

Corruption, The Re-Design of Tax Systems and the Value-Added Tax

John Toye*

The Institute of Development Studies at the University of Sussex

Abstract: Although the transition from socialism may improve the transparency and efficiency of the tax system, both democratic politicians and tax officials may still bias its design. In the case of corrupt tax officials, they will maximise opportunities for discretion and personal interviews. The simplification of the tax system, including the introduction of a value-added tax, is widely used strategy of economic reform which has also been advocated as an anti-corruption device. This article suggest that, even though VAT collection methods are not corruption-proof, the VAT has been used with some success in Indonesia to reduce corruption in revenue collection.

JEL Classification: H 26

Key words: Revenue collection, corruption, value-added tax, Indonesia.

Political and Administrative Biases in Tax Design

The transition away from socialist forms of economic management usually includes a move by the state away from reliance on state enterprise turnover taxes to more transparent forms of taxation of consumption. Such a move has the effect of reducing the degree of insulation of the government from the governed. It creates a greater

* John Toye is a Fellow of the Institute of Development Studies at the University of Sussex (UK) and a Professorial Fellow of the University. He has served as Director of the IDS from 1987 to 1997.

Author has been benefited from the extensive comments on an earlier draft by participants in a DFID-sponsored Workshop on Corruption and Development that was held at IDS in May, 1997. Special thanks are owed, for their most helpful comments, to Ajay Chibber, Satya Mohanty and Mark Robinson. An excellent research assistance of Francis Hutchinson and Garrett Pratt is gratefully acknowledged. The usual disclaimer applies.

opportunity for taxpayers to call the government to account for its spending policies. To the extent that the government decides to respond to these demands, the basis exists for the growth of government accountability, and therewith the growth of government legitimacy. Indeed, such demands and responses have historically led on towards the emergence of more democratic types of government.

However attractive such an evolution may seem, and however much one would wish to encourage it, it is also true that democracies have drawbacks of their own in the matter of revenue raising. Politicians in a democracy tend to think that they have to be concerned more with what the taxation system looks like to the median voter than with how it actually performs in terms of criteria of net revenue raised, horizontal and vertical equity and its distorting effects on the economy¹. They will, therefore, as the socialist governments that preceded them, also be inclined to favour taxation that is as invisible to the general public's eye as possible, and when visible as equitable-looking as possible. Thus democratic politicians, when they can no longer rely on state enterprise taxes, will still favour indirect taxation over direct, since the former tends to become consolidated into the purchase price of the taxed goods and services. They will also favour cascading indirect taxes to VAT, because the headline rate per unit of revenue is lower (Due, 1976: 86). In direct taxes, steep progression of rates with numerous detailed exemptions will be preferred to mild progression or proportionality with no exemptions, because the former appears to be less harsh on the median voter. Thus it is well to beware of against exaggerated expectations of rational taxation in newly established democracies.

But whether the overarching political constraints are set by an autocrat or by democratic politicians, it is also important to realise that, within those constraints, the detailed design of particular taxes can be shaped to fit the preferences of the tax officials themselves. Is this such a bad thing? The answer depends on what assumptions one makes about what the preferences of the tax officials themselves are likely to be. For the purposes of this paper, I assume the existence of corrupt tax officials, as well as of dishonest taxpayers (Besley and McLaren, 1993:120 n.2). I argue that, if tax officials are corrupt, or would seriously like to become so, a discreetly manipulative approach to tax design is an important lever to advance their purposes.

Corrupt officials will have their own favoured methods for collecting any tax. Essentially, their collection methods should be complicated enough for them to be able, without undue difficulty, to make the life of the honest taxpayer miserable. If they can do that, then they will be able turn some honest taxpayers into dishonest taxpayers who will collude in a secret agreement that, if their tax assessments are wrongly reduced, part of the revenue that the state loses thereby will be paid to the tax officials themselves. Both dishonest parties can secure private benefits at the expense of the state.

In order to structure incentives in a way that will promote such dishonest bargains, corrupt tax officials will prefer particular methods of tax collection. Four of these preferred methods are:

- (a) multiple, overlapping tax jurisdictions (not unified jurisdictions);
- (b) complex eligibility criteria (not simple ones);
- (c) discretionary procedures (not automatic ones);
- (d) full investigation of cases (not summary disposals).

These features can readily be legislated into any tax system, whatever the balance between direct and indirect taxes and whatever the nature of the separate tax bases (Toye, 1989:811). Moreover, either singly or in combination, they effectively set up a situation in which the typical encounter between tax officer and citizen has the following characteristics. Relevant information will be grossly asymmetric, in favour of the tax officer. More than one type of tax officer can be involved in settling an individual case. One or more face-to-face meetings may take place before the assessment is confirmed. The severity of the assessment can vary widely without any breach of the tax rules. Such an encounter will contain ample scope for oppressive behaviour intended to induce collusion, the actual offer of bribes in return for a reduced assessment, and punitive sanctions on those honest taxpayers who still refuse to bribe.

To lend some verisimilitude to this account, here are some instances of this kind of collusion, taken from Nigeria, Taiwan and Indonesia. We may note at this point that each of these three countries falls in the bottom half of the Transparency International Corruption Perception Index, Taiwan being ranked 29th, Indonesia 45th and Nigeria 54th out of the 54 countries represented. The Index is a composite one based on various measures of corruption, as perceived by private sector business people.

The first example is taken from an anthropological narrative, referring to a village in south-east Nigeria.

‘When the tax man came the following day, the (village council) had not met to decide how to welcome him; the food drinks and money usually offered to mitigate the harsh tax assessment were not ready. When the tax man left, the elders and teenagers who had been exempted from the tax the previous year were now enrolled to be taxed’ (Iyam, 1995:170-1).

Since no gifts were available for him at the meeting, the tax man was able to punish the villagers by exercising his legal discretion on the question of which persons were liable to head tax in the way least favourable to their interests. Another description of the same problem, this time from Taiwan, says this.

'It is this unintentional "flexibility" of the tax laws that has yielded discretion to individual tax officials in interpreting the law. From the taxpayer's point of view, this arbitrariness means that the tax officials can raise hell with anyone they pick, and that "anyone" could very well be the one that fails to buy them out. Unless the taxpayers receive extremely unfair treatment, they are usually reluctant to bring their cases to court. . . .' (Chu, 1990:394).

The situation was similar in Indonesia in the early 1980s.

'We had a dense forest of overlapping regulations that no one really understood. It could take years to figure out which laws were in effect and which ones had been superseded. This put businessmen and individual taxpayers at the mercy of tax officials . . . The result was that businessmen needed to develop personal links with individual officials to ensure that all went well . . . Of course, you had to pay a lot to this person to be certain he'd take good care of you' (quoted in Winters, 1996:165-6).

The exercise of discretionary power as a method of extracting bribes from taxpayers seems to be quite widespread in Africa and Asia. It is based on deliberately created asymmetries of information as between tax officials and taxpayers, as have been analysed in the new institutional economics.

The Strategy of Tax Simplification

It is in order to prevent this sort of outcome that the strategy of simplifying the structure of the tax system has been widely adopted in the current wave of tax reform in developing countries. Needless to say, the tax simplification strategy has more than this one objective. Other objectives include increasing total tax revenue by broadening the tax base, improving horizontal (if not vertical) equity and minimising tax-induced distortions of the economy. But in addition to these aims, tax simplification was expected to pay dividends in terms of the reduction of corruption. According to the head of the HIID tax reform mission to Indonesia in the mid-1980s, 'it was expected that simplification would reduce the scope for corruption, since the complexities and ambiguities in tax law were used by tax collectors and taxpayers alike to cloak their transgressions' (Gillis, 1989: 93).

One of the benefits of a less complex tax structure and a less ambiguous tax law is that it should reduce the frequency of face-to-face interactions between tax officials and taxpayers. There is much support in the tax literature for such a reduction, on the grounds that it reduces the temptation and the practical scope for tax officials to

solicit bribes or to accept those offered. The introduction of withholding systems (like pay-as-you-earn) and presumptive assessments (where liability is assessed by reference to publicly monitorable factors) are effective ways of reducing the need for face-to-face interactions. Another benefit of tax simplification should be that the number of separate but overlapping tax jurisdictions are reduced, and that this reduces the degree of discretion that individual tax officials are allowed to exercise. This decreases the area of uncertainty about true liability, and thus the taxpayer's incentive to offer a bribe for a wrongly reduced settlement. 'Public officials who are in direct contact with their clients and those who can exercise discretion tend to figure more prominently' in the corrupt practices of revenue-raising agencies, according to one study of seven Asian countries (Alfiler, 1986:39).

Is there a conflict between the two anti-corruption tactics of reducing face-to-face interactions between tax officers and taxpayers and reducing official discretion over liability assessments? Does not the resort to presumptive methods of assessment widen the tax officer's discretion? The answer is that it does not, provided that the presumptive rule is well defined and is based on available and transparent data. Consider the example of a tax which is intended to fall on incomes in the agricultural sector. Given that households' annual crop yields and the costs of producing them vary from year to year, it might be decided that regular on-farm inspections were needed to determine liability, and that tax inspectors should be allowed discretion to estimate the off-farm income of the farmer. Suppose that this method gave rise to corruption. A presumptive assessment method is then substituted for regular site inspections. Henceforth liability is determined by the size of the farm household's land holding, after allowance is made for the fertility of the soil. If there are accurate numbers from a recent cadastre of the size of all farm holdings, plus a transparent official classification of agro-climatic zones, presumptive tax liabilities can be calculated at once with no inspections and no scope for official discretion. What suffers in such a change is horizontal equity. Less discretion may cause more arbitrariness, for example, as between farmers who are able to cultivate their holding fully and those who are not. The reduction of corruption may have to be traded off against the degree of horizontal equity in a tax-simplifying reform, if extensive resort is had to presumptive methods.

Value-Added Tax and the Costs of Tax Simplification

Another trade-off exists between tax simplification and collection costs. The simplification of the tax system does not necessarily make it less costly to administer: it may make it more so. The proposition that tax simplification can raise the cost of revenue collection may be illustrated by reference to a policy of transition from

assorted indirect taxes to a value-added tax (VAT). In the first place, it is clear that the introduction of a VAT does typically involve a great simplification of the structure of indirect taxation, in that it normally replaces a number of different existing indirect taxes. These are export taxes, excises (both specific and *ad valorem*), sales taxes (at manufacturing and/or wholesale and/or retail levels), selective taxes on services (usually those defined as luxuries) or, indeed any indirect tax that the government has thought fit to impose. Each of these different existing taxes will typically have its own structure of rates, its own list of exemptions, its own set of compliance requirements and so on. Many rate structures will be excessively differentiated. There will be many examples of overlapping incidence, leading to an irrational and inefficient distribution of the tax burden as well as the wide scope for official discretion that is conducive to corruption. Compared with all this, a VAT of the tax credit type is an immense simplification.

But this does not necessarily imply that adoption of a tax credit type of VAT will lower the costs of collecting the previous amount of revenue. It is a feature of all VATs that use tax credits, and therefore incorporate the potential anti-evasion advantage of the ability to cross-audit, i.e. to check the declarations of one taxpayer by reference to the declarations of others, that:

(a) They are likely to require a more extensive taxpayer registration than pre-existing taxes, as efficiency benefits depend on comprehensiveness of coverage (as well as simplicity of rate structure). Also, the work of registration is heavier, for both parties, than registration for other types of taxes.

(b) They require the establishment of a refund or credit facility, partly for those taxpayers whose purchases and sales volumes are 'lumpy', i.e. discontinuous and variable in size, but particularly for those whose sales are wholly or mainly for export, and therefore zero-rated.

(c) Tax officers' skills will need to be significantly upgraded to operate this more sophisticated method of indirect taxation. This will involve high training costs, particularly in countries that previously relied more heavily on revenue from excises than from sales taxes.

Thus simplification by means of transition to a VAT is likely to generate additional recurring costs. This has some interesting implications.

In principle, such costs can be traded off against the efficiency gains that tax simplification brings by reducing economic distortions, and this sets a limit to how much simplification is worthwhile. Also, the acceptable level of the costs of simplification will be affected by the size of the government's revenue target. If the government wants to raise more revenue than it did before, the distortion costs of persisting with the previous system of assorted taxes will rise at the margin, and this

will make the additional costs of moving to a broad-based tax system like VAT more acceptable (Gemmell, 1991). Tax reform inevitably requires achieving a balance between progress towards a number of different objectives, of which minimizing collection costs is only one.

Will a Credit-type VAT Reduce Corruption?

We have already referred to the fact that the tax credit form of VAT makes cross-auditing a possibility. Cross-auditing means the ability to use information from one taxpayer's returns to check on the accuracy of the information supplied in another taxpayer's returns. This possibility arises because every transaction involves both a buyer and a seller, and under a comprehensive VAT both buyer and seller will have to file returns, each of which will record one side of an identical transaction. Also, the incentive to mis-declare the amount of tax paid work in opposing directions. A buyer may want to overstate the amount of VAT in her purchases of inputs, because that amount may be deducted from her own VAT liability. But a seller will not be willing to collude in this, because she can only do so by raising her own tax liability.

How in principle a cross-audit can be done is illustrated by the following table. In Table 1, the rows represent the stages of production, starting at the top and working down. To make this less abstract, one can visualise a farm growing wheat, a mill milling the wheat into flour, a bakery using the flour to make bread and a sandwich shop using the bread to make sandwiches to retail to the public. The columns represent the build up of gross costs of production, including VAT, at each of these stages of the production of retail sandwiches. In the fifth column, it can be seen that the seller's tax payment at any stage should be equal to the claim for tax credit of her buyer, who is also the seller of another product with additional value-added at the next subsequent stage of production. If there are four stages of production from a to d , if VAT $a = 1$, then VAT credit $b = 1$; if VAT $b = 10$, then VAT credit $c = 10$; and if VAT $c = 13$, then VAT credit $d = 13$. Observed inequality of any of these three required equalities indicates error, or, more likely, malfeasance. So much is well known and has been much discussed.

Table 1: Illustrative VAT calculation, showing potential for cross-audit.

| Stage of production | Value of purchases | VA added by stage | Cumulative VA | Tax due at stage (10 per cent) | Cumulative VAT | Sale price to next stage |
|---------------------|--------------------|-------------------|---------------|--------------------------------|----------------|--------------------------|
| a. Raw material | 0 | 10 | 10 | $1 - 0 = 1$ | 1 | $10 + 1 = 11$ |
| b. Manufacturing | 11 | 90 | 100 | $10 - 1 = 9$ | 10 | $100 + 10 = 110$ |
| c. Wholesale | 110 | 30 | 130 | $13 - 10 = 3$ | 13 | $130 + 13 = 143$ |
| d. Retail | 143 | 70 | 200 | $20 - 13 = 7$ | 20 | $200 + 20 = 220$ |

Source: *author*.

But how far is this cross-audit feature of VAT likely to reduce corruption in practice, when corruption takes the form of collusion between dishonest tax officials with dishonest taxpayers? There are two major considerations which derive from two characteristic features of a credit-type VAT which we have already mentioned because they lead to increased administrative costs, namely the desirability of comprehensive coverage and the need for a refund facility..

As has been already emphasised, the VAT has many advantages that make it a good form of taxation, whether it reduces corruption or not. It is income elastic, very productive of revenue with much reduced distortion of economic incentives, and neutral with respect to vertical equity. But these benefits are realised in full only if coverage is made as comprehensive and uniform as possible. There are good reasons, then, apart from a government's desire to raise the share of its income that it 'earns', for the desire to register and tax as many small businesses as possible. The question is how far to go in this direction. To exclude entirely the retail stage, as was initially done with some francophone African versions of VAT, is probably to be too pessimistic about what can be done.

The difficulty of their inclusion, however, arises from the illiteracy and poor record-keeping of many retailers and owners of small businesses in developing countries. Their inclusion by use of the *forfait* (or negotiated assessment) procedure, while increasing the efficiency benefits of the tax and augmenting its revenue, can easily lead to bribery and corruption. It introduces into the new system the face-to-face meeting and the wide permitted discretion that opened the door to corruption in the old. It is particularly vital that, if resort is had to the *forfait*, that it should be confined to sales, and not also applied to purchases. Tax credits should be permitted against actual invoices only (Due, 1976:179). The collection of the latter is not onerous, even in a world of tropical rainstorms and hungry rats, and it provides an important reality check on the negotiated assessment of sales volumes. But the best solution is probably to steer clear of *forfait* altogether, and instead grant outright exemption to some small firms and farms with less than a stated threshold value of sales.

With the exception of the *forfait*, when used, the VAT operates by taxpayer self-assessment, based on records of sales and purchases. For every transaction, therefore, two independent records should be available to the VAT administration. In an ideal world taxpayer returns could be extensively, but not completely, cross-checked by computer, as a means of identifying discrepancies and possible delinquencies. In most developing countries, that time is still distant. In practice, the much-heralded cross-audit is so onerous as to be, with rare exceptions, useless as a means of policing self-assessment. There are still too many cash transactions, with neither invoices nor receipts (Chu, 1990:404). Moreover, a market in forged invoices can quickly develop. Bear in mind also that the cross-audit does not, in any event, detect every possible form of VAT evasion. Therefore, much of the success in reducing corruption still depends on more low-tech, and thus more fallible forms of audit and inspection.

It is usually impossible to audit every taxpayer every year, so a selection has to be made. Who to audit, and who to ignore? Although this choice should be made on rational and impersonal criteria, this does not always happen. It is clear that discretion about who to audit will be a residual source of corruption. There have certainly been cases of policy failure in the auditing of VAT returns. The ratio of inspectors to taxpayers may be acceptable, and numerous audits and inspections may take place. Yet these may be quite ineffective where clear audit priorities are not established, a system for reporting findings does not exist and the regular reviewing of audit work by senior officials is absent, as is all too often the case. This kind of laxity will act as a breeding ground for corruption even when a VAT is in place.

But much more damaging is the fact that, without a workable cross-audit facility, there is nothing in the pure mechanics of a VAT that would stop the tax inspector and the tax payer meeting in advance to agree the level of the assessment, and then hiring corrupt accountants to prepare false paperwork that appeared to validate the wrongly reduced assessment. It is, after all, still in the interest of both the taxpayer and the tax official to agree on a wrongly reduced assessment and a bribe smaller than the amount of the reduction. Where corruption is already endemic, as in Indonesia, some collusion is likely to survive the introduction of VAT. In Taiwan, apparently, the existing system of regular payoffs to the local tax office can be relied upon to secure at the very least an understatement of the amount of evaded tax, if evasion is detected and reported from an audit (Chu, 1990:397).

Do Corrupt Tax Officials Rationally Resist the Tax Simplification Strategy?

A final difficulty of implementing a tax simplification strategy is that, alongside the various pressures on government to move forward on tax reform, which have already

been noted, other pressures exist that deter them from so moving very vigorously and wholeheartedly (Bird and Casanegra de Jantscher, 1992:100). One of the reasons for this may be the existence of corruption in the tax administration. It is a matter of great interest, therefore, to enquire whether corrupt tax officials try to resist policy-makers' efforts to bring in reforms that restrict their meetings with taxpayers and the scope of their discretion, and if so whether they can succeed.

The focus here is on the Indonesian tax reform of the 1980s. The original aim of the technocratic economics ministers who conceived the tax reform was to modernise a tax system which had become over-complex, income-inelastic and administratively lax through years of high-level neglect. But as the oil price declined from its 1979-80 peak, the motivation for the reform came to include the enhancement of 'earned' government income, as well as squeezing out corruption within the tax administration. Both of these objectives were to be served by a drastic tax structure simplification centred on the introduction of a VAT.

'The second part of the Indonesian tax reform was the replacement of its complex sales tax structure with a more general credit-type VAT. The drastic simplification of the rate structure (to only one basic rate) and the elimination of many exemptions and other forms of special treatment reduced much of the discretionary authority of the tax officers . . . Equally important in this regard was the built-in incentive under the credit-type system for taxpayers to engage in self-monitoring of tax collections . . .'

These observers testify to the active opposition of the tax officials.

'The Indonesian customs service and the sales tax office strongly resisted both of these aspects of the tax reform. Similar stories could be told about resistance of tax collectors, in Indonesia and elsewhere, to simplifications in property tax administration, income tax laws and tariff structures' (Flatters and Macleod, 1995:409).

Flatters and Macleod's story of bureaucratic resistance is corroborated by one of the key Indonesian tax reformers, as follows.

'The strongest resistance to tax reform, as it turns out, came from the tax officials themselves. They had the most to lose from the depersonalisation and simplification of the system. It was the same with customs. Before we could go ahead with tax deregulation, we had to replace the director general of taxes. Without this move, we could achieve nothing' (quoted in Winters, 1996:166, n.62).

Despite this clear documentation of the tax reformers' view that the resistance of the tax officials to tax simplification in Indonesia was strong, it has been argued that the resistance was more apparent than real, and that the tax officials were content with mere shadowboxing. The tax reformers' view could, after all, be criticised as complacent, on the grounds that, if the tax officials had not resisted, this would show that the design of their reforms were in fact inadequate to prevent corruption, and seen by insiders to be toothless. By the same token, the tax officials would have been obliged to do some shadowboxing, if they were not in effect to admit publicly that they saw the reforms as toothless against corruption, and thus push the reformers into trying more effective measures. We should be wary of accepting the tax reformers' view without considering some of the subtleties of political signalling that might be involved. How can we check the likelihood that the resistance of the Indonesian tax officials was rationally motivated by fear of the anti-corruption impact of the tax reform?

The weight of the evidence is on the side of the view that Indonesian tax officials did see the reforms as a threat, and that fear was a rational one given that they did indeed have a corruption-reducing effect within the tax system. We would not go so far as to claim that corruption in Indonesia has declined in the last decade: corruption may have reduced in the tax system and increased elsewhere in the economy. But a decline within the tax system does seem probable, for the following reasons. The Indonesian VAT was designed to be as simple a VAT as existed anywhere in the world. It did not extend below the importer and manufacturer levels, not even to wholesalers. There are very few exemptions, and there is only one rate of levy, 10 per cent. Perhaps most important of all,

'nearly two-thirds of the base of the tax passes through three bottlenecks that are easily accessible to the government, and therefore the tax administration: the customs house, sales of refined petroleum products by Pertamina . . . and sales of the 200-odd government-owned enterprises . . . Given these bottlenecks, the tax administration is in a position to collect more than half the potential VAT revenues with minimal expenditure of administrative resources, thereby allowing enforcement efforts to be focused on the remaining, less accessible shares of the tax base' (Gillis, 1989:99).

In these circumstances, and given also that the task of certificating the value of all Indonesian imports has been contracted out to a European firm, it is hard to argue that the same or a larger percentage of potential indirect tax revenue would be lost through corruption than was previously the case.

Secondly, the VAT revenue figures are too high to be consistent with a constant or increasing level of leakage. This can be shown by a simple calculation. The nominal

proceeds of a single-rate VAT with completely comprehensive coverage have to increase at the same rate as the total of value added at current prices, i.e. the nominal rate of economic growth. Between 1985 and 1995, the real rate of growth of GDP in Indonesia was approximately 7 percent per annum, while the GDP deflator was approximately 8 per cent per annum. If nominal GDP was growing at 15 per cent per annum, the tax base for a comprehensive single-rate VAT would be growing at 15 per cent also. According to the IMF *Government Finance Statistics Yearbook 1996* (page 192) the revenue from 'general sales tax, turnover or VAT' amounted to 2,327 billion rupiahs in 1985, and had grown to 18,335 billion rupiahs in 1994. This is a rate of growth of approximately 22 per cent per annum. It follows from this that the degree of exploitation of the VAT tax base was growing rapidly and significantly in the period 1985-94, at a rate of around 7 per cent a year. Although in an initial transitional phase, this rate of growth could theoretically occur while the degree of revenue leakage was rising, growth of the exploitation of the tax base *plus* increasing revenue leakage could not persist over the longer term. There must come a point of inflection in both growth functions after which both decelerate as the limits of the VAT tax base are reached. Under the collection conditions described, it seems likely to us that the revenue leakage already has been, and will continue to be, squeezed.

Thirdly, the obvious success of the VAT in revenue enhancement, deriving from the inherent income elasticity of the tax base as well as the increase in the degree of exploitation of that base, created a virtuous circle. Once the government had succeeded in putting in place a 'cash machine' of this degree of productivity, short term revenue pressures were reduced. The temptation to set revenue targets for other types of taxes, and allow discretion as to the means by which they are met, becomes less urgent and easier to resist.

Conclusions

(1) *One very frequent practical obstacle to the successful implementation of a strategy of tax simplification is that the tax authorities are rarely left alone to develop simpler and more productive revenue-gathering systems.* They are often the victims of a policy-activism that is dictated by considerations of visibility rather than effectiveness. Governments often make sudden highly visible changes in tax policy, which look dramatic, but are undertaken primarily to demonstrate that 'the government is doing something about it', whatever 'it' may happen to be at the time. The real impact in solving the chosen short-run problem may be small, but the side effects on the task of simplifying the tax system may be large. A good example of this is the proliferation of different rates and exemptions within a VAT in response to the agitation of particular socioeconomic groups. Another example is the existence of

short term pressures for extra revenue which lead to the retention or introduction of taxes that are productive of revenue but quite undesirable from the viewpoint of the other goals of taxation (Gray, 1989:2). It is worth noting, with reference to the Indonesian reform that neither of these things happened.

In the 1980s, there has been a particular kind of policy activism, which goes under the name of structural adjustment. The reform of the budget or tax system was a condition in over two-thirds of the World Bank's structural or sectoral adjustment loans in the period 1980-86 (Mosley, Harrigan and Toye, 1995 (1991):44). Inevitably in the circumstances, in some countries schemes of tax simplification themselves came to be regarded as a quick fix for a burgeoning fiscal deficit. Guatemala's 1983 tax reform may be cited as an example of this. Under the guidance of the IMF, the government decided to increase revenue by replacing the existing turnover sales tax and a stamp duty with a tax credit method VAT. The VAT became operational one month after it was announced, leaving no time to organise and train the tax administrators or to educate the taxpayers. Far from being 'self-enforcing', as the authorities seemed naively to believe, the VAT got into immediate difficulties because the administration received a flood of refund requests, most of which were believed to be fraudulent, but which there was no capacity to audit. The refunding was suspended, reintroducing cascade effects, public confidence was lost, the VAT rate was drastically lowered and the stamp duty brought back to fill the consequent revenue gap (Bird and Casanegra de Jantscher (editors), 1992:79-83). This was *not* the way to simplify the Guatemalan tax system!

(2) *Much would be gained in the war of attrition against corruption if politicians could be weaned away from their habit of pursuing the politics of visibility in taxation decisions.* There is an obvious link between the adoption of tax policies that look good to the median voter and the maintenance of extensive bureaucratic discretion. This is because tax policies that look good to the median voter would be unworkable if their regulations were to be enforced as written. This is true of income taxes with an extremely steep rate progression, for example. Such taxes would be very difficult to collect without allowing enough bureaucratic discretion to ensure that the effective progression of the tax incidence is much milder than the nominal rate schedule would lead one to expect. Thus the pursuit of visibility politics in taxation is not merely compatible with bureaucratic tax discretion, it is symbiotic with it. The symbiosis is, needless to say, strengthened when the proceeds of bureaucratic tax corruption are partly siphoned off by politicians. However, what looks good to the median voter (assuming here the success of the democratisation agenda) need not remain fixed and unchanging. Electorates may learn eventually that all that glisters is not gold, and that democratic politicians, like conjurers, win the applause of their parties by the extravagant practice of misdirection. As Abraham Lincoln memorably put it: 'you can fool some of the people all of the time and you

can fool all of the people some of the time, but you cannot fool all of the people all of the time'.

(3) *The Indonesian case shows that tax reform does not always fail, and that the tax simplification strategy can bring some anti-corruption dividends.* However, the Indonesian case, in tax reform as in structural adjustment policy more generally, has unusual features which mean that it is not easy to draw easily applicable policy lessons for other developing countries. For one thing, Indonesia since 1966 has benefited from an economic leadership that is far-sighted and technocratically skilful. The lesson of Indonesia is not that there are technical fixes for cultural dispositions that hinder development, but that what is required is a long-lasting political drive from a very high level to a particular vision of development, and that that vision must be technically well-informed.

(4) *Where such political preconditions are lacking, however, second best and n-th best solutions have to be considered.* These involve some toleration of corruption, but also an attempt to limit the damage that it can do to a government's efforts to 'earn' more of its income. Under this scenario, corruption will never disappear, and anti-corruption policy will always be a matter of containment, a little more or a little less.

Flatters and Macleod (1995) analyse this problem using a model of collusion between tax collectors and taxpayers to reduce the latter 's' liability, the difference between this and the true liability being divided between them. They argue the case for limited toleration of this corruption, when four conditions apply. They are that:

- (i) the government cannot pay tax collectors more than the normal civil service rate;
- (ii) the tax collectors have better knowledge of the true tax liability than is available to the Finance Minister;
- (iii) for the collectors, bribes are a perfect substitute for wages;
- (iv) collectors exert more effort to establish true liability when they are paid higher wages-plus-bribes.

In these conditions, if the Finance Ministry tolerates limited corruption, it can overcome the handicap imposed by poor knowledge of individual tax liabilities. It can collect more revenue compared with a situation in which the tax collectors are uncorrupted, but also unmotivated to exploit their superior knowledge to increase the Finance Ministry's revenue total. Corruption of tax officials may be one problem, this model is telling us, but personal integrity when it is combined with a minimal incentive to work is another.

This is a good warning against the practical consequences of taking an excessively moralistic approach to policy-making, and in that sense it follows a familiar tradition

in political economy. The four assumed conditions are not wholly implausible individually, and there may indeed be countries where all hold good at the same time. The Indonesian case certainly shows that they are not universally true, and that the strategy of tax simplification ought to reduce the need to tolerate corruption because it reduces the asymmetry of information between the Finance Ministry and the tax officials.

(5) *Even where the conditions of the Flatters and Macleod model do hold, and limited corruption does augment government revenues, the government remains vulnerable to the evaporation of its revenues, unless it is able to enforce its chosen limits to corruption.* It must at all times be able to exercise powers of dismissal and financial penalty over both excessively lazy and excessively greedy tax collectors. If it cannot do these two things, the revenue benefit of its Faustian bargain will disappear. Maybe the disciplining of the excessively greedy tax collectors will prove easier than it seems. In this connection, one is much heartened by the true story of the developing country government that introduced a system of self-assessment for import duties, stood down all its customs officers and found that its customs revenue sharply increased.

NOTE

¹Horizontal equity refers to the equal tax treatment of equally placed individuals, or companies: it requires the like treatment of like. Vertical equity requires that differently situated individuals (or companies) are treated differently and in a manner appropriate to their differences. What is appropriate is controversial. Some argue for proportionate taxation, that is tax payments proportionate to income, while others argue for progressive taxation, where the tax rate rises as income increases, on the grounds of the declining marginal utility of income. The distorting effects of taxation on the economy arise if the tax element in the prices of goods and services is not strictly proportional to the non-tax element. In this case, the relative prices of goods and services will be changed by the taxation, and people's economic behaviour will be distorted away from the pattern that they would freely choose in the absence of taxation, and which ipso facto they regard as preferable. The neutral impact of VAT, as shown later in Table 1, is therefore a highly desirable feature of any tax, but which very few other taxes have in the same degree as VAT.

REFERENCES

- Afilier, C. P., (1986), 'The Process of Bureaucratic Corruption in Asia: Emerging Patterns' in Cariño, L. V., (1986), *Bureaucratic Corruption in Asia: Causes, Consequences and Controls* (Quezon City: JMC Press Inc.).

- Besley, T. and J. McLaren, (1993), 'Taxes and Bribery: the Role of Wage Incentives', *Economic Journal*, 103:(416).
- Bird R. M., M. Casanegra de Jantscher (eds.), (1992), *Improving Tax Administration in Developing Countries* (Washington, DC: International Monetary Fund).
- Chu, C. Y. C., (1990), 'A Model of Income Tax Evasion with Venal Tax Officials; the Case of Taiwan', *Public Finance/Finances Publiques*, 45:(3).
- Due, J. F., (1976), 'Value-added Taxation in Developing Countries' in Wang, N. T. (editor), (1976), *Taxation and Development* (New York: Praeger).
- Flatters, F. and W. B. Macleod, (1995), 'Administrative Corruption and Taxation', *International Tax and Public Finance*, 2: 397-417.
- Gemmell, N., (1991), *Tax Collection Costs and the Choice of Tax Base in Less Developed Countries: a Geometric Note* (Nottingham: University of Nottingham), Credit Research Paper No. 91/3.
- Gillis, M., (1989), 'Comprehensive Tax Reform: The Indonesian Experience, 1981-1988' in Gillis, M. (ed.), (1989), *Tax Reform in Developing Countries* (Durham NC: Duke University Press).
- Gray, C. W., (1989), *Issues in Income Tax Reform in Developing Countries* (Washington DC: World Bank), Working Paper Series 267.
- Iyam, D. U., (1995), *The Broken Hoe: Cultural Reconfiguration in Biase Southeast Nigeria* (Chicago: Chicago University Press).
- Mosley, P., J. Harrigan, J. Toye, (1995, 1991), *Aid and Power: The World Bank and Policy-based Lending*, II. edition, Vol. 1 (London: Routledge).
- Toye, J., (1989), 'Tax Reform in South Asia: Yesterday and Today', *Modern Asian Studies*, 23:(4), October.
- Winters, J. A., (1996), *Power in Motion: Capital Mobility and the Indonesian State* (Ithaca: Cornell University Press).