

**Division 42**

Sector Project: Development and Testing of Strategies  
and Instruments for the Prevention of Corruption



# Preventing Corruption in Public Finance Management

A Practical Guide



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**Division 42**

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# **Preventing Corruption in Public Finance Management**

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Sector Project: Development and Testing of Strategies  
and Instruments for the Prevention of Corruption

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## Foreword

Corruption constrains development and reforms: Development potentials go unutilised, public funds are wasted, and processes of democratic consolidation are jeopardised. This calls into question the possible success of development initiatives in all areas where the distribution and wielding of political and economic power come into play. Corruption prevention is therefore a cross-cutting task.

Corruption is everywhere. Therefore, our field staff are sensitised to the problem. Yet there is a need for analytical tools and recommendations for action to prevent corruption in the specific areas of work.

Germany's Federal Ministry for Economic Cooperation and Development (BMZ) has therefore commissioned the GTZ "Development and Testing of Strategies and Instruments to Prevent Corruption" project to prepare the present studies and practical guides.

They are designed primarily for seconded experts responsible for preparing and implementing projects and programmes in the areas covered, or who address the theme of corruption prevention at the level of political dialogue. We would be delighted to receive feedback on their experiences when using the guides, and helpful suggestions as to how we might improve them.

The **Chapeau Paper** "Mainstreaming Anti-Corruption" defines the analytical framework for all papers.

The **Practical Guides** cover the following themes:

- ◆ Public Finance
- ◆ Public Administration at the National and Local Levels
- ◆ the Legal and Judicial System
- ◆ Education
- ◆ Resource Allocation (Land, Forests, Water)
- ◆ Privatisation
- ◆ Tools for the Analysis of Anti-corruption Measures.

Two more extensive **studies** cover:

- ◆ Combating Poverty and Corruption – Institutionalising Corruption Control in the PRS
- ◆ Corruption and Gender.

Our thanks to the authors who through their professional expertise and personal commitment made these publications possible, as well as to all the commentators and professional advisors whose valuable contributions helped make them a success. Dr. Mechthild Runger initiated the project and set it on course, Birgit Pech brought it to a successful conclusion.

Bernd Hoffmann	Dr. Albrecht Stockmayer
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## Summary

Barely any area of administration is as susceptible to corruption as public finance. This includes taxation, customs, and budgeting and expenditure management. International observational studies suggest that well over 50% of all acts of corruption in the public sector take place in public finance. The macroeconomic costs of corruption in this sector are enormous.

## Activity Areas of German Development Cooperation in Public Finance

### 1. Taxation (Fiscal Policy and Tax Administration)

**Fiscal corruption** is manifested in legislation and tax administration. In the case of legislation, influence is exerted on the wording of the content of the laws in question. It is exerted inter alia on the definition of taxable items, including exemptions, the scope and structure of tax rates, and the basis for assessment. In tax administration, influence is exerted first of all by encouraging a particular interpretation or the waiving of legal provisions, in order to establish a certain definition of tax routines. Secondly, influence is exerted on the various steps of the taxation process, for the same purpose.

These steps can be affected by corruption, albeit to varying degrees: in the identification and registration of taxpayers, the assessment and collection of taxes due, the monitoring of incoming payments, the assessment of surcharges or refunds, or investigation by the tax authorities (possibly for suspected tax offences). Corruption violates the principles of budgeting and expenditure management, and compromises the political will of the legislature.

**We recommend the following anti-corruption measures:**

#### Systemic Legal and Institutional Changes

- ◆ simplification of the tax system: reduction of the number of taxes and tax rates, low tax rates and restriction to just a few exemption provisions;
- ◆ tax assessment on the basis of estimated values;
- ◆ elimination of quasi-fiscal provisions;
- ◆ intelligent use of self-assessment or taxation at source systems;
- ◆ establishment of independent revenue authorities;
- ◆ privatisation of selected functions of the tax authorities.

### **Measures within the Tax Authority**

- ◆ separation of functions, e.g. separation of assessment and collection of taxes; spatial and organisational separation of the processing of applications and the delivery of professional advisory services; clear separation of spheres of responsibility along functional lines;
- ◆ setting of performance standards, creation of standardised procedures, and simplification and rationalisation of procedures (computerisation);
- ◆ reduction of personal interaction in procedures, including the avoidance of long-term relationships between taxpayers and tax officials;
- ◆ strengthening of the internal monitoring system; adjustment of the tax audit strategy, monitoring of tax audit results and, if appropriate, punishment of tax inspectors where tax evasion has been concealed;
- ◆ increased utilisation of third-party data for tax assessment;
- ◆ clear regulations for secondary employment, introduction of bonus systems;
- ◆ international exchange of information and experience.

### **Changes at the Interfaces of the Tax Authority**

- ◆ clear definition and publication of standards of service for taxpaying citizens;
- ◆ survey of taxpayers and publication of the results of studies on anti-corruption measures, as well as information and education campaigns for taxpayers;
- ◆ creation of an independent jurisdiction over tax matters, characterised by integrity;
- ◆ establishment and support of taxpayers' associations;
- ◆ participation of private associations and civil society organisations in the monitoring process, possibly also in an advisory/consultative capacity.

## **2. Customs (Customs Policy and Customs Administration)**

The customs sector influences the strength and structure of trade flows, and a significant proportion of public revenues. **Customs corruption** leads to a reduction in public revenue, impedes the fight against illegal trade and makes legal international trade more difficult. Higher transaction costs caused by customs corruption constrain the competitiveness of a country and its enterprises, and dampen the interest of foreign investors.

Customs corruption is manifested in legislation and customs administration, especially in the context of freight clearance and payment of duty. Here, attempts are made to influence the scope and structure of customs tariffs, the basis for assessment, the nature and scope of non-tariff trade barriers, and the time taken for release of the cleared consignment.

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**We recommend the following anti-corruption measures:****Systemic Legal and Institutional Changes**

- ◆ separation of responsibilities for policymaking and administration;
- ◆ review and revision of the customs codex and simplification of customs tariffs, including reduction of customs and value-added tax exemptions for imports, and reduction of non-tariff trade barriers;
- ◆ creation of transparent licensing procedures for importers and exporters, and simplification of import and export regulations; introduction of a self-assessment system;
- ◆ definition and publication of standards of service.

**Customs Administration Reform**

- ◆ strategic separation of functions and creation of a mutual monitoring system, also applying the "two heads are better than one" or "greater scrutiny" principle in key decisions;
- ◆ reduction of information and documentation demands on traders, restriction of direct interaction between customs officials and traders during customs clearance;
- ◆ introduction of risk analysis: identification of points in the customs system that are conducive to incorrect payments; reduction of freight inspections;
- ◆ introduction of modern information systems and a system of paperless and cashless customs clearance, in order to automate, simplify, accelerate and optimise procedures;
- ◆ privatisation of individual steps of customs administration work;
- ◆ establishment of a professional, meritocratic customs service whose staff are selected on the basis of open competition, and with clearly defined rules for job appointments and transfers;
- ◆ publication of countrywide standards for customs clearance and for all customs services, as well as provision for appeal against customs duty assessments;
- ◆ incorporation of a code of ethics into the curriculum for induction training of all new customs officials, and for refresher courses .

**Changes at the Interfaces of the Customs Service**

- ◆ creation and publication of clearly defined service standards for customs clients;
- ◆ survey of traders liable to customs duties; publication of the results of these studies;
- ◆ creation of an independent fiscal jurisdiction;
- ◆ creation of an external organisation to monitor and protect the integrity, the systems and the staff of the customs service;

- ◆ promotion and involvement of the private sector, and of private associations and civil society organisations, in the reform process and its implementation;
- ◆ linking of anti-corruption measures in the customs sector with the government strategy for corruption control.

### **3. Budget and Expenditure Management**

The budget is the key instrument of the state for planning the scope and structure of public revenues and expenditure. **Corruption in budget management** leads among other things to an allocation of resources that lacks democratic legitimacy, which impacts negatively on growth and development.

In budget and expenditure management, corruption is manifested in budget preparation, the use of funds and financial control. Corruption occurs particularly where internal and external monitoring and audit bodies are not well developed, and institutional monitoring is correspondingly weak.

The importance of independent financial control bodies lies not only in the detection of corruption. They also have a preventive effect, by helping strengthen the financial, legal and institutional framework for professional, legal, economically efficient, accountable and transparent fiscal management, and eliminate systemic weak points and points of entry for corruption. Furthermore, as an independent source of information for parliaments, they also help the latter perform their political control function, and support their political will-building processes.

**We recommend the following anti-corruption measures:**

#### **Changes to Budget Preparation Procedures**

- ◆ introduction of an appropriate and comprehensive legal framework that guarantees the universality of the budget, at least restricts the emergence of extraordinary budgets and thus helps reduce the discretionary scope of decision-makers;
- ◆ strengthening of the rights of members of parliament in the budget preparation process;
- ◆ improvement of transparency and accountability in preparation of the budget;
- ◆ establishment of a transparent budget system and performance-oriented budgets; minimisation or elimination of earmarking arrangements, and removal of subsidies.

#### **Reform of the Use of Budget Funds**

- ◆ clear rules and administrative regulations for expenditure management by the public administration;
- ◆ increased monitoring of the sectoral ministries by the ministry of finance, through a special budget officer;
- ◆ separation of responsibilities for payment instructions and outgoing payment;

- ◆ ongoing documentation and review of payments.

### **Reform of External Financial Control**

- ◆ legislative institutionalisation of independent financial control;
- ◆ clear competences, adequate resources and explicit authority to expose corruption within any sphere of government activity, to identify weak points, to put forward recommendations on how to eliminate them, and to initiate sanctions;
- ◆ strengthening of parliamentary rights of control, strengthening of the legal foundations and institutionalisation of budget and accounts auditing committees and their cooperation with external financial control bodies;
- ◆ strengthening of the legal foundations for appropriate reporting duties of administrations to parliament and the public, timely publication of the budget, public access to information on the status of the use of the monies;
- ◆ strengthening of the legal and procedural bases for the institutionalised involvement of civil society organisations in the monitoring of expenditure and results, the work of audit bodies, the implementation of recommendations for the elimination of systemic weak points, and the follow-up of cases of corruption/sanctions.

### **Development Cooperation Activities for Procedural Development:**

- ◆ ongoing, mutual monitoring of the individual procedural steps during the use of the budget funds by budget officers of the ministry of finance and the respective sectoral ministries;
- ◆ advisory services to help develop corruption-specific audit techniques and procedures in accordance with international standards, and to facilitate the planning and implementation of audits in high-risk agencies/areas; advisory services for professional and timely preparation and publication of audit results; introduction of telephone hotlines or similar procedures to take anonymous reports of cases of corruption;
- ◆ establishment of a monitoring system to facilitate the implementation of recommendations for eliminating systemic weak points;
- ◆ development of mechanisms to include NGOs in monitoring tasks; development of mechanisms for cooperation between parliaments/responsible committees with audit bodies and civil society watchdog organisations.

### **Development Cooperation Activities for Institutional Capacity Building:**

- ◆ establishment of internal supervisory and monitoring mechanisms to fight corruption;
- ◆ organisational consultancy services to help develop structures and procedures in line with the tasks in hand, and establish communication and coordination systems between the audit office, ministry of finance and ministries responsible for the sectoral and legal supervision of subordinate levels; improvement of professional cooperation

between the administration, audit bodies, parliaments, the public prosecutor's office, courts, civil society and the media;

- ◆ human resources development in the identified institutions: development of anti-corruption training and upgrading systems / training of trainers, exchange of information and experience;
- ◆ measures to support the capacity development of parliaments / the responsible committees for their supervisory and monitoring functions vis-à-vis the executive, including technical equipment;
- ◆ support of NGOs in the exercise of the identified monitoring functions;
- ◆ public relations work by the identified institutions: publication of audit results, active and media-friendly, target-group-oriented, comprehensible information and education work on corruption.

## I. Introduction

The present guide is designed to support consultants, seconded experts and other development cooperation actors in their task of integrating corruption prevention into their advisory and monitoring work. It also aims to help enable readers recognise manifestations and problems of corruption that are specific to the public finance sector, and to make sector-specific recommendations for corruption prevention.

Corruption can be defined as the conduct of individuals who, entrusted with public or private tasks, fail to respect their duties, and instead obtain illegitimate benefits. German development cooperation's approach to fighting corruption is based on the principle of promoting systemic institutional change for prevention. The analytical framework for addressing the problem of corruption is set out in the Chapeau Paper "Mainstreaming Anti-Corruption".

Barely any area of administration is as susceptible to corruption as public finance.<sup>1</sup> International observational studies suggest that well over 50% of all acts of corruption in the public sector occur in public finance. The "prices" paid for jobs as tax or customs inspectors are very high. A list of possible anti-corruption measures prepared by public officials and representatives of civil society puts measures such as "tax reforms" and "budget transparency" at the top of the list.

The causes of this particularly high susceptibility to corruption in the public finance sector are on the one hand the unusually large benefits that corrupt individuals or enterprises are able to obtain. For instance, they can obtain both direct and indirect financial benefits (e.g. by evading or reducing tax payments, or by receiving inappropriate tax breaks), and they can profit indirectly by obtaining competitive advantages over domestic and foreign competitors (as for instance in the case of non-tariff trade barriers or shortened customs

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<sup>1</sup> Hindriks et al. (1999) combed through the literature for anecdotes. They reported that in Taiwan, 94% of surveyed tax authority officials admitted to having accepted bribes, while in India 76% of all government tax inspectors took bribes.

clearance times). On the other hand, the strong demand leads to a high degree of receptiveness among public officials, who further increase the opportunities for corruption by introducing special practices – e.g. by creating complex and poorly transparent tax systems and procedures.

The costs of corruption in public finance to a country's economy are enormous. Taxes are raised in pursuit of both fiscal (revenue generation) and non-fiscal objectives (e.g. redistribution or environmental protection).

**Fiscal corruption** is manifested in legislation and tax administration practices. Revenue losses caused by corrupt tax evasion<sup>2</sup> and/ or flight into the hidden economy need to be compensated either by reducing infrastructural services and/or by transfer payments, or by higher borrowing or taxation. These options usually lead to major distortions of allocation, combined with negative impacts on employment and growth, as well as growing budget deficits. Higher taxation, instead of leading to an increase in revenue, may lead only to an increase in the payment of bribes and a growing shift into the shadow economy<sup>3</sup>. Yet corruption affects not only the scope, but also the structure of tax revenues<sup>4</sup>. Since direct taxes are usually more susceptible to corruption than indirect taxes, this implies that as an increase in corruption will mean a reduction in the progressivity of an existing tax system, with correspondingly negative effects on the distribution of income<sup>5</sup>.

Customs arrangements influence the strength and structure of trade flows, and a significant proportion of public revenues. Customs also play a key role in the fight against smuggling.<sup>6</sup> **Customs corruption** leads to a reduction in public revenue. It also impedes the fight against illegal trade, and makes legal international trade more difficult. Elevated transaction costs caused by customs corruption constrain the competitiveness of a country and its enterprises, and dampen the interest of foreign investors.<sup>7</sup>

The budget is the state's key instrument for planning the scope and structure of public revenues and expenditure. It lays down the allocation of resources between the private and public sectors, as well as within the public sector and the various levels of

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<sup>2</sup> According to Torgler (2003), in the public perception the main reasons for tax evasion are high tax burdens, dishonesty and corruption. On average, 44.2% of respondents in Latin America identify corruption as a reason for tax evasion. Tanzi/Davoodi (2000) report in their paper that a 1% increase in the perceived rate of corruption leads to a 1.5% decline in total revenue as a percentage of GDP, and a 2.7% decline in tax revenues as a percentage of GDP.

<sup>3</sup> According to Johnson et al. (1999) there is evidence to support the assumption that countries with more corruption tend to have a larger shadow economy. And countries with a larger shadow economy tend to display slower growth.

<sup>4</sup> It is to be expected that different types of tax will respond to corruption in different ways, as the payment of some taxes is negotiable, which with others it is not. In some countries, a number of taxes (e.g. income tax) are assessed by taxpayers themselves, while others are assessed by tax inspectors and can thus be influenced by opportunistic or even extortionate behaviour on the part of those inspectors. Some taxes (e.g. international trade taxes) are easier to administrate than others (Tanzi/Davoodi, 2000).

<sup>5</sup> Cf. Tanzi (2000c, p. 173).

<sup>6</sup> Cf. Hors (2001, p. 11).

<sup>7</sup> Cf. Garamfalvi (1997) and Tanzi (2000b, p. 157).

government. **Budgetary corruption** leads inter alia to an allocation of resources that lacks democratic legitimacy. It is then rather corrupt behaviour that determines the distribution of budgetary funds to various government departments, and areas and items of expenditure within those departments. Investment in large-scale projects is usually more susceptible to corruption, and "more profitable" for actors, than current expenditure on the maintenance of existing infrastructure (e.g. road renewal) or smaller-scale projects (local health centre). Corruption thus leads to a change in the structure of expenditure, and at the same time a decline in the productivity of public investments and a deterioration in the quality of infrastructure. This impacts negatively on growth and development.<sup>8</sup>

The task of a financial control unit is both to detect corruption, and prevent it. In its capacity as a neutral monitoring and advisory body, it is mandated to strengthen the financial, legal and institutional framework for legal, economically efficient and transparent financial management, and to systematically eliminate weak points and points of entry for corruption. It also serves as an independent source of information for local parliaments and standing committees, whose political control function and will-building processes it supports (e.g. prior to approval of a new budget or when procedures are introduced to ease the budget). **Corruption in financial control** – as an integral part of the budget cycle – not only makes it more difficult to identify corruption, but also constrains the preventive effect of monitoring. Corruption in the award of public contracts affects the competitiveness of individual enterprises, and usually causes a deterioration in the quality of their services, which also become more expensive.

As well as the aforementioned effects, there is also sufficient evidence to indicate that corruption in public finance also impacts particularly negatively on small and medium-sized enterprises<sup>9</sup> and poor sections of the population. Poor groups are hit harder than others by the corrupt allocation of funds for public services, inter alia because they are politically less influential. At the same time, it is above all the poor who suffer the effects of sluggish economic development and low growth. Furthermore, the poor are hit harder than the rich by increases in public service charges caused by corruption. This makes it more difficult for them to gain access to public services. It is to be assumed that, generally speaking, the costs of petty corruption, e.g. to speed up the payment of unemployment benefit or pension monies, are disproportionately high for poor sections of the population compared to richer groups.

A number of points of entry for corruption emerge in taxation, customs, and budget and expenditure management. Many of the factors that "lure" individuals into corruption in these fields, and many of the corresponding counter-measures required, are identical to those in other fields of public administration. It is not possible to discuss these phenomena in detail here. Interested readers are therefore referred to GTZ's Practical Guide "Preventing Corruption in Public Service on the National and Local Level".

The present paper will identify **specific** signs, manifestations and weak points for corruption in taxation, customs, and budget and expenditure management, and present

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<sup>8</sup> Cf. Tanzi/Davoodi (2000, p. 5).

<sup>9</sup> Cf. Gupta et al. (1998).

possible corruption prevention measures.<sup>10</sup> When doing so it will draw on good practices and lessons learned. Financial control is treated as a component of budget and expenditure management. Annex I presents examples of results indicators at the project level. An overview of the literature used and other sources of information can be found in Annex II.

The present guide is closely linked thematically to the GTZ Practical Guides "Preventing Corruption in the Legal and Judicial System" and "Preventing Corruption in Public Service on the National and Local Level", both of which were prepared by the Sector Project for Corruption Prevention.

## **II. Activity Areas of German Development Cooperation in Public Finance**

### **1. Taxation (Fiscal Policy and Tax Administration)**

#### **1.1 Typical Manifestations and Possible Weak Points**

Corruption in fiscal affairs is manifested in the spheres of tax legislation and tax administration. In the case of legislation, influence is exerted on the wording of the content of the laws in question. Those involved in such activities, which is classed as grand corruption or political corruption, are first and foremost government members (up to the level of ministers and presidents), and members of parliaments. Influence is exerted inter alia on the definition of taxable items, including the exemptions. In tax administration, influence is exerted first of all by encouraging a particular interpretation or the waiving of legal provisions, in order to establish a certain definition of tax routines. Secondly, influence is exerted on the various steps of the taxation process, for the same purpose. These steps can be affected by corruption, albeit to varying degrees: the identification and registration of taxpayers, the assessment and collection of taxes due, the monitoring of incoming payments, the assessment of surcharges or refunds, or investigation by the tax authorities (possibly for suspected tax offences).

#### **Possible Weak Points in the Tax System**

The complexity of a tax system can be a very significant contributory factor toward corruption within the tax authorities. Tax inspectors can abuse complex tax regulations, or the discretionary scope they have as a result of unclear laws, rules and procedures, to extort bribes (for instance when selecting taxpayers for investigation or when acknowledging a tax deduction). Taxpayers who evade paying tax pay bribes in order to avoid detection.

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<sup>10</sup> To the extent possible and appropriate, in the lists compiled and phraseology chosen a distinction will be made between signs of corruption (e.g. falsely declared goods) and actual offences (e.g. forged declaration of goods). Sometimes, however, it is very difficult to draw this distinction.

**Incentives to corrupt behaviour arise from:**

- ◆ poor transparency in the form of numerous exemptions and special regulations that are difficult to understand: Where there are many exemptions, taxpayers often have to deal personally with tax officials, in order to discuss the application of the laws to their particular case. This creates points of entry for bribery.
- ◆ poorly verifiable, discretionary scope for tax officials when taking key decisions, e.g. when granting tax incentives, assessing taxes owed, selecting individuals for tax audits, initiating proceedings etc.;
- ◆ high tax rates<sup>11</sup> combined with marked tax rate differentials, which normally increase willingness to engage in corrupt activities due to the greater potential benefit;
- ◆ tax laws and forms so difficult to understand that, in order to apply them, taxpayers require help from tax officials and are forced to deal with those officials personally;
- ◆ weak and poorly monitored selection systems for tax audits;
- ◆ poorly monitored systems for collecting tax arrears;
- ◆ inadequate sanctioning systems (fines and interest);
- ◆ slow and cumbersome enforcement procedures;
- ◆ absence of an independent court of appeal.

**Signs of possible corruption include e.g.:**

**Tax System**

- ◆ the existence of a large number of seemingly arbitrary exemptions and special rules;
- ◆ the existence of certain types of tax and taxable items that are particularly susceptible to corruption.

**Administration**

- ◆ Corrupt actions by tax officials are ignored, rarely detected or, if reported, punished only lightly or not at all.
- ◆ frequent personal interaction between taxpayers and civil service officials: A high frequency of interaction between taxpayers and tax officials, especially where taxes are being assessed and collected, creates opportunities for the formation of corrupt networks.

**Identification and Registration of Taxpayers**

- ◆ deletion or removal of taxpayer records from the registers, files and accounting systems of the tax authorities

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<sup>11</sup> It is assumed that higher tax rates lead to more cases of corruption, as individuals seek to evade taxation. Yet there is no empirical evidence to confirm or refute this (see Johnson et al., 1999, p. 25).

- ◆ allocation of tax numbers and tax cards to fictitious taxpayers;
- ◆ a large number of cases where the taxpayers are incorrectly identified;
- ◆ no registration of taxpayers, especially in countries where records of natural or legal persons are either incomplete or non-existent;
- ◆ multiple registration of taxpayers in different tax districts (or jurisdictions).

#### **Assessment and Collection of Taxes Due**

- ◆ issue of tax exemptions notices to individuals not entitled to such;
- ◆ writing off of tax debts without precise explanation;<sup>12</sup>
- ◆ unwarranted deferment of taxes due.

#### **Monitoring of Incoming Payments and Enforcement of Payments**

- ◆ non-payment of correctly assessed taxes due;
- ◆ incorrect receipts;
- ◆ support of taxpayers in their efforts to delay the payment of tax arrears, for instance by tax officials being supposedly unable to locate the taxpayers or withholding the case files and failing to pass them on to enforcement agencies;;
- ◆ demanding of fees for expedition of tax reimbursements, even though taxpayers are entitled to reimbursement free of charge;
- ◆ passing on of confidential information from the tax declaration to the taxpayer's business competitors;

#### **Tax Audits<sup>13</sup>**

- ◆ poor transparency of the criteria for selection of taxpayers to be audited;
- ◆ completion of a tax audit without any adjustment being made or any fine for tax evasion being imposed;
- ◆ poor transparency or suspicious patterns in the selection of cases for audit;
- ◆ failure to inform taxpayers of their rights and duties;
- ◆ removal of taxpayers from the list of individuals to be audited drawn up by the enforcement selection systems;

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<sup>12</sup> It should be borne in mind here that this decision is often dependent on a subjective assessment of whether an investment is "necessary" or "in the national interest". Requests for exemption for certain economic activities are often made by foreign companies, which then leads to decisions being taken by more senior political decision-makers.

<sup>13</sup> Corruption in the context of tax audits has perhaps the strongest – both immediate and long-term – impacts on tax revenue. Basically, this form of corruption occurs when a taxpayer who has been found to have evaded paying tax then "negotiates" with the inspector, in order to avoid paying either the amount owed, dunning charges, default interest or possibly fines incurred. Cf. Dos Santos (1995, p. 137) and Das-Gupta et al. (1999).

- ◆ wrong decisions against the tax authorities in appeal proceedings concerning audit results;
- ◆ threat of unwarranted investigation for suspected tax offences by the investigation service;
- ◆ no prosecution, despite the detection of tax evasion.

### **Legal Remedy Procedures**

- ◆ long and drawn-out legal remedy procedures;
- ◆ lack of clearly defined competences, complicated legal recourse;
- ◆ low capacities of decision-making bodies.

### **Amnesties and Special Procedures to Cancel Taxes Due**

- ◆ poor transparency of the relevant facts;
- ◆ frequent cancellation or waiving of taxes due.

## **1.2 Corruption Prevention Measures**

Appropriate for preventing fiscal corruption are all those measures that are normally considered suitable for preventing corruption in public administration: greater transparency and improved documentation of decision-making procedures; standardised practices and procedures to minimise personal interaction; deregulation; increased professionalism; staff rotation (to prevent and expose cases of corruption) and the "two heads are better than one" or "greater scrutiny" principle; clear division of responsibilities; improved internal and external monitoring (it is not the threat of heavy sanctions that deters, but the strong probability of discovery); the formulation of binding codes of conduct; stronger sanctions; rewards and fair remuneration, and participation by as many members of society as possible, especially in the implementation of comprehensive reforms<sup>14</sup> etc.

Development cooperation measures to prevent fiscal corruption include activities for system and procedural development (e.g. advisory services to help formulate and implement laws and ordinances), and for institutional development (e.g. support to help improve organisational structures and procedures, as well as training and upgrading). Most tax experts are unanimous in the view that institutional strengthening of tax authorities is the most effective corruption prevention measure. The administration must be acknowledged by the public as acting professionally.

One of the key overarching measures is the strict division of responsibilities for policymaking and administration. Furthermore, maximum transparency of all decision-making processes and procedures must be guaranteed. This includes improved access to information and stronger public participation. The discretionary scope of policymakers and

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<sup>14</sup> For more detailed discussion see: GTZ, Preventing Corruption in Public Service on the National and Local Level. A Practical Guide.

tax officials must be reduced to a minimum. At the same time, accountability must be strengthened, also by significantly improving internal and external monitoring systems. Finally, there is a need to systematically incorporate ethical aspects into the professional training and upgrading of tax officials.

To increase efficiency and integrity, appropriate organisational independence of the fiscal authorities is often recommended, combined with a performance-oriented budget. Negative incentives should be complemented by positive incentives (salary-based performance incentives). Having said that, experience with autonomous fiscal authorities to date has shown that their effectiveness and susceptibility to corruption vary considerably.<sup>15</sup> Finally, independent taxpayer surveys can help identify parts of the organisation or individual tax authorities where corruption is taking place.

The following activities can also help fight fiscal corruption:

### **Systemic Legal and Institutional Changes**

- ◆ simplification of the taxation system: reduction in the number of taxes, low tax rates and a low limit on exemptions;<sup>16</sup>
- ◆ tax assessment based on estimated values;<sup>17</sup>
- ◆ elimination of quasi-fiscal provisions;<sup>18</sup>
- ◆ intelligent use of self-assessment or taxation at source systems;<sup>19</sup>

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<sup>15</sup> Cf. Devas et al. (2001).

<sup>16</sup> There is broad consensus in the literature that a simplification of the tax system is perhaps the most effective method of limiting scope for corruption. Wherever possible, the system should be characterised by few tax rates, few exemptions, easily defined tax assessment bases, easily calculable tax liabilities, broad application of tax deductions at source, tax assessment on the basis of estimated income, minimum tax rates, clear rules and narrow discretionary scope for tax officials (see also Lambsdorff, 2001). In practice, however, the prospects for implementation of such reforms are low, as tax officials themselves are an obstacle when attempts are made to simplify property and income tax, and tax rates (Flatters/MacLeod, 1995, p. 409). Policymakers usually resist calls to abolish special ministerial privileges. The private sector fights for those exemptions and subsidies that favour it.

<sup>17</sup> As Das-Gupta et al. (1999) show, the taxation of small enterprises (that perhaps do not keep extensive books and records) on the basis of estimated values reduces the discretionary scope of tax officials, and make tax calculations simpler and clearer. Attempts can also be made for instance to assess the appreciation of an enterprise on the basis of sales statistics or other criteria (size of staff, business premises etc.).

<sup>18</sup> This includes all those inputs that private individuals are required by law to provide to the state free of charge (e.g. military service). They also include inter alia tax exemptions and the waiving of leviable tax revenues.

<sup>19</sup> According to Tanzi (1997, p. 8), self-assessment is the key principle on which the procedures and systems of modern tax and customs administrations are built. This means that taxpayers should have the right to submit to a tax or customs administration their own declarations, in which they themselves calculate their obligations according to their understanding of the law and the explanation of the law provided by the tax authorities. It goes without saying that a tax and customs administration will always have the right to selectively question and audit the taxpayer's self-assessed tax liability. Since self-assessment reduces interaction between taxpayers and tax officials, it should also lead to a reduction in tax evasion caused by corrupt officials. At the same

- ◆ creation of independent revenue administrations;<sup>20</sup>
- ◆ privatisation of selected functions of the tax authorities;<sup>21</sup>

### Measures Within the Tax Authority

- ◆ separation of functions, e.g. separation of assessment and collection of taxes; spatial and organisation separation of the processing of applications and the delivery of professional advisory services; separation of tax audits from the processing of applications; writing off of revenues within a single unit that is organisationally separate from the rest; through to outsourcing of payment and accounting operations to private providers (banks); organisational separation of the investigation of suspected tax offences unit from other units; clear separation of spheres of responsibility along functional lines;
- ◆ adjustment of the tax audit strategy (the strategy for selection and incidence of audits and monitoring) to each change in the tax rate;
- ◆ increased utilisation of third-party data for tax assessment;
- ◆ strengthening of the internal monitoring system;<sup>22</sup> monitoring of tax audit results and, if appropriate, punishment of tax inspectors where e.g. tax evasion has been concealed;
- ◆ reduction of personal interaction in procedures,<sup>23</sup> including the avoidance of long-term relationships between taxpayers and tax officials;

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time, however, it can, at least under certain circumstances, encourage tax evasion by the taxpayer acting independently.

<sup>20</sup> Opting for a revenue administration based on the executive agency model aims on the one hand to limit the direct political influence of the ministry of finance, and on the other hand to free the tax authorities from constraints, and above all from civil service pay regulations. Opting for a revenue administration can also be an attractive option for donors and political leaders, as this creates opportunities for more comprehensive tax administration reforms. However, Fjeldstad (2003a, p. vii) also points out that a fragmentation of the civil service can lead to a proliferation of rules and discretionary decisions, as any agency of the civil service will seek new ways to obtain money. Thus under certain circumstances corruption in the civil service, measured by the size of bribes demanded, may increase as a result of the creation of independent bodies.

<sup>21</sup> One suggestion for strengthening the tax authorities is to contract out to private suppliers. Fjeldstad (2003a, p. xi), however, points out that historical evidence and current experience make it imperative to pursue a cautious approach: Reforms of this kind have generated barely any sustainable results; the transfer of expertise was limited, and the contract was very costly for the government. Consequently, expert tax practitioners increasingly doubt the value of outsourcing tax administration tasks. (Analogous arguments apply to customs.)

<sup>22</sup> According to Dos Santos (p. 139) the internal monitoring unit should report directly to the director of the tax authority. It should also have an information desk responsible for identifying the most common and damaging forms of corruption, and for identifying ways to stem these corruption problems. Random sampling of completed inspections should be introduced for all inspectors. Inspectors can be made subject to a special surveillance system. Special procedures can be applied to them, such as a precise inspection of their annual tax returns, an obligation to complete additional questionnaires on their financial circumstances, and the obtaining of additional information on their capital growth. The in-house monitoring unit would also monitor whether those taxpayers selected by the system for inspection have actually been audited.

- ◆ introduction of standardised procedures that can be audited more easily using indicators etc.;
- ◆ simplification and rationalisation of procedures (computerisation);
- ◆ setting of performance standards;<sup>24</sup>
- ◆ strict rules for secondary employment (avoidance of conflicts of interests);
- ◆ introduction of bonus systems (precondition: more senior officials must not be corrupt).<sup>25</sup>

### **Changes at the Interfaces of the Tax Authority**

- ◆ clear definition and publication of service standards for taxpaying citizens;
- ◆ feedback mechanism to monitor the actions of officials in the field (e.g. when conducting taxpayer surveys);
- ◆ publication of the results of studies conducted within the scope of anti-corruption measures;
- ◆ taxpayer information and education campaigns (taxpayers' charters etc.<sup>26</sup>);
- ◆ creation of an independent jurisdiction over tax matters, characterised by integrity;<sup>27</sup>

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<sup>23</sup> Research indicates that personal interaction between taxpayers and tax authorities is a key factor influencing the scope of tax evasion. Therefore, as many procedures as possible should be automated or mechanised, in order to minimise interaction between tax officials and taxpayers. Other key instruments for preventing inappropriate interaction between taxpayers and tax officials are more intensive use of third-party data for tax assessment, and the privatisation of selected functions of the tax authorities. However, it should be ensured that the modus operandi of the tax authorities when they do interact with taxpayers remains transparent and clear, and that seeking strategies to avoid this interaction is not the only approach pursued. As Feld/Frey (2002) indicate, taxpayers have an incentive to pay taxes honestly when the tax authorities treat them as partners, as if they had entered into a tax agreement, and not as subordinates in a hierarchical relationship.

<sup>24</sup> Performance standards enable policymakers, managers and the public to judge how well an administration is working. All too often, the only standard of performance by an administration is the achievement of certain revenue targets. According to Crotty (1997, p. 7), performance standards should include not only revenue targets, but also standards of service. Service standards enable an administration to introduce monitoring mechanisms, in order to identify those operations, offices or officials which are not meeting the required standards – perhaps due to corrupt behaviour.

<sup>25</sup> Cf. Fjeldstad (2003a, p. vii).

<sup>26</sup> The tax authorities of Uganda, Ghana and Tanzania created offices for taxpayer information and education, which used information sheets, radio and occasionally TV broadcasts to raise awareness on fiscal affairs. These three countries have either published or are currently preparing taxpayers' charters that set out not only the rights and obligations of taxpayers, but also – even more important for taxpayers – the obligations of the tax authorities (See Fjeldstad, 2000, Review of Integrity Management of staff in the Ghana Tanzania and Uganda Revenue Authorities).

<sup>27</sup> To safeguard the independence of civil servants and the integrity of the system, it is important that taxpayers are able to challenge decisions, that their concerns are treated fairly and independently, and that decisions are broadly published (Crotty, 1997). See the GTZ Practical Guide "Preventing Corruption in the Legal and Judicial System", Eschborn, 2004.

- ◆ establishment and support of taxpayers' associations;
- ◆ participation of private associations and civil society organisations in the monitoring process, or in an advisory/consultative capacity;
- ◆ international exchange of information and experience.

## **2. Customs (Customs Policy and Customs Administration)**

### **2.1 Typical Manifestations and Possible Weak Points**

Customs corruption is also manifested in legislation and administration. Attempts are made to influence the scope and structure of customs tariffs, as well as the assessment basis, nature and scope of non-tariff trade barriers (e.g. import quotas), and the time taken to clear goods through customs. This affects all the procedural steps of customs administration, though to differing degrees. To simplify matters, these procedures can be divided into two categories: freight clearance and customs enforcement.

Freight clearance embraces the processing of cargo manifests and customs declarations, the classification of goods, valuation and assessment, the payment of duties, the handling of goods in transit, the release of goods and the clearance of exports. Customs enforcement embraces all measures taken by the customs authorities to keep under surveillance and expose breaches of customs regulations, fraud and smuggling. This includes information procurement, risk analysis, freight inspections, inspections after customs clearance, measures to control smuggling, the sale or destruction of confiscated goods, the collection of payments in arrears and the monitoring of bonded warehouses. Small bribes are paid above all in connection with freight clearance. Enforcement deals with serious cases of customs fraud. For those concerned, much more is at stake than is the case with routine freight clearance, because fraud can be punished with heavy fines or imprisonment. However, since high profits can be expected from corruption, this area is susceptible to corrupt practices.

### **Possible Weak Points in Customs Policy and Customs Administration**

Conducive to possible corruption in this field are above all the following aspects:

#### **Political Measures and Administration**

- ◆ poor transparency and high complexity of customs tariff systems;
- ◆ high or excessive duty rate differentials;
- ◆ extensive quantitative trade restrictions or trade bans (non-tariff trade barriers);
- ◆ large number of exemption provisions;
- ◆ complex rules and regulations;
- ◆ low probability that corruption will be detected and punished.

### **Freight Clearance**

- ◆ outdated and complex customs code – defining the competences and procedures of the customs authority in the context of freight clearance – that is also difficult to understand;
- ◆ poorly designed and cumbersome customs clearance procedures;
- ◆ lack of standardisation in customs clearance, as a result of which the same operation is handled differently at different points;
- ◆ absence of automated information systems to process the many declarations received daily;
- ◆ interruptions in the information flow between those points handling declarations, and banks and warehouses;
- ◆ lack of access to reference prices, which gives customs officials broad discretionary scope when valuing goods and assessing duties and charges.

### **Customs Enforcement**

- ◆ transfer of inappropriate enforcement competences to customs officials;
- ◆ Due to the absence of risk analysis systems, the inspection and monitoring strategies of customs offices are deficient or non-existent. This leads to those offices becoming overstretched, and to inadequate inspection and monitoring.
- ◆ weakness of information systems in many customs offices, such that customs officials are unable to detect either fraud or corruption;
- ◆ inadequate infrastructure and inspection systems at border customs posts;
- ◆ shortcomings in the monitoring of customs warehouses and in the handling of confiscated goods.

### **Signs of possible corruption include e.g.:**

- ◆ complex, poorly transparent customs tariff systems;
- ◆ high customs tariffs;
- ◆ large number of (apparently arbitrary) exemptions and other special provisions;
- ◆ excessive use of non-tariff trade barriers (e.g. import and export quotas and licences);
- ◆ poorly transparent licensing procedures;
- ◆ political interventions into customs affairs;<sup>28</sup>
- ◆ systematic distortions in the granting of import-export licenses;
- ◆ special agreements with individual industrial enterprises instead of with the entire sector;

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<sup>28</sup> It must be quite clear that it is not possible to obtain preferential treatment by exerting influence on political decision-makers. It should not be the task of the political leadership or ministers to investigate and take decisions on individual cases (Crotty, 1997, p. 4).

- ◆ allocation to incorrect tariff groups;
- ◆ declarations of value of goods incorrect or too low ;
- ◆ release of goods stored in a customs warehouse for consumption on the domestic market, without payment of duties and charges ;
- ◆ support of false claims for reimbursement of duties and charges by certifying the export of goods, even though these were consumed on the domestic market or never produced;
- ◆ payment of too low import duties where the value of the goods was correctly declared and the correct tariff assigned, due to incorrect assessment;
- ◆ customs evasion in cases where the duties were correctly assessed, but never paid, and the goods nevertheless released;
- ◆ demanding of fees for swift issue of customs clearance certificates, although the individuals paying the charges would be entitled to those certificates free of charge.

## **2.2 Corruption Prevention Measures**

For the customs sector too, one of the key overarching measures would be the strict division of responsibilities for policymaking and administration. Furthermore, maximum transparency must be guaranteed in all decision-making processes and procedures. Discretionary scope for policymakers and customs officials must be reduced to a minimum. Accountability must be strengthened, also through measures to significantly improve internal and external monitoring systems. Finally, there is a need to systematically incorporate ethical aspects into the professional training and upgrading of customs officials. The systemic approach should also include greater access to information and participation by the concerned traders and the public.

### Good Practice: Customs Reform in Peru

The Peruvian customs service provides one example of the successful implementation of customs reform. Having addressed their existing problems of corruption and competences, the customs authorities of Peru can now serve as a model for customs authorities the world over. Six years ago, the Peruvian customs service was renowned for its incompetent way of working and corrupt structures. Under new management and using a charter, the service was reformed and modernised. With support from the Inter-American Development Bank, Peruvian customs dismissed corrupt employees, introduced a knowledge test, trained the remaining staff, hired new well-qualified personnel, laid down standard customs clearance times, simplified customs tariffs, and lowered the charge rates. The results were impressive. As the volume of imports doubled, customs revenues quadrupled - while charge rates were lowered and customs provisions otherwise remained the same. Staff numbers were reduced by around 30%, while the scope of tasks performed remained constant. Customs clearance times were reduced from 15 to 30 days, down to a maximum of one or two days.

Cf. Lane (1998).

**The following measures are also appropriate for fighting customs corruption:**

#### Systemic Legal and Institutional Changes

- ◆ separation of customs policymaking and administration;<sup>29</sup>
- ◆ simplification of the customs codex;
- ◆ reduction in the number of customs tariffs;<sup>30</sup>
- ◆ reduction of customs and value-added tax exemptions for imports;
- ◆ reduction of non-tariff trade barriers (e.g. import and export quotas);
- ◆ creation of transparent licensing procedures for importers and exporters, and simplification of import and export regulations;
- ◆ definition and publication of service standards;
- ◆ introduction of a self-assessment system.<sup>31</sup>

<sup>29</sup> Cf. Hors, I. (2001, p. 60).

<sup>30</sup> According to a study by Gatti (1999), which deals explicitly with interaction between importers and corrupt tax officials, where corruption is ubiquitous a uniform tariff system for imported goods can generate higher revenues and greater prosperity than optimally differentiated tariffs (based on Ramsey's law, which calls for different tax rates for goods with different price elasticity). This is due to the fact that with uniform import duties, customs officials have very much less scope to use differences in tax rates on various goods to appropriate public revenues for themselves, and inflict efficiency losses on the economy.

<sup>31</sup> The self-assessment system should be based on the following principles, in order to be effective and offer few opportunities for corruption (see: Crotty, 1997, p. 4): One-stop clearance (a customs declaration should be handed in at the reception counter of the customs authority, and the necessary paperwork performed by the authority without the need for further interaction, until clearance is complete); minimisation of the need for information and documentation (customs

### **Customs Administration Reforms**

strategic separation of functions and creation of a mutual monitoring system, e.g. spatial and organisational separation of processing of applications and delivery of advisory services, separation of the processing of a customs declaration from the physical inspection of the goods;

- ◆ customs procedures designed to minimise the abuse of discretionary scope;
- ◆ reduction of the information and documentation demands on traders;
- ◆ formulation of procedural manuals;
- ◆ application of the "two heads are better than one" or "greater scrutiny" principle in key decisions;
- ◆ creation of a suitable working environment in which the customs authorities are not dependent on importers, exporters or their agents with respect to premises or equipment;
- ◆ introduction of risk analysis: identification of those points in the customs system that are particularly conducive to incorrect payments, be they initiated by the customs or by traders and their representatives;<sup>32</sup>
- ◆ publication of standards concerning the overall duration of individual procedural steps;
- ◆ reduction of freight inspections to 10 to 20% of the incoming consignment, with selection of the consignments to be inspected based on a risk analysis system;
- ◆ privatisation of individual steps of customs administration work;
- ◆ introduction of modern information systems, in order to:
  - ◆ automate critical processes, accelerate processing and reduce administrative discretionary scope;
  - ◆ better network mutually independent processes such as the processing of declarations, payments and warehousing;
  - ◆ facilitate the allocation of declarations and inspections to officials on a random basis;

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authorities must define their information and documentation needs such that administrative demands on importers and exporters are kept to a minimum); consistent interpretation (importers can only be expected to make a correct self-assessment in an environment where the laws are interpreted consistently, the procedures standardised and each case is dealt with just like the previous one); processing by computer, to limit the discretionary scope of officials.

<sup>32</sup> The conduct of risk analyses should be a permanent task of customs authorities. In a system of this kind, the likelihood of a consignment infringing the customs regulations is evaluated by comparing its specific characteristics with a number of reference tables and documents. Only those consignments identified as high risk need to undergo standard customs clearance. Consignments with a low risk profile must be directed along a green lane, and subjected to a clearance process that does not require the individual to proceed to the desk or to interact personally with a tax official (Hors, 2000, p. 37).

- ◆ improve monitoring of the measures taken by customs officials, such as physical inspection of the consignment;
- ◆ better identify wrong classifications and undervaluations;
- ◆ optimise the availability of information at central and regional offices, thus improving process monitoring;
- ◆ rationalise the issue of orders to stop, raise the alarm and deploy;
- ◆ utilisation of systems for direct payment of duties and charges into a bank, including the establishment of a system for paperless and cashless customs clearance;
- ◆ anonymisation of procedures;
- ◆ establishment of a professional, meritocratic customs service whose staff are selected on the basis of open competition, and with clearly defined rules for job appointments and transfers;
- ◆ restrictive approval of secondary employment;<sup>33</sup>
- ◆ restriction of direct interaction with customs officials and traders during customs clearance;
- ◆ publication of standards for customs clearance and for all customs services, as well as provision for appeal against customs duty assessments;
- ◆ implementation of standardised nationwide application of procedural directives;
- ◆ improvement of human and technical infrastructure at customs border posts;
- ◆ increase in the number of customs border posts;
- ◆ promotion of customs service standards;
- ◆ incorporation of a code of ethics into the curriculum for induction training of all new customs officials, and for refresher courses;
- ◆ promotion of corporate identity, based on customs officials' feeling of loyalty and pride in their work.

### **Changes at the Interfaces of the Customs Service**

- ◆ clear definition and publication of service standards for customs clients;
- ◆ survey of traders liable to customs duties; publication of the results of these studies;
- ◆ creation of an independent fiscal jurisdiction;
- ◆ conclusion of agreements on the exchange of information with neighbouring states;
- ◆ creation of an external organisation to monitor and protect the integrity, the systems and the staff of the customs service;

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<sup>33</sup> For tasks to be performed by customs authorities, approval should not be granted in particular for the secondary employment of individuals/enterprises who/which (a) are not meeting their tax obligations, (b) are employed in tax consultancy, or (c) are employed in the shipping trade.

- ◆ creation of an environment in which importers and carriers are able to inform customs management of dishonest behaviour without hesitation;
- ◆ clear signal to trade and industry that corruption will not be tolerated either on the part of customs or on the part of traders. Definition of appropriate sanctions for cases where customs or traders nevertheless break the regulations;
- ◆ promotion of the private sector (creation of a partnership between the private sector and customs), also involving the private sector in the reform process and its implementation;
- ◆ participation of private-sector associations and civil society organisations in the monitoring process, possibly also in an advisory/ consultative capacity;
- ◆ building of strategic alliances with the formal sector, to obtain information on fraudulent activities;
- ◆ cooperation with security services for improved border controls and greater physical security of customs staff;
- ◆ creation of a common mindset among the political elite, with the aim of (a) depoliticising appointments within the customs service, (b) putting a stop to the wielding of influence over appointments and transfers, and (c) setting an example as to how members of the political elite can adhere strictly to customs regulations and procedures when travelling;
- ◆ encouragement of lawmakers to develop a political commitment against customs corruption;
- ◆ linking of anti-corruption measures in the customs sector with the government strategy for corruption control;
- ◆ publication in the media of sanctions against corrupt officials and traders;
- ◆ publication of information on imported and exported goods, so that civil society can also monitor the flow of goods.

### **Good Practice: Customs Reform in the Philippines "Customs Development Towards the Year 2002"**

The Customs Development Towards the Year 2002 reform programme, launched by the Philippines in 1992, resulted in major progress in the national efforts to more efficiently collect public duties, and reduce corruption. In a first component of the reforms, many of the traditional customs activities were computerised. These changes reduced the volume of paperwork. Also, the number of steps of work and signatures required to complete an operation was reduced significantly. In a second component a risk evaluation system was introduced, through which the number of transaction requiring the close attention of customs could be limited. In this restructuring of systems and procedures, care was taken to ensure that the monitoring required did not become part of routine working practices. Given the tendency of customs staff to conceal the real extent of corruption and provide each other with cover, the management called in external assistance - and independent audit commission reporting directly to the top management and the enterprises.

The measures specifically designed to fight routine corruption included: restriction of direct interaction between customs officials and traders during customs clearance; reduction of queues and bottlenecks; definition of clear and simple assessment regulations; privatisation of certain operations; greater transparency of individual phases of clearance; comprehensive use of information technologies instead of manual procedures; establishment of a paperless and cashless system of customs clearance.

Two of the key private-sector interest groups, the Philippine Chamber of Commerce and Industry and the Federation of Philippine Industries, as well as other associations, were involved in the design and implementation of these reforms.

Source: OECD (Hors, 2001).

## **3. Budget and Expenditure Management**

### **3.1 Typical Manifestations and Possible Weak Points**

In budget and expenditure management, corruption is manifested – to varying degrees – in the preparation of budgets, in the use of funds and in financial control. Certain politicians – members of parliament, general secretaries, ministers or even heads of state – attempt to shape investment expenditure largely to suit their own interests. Essentially, basic decisions need to be taken concerning (a) the entire public investment budget, (b) the general composition of that budget, i.e. the rough allocation to various categories of investment expenditure, (c) the selection of specific projects and their locations, and (d) the scope and design of each project. In these decisions, and especially in the areas specified at (c) and (d), a number of high-ranking agents have a strong degree of control

or influence. This is the case especially where key monitoring or control bodies are not well developed, and institutional monitoring is correspondingly weak.<sup>34</sup>

In many partner countries, fiscal management is so poorly transparent that manipulations can easily be concealed. In addition to poorly transparent decision-making processes in the preparation and approval of budgets, monitoring problems are caused by the frequent confusion of budgetary and extra-budgetary figures and special budgets, as well as budget breakdowns that make functional and administrative allocation of the various budget items – and thus the further tracking of actual expenditure and competences - very difficult. One general obstacle are deficient reporting duties, and/or the incomplete, unsystematic, possibly late or even non-existent provision of financial data by administrations to monitoring bodies, parliaments and the public. This causes problems in the implementation of effective monitoring by independent financial control bodies.

The importance of independent financial control bodies lies not only in the detection of corruption. They also have a preventive effect. Acting as neutral monitoring and advisory bodies, they help strengthen the financial, legal and institutional framework for professional, legal, economically efficient, accountable and transparent fiscal management, and eliminate systemic weak points and points of entry for corruption. Furthermore, as an independent source of information for parliaments, they also help the latter perform their political control function, and support their political will-building processes.

### **Possible Weak Points in Budget and Expenditure Management**

#### **Points of entry for corruption include:**

- ◆ complexity and poor transparency of the budget system;
- ◆ lack of budgetary principles, financial regulations and administrative regulations;
- ◆ poorly transparent consultation and decision-making procedures for the funds allocated to individual ministries;
- ◆ existence of secondary budgets;
- ◆ number, scope and allocation of subsidies;<sup>35</sup>
- ◆ payments not made through the banking system;
- ◆ poor constitutional independence of parliament from the government;
- ◆ lack of politically and operationally independent external monitoring bodies;
- ◆ unclear division of competences and poor coordination between existing internal and external monitoring bodies;

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<sup>34</sup> Cf. Tanzi (2000b, p. 155).

<sup>35</sup> Studies indicate that corruption is able to thrive in an industrial-policy environment in which subsidies are granted relatively unsystematically, and in which enterprises for which the subsidies are not intended are able to obtain them. The more subsidies that are available for industrial enterprises, the higher the corruption index is (Mauro, 1997, p. 4).

- ◆ weak mandate and inadequate competences of the monitoring bodies to detect corruption (especially rights of inspection and information), to identify systemic weak points for corruption, to put forward and monitor recommendations on how to eliminate those weak points, to introduce sanctions, and with respect to cooperation with judicial authorities, possibly local parliaments/parliamentary commissions, and access to the public;
- ◆ audit competence of the monitoring bodies does not always extend to all activities of the state (including parastatal enterprises and recipients of public subsidies);
- ◆ low capacities and poor expertise of monitoring bodies in the development and application of monitoring techniques and procedures to detect corruption, including the monitoring of actual expenditure and results (ex post evaluations) and systemic monitoring;
- ◆ lack of precautions against corruption within the monitoring bodies themselves;
- ◆ lack of public awareness of budgetary affairs, no public access to adequate and transparent information on the budget and the use of funds.

**The following circumstances may (clearly) indicate possible corruption:**

#### **Budget Preparation Procedures**

- ◆ complexity and poor transparency of the budget system;
- ◆ lack of budgetary principles, financial regulations and administrative regulations;
- ◆ poorly transparent consultation and decision-making procedures for the funds allocated to individual ministries;
- ◆ budgeting of inappropriate and extensive investment projects, while maintenance projects and projects in the social sectors are neglected;
- ◆ systematic preference for certain ministries in the allocation of budget funds;
- ◆ existence of secondary budgets;<sup>36</sup>
- ◆ excessive use of earmarking.

#### **Use of Funds**

- ◆ systematic preference for certain ministries by the individual responsible for approving expenditure in times of cuts;<sup>37</sup>

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<sup>36</sup> Though it should not automatically be assumed that these monies are being misdirected, there is more than sufficient evidence that "small empires" have been built using extra-budgetary and/or earmarked public funds (Garamfalvi, 1997, p.10).

<sup>37</sup> During the phase of the use of budget funds there are many opportunities for intervention and manipulation, given that officials have broad scope for deciding which ministry or which agency should receive spending approval for the appropriations. If spending approval is not granted according to plan, a ministry is unable to make any pledges, and goods and services are not ordered in time (Garamfalvi, 1997, p. 7). The responsible official is thus able to influence budget priorities for the year.

- ◆ ordering of goods and services not approved in the budget;
- ◆ manipulation of the dates of outgoing payments for the purchase of goods and services and transfers (e.g. pension payments); issue of payment instructions that reflect an unofficial schedule for the payment of arrears;
- ◆ payments to fictitious staff members, goods and services.

### **Financial Control**

- ◆ absence of independent monitoring bodies;
- ◆ deficient reporting duties, and/or the incomplete, unsystematic, possibly late or even non-existent provision of financial data by administrations to monitoring bodies, parliaments and the public;
- ◆ lack of precautions against corruption within the monitoring bodies themselves.

## **3.2 Corruption Prevention Measures**

In addition to helping bring about a commitment on the part of the political leadership, a package of measures to reduce scope for corruption should also certainly help guarantee maximum transparency in all decision-making processes and other procedures. Furthermore, the discretionary scope of politicians and those responsible for the budget should be defined at a minimum level. With regard to budgetary expenditure, special attention should be focused on the award of public contracts, an area very highly susceptible to corruption.<sup>38</sup>

**Special measures to combat corruption in budget and expenditure management could include:**

### **Changes to Budget Preparation Procedures**

- ◆ introduction of an appropriate and comprehensive legal framework that guarantees the universality of the budget, at least restricts the emergence of extraordinary budgets and thus helps reduce the discretionary scope of decision-makers;<sup>39</sup>
- ◆ strengthening of the rights of members of parliament in the budget preparation process;
- ◆ improvement of transparency and accountability in preparation of the budget;
- ◆ establishment of a transparent budget system and performance-oriented budgets;
- ◆ minimisation or elimination of earmarking arrangements;

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<sup>38</sup> Cf. GTZ, Preventing Corruption in Public Service on the National and Local Level. A Practical Guide.

<sup>39</sup> While the legal framework may correctly cover transactions made via the general budget, extra-budgetary transactions are not recorded in a manner that would rule out from the outset all possible quasi-illegal activity by officials. This is also the case where the government sells natural resources, public assets or other marketable goods to the private sector. In the transition countries this is perhaps the most fertile ground for the illegal appropriation of public funds, for the very reason that there is no corresponding legal framework.

- ◆ removal of subsidies;
- ◆ introduction of medium-term budget planning.

### **Good Practice: Participatory Budget Audiences in Venezuela**

A World Bank initiative launched in Campo Elias, Venezuela, is pursuing an innovative approach to creating participatory institutional frameworks, and applying best practice public policy procedures. Public Audience 2000 is a programme for participatory budget planning within the scope of hearings. This was developed to overcome the problem of poor information flow, which constrains transparency and a clear division of competences, and is conducive to corruption. Public hearings enable a municipality to develop its budget jointly with citizens. The latter identify and prioritise their needs, participate in the management of municipal monies, monitor and evaluate the pledges made by the mayor, and create transparency and opportunities for the assumption of responsibility. Furthermore, to monitor activities within the municipalities they are also able to access corresponding computer databases.

Finally, a tripartite monitoring commission comprised of citizens, a representative of the municipality and local government officials was formed, to facilitate popular participation in the municipality's budget hearings, as well as to select and monitor public investments and services.

Participatory budgeting leads to better (more democratic, more legitimate) allocation and distribution, and under certain circumstances also to more transparent management. Although corruption prevention is not the prime purpose of this participation, it can also help prevent it.

Cf. World Bank, PREM Note No. 39 (2000).

### **Reform of the Use of Budget Funds**

- ◆ clear rules and administrative regulations for expenditure management by the public administration;
- ◆ increased monitoring of the sectoral ministries by the ministry of finance, through a special budget officer;
- ◆ separation of responsibilities for payment instructions and outgoing payment;
- ◆ ongoing documentation and review of payments.

Concerning the award of public contracts, the reader is referred to the GTZ practical guide "Preventing Corruption in Public Service on the National and Local Level".

### **Reform of External Financial Control**

- ◆ legislative institutionalisation of independent financial control that is not just confined to checking formal correctness, but also evaluates the economic efficiency of the use of funds;

- ◆ clear competences, adequate resources and explicit authority to expose corruption<sup>40</sup> within any sphere of government activity, to identify weak points, to put forward recommendations on how to eliminate them, and to initiate sanctions;
- ◆ strengthening of parliamentary rights of control, strengthening of the legal foundations and institutionalisation of budget and accounts auditing committees and their cooperation with external financial control bodies (call for audit reports, verification by consultation with civil society organisations, elaboration of recommendations for parliament, reporting to the public);
- ◆ strengthening of the legal foundations for appropriate reporting duties of administrations to parliament and the public; timely publication of the budget (if possible at the draft stage), public access to information on the status of the use of the monies (showing allocations to concrete projects and responsible individuals) and the aforementioned publication of audit reports;
- ◆ strengthening of the legal and procedural bases for the institutionalised involvement of civil society organisations in the monitoring of expenditure and results, the work of audit bodies, the implementation of recommendations for the elimination of systemic weak points, and the follow-up of cases of corruption/sanctions.

#### **Good Practice: Participatory Audit - An Example from the Philippines**

The Philippine NGO Concerned Citizens of Abra for Good Governance (CCAGG), which today has around 1,000 members, has been conducting expenditure monitoring of public infrastructure projects in the province of Abra since 1987. In this context, discrepancies were detected between accessible government information on the use of funds and actual events on the ground, the issue of corruption was raised at public hearings, and sanctions were successfully imposed on those responsible. Supported by the active moderation of UNDP, CCAGG has been making its expertise available in the participatory audits held as part of the decentralised financial control measures of the Philippines Commission on Audit (COA) since 2000. The approval of new public projects is made dependent - inter alia - on the results of the CCAGG evaluation reports. A Manual on the Conduct of Participatory Audit has been available since early 2003.<sup>41</sup>

#### **Development Cooperation Activities for Procedural Development:**

- ◆ ongoing, mutual monitoring of the individual procedural steps during the use of the budget by budget officers of the ministry of finance and the respective sectoral ministries;<sup>42</sup>

<sup>40</sup> Explicit anti-corruption mandates are held for instance by the supreme audit institutions in South Africa, Indonesia, India and the Philippines, among others. Cf. Dye/ Stapenhurst (1998). See also Kellner (2000) on the following activities.

<sup>41</sup> Cf. [http://www.coa.gov.ph/COA\\_htm/COA\\_News/2003/v4n1/news5-1\\_n1.asp](http://www.coa.gov.ph/COA_htm/COA_News/2003/v4n1/news5-1_n1.asp).

<sup>42</sup> According to Garamfalvi (1997, p. 14), alongside the traditional approach the value-for-money (VFM) audit - an approach embracing numerous dimensions such as economic efficiency and effectivity - should also be considered an important anti-corruption measure. The introduction or

- ◆ advisory services to help develop corruption-specific audit techniques and procedures in accordance with international standards, and to facilitate the planning and implementation of audits in high-risk agencies/areas; advisory services for professional and timely preparation and publication of audit results;<sup>43</sup> introduction of telephone hotlines or similar procedures to take anonymous reports of cases of corruption; advisory services to help develop corruption-specific audit methods and procedures in individual sectors such as education, health, infrastructure;<sup>44</sup>
- ◆ establishment of a monitoring system to facilitate the implementation of recommendations for eliminating systemic weak points;
- ◆ development of mechanisms to include NGOs in monitoring tasks;
- ◆ development of mechanisms for cooperation between parliaments/responsible committees with audit bodies and civil society watchdog organisations.

### **TC Project "Operational Strengthening of the Court of Audit" in Nicaragua**

Nicaragua is undergoing a phase of consolidating its economic and democratic structures. In this context, corruption at both the central and local levels is a major problem. Key weak points are the absence of a transparent budget and accounting system, the large absence of external and internal monitoring - or the prevention of monitoring in key institutions, and a weak legal system. Nicaragua's efforts to improve financial control have been promoted since 1999 by the GTZ project "Operational Strengthening of the Court of Audit". The Court of Audit and its regional branch offices, as well as the internal appeal bodies of municipal administrations, are being strengthened, complaint mechanisms are being improved, and the systematic involvement of civil society groups in the monitoring of government tasks is being supported. The project aims both to improve legal and institutional frameworks, to further develop audit methods (including introduction of the manual for revenue audit, budget management monitoring, further development of municipal audits and procedural audits), and to conduct specific institutional capacity-building measures. On the civil society side, a network of 350 NGOs and private individuals with experience in the monitoring of expenditure and results in the social sectors at the municipal level, are being involved through the *Coordinadora Civil*.

more intensive application of VFM audits would be especially important, because it already takes effect before funds are bindingly pledged. Corrupt activities can therefore be stopped before they affect the use of funds.

<sup>43</sup> Examples of the development of anti-corruption programmes, including the creation of anti-corruption task forces, with audits of high-risk agencies and high-risk areas, can be found for instance at the Polish Supreme Chamber of Control (<http://www.nik.gov.pl>) and the Czech Supreme Audit Office (<http://www.nku.cz>). An overview of international standards is provided by PEFA - Public Expenditure & Financial Accountability (2003): Overview of International Public Sector Standards in Accounting, Auditing and Internal Control, Washington D.C.: <http://www.pefa.org/Overview2003.doc>.

<sup>44</sup> The International Organization of Supreme Audit Institutions (INTOSAI) offers advisory services of this nature. Cf. <http://www.intosai.org>.

**Development Cooperation Activities for Institutional Capacity Building:**

- ◆ establishment of internal supervisory and monitoring mechanisms to fight corruption;<sup>45</sup>
- ◆ organisational consultancy services to help develop structures and procedures in line with the tasks in hand, and establish communication and coordination systems between the audit office, ministry of finance and ministries responsible for the sectoral and legal supervision of subordinate levels; improvement of professional cooperation between the administration, audit bodies, parliaments, the public prosecutor's office, courts, civil society and the media;
- ◆ human resources development in the identified institutions: development of anti-corruption training and upgrading systems / training of trainers<sup>46</sup>, exchange of information and experience;
- ◆ measures to support the capacity development of parliaments / the responsible committees for their supervisory and monitoring functions vis-à-vis the executive (especially in the fields of budget analysis, analysis of audit reports), including technical equipment;<sup>47</sup>
- ◆ support of NGOs in the exercise of the identified monitoring functions (especially concerning the implementation of expenditure and results monitoring, analysis of audit findings and recommendations of audit bodies);
- ◆ public relations work by the identified institutions: publication of audit results, active and media-friendly, target-group-oriented, comprehensible information and education work on corruption.

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<sup>45</sup> For possible instruments see: GTZ, Preventing Corruption in Public Service on the National and Local Level. A Practical Guide.

<sup>46</sup> See also the training on offer from the INTOSAI Development Initiative: <http://www.idi.no>.

<sup>47</sup> Cooperation with the Global Organization of Parliamentarians Against Corruption (GOPAC) is a possible option here. This organisation offers among other things training in budget and financial control, a corruption control manual, and the development of codes of conduct. Cf. [http://www.parlcent.ca/gopac/cbm\\_e.php](http://www.parlcent.ca/gopac/cbm_e.php).

## Annex I: Examples of Results Indicators – Anti-corruption Projects in Public Finance

	Possible indicators	Further hints
<p>Within the scope of the project, rules, procedures, instruments, competences and/or boards for financial control are developed/ improved/ strengthened.</p>	<p><b>Main indicators:</b></p> <p>The audits of the audit office/ internal audits/ audits of the inspectorate reveal a reduction in the number of acts of corruption from x p.a. in baseline year yyy to at least y p.a.</p> <p>[Before that:] Increase in the number of systematic corruption monitoring measures implemented in personnel administration and personnel management from x in baseline year yyy to y.</p> <p>Drop in the number of cases of corruption (reported/ after conviction/ after charges brought/ after opening of preliminary investigations/ after launch/ conclusion of disciplinary proceedings/ after detection by the top management or by the monitoring body) of at least x p.a. as compared with the peak figure / the figure for baseline year yyy under otherwise equal conditions.</p> <p>Rise in the number of corruption prevention or corruption control measures introduced by the top management in response to monitoring/audit findings, from x in baseline year yyy to y.</p> <p>Drop in the number of cases of corruption exposed though escaping sanction from x in baseline year yyy to y.</p> <p>[Procurement:] Increase in the number of contracts worth x or more that comply with international standards for tendering procedures, from y in baseline year yyy to z.</p>	<p>Recommended: further investigation, e.g. in-depth interviews exploring the plausibility of the link between these developments and the project.</p> <p>This indicator captures "intermediate steps", and is not so oriented toward the desired result. In fact, it does not actually capture the results generated by the audits.</p> <p>Another option would be to measure the proportion of contracts awarded to international standards in relation to the total number awarded. This is likely to be complex and time-consuming, however.</p>

	<b>Possible indicators</b>	<b>Further hints</b>
	<p><b>Further indicators:</b></p> <p>In a representative survey at least ...% of the members of parliament surveyed believe the work of the audit office/ cooperation with the audit office/ their specific capacities developed for monitoring the executive to be better than at the beginning of their term of office.</p> <p>Increase in the number of public hearings</p> <ul style="list-style-type: none"> <li>◆ during the phase of project selection /</li> <li>◆ of decision to award /</li> <li>◆ of discussion of audit reports, (followed by the publication of information in relevant newspapers)</li> </ul> <p>from x p.a. in baseline year yyy to at least y p.a.</p> <p>Increase in the number of formalised consultations between local representative bodies and anti-corruption NGOs for analysis and verification of audit reports, statements of accounts and budget analysis from ... to at least .... p. a.</p> <p>Increase in regular (at least x times p.a.) contact between court of audit branch offices and at least y NGOs availing themselves of their right to information on audit results, and disseminating that information in the local media.</p> <p>Decline in the number of complaints received by the central tender board concerning award decisions to x p.a. as compared with the baseline year / the peak figure since reached.</p> <p>(Regular) surveys among the inferior bidders for public tenders reveal that at least x % of respondents judge the tendering procedure to be transparent and fair.</p> <p>The ratio of new exemptions to old regulations cancelled has shifted in favour of the former, marking an improvement on comparable figures for the baseline year.</p> <p>The duration of the tax collection procedure has been shortened from x [weeks or months] in baseline year yyy to an average of y [weeks or months].</p> <p><b>Outputs or results (without clear management for development results):</b></p> <p>100% of cases of tax evasion detected are</p>	<p>The survey should be conducted as close to the target year as possible, though not right at the beginning of a new term of office.</p> <p>Caution! Here too, a decline in complaints need not necessarily be attributable to a desired reason (further investigation needed).</p> <p>Trends can be observed in panel surveys.</p> <p>This might be an idea for an</p>

	Possible indicators	Further hints
	<p>being reported (compared with ...% in baseline year yyy).</p> <p>Internal audits reveal a significant improvement in the quality of works performed (measures in relation to quality standards), and a reduction in costs.</p>	<p>indicator that would require precise adaptation in order to be made AURA-compatible.</p>
Target-group level	<p><b>Main indicators:</b></p> <p>A representative survey (of households with an income of less than ... [currency/capita&amp;year]) reveals that</p> <ul style="list-style-type: none"> <li>◆ ...% of respondents are aware of the respective opportunities for participation /</li> <li>◆ obtain information on them via local media, NGOs or other sources /</li> <li>◆ in their estimation, municipal planning and budgeting now take greater account of the interests of the poor.</li> </ul> <p>...% of low-income respondents indicate that their access to public services has improved significantly since ... - without their having to pay bribes.</p> <p>... % of respondents are able to avail themselves of services of the tax and customs authorities "free of charge", for which they have previously paid or had to pay bribes.</p> <p><b>Further indicators:</b></p> <p>One year after the introduction of reforms, ... % of respondents who have repeatedly made concrete complaints or requested assistance to obtain information, now see these as having been satisfactorily answered or dealt with within an appropriate period of time.</p> <p><b>Outputs or results (without clear management for development results):</b></p> <p>... % of surveyed taxpayers or individuals liable to customs duties are aware of the information and education campaigns launched by the authorities, and ... % have already participated in them.</p>	<p>Only qualitative indicators are given here.</p> <p>Surveys on issues as sensitive as this require careful methodological design, in order to generate sound and significant findings.</p>

## **Annex II: Resources**

### **World Bank and World Bank Institute**

Resources on the World Bank website that are most relevant to the present guide can be found at:

<http://www.worldbank.org/publicsector>

Tax:

<http://www1.worldbank.org/publicsector/tax/anticorruption.html>

<http://www1.worldbank.org/publicsector/egov/taxadmin.htm>

<http://www1.worldbank.org/prem/notestpa.cfm>

Further interesting information of general relevance to the present guide can be found at the following addresses:

Public Sector Management:

<http://www1.worldbank.org/publicsector/anticorrupt/publicsectormanagement.htm>

Public Expenditure Institutional Assessment:

<http://www1.worldbank.org/publicsecotr/anticorrupt/toolkitpe.htm>

Diagnostic Framework for Revenue Administration:

<http://www1.worldbank.org/publicsector/anitcorrupt/toolkitax.htm>

Assessing Government Performance: Diagnostic Toolkits:

<http://www1.worldbank.org/publicsector/anticorrupt/diagnostictools.htm>

Tools and Resources:

<http://www1.worldbank.org/publicsector/anticorrupt/tools.htm>

Public Expenditure Resources:

<http://www.worldbank.org/publicsector/pe/peresources.htm>

World Bank Institute:

<http://www.worldbank.org/wbi/governance/pubs.html>

### **Anti-Corruption Resource Centre of the Utstein Group**

<http://www.u4.no>

The headings "Projects" and "Resources" can be searched by key words such as: procurement, auditor general and national audit office, budgetary reform, expenditure management, accounting, taxation and customs, all of which are relevant to the present guide.

### **Homepage of the Christian Michelsen Institute, particularly relevant for publications on the theme of tax:**

<http://www.cmi.no>

**World Customs Organisation (WCO)**

[http://www.wcoomd.org/ie/En/Topics\\_Issues/CustomsModernizationIntegrity/](http://www.wcoomd.org/ie/En/Topics_Issues/CustomsModernizationIntegrity/)

**Other Internet Links**

Global Organization of Parliamentarians Against Corruption (GOPAC):

[http://www.parlcent.ca/gopac/cbm\\_e.php](http://www.parlcent.ca/gopac/cbm_e.php)

PEFA (Public Expenditure & Financial Accountability):

<http://www.pefa.org>

IMF: Code of Good Practices in Fiscal Transparency:

<http://www.imf.org>

INTOSAI:

<http://www.intosai.org>

INTOSAI Development Initiative:

<http://www.idi.no>

Philippines Commission on Audit:

<http://www.coa.gov.ph>; this website contains other interesting links also referred to in the present paper.

Website of the Polish Supreme Chamber of Control:

<http://www.nik.gov.pl>

Website of the Czech Supreme Audit Office:

<http://www.nku.cz>

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