

U4 Helpdesk Answer 2018:13

# Corruption risks in tax administration, external audits and national statistics

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Date: 05 November 2018

There are a number of approaches to identify corruption risks in different settings. This Helpdesk Answer adopts a value chain analysis, which conceives of a sector in terms of the processes required to produce and deliver public goods and services. It then considers the value chain in the sectors of interest at three levels: policymaking, organisational resources and client interface. Corruption risks at the policymaking level include political corruption, undue influence by private firms and interference by other arms of the state. At the level of organisational resources, possible risks include fraud, embezzlement and the development of patronage networks. Finally, at the client interface, the most common risks relate to bribery and extortion.

# Query

What are the areas within tax administration, external audits and national statistics with the greatest risk of corrupt behaviour?

## Caveat

This Helpdesk Answer does not attempt to provide a comprehensive list of all potential corruption risks in the sectors of interest. Instead, it seeks to identify and describe predictable risks based on the known general types of corruption.

The exact drivers, forms and modus operandi of corruption depends on a range of variables, including country context, sector, institution and working practices. Specific risks may only be identified as part of a thorough corruption risk assessment in the area of interest. The actual application of any given corruption risk assessment framework to these sectors in the Cambodian context would require extensive in-country research and, as such, goes beyond the scope of this Helpdesk Answer.

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## Corruption risk assessments

To identify typical corruption risks in the areas of tax administration, external audits and national statistics, it is necessary to adopt an analytical framework to assess and characterise risks.

## Main points

- Value chain analysis is a useful way to map corruption risks at sector level (Campos and Pradhan 2007).
- Risks can be characterised according to whether they occur at the stages of policymaking, organisational resources or client interface along the value chain (Transparency International 2017a).
- To gain meaningful insights, it is necessary to go beyond high-level mappings of corruption risks and conduct bespoke appraisals of different sectoral value chains.

Corruption risk assessments provide just such a framework. Risk assessments do not seek to measure the actual incidence of corruption, which is difficult to detect since most corrupt acts take place in secret. Nor are these assessments designed to deter or detect corruption. Rather, the aim is to diagnose vulnerabilities within a system that may present opportunities for corruption to occur.

As such, the findings of corruption risk assessments are frequently used to guide anti-corruption interventions by prioritising risks and

informing the development of appropriate preventive measures. In this sense, corruption risk assessments can also be understood as a management tool to improve the governance of a specific institution, sector, project or process (Selinšek 2015).

Corruption risk assessments are thought to have a number of strengths, including (Selinšek 2015):

- consolidating the coherence and quality of public management
- facilitating the identification of shortcomings in integrity frameworks
- supporting reforms to the institutional, legal or operational environment
- serving both as symbolic and procedural commitments to integrity and good governance

In addition, risk assessments can illustrate relationships between different risks, processes and actors and help prioritise the limited resources available for anti-corruption measures (McDevitt 2011). However, while risk assessments can serve as a key pillar of a preventive strategy, they are no substitute for good governance, effective management or appropriate legal and institutional frameworks.

### Model for identifying corruption risks in sectors

There are various approaches, models and conceptual frameworks that attempt to identify corruption risks in different settings. Corruption risk assessment methodologies for the public sector include:

- Asian Development Bank. 2008. *Guidelines for Implementing ADB's Second Governance and Anticorruption Action Plan*.

- Blais, D. and Schenkelaars, F. 2009. *Institutional Risk Assessment – Best Practices Compendium*.
- Council of Europe. 2010. *Corruption Risk Assessment Methodology Guide*.
- Selinšek, L. 2015. *Corruption Risk Assessment in Public Institutions in South East Europe: Comparative Research and Methodology*.
- United Kingdom Home Office. 2016. *Bribery and Corruption Assessment Template*.
- USAID. 2005. *Tools for Assessing Corruption & Integrity in Institutions: A Handbook*.
- USAID. 2009. *Anti-Corruption Assessment Handbook*.

There are also a number of risk assessment tools that have been designed for the private sector, such as:

- Ethisphere. 2013. *Anti-Corruption Risk Assessment*.
- Transparency International UK. 2013. *Diagnosing Bribery Risk*.
- UN Global Compact. 2013. *A Guide for Anti-Corruption Risk Assessment*.

Common to virtually all risk assessment models are the following four steps (Selinšek 2015). First, an analysis of how corruption manifests itself in a particular setting. Second, an identification of underlying drivers of this behaviour. Third, an appraisal of the efficacy of existing laws, regulations and other control mechanisms. Finally, the development of appropriate anti-corruption measures for the most important risks. Most risk assessments also adopt a broad understanding of “corruption” to include a range of unethical behaviour and integrity failings (Selinšek 2015).

When done well, risk assessments can be an effective means of sensitising anti-corruption interventions to local settings. However, there is no “off-the-shelf” solution. Instead, various approaches need to be considered in light of the nature of the system under assessment, available resourcing, background context and so on. Indeed, the literature stresses that, rather than dogmatically adhering to any particular template, the key is to find a broadly appropriate model and develop a custom approach best suited to the task (Selinšek 2015).

This Helpdesk Answer provides a starting point by providing an overview of common types of corruption in the three sectors of interest. As we see, the major types of corruption are often relatively generic: bribery, embezzlement, fraud, extortion, favouritism, unresolved conflicts of interest and so on.

However, the crux of the matter is to translate this kind of high-level mapping exercise into a bespoke appraisal of the idiosyncratic manifestations of these forms of corruption. The challenge does not end here; the key to a successful anti-corruption intervention necessitates going beyond producing exhaustive taxonomies of different types of corruption in specific settings (c.f. Page 2018) to tackle the underlying causes of bad governance (Mills May 2012).

To help make analytical sense of corruption risks, this Helpdesk Answer broadly adopts the model proposed by Selinšek (2015), and adapted by Transparency International (2017a).

Selinšek (2015) proposes assessing corruption risks in terms of the level at which they occur: contextual, organisational, individual or procedural.

Contextual risks refer to factors outside the control of the organisation or sector in question, and relate to the external environment in which a given organisation or process operates. Contextual risks could include poor legal frameworks, ineffective law enforcement, a weak judiciary, a lack of transparency in public financial management and so on.

Organisational risks are those factors that are internal to a given agency, and may be the result of their action or inaction. Organisational risk factors could relate to management policies, decision-making processes, operational guidance, and internal oversight and control functions.

Risks at the individual level arise where there are factors that motivate employees to engage in corrupt or unethical behaviour, such as social norms, excessive discretion and inadequate supervision, inappropriate relationships with clients, lack of awareness of expected standards.

Finally, procedural factors that can heighten corruption risks include non-transparent decision making, poor record- or bookkeeping and so forth.

**Table 1.** Factors that encourage corruption at different levels.

Level	Specific risk factors
<p><b>Contextual factors</b> Factors outside of the control of the organisation or sector</p>	<ul style="list-style-type: none"> <li>• unclear or inconsistent legislation regulating a certain sector or field of work</li> <li>• absence of basic legal framework needed to fight corruption and strengthen integrity (such as the effective criminal and civil codes, conflict of interest laws, free access to public information laws, asset disclosure rules, codes of conduct, lobbying regulation and whistleblower protection)</li> <li>• unclear competences of the authorities</li> <li>• unadjusted or disharmonised work of public sector institutions</li> <li>• inefficient law enforcement and prosecution</li> <li>• inefficient or incompetent oversight institutions or supervisory authorities</li> <li>• non-transparent public finance processes</li> <li>• poor or wrong understanding of proper public sector functioning</li> </ul>
<p><b>Organisational factors</b> Factors within the control of the organisation or sector that are the result of their actions or inactions, such as the rules and policies for good governance, management, decision making, operational guidance and other internal regulations</p>	<ul style="list-style-type: none"> <li>• poor strategic and operational guidelines (policy) or inadequate policies, procedures or systems</li> <li>• chronic failure to follow existing policies, procedures or systems</li> <li>• unclear mandate of an institution, project, etc.</li> <li>• poor or inconsistent internal acts and regulations</li> <li>• absence of warning and alert systems in case of different types of irregularities</li> <li>• weak managerial and administrative measures against corruption</li> <li>• inadequate/weak work review, supervision, oversight or control procedures and audit mechanisms</li> <li>• absence of rules and procedures that promote ethical behaviour and transparency</li> <li>• inadequate or insufficient system of training and education of public officials, including superiors and supervisors</li> <li>• inadequate human, finance or time resources in the organisation or its teams</li> <li>• high levels of power or influence, not consistent with their actual position</li> </ul>
<p><b>Individual factors</b> Factors that could motivate individuals to engage in corrupt or unethical behaviour</p>	<ul style="list-style-type: none"> <li>• lack of knowledge (ignorance)</li> <li>• lack of integrity</li> <li>• lack of practical skills</li> <li>• pressures in the work environment</li> <li>• inadequate supervision or performance review</li> <li>• inappropriate relationship with clients</li> <li>• omission of conflict of interest declarations</li> <li>• feelings of dissatisfaction or perceptions of unfairness at work</li> </ul>
<p><b>Working process factors</b> Factors that arise from working procedures in an organisation</p>	<ul style="list-style-type: none"> <li>• high levels of personal discretion</li> <li>• non-transparent or unrecorded decision making</li> <li>• poor organisation of work processes</li> <li>• unconnected work process and procedural gaps</li> <li>• lack of vertical and horizontal controls in the work process</li> </ul>

Source: Adapted from Selinšek 2015.

## Value chains

In practice, there seems to be little meaningful distinction – or at least considerable overlap – between organisational and procedural risk factors. Moreover, Selinšek’s approach implicitly focuses on assessing individual institutions; the four levels are primarily categorised by being internal or external to a given organisation. Indeed, Selinšek’s definition of a corruption “risk factor” is telling in that it clearly takes a specific institution as the locus of the risk assessment. For Selinšek (2015), a risk factor is “any attribute, characteristic or exposure of an individual, institution or process that increases the likelihood of corrupt behaviour, breach of integrity, unethical behaviour or other conduct that can have negative effects *on the objectives and goals of a public sector institution*”.<sup>1</sup>

However, when considering corruption risks in sectors such as tax or audit, there is a need to go beyond a narrow focus on a specific body or agency to consider these bodies’ interactions with a range of other institutions, both formal (the executive, the judiciary) and informal (kinship groups, socio-economic elites). Indeed, the problem with focusing primarily on legal, institutional and organisational frameworks is that these approaches can overlook the role played by informal practices in enabling and perpetuating corruption. As Fjeldstad (2006) observed in Uganda, technocratic, donor-supported reforms to the Uganda Revenue Authority were rendered largely ineffective as by concentrating on the “administrative features” of the tax administration, the reform effort underplayed the role of “social norms and patterns of behaviour”.

It is therefore worth considering a modification to Selinšek’s approach that instead conceptualises **a sector as a value chain designed to deliver a**

**service**. By foregrounding the processes needed to produce and deliver public goods and services, the analysis becomes less concerned with any one institution and better able to account for informality. At the same time, interrogating the various stages of the value chain sheds light on the different opportunities for and forms of corruption at vulnerable decision points (Asian Development Bank 2008).

The concept of a value chain originates in the private sector, where it refers to the idea that a company can be conceived of in terms of the processes it relies on to generate profit. In other words, the value chain conceptualises a company as a “system made up of subsystems each with inputs, processes and outputs. Inputs, processes, and outputs involve the acquisition and consumption of resources – money, labour, materials, equipment, buildings, land, administration and management” (Cambridge University 2016). The efficiency of this system and the interaction between the subsystems determines a company’s costs and profits.

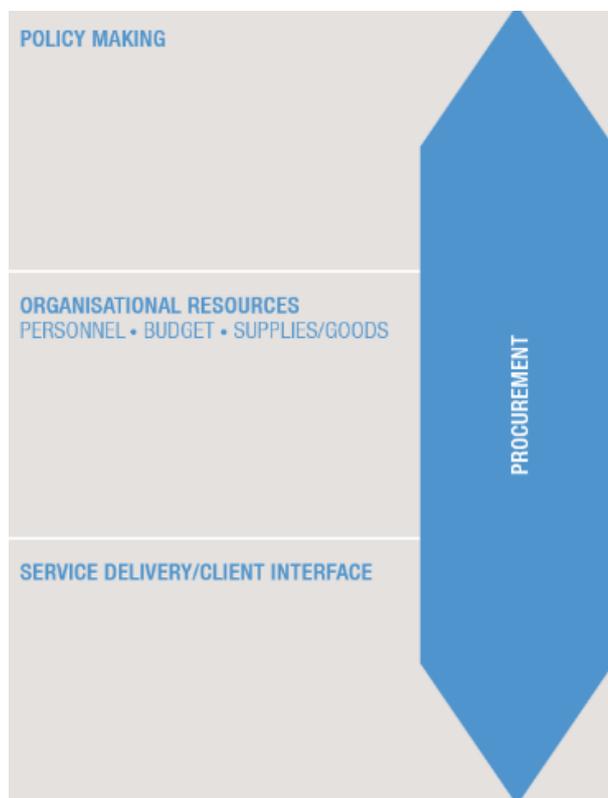
More recently, the notion of a value chain has been adopted to the public sector (Rapcevičienė 2014). The essential difference is in the definition of the “value” being produced. While a private sector value chain describes processes used to generate profit, a public sector value chain lays out the processes used to deliver goods or services to citizens. The value chain describes the full range of activities required to do so, from designing the good or service at the policymaking level, through the different phases of mobilising or procuring resources to produce this good or service and ultimately to the final delivery to citizens. We can conceive of a distinct value chain for each public

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<sup>1</sup> Emphasis added

service being provided to citizens: healthcare, education, clean water, electricity and so on.<sup>2</sup>

Indeed, when thinking about corruption risks in any given sectoral value chain, the following model may prove useful.



Source: *Transparency International 2017a*.

It shows the various levels at which corruption can occur: policymaking, organisational resources and client interface, as well as the procurement processes that connect them.

At the policymaking stage, corruption risks can be found both inside *and* outside of government. Inside government, “grand corruption” can take place when senior government officials distort policies or take actions that enable insiders to benefit at the

expense of the public good. Outside of government, private firms can exert “undue influence” to shape the formulation of laws or regulations through illicit payments to legislators, for instance through parliamentary vote buying or illicit contributions to electoral campaigns. Undue influence is not always illegal, even though it distorts political incentives and affects the direction of policies.<sup>3</sup>

The management of organisational resources, such as personnel, goods, supplies and budgets, is often characterised by weak oversight and discretionary abuse in the context of complex bureaucracies with overlapping responsibilities and jurisdictions. Corruption at this level can take many forms, including embezzlement of funds during procurement processes, as well as patronage and nepotism in licensing and hiring practices.

Finally, at the service delivery stage where citizens interact with officials and receive services, delays or inefficiencies can affect both incentives and opportunities for corrupt conduct on both sides of a potential corrupt transaction (Rose-Ackerman 1996). At this level of client interface, corruption risks often take the form of bribery or extortion. This type of “petty corruption” is usually perpetrated by low- and mid-level public officials in places such as hospitals, schools or police stations.

The value chain approach can be used to identify corruption risks in specific sectors. By conducting key informant interviews or focus groups,<sup>4</sup> one could map opportunities for corruption at the various levels, such as at the service delivery stage in the electricity sector, as shown in the diagram below (Loughborough University 2007). For

<sup>2</sup> There are a number of different applications of value chain analysis, including sequential stages in a (sub)sector, levels of operation within a (sub)sector, interactions in a (sub)sector, project cycle and process flow. For more information, see Asian Development Bank 2008.

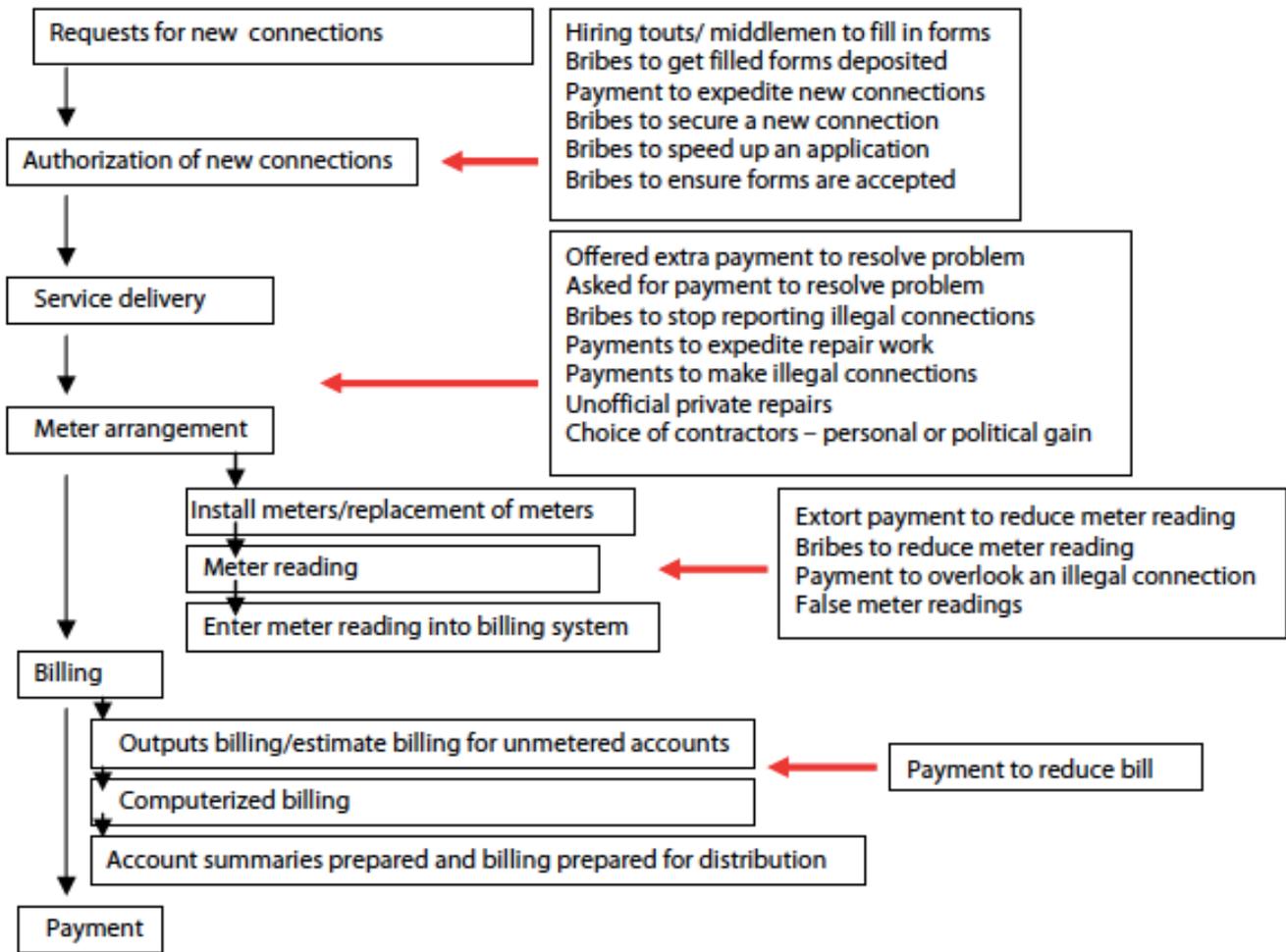
<sup>3</sup> Undue influence may consist of coercion and fraud, but it may also include kinship and personal relationships. It may require an

act to be performed in bad faith, or simply that a corrupt outcome occurred. The definition and criminalisation of undue influence therefore depends on the context and country laws (Martini 2012).

<sup>4</sup> Such as with civil society representatives, the private sector, academic researchers, retired public servants and current officials.

instance, people would probably point to the possibility for bribes paid to secure a new

connection, expedite repair work or to reduce meter reading at the billing stage.



Source: Loughborough University 2007.

Conducting a full risk assessment using this method would necessitate an in-depth study of the specific value chains in each of these sectors in the country context. The remainder of this Helpdesk Answer therefore seeks to apply this broad conceptualisation of corruption along value chains to the three sectors under consideration in order to identify general types of corruption that could occur at different levels.

## Revenue administration

Revenue administration covers the collection and management of domestic revenues such as taxes, customs duties, income from state-owned enterprises and other forms of public revenue. Tax administration in particular is often perceived to be one of the sectors most vulnerable to corruption: 32% of respondents across 119 countries believe that “most” or “all” tax officials are corrupt (Transparency International 2017b). A previous survey in 95 countries found that 15% of all respondents reported paying a bribe when

interacting with tax officials (Transparency International 2013a).

The sector has certain characteristics that are particularly conducive to corruption, notably the complexity of tax systems, the high discretionary powers of tax officials and disproportionate potential gains from illicit activity compared to the risk and cost of being caught (McDevitt 2015; Morgner and Chêne 2015a; OECD 2016).

Tax legislation is notoriously complex, and tax procedures tend to have many special rules and exemptions overseen by highly technical staff, who often exercise a high degree of discretion over how taxes are levied (Albisu Ardigo 2014).

The complexity of tax administration also reduces the chances of detection (Bridi 2010). Penalties for tax officials found guilty of malfeasance tend to be minimal (Antonakas, Giokas and Konstantopoulos 2013), and many tax administrations have a poor track record of investigating internal fraud and corruption, particularly in cases where senior officials are involved (Fossat and Bua 2013).

Systems characterised by considerable red tape, burdensome rules and procedures and numerous personal interactions between public and private sector players generate strong incentives to engage in corruption (Albisu Ardigo 2014). This is true for taxpayers, who want to cut their tax burden or speed up procedures, as well as for tax officials, who might seek to manipulate and extort taxpayers who do not know their rights (Martini 2014). Indeed, the preservation of highly regulated and complex revenue frameworks is often attributed to the desire of tax officials or civil servants to protect their rent-seeking behaviour (Bridi 2010).

Consequentially, no area of tax administration is immune from corruption. Corruption can affect all tax-related processes, from the registration and

removal of taxpayers from the national registry to the collection of tax dues, the identification of tax liabilities and the inspection and prosecution of alleged tax offences (Albisu Ardigo 2014).

Corruption in tax administration can be either collusive, where tax officials strike deals with taxpayers to allow the latter to underpay taxes in exchange for a share of the money “saved”, or abusive, where tax officials use their discretionary powers to extort bribes from taxpayers (Fjeldstad 2005).

Ultimately, corruption undermines a country’s tax structure and its revenue collection capacity, resulting in significant loss of revenues and funding available for public service provision. Not only does it lower the tax to GDP ratio, but also causes long-term damage to the economy by increasing the size of the underground economy, distorting the tax structure, corroding the tax morality of taxpayers as well as eroding public trust in government institutions (Nawaz 2010).

Purohit (2007) notes that the hierarchy of different tax administrative levels are typically associated with different kinds of corrupt transactions. For instance, high-level officials and politicians are more likely to be involved in corrupt practices related to fiscal incentives or exemptions. On the other hand, more routine corruption, such as extortion, is most likely perpetrated by lower-level officials, who might pass a share of their illicit gains up the chain of command in return (Purohit 2007). On that note, the next section considers the various factors that exacerbate corruption risks, as well as the risks themselves, at the three levels of policymaking, organisational resources and client interface.

## Policymaking

At the policymaking level, there are a number of factors that can heighten the risk of corruption.

Unclear tax regulation or inconsistent tax codes can lead to loopholes that can be exploited by those seeking to evade taxes. Lack of access to information regarding tax processes and practices and the absence of effective and regular monitoring allows corrupt officials to remain undetected (Albisu Ardigo 2014). Overlapping or unclear mandates of relevant institutions, such as law enforcement bodies, ministries and customs agencies, may undermine the consistency of application and enforcement of rules. McDevitt (2015) notes, for instance, the importance of a clear separation of functions between the tax administration, which manages taxpayer datasets, and the responsible ministry (usually the ministry of finance) which develops tax policy and drafts legislation. This is to minimise political interference in the day-to-day operations of the tax administration through, for example, politically motivated appointments of staff (McDevitt 2015).

Corruption risk factors at the policymaking level are likely to be compounded by other shortcomings in the external environment. For example, a lack of transparency in public financial management can lead to information asymmetries that officials could use to extort additional funds from individuals and companies. These risks will be higher where control and monitoring mechanisms, such as criminal codes, conflict of interest provisions, public access to information regimes and whistleblower frameworks are inadequate (Bridi 2010). These risk factors could contribute to corruption in various forms. In settings where integrity is generally low, or there are corruption problems in related private sector fields, like auditing and accounting, it may be likely that tax administration also suffers from similar issues (Albisu Ardigo 2014).

### **Political corruption**

Politicians may seek to interfere in the tax administration to grant favours, such as tax

exemptions to supporters or to harass political opponents through excessive tax audits (Fjeldstad 2006; Bridi 2010; McDevitt 2015). Corruption in tax administration is associated with neo-patrimonialist networks in many countries. Neo-patrimonialism is a form of state capture where patrons within a state's public service use state resources to develop clientelistic relationships with friends, family or associates of a similar political, ethnic or religious background (Gauthier and Reinikka 2001).

Tax administration becomes a powerful tool for corrupt politicians to divert state resources to their clients, with the aid of corrupt tax officials (Albisu Ardigo 2014). These networks can run deep and frustrate purely technocratic attempts to reform the sector. Fjeldstad (2006) notes that attempts to tackle corruption in the Uganda Revenue Authority failed to appreciate the extent to which the motives of tax officials were inextricably tied to the interests of the social groups to which they belong.

In Zambia, for instance, the government reportedly instructed the agency not to tax certain businesses owned by members of the ruling party (Fjeldstad and Moore 2009). Likewise, in Ghana, Malawi and Uganda there is a broad perception that the enforcement of tax law is not uniform. Individuals and companies related to politicians often receive tax breaks or are not audited (Global Integrity 2011).

### **Undue influence**

Corruption may also happen at the policymaking level to change the rules of the game in favour of certain groups. Special interest groups can exploit gaps in the integrity framework to exercise undue influence over policymaking on tax, as well as to lower or circumvent their tax liabilities. Business lobbies or other well-connected groups might seek to pressure authorities into changing tax policy and

regulation at the expense of the public interest. These efforts could seek to target tax thresholds, tax exemptions, VAT duties on various goods and other policies.

There is the risk that undue influence can spill over into regulatory capture. The US Climate Investment Statement, for instance, highlights that in Nigeria many companies report having “negotiated” their own taxation levels using their personal connections or bribing officials (US Department of State 2013). In the Netherlands, according to Teeffelen (2018), internal documents revealed that pressure from Unilever, Shell and the chemical firm AkzoNobel to the effect that they would move their operations abroad played an influential role in the government’s decision to abolish the withholding tax on dividends.

#### **International tax fraud and evasion schemes**

Tax fraud and evasion schemes typically exploit legal loopholes providing for profits and assets being transferred to tax havens instead of being reported to domestic authorities. Such schemes are facilitated by inadequate legislation, but the underlying incentive on the part of companies and high net worth individuals to lower tax rates could also constitute a corruption risk in its own right, as they seek to influence legislative and judicial processes to protect loopholes and grey areas.

#### **Organisational resources**

At the level of organisational resources, corruption risk factors typically relate to the adequacy and effectiveness of an organisation’s structure and systems. These include poor operational guidelines, inadequate policies, substandard control and audit mechanisms, as well as weak managerial oversight of personnel, supplies and budgets. Where these shortcomings coincide with high levels of personal discretion, poor record-keeping and non-

transparent decision making, there are likely to be many opportunities for corruption.

Other factors, such as the absence of merit-based recruitment practices, a lack of regular staff rotation schemes to prevent the establishment of lucrative corrupt networks, the lack of capacity to monitor fiscal transactions and evidence of officials living beyond their means, may increase the likelihood of corruption in tax administration (Purohit 2007).

#### **Fraud and embezzlement**

Tax officials may dishonestly and illegally appropriate or divert funds they have been entrusted with for personal enrichment, sometimes with the complicity of bank officials or auditors (Martini 2014). Other forms of corruption might involve falsifying tax receipts or turning a blind eye to irregularities in exchange for illegal payments (McDevitt 2015).

In many countries, tax officials facilitate revenue fraud through the undervaluation or under-declaration of goods (using fraudulent invoices). For instance, several companies operating in the informal sector in Nigeria resort to smuggling instead of legal trade to avoid paying taxes, with the support of tax officials (Business Anti-Corruption Portal 2013).

#### **Patronage, nepotism and the revolving door**

Revenue authorities should have well defined appraisal systems that reward staff according to performance (based on agreed personal objectives beyond monetary collection targets), clear professional advancement opportunities based on merit and a clear career path, a sense of organisational belonging and professionalism, and competitive salaries commensurate with similar jobs in the private sector (USAID 2013).

However, corrupt officials often operate in informal networks of patronage composed of internal and external actors. These kinds of patronage networks based on ties of kinship or community may permeate the operations of tax administration, negatively influencing the appointment, selection, transfer and promotion of officials (Martini 2014). As well as undermining meritocratic practices, this will likely lower the quality of tax administration (Martini 2014).

Moreover, where an official has purchased their position with a bribe, they will have an incentive to recuperate the costs of their “investment”, perhaps by extorting a share of their staff’s salaries.

On the other side of the equation, former tax officers may be recruited by the private sector as they have insider knowledge on, and connections to, the operations of revenue authorities and can thus help game the tax system (Martini 2014).

### Client interface

At the level of service delivery and interaction between taxpayer and tax collector, there are a number of factors that can exacerbate the risk of corruption. Purohit (2007) notes that tax officers are typically allotted a particular geographical area of operations, meaning that for a given taxpayer, the tax officer is the tax department. This monopoly power gives tax officers the opportunity to provide “favourable” interpretations of government rules and regulations to businesses in exchange for illegal payments (Purohit 2007).

Other risk factors include the number of interactions between taxpayer and tax official, ignorance on the part of the tax collector about the tax code, inexperience dealing with more complicated cases, inadequate supervision, conflicts of interest and so on (McDevitt 2015). In turn, these can lead to various corruption risks.

### Collusion between tax officers and taxpayers

There is evidence that corruption in tax administration takes place in an organised manner with tax officials and taxpayers acting together to systematically evade taxes (Kabera 2008). In Ghana, for instance, the 2009 Global Corruption Report found that some high-ranking tax officials were covering up tax evasion and conducting secret dealings (Transparency International 2009).

Tax officials can abuse their position to issue unjustified tax exemptions, apply lower tax rates, and deregister individuals from the tax registers in exchange for bribes (McDevitt 2015). Such collusive schemes typically benefit both tax inspectors and taxpayers, to the detriment of the state coffers (Antonakas, Giokas, and Konstantopoulos 2013). In South Africa, for example, a customs official was convicted of corruption after being accused of receiving illegal payments in exchange for charging lower tax rates (United States Trade Representative 2014).

Illegal payments may also be made to tax officials to falsify claims for VAT refunds, make files disappear or to sell insider information about competitors. Bribes can also be paid to speed up processes or to hold back a competitor's business activities.

### Tax evasion committed by taxpayers

Taxpayers can abuse the complexity of tax laws to evade taxes by underreporting (or failure to report) taxable income/transactions, underreporting turnover, underreporting the value of imports, or over-reporting of expenditures (McDevitt 2015). Taxpayers may also seek to misclassify goods with high tax and duty rates into lower categories (McDevitt 2015).

## Extortion by tax officials

Tax officials might take advantage of taxpayers' lack of knowledge of tax laws and procedures to extort illicit payments from them or require them to pay above official rates (McDevitt 2015).

Alternatively, they might charge for services that should be free or for speeding up processes (to overcome complicated procedures or artificial delays) and to qualify for exemptions or duty free treatment (McDevitt 2015).

In situations where tax officials hold discretion to personally levy taxes, these officials may use these powers to coerce taxpayers into paying bribes or face being overcharged or suffering the consequences of being arbitrarily labelled a tax evader (Albisu Ardigo 2014).

## Further reading

### **Bribery and Corruption Awareness Handbook for Tax Examiners and Tax Auditors. OECD 2013.**

<http://www.oecd.org/tax/crime/bribery-corruption-awareness-handbook.htm>

This handbook is targeted to tax inspectors to provide them with tools and indicators to detect possible bribery or other forms of corruption in the course of regular tax examinations and audits.

### **CleanGovBiz Toolkit on Tax Administration. OECD July 2012.**

<http://www.oecd.org/cleangovbiz/toolkit/taxadministration.htm>

The toolkit for tax administrations comprises of a priority checklist to detect corruption, as well as an implementation guidance which is illustrated by a number of country case studies.

### **Tax Administration Diagnostic Assessment Tool (TADAT). IMF 2016.**

[http://www.tadat.org/files/TADAT\\_at\\_a\\_Glance\\_web.pdf](http://www.tadat.org/files/TADAT_at_a_Glance_web.pdf).

TADAT was developed by the IMF to produce objective, evidence-based assessments and baselines of a tax administration's performance. Among other areas, the tool assesses the external oversight of the tax administration, the level of internal controls, the public perception of integrity of the tax administration, and publication of activities, results and plans.

## External audits

Auditing is a central element of any accountability system, as it verifies and legitimises the information on the basis of which organisations are to be evaluated (Power 1997). Audits, when performed well, therefore help public institutions to act in accordance with the principles of accountability and integrity, improve their performance and earn the confidence of citizens (Assakaf, Samsudin and Othman 2018).

Most countries have established a supreme audit institution (SAI) to monitor the financial operations and performance of public sector bodies. International standards stipulate that supreme audit institutions should have the mandate to audit (Chêne 2018):

- the use of public money, resources and assets
- the collection of revenues owed to the government or public entities
- the legality and regularity of public institutions' accounts
- the performance of public institutions in terms of value for money

SAIs can take different forms, such as a national audit office, court of accounts or collegiate board (Chêne 2018). In addition, external audits of

organisations in receipt of public funds may occasionally be outsourced to private audit firms. This Helpdesk Answer therefore focuses largely on supreme audit institutions, but considers some additional integrity risks where private sector audit firms are involved.

SAIs are key components of the formal system of financial accountability in many countries. As the institution in charge of auditing government revenues and expenditures, SAIs act as a watchdog over the country's financial integrity with the mandate to assess whether public funds are managed in an effective and efficient manner in compliance with existing laws (OECD 2011). They are also tasked with ensuring that the government's reported financial data is credible and of good quality (World Bank 2001).

While the primary responsibility for the detection of corruption lies with institutions such as the police or anti-corruption agencies, SAIs have a role to play in uncovering malfeasance.<sup>5</sup> Indeed, auditors are experts in detecting fraudulent financial reporting that can conceal corrupt activities (Dye 2008). By focusing audit efforts on areas known to be susceptible to corrupt practices, such as public procurement, SAIs can assist other anti-corruption players by producing hard financial data.

Fraudulent or corrupt activities that auditors may encounter include falsified statements and claims, illegal bidding practices, tax and customs evasion, overpayment and non-delivery of goods and services as well as malpractice in the liquidation of public companies.

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<sup>5</sup> In fact, some studies show that SAIs are generally perceived as "guardians of the public interest" and often enjoy greater levels of citizen trust than other arms of government (Tara et al. 2016). As such, some scholars argue that this legitimacy positions them to

However, in many countries, the external audit process faces challenges of independence, transparency, resources, as well as lacking political will of the executive and the legislature to implement auditors' recommendations. SAIs can also face major capacity challenges, in terms of a lack of financial autonomy, human resources and expertise. This can pose particular difficulties where integrated financial management information systems (IFMIS) or performance auditing has been recently introduced, or where the number of organisations to be audited has grown rapidly (Morgner and Chêne 2015b). In some instances, SAIs are subject to limited oversight and not immune from risks of undue influence or corruption in their operations. Indeed, SAIs can be compromised by internal integrity failings, as well as by vulnerabilities in their interactions with other actors.

An external audit has several features that make it vulnerable to corruption, such as the politically sensitive nature of its mandate to provide an objective appraisal of the efficacy, management, governance and performance of public institutions. Corrupt elites inside government will have an incentive to curtail the operational freedom of SAIs if this is felt to threaten their ability to commit acts of grand corruption with impunity. This can result in political capture of a nominally independent agency, which can mean in turn that audits become a political instrument to harass opponents.

Further down the value chain at the level of organisational resources, staffing decisions at the SAI may be influenced by patronage networks, where loyal auditors do not look too closely into the financial dealings of their sponsor. At the level of client interface, collusion between auditors and the

promote transparency and ethical conduct in the public sector more widely (Dye and Stapenhurst 1998).

organisation they are auditing can lead to the facilitation or cover up of fraud and corruption by falsifying records and misrepresenting financial statements to disguise illicit activities (Wu 2005).

Finally, where private sector audit firms are involved, the nature of the relationship that auditors maintain with their clients can lead to additional conflicts of interest that undermine the independence and impartiality of auditing (Chêne 2017).

The following section examines corruption risk factors and risks in external audits in more detail at the three main stages of the value chain: policymaking, organisational resources and client interface. It is worth noting that, compared to value chains for other sectors such as healthcare, education or even tax administration, the area of external auditing is somewhat different in that it involves different arms of the state interacting with each other, rather than dealing directly with citizens to provide goods or services.

This has an impact on the type of corruption risks involved. Where a SAI is responsible for conducting an external audit on a public body, the greatest risks are likely at the level of policymaking (such as political interference) and organisational resources. Where a private audit firm has been contracted to conduct the audit, the greatest risk is one of conflict of interest at the level of client interface.

Moreover, the nature of the value chain will depend on the auditing model in question, be this the Westminster model, the judicial model, or the collegiate model. In the Westminster model, for instance, the SAI produces and submits its audit findings to a parliamentary body, such as a public accounts committee (PAC), which is not the case in the judicial model. Different models will thus have different vulnerabilities to corruption. For example, the collegiate model is believed to be more

susceptible to political interference than the Westminster or judicial models. For more information, see Chêne 2018.

Finally, the exact nature of the processes involved will depend on which type of audit is being conducted, be this financial, compliance or performance (Evans 2008):

- financial audits focus on providing a financial opinion on the annual accounts of public institutions
- compliance audits seek to verify the legality of the transactions made by public institutions
- performance audits that assess the efficiency and effectiveness of public institutions' use of resources

## Policymaking

At the policymaking level, several factors can facilitate corrupt practices. Where the independence of an SAI is not strongly anchored in legislation that provides it with a permanent mandate to audit public institutions, it may have less wherewithal to resist attempts to politicise its activities (INTOSAI Professional Standards Committee 2009). Alongside an adequate mandate, the level of independence an SAI enjoys is a key determinant of its ability to operate with integrity. Indeed, for an oversight mechanism such as an SAI to function adequately, it is crucial to separate its operational control from the ministry or other public body nominally subject to its supervision (Gustavson 2015). Likewise, the SAI should have clearly defined protocols for reporting to institutions like the parliament or head of state who are distinct from the bodies it is auditing, such as line ministries (INTOSAI Professional Standards Committee 2009).

The risk of conflict of interest during the conduct of audits will be greater when SAIs are not financed in a way that provides them a high degree of economic independence (INTOSAI Professional Standards Committee 2009). SAIs must necessarily exercise a degree of discretion during audits, such as which information to request and which decisions to take (INTOSAI Professional Standards Committee 2009). On the other hand, as the supreme body responsible for audit, if the integrity of the SAI itself is questionable, the lack of oversight or control mechanisms could pose a problem. This may be more likely in systems that adopt the Westminster model, where power is centralised in the position of auditor general, rather than dispersed among a number of members of a court of accounts (Chêne 2018). A lack of transparency can exacerbate the risks of malpractice. In many countries, SAIs do not publish their reports, limiting opportunities for public scrutiny (Morgner and Chêne 2015b).

Other characteristics of the external environment can exacerbate these risks. SAIs are typically reliant on other institutions, such as law enforcement, to pursue cases of corruption they have identified, and on parliament to ensure implementation of their recommendations. In the absence of a mechanism to ensure auditors' recommendations are followed up on, public SAI reporting alone has been found to be ineffective (Gherai, Tara and Matica 2016).

However, oversight of government finances and operations is performed poorly by parliaments in many countries. Parliaments in some countries are unable to ensure that their recommendations are acted upon by the executive, and the lack of enforcement mechanisms and incentives to impose sanctions is a major weakness of the external audit process (Morgner and Chêne 2015b).

Forms of corruption at this level could relate to political interference by the executive and other arms of the state, as well as undue influence over auditing regulation on the part of private audit firms. In settings where an SAI is effectively controlled by a self-serving elite, it can play a role in ostensibly legitimising corrupt transactions, allowing corrupt officials to siphon off their ill-gotten gains. Likewise, private audit firms have played dubious roles in facilitating secret tax agreements and murky offshore transactions for politically exposed persons and multi-national corporations, allowing them to slash their global tax bills (the Guardian 2014). Leaked papers showed how these companies used complex webs of financial structures, internal loans, interest payments and inventive profit-shifting strategies to secure drastic tax reductions. Revealingly, all of the “big four” accounting firms have been identified as international intermediaries in the Panama papers (Vella 2017).

Private audit firms may also seek to exert undue influence over legislation regulating the industry through the use of lobbying or the revolving door. For example, the big four accounting firms have reportedly lobbied against giving national tax authorities more powers to demand information on global corporations' activities around the world. Revolving doors between governments and accounting firms are seen to further undermine efforts by government to scrutinise auditing activities or its ability to effectively reform laws regulating the accounting industry (Zulkarnain and Shamsher 2007; International Consortium of Investigative Journalists 2014).

Even when enacted, reforms of accounting standards are not always enough to change accounting practices, due to implementation challenges and the incentives of the various stakeholders. Firms may lack incentives to improve

the quality of financial reporting as they can benefit from lax rules for tax evasion purposes, while corrupt officials tolerate the manipulation of accounting information as it provides them with opportunities for extortion. In Asia, for example, there are major disparities between accounting standards in place and their implementation. A study shows that while 50% of firms use international accounting standards and 60% hire external auditors to audit their financial reports, only 34% report all of their sales for accounting purposes (Wu 2005).

### Organisational resources

Financial and administrative autonomy is also key to ensuring the independence and impartiality of SAIs. Factors that could leave opportunities for corruption could arise from the lack of human, technical and financial resources and capacity that SAIs require to carry out their duties in a professional, independent and impartial manner (Morgner and Chêne 2015b). Indeed, where there is external interference in operational decision making, such as the appointment or removal of staff, it will be much harder for SAIs to fulfil their mandate.

In many low-income countries where training programmes are underfunded or non-existent, the quality of professional accountancy education is generally low (Everett, Neu and Ramahan 2007). Beyond educational requirements, external auditors need training and other awareness-raising activities to be made aware of weaknesses in internal controls and high-risk accounts that provide opportunities for corruption, such as procurement, loans, petty cash, credit card expenses and accounts receivables. They should also be provided with guidance on how to react when management repeatedly ignores irregularities and weaknesses, which could indicate a deliberate

intention to commit fraud and corruption (Kassem and Higson 2016).

Corruption might be more normalised in settings where there is an absence of operational guidelines or codes of conduct outlining expected standards of integrity, objectivity, professionalism, confidentiality and independence (Chêne 2017). In fact, audit standards should treat corruption not only as a type of internal fraud that can have an impact on the financial statement but also as an illegal act and provide guidance on how to assess and respond to corruption risks (Chêne 2017).

### Client interface

Risk factors at the client interface include the establishment of close bonds between auditors and the organisations they are auditing. This is particularly the case for the private sector, where recent scholarship has highlighted the “impossibility” of an unbiased custodian relationship between audit firms and their clients, pointing to the transactional nature of the arrangement in which a clean audit report is provided in exchange for a fee (Moore et al. 2006; Mitchell and Sikka 2011; Bazerman et al. 1997; Kassem and Higson 2016). Issuing a modified audit report would likely damage the relationship with the client and reduce the probability that the audit firm’s services will be retained in the future. This is especially problematic where audit firms are simultaneously providing lucrative consultancy services to the bodies they are auditing. This profit-making rationale can provide accountancy firms with incentives to offer services to their clients that raise legal and ethical questions, such as facilitating the use of the offshore financial system to minimise multi-nationals’ tax payments (International Consortium of Investigative Journalists 2014).

For public sector auditors too, there are interpersonal dynamics that have the potential to

develop into collusive relationships designed to obscure illicit behaviour. This is why the professionalism of the officials conducting the oversight activities is such an important determinant of the effectiveness of audit institutions. Indeed, this can be somewhat of a vicious circle, as a lack of expertise creates greater dependency on the body being audited and reduces opportunities to be critical with regard to the information obtained through the audit process (Gustavson 2015).

Where external auditors effectively become “embedded” into the institutions they are auditing, conflicts of interest may arise. One way to address this is the introduction of mandatory rotation, so that no one auditor stays in any particular institution for too long (Clikeman 2013; Tysiac 2014).

Where corruption does occur at the client interface, auditors can be influenced by outright bribery or conflicts of interest to produce misleading financial statements intended to misrepresent expenses and assets and disguise corrupt and fraudulent practices like money laundering (Otalor and Eiya 2013). External auditors from Deloitte, for instance, allegedly helped a British bank violate sanctions against Iran, submitting a softened report to regulators that omitted information on the bank’s avoidance of money laundering controls (International Consortium of Investigative Journalists 2014).

## National statistics

According to Eurostat (2018), national statistical systems (NSS) typically consist of the national statistical institute (NSI) and any other institutions and administrations that produce official statistics. An effective and efficient national statistical system that provides regular and reliable data is an essential element for good governance as they help governments improve their policies and to be

transparent and accountable about the delivery of development results.

In developing countries, reliable statistics are a key element towards better measurement, monitoring and management of the results of development assistance, but many of them still have weak statistical systems and mechanisms for measuring results (NORAD 2015). Good, reliable statistics are essential for measuring progress in reaching development goals. They help identify targets, monitor outcomes, design development policies and strategies and inform decision making. Statistics can also serve as the basis for predictions and to test hypotheses or develop new theories and are essential building blocks of sound economic policy (Seltzer 2005).

The importance of official statistics for economic and social and development policy means also that this data might have political or financial consequences for a country. The academic literature argues that poor economic performance can be a great threat to both authoritarian and democratic regimes. In authoritarian regimes, economic downturn can strengthen the calls for democratisation (see Wallace 2015; Geddes 1999; Gandhi 2008; and Acemoglu and Robinson 2005). In the case of democratic governments, economic data becomes a way to avoid losing votes for unsatisfying economic performance. Voters’ tendency to focus on economic issues during electoral periods provides incentives for the incumbent government to falsify economic statistics.

Countries where “election-motivated” data manipulation has occurred include Argentina, Russia, Turkey, Mexico and the United States (Healy and Lenz 2014). In the case of Argentina, the government of Cristina Fernández was reported to continuously falsify data to keep citizens’

support, even though the fake data cost the country billions of dollars (the Economist 2013). According to Wallace (2015) this is because “manipulating economic data might hide the extent of an economic downturn until government policy can ameliorate the situation, allowing the regime to survive a particularly vulnerable moment”. Moreover, it might bring political gains for the regime: “while data manipulation may be expensive in the long run, loss of credibility is damaging for a leader or regime only if it believes that it will be the one that has to pay those costs. However, if a regime believes that its very grasp on power is no longer certain, then it might be willing to engage in extraordinary behaviour” (Wallace 2015).

In addition to political manipulation, the required technical capacity and technological infrastructure to guarantee the integrity of national statistics can be a challenge for many countries, particularly developing ones. In the case of Cambodia, for example, allegations of corruption in official statistics came to light as recently as 2016 when a US\$750 million discrepancy was uncovered between the country’s documented sand exports and Singapore’s recorded imports (Willemys and Dara 2016). According to the UN Commodity Trade Statistics Database, between the years of 2007 and 2015, the Cambodian authorities reported exporting US\$5.5 million worth of sand to Singapore. However, the database shows for that same period, Singapore imported US\$752 million in sand from Cambodia. Some observers have pointed at corruption as the source of the discrepancy (Handley 2016).

Other ethical and corruption-related challenges in the field of statistics include:

1. the reliability of the statistical methods being used: although technically sound science is not necessarily ethical science,

the failure to use sound technical methods can be so flagrant or long-standing as to present serious ethical issues. In official statistics, this sort of situation may arise when a seriously flawed or outdated methodology continues to be used by an agency long after its shortcomings have been identified and alternative approaches explored, but for inappropriate reasons (for example, political pressures), the flawed approach remains in use, sometimes for decades.

2. the absence of appropriate quality control: official statistics are created in a world of deadlines and limited resources. Also, as in any scientific endeavour, the process uses imperfect methods and data. Indeed, a sound statistical system benefits from studying its mistakes, examining ways of overcoming them, and over time introducing needed improvements.
3. protection of confidentiality: the protection of confidentiality is a way to ensure that the parties reporting the data do so accurately without fear of competing businesses, journalists or other government agencies gaining access to the information they provided, except as statistical aggregates. Legal protections relating to statistical confidentiality are thus essential.

The OECD (2015) sees the independence of statistical offices as a good practice to guarantee the quality and reliability of data. Lack of independence can result in threats to the integrity of the agency in a number of ways (see Seltzer 2005), including: arbitrary political manipulation of concepts, definitions, and the extent and timing of the release of data, doctoring the actual data released, using the agency for political analysis or other political work and politicising agency technical staff.

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## **Keywords**

Corruption risk assessment – tax administration - external audit - statistics

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