Fiscal Corruption: A vice or a virtue?

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Summary.

Recent literature on tax administration in poor countries suggests there are virtues of allowing fiscal corruption. By strengthening the bargaining power of corrupt tax officers, it is argued that tax evasion may be reduced and tax revenues increased. But does such an intriguing paradox justify policies that stimulate corruption? Our answer is no, and this note puts forward three arguments to support our view. First, while an increase in corruption may raise revenues in the short run, in general the opposite will be the case in the longer run. Second, the instrumental value of reducing corruption goes far beyond its effects on tax evasion and tax revenues. Accepting corruption as a policy strategy to increase tax revenues may undermine values of democracy and good governance. Third, eliminating corruption should be considered an end in itself. Thus, contrary to recent suggestions on incentive reforms in tax administration, the reasonable starting point for policy debates in this area should still be that an increase in fiscal corruption is not an appropriate instrument for raising tax revenues. Sustained development cannot grow from an institutional framework that fosters corruption and extra-legal tax enforcement.

Key words - corruption, tax evasion, tax administration, incentives

1. INTRODUCTION

One of the areas of government where the impacts of corruption loom largest is in the assessment and collection of taxes (Galtung, 1995). Studies in various developing countries indicate that it is not uncommon that half or more of the taxes that should be collected cannot be traced by government treasuries due to corruption and tax evasion (Alm, Bahl, & Murray, 1991; Bird, 1990, 1992; Krugman, Alm, Collins, & Remolina, 1992; Richupan, 1984). This tax-base erosion is particularly damaging since insufficient domestic revenue mobilisation is considered the root of the adjustment and growth problems faced by many poor countries (Chand & Moene, 1999). To alleviate this problem, tax reforms in recent years have focused on redesigning the tax structures and improving tax administration. Addressing fiscal corruption and tax evasion have become integrated parts of this strategy (Klitgaard, 1988; Toye & Moore, 1998).

A growing literature emphasises the importance of incentive schemes in motivating tax officers to work harder and in accordance with the overruling objective of improving revenue performance (Mookherjee, 1997; Das-Gupta & Mookherjee, 1998; Chand & Moene, 1999). Such incentive schemes *may*, however, increase corruption. Actually, as we will elaborate on in Section 2, a standard way of justifying incentive schemes is by showing that such schemes strengthen the position of corrupt tax officers and thereby makes tax evasion less attractive. Nevertheless, it is argued, in cases where the effect on taxpayers' compliance and government revenues is positive, incentive schemes are still justified: "Eliminating corruption is … not an end in itself; effects on tax evasion and revenues are more fundamental" (Mookherjee, 1997, p. 16).

In this note we put forward three arguments that question this way of defending incentive schemes. First, while an increase in fiscal corruption may contribute to an increase in tax revenues in the short run, it is highly implausible that such an increase is sustainable (Section 3). The dynamics of corruption suggest that policies of this kind will decrease tax revenues in the longer run. Second, a much broader view of this problem is needed in the development debate, including the effects of fiscal corruption on accountability and government legitimacy (Section 4). Third, eliminating corruption *is* an end in itself. In our view, any reasonable conception of a good society should count corruption - that is, the abuse of public offices and rules for personal gain - as intrinsically bad (Section 5).

2. THE VIRTUE OF FISCAL CORRUPTION

How may corruption contribute to reducing tax evasion and thereby increasing tax revenues? The essential link, studied by Mookherjee (1997) among others, is based on the idea that the possibility to negotiate bribes from evasive taxpayers motivate corrupt tax officers to work harder in order to detect evasion.[1] This will be anticipated by the taxpayers, and hence tax evasion will be less attractive because it is more likely to be detected.

Since corruption works to make tax evasion less appealing and thereby may increase tax revenues, one might find it a good idea to design a bonus system for tax collectors that mimics or competes with the bribery system already in place in many tax administrations. Actually, this has been attempted in Ghana (Chand & Moene, 1999) and suggested in several other countries. The intention behind a bonus system is to initiate more work effort among tax collectors by promising them a share of the tax revenues. And this is the way it works for non-corrupt tax collectors, who within a bonus system aim at detecting evasion because this increases tax revenues and *thereby* their income. But what about corrupt tax collectors?

Consider a bribe as the outcome of a negotiation between an evasive taxpayer and a corrupt tax collector. The introduction of a government bonus certainly makes the bribe less attractive for the corrupt tax collector, because he has to give up the bonus when accepting the bribe. But this does not necessarily insure that the tax collector becomes less corrupt. Actually, it makes him stronger in his negotiations with the taxpayer, and as a result he receives a larger part of the pie not reported to the tax authorities. Thus, the bonus system provides incentives for the corrupt tax collector as well (by increasing the negotiated bribe), and may thereby contribute to increase tax revenues. This happens because the bonus system strengthens the position of the corrupt tax collector and therefore may increase overall corruption.[2]

Generally, the implications of a bonus system depend on whether the tax administration consists of corrupt or non-corrupt tax collectors. In both cases, we might experience an increase in overall tax revenues, but in the case with corrupt tax collectors the bonus system may also lead to increased corruption. Hence, in a situation where there is a mixture of corrupt and non-corrupt tax collectors, it seems straightforward to say that we have to make a trade-off between the gain of more revenues and the problem of more corruption when evaluating a bonus system. However, this is not how bonus systems are justified in the theoretical literature on corruption and incentives.

Mookherjee (1997), for example, considers bonus systems in the context of corrupt tax collectors *only*, and then argues for the need "to go beyond the question of what levels of corruption arise and examine induced effects on tax compliance and audit incentives" (p. 13). Hence, when evaluating bonus systems, Mookherjee solely considers the possible gain in tax revenues following from the fact that the position of corrupt tax officers is strengthened. In our view, this way of justifying bonus systems should be rejected because it does not capture the long-term effects of an increase in corruption on tax revenues and government legitimacy. We find it highly implausible that sustained development can grow from an institutional framework that fosters corruption and extra-legal tax enforcement.

Mookherjee is of course aware of the vices of corruption, and stresses the important point that when considering incentive reforms we also need to take into account the possibility of wider administrative reforms, including changes in supervision systems, information and monitoring procedures. More precisely, he suggests that "if incentive reform causes various undesired side effects, the range of policy instruments must be expanded to moderate their effects" (p. 8). However, this is a problematic position within the present mode of reasoning. If one considers an increase in corruption an undesirable side effect to be moderated, then an incentive reform cannot be justified by showing that it increases tax revenues by (possibly) inducing *more* corruption. Such a justification would be undermined by the policies aiming at reducing corruption.

Let us consider another example of how the strengthening of the position of corrupt tax collectors has been considered part of a "virtuous circle" in reforming tax administrations. Chand & Moene (1999) are concerned with the need for non-corrupt higher-level bureaucrats in tax administration when introducing bonus systems, and motivate this by the following story. Look at a corrupt tax collector who tries to negotiate a bribe from an evasive taxpayer in return for underreporting his tax liabilities. If they don't reach an agreement - that is, if the taxpayer refuses to pay the bribe and the collector reports the evasion - a higher-level bureaucrat is informed about the true tax liability of the taxpayer and settles the case. If the higher-level bureaucrat is corrupt, the evasive taxpayer pays him a bribe and provides taxes only on the underreported tax liability. In contrast, a non-corrupt higher-level bureaucrat collects the taxes on the true tax liabilities. Therefore, the presence of a non-corrupt higher-level bureaucrat strengthens the position of the corrupt tax collector in the negotiations with the taxpayer. Why? Because it becomes less important for the corrupt collector to reach an agreement with the taxpayer. The collector knows that as long as the higher-level bureaucrat is not corrupt, he will receive the bonus on the whole tax liability if he does not reach an agreement with the taxpayer. This would not be the case if the higher-level bureaucrat were corrupt. The tax collector would then not receive any bonus. Hence, in order to have an effective bonus system, non-corrupt higher-level bureaucrats are required. They make it possible for the *corrupt* tax collector to get a higher bribe by strengthening the collector's bargaining position in relation to taxpayers and thereby also stimulates his work effort. Consequently, this will contribute to an increase in tax revenues in the short run. But is this really the virtue of having non-corrupt higher-level bureaucrats in tax administration when introducing a bonus system?

Let us close this section by briefly pointing at some of the mechanisms we expect to reflect the real virtues of an incentive reform. First, as already stressed, an effective bonus system induces more effort among non-corrupt tax collectors. Second, and maybe more important, a bonus system, within an administration containing non-corrupt higher-level bureaucrats, may cause less corruption among tax collectors.[3] Let us provide a simple illustration of this point. Assume that a company reports the profit R, whereas the true profit is P. The tax rate is t and the bonus rate is γ. All tax collectors assign a certain disvalue $\frac{1}{m}$ to accepting a bribe, $m \geq 1$, where

$m = 1$ would imply that the tax collector is indifferent between receiving a certain amount of money as a bribe or as a regular bonus.[4] If the tax collector does not accept the bribe and reports the evasion to a non-corrupt higher-level bureaucrat, then he receives a bonus on the true profit. In this case, a collector would only accept a bribe b if:[5]

(1) $\gamma tR + b/m > \gamma tP$.

Obviously, the bribe will not exceed the tax saved on the underreported amount $t(P - R)$.[6] Hence, on the basis of (1), we find a cut-off value m^* such that no tax collector having a value *above* m^* would choose to be corrupt.[7]

(2) $m^* = 1/\gamma$.

From (2), we can see that an increase in the bonus (γ) decreases m^* which indicates that the number of corrupt tax collectors should decrease in an effective bonus system.[8]

To summarise, there are important positive effects from incentive reforms in the tax administration. It makes non-corrupt tax collectors work harder, and it may reduce the number of corrupt tax collectors in the administration. Hence, possible trade-offs must be made between reducing corruption and increasing tax revenues when considering incentive reforms. However, we doubt that it is a reasonable strategy to improve revenue collection by strengthening the bargaining power of corrupt tax officers vis-à-vis taxpayers. Thus, we question the claim that one of the positive effects of such reforms is that increased tax revenues can be achieved by stimulating corruption among corrupt tax collectors. We now turn to a further discussion of this issue.

3. LONG-TERM IMPACTS OF FISCAL CORRUPTION

Poor taxpayer compliance is particularly damaging in situations with substantial budget deficit, as is the case in many poor countries (Tanzi, 1991). However, accepting fiscal corruption as an instrument for raising revenues in the short run may undermine tax collection in the longer run, for several reasons. Let us here point at some of the most important ones.

First, implicit in the discussion of the positive link between fiscal corruption and tax revenues is the assumption that the willingness to pay taxes is independent of the way taxes are collected. This assumption is in contrast to the literature on reciprocity considerations in tax collection. For instance, Smith (1992, p. 227) argues that tax authorities' unresponsive, corrupt and unfair treatment of taxpayers foster disrespect for and resistance against tax authorities and tax laws.[9] In a study from Tanzania, Fjeldstad & Semboja (2001) find that the unresponsive way taxes are enforced appears to have fuelled tax resistance. Accordingly, they argue, tax evasion may to some extent be interpreted as a strategy of public resistance and opposition against the authorities. Hence, an increase in corruption may establish a negative public perception that causes citizens to be unwilling for a long period to enter into reciprocal relationships with the government. Thus, accepting fiscal corruption as an instrument to raising revenues may contribute to undermining the legitimacy of the tax administration, and thereby *increase* tax evasion and decrease tax revenues over time (Tanzi, 2000, 1995). We believe this to be an important issue, because public opinion is not easily restored over time.

Second, the relationship among tax collectors also needs to be considered. Tax collectors do not operate on their own, but are influenced by the behaviour of their reference group, such as colleagues and friends.[10] As stressed by Fehr & Gächter (2000, p. 167), "[s]ocial sanctions by peer members are probably a very important determinant of effort behavior in work relations." Therefore, if a tax officer knows that colleagues are getting more corrupt, his commitment to honest behaviour probably will be weakened. There are at least three arguments supporting this view (Sah 1991; Banerjee

1992):

- internalised moral feelings of guilt by fraudulent behaviour become weaker as the number of corrupt tax officers increases;
- when many others are involved in corruption, the loss of reputation (stigma) for each collector when discovered decreases; and
- when many others are corrupt, this lowers the probability of being revealed due to the fact that the capacity of internal and external investigation units are constrained.

In other words, “corruption may corrupt” (Andvig & Moene, 1990). Thus, an increase in fiscal corruption may initiate a vicious circle in the long run in the tax department.

Third, this vicious circle may have impacts on the recruitment process of the tax administration. It is reasonable to assume that more fiscal corruption among tax collectors will attract potentially more corrupt employees (Besley & McLaren, 1993). Furthermore, in an atmosphere of corruption we can easily end up with a recruitment process based on the wrong premises (Huther & Shah, 2000). Significant above market rate wages in specific public institutions in order to reduce shirking and corruption may imply that one gets two prices for the same type of service. This may in general make a fertile ground for corruption and rent-seeking where attractive jobs are likely to be sold, and the sales price has built in the capital value of the salary surplus. Andvig (1999), for instance, reports from Azerbaijan that a regular customs official at a “fat site” has to pay USD 100 000 to get his position. A position is normally financed by the incumbent borrowing from family and friends. The customs official is assumed to have earned enough for repaying the investment after 6 months. Thereafter he is supposed to send a percentage (85 % is indicated by Andvig) of what he gains on corruption upwards to his superiors.

Fourth, accepting corruption may have negative impacts on the future possibilities for reforming the tax system. For instance, important stakeholders, including bureaucrats and politicians, as well as powerful taxpayers, may resist changes in an attempt to protect their influence and control of the tax system. According to Winters (1996, p. 166), the strongest resistance to tax reforms in Indonesia came from the tax officials themselves, since they had the most to lose from the depersonalisation and simplification of the tax system. Flatters & Macleod (1995, p. 409), also referring to Indonesia, assert that tax collectors actively opposed simplifications in property tax administration, income tax laws and tariff structures. Moreover, some observers argue that the extensive public sector regulations and complicated tax systems observed in many poor countries are the result of a deliberate strategy by civil servants, including senior tax officials, to facilitate corruption (Tanzi, 2000; Myrdal, 1968).

Developments in the tax administration in Ghana, which is the cross-cutting case to which Chand & Moene (1999) refer, may support our general point. Following the reforms, tax revenues in Ghana increased from 4.6% of GDP in 1983 to 17% in 1994 (ibid., p. 1135, table 2), despite reductions in tax rates. However, if the increase in tax revenues in Ghana were due to a strengthening of the positions of corrupt tax officers, then we would expect a difficult future for the tax administration in the longer run. And actually, this seems to be what Ghana has experienced; the initial success has not been sustained (Devas, Delay, & Hubbard, 2001, p. 213). According to Hadler (2000, p. 40), the tax administration in Ghana, the first country in Africa to establish an autonomous revenue agency, is "reputedly now in disarray".[11]

In summary, increasing fiscal corruption by strengthening the position of corrupt tax officers may initiate two vicious circles in the longer run. On the one hand, it may reduce peoples' willingness to pay taxes; on the other hand, it may weaken a commitment to honest behaviour in the tax administration. Both these effects are closely related to the importance of values in tax collection and tax compliance. Our general point is that inducing fiscal corruption in the long run undermines the values essential to an efficient tax administration. As observed by Amartya Sen:

> Indeed, in societies in which corrupt behaviour of the standard type is quite unusual, the reliance is, to a great extent, on compliance with codes of behaviour rather than on financial incentives to be corrupt. This forces attention on the norms and modes of behaviour that respectively prevail in different societies (Sen, 1999, p. 276).

Of course, this does not imply that incentives are of no importance. But we question the idea of fostering fiscal corruption in order to gain short-term increases in tax revenues.[12]

4. GOVERNMENT TRUSTWORTHINESS

Fiscal corruption is likely to undermine government trustworthiness and, thus, the legitimacy of the government, where legitimacy refers to citizens' approval of the government, and justifies citizens' obedience.[13] When the institutions are legitimate, citizens have a predisposition to consider obedience to them as reasonable and appropriate (Fauvelle-Aymar, 1999). A government's lack of legitimacy, on the other hand, diminishes almost by definition the perceived moral justification for obeying its laws (as we will return to in Section 5). Furthermore, of particular importance in this context is that citizens' disrespect for the tax laws may initiate disrespect for other laws, and, thus contribute to further undermining the legitimacy of government (Graetz, Reinganum & Wilde, 1986). This suggests a vicious circle where distrust breeds distrust. In contrast, government trustworthiness and widespread public support tends to legitimise the public sector, and may so impose some social norm to pay taxes. Hence, it is important to take a broader view of the societal effects of corruption in tax administration.[14]

The need for a broader view on taxation derives from the fact that taxation is essential for shaping state-citizen relations (Levi, 1988; Moore, 1998). For instance, in Europe over the past two centuries, taxation and disputes over the use of revenues have stimulated the development of greater citizen rights and privileges, with democratic institutions enforcing accountability and greater transparency in expenditures (Tilly, 1992). And it almost goes without saying that fiscal corruption, as an integral part of tax collection, does not contribute to establish productive state-society relations. Survey research from a number of countries concludes that citizens' in general view corruption negatively even in countries where it is widespread. Miller, Grødeland & Koshechkina (1998), for instance, in a study of bribery in the Czech Republic, Slovakia, Bulgaria and Ukraine, find that public opinion in all four countries is against corruption. The morality of public office holders is therefore most likely an important source of government trustworthiness (Hardin, 1996; Brennan, 1998).

Recent research also indicates that citizens' trust in their fellow citizens is strongly influenced by whether they have confidence in the government that they share (Brehm & Rahn, 1997). This observation strengthens the need for a broader view of the societal effects of fiscal corruption. We know that a functioning social order requires social behaviour (Coleman, 2000; Serageldin & Grootaert, 2000; Putnam, 1993) and a productive set of common norms (Offe, 1999; Bardhan, 1995), which will only evolve in a society of trustworthiness (Sztompka, 1999; Dasgupta, 1988).

To summarise, there are two main reasons for taking a broader view on fiscal corruption. First, when government is perceived to be trustworthy, citizens are more likely to comply with its demands in general (Levi & Stoker, 2000). In this perspective, government trustworthiness is closely linked to citizens' perceptions of the capacity of the government to make credible commitments about the use of their taxes, as well as the government's procedures for designing and implementing policy non-arbitrarily (Levi, 1997, 1988). Second, government trustworthiness contributes to social behaviour in general and a productive set of common norms in society. These norms are important for establishing the more informal social networks and associations of civic engagement that effects the productivity of the community (Putnam, 1993). Moreover, they are also crucial for strengthening the formalised institutional relationships in society such as the political regime, the rule of law, the court system, as well as the tax system, that may have important effects on the rate and pattern of economic development (North, 1990; Olson, 1982).

5. ELIMINATION OF CORRUPTION AS AN END IN ITSELF

Mookherjee (1997, p. 6) claims that the elimination of corruption should *not* be considered an end in itself, and he substantiates this point by arguing that complete elimination of corruption may be impossible. We reject this line of reasoning. A non-corrupt society may be a utopian ideal, but this does not undermine the possibility of assigning intrinsic disvalue to corruption. To consider reduced corruption an end in itself is simply to say that is important in its own right, and does not have to be justified (as a value) on the basis of its effects on the economy and society in general. We believe this to be a reasonable position to take. Of course, there will be other ends to consider, and hence there we have to make trade-offs. But this only shows that there is a plurality of constitutive elements in the process of development.

Corruption is the violation of established rules for personal gain, and the disvalue of corruption depends on the legitimacy of these rules. However, within a fair system of co-operation, the elimination of corruption should be considered an end in itself. This has been argued forcefully by Rawls among others, who views a fair system of co-operation as involving:

> terms that each participant may reasonably accept, provided that everyone else likewise accepts them. Fair terms of co-operation specify an idea of reciprocity: all who are engaged in co-operation and who do their part as the rules and procedures require, are to benefit in an appropriate way as assessed by a suitable benchmark of comparison. Since the primary subject of justice is the basic structure of society, these fair terms are expressed by principles that specify basic rights and duties within its main institutions... (Rawls, 1993, p. 16).

Moreover, Rawls (1993, p. 19) argues that anyone with a sense of justice should apply and act from the public conception of justice which characterises the fair terms of social co-operation, and hence ought not to be involved in any kind of corruption.

Considerations of this kind may be perceived to be of little relevance to policy debates in poor countries that are far from any ethical equilibrium of fair co-operation. We doubt, however, the validity of such a point of view. In particular, we believe that Rawls' line of reasoning may contribute to establish an understanding of the main institutions in society in general – and tax administration in particular – as ways of specifying fair terms of co-operation, where violations of these terms is considered wrong in itself. By recognising this, we also see the plausibility of considering the elimination of corruption as an end in itself.

6. CONCLUDING REMARKS

The point of departure for this note is the literature showing that increased fiscal corruption in some contexts may contribute to increased tax revenues. We do not argue against the relevance of this argument. On the contrary, it is important to clarify this relationship. There are obviously cases where trade-offs must be made between reducing corruption and increasing tax revenues by using incentive reforms. However, we doubt that it is a reasonable strategy to improve revenue collection by strengthening the bargaining power of corrupt tax officers vis-à-vis taxpayers. Hence, we question the claim that one of the positive effects of such reforms is that increased tax revenues can be achieved by stimulating corruption among corrupt tax collectors. Based on existing literature on corruption, incentives, compliance and normative reasoning, we conclude that the reasonable starting point for policy debates in this area should be the straightforward one that an increase in fiscal corruption is not an appropriate instrument for raising tax revenues. Sustained development cannot grow from an institutional framework that fosters corruption and extra-legal tax enforcement.

NOTES

[1] More generally, Mookherjee (1997) focuses on the problems likely to be encountered in designing and implementing incentive reforms, and on evaluating the effects of pay-for-performance schemes for tax collectors on corruption and tax revenues.

[2] The total amount of bribes received by corrupt tax collectors will not necessarily increase in equilibrium. This depends on the reaction of the taxpayer to the fact that the work effort of the tax collector increases. There are of course other ways of measuring corruption than by the bribe rate. For instance, corruption can be measured as the proportion of corrupt tax officers in the tax administration. Although the precise conclusion on the effect of incentive reforms on corruption may depend on how corruption is measured, this is not essential for our argument.

[3] See also Besley & McLaren (1993) for a related discussion.

[4] This way of modelling moral costs is quite standard within a static framework, and pursued by among others Laffont and Tirole (1991). However, within a dynamic setting more elaborate modelling is needed.

[5] We do not consider the issue of monitoring, and hence the tax collector knows for certain that the acceptance of a bribe will not be punished. The example can, however, easily be extended to include monitoring, but this would not add anything to our story.

[6] The possibility of extortion is not considered in this simple example (see Hindriks, Keen, & Muthoo, 1999; and Klitgaard, 1988).

[7] Equation (2) is not well defined for the exact case where there is no bonus, but the implication of the equation is that if the bonus approaches zero then all tax officers will be corrupt (except for tax officers having a deontological approach to corruption; represented by m equal to infinity).

[8] Here, we ignore the equilibrium response of the companies, and assume that they do not increase underreporting when the bonus increases. Notice that m^* is not the critical value of m defining the partitioning of the set of tax collectors into corrupt and non-corrupt, and that we implicitly assume a continuous distribution of the value of m among tax collectors. Thus, we cannot draw any definite conclusions from (2), but for our purpose this should give a reasonable indication of the mechanism in question.

[9] This proposition can also be stated in positive terms: Tax authorities responsive, honest, respectful and fair treatment of taxpayers tend to foster respect for and co-operation with the tax system.

[10] For a more general analysis of these mechanisms, see Hessing, Elfers, & Weigel (1988) and Snavely (1990).

[11] To explaining this development in revenue performance, clearly we have to look also at other factors than corruption, including general economic trends and changes in tax policy.

[12] See also Elster (1989, p. 158).

[13] Following Lipset (1959, p. 86), legitimacy can be defined as “the capacity of a political system to engender and maintain the belief that existing political institutions are the most appropriate or proper ones for the society”.

[14] Martin Daunton (1998) provides an excellent historical account of the role of trust and trust formation in the British fiscal administration from the Napoleonic wars to the Second World War.

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