

U4 Expert Answer



Corruption in tax administration

Query

How can we address corruption risks in the Albanian Tax Administration? Are there experiences related to Tax Administration projects within the area of tax that could be relevant when it comes to the overall objective to minimize the risks for corruption in the Albanian Tax Authority?

Purpose

Our agency is preparing support to the Albanian General Tax Directorate. The draft project document does not fully integrate and analyze aspects related to anti-corruption and how aspects related to anti-corruption could be included in the different activities proposed in the project and/or in the risk assessment. The main components included in the project are (1) tax payer services (2) tax audit (3) efficiency in management (4) tax statistics.

Content

1. Overview of corruption risks and effects in tax administration
2. Combating corruption in tax administration
3. Further reading
4. References

Summary

Revenue administration is often ranked as one of the poorest performing public sectors in terms of corruption and, as Transparency International's latest [Global Corruption Barometer](#) (TI 2009) illustrate, corruption continues to affect the sector in 2009. This sector is very important to a state's development and economic health as it significantly affects its capacity to spend on public projects and programmes, thus making problems of inefficiency and revenue leaking especially damaging. Corruption in tax administration also dissuades honest taxpayers by rendering them less competitive and making the black-market a more attractive alternative. Tax administration is an attractive sector for corruption to take place as the opportunities and incentives to engage in illicit activity are numerous. The complexity of tax laws, the high discretionary powers of tax officials, the low cost of punishment are only some factors creating opportunities for corruption in revenue administration.

Efforts to combat fiscal corruption have focused on value added tax (VAT) refunds, semi-autonomous revenue authorities, increasing transparency and citizen participation and employment practices. The importance of strong management, performance objectives and taxpayer participation, among other

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issues, are given as examples of means to combat fiscal corruption.

A state's revenue processes involve several major stakeholders and make the opportunities for and motivations to engage in corruption both numerous and widespread. These stakeholders include the tax officials, politicians, patrimonial networks and the taxpayers themselves. As is illustrated below, these actors are involved in varying revenue procedures and thus the corruption risks that they cause and/or are exposed to vary with them.

1 Overview of corruption risks and effects in tax administration

Opportunities for corruption

Firstly, none of the principal processes conducted by a state's tax administration can be deemed immune to corruption: the registration and removal of taxpayers from the national registry, the collection of tax dues, the identification of tax liabilities and the inspection and prosecution of alleged tax offences.

In relation to tax administration, corruption risks can be identified in three major forms, namely (Fjeldstad 2005a):

- tax evasion committed by taxpayers;
- collusion between tax officers and taxpayers;
- corruption by the tax officers themselves, without any direct taxpayer interaction.

Taxpayers can turn to corruption in their relations towards the national revenue services by i) abusing the sometimes high discretionary powers of tax officials for their own personal ends, ii) taking advantage of complex tax laws to evade taxes with a low likelihood of detection and punishment or iii) as a reaction to very high taxes and distrust in both the revenue administration and government as a whole which may be suffering from more widespread governance problems. The most common form of corruption is tax evasion, which could occur as a result of underreporting turnover or overreporting expenditures.

Opportunities for **tax officials** arise in the context of corrupt networks, wages (with low wages raising

pressure to accept bribes and high wages making the revenue service an attractive target for corruption as bribe payers are looking to also access jobs), wage differentials, corrupt management which legitimises corruption, and in the context of poor internal detection and punishment mechanisms concerning corruption. Officials' corrupt actions often take one of two forms: they are either abusive, where officers extort from honest taxpayers, or are collusive, in which case they collude with non-payers (U4 2003). Finally, **patrimonial networks** can also abuse of the discretionary power of tax officials using justifications of kinship and ethnicity and **politicians** can use the revenue service to either favour their supporters or burden their opponents (Fjeldstad, 2005b).

Corruption indicators pertaining to the revenue service

Various indicators can be employed to identify what components of a revenue service's tasks are particularly vulnerable to corruption. Many of those used to map corruption risks in tax administration are also valid and employed in other public sector contexts. More specifically, however, opportunities for corruption in the tax sector often arise as a result of complex tax legislation and procedures, many special rules and exemptions and an abundance of discretionary practices by tax officers (U4 2003).

Indicators covering the institutional framework of a nation's tax administration effect the probability of corruption. Such **institutional indicators** include a lack of effective access to information, the absence of credible review mechanisms, excessive income tax and institutional red tape, frequent personal contact between tax officials and taxpayers and the ineffective enforcement of tax regulations. An unexplained disparity between tax revenue and money in circulation is another strong indicator of tax evasion and wider corruption. Furthermore, where corruption is rife in other areas of the state's public sector or in related private sector fields such as auditing, the likelihood of corrupt practices taking place within tax administration increases.

Staff-related indicators pertaining specifically to the revenue sector also identify potential corruption risks. Where there are no staff integrity measures, ethics codes, or where one finds weak enforcement of ethical standards, corruption is more likely to occur. Other factors include the absence of merit-based recruitment practices, regular staff rotation schemes to fight the

establishment of corrupt networks, the lack of capacity to monitor fiscal transactions and evidence of officials living beyond their means are other factors which often point to corruption in the revenue sector. Finally, if corruption is plaguing related professions such as accountants, the proximity of contact and work between the professions is also an indicator of corruption risk.

Effects of corruption in tax administration

Corruption in a nation's revenue service often has severe and widespread repercussions. Several studies in developing countries have shown that, as a result of tax evasion, losing half or more of a state's taxable income is not unusual. In Yemen, for instance, businesses claim that paying a bribe of 25-40% of a tax assessment can lower it by 50% (Rahman 2009). The fact that such **large amounts of a nation's taxable revenues are unaccounted for** has lasting effects since the quality of public services is damaged as a result of the postponing or discontinuation of many growth and reform projects. Also, the fact that the bribes only account for a fraction of what becomes a state's lost revenue only intensifies the impact.

According to estimates, for example the Guatemalan revenue administration saw more than two-thirds of its actual tax collections lost to tax evasion in 2003. The problem was made more complicated by the fact that tax evasion rates were not uniform over the various revenue bases as, for instance, VAT collection had a 29% evasion rate compared with 63% for income taxes. (For more information, see USAID (2004)).

By paying bribes to public officials with the hope of diminishing tax obligations, not only are a state's revenue directly affected but bribes can also have the result of **reducing voluntary compliance with tax laws and regulations**. If an honest taxpayer sees that paying taxes would only further lead to inequities by transferring tax dues to a corrupt and inefficient tax administration, he or she would rather avoid being burdened by this competitive disadvantage and seek to either evade taxes or bribe an official to pay less. For instance, a 1998 survey of 243 businesses in Uganda showed that the frequency of bribe-paying increased with firm size. The burden of bribe extortion by public officials, however, was heaviest for medium sized firms (26-75 employees). These medium-sized enterprises paid what amounted to an average of 3.5% of their sales in bribes – comparable to 60% of what the

company actually paid in taxes. (For more information, see Gauthier & Reinikka (2001)).

As a consequence of rampant corruption in revenue administration more generally and the competitive disadvantage this causes specifically, **the distributive function of tax collecting is itself undermined**. Increased income inequality is inevitable as both the state's ability to address the problem is hindered by lower revenue and as certain groups or businesses are found to bear a heavier tax burden than those who evade their fiscal obligations. By driving resources from the public purse, corruption in tax administration emphasises the scarcities in the sector and creates opportunities for corruption to increase throughout the public sector.

Corruption in revenue administration also leads to **increased difficulties in relation to tax reform**. Given their desire to maintain their influence on the tax system, major stakeholders such as politicians and bureaucrats may strive to maintain the status quo and avoid any calls for modernisation and change. Even tax officials themselves have been seen to be the strongest opponents to reforming a corrupt revenue administration, as was the case in Indonesia in the early 1990s: depersonalisation and simplification of the tax system threatened the officials more than any other group as they were the main benefactors from the systematically corrupt practices in the sector. Indonesia is not the only example of this situation arising as several observers argue that the preservation of highly regulated and complex revenue frameworks can frequently be attributed to the desire of tax officials or civil servants to uphold corruption (Fjeldstad 2005a).

Given the **importance of taxation in state-citizen relations**, it is clear that corruption would seriously harm that relationship. Data from many national surveys show that public perception is often negative when corruption is rife, and revenue services are no exception to this trend. As stated above, where public trust is weakened as a result of corruption, there is a greater incentive to either evade taxes or process fiscal obligations outside the formal sphere, by paying bribes to officials directly with the intention of reducing fiscal obligations. Also, tax administration does not operate in a vacuum. If citizens hold the revenue services to be corrupt, it is likely that this would undermine government legitimacy more generally. A citizen's disrespect for fiscal regulations may be an opener to illicit actions in other areas – which would cumulatively

lead to further government distrust and corruption. (For more information, see Fjeldstad and Tungodden (2001).

2 Combating corruption in tax administration

Specific corruption risk-mitigating strategies

Taxpayer services

Taxpayer services are one of the leading areas where corruption occurs in revenue administration. In Bulgaria, for instance, 23% of taxpayers pay bribes to obtain better services, with speeding up procedures and VAT refunds being the services most bribed for. (Pashev 2006). Bribes related to these two services highlight the administrative shortcomings as well as the legal irregularities which are often strong proponents of corruption in transition economies.

Previous attempts at reducing corruption in taxpayer services, notably in Bolivia relating to VAT refunds, have strived to produce simpler and more reliable procedures by rendering processes more transparent and by reducing human contact between taxpayers and tax officials. An increase in the use of information technology and systems replaced previous procedures which were often controlled by a very small number of individuals. Measures to diversify the tax officers who perform inspections and cross-checks as well as to reduce discretion are other measures which were introduced as part of the reform. The reforms, on the whole, had a positive impact on VAT refunds and collections. That said, constraints still persist as a result of the remaining deficiencies of the existing regulatory framework. As the Bolivian experience demonstrates, corruption and fraud will continue to occur unless improvements are made to regulatory processes. (For more information, see: Zuleta et al (2006)).

Tax Audit

Auditors can only succeed in an environment where combating corruption is supported by measures such as code of conducts for employees, awareness-raising campaigns, internal controls, sanctions and incentives, whistleblower protection and regulations against corrupt practices. In such a context, a professional and swift internal and independent audit that concentrates on the highest risk areas in tax administration would be most effective. Also, if the top management of a public body

or private entity is corrupt, an auditor's tasks become far more difficult.

In terms of corruption auditing (i.e. the prevention of corruption by highlighting areas where opportunities for corruption exist) sources suggest the following steps: collecting information from outside sources such as users of a public body, client organizations and even the general public; ensuring that a tax administration has the power to audit individual taxpayers when necessary; setting up standing commissions to review operational procedures, rules and regulations to reduce corruption; publishing audit reports in accessible language for the general public; establishing a way by which previous audit recommendations are taken into account to avoid repeating errors; and developing training material on corruption auditing (Akram Khan 2006).

The frequency at which audits occur also play an important role in the fight against fiscal corruption. More regular audits may strongly impact the effectiveness of wage-levels as an anti-corruption tool. The probability of audits and reviews should also be adjusted to every change in the tax rate or penalty bracket in order to decrease the potential gains of corruption more precisely and make tax evasion unprofitable. Secondly, reviewing all audit results by a corruption officer where a concealed tax evasion has been uncovered is also recommended (Vasin & Panova 2000.)

Anti-corruption and revenue management

For both revenue authorities located within the Ministry of Finance and for those who operate semi-autonomously, a **strong and well-placed management** is critical to addressing corruption and pursuing reform. For this to be achievable, a clear separation of management authority and entrusted tasks are necessary between the tax administration, which manages taxpayer datasets and revenue bases, and the Ministry of Finance, which develops tax policy and drafts legislation. As illustrated by the failure of the Ministry's micro-management practices in Uganda, it is recommended to uphold this clear separation (though this is not meant to preclude cooperation between the bodies) in order to avoid undermining the administration's senior management and creating an environment in which corruption can be effectively dealt with (Fjeldstad 2005a).

Tax Statistics

Unfortunately, there is insufficient literature concerning the anti-corruption dimension of tax statistics.

Generally, however, transparency concerning statistics as a measurement of the fiscal policy intentions and projections and public sector accounts is a strongly recommended feature of a healthy tax administration. Greater openness in this area may spark public debate and stronger accountability of government for the design and execution of fiscal policy.

Country experiences with fighting corruption in tax administration

Many projects in numerous countries have attempted to tackle corruption in revenue administration, however, with mixed results. Major setbacks in the fight against fiscal corruption have persisted despite the huge amounts of resources which have targeted capacity building and training of tax officers recently. Some point the finger at the **low levels of human capital**, though this begs the question: for what reason should a tax administration's performance worsen over time in spite of donor efforts on capacity building projects? Other factors which have entered the debate include the insufficient informational environment in the sector which has constrained the progress of such donor efforts, such as operating in a **political environment** where control trumps corruption and the **failed implementation of incentive systems** in tax administration (Fjeldstad 2005a).

The Mexican experience

In Mexico, the national tax administration service developed a strategy to fight fiscal corruption by i) establishing a system to anonymously denounce likely acts of corruption using phone, email or paper communication; ii) continuously monitoring the internal transparency and service indexes using surveys, and iii) evaluating staff reliability and reviewing the employment practices – with a focus on the removal and rotation of staff – for those in high-risk positions. Public disclosure of tax officials' income and assets, media campaigns, the establishment and dissemination of institutional values and cooperation with international organisations have also highlighted the advocacy initiatives which accompanied the SAT policy (Kaufmann 2008.)

The Tanzanian experience

The establishment of the Tanzania Revenue Authority (TRA) in 1996 marked to what extent corruption in tax administration was a priority for anti-corruption reform. The fledgling TRA was founded as a semi-autonomous revenue authority to both eliminate Ministry of Finance involvement in day-to-day tax administration processes

and to increase the wages of tax officials without sparking a wider public sector wage rise. Attempts to reform the revenue authority in Tanzania underscored two principal lessons: Firstly, corruption may persist even given relatively high wages and satisfactory working conditions. Even by providing revenue officers with pay rates which are tantamount to the sum they would gain through bribery, corruption will continue to thrive where there is high demand for it. Instead, there is a strong need to implement effective and extensive monitoring system as wage increases may simply add to the administrations corruption problems. Secondly, employment practices may also lead to further corruption becoming further entrenched in a given tax administration. Given the importance of the corrupt or patrimonial networks corrupt tax officers often operate in, these networks have been seen to have become stronger through the recruitment of fired national tax administration officials to the private sector as "tax experts". This experience likely was a factor in the subsequent reversal of the new revenue authority's initial success (Fjeldstad 2003).

The Bulgarian experience

A relatively recent study of fiscal corruption in Bulgaria approached the problem from a new perspective: assessing corruption from the point of view of transaction as opposed to extra imposed cost on business. Concerning tax services such as accelerating tax returns or procedures, the paper also finds that corruption is more likely to be instigated by the supplier of such services (tax administrations) than by businesses or taxpayers. The report then continues by demarcating fiscal corruption from other types of corruption by discussing its drivers and mechanisms before emphasising the importance of monitoring and evaluating the effectiveness of anti-corruption measures. These findings may be eventually used to compare experiences of corruption in tax administration between transition countries in order to obtain a more profound understanding of both the reasons for and solutions to fiscal corruption. (For more information, see: Pashev (2009)).

The Bolivian experience

Beginning in 2001, efforts to proceed with institutional reform of the tax administration in Bolivia had the effect of helping to reduce the amounts of VAT refunds actually paid to exporters which, in turn, led to a reduction of corruption. Part of this policy's success lies in the fact that it was not conducted in a vacuum: the VAT reform was part of broader institutional reform of the tax administration, which stresses the importance of

a strong and integrated governance framework to support specific reforms in the sector. Continuing this theme of broader reform, the findings of the Bolivian case raise the notion of “islands of integrity” in tax administration. In a public sector environment plagued by governance, corruption and other severe problems, such islands may not be realised or sustainable. Also, the benefits of using information technology to reduce the discretionary powers of tax officials and, as a result, enhance the transparency of a VAT administration were seen to have also positively contributed to the Bolivian experience. (For more information, see: Zuleta et al (2006)).

Lessons learned from anti-corruption experiences in tax administration

As is illustrated above, tackling corruption through reforms in tax administration is both a complex and highly political undertaking. Many domestic stakeholders will inevitably be threatened and may well resist changes to the status quo. For this reason, no effective reform can survive without political will and support from leading government figures and bodies. Unless the principal source and leadership for reforming a nation’s revenue administration comes from a domestic source, it is doubtful that reforms will be successful. Below are certain points which may prove to be useful when developing strategies to fight corruption in tax administration (Fjeldstad 2005a and 2005c).

Organisational emphasis on performance objectives

Previous experiences in several countries have demonstrated that public institutions which boast a culture that is outcome-oriented and mission-driven tend to perform better than those who do not. Placing an **organisational emphasis on performance objectives** and measuring progress highlights the significance of managerial styles and correlates with stronger performances by public bodies more generally, as was illustrated in a Harvard University study of 29 organisations in Bolivia, the Central African Republic, Ghana, Morocco, Sri Lanka and Tanzania. The study also concluded that the organisations which paid higher salaries to their staff did not perform better than those which did not, further emphasising the importance of organisational culture and leadership style (Grindle 1997).

Patronage networks

Breaking the influence of patronage networks and the social obligations they demand is essential to ensuring success in tax administration. Given the fact that revenue services are not immune to the corruption and graft problems which can be associated with these networks, this is an area in which policy efforts must be directed if the development of an efficient and professional revenue administration is to prove successful. One approach has been to employ expatriate senior advisors and managers for a pre-defined period in order to avoid the development of patronage-friendly norms. This approach, which proved successful with the Zambia Revenue Authority, may also serve to facilitate the confrontation with political and bureaucratic pressures, as well as to mark a break from previous customs and emphasise professionalism and integrity building. Experiences from other countries, for instance Uganda, with expatriate top management, however, are mixed (Fjeldstad 2005a).

Outsourcing

Outsourcing and private management of revenue administration has also been an attempted approach to improve results in countries where the tax bodies were marred by corruption. The results, however, have been mixed. The policy achieved few lasting results in the fight against corruption in Mozambique as the foreign-contractors had limited impact in terms of transferring skills to the local administration and placed a heavy financial burden on the government. Also, in countries where corruption is a widespread problem, processes such as valuation and entry processing are best dealt with in-house, as there is no guarantee that the non-government body will be more transparent or less corrupt than those of the national administration. Though outsourcing certain customs processes can be legitimately argued for, previous instances have shown for this approach to be both expensive and susceptible to corruption. What is recommended, therefore, is to focus on building internal capacity in order to prolong the impact of the reforms and avoid the risks associated with transferring processes to non-government entities.

Taxpayer involvement in anti-corruption reform

Tackling corruption in tax administration needs strong local leadership, though without **involving taxpayers**, real reform will be unachievable. Allowing a tax administration to reform itself without addressing concerns of taxpayers specifically and citizens more generally is to pursue an incomplete reform process.

Taxpayer associations, trade unions, business communities and other domestic institutions must also play a role to press for an improvement in the quality of services provided by the revenue administration. The issue often referred to as the key obstacle to citizen participation in the tax reform process is the so-called “lack of a taxpaying culture”. If a tax administration’s culture, however, is publicly perceived as corrupt, it is unlikely that citizens will attempt to develop a more cooperative taxpayer culture. To limit tax evasion, reforms must concentrate on simplifying often highly-complex tax laws and addressing distrust between taxpayers and tax officers. **Increasing transparency and access to information as well as improving accountability in taxpayer-tax officer relations** are necessary steps to reform. Only once taxpayers are subject to a relatively comprehensible legislative framework and, as a result, rid themselves of the perceived limited benefits gained for paying taxes, will tax evasion be reduced.

Recruitment practices and policies

A common symptom of a poorly performing tax administration is an unsatisfactory human resources management system. If an administration does not enjoy genuine autonomy in personnel matters, its ability to set performance and accountability standards for its employees would be undermined. Independence in terms of personnel decisions allows for the administration to break the public sector norm in a country by, for instance, introducing policies of **transparency recruitment, sufficient remuneration, pension/retirement schemes**, etc. These measures should be accompanied by a policy of attracting, retaining and motivating highly qualified staff, as personnel mobility in revenue administration is often characterised by seniority and not quality.

Sustainable change takes time

Finally, patience is often the one of the most overlooked lessons concerning tax reform. As experienced by Western countries, it took centuries to develop reasonable effective revenue administrations. Therefore, it is important to remember that **sustainable change demands sustained effort, commitment and leadership over a long period of time**. Previous reform efforts in both the developed and developing world seem to be in favour of **incremental reform**. Given that most developing countries have neither the administrative capacity nor political capital to harbour more than a limited range of simultaneous initiatives, over-ambition can often be a reason for reform failure. The main challenge therefore is to view failures as

opportunities to learn rather than excuses for discontinuing reform efforts.

3 Further reading

Revenue administration and corruption

(Fjeldstad, O-H. (2005). *U4 Issue*, 2005:2.)

An overview of the major challenges, appropriate responses and relevant tools for tackling corruption in tax administrations.

<http://www.cmi.no/publications/publication/?2558=revenue-administration-and-corruption>

Are semi-autonomous revenue authorities the Answer to tax administration problems in developing countries? – A practical guide

(Mann, A. (2004). USAID)

This study explains and analyses the experiences of five countries – Peru, Tanzania, Guatemala, Ecuador and Peru – who have taken measures to establish semi-autonomous revenue authorities.

http://www.fiscalreform.net/best_practices/pdfs/sara_study_final_jan-4-2005.pdf

Designing a Taxpayer Baseline Survey in Uganda

(Chêne, M. (2007). U4 Expert Answer)

This U4 Expert Answer discusses the rising corruption levels in the Uganda Revenue Authority and highlights problems of political corruption, patronage and managerial corruption in the country’s tax sector. The study aims to recommend improvements to the country’s tax administration by analysing its structure and procedural framework.

<http://www.u4.no/pdf/?file=/helpdesk/helpdesk/queries/quiry147.pdf>

Combating Corruption in the Revenue Service: The Case of VAT Refunds in Bolivia

(Zuleta, J. C. (2008). U4 Brief)

Following a relatively successful anti-corruption reform initiative on value added tax refunds in Bolivia, this study identifies opportunities for corruption, produces measurable indicators and recommends methods and strategies to combat corruption in the revenue sector.

<http://www.u4.no/document/publication.cfm?3040=combating-corruption-in-the-revenue-service>

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