Goodman Group Stapled	GMG	Real Estate
GPT Group Stapled	GPT	Real Estate
Graincorp Limited	GNC	Consumer Staples
GWA Group Limited	GWA	Industrials

Company	RIC	GICS Sector
Harvey Norman Holdings Limited	HVN	Consumer Discretionary
Henderson Group	HGG	Financials
Horizon Oil Limited	HZN	Energy
Iluka Resources Limited	ILU	Materials
Incitec Pivot Limited	IPL	Materials
Independence Group NL	IGO	Materials
Insurance Australia Group Limited	IAG	Financials
Investa Office Fund	IOF	Real Estate
InvoCare Limited	IVC	Consumer Discretionary
Ioof Holdings Limited	IFL	Financials
Iress Limited	IRE	Information Technology
James Hardie Industries Plc	JHX	Materials
JB Hi-fi Limited	JBH	Consumer Discretionary
Karoon Gas Australia Ltd	KAR	Energy
LendLease Group	LLC	Real Estate
Lynas Corporation Limited	LYC	Materials
M2 Group Limited	MTU	Telecommunication Services
Macquarie Atlas Roads Group Stapled	MQA	Industrials
Macquarie Group Limited	MQG	Financials
Magellan Financial Group Limited	MFG	Financials
McMillan Shakespeare Limited	MMS	Industrials
Medusa Mining Ltd	MML	Materials
Mesoblast Limited	MSB	Health Care
Metcash Limited	MTS	Consumer Staples
Mineral Resources Limited	MIN	Industrials
Mirvac Group Stapled	MGR	Real Estate
MMA Offshore Limited	MRM	Industrials
Monadelphous Group Limited	MND	Industrials
Mount Gibson Iron Limited	MGX	Materials
Myer Holdings Limited	MYR	Consumer Discretionary
National Australia Bank Limited	NAB	Financials
Navitas Limited	NVT	Consumer Discretionary
Newcrest Mining Limited	NCM	Materials
News Corp	FOX	Consumer Discretionary
Northern Star Resources Ltd	NST	Materials
NRW Holdings Limited	NWH	Industrials
Nufarm Limited	NUF	Materials
Oil Search Limited	OSH	Energy
Orica Limited	ORI	Materials
Origin Energy Limited	ORG	Energy

Company	RIC	GICS Sector
OZ Minerals Limited	OZL	Materials
Pacific Brands Group	PBG	Consumer Discretionary
Paladin Energy Ltd	PDN	Energy
Perpetual Limited	PPT	Financials
Platinum Asset Management Limited	PTM	Financials
Premier Investments Limited	PMV	Consumer Discretionary
Primary Health Care Limited	PRY	Health Care
Qantas Airways Limited	QAN	Industrials
QBE Insurance Group Limited	QBE	Financials
Qube Holdings Limited	QUB	Industrials
Ramsay Health Care Limited	RHC	Health Care
REA Group Ltd	REA	Consumer Discretionary
Regis Resources Limited	RRL	Materials
ResMed Inc.	RMD	Health Care
Resolute Mining Limited	RSG	Materials
RIO Tinto Limited	RIO	Materials
SAI Global Limited	SAI	Industrials
Sandfire Resources NL	SFR	Materials
Santos Limited	STO	Energy
Seek Limited	SEK	Industrials
Senex Energy Limited	SXY	Energy
Seven Group Holdings Limited	SVW	Industrials
Seven West Media Limited	SWM	Consumer Discretionary
Shopping Centres Australasia Property Group Stapled	SCP	Real Estate
Sigma Pharmaceuticals Limited	SIP	Health Care
Sims Metal Management Limited	SGM	Materials
Sirtex Medical Limited	SRX	Health Care
Sonic Healthcare Limited	SHL	Health Care
Southern Cross Media Group Limited	SXL	Consumer Discretionary
Spark Infrastructure Group	SKI	Utilities
Spark New Zealand Limited NZ	SPK	Telecommunication Services
Stockland Stapled	SGP	Real Estate
Suncorp Group Limited	SUN	Financials
Super Retail Group Limited	SUL	Consumer Discretionary
Sydney Airport	SYD	Industrials
Tabcorp Holdings Limited	TAH	Consumer Discretionary
Tatts Group Limited	TTS	Consumer Discretionary
Telstra Corporation Limited	TLS	Telecommunication Services
Ten Network Holdings	TEN	Consumer Discretionary

Company	RIC	GICS Sector
The Reject Shop	TRS	Consumer Discretionary
TPG Telecom Limited	TPM	Telecommunication Services
Trade Me Group Limited NZ	TME	Consumer Discretionary
Transfield	BRS	Commercial Services & Supplies
Transurban Group Stapled	TCL	Industrials
Treasury Wine Estates Limited	TWE	Consumer Staples
United Group	UGL	Consumer Discretionary
Wesfarmers Limited	WES	Consumer Staples
Western Areas Limited	WSA	Materials
Westpac Banking Corporation	WBC	Financials
Whitehaven Coal Limited	WHC	Energy
Woodside Petroleum Limited	WPL	Energy
Woolworths Limited	WOW	Consumer Staples
WorleyParsons Limited	WOR	Energy