



Corruption and Tax Evasion: Economic Dimensions

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Introduction

Corruption is one of the most destructive phenomena in the establishment of a sovereign state and a democratic society. This phenomenon has a negative impact on the cultural, social, political, democratic, economic spheres and on the state security.

The economic impact of corruption is most obviously observed. Corruption hinders the entrepreneurial initiative and discourages investments, distorting the mechanism of the economic competition and putting companies in unequal conditions. These conditions decrease income to the local and central budgets. The shortage of financing to the budget manifests in the state's incapacity to offer a decent remuneration to the public officers, to support the vulnerable layers of the society, to carry on social, educational and public health protection programs. In this case we deal with the social impact.

Corruption has a negative effect on the political and democratic values of the state, expressing the interests of relatively narrow groups of people who impose their will on the whole society avoiding the legal channels.

The cultural and human impact shows in the degradation of the society's ethical values and the increasing tolerance towards this phenomenon, which contributes to its continuous spreading.

Corruption diminishes the credibility of the state institutions and destroys the dialogue between the civil society and the state. It generates an atmosphere of disrespect and legal nihilism, which presents a danger to the state security.

The study under consideration has the goal of evaluating the economic impact of corruption in public sector on the business environment in the Republic of Moldova, as well as to explore proposals on creating a more favorable business environment.

1. The Impact of Corruption on the International Scale

1.1. The Impact of Corruption in the Advanced Market Economies

It should be mentioned that the corruption phenomenon is rather

widespread not only in

developing

countries, but

also in the states

with well-

developed

economies. The

report “Facing up

to Corruption”,

2002, by *Control*

Risks Group,

presents an

analysis of this

problem for such

countries as

Germany, Hong

Kong, Holland,

Singapore, Great

Britain and the

United States of

America, which are known to have a rather low

level of corruption. It is seen from the data in the report that even

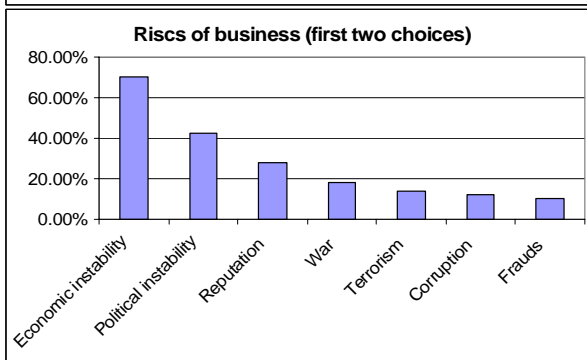
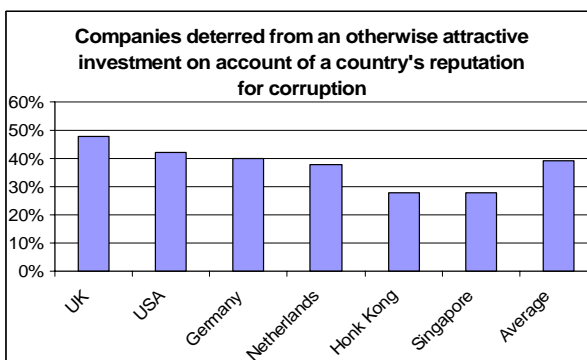
in these countries, corruption creates difficulties and presents an

obstacle for business and investments.

Thus, the manager of one out of every eight companies considers

corruption to be the main risk for the development of enterprise

activity in these countries.



United States of America, which are known to have a rather low level of corruption. It is seen from the data in the report that even in these countries, corruption creates difficulties and presents an obstacle for business and investments.

Thus, the manager of one out of every eight companies considers corruption to be the main risk for the development of enterprise activity in these countries.

According to the study, about 48% of British companies, 42% of the American and 40% of the German companies refrained from investing in the countries with a bad reputation for corruption.

Corruption

presents an obstacle, not only for starting business activity and for penetrating the market, but for further economic activity as well. The data shows that in the years 2001-2002 the managers of more than half of the

enterprises that went bankrupt in Hong Kong and Singapore consider the fact that the competitors paid bribes to be the main reason for their bankruptcy. In the Netherlands and Germany this was the cause of bankruptcy in about a quarter of the enterprises. In the USA and Great Britain corruption was the cause of bankruptcy in 20% of all cases. Considering the type of activity, the enterprises that have been most frequently affected

are those offering public services, construction, as well as pharmaceuticals and healthcare.

Companies that lost business because a competitor paid a bribe

	In the last 12 months	In the last 5 years
Honk Kong	56%	60%
Singapore	52%	64%
Netherlands	24%	40%
Germany	24%	36%
USA	18%	32%
UK	16%	26%
Average	27.20%	39.20%

Companies that lost business because a competitor paid a bribe

	In the last 12 months	In the last 5 years
Public works, construction	40.40%	55.80%
Pharmaceutical/medical ca	28.60%	35.70%
Telecoms	27.30%	40.90%
Oil, gas and mining	26.10%	43.50%
Banking and finance	24.10%	34.20%
Retail trade	21.40%	28.60%
Defense	20%	30%
Power generation	18.80%	31.30%

Source: *Facing up to Corruption 2002, Control Risks Group*

Anti-corruption management practice

	Companies with programs to train executives in ways of avoiding corruption	Companies where senior managers sign annual compliance statements	Companies with confidential hotlines
UK	44%	42%	32%
USA	68%	52%	34%
Germany	26%	14%	14%
Netherlands	38%	32%	28%
Singapore	12%	8%	4%
Honk Kong	28%	8%	8%

Source: *Facing up to Corruption 2002, Control Risks Group*

In order to prevent corruption, companies have strict prohibition against bribery. The regulations of 94% of British companies, 92% of US companies and 84% of German and Dutch companies contain this categorical prohibition.

More than one half of the US companies and over 40% of the British ones provide corruption prevention programs for their employees and there are also written procedures in which the managers of each company are expected to report to their employees how they comply with regulations.

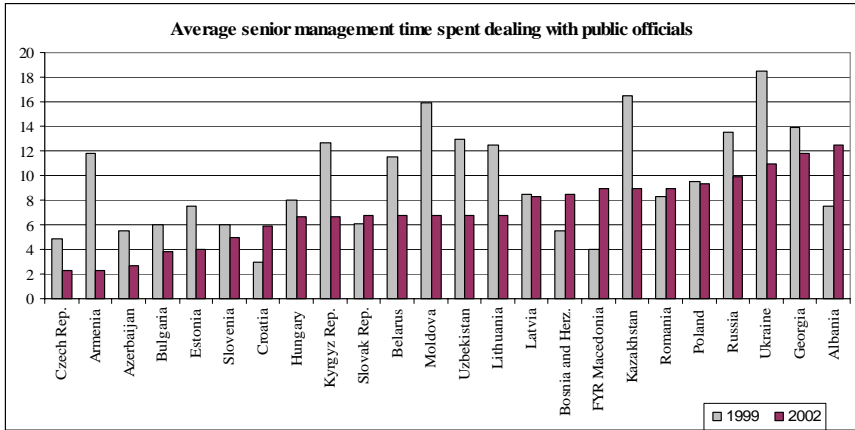
About one third of the companies have confidential hotlines where the employees may report on cases of conflict of interest and breaking of regulations. The state institutions take many measures for preventing corruption in the public sector and that is why they are successful in preventing corruption.

The question arises: if the impact of corruption is so destructive in the countries with stable market traditions, then what is the situation with the developing countries?

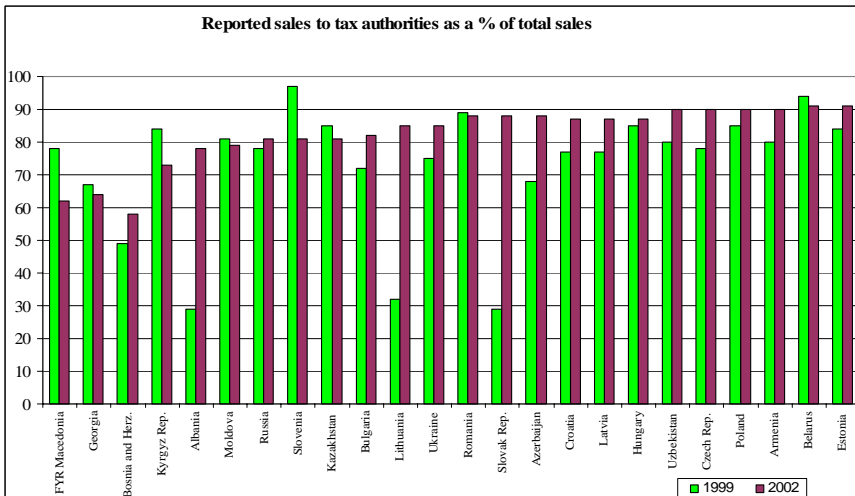
1.2. The Economic Impact of Corruption in Countries in Transition

There are a number of studies that attempt to quantify the economic impact of corruption. One such study is the EBRD Transition Report 2002. According to this report, starting with 1999, in the region of countries in transition, the business environment improved significantly and this is due not only to the ascending economic cycle, but also to a range of measures that have been taken to support the private sector. According to the authors, there are three key-factors for successful public sector reform. First, liberalization of the economy and free markets generate a demand for economic institutions that support the enterprises through efficient policies and practices. Second, market competition must be accompanied by political competition. Third, the transition process takes place in the

framework of international integration and all possible measures are taken for eventual accession to the European Union.



The data from this study shows that in the majority of the developing countries, the time spent by the enterprise managers solving problems with state officers diminished considerably. Although these results refer to big joint companies, which are very few and do not reflect the situation of the majority of enterprises from the country, in Moldova there has been marked progress – from 16% of the total time in 1999 to 7% in 2002.



Concerning the frequency and the dimensions of bribes paid by companies to state officials in the year 2002, Moldova ranked on an intermediary position among the developing countries. About one third of the companies declared that in order to continue their business activities, they have to pay bribes frequently. The total volume of bribes decreased from 3.2% of total income in 1999 to 2.1% in 2002.

Frequency and extent of the "bribe tax"

	% of firms making bribes frequently		Average bribe as % of annual revenues	
	1999	2002	1999	2002
Albania	46.7	36.4	1.7	3.3
Armenia	40.3	14.3	4.2	0.9
Azerbaijan	59.5	27.5	3.7	2.7
Belarus	14.8	24	1.6	1.5
Bosnia and Herz.	20.5	22.4	2.1	0.9
Bulgaria	23	32.8	1.3	1.9
Croatia	17.7	12.9	0.6	0.6
Czech Republic	26	13.3	1.7	0.9
Estonia	12.9	12.1	0.9	0.3
FYR Macedonia	33	22.7	1.4	0.8
Georgia	36.8	37.8	3.5	2.7
Hungary	32.3	22.6	0.9	1
Kazakhstan	26.1	29.7	1.9	2.1
Kyrgyz Rep.	28.2	43.7	2.4	3.7
Latvia	22	17.9	0.9	0.9
Lithuania	23.2	20.6	1.6	0.7
Moldova	34.4	34.3	3.2	2.1
Poland	33.2	18.6	0.7	1.2
Romania	50.9	36.7	1.7	2.6
Russia	30.6	38.7	1.7	1.4
Slovak Republic	33.6	36	1.3	1.4
Slovenia	7.7	7.1	1.4	0.8
Ukraine	39.1	34.9	3.1	2.2
Uzbekistan	46.2	20.2	2.5	1.5

Source: *Business Environment and Enterprise Performance Survey, 2002*

Unfortunately, in 2002 in Moldova, the rate of sales reported to fiscal authorities as compared to total income decreased slowly and constituted less than 80%. This is the same as Georgia, Kyrgyzstan, Kazakhstan and Belarus. Keep in mind that in this study we deal with selective enterprises which are doing better than average.

What are the causes of such low development of the private sector in the Republic of Moldova? To answer this question, we have resorted to a more thorough study of the impact of the state

administration and corruption on the economic development in the Republic of Moldova.

This study includes an analysis of the impact of state regulation on the economic activity in the Republic of Moldova in the years 2001-2002. We have evaluated the costs of companies to satisfy the requirements of the state, the transparency of legislative procedures, the administrative barriers in business activity and the threats of corruption.

2. The Impact of the State Administration on Economic Development at National Level

The main purpose of this study is to determine the impact of the state regulatory process and of corruption in state institutions on the economic development of the Republic of Moldova in the years 2001-2002 at national and local level. Particularly, the main points of this study are the following:

- Evaluation of the pressure exerted by corruption in public sector on national economic development, including the evaluation based on economic sectors and types of companies.
- Comparative analysis of the costs of “voluntary” and unofficial payments (bribes) with the state regulatory costs borne by the economic units on the national and local levels, as well as the main domains of state regulation.
- Evaluation of the situation regarding tax evasion; studying the connection between corruption and tax evasion.
- Specific recommendations for preventing corruption in the public sector in order to improve the entrepreneurial environment in the country.

The study includes the analysis of the changes that occurred during the last year and evaluates the impact of state administration on the country's economic development.

For this study we have used data obtained as a result of face-to-face interviews carried out in 630 enterprises in the framework of the World Bank's survey "Costs of Business", 2003, data from the Department for Statistics and Sociology and those of the central public institutions. For comparing the results of study with those from other countries, we have used the results of the World Bank's report "The Business Environment of Western CIS: Belarus, Moldova, Ukraine", 2003.

The official and unofficial costs have been estimated for the principal state regulatory procedures, as well as for all types of enterprise including legal entities and physical persons. The costs for state regulations have been determined for the entire country, as well as for the regions. The total costs for state administration borne by the enterprises in order to satisfy the state's regulatory requirements have been assessed by totaling the costs of enterprise registering, licensing, construction, certification of conformity to the national standards, sanitary authorizations, import-export authorizations, customs procedures and state inspections. The costs due to every regulatory procedure have been assessed using the data on unitary state regulation costs reported by the interviewed enterprises and the data of public organizations referring to the number of enterprises, of various authorizations emitted by state institutions, and the number of enterprises inspected by the state institutions.

The period analyzed includes the years 2001-2002. We have used the National Bank's currency rate of exchange: 1999 – 10.5242 MDL for 1 USD, 2000 – 12.4334, 2001 – 12.8668, 2002 – 13.5730 MDL for 1 USD.

2.1 Indicators of the Impact of State Administration

Entrepreneurs must receive various legal authorizations, licenses, certificates and other permits from central and local authorities or other specialized organizations to:

- start up an economic activity;
- produce goods;
- sell goods and render services;
- build or put into operation new buildings, renew or reconstruct buildings, or put them into operation, as well as install certain types of equipment;
- import and export goods and services, etc.

The conditions of companies' activity determine the business environment. Quality is revealed by the amount of money and time spent by economic units to carry out the state regulatory procedures. The state regulatory costs incurred by economic units have a direct proportional impact on the enterprises' costs of economic activity and, in the end, on the country's economic growth.

The impact of the state administration on the economic activity has been determined on the basis of the following indicators:

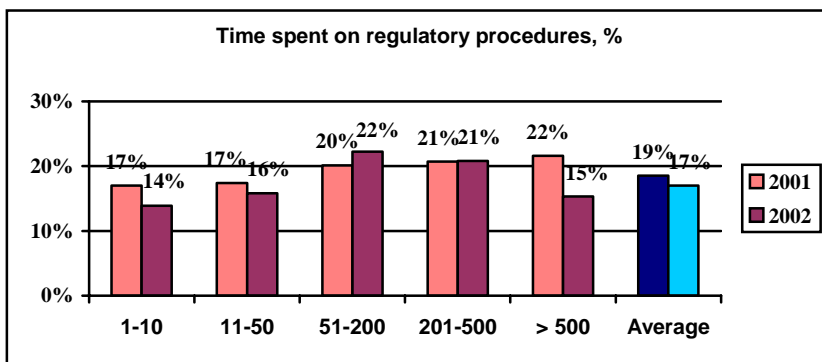
- the time spent by economic units to meet the state regulatory requirements;
- the total costs, including the formal and informal costs incurred by economic units to meet the state regulatory requests;
- the share of the state regulatory costs incurred by economic units in the main macroeconomic indicators: GDP, net sales, revenues of the consolidated budget;

- transparency of the state regulatory procedures and corruption.

The formal costs include the taxes and payment for the services provided by public institutions, expertise and evaluations, notary, and legal, as well as other types of services to meet the state regulatory requests. The informal costs include the informal payments (bribes), “volunteer contributions” (the “benevolent” payments incurred by enterprises for philanthropic purposes, sponsorship, etc), fines and financial sanctions, seizure and other types of confiscation, the losses borne by economic units as a result of interventions from public bodies.

2.2 Time Spent to Meet the Regulatory Requirements

The research has revealed that in 2002 the management of economic units used on average 17% of their time to meet the state regulatory requests, in comparison with 18.5% in the previous year.



According to the results, the small enterprises, with less than 50 employees, spend less time for regulatory procedures, because they are less subject to state regulations in comparison with the medium and large and state owned enterprises. The large enterprises, that have managers specializing in state regulatory procedures, also spend less time for these procedures.

2.3 The Costs Incurred by Economic Units to Meet the State Regulatory Requirements

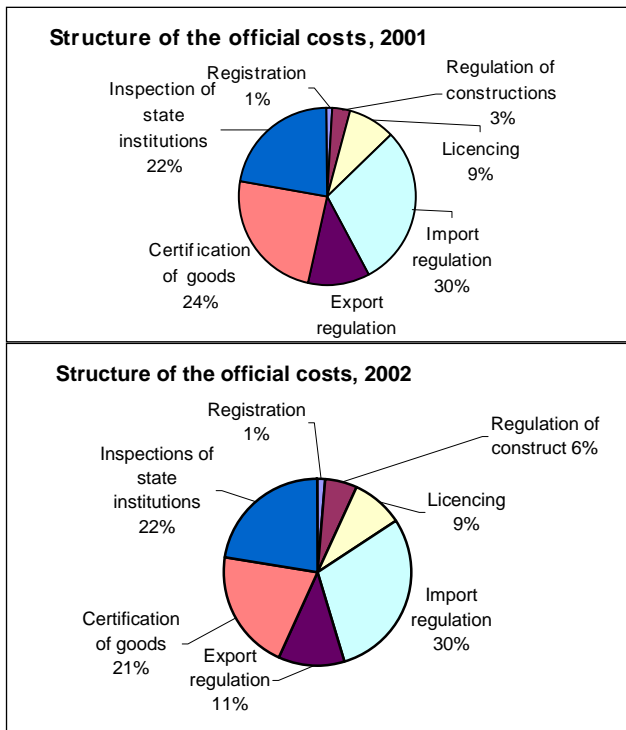
The analysis of total costs, both formal and informal, of the state administration incurred by economic units to meet the state regulatory requests proves that in the year 2002 the economic units incurred costs in the order of 76.8 million USD to receive authorizations issued by central and local state bodies and other specialized organizations.

The state administration costs incurred by economic units

	U/M	2001	2002	2002 / 2001,%
GDP	Mil. USD	1480.7	1623.8	9.7
Total costs of state regulation	Mil. USD	67.3	76.8	114.0
Official costs of state regulation	Mil. USD	54.2	60.9	112.4
Unofficial costs of state regulation	Mil. USD	13.1	15.8	120.7
Unofficial costs to the official costs	%	25.2	26.0	1.8

The structure of official costs changed some during 2001-2002.

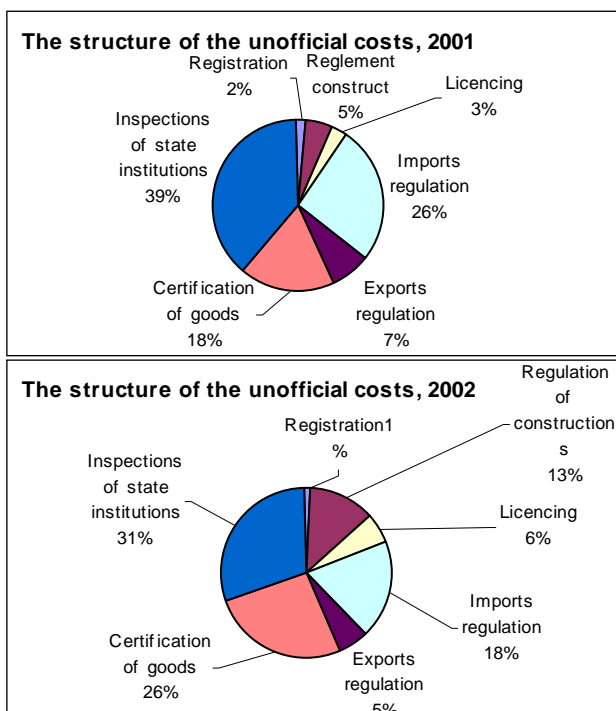
The companies bear the highest costs for the import of goods (29% of the total formal costs), followed by the costs of inspections carried out by state



institutions (22%) and the costs for certification to the national standards (21%). The official costs incurred by economic units for other types of state regulation have a more reasonable share, and namely: for export authorizations and customs procedures – 11%, for licenses – 9%, for building authorizations – 6%, start-up costs – 1% of total official costs. The share of building-related regulation costs has increased in the structure of official costs.

The unofficial costs are correlated with the formal costs of state administration.

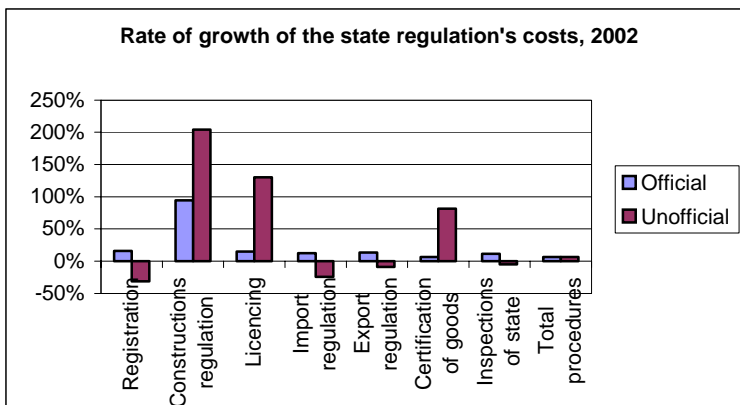
The highest unofficial costs borne by companies are as follows: the costs of inspections carried out by state institutions (31% of the total informal costs), certification of goods to the national standards and authorizations (26%), import of goods (18%) and building regulations (13%). Other unofficial costs incurred by companies have a smaller share, and namely: licensing – 6%, export authorizations and customs procedures – 5%, start-up costs – 1% of the informal costs. The share of costs related to building regulation, certification and licensing has increased within the structure of unofficial costs. This reveals an



increase in the level of corruption in these areas of state regulation.

There is an upward trend in the evolution of the state administration costs during 2001-2002, which is bigger than the growth of GDP. The economic growth in Moldova in 2002 constituted 7.2% in national currency in real terms or 9.7% in US dollars. The total costs incurred by companies to meet the state regulatory requests increased by 14%, when compared to 2001, as a result of the increase in formal costs by 12% and the increase in informal costs by over 20%. Unofficial costs related to the state regulatory procedures increased at a higher rate than formal costs. It follows from this analysis that an increase in the price of services provided by state bodies causes an increase in informal costs.

The change of the official and unofficial costs related to state regulatory procedures incurred by economic units in 2002 in comparison with 2001, represented by the annual growth rate, reveals that in 2002 the official costs incurred by economic units to meet the state regulatory requests had positive rates for all types of state regulation. The unofficial costs incurred by economic units increased considerably for three state regulatory procedures, namely building regulation, licensing and certification of goods.



At the same time, the informal start-up costs, and the informal costs related to import and export regulation and inspections by state bodies have diminished. This reveals that the measures carried out by the Government slightly diminished the corruption in these fields of state regulation.

2.4 The Share of State Regulatory Costs in Macroeconomic Indicators

The impact of state administration costs on the activity of the companies is characterized by the share of the state regulation costs in the main macroeconomic indicators.

The impact of state administration on the main macroeconomic indicators

Share in %	2001	2002
Total costs to GDP	4.55	4.73
Total costs to net sales	2.07	2.18
Total costs to the revenues of the consolidated budget	20.04	20.49
Formal costs to GDP	3.66	3.75
Formal costs to net sales	1.66	1.73
Formal costs to the revenues of the consolidated budget	16.13	16.26
Informal costs to GDP	0.89	0.98
Informal costs to net sales	0.40	0.45
Informal costs to the revenues of the consolidated budget	3.91	4.23

The impact of state regulation on the national economy, in terms of costs incurred by economic units, is substantial. The share in GDP amount at about 5%, in net sales – at about 2%, and in the revenues of the consolidated budget – at over 20%. There was an upward trend in the share of the formal and informal costs in the macroeconomic indicators.

2.5 The Burden of State Regulation at the National Level

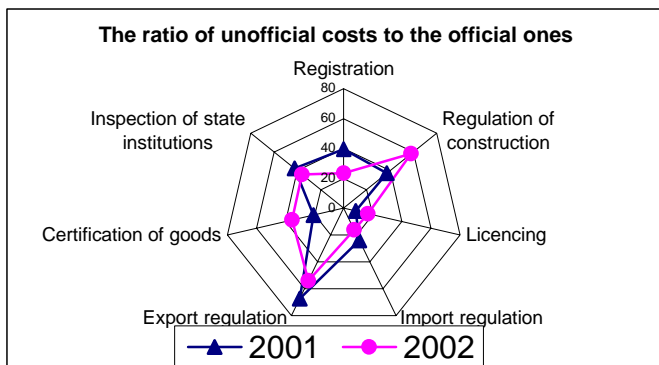
In this study the burden of state regulation was computed as a ratio of unofficial costs to official costs incurred by companies to meet the state regulatory requirements. The positioning of this indicator by types of state regulation was determined through the computation and comparison of two indicators. The first is the ratio of unofficial costs to the official ones, which determines the position of each state regulation. The second is the structure of informal costs by type of state regulation, which determines the position of each state regulation.

The ratio of unofficial costs to the official ones is high, at the national level. The ratio of unofficial costs to the official ones is substantial (about 26%) on the average.

The ratio of informal costs to the formal ones

	2001		2002	
	%	Position	%	Position
Registration	39.7	2	23.6	4
Regulation of construction	37.2	3	51.5	1
Licensing	8.4	7	16.8	5
Import regulation	21.6	4	16.4	6
Export regulation	14.9	6	12.6	7
Certification of goods	18.2	5	32.3	3
Inspections carried out by state institutions	42.3	1	36.1	2
Total	24.2	x	26.0	X

In 2002 the data revealed a substantial increase in the level of corruption in the field of



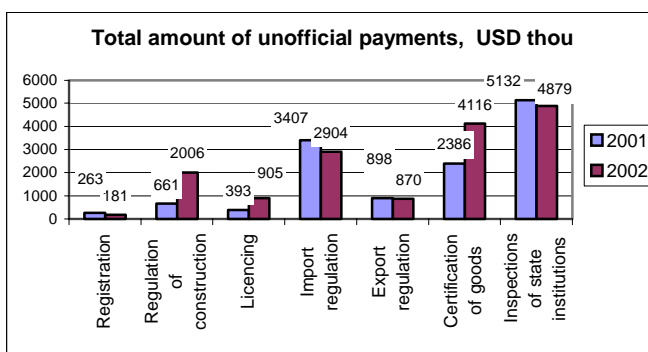
construction, where the ratio of unofficial payments to the official ones reached 52%. In addition, it is worth mentioning that the corruption level is very high in the field of state inspections, with a share of 36%. In 2001, the inspections carried out by state institutions had a share of 42%.

Structure of unofficial costs, %

	2001		2002	
	%	Position	%	Position
Registration	2.0	7	1.1	7
Regulation of construction	5.0	5	12.6	4
Licensing	3.0	6	5.7	5
Import regulation	26.0	2	18.3	3
Export regulation	6.8	4	5.5	6
Certification of goods	18.2	3	26.0	2
Inspections carried out by state institutions	39.0	1	30.8	1
Total	100	x	100	X

The amount of informal costs borne by economic units has the following distribution by the type of state regulations. The inspections carried out by state institutions are the most costly, being frequent and many receive large amounts of financial and material resources from entrepreneurs.

During 2001-2002 the institutions charged with import regulation and certification of products to the national



standards were placed second. The shift of imports, in the year 2002, from the second to the third position was not caused by the

diminution in the unofficial costs related to import authorizations and procedures, but by the increase in the official costs related to the introduction of pre-shipment inspection of imported goods, fact that generated official costs for importers. As mentioned by the interviewees, the latter have not been followed by unofficial costs.

The high unofficial costs of product certification is explained by the fact that it is necessary to certify according to the local standards of production, sale, or import of goods. The certificates are issued by various state bodies and organizations charged with such functions by state authorities. The specialized laboratories also issue certificates. In the opinion of the interviewees, almost every product line is certified, even when the products have been certified by the foreign producers.

The bodies charged with regulation of construction, or the local public authorities that issue urbanism certificates and building authorizations are placed second with respect to the amounts of unofficial payments. These are the most expensive procedures for getting an authorization. Given the low level of investment in the national economy, there are few works of construction and reconstruction, and respectively, the amounts of informal payments borne by economic units, though on the upswing, are still modest if compared to the first three types of state regulation.

Other types of state regulation, such as licensing, export regulation and registration of enterprises rank last by the amount of unofficial payments made by economic units because enterprises do not have them annually.

The unofficial costs consist of unofficial payments (bribes) and the “volunteer contributions”, paid “benevolently” in form of sponsorship to public authorities. Enterprises are forced into such costs by local authorities, sometimes without introducing them into the accounting records. The companies are forced to make “voluntary contributions”, especially on the eve of holidays. The

share of the “voluntary contributions” accounts for 16%, being sizeable in case of building authorizations and licensing, bribes constitute 84% of the total unofficial costs.

Taking into account the aforementioned, we draw the following *conclusions*:

- the heaviest burden of state regulation and corruption are registered during inspections carried out by state authorities, being followed by the regulation of imports;
- the burden of state regulation and corruption increased in the fields of construction, licensing and certification to national standards;
- the level of corruption during the registration of enterprises and export regulation decreased.

3. The Impact of State Administration at the Regional Level

The impact of the state administration on economic activity at the regional level has been analyzed on the basis of the following indicators:

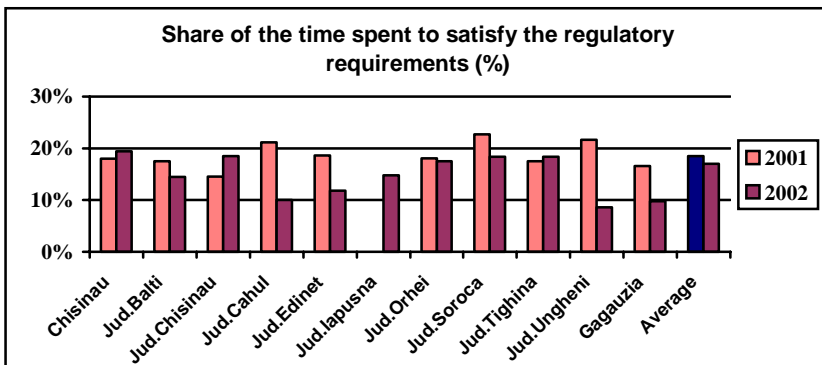
- The time spent by companies to meet the state regulatory requirements;
- The official and unofficial costs incurred by companies by types of state regulation carried out by regional and local public authorities;
- The burden of overregulation is characterized through the ratio of unofficial costs to the official ones and positioning of regions according to this indicator.

The positioning of the costs of state regulation is valid for the types of state regulation carried out by local public authorities and field offices of the central public institutions. These institutions have a big share in the inspection of companies,

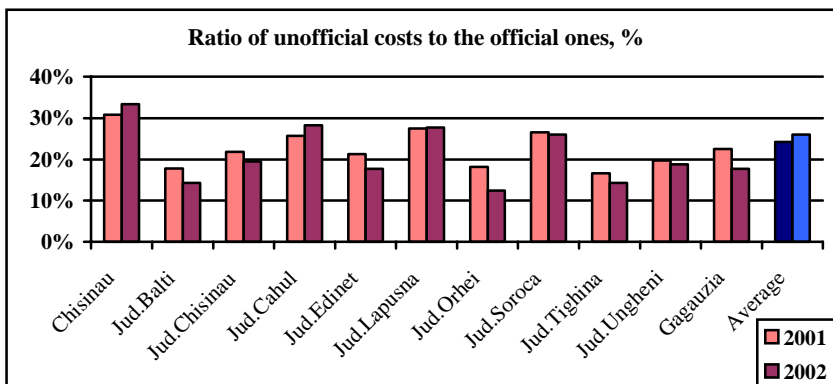
issuance of licenses, construction authorizations, certificates of conformity to local standards, sanitary authorizations and registration of companies. It is irrelevant to assess by region the costs of import and export regulations, as these procedures are conducted by central public authorities and customs offices. Therefore, at the regional level we have evaluated the start-up costs, licensing costs, the costs of obtaining sanitary certificates and authorizations of inspections carried out by state institutions. The costs of Construction Regulation haven't been assessed by regions as the number of enterprises that have obtained authorizations for construction in each region is too small and cannot be regarded as objective data. It is necessary to conduct an additional opinion poll so as to obtain veridical data with respect to the costs of Construction Regulation at the regional level.

3.1 The Time Spent to Meet the State Regulatory Requirements

The amount of time necessary to meet the state regulatory requests in 2002 varies by region, unlike 2002, when time spent was quite similar in all regions. In some regions there was a registered diminution in the time spent by entrepreneurs to carry out regulatory procedures (Ungheni, Cahul, Gagauzia TAU, Edinet). The companies from the city and county of Chisinau had spent more time complying with state regulatory procedures.



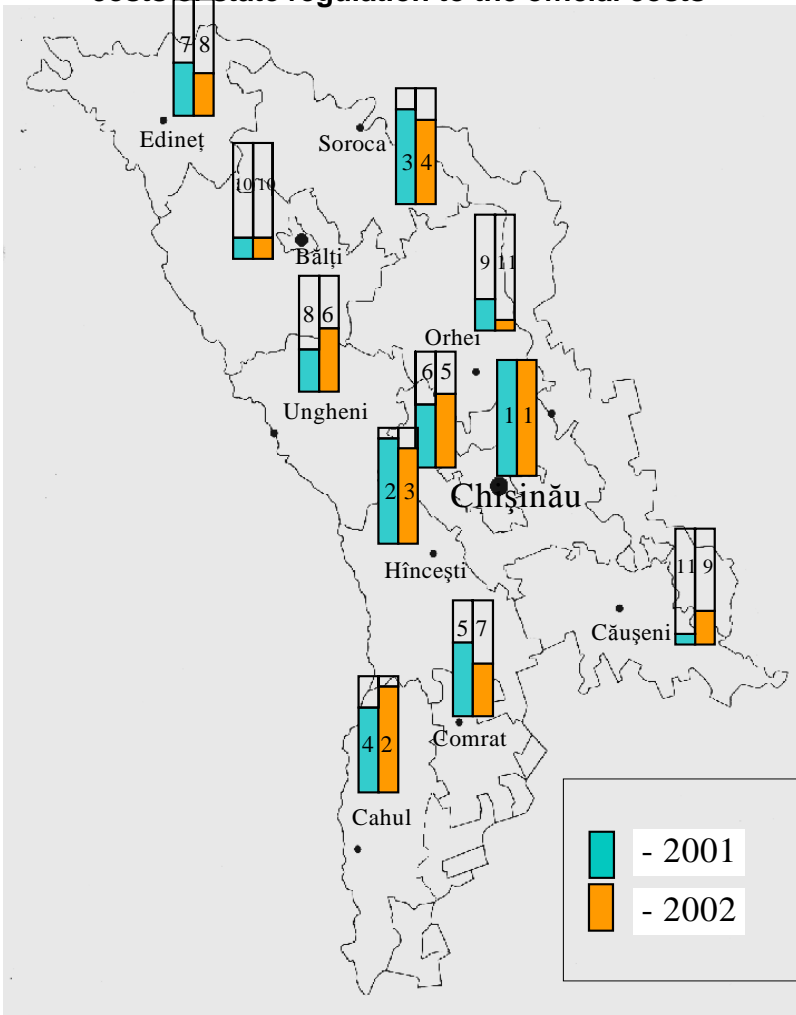
3.2 The Unofficial Costs of the State Regulation by Regions



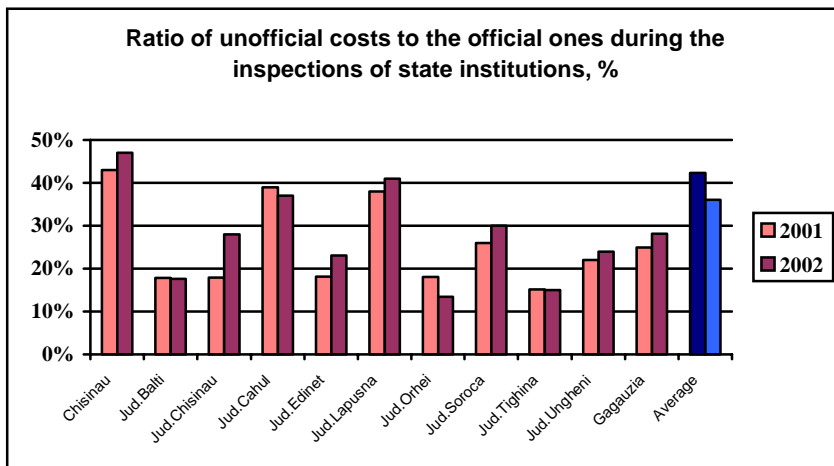
The burden of unofficial payments has been computed as a ratio of the informal costs to the formal ones related to the state regulatory requests. The costs incurred by companies have been assessed for the city of Chisinau, the counties and Gagauzia TAU. As a result, the regions have been positioned by the level of corruption per total and by types of state regulation.

In the municipality of Chisinau this indicator has the highest level, with half of the national economy being concentrated here and the average revenue of enterprises being higher than in other regions. In addition, this indicator has high levels in Cahul, Lapusna, and Soroca. In these regions the unofficial costs exceed one quarter of the official ones. The situation is better in Orhei, Balti, and Tighina. In 2002 the burden of state regulation increased.

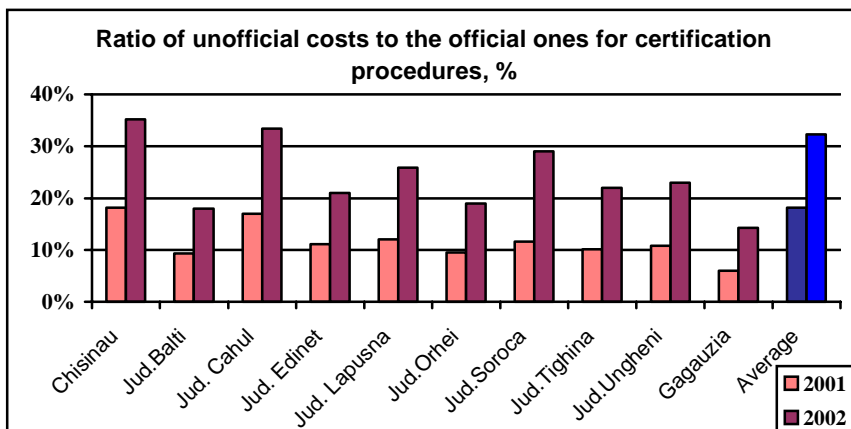
Positioning of regions according to the ratio of unofficial costs of state regulation to the official costs



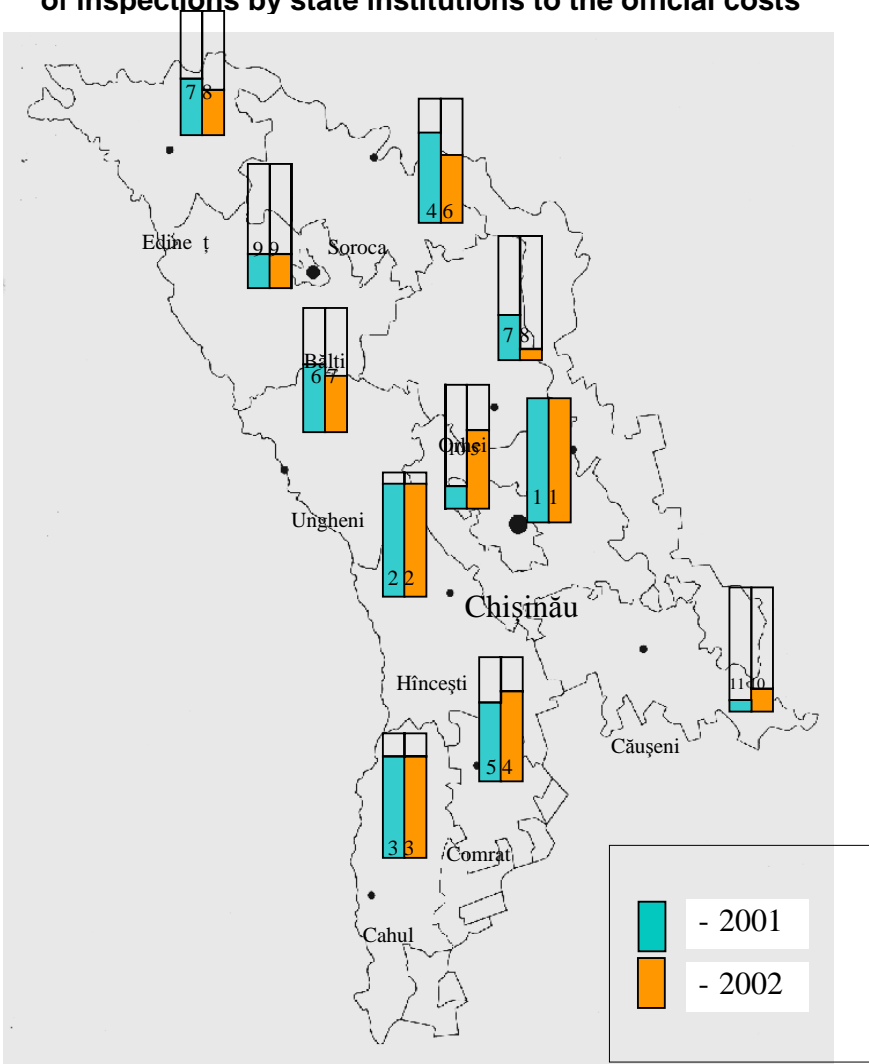
Generally, corruption generated by inspections carried out by state institutions has a negative impact on the total level of corruption.



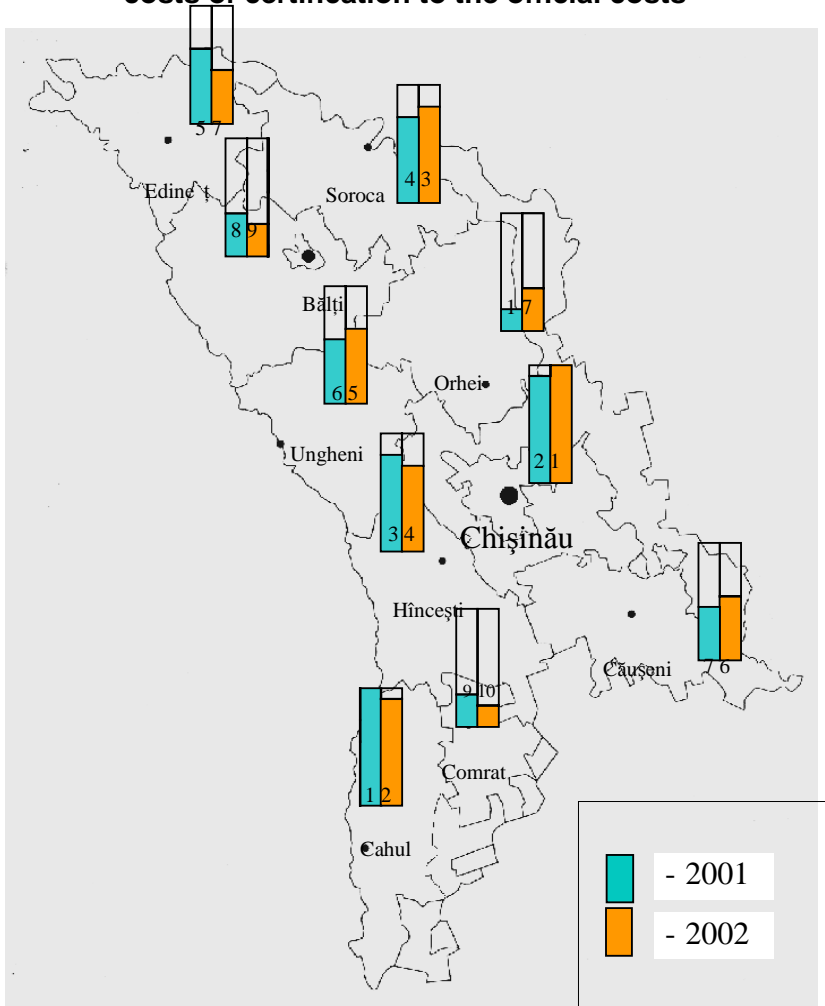
The analysis of the ratio of unofficial costs to the official costs, incurred by entrepreneurs during the inspections from regional state institutions reveals that the highest level is registered in the municipality of Chisinau, being followed by the regions of Lapusna, Cahul, and Soroca. This indicator is relatively low in the regions of Orhei, Tighina, Balti, and Edinet.



Positioning of regions according to the ratio of unofficial costs of inspections by state institutions to the official costs



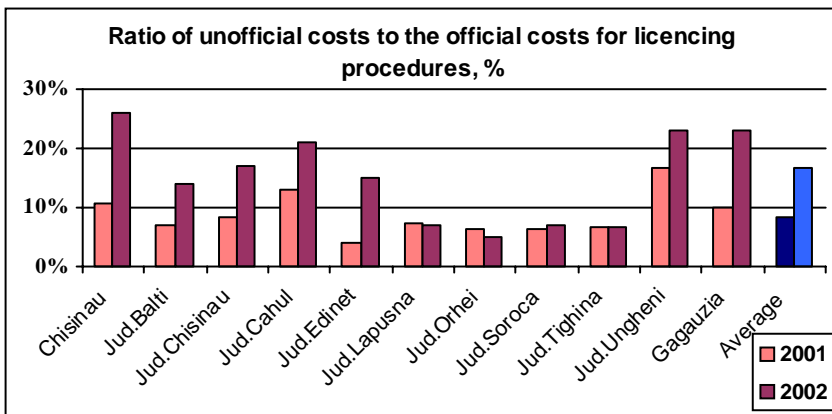
Positioning of regions according to the ratio of unofficial costs of certification to the official costs



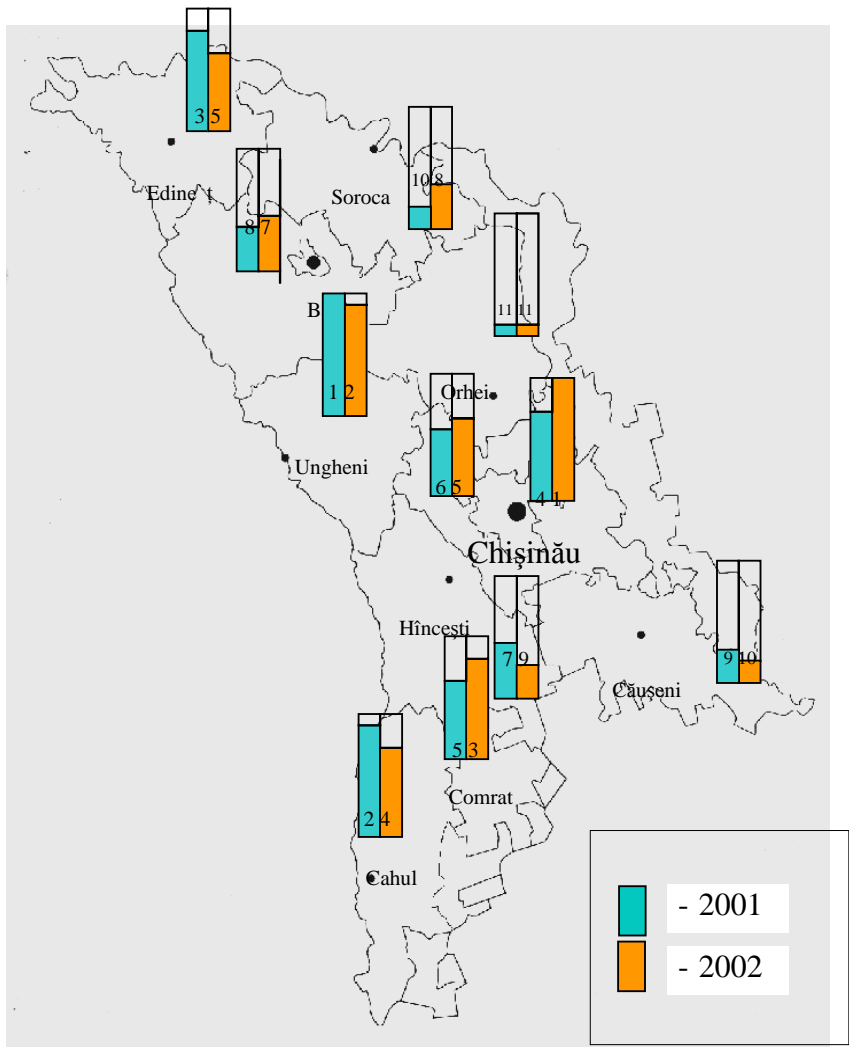
The issuance of certificates of conformity to national standards, sanitary authorizations and other certificates for production is the second factor that influences the general level of corruption. As each product batch or product line has to be certified, these costs are high. In 2002 the ratio of official costs to the unofficial ones attained the highest level in Chisinau municipality, being followed by the counties of Cahul, Soroca, Lapusna, and Ungheni, and the lowest level was attested in Gagauzia TAU and Balti county.

The unofficial payments incurred by economic units to license their economic activity also considerably influenced the level of corruption. The highest levels of corruption during licensing procedures are registered in Chisinau, Ungheni, Gagauzia TAU and Cahul.

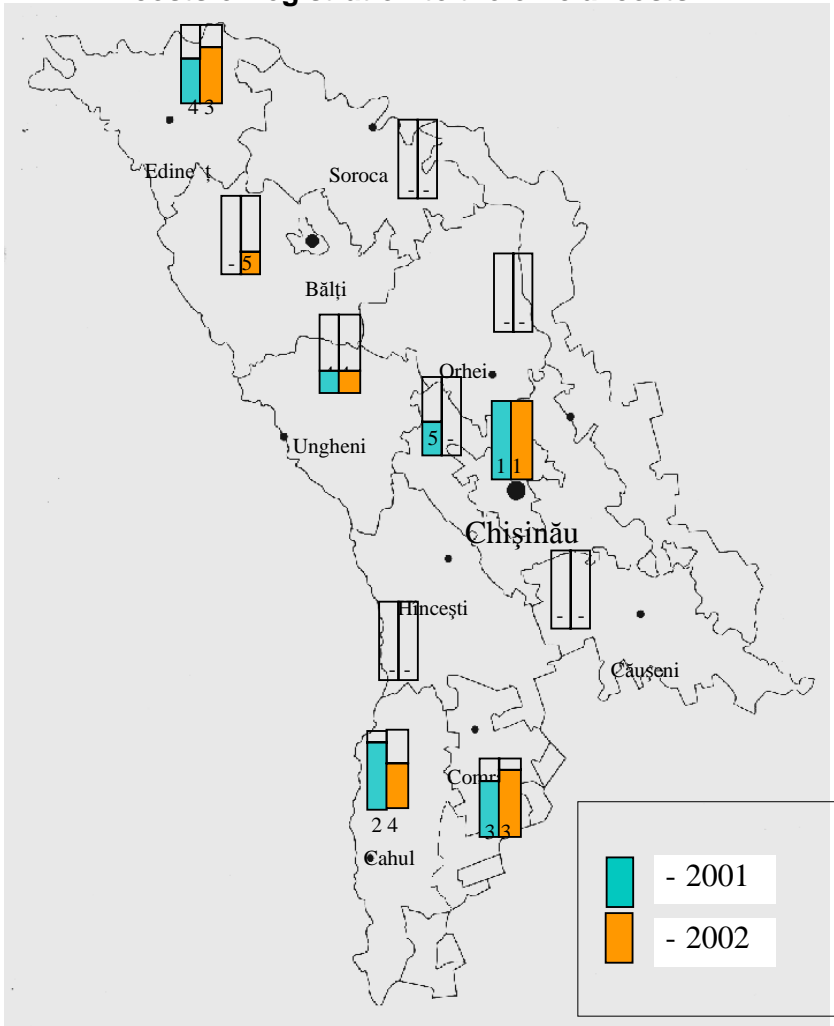
The unofficial payments incurred by economic units during the registration of the enterprise have a low impact on the total amount of informal payments, hence they have a low influence on the level of corruption.

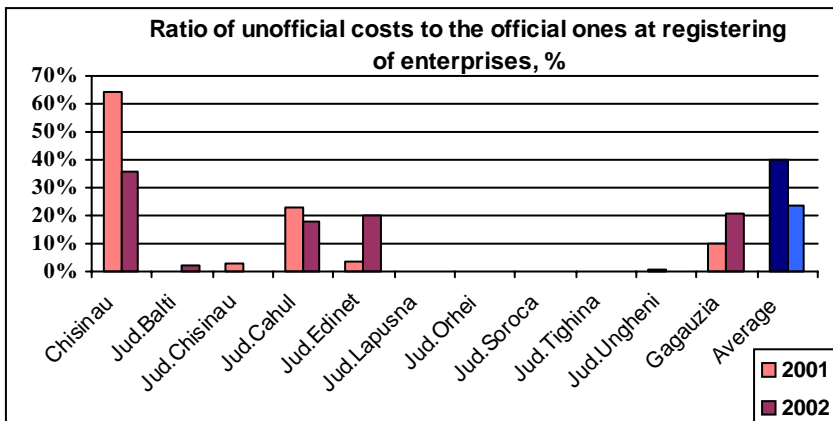


Positioning of regions according to the ratio of unofficial costs of licensing to the official costs



Positioning of regions according to the ratio of unofficial costs of registration to the official costs





The analysis reveals a high level of corruption in Chisinau municipality and in Cahul, Edinet, and Gagauzia TAU. The reform of the system of enterprise registration, which started in 2002 and continues in 2003, led to a substantial decrease in unofficial payments and, consequently, in the level of corruption.

4. The Transparency of Regulatory Procedures and Corruption

It follows from the above-mentioned information that the system of state regulation of economic activities in the Republic of Moldova is quite sophisticated and not transparent. Thus, there is a paradoxical situation when the state hinders the entrepreneurial activity. The interests of departments, local public authorities and various organizations that are expressed through the increase in payments for their services and authorizations run counter to the national interests that plead for the development of the small business. In the opinion of entrepreneurs, the administrative barriers, insecurity and lack of transparency in the procedures of state regulation are the biggest problems of the entrepreneurial activity. As a result, corruption is generated by non-transparent and costly procedures in terms of money and time.

4.1 Starting Up a Business (the Registration Procedure)

Pursuant to the Law on Registration of Enterprises and Organizations, in the Republic of Moldova enterprises have to be registered in the State Register and carry out post-registration procedures. Any change in the structure of owners, general manager, legal address, amount of statutory capital, name of the company, establishment (disbandment) of structural subunits through division and other information that, according to the legislation in force, represent the founding documents of the company, generates the change of start-up documents. In all these cases, the companies are to amend the start-up documents and introduce the amendment in the State Register.

Prior to the autumn of 2001, the start-up documents were drawn up by paid intermediaries or by entrepreneurs themselves. The intermediaries also used to represent the entrepreneurs in the registration process and carried out the post-registration

procedures. Obviously, the fees for intermediaries' services used to account for the largest share of the start-up costs, while the registration costs themselves charged by the State Registration Chamber used to be modest, in comparison.

The registration procedure was broken into a number of procedures in a chain, carried out by different organizations and people. As a result, entrepreneurs had to deal with non-transparent and burdensome procedures, which generated high unofficial costs. According to the results of the opinion poll, in 2001, an enterprise spent on average 119 US dollars in unofficial costs.

The first step in the process of reforming the registration of enterprises was done in the autumn of 2001, when the Chamber of State Registration concentrated all pre-registration and registration procedures into a single place – at the Chamber of State Registration, thus avoiding the intermediaries. In November 2002, in the second step of the reform, they started to concentrate the post-registration procedures, through the introduction of the identification number of legal entities (IDNO). The introduction of the single code IDNO for each economic unit, which unified the registration number, statistical and fiscal codes, will lead to further enhancement of the registration procedure, and, consequently, will increase transparency during the post-registration stage.

The analysis of the registration process proves that during 2001 and 2002, the Government had undertaken notable measures to improve the registration procedure. The efforts to simplify the registration procedures have enhanced the business environment. Thus, the number of polled enterprises claiming that they resorted to bribery is much smaller.

The more transparent and qualitative registration procedures became more expensive. In 2002 the registration costs increased due to official costs. The Chamber of State Registration, using

new procedures of registration through the exclusion of intermediaries and higher fees for its services, has pooled the financial resources obtained from the registration fees into the state budget. On the basis of the analysis it can be asserted that companies look more favorably towards the pre-registration and registration procedures. The more transparent procedures generated a decrease in the unofficial costs related to the pre-registration and registration procedures.

As a result of the reform, the corruption level decreased a little; in 2002 the level of informal costs for a single procedure decreased by 30%, if compared to the previous year. It is worth mentioning that the excessive burden of state regulation has been assessed only in Chisinau municipality and the regions of Cahul, Gagauzia TAU, and Edinet.

4.2 Construction Regulation

The utilization of plots of land and buildings, design and construction works are regulated through urbanism certificates and construction authorizations, issued by local public administration. The State Inspection for Constructions under the Ministry of Ecology, Construction, and Territory Development, assures the correspondence between buildings and the Quality Manual.

Enterprises that may have a negative impact on the environment must present an assessment of the environment, which is compulsory for 32 types of buildings, but can be requested for any type of building. The list of documents necessary for the state evaluation of the environment is quite long.

According to the study, the issuance of urbanism certificates and building authorizations are the least transparent procedures of state regulation. They are regulated by many normative and legal acts, which that set the regulating terms, the required documents

and payment for services. In the opinion of the polled companies, the list of requested documents is not complete. As a result, local authorities can demand additional documents. In addition, there are no deadlines for the issuance of building authorizations. Hence the insecurity and cost of these procedures are very high. That is why there is a high level of corruption, with an upward trend in this sector. In 2001 each forth, and in 2002 25%, in 2002, 50% of polled respondents mentioned he/she had resorted to bribery or “voluntary contributions”. Data shows that the unofficial payments for building authorizations are equal to or even higher than the official ones.

The analysis shows that the regulating environment in the construction sector has worsened over the past few years. To have buildings put into operation, companies have to follow time and money-consuming procedures. These are the most expensive regulatory procedures. As a consequence, the terms of building exploitation represent a huge hindrance for the development of the private business.

The allotment of land for construction purposes and the conclusion of contracts are extremely complicated and time-consuming procedures. Moreover, to construct production facilities it is necessary to have the approval of local authorities (the city’s architect) and the authorization of a designer. To be able to use the constructed facility, the enterprise must obtain permits from the following bodies: the sanitary-epidemiological service, fire-fighters, environment protection, energy, architect, and the local authorities. These institutions verify as to whether the building had been constructed in accordance with the code.

To assure the transparency of Construction Regulation procedures, the following measures are proposed:

- To introduce deadlines for the examination of the requested document and to avoid duplications during this process (i.e.,

the examination of the same documents by several institutions);

- To display the information about duration, terms and costs of the procedures carried out by local public authorities.

4.3 Licensing Economic Activities

Economic activities are being licensed by the Licensing Chamber, ministries, departments and other central and local public authorities. The legislation on licensing procedure was completely changed during 2001-2002. As a result, the number of activities subject to licensing decreased from 106 to 55 and in 2002 the number of activities subject to licensing increased from 55 to 57. At the beginning of 2002, the Licensing Chamber was established, which consolidated all ministries, departments and agencies which used to issue licenses. At present, this institution issues *44 types* of licenses. Most of the licenses are issued by local public authorities.

Over the past two years the Government completely changed the licensing system, diminishing the number of licensed activities, centralizing the licensing procedures at the Licensing Chamber, and simplifying the licensing process. As a result the following positive trends have occurred:

- the companies can obtain a single license for related activities, thus avoiding repeated licensing procedures for each type of activity;
- the companies deal with licensing procedures much less. Now licenses have a longer period of validity and are issued in a shorter period of time;
- the process of license issuance by the Licensing Chamber has become more transparent after the publication of Order No. 38-g “On the Licensing Terms for Certain Types of Activity”,

passed by the Ministry of Economy and the Licensing Chamber on September 16th, 2002.

The more transparent licensing procedures carried out by central authorities resulted in a decrease in the number of economic units resorting to bribery. In 2002, 28% of respondents admitted having offered bribes, in 2001 in excess of 37% declared such payments. On the one hand, the incidence of bribery decreased, on the other, the average amount of informal payments increased about 2.5 times.

In spite of the changes the respondents said that the licensing process still lacks transparency, citizens are not informed about the licensing procedures, there are no deadlines for license issuance, and they have a short period of validity.

In order to decrease the impact of state administration and corruption on the licensing procedure recommendations have been formulated, taking into account the problems mentioned by the polled companies. Most of the documents needed to obtain a license haven't been modified since 2000. Much time and money is spent obtaining these documents, a fact that fosters corruption. The costs will be essentially decreased if less documents are required solicited from entrepreneurs who often apply for licenses.

4.4 Import-Export Activities Regulation

The legislation of import-export activities is complex and frequently changed. To avoid huge fines, the companies have to continuously monitor the normative and regulatory acts on foreign transactions including pre-shipment inspection, customs procedures, certificates of conformity and hygienic certificates for food products and medicine. The import and export of agricultural products is regulated through sanitary authorizations,

and livestock products require veterinary and radiological inspections.

Order of the Customs Department No. 276-0 “On the customs documents and duties for goods coming from foreign economic transactions” dated October 24th, 2002, stipulates the list of documents necessary for the customs procedures, greatly increasing the level of transparency. In spite of the endeavors to simplify the customs procedures in foreign trade, there are still administrative barriers, and the importers and exporters must present several authorizations and authenticated documents for customs procedures. Exported goods are accompanied by approximately *13 authorizations and documents*.

The organizational measures undertaken by the Government and the Customs Department to reform the personnel, along with the increase in the transparency of the solicited documents have decreased the unofficial costs by 40% for an import or export transaction.

The analysis reveals that the import-export procedures are more complicated than other fields of state regulation. These procedures demand a large number of authorizations, permits and other documents, and procedures for pre-shipment inspection of imported goods and VAT refund are complicated and costly.

Various public entities demand the same documents, permits, and authorizations. In most of the cases, the documents must be authenticated or original. The study has not revealed any improvement in the communication between authorities and entrepreneurs. The polled companies have mentioned a single plausible measure – more transparent customs procedures at the Chamber of Commerce and Industry and at the customs office. There is low transparency in the activity of other public institutions.

The certification of imported-exported goods is regarded as a very complex procedure. It is compulsory to certify each batch. The recognition procedures for certificated goods issued in other countries, including the developed countries with which Moldova does not have any agreement of mutual recognition with, are very complicated.

In 2002, the procedures of VAT refunding improved. In spite of this, in the opinion of the polled, these procedures are still complicated and time-consuming even for the enterprises with a high degree of credibility. According to the regulations, VAT refunding shouldn't exceed 45 days, however, in reality this procedure lasts about 112 days. Sometimes, when the amount to be refunded is small, the enterprises are reluctant to solicit refunding.

As a result of this study, we can formulate the following recommendations aimed at increasing the transparency and fighting the corruption:

- The customs procedures should be considerably simplified, especially by decreasing number of documents demanded and avoiding repeated examinations of the same documents by different institutions. The procedure for exported goods' transportation should be simplified on the same grounds. In order to avoid their duplications, we recommend revising the list of documents required for the customs clearing.

4.5 Issuance of Certificates and Authorizations for Goods

In Moldova there are two types of certification: *compulsory* and *voluntary*. The goods that may endanger the life, health, and private ownership of citizens, as well as the environment are subject to compulsory certification pursuant to the National System of Standardization of the Republic of Moldova.

Chemical and biological agents, both produced in Moldova and imported, that may endanger the public health, as well as the industrial and consumer goods, including food products, are subject to sanitary certification. The local centers of preventive medicine and the National Center of Chisinau are empowered to issue sanitary certificates on the basis of laboratory analysis.

The analysis of the procedure for goods and services certification reveals that the certification system in Moldova differs much from similar systems of advanced economies. The difference is mainly related to the certification policy and institutional framework. In Moldova compulsory certification is the norm while voluntary is less usual. In developed countries the inverse holds true. It is worth mentioning that the system of goods and services certification hasn't suffered significant changes, when compared to other fields of state regulation. Companies claim that the standards passed in the 1980's are still in force.

In the opinion of the respondents, the certification system of Moldova has the following flaws:

- Every batch of product, manufactured, imported or sold by an enterprise, has to be certified. These goods could be certified once, and then registered, thus avoiding subsequent multiple certifications. Importers would only have to prove that the imported goods conform to the ones imported and certified before.
- At present, the recognition procedures for foreign certificates are very complicated and time-consuming, even for the certificates issued in industrialized countries.

The frequent certification of goods fosters the development of corruption. Around 25% of respondents who obtained certificates of conformity or sanitary authorization has mentioned that he/she incurred informal costs. To facilitate the procedure of goods and services certification, the following measures are recommended:

- Moldova's system of goods and services certification calls for major enhancements, to be simplified and adjusted to the EU standards. It is necessary therefore to change the ratio of compulsory to voluntary standards (diminishing the first and increasing the latter).

4.6 Inspections Carried Out by State Institutions

In the Republic of Moldova the activities of state institutions empowered to control companies, are regulated by many normative acts issued by the respective units. Though the inspection procedures have been liberalized, to some extent, the state control is still a major burden for the development of private entrepreneurship.

The Government, worried by the excessive number of controls over companies, passed the Decision No. 168 "On the coordination of supervision and control activities" on February 18th, 2003. With this the Government assigned the Ministry of Economy the role of coordinating the control activities and empowered it, along with the Department of Informational Technologies, to develop concrete measures to improve the situation in this field.

The opinion poll has shown that Moldovan enterprises are continuously subject to inspections carried out by many control institutions. In 2002, on average, companies in Moldova faced 19.5 official inspections, which is by 3 inspections more than during the previous year. During 2002 alone inspectors spent an average of 48 days at one enterprise, which was as many as during the previous year (2001).

Enterprises with more employees are more attractive for control bodies. Most of those believe the number of inspections increased, when compared to the previous year, and only 6% of

the respondents believe the state of affairs has improved in this respect.

In the opinion of respondents, most of the inspections in 2002 were conducted by fiscal Inspectorates, the Firefighters and Emergency Service, sanitary-epidemiological inspections and environment protection institutions.

Usually the inspections result in fines. In some cases – inspections carried out by firefighters service, police, bodies of law, environment protection and licensing – the amount of unofficial payments equals or even exceeds the fines. In spite of this, the opinion poll has proved that the small enterprises (with less than 10 employees) bear the highest burden with respect to the share of fines per employee, amounting to about 50 US dollars annually. At large enterprises, with more than 200 employees, the amounts is about 5 USD per employee.

The unofficial costs related to state inspections are high. In 2002 one out of three respondents admitted to having made unofficial payments and “voluntary contributions” to fiscal inspectors; one out of four respondents paid amounts to officers of firefighters and sanitary-epidemiological services; one out of six – to officers of local public authorities; one out of eight – to officers of bodies fighting against economic crimes and corruption; one out of fourteen – to officers of certification bodies.

The analysis proves that the state institutions carry out plenty of inspections, a fact that fosters the development of corruption. The attempts to diminish and simplify these inspections have failed, because the enhancements in one field were followed by worsening in other fields. For instance, measures aimed at coordinating inspections there have been introduced, and simultaneous fiscal inspections have been introduced. On the other hand, due to the high level of fines and sanctions, companies prefer to have visits from fiscal inspectors at least once a year.

5. Regulatory Policies and Transparency in the Small and Medium Business Sector

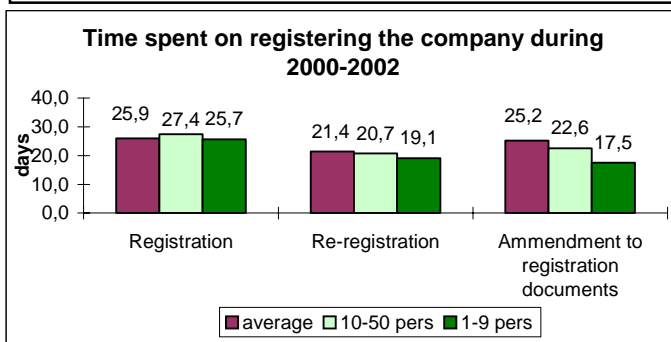
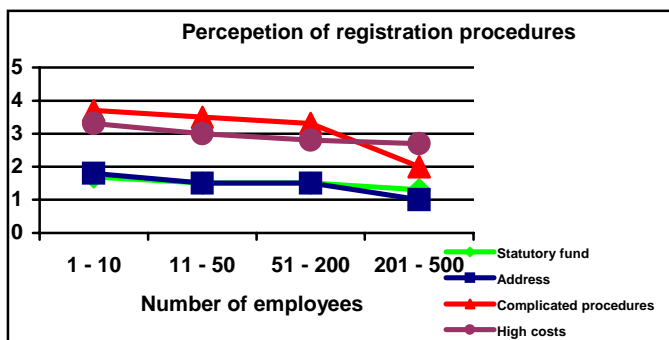
In the Republic of Moldova the small and medium-sized enterprises (SME) are developing slower than is needed for creating employment and decreasing social tension. Studies reveal that the excessive regulation of the MSE represents one of the main factors that hinders their development. This chapter contains the analysis of the SME business environment and reveals the major barriers to their development, comparing them to the national economy on the whole.

5.1 Starting Up a Business (the Registration Procedure)

According to the opinion polls, during 2001-2002 the companies with over

50 employees did not encounter barriers during the registration process. The situation is different for

the micro and small enterprises, with less than 50 employees. It



was concluded that the start-up procedures (registration) were very complicated and costly, and it was difficult to rent space for the legal address and form the statutory fund.

On the chart (perception of registration procedures) the vertical axis represents the positioning of SME from 1 to 5 by the burden of registration procedures.

All procedures are complicated for the small, especially micro-enterprises. They find it difficult to implement the regulatory reform in this sector due to low managerial skills. This is why these enterprises go through the longest period of registration, from the development of founding documents to the completion of the registration procedure by the Chamber of State Registration.

5.2 Construction Regulation

Construction Regulation procedures are the most costly and burdensome for all companies, in particular for SME. The total lack of transparency in this sector is the main cause. Therefore to assure transparency for these procedures, it is necessary to inform citizens, simplify the procedures of examination, decrease the number of documents demanded for building authorizations and to liberalize the access of SME to buildings and equipment. All of these actions would contribute considerably to the development of the SME sector.

5.3 Licensing Economic Activities

The SME enterprises do not have any privileged conditions regarding the licensing of economic activities. Most of the licenses are issued by local public authorities. The licensing costs do not depend on the size of the enterprise, but on the type of economic activity, so the licensing costs of SME do not differ

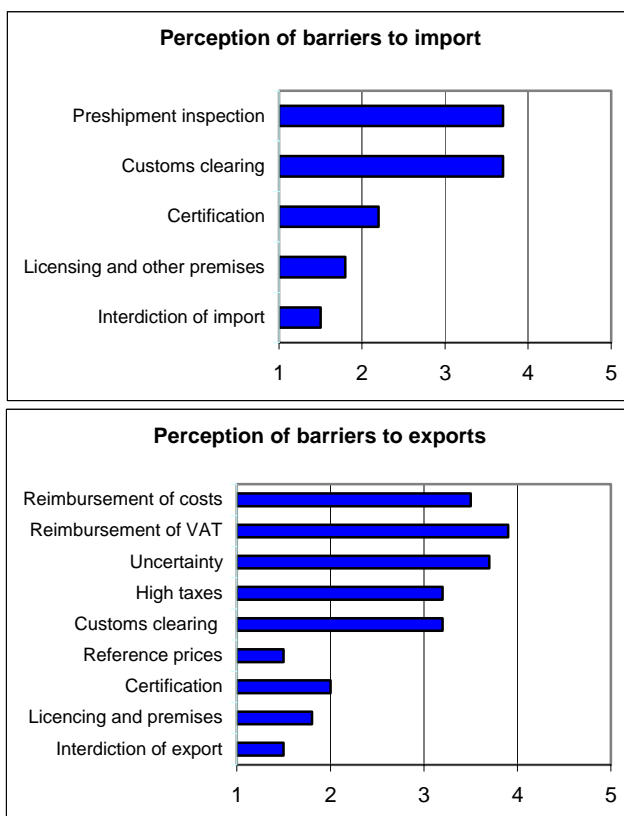
much from the average. However, the survey reveals that in Moldova the licensing procedures are extremely complicated for SME due to the volume of documents issued at different institutions, and thus fostering the development of corruption. The transparency of the licensing process can be assured through the use of simplified procedures for the economic units that apply for repeated licenses.

5.4 The Perception of Import-Export Barriers

The analysis reveals that the import of goods is hindered mainly by the customs and pre-shipment inspection procedures.

Commercial contracts that exceed 3,000 USD are subject to the pre-shipment inspection. We can state the following administrative barriers to the export of goods:

refunding of the value added tax (VAT) paid at the import,



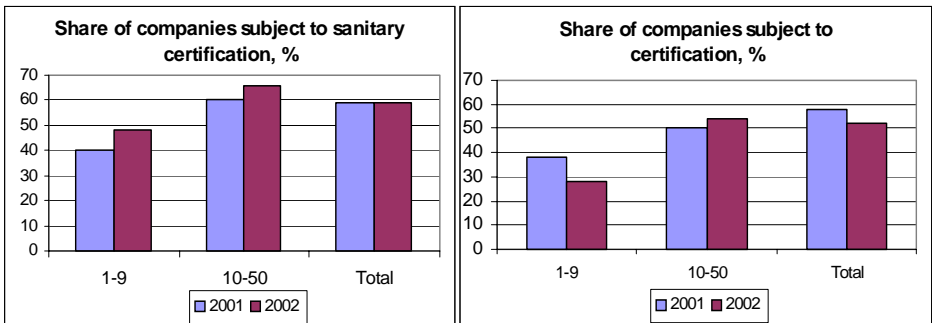
uncertain procedures (there can be surprises any time), the restriction on money reimbursement for the exported goods, complex customs procedures and high duties. Other regulations, such as certificates and authorizations, indicative prices fixed by the state, etc. are regarded by companies as less burdensome procedures, when compared to the aforementioned ones.

It is necessary to enhance the state regulatory procedures, the fulfillment of which is costly and time consuming for the companies specializing in import-export transactions.

5.5 Issuance of Certificates and Authorizations for Goods

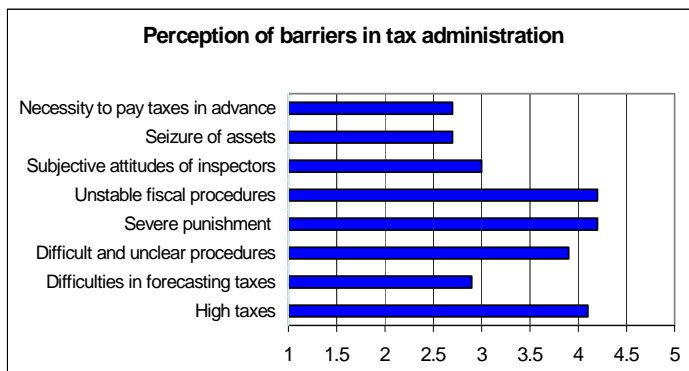
Goods that can endanger the life, health, and private ownership of citizens, as well as the environment, are subject to compulsory certification pursuant to the National System of Standardization of the Republic of Moldova. The bigger the enterprise, the more often it is subject to compulsory certification.

SME are excessively subject to compulsory certification. The enterprises in food industry also must obtain several certificates. According to respondents, it is necessary to have certificates of conformity to the national standards even for products that have certificates form exporters.

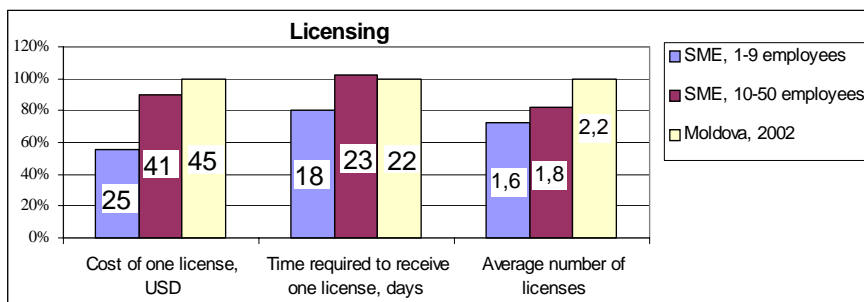


5.6 Administration of Taxes

According to the survey data, the SME pay 5.7 taxes on the average, in comparison with the country's average of



8.6 taxes. To manage these, 50% of micro-enterprises, as well as 14% of small enterprises have a bookkeeper in the staff. Only 30% of the micro-enterprises and 14% of small enterprises do accounting on their own. 45% of respondents reported the tax system got more complicated in 2002.



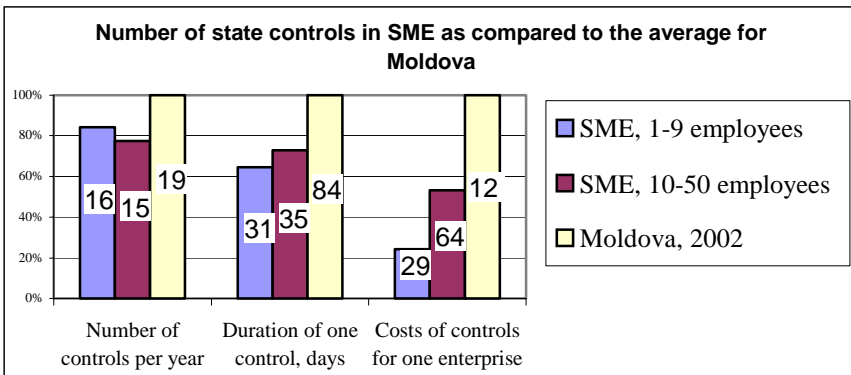
The biggest problems related to the tax administration are generated by the volatile, complicated, and unclear fiscal procedures, which result in entrepreneurs breaking the law. As a result, there appeared yet another problem – sanctions for the committed infringements. High taxes and subjective actions of inspectors are also regarded as major difficulties for the entrepreneurial activity.

In the opinion of the SME representatives, there is no transparency in the taxation of SME. A simplified fiscal system (through the introduction of a unique (single) tax) for small enterprises, especially the micro-enterprises, would contribute to a more efficient administration of taxes in this sector.

The analysis shows that the system of tax administration in the Republic of Moldova is complicated, volatile, requires many fiscal invoices, many accountants and large sanctions. Therefore, the efficiency of fiscal policy will improve if the draft laws in the fiscal field are published, discussed and coordinated with business people.

5.7 Inspections Carried Out by State Institutions

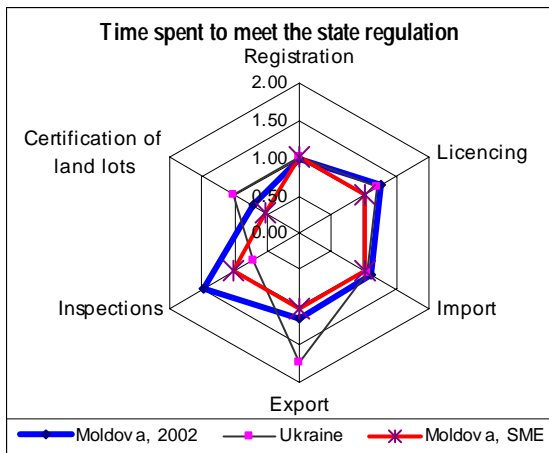
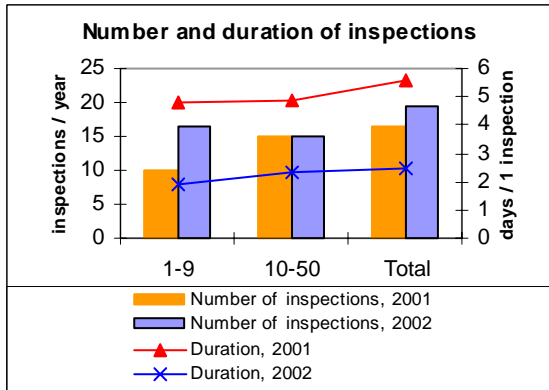
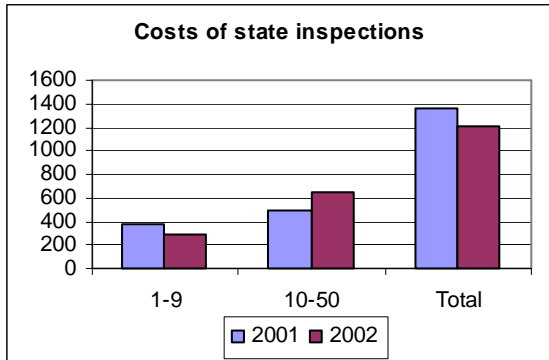
Opinion polls reveal that SME are frequently inspected by state bodies. In 2002, when compared to 2001, the number and length of such inspections decreased in the SME sector.



5.8 Time Spent to Meet State Regulation

The time used by SME to meet state regulatory procedures has decreased, when compared to the country's average. The difference is small, however revealing that the micro and small enterprises are subject to excessive state controls.

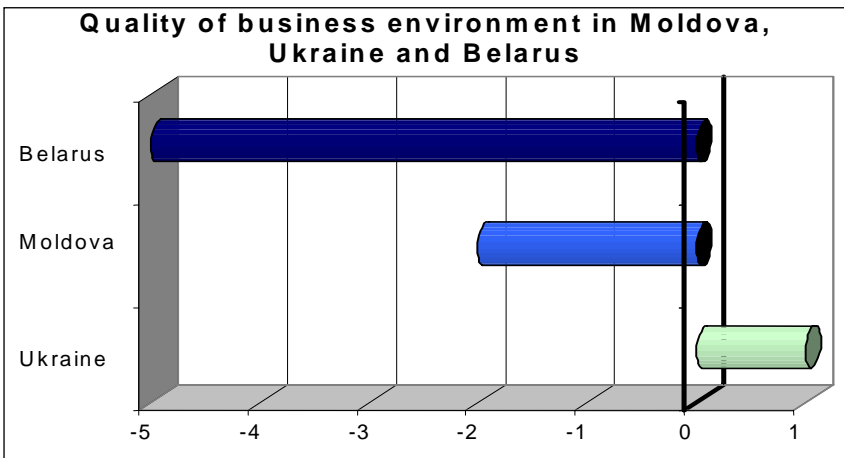
Though the inspection procedures have been liberalized to a certain extent, state control is the main burden to the development of the private entrepreneurship. To foster the development of the SME sector, it is recommended that interministerial body be created, after the Ukrainian model, charged with the task to diminish the impact of state administration on SME and examine the draft laws aimed at protecting SME in case their rights are violated.



6. The Regulatory Environment in Moldova and other Countries

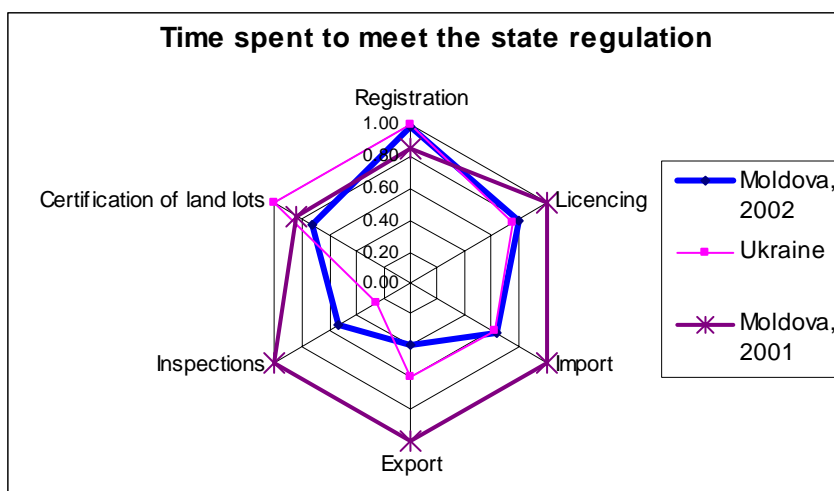
The survey has shown that the private sector of Moldova is subject to excessive state regulation. Local enterprises are at a disadvantage compared to other countries of this region. As a result, foreign investors favor other regions. In this unfavorable business environment, neither the local individual nor local legal entities are interested in investing in economic activity.

Moldova's business environment has been compared to that of Ukraine, which has tremendously improved over the last few years due to regulatory reform implemented at national and regional levels. It has also been compared to Belarus, which is regarded by the World Bank as the country with the most unfavorable business environment. The diagram below reveals the positive or negative changes (from minus five to plus five points) in the quality of the business environment over the past three years, that affects the enterprises in the aforementioned countries.



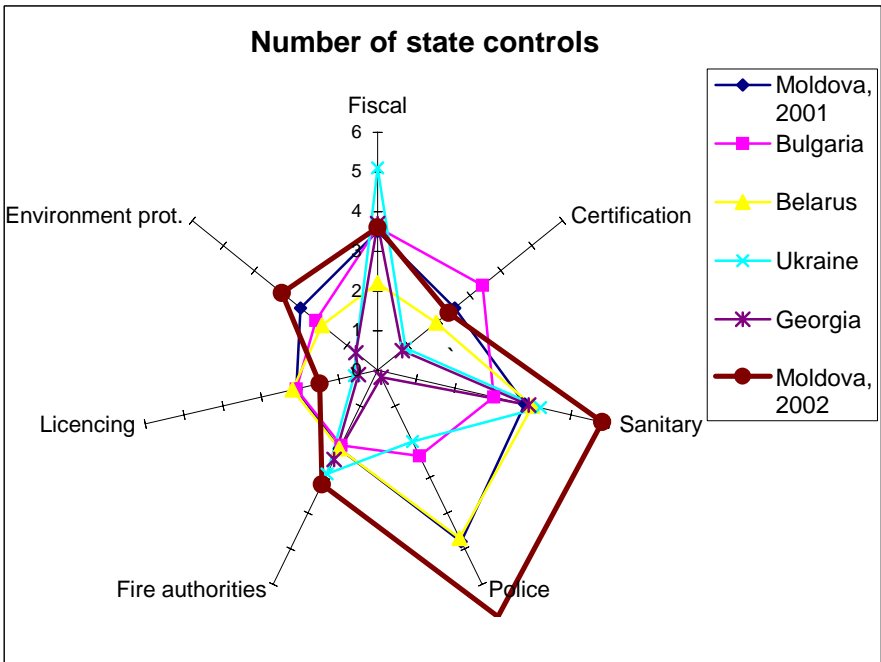
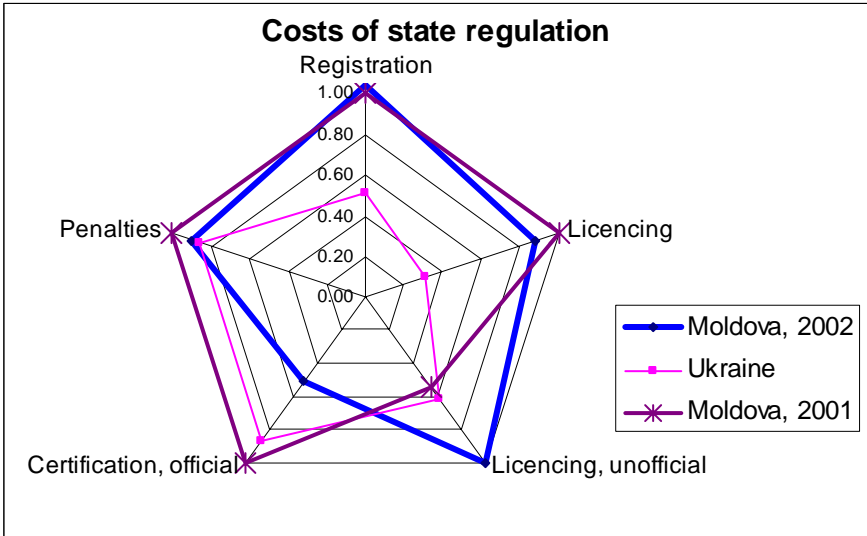
Source: The Business Environment of Western CIS: Belarus, Moldova, Ukraine. World Bank, 2003

Moldova ranks between the two countries and shows a worsening business environment, on average. This situation is caused by the lengthy time consuming regulatory requirements, high formal costs of state regulation, increased number of inspections carried out by state bodies, duplication of the functions and responsibilities of public institutions, an inefficient legal system, as well as the level of corruption which remained practically unchanged in 2002. The amount of unofficial payments decreased in only a few fields.



The comparative analysis of the time needed to meet the regulatory requirements by types of state regulation, of the costs related to these procedures and the frequency of inspections in Moldova and other countries is presented in below.

Comparing the impact of state administration in Moldova and other countries we can see that the local companies are at a disadvantage, incurring higher costs. The frequency of state inspections is higher in Moldova than in other countries.



7. Corruption and Tax Evasion: Is there a Trade-off?

The impact of corruption on the entrepreneurial environment in the Republic of Moldova has been clearly shown in the previous sections. All additional costs (bribes and “voluntary contributions”) are subsequently included in the prices of goods and services, diminishing their competitiveness. In this situation, questions arise: is there any relationship between corruption and tax evasion? Which indicators describe the fiscal discipline at regional and national levels? Which indicators describe the corruption (or at least bribery) phenomenon? What is the relationship between these indicators?

7.1 Fiscal Discipline at the Level of National Economy

Pursuant to data made available by the Main State Tax Inspectorate of the Republic of Moldova, in 2002 the total number of taxpayers was 593,069 (out of which 60,195 were legal entities and 532,824 were individuals). 204,474 taxpayers were subjected to tax audits (out of which 11,756 were legal entities and 8,718 were individuals). Tax audits revealed infringements of tax legislation in 10,966 cases or 53.6% of total cases (including 5,968 legal entities and 4,998 individuals). As a result, additional charges accrued in the amount of 274,418.3 thousand MDL, out of which 48.6% were sanctions.

According to our own calculations, on the basis of reports from the Main State Tax Inspectorate, the dynamics of tax evasion indicators can be briefly described as follows:

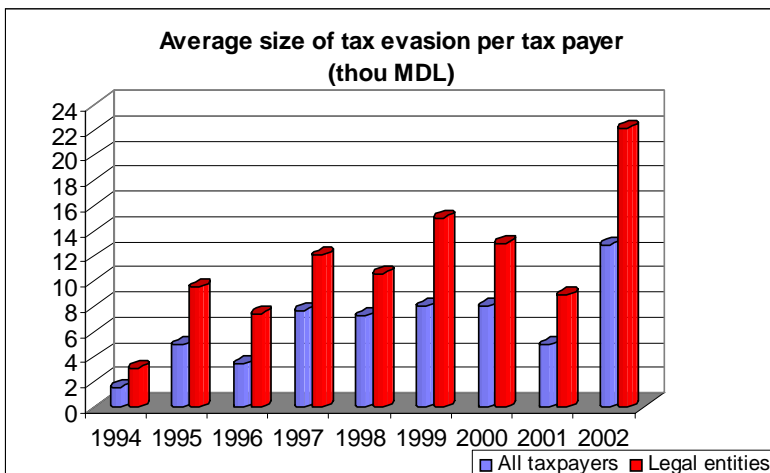
The share of legal entities subject to tax audits decreased from 29.37% in 1994 to 19.52% in 2002. Effectively, this change can be explained by the notable increase of legal entities during these years (from 11,598 to 60,195). This highlights an almost two fold decline of the probability of tax evasion disclosure in the case of

legal entities. The number of individuals registered as taxpayers has grown and has shown even more astounding proportions. Despite this fact, the share of their contribution to the budget revenues, as well as tax evasion, is rather minor and therefore the attention of this study is concentrated on the legal entities.

Occurrence of Tax Evasion (percentage of total controls)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
All entities	34	40	39	53	59	59	65	70	70
Legal entities	53	63	65	53	66	70	71	68	64

One of the indicators that somehow describe the tax discipline is the *occurrence of tax evasion* or share of taxpayers that violated the tax legislation in the total number of taxpayers subject to tax inspections. According to our calculations, this figure has grown from 34% in 1994 to 70% in 2002, i.e. has nearly doubled.



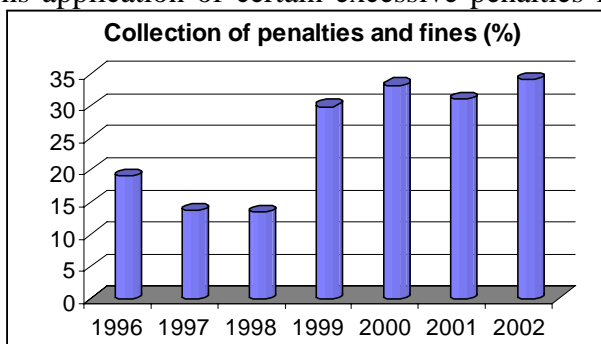
Yet another indicator describing the level of tax discipline is the *average amount (size) of tax evasion* per taxpayer. This indicator has grown from 1.59 thousand MDL in 1994 (3.1 thousand MDL per legal entity) to 12.9 thousand MDL in 2002 (22.1 thousand MDL per legal entity).

An indicator that shows the severity of penalties applied to those who attempted to perpetrate tax evasion is *the penalty rate*, or “sanction-to-tax evasion” ratio. From 1994-2002, this figure was subject to numerous changes decreasing from 150% in 1994 to 66% in 1999 and then increasing again to 94% in 2002.

Penalty rates (% - penalties/tax evasion)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
All entities	149	80	165	129	102	66	70	118	94
Legal entities	150	79	161	130	102	66	68	108	94

On many occasions application of certain excessive penalties is accompanied by the decrease of penalties by the tax service during the next year. Thus, in 2002, following application of certain higher penalties in



2001, recalculations of financial sanctions followed and their decrease by 62,889.6 thousand MDL.

To a certain extent the *restitution of prejudices* disclosed by tax inspectors being expressed in percent of the accrued amount can also serve as an indicator of fiscal discipline. This indicator oscillated within 14% in 1997 and 34% in 2002, which actually proves that the Main State Fiscal Inspectorate has contributed greater efforts to collect budget revenues as compared to previous years.

The evaluation of the total tax evasion in the Republic of Moldova during 1994-2002 was based on a tax evasion model described in “Tax Evasion in a Transition Economy: Theory and Empirical Evidence from the Formal Soviet Union Republic of

Moldova” (J. Andersen and Lilia Carasciuc, 1999, journal “Public Economics”). The outcome of 180,564 tax audits was used as input data for this model and was carried out by the Main State Tax Inspectorate of the Republic of Moldova during 1994-2002. Duly accounted for were both the geographical breadth of tax evasion and the frequency and dimension of average tax evasion by type of legal organization of taxpayers (total of 15 types, including legal entities – state enterprises, joint ventures, leasing companies, cooperatives of all kinds, LTD’s, stock companies, enterprises with share of foreign capital, public organizations, banks, insurance companies, associations, concerns, other amalgamations, farmers, budget institutions; as well as individuals – individual enterprises, collective societies, citizens owing taxable property, etc.).

Evaluation of total tax evasion

	1999	2000	2001	2002
Number of legal entities	47997	51723	56393	60195
Number of natural persons	405019	497950	519573	532824
Frequency of tax evasion-legal entities(%)	70	71	68	64
Frequency of tax evasion-nat.persons(%)	48	55	71	57
Average tax evasion, legal entities(thou.MDL)	15.40	13.44	8.84	22.10
Average tax evasion, natural persons(thou.MDL)	0.59	0.75	1.01	1.85
Tax evasion - legal entities (mln. MDL)	517	494	339	851
Tax evasion - natural persons (mln. MDL)	115	205	371	562
TOTAL TAX EVASION (mil.MDL)	632	699	710	1413

Unfortunately, since 2001 the annual reports made by the Main State Fiscal Inspectorate have suffered certain modifications and do not contain detailed financial data by types of taxpayers. Therefore, prior to carrying out an estimation of the overall tax evasion it was necessary to assume that the average tax evasion was changing at the same rate for all organizational forms of taxpayers. To some extent this diminishes the accuracy of estimates, but nevertheless it offers a chance to see a rather comprehensive picture of tax evasion.

According to our estimates, the total amount of tax evasion has increased from about 4% of the consolidated budget revenues up to 24% in 2002. Of this amount, the share of legal entities constitutes about 50%. In absolute terms, tax evasion in 2002 had reached MDL 1.4 billion, which is a considerable increase compared to 2001 when tax evasion was estimated at roughly MDL 700 million. The total number of legal entities decreased from 68% to 64%, while average tax evasion increased by 2.5 times.

It is worthy to note that in 2002, due to a deficit of state budget revenues, tax authorities had to work with a heightened awareness to find law breakers. When carrying out tax audits, it is normal procedure to examine financial statements of previous years and therefore estimated amounts of tax evasion partially include data referred to previous years. One more factor of prime importance is corruption amidst fiscal inspectors. If, corruption had been decreasing among fiscal inspectors in 2002, they might have been more willing to report higher amounts of tax evasion.

The results of the sociological study carried out by Transparency International – Moldova¹ serves to confirm this fact. Therefore, the business people were questioned on behavior of tax inspectors in cases when they disclose tax evasion. The results have shown that if in 2000 in only 19% of total cases tax inspectors were registering all the infringements in compliance with the law without proceeding to a bribe, then in 2002 this share was already 35%. Accordingly, one may take note of certain improvements in the situation. On the other hand, entrepreneurs were stating that in order to “avoid” paying a penalty in 2000, it was sufficient to pay an average bribe worth 34.22% of the size of the penalty, while in 2002 it went up to 37.8%.

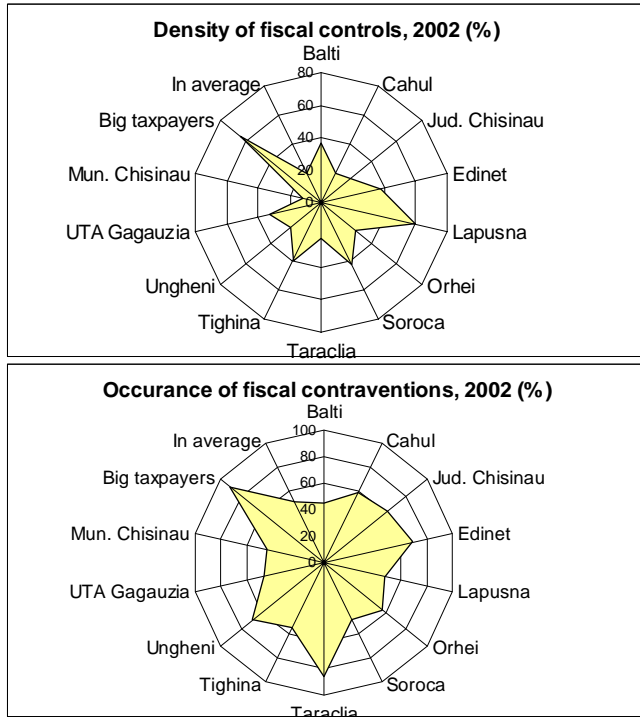
¹ Carasciuc Lilia and Obreja Efim (2002) Corruption and Access to Justice, Transparency International - Moldova, 120: 3-40

7.2 Regional Differentiation in Fiscal Discipline

The analysis of the tax evasion phenomenon in cases of legal entities in judets (territorial-administrative regions in

Moldova) shows a rather differentiated picture. The *frequency of controls* varies from 11.4% in the municipality

of Chisinau up to 42.17% in judet Soroca, with the nation-wide average being 19.53%. If in the municipality of Chisinau 11% of legal entities were subject to tax audits, then in judet Soroca it applied to almost 50% of legal entity. This can be explained due to a high business concentration in the municipality of Chisinau (38,750 enterprises) as compared to Soroca (2,132). Large taxpayers are a special case as 64.44% of them were subject to tax audits in 2002.



Minimum *occurrence (density) of tax violation* amongst legal entities disclosed by tax service officers was again concentrated in the municipality of Chisinau (43.86%), followed by Balti (44.86%) and Gagauzia (45.86%). In 2002, the maximum occurrences were registered in judet Taraclia (85.71%), judet Ungheni (68.58%) and Edinet (68.5%), the national-wide average being 50.77%. Here, again, a special case is being represented by the large taxpayers for whom this indicator in 2002 was 91.38%.

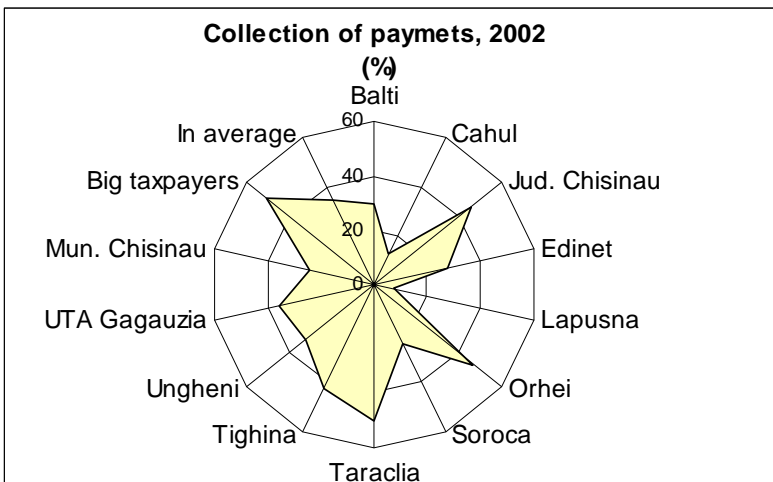
	Average tax evasion all tax payers, 2002 (thou.MDL)
Balti	1.59
Cahul	2.51
Jud. Chisinau	2.39
Edinet	2.24
Lapusna	4.84
Orhei	1.87
Soroca	2.44
Taraclia	5.49
Tighina	2.90
Ungheni	2.72
UTA Gagauzia	5.66
Mun. Chisinau	8.81
Big taxpayers	224.23
In average	6.89

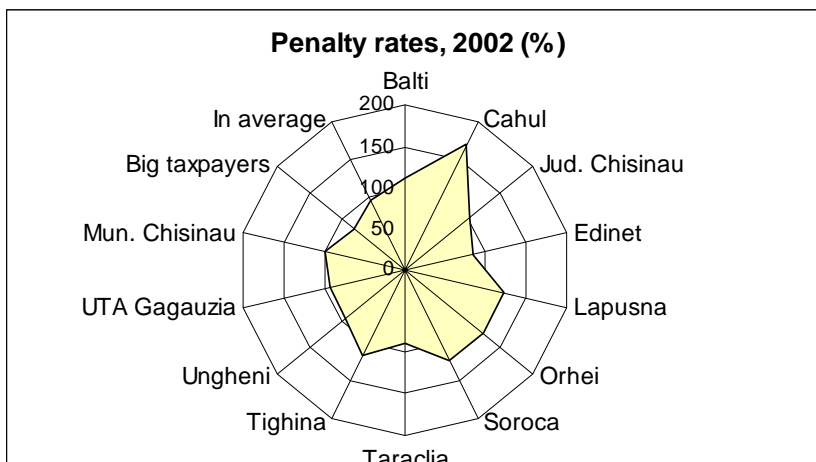
The average tax evasion per one taxpayer differs significantly depending on the organizational form. Unfortunately, in 2002 the Tax Inspectorate presented the information on additional calculations of taxes and charges, as well as on sanctions, as judet total (including both legal entities and individuals). Therefore, the average tax evasion for all categories of taxpayers reached its highest level in the municipality of Chisinau (MDL 8.81 thousand). Bear in mind that about 65-70% of businesses, and incomes, are concentrated in the municipality of Chisinau. Less explainable is that the average tax evasion per one taxpayer in

	Average sanction, 2002 (thou. MDL)
Balti	1.78
Cahul	4.24
Jud. Chisinau	2.41
Edinet	1.91
Lapusna	6.02
Orhei	2.29
Soroca	2.97
Taraclia	4.88
Tighina	3.34
Ungheni	2.54
UTA Gagauzia	5.28
Mun. Chisinau	8.67
Big taxpayers	175.18
In average	6.51

Gagauzia is ranked second after Chisinau (MDL 5.66 thousand), with the nation-wide average being MDL 6.89 thousand. If the national average amount of tax evasion in case of legal entities amounts to MDL 22.1 thousand, then this indicator for large taxpayers is 10 times higher. It is evident why tax authorities pay special attention to this category of taxpayers. About 65% of the total number of such legal entities are the subject of tax audits.

The *average sanctioning* of each taxpayer that has admitted infringement of tax legislation also varied in 2002 depending on the region, beginning with MDL 1.78 thousand in Balti, MDL 1.91 thousand in Edinet and ending up with MDL 8.67 thousand in the municipality of Chisinau. The nation-wide average amounted to MDL 6.51 thousand, while the average for the large taxpayers category amounted to MDL 175.18 thousand. This indicator is heavily dependent on the average tax evasion, and on the penalty rates applied in different regions.





The chart of *collection charges and sanctions*, applied as a result of tax audits, also varies significantly. In 2002, out of a total amount of accrued charges and sanctions, only 34% was collected. In judet Lapusna only 7.54% was collected, in judet Cahul 12.47%, and in municipality of Chisinau – 24.19%. The highest were registered in judet Taraclia - 50%, judet Orhei – 47.05% and judet Chisinau – 45.75%. Before the end of 2002, large taxpayers had managed to settle 50.54%.

Among the on-going causes of tax evasion are heavy tax burden, weakness and corruption amidst controlling bodies, as well as tax exemptions granted. Although the tax burden in the Republic of Moldova is fluctuating between 25-30%, which is close to the tax burdens in Western European countries, this figure is being formed as an average under conditions where one portion of taxpayers is paying taxes due, while the other portion is failing to do so. Therefore, a “theoretical” tax burden far exceeds the “practical” one.

7.3 The Relationship between Corruption and Tax Evasion

In order to see if there is a connection between tax evasion and corruption, we used information published in the World Bank survey “Costs of doing business”. The data was used to estimate the total amount of unofficial payments made by business people to public officials. The estimation was based on the average size of a bribe, the frequency of bribe payment for licensing, obtaining various types of certificates, sanitation authorizations, authorizations for export-import, inspections, and authorizations for construction. The calculations did not include unofficial payments for opening the business. The estimation was made for the entire country, as well as for its regions.

Evaluation of the total unofficial payments in 2002 (Thou USD)

	Licensing	Certificates, authorizations, sanitation controls	Authorizations for import	Authorizations for export	Inspections	Construction authorizations	TOTAL
Mun. Chisinau	504514	2996822	2422663	542393	1639891	1194012	9300295
Jud. Balti	13407	306070	128820	87930	460158	127465	1123850
Jud. Chisinau	67301	147654	52656	39028	309296	111145	727080
Jud. Cahul	66313	74613	23507	23511	257615	57279	502838
Jud. Edinet	84612	84272	16455	19044	349528	60373	614283
Jud. Lapusna	23315	75703	48895	15282	509581	63786	736562
Jud. Orhei	6098	85958	23977	18573	291472	68052	494131
Jud. Soroca	15059	108585	94029	59247	309500	108479	694899
Jud. Tighina	23003	41895	12694	13166	48934	93972	233665
Jud. Ungheni	32448	76704	50306	30799	247296	31253	468806
UTA Gagauzia	68812	118055	30089	20925	455410	90132	783422
Total	904882	4116331	2904093	869898	4878680	2005948	15679832

The results of calculations show that in 2002 the main portion of the unofficial payments is in the Chisinau municipality (59 %). This is quite natural, because the main economic activities are concentrated in Chisinau. Chisinau is followed by Balti (7%), Lapusna (5%) and Gagauzia (5%). The smallest amount of unofficial payments took place in Tighina (1%) and Ungheni (3%). Still this data does not fully show the extent of corruption in the regions, because it would be natural to expect the more unofficial payments in the more economically developed regions.

An indicator that conventionally links the amount of bribes with the economic activity is the ratio “*paid bribes to the fiscal revenues*” in the region. This revenue can serve as an indicator of economic activity of the region, to some extent. This indicator describes the *bureaucratic burden on business* in the region. The analysis of this indicator in the territorial divisions shows an essential differentiation between the regions. Therefore, the ‘bureaucratic burden’ constitutes 21% within the municipality of Chisinau, 20% in Gagauzia, and the nation-wide average is around 16%. We can see that this constitutes a high bureaucratic burden for the regions.

One could consider that this estimation was made only for those about 24,000 enterprises that provide their information to the State Department for Statistics; however, a considerable number of enterprises are not included in this group. Also, the unofficial payments for opening the enterprises have not been considered. These payments could reach a total of around 250,000 USD.

Another indicator that can describe corruption in the public sector is *the average size of bribe* paid by one enterprise. The size of the bribe varied in the Republic of Moldova during 2002 from 205 USD in Balti to 726 USD in Chisinau and almost 800 USD in Edinet, with the nationwide average being around 500 USD.

Comparison between unofficial payments and fiscal revenues in the region, 2002

	Unofficial payments, thou USD	Fiscal revenues, thou USD	Unofficial payments as % of the fiscal revenues
Mun. Chişinău	9300	43616	21
Judeţul Bălţi	1124	15221	7
Judeţul Chişinău	727	6550	11
Judeţul Cahul	503	4089	12
Judeţul Edineţ	614	5032	12
Judeţul Lăpuşna	737	4538	16
Judeţul Orhei	494	4664	11
Judeţul Soroca	695	6012	12
Judeţul Tighina	234	2667	9
Judeţul Ungheni	469	4104	11
UTA Gagauzia	783	4008	20
Total	15680	100501	16

Average bribe and frequency of bribe payments

	Average bribe (USD)	Frequency (% of total)
Mun. Chişinău	473.6	26.7
Jud. Balti	205.6	11.6
Jud. Chisinau	726.6	11.5
Jud. Cahul	375.6	35.0
Jud. Edinet	799.7	19.4
Jud. Lapusna	183.1	16.0
Jud. Orhei	314.0	22.3
Jud. Soroca	224.8	20.0
Jud. Tighina	404.3	21.0
Jud. Ungheni	403.0	8.9
UTA Gagauzia	496.1	75.5
Average in Moldova	504.1	28.4

In terms of *frequency of bribe payments* in 2002, highest is found in Gagauzia. One of the explanations for this is that in this autonomous region business people have to pay bribes to both local and central authorities. (The autonomy of the region, instead of improving the entrepreneurial environment, creates additional impediments). Gagauzia is followed by Cahul – 35%, the municipality of Chisinau – 26.7% and Orhei 22%.

It is evident that in Chisinau, Cahul, Edinet and Gagauzia the public officials were more active in taking bribes. At the same time, these regions showed worse fiscal discipline (higher average bribe, or higher occurrence of bribes). It is difficult to determine what is the cause and what are the consequences. Obviously, this information is not sufficient to see if there is a strong correlation, a clear trade-off between tax evasion and corruption among fiscal inspectors. However, it would not be surprising if another more accurate study would prove that, in a system with a high level of corruption among public officials, high penalty rates do not result in improving the fiscal discipline, or growth of the budget revenues, but simply intensify corruption.

7.4 Small Model of Tax Evasion

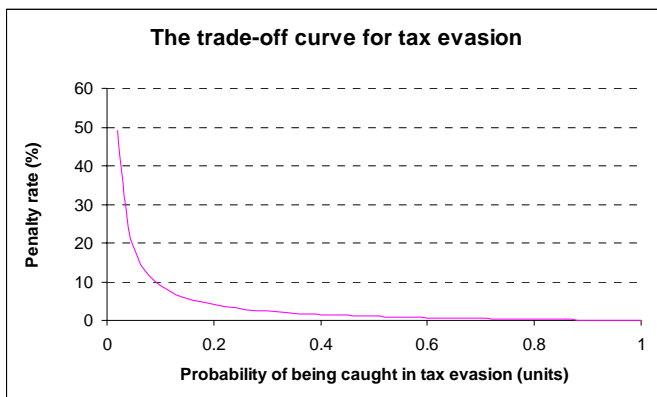
The paper “Tax Evasion in a Transition Economy: Theory and Empirical Evidence from the Former Soviet Union Republic of Moldova” (J. Andersen and Lilia Carasciuc, 1999, journal „Public Economics”) used an elementary model of tax evasion that developed a trade-off curve, that shows the combinations for the frequency of fiscal controls and penalty rates that could discourage tax evasion. A simplified mode follows:

Tax evasion will take place until the net benefit of tax evasion will be equal to zero. The net benefit of tax evasion is the difference between the revenues of tax evasion (the amount of tax evasion itself – E) and the expected losses, taking into the consideration the probability of disclosure in tax evasion – P and penalty rate - r that is applied to the fiscal law breakers. The expected losses in this case can be described as follows: $P * E * (1+r)$. The net benefit is equal to zero when the revenues of tax evasion are equal to the expected losses:

$$E = P * E * (1+r) \quad (1),$$

$$\text{or } P = 1 / (1+r) \quad (2)$$

The curve illustrated by this relationship is the *trade off curve* for the penalty rates and the probabilities of disclosure in tax evasion.



One can clearly see that when considering the realistic probabilities that vary between 10 and 20%, the penalty rate has to be very high. Normally the tax inspectors do not control the fiscal information for a single year. Usually they do this for a number of years (N), with the average being about 3. In this case the formula (1) will take the following form:

$$E = P * N * E * (1+r) \quad (3)$$

This means that the trade-off curve will shift to the left and allow lower penalty rates that discourage tax evasion.

The estimates of tax evasion described above were based on the assumption that all fiscal inspectors were honest and they registered all detected infringements. In fact, this is quite unrealistic. This model can be adjusted to illustrate when a portion of the fiscal inspectors are corrupt and being bribed and do not report portions of detected fiscal infringements.

Let's assume that the share of cases when the inspectors do not obey their obligations is S , and the share of cases when they behave honestly is, correspondingly, $(1-S)$. We also note the average amount of tax evasion that has been detected and registered by honest tax inspectors is Ed , and the average amount of tax evasion that has been detected by fiscal inspectors, but not registered, is En . The bribe paid by those who want to circumvent the law is usually a certain percent (R) of the amount of tax evasion plus the penalties calculated by the tax inspector $E*(1+r)$.

The condition when the net benefit of tax evasion is equal to zero takes place again when the revenues of tax evasion are equal to the expected losses. This is taking into consideration the share of cases when the tax inspectors do not obey their obligations and the bribes that have to be paid to the inspectors:

$$S*Ed + (1-S)*En = S*Ed*P*N*(1+r) + (1-S)*En*P*N*(1+r)*R \quad (4)$$

From here we have

$$Ed*S*(1- P*N*(1+r)) = En*(1-S)*(P*N*(1+r)*R-1) \quad (5)$$

One can use this expression to deduce the amount of tax evasion that has been detected, but hidden by dishonest tax inspectors in exchange of a bribe.

$$En = S*Ed*(1- P*N*(1+r)) / (1-S)*(P*N*(1+r)*R - 1) \quad (6)$$

How can we obtain concrete results?

As we have already mentioned, the average for the Republic of Moldova is $N=3$. We can see from the data of the Main Fiscal Inspectorate that the probability P of being disclosed in tax evasion, (which is the frequency of tax controls) is about 20% for the legal entities. Thus, $P = 0.2$. From the same source, we obtain the penalty rate that is about 100% on average, or $r = 1$.

In two sociological studies conducted by Transparency International – Moldova², 600 entrepreneurs were asked about the usual behavior of tax inspectors when they disclose fiscal law infringement. According to the results, the share of those who named the “price for keeping the silence”, or accepted the bribe and did not report the tax law violation was around 60% in 2002 and 78% in 2000. We can assume the minimum for S as being 60%, or: $S = 0.6$.

Another question from the same sociological study arises: “If during the fiscal control the inspector finds that you broke the law and now are supposed to pay X amount of money, what part of this sum in % is usually sufficient to pay directly to the tax inspector in order to “solve” the problem?” The results varied

² Carasciuc Lilia (2002), Corruption and Quality of Governance: The Case of Moldova, Transparency International – Moldova, 108 p.

from 34.22% in 2000 to 37.8% in 2002. Again we can accept the lowest value: **$R=0.34$** .

One can substitute the data in our model and derive the share of tax evasion that has been detected, but not registered by fiscal inspectors. In the case of Moldova, tax inspectors hide approximately 50% more tax evasion than they declare. This means that one can add 50% to the estimated amount of tax evasion based on the data from the Main Fiscal Inspectorate described previously in this paper. Accordingly, the total tax evasion could reach about 35-40% of the consolidated budget revenues.

This paper presents a rough model of tax evasion. Reality may be on a slightly different scale and it is well known that business people tend to exaggerate things and situations after personal encounters with tax inspectors. However, such a model can give an approximate but quite valid picture of the scale of tax evasion in the country as a whole and its regions.

At the end of the section we conclude that the tax evasion and budgetary losses could be much lower if the corruption and excessive regulation is decreased.

The international conference “Tax Evasion, Trust, and Capacities of the State” was held during November 17-19, 2002 at St. Gallen university of Switzerland. At the conference it was concluded that tax evasion is high because the citizens do not trust state institutions. This is why the state should create a trustworthy environment and enhance the image of public officers. Perhaps this conclusion is too general. What is expected from the public officers of a state, which has had a dictatorial or rigid administration for a long period of time, and the transition to the democratic principles is treated suspiciously and skeptically? What will we do if there is not trust, but a negative mentality, when citizens have a more negative attitude toward both, the state

and taxes? How can we express citizens' trust in state institutions in quantitative terms, avoiding emotional judgment?

The answer to these questions is quite simple: the indicators presented above, that assess the corruption and the quality of governing, are related to trust in state institutions and tax evasion. There are other indicators suitable for this. For instance:

- The number of state institutions – 60 in the Republic of Moldova – that control the activity of enterprises;
- The average number of controls carried out at an enterprise during a single year, which in 2002 was 17. If we take into account the informal visits, then this indicator reaches 33;
- The time used by businessmen to settle issues with state institutions, which according to different research ranged between 17 and 24% of the total time in 2002;
- The possibility to quickly settle problems via legal methods;
- The fiscal burden, which ranges between 25 and 30%, this is the level of taxation under the conditions when a part of producers pay about 50% of the revenues as taxes, while the other part evade paying taxes;
- The number of amendments to the legislation on the private sector, which exceeded 760 over the 10 years of transition. The low access to the information about the amendments introduced in the legislation makes entrepreneurs even more vulnerable to state controls;
- The number of economic branches that have a monopoly or monopsony (a single buyer);
- The exaggerated number of taxes. In some cases it is about some insignificant payments, such as 2-3 MDL (30-35 US cents), however, in order to pay these taxes accountants have to collect about 3 signatures and stamps from institutions

located in different parts of the city, spending plenty of time on this.

The lack of a system, widely spread abroad, whereby payment can be made through mail, the necessity to hand in the documents personally by a representative of the enterprise, as well as other factors diminish the trust in state institutions. Besides this, we can mention the taxpayers' distrust that the state will make an efficient use of the taxes raised from citizens.

Increase Transparency and Prevent Corruption: Conclusions and Recommendations

On the basis of this study, we can conclude that in the Republic of Moldova the system of state regulation is focused on the development and approval of legal and regulatory acts and/or supplementation of the enforced ones, without taking into account their efficiency and impact on entrepreneurial activity. The state institutions rarely propose to abrogate previous decisions on the grounds of their inefficiency or tackle the implementation of regulatory acts in a more convenient way for entrepreneurs. As a result, the system of regulating is becoming more and more complicated, with repeated functions that cause dissatisfaction within the business environment.

This system, being sophisticated and little transparent, places the interests of departments, targeted at raising money for their services, above the national interests, targeted at business development and economic growth. The administrative barriers to economic development, insecurity and lack of transparency in the state regulatory procedures are the main factors having a negative impact on entrepreneurial activity. These factors also facilitate the development of corruption.

With the purpose of diminishing the level of corruption and improving the efficiency of the policies regulating the development of private sector the following are proposed:

- To join the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and to ratify the European Civil and Criminal Convention on Fighting Corruption;
- To join the International Convention of simplification and harmonization of customs procedures, concluded in Kyoto in 1973 and to acknowledge the principles of customs activity stipulated in the Declaration of Customs Cooperation Council on integrity in customs, concluded in Arusha, Tanzania in 1993;
- To introduce a system of monitoring the efficiency of the legal and regulatory acts. The system should have the following aspects: 1. clearly determined procedures for public debates on each draft law; 2. the state bodies that have submitted the draft should assess the efficiency of the acts of the foregoing documents on a periodic basis and the assessments should be accessible to the civil society. The efficiency indicators include three groups of quantitative indicators: whether the decision has been carried out; has the document's target been attained; and the costs incurred by entrepreneurs to implement this decision.
- To introduce amendments to the Constitution of the Republic of Moldova in order to increase the number of persons with the right of legislative initiative; to conduct on a competitive basis the development of draft laws and regulatory acts; to ensure discussions with experts, representatives of business, mass-media, civil society and academic media;
- To eliminate overlapping the functions of the state control institutions such as the Center for Fighting Economic Crimes

and Corruption (CFCEC) and the Fiscal Inspectorate. To make it possible for the CFCEC to concentrate on fighting corruption, leaving the private sector to the fiscal inspectorates;

- To simplify and ensure transparency of the private sector regulatory system by diminishing the number of documents required, simplifying the procedures of authorization, licensing and taxation;
- To create a unified data base of all economic agents from state institutions in order to avoid the duplication of documents required; to recommend that the state control institutions which coordinate the schedules of the inspections and, avoid duplications, and, where possible, to make joint inspections;
- To minimize the direct contact between state officials and solicitants of licenses and other documents by introducing of a new system of contact (including on-line);
- Develop and pass a Law on the protection of businessmen's rights;
- To diminish the number of taxes and duties through the introduction of a single tax for certain categories of small businesses. To reduce the number of fiscal, statistical, and financial forms. To cut the frequency of reporting to once a semester or once a year;
- To monitor the process of granting facilities (tax exemption) with the participation of representatives of civil society; to increase the efficiency of these facilitations;
- To expand Codes of Conduct for public officials and business people, as well as the mechanism of monitoring its implementation.