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The Economic Impact of Corruption

All states, whether benevolent or repressive, control the distribution of valuable benefits and the imposition of onerous costs. The distribution of these benefits and costs is generally under the control of public officials who possess discretionary power. Private individuals and firms who want favorable treatment may be willing to pay to obtain it. Payments are corrupt if they are illegally made to public agents with the goal of obtaining a benefit or avoiding a cost. Corruption is a symptom that something has gone wrong in the management of the state. Institutions designed to govern the interrelationships between the citizen and the state are used instead for personal enrichment and the provision of benefits to the corrupt. The price mechanism, so often a source of economic efficiency and a contributor to growth, can, in the form of bribery, undermine the legitimacy and effectiveness of government.

This chapter isolates the most important situations where widespread corruption can determine who obtains the benefits and bears the costs of government action.

- The government may be charged with allocating a scarce benefit to individuals and firms using legal criteria other than willingness to pay. *Bribes clear the market.*
- Officials in the public sector may have little incentive to do their jobs well, given official pay scales and the level of internal monitoring. They may impose delays and other roadblocks. *Bribes act as incentive bonuses.*
- Those engaged in legal pursuits seek to reduce the costs imposed on them by government in the form of taxes, customs duties, regulations. *Bribes lower costs.*
- Illegal businesses frequently purchase corrupt benefits from the

state. In extreme cases illegal businesses and organized crime bosses dominate the police and other parts of the state through corruption and intimidation. *Bribes permit criminal activity.*

These categories are not mutually exclusive. A bribe that acts as an incentive payment, for example, might also allocate a scarce benefit or provide a tax exemption. Nevertheless, each raises enough distinctive issues so that it is worth considering each one separately.

Payments that Equate Supply and Demand

Governments frequently provide goods and services for free or sell them at below market prices. Often dual prices exist – a low state price and a higher free market price. Firms will then pay off officials for access to below-market state supplies. In China, for example, some producer goods were sold at both state-subsidized prices and on the free market. Although the price differences have shrunk in recent years, they were once very large. Chinese researchers reported that in 1989 the market price of coal was 674 percent of the subsidized price. The market prices of seven other producer goods were from 250 percent to 478 percent of the prices fixed by the state. Not surprisingly, payoffs to obtain supplies at state prices were reportedly very common.[1] In Nigeria when oil prices were set artificially low relative to the market price in neighboring Benin, smuggling facilitated by corruption was apparently widespread. The price difference provided benefits both to the smugglers and to the officials who were paid to overlook the illegal trade.[2]

If the supply of credit and the rate of interest are controlled by the state, bribes may be paid for access. Interviews with business people in Eastern Europe and Russia indicate that payoffs are frequently needed to obtain credit (De Melo, Ofer, and Sandler 1995; Webster 1993; Webster and Charap 1993). In Lebanon a similar survey revealed that loans were not available without the payment of bribes (Yabrak and Webster 1995). Personal influence and corruption lead banks into high-risk lending – sometimes to "borrowers" with no intention of repaying the funds. In Kenya, for example, one well-placed observer estimated that a third of banking assets were close to worthless in 1992 as a result of political

[1] Data from the Price Reform Group of the Finance and Trade Institute of China's Academy of Social Science, printed in *Zhongguo Wujia (China Price)*, Beijing, October 1990. For an example, see "China's Paragon of Corruption," *New York Times*, March 6, 1998. On corruption in China, see Gong (1993), Hao and Johnston (1995), and Johnston and Hao (1995).

[2] "Camel Through the Needle's Eye," *Newswatch*, February 3, 1991. Excerpts reprinted in World Bank (1993b, Annex 26).

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interference in the financial system (Bigsten and Moene 1996: 191). A similar situation existed at the National Bank of Fiji where political influence was apparently widespread (Findlay 1997: 54). In Korea bank loans continued to be made to well-connected companies after they experienced serious financial difficulties. The companies had made substantial payoffs to powerful politicians, and these same officials pressured the banks to continue making loans. The bankers themselves were also bribed.[3] In Pakistan well-informed researchers calculated that it would cost the government 10 to 15 percent of 1996–1997 gross domestic product to deal with a banking crisis based on nonperforming loans provided to friends of the regime (Burki 1997: 9).

Exchange rates often do not reflect underlying economic fundamentals, thus producing incentives to pay bribes to get scarce foreign exchange at favorable rates. For example, Paraguay's multiple exchange rate system led to corruption before it was reformed (World Bank 1994b). South Africa's twin currency system was a source of payoffs. The financial rand was abolished in March 1995, a policy change that removed one set of corrupt incentives.[4]

The allocation of scarce import and export licenses is a frequent source of payoffs and patronage with bribes linked to the value of the benefits conferred. In the Philippines in the early 1950s both methods operated. Those with political connections could easily obtain licenses so long as they paid a 10 percent commission (Hutchcroft 1998: 73). In Nigeria, the regime in power in the early 1980s resisted free trade reforms favored by the International Monetary Fund (IMF) apparently because the existing system of import licensing was a major source of payoffs and patronage (Herbst and Olukoshi 1994: 465). By the late 1980s the import licensing system had become so discredited that it was abolished. Apparently the Manufacturers Association of Nigeria, whose members had paid bribes without complaint in earlier years, began to see that they would be better off without the system. Furthermore, at the same time that the import licensing system ended, the state introduced other new rent-seeking opportunities (Faruqee 1994: 246; Herbst and Olukoshi 1994: 481–482).

The incentives to make payoffs are clear enough in these cases, but

[3] "Yet Another Shock to South Korea's System," *The Economist*, May 24, 1997; "Hanbo Group Founder Is Jailed for 15 Years," *Financial Times*, June 3, 1997.

[4] *Transparency International Newsletter*, June 1995; "South African Economy in Global Firing Line," *Financial Times*, March 13, 1995; and "Strong Debut for Unified Rand," *Financial Times*, March 14, 1995. According to the March 13 article, however, South Africans still face tough controls on taking funds abroad, a situation that could encourage illegal attempts to circumvent the controls.

what are their efficiency and distributive consequences? Do they simply equate supply and demand, functioning much like prices in a legal market? I consider three cases. First, the public benefit is scarce and fixed in supply. The officials charged with its allocation have no discretion to increase or decrease total supply. Second, the benefit is scarce, but officials themselves can influence the quality and quantity available. Third, the service is available to all who qualify, but officials have discretion to determine who meets the requirements.

Fixed Supply

In the first case, where the official must allocate a fixed number of licenses or benefits, the number of people qualified to obtain the service exceeds the supply. If the corrupt market operates efficiently, the service will be provided to the applicants with the highest willingness to pay. If there is no price discrimination, the "market clearing" bribe will be equivalent to the price in an efficient market. The state could have legally sold the service with the same result except for the distribution of the revenue. Bribes increase the incomes of civil servants. Legal payments go into the government's treasury. But even that difference may be illusory. If the labor market is competitive, the government can reduce the pay of civil servants to below private sector wages because of the payoffs available to public officials (Besley and McLaren 1993; Flatters and MacLeod 1995). In short, if competitive conditions exist both in the corrupt market and in the labor market, illegal payoffs are like market prices. The winners are those willing to pay the most in bribes; the losers are those willing to pay in other forms such as time spent in a queue or persistence in petitioning officials.

Consider, however, the ways in which inefficient or unfair results can arise even in this simple case. To begin, suppose allocation to those with the highest willingness to pay is acceptable. Then one must ask whether corrupt markets are likely to differ much from open competitive ones. In general, they will not work as efficiently as legal markets (Bardhan 1997; Cartier-Bresson 1995; Gambetta 1993; Rose-Ackerman 1978). The illegality of bribery induces participants to spend resources keeping the transaction secret. This, in turn, means that information about bribe prices will not be widely available. Prices may be relatively sticky because of the difficulty of communicating market information. Some potential participants may refuse to enter the market because of moral scruples and fear of punishment, and public officials may limit their dealing to insiders and trusted friends and relations to avoid disclosure (della Porta and Vannucci 1997a). For all these reasons, a corrupt system will be not only less competitive but also more uncertain than a legal market.

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Furthermore, payoffs may undermine the goals of a program. In Great Britain in the eighteenth century many officials were legally remunerated by retaining a portion of the fees they collected. Reformers, urging a shift to fixed salaries, claimed that officials unfairly focused on the most "profitable" parts of their jobs (Chester 1981: 139). In particular, services designed to benefit the needy or the well-qualified will go instead to those with the highest willingness to pay. Thus the sale of import and export licenses or restaurant licenses could be efficient, but the allocation of subsidized credit, housing, or university admissions by price would undermine the programs' distributive goals even if those admitted are nominally "qualified" under the law.

Consider the allocation of subsidized housing. Corruption has occurred in public housing programs in the United States where the number of qualified households far outstrips the number of places in subsidized units. In one Connecticut town, officials operated two lists – one for the honest and another, faster moving queue for those who made payoffs (cited in Rose-Ackerman 1978: 96). In Washington, D.C., two city officials were convicted of accepting bribes to certify unqualified people for subsidized housing and to give applicants higher priority on the waiting list than they deserved [*United States v. Gatling*, 96 F. 3d 1511 (1996)]. Similar corruption has arisen in the allocation of public housing in Hong Kong and Singapore where demand also exceeds supply (Lee 1986: 98). In Hong Kong the amounts paid were a function of the value of the benefit disbursed (Alfiler 1986: 54).

The allocation of irrigation water or land is another case where allocation to the high bribers is inconsistent with the programs' distributive goals. In irrigation projects, payoffs from upstream farmers to public officials may mean that little or no water reaches the farmers at the bottom of the system. In some irrigation systems in India and Pakistan, downstream farmers obtain too little water even for subsistence farming, and some ditches run dry before the end of the system is reached (Murray-Rust and Vander Velde 1994; Vander Velde and Svendsen 1994; Wade 1982, 1984). When land reform is designed to benefit poor farmers, corrupt payments for the best plots will favor the more well-to-do and those with connections to the officials administering the program (Bunker and Cohen 1983: 109).

Variable Supply

Consider now the second and third cases where officials can influence the quantity and quality of services provided and the identity of beneficiaries. In these cases, corruption is almost certain to lead to inefficiency. A single individual may have authority to issue permits or subsidies, overlook violations of the law, or grant contracts (Findlay 1991; Klitgaard 1988; Rose-Ackerman 1978; Shleifer and Vishny 1993).

In the second case, where the quantity is scarce but variable, the official, like a private monopolist, may distribute less than the officially sanctioned level to increase the economic rents available for division. In contrast, if the government has set the supply below the monopoly level, the corrupt official will seek to provide an increased supply of the service. The official seeks to maximize his or her gains, not set the optimal level of services. The official's behavior depends not only on the total economic rents but also on the share that the official can extract in dealing with corrupt beneficiaries. If several officials have authority over the allocation of scarce benefits, the problems can multiply as each tries to extract a share of the gains.

Consider, for example, the market for commercial real estate in Russia. Local government councils hold ownership rights, but the head of the administration has a great deal of personal discretion in deciding how much real estate to supply to the private sector. Real estate allocation does not follow commercial principles. Existing occupants are favored, and rental rates are far below market prices. The low rents create "a huge economic rent which accrues to local officials" (Harding 1995: 10) and creates pervasive excessive demand. The ambiguity and inconsistency of federal requirements have left room for corrupt and self-seeking maneuvering by local agencies. The lack of a rule of law leads to rent seeking by officials. This process is exacerbated in Russian cities by the existence of overlapping authorities, each of which tries to extract benefits from its strategic situation. The result is an inefficient, unfair, and corrupt system.

In the third case, a public service – such as a passport, a driver's license, or an old age pension – is not scarce, but is available to all who "qualify." Unqualified people and firms frequently pay bribes to obtain such benefits. For example, in Thailand individuals paid to pass the entrance exam for the Police Cadet Academy and to obtain driver's licenses without taking any tests (Alfiler 1986: 37, 56). In Korea officials were accused of accepting bribes to fake the qualifying scores of nursing students, to issue a license to an unqualified bonesetter, and to conduct inspections of food corporations and polluting firms (ibid.: 38, 47). In the United States officials of the Immigration and Naturalization Service have been bribed to issue fraudulent working papers.[5] In Brazil massive fraud in the processing of workmen's compensation claims involved the

[5] "Immigration Department's Eyes Are Still on Newark Office," *New York Times*, August 18, 1996.

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corruption of social security officials, politicians, prosecutors, and judges (Fleischer 1997: 309–310). Andrei Shleifer and Robert Vishny (1993: 601) call this case "corruption with theft" because their archetypal example is a firm that bribes to be excused from paying customs duties, but the range of examples also includes cases in which a qualifications process is undermined or a regulation violated. Clearly, the unqualified will often be those with the highest willingness to pay because they have no legal way to obtain the service.

Even those who are qualified may pay, however, if officials have sufficient monopoly power to create scarcity either by delaying approvals or withholding them unless paid bribes (Paul 1995). Attempts to create scarcity can successfully generate bribes if applicants have no alternative source of the service and no effective means of appeal. Another strategy is to maintain vague and uncertain qualification standards. Then officials can withhold services from anyone who does not make a payoff, but it will be difficult for anyone to prove that they have been unfairly treated.

The greater the discretion of officials and the fewer the options open to private firms and individuals, the higher the costs of a system that condones corruption even if all who obtain the service are, in fact, qualified. The costs are the time and trouble suffered by potential beneficiaries as a result of officials' efforts to extract bribes (Bardhan 1997; Klitgaard 1988).

Bribes as Incentive Payments for Bureaucrats

Since time is money, firms and individuals will pay to avoid delay. In many countries a telephone, a passport, or a driver's license cannot be obtained expeditiously without a payoff. Sometimes the service is available only to the corrupt, but not to the patient but honest citizen.

An Indian newspaper published a list of the standard "fees" for a range of routine public services.[6] In St. Petersburg in 1992 the going rate for a telephone installation was $200 (Webster and Charap 1993). A study of the informal economy in the Ukraine lists the payoff levels for a range services needed by private businesses. Most firms reported paying fees in connection with importing and exporting. Phone lines almost invariably involved an "informal payment." Payments to tax, fire, and health inspectors were common, as were unofficial lease fees and payments for access to credit. The high cost of dealing with state officials through bribery induces many firms to operate in the informal sector

[6] "Bribe Index," *Sunday Times of India*, December 17, 1995. For example, a driver's license cost 1000 to 2000 rupees, and installation of an electric meter cost 25,000 to 30,000 rupees.

and many others to underreport sales, costs, and payroll to the authorities. The losses to the state are large, and, in addition, the level of payoffs discourages investment and the entry of new firms (Kaufmann 1997).

Similar corrupt incentives exist if the government does not pay its bills on time. In Argentina, for example, a scheme in which insurance companies bribed to get delayed claims paid by a state-run reinsurance company degenerated into a system of outright fraud against the state organized by corrupt state officials and intermediaries (Moreno Ocampo 1995).

In highly corrupt countries managers spend many hours dealing with state officials. In surveys of business people from a number of countries, Ukraine is an extreme case. In 1996 proprietors and senior managers spent an average of 30 percent of their time dealing with officials. Elsewhere the percentages range from 7 percent in El Salvador to 15 percent in Lithuania and Brazil (Kaufmann 1997).

Some scholars have constructed economic models where bribes have desirable incentive properties. For example, payoffs to the managers of queues can be efficient (Lui 1985). The payments give officials incentives both to favor those who value their time highly and to work quickly. The provision of telephone services in India illustrates the point. Officially, an egalitarian norm prevails, but businesses pay bribes to obtain preferential treatment in placing calls (Rashid 1981). Some argue that in developing countries the corruption of tax collectors can be efficient so long as the government can impose a binding overall revenue constraint (Flatters and MacLeod 1995). The minister sets a revenue target, a nominal tax liability schedule, and the wage rate of the tax collector. Corruption gives the tax collector an incentive to seek tax revenue, and the government tolerates bribery so long as the collector turns in an amount equal to the revenue target. The larger the difference between nominal tax liabilities and the revenue target, the higher the corruption.

The authors of some of these studies conclude that routine corruption may be tolerable. I disagree. First, toleration of corruption in an important agency, such as tax collection or the provision of public utilities, may encourage its spread to other areas with harmful consequences. Second, the authors assume that officials have only limited discretion. For example, the tax collector "discovers" the tax liabilities of citizens and firms. In reality, he or she might "create" tax liabilities as a bribe extraction device. If firms' and individuals' vulnerability to corrupt demands varies, the result is an arbitrary and unfair pattern of payments. The sum of taxes and bribes would vary across taxpayers in a way that reflects the collector's leverage, not the underlying tax rules. If taxpayers differ in

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their propensity and willingness to bribe and if the tax breaks given in return for payoffs are not publicized, the result can be a system based on special favors given to some, but not others. Similarly, officials may create corrupt opportunities that harm the government. For example, in India telephone operators moved from expediting calls to failing to bill customers (Rashid 1981: 456–458). In Italy, where long bureaucratic delays are the rule, officials often ask for bribes just to do their job. As a consequence, the rest of the public suffers even longer holdups (della Porta and Vannucci 1997a: 525–526).

Third, corruption can contribute to an uncertain business climate. Firms pay bribes to obtain certainty,[7] but the certainty may be illusory because they cannot enforce corrupt deals. In the short term, bribes may enhance efficiency in tax collection or the provision of services, but difficulties arise in the longer term. Payments made to increase certainty for individual firms result in a wide variance in conditions across firms. For example, although they present no direct evidence of corruption, Lant Pritchett and Geeta Sethi (1994), using data from Jamaica, Kenya, and Pakistan, show how higher tariff rates are associated not only with lower proportional collections, but also with greater variance in the rates actually paid. Surveys of business people in Pakistan and Ukraine indicate high interfirm variability in reported bribes (Rose-Ackerman and Stone 1998). Nominal tax liabilities are poor predictors of actual tax liabilities for the firm itself and for its competitors. Individualized attempts to reduce uncertainty can, at the level of society, increase uncertainty. As a consequence, potential entrants will view the economic environment as risky and unpredictable.

Ingrained corruption can also hold back state reform. Firms that have benefited from payoffs will resist efforts to increase the clarity of rules and laws. Their allies within the state apparatus will also oppose reform efforts designed to make the economy more open and competitive (Bigsten and Moene 1996). In short, although bribes can sometimes be characterized as incentive payments to public officials, a policy of active tolerance will undermine the prospects for long-term reform. It will also tend to delegitimate government in the eyes of its citizens. Payoffs that are widely viewed as acceptable should be legalized, but not all "incentive pay" schemes will improve bureaucratic efficiency. Some may simply give officials an incentive to create more delays and red tape and to favor the unscrupulous and the well-off.

[7] Legal and regulatory uncertainty is frequently mentioned by business people interviewed in surveys in developing countries. See, for example, Economisti Associati (1994), Webster (1993), Webster and Charap (1993).

Bribes to Reduce Costs

Governments impose regulations and levy taxes. Individuals and firms may pay for relief from these costs. I first consider corrupt incentives in regulatory programs followed by corruption in the collection of taxes and duties. I then consider the economic and political impact of this type of corruption.

Regulatory Programs

Under public regulatory programs, firms may pay to get a favorable interpretation of the rules or to lighten the regulatory load. Rules and regulations can be used by corrupt officials as a means of enriching themselves. Everywhere rules are bent in return for payoffs. The loci of payoffs are remarkably similar throughout the world considering the large differences in culture, economic conditions, and political organization. Payoffs occur in business licensing, in the inspection of construction sites and buildings, and in the regulation of environmental hazards and workplace safety. Whenever regulatory officials have discretion, an incentive for bribery exists.

For example, in Korea after a department store collapsed in 1995, it was revealed that the contractors used substandard concrete and that city officials had taken bribes to allow the violation of safety rules.[8] In Turkey, after earthquakes destroyed many buildings in late June 1998, construction deficiencies were revealed. Government-built schools and hospitals were especially hard-hit, leading many people to suspect that building inspectors and other government officials had been corrupted.[9] These allegations will sound familiar to anyone knowledgeable about the corruption of inspectors of construction projects in New York City or of housing authorities in Russia (Anechiarico and Jacobs 1996: 26–28; Harding 1995).

In Mexico payoffs have been common in regulatory agencies that issue permits and licenses (Morris 1991: 51). The same is true in Kenya where companies connected with the president enjoy a regulatory advantage.[10]

[8] Other Korean examples include an apartment house that collapsed, killing 28 people, and a bridge in Seoul that fell apart, killing 31. See "Owner, Son Jailed in Fatal South Korea Store Collapse; City Officials Also Found Guilty of Accepting Bribes," *The Baltimore Sun*, December 28, 1995; "Grease That Sticks," *Far Eastern Economic Review*, March 23, 1995.

[9] John Barham, "Political Aftershocks Rumble on after Turkish Earthquake," *Financial Times,* July 6, 1998.

[10] Bigsten and Moene (1996: 182); "American, Other Foreign Companies Selling Off Holdings: Kenya Corruption Overwhelms Investors," *Los Angeles Times,* June 25, 1989.

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In Indonesia connections are important (Robison 1986), and less well-connected small businesses experience high bribery demands. One study claimed that small entrepreneurs make payments that range from 5 to 20 percent of annual gross income.[11] In Pakistan control over the implementation of environmental rules has been viewed as a source of rents (Burki 1997: 16–17).

Regulations that surround the exploitation of natural resources are particularly open to corruption since bending the rules will often produce high profits. Studies of the forestry industry, for example, indicate that corrupt payoffs have frequently been used to enhance the profitability of forestry concessions (Roodman 1996). Similarly, corrupt incentives are high for newly privatized state enterprises dealing with fledgling regulatory agencies without a track record. Squeezed by a competitive bidding process, a firm may try to increase its gains ex post by using bribes to secure a favorable business climate.

Taxes and Customs Duties

Paying taxes and customs duties is always burdensome. In addition, customs agents control something that firms value – access to the outside world. Thus businesses and individuals may collude with tax collectors and customs agents to lower the sums collected and to expedite services. As a result, revenue collection may be both inadequate and distributed unfairly. For example, in Pakistan one study estimated that if the leakages caused by corruption and mismanagement could be reduced by 50 percent, the tax to Gross Domestic Product (GDP) ratio would increase from 13.6 to over 15 percent (Burki 1997: 16). In New York City workers used their computer skills to reduce or eliminate tax liability for hundreds of property owners. The officials generally collected bribes equal to 10 percent of the tax liability eliminated, but sometimes their share was as high as 20 to 30 percent. Using a similar technique a city water-meter reader collected bribes in return for reducing water bills.[12]

The experience of a number of African countries illustrates the magnitude of the problem. In Gambia, in the early nineties, forgone revenue from customs duties and the income tax was 8 to 9 percent of GDP (six to seven times the country's spending on health). Income tax evasion alone was 70 percent of revenue due. Only 40 percent of small- and medium-sized enterprises paid taxes, and many individuals did not file

[11] Hetifah Sjifudian, "Graft and the Small Business," *Far Eastern Economic Review,* October 16, 1997.

[12] "29 Arrested in Tax Fraud Scheme Described as New York's Largest," *New York Times,* November 22, 1996; "20 Arrested in Scheme to Cut Water Bills," *New York Times,* October 22, 1998.

returns. Underpayment of customs was facilitated by the lack of clear guidelines and of published tariffs. The extensive discretion of officials encouraged corrupt payoffs designed to evade tariffs. Of course, a well-working system would have been able to reduce tax and tariff rates, but the distortionary effect of such a high level of evasion is clear (Dia 1996: 46–47, 94–100). A study of tariff exemptions in Zambia, Tanzania, and Mali estimated that exemptions, both justified and unjustified, produced a revenue shortfall of close to 50 percent (Low 1995). In Mozambique in 1995 the customs service collected 49 percent of the revenue it would have collected if no exemptions had been given. This total includes validly granted exemptions, but it excludes false declarations of value. Customs officials had discretion to grant exemptions without guidelines. Officials added extra delays, overestimated the value of goods, and applied higher rates in an attempt to extract payoffs (Stasavage 1996). In Zaire, much of the country's output was smuggled out with the complicity of customs officials. Corruption was also pervasive in evading import duties and controls. A study of cross-border trade reported how importers would undervalue their load by half and divide the resulting benefit with customs officials. The Anti Fraud Brigade was also paid off (MacGaffey 1991).

Taxpayers and corrupt officials divide the savings in taxes and duties. The costs are born by those taxpayers who are poorer and less well-connected and by the general public in the form of reduced services. In Africa, for example, studies of Gambia, Mozambique, and Ghana suggest that corruption permits the rich to avoid taxes (Dia 1996; Stasavage 1996). Tax avoidance in the Philippines reputedly means that the poor contribute twice as much as the rich, and 63 percent of imports pay no duty.[13]

New corrupt opportunities are one of the growing pains of economic and political transformation and can undermine otherwise promising reforms by reducing their legitimacy and fairness. A corrupt tax and customs system that favors some groups and individuals over others can destroy efforts to put a country on a sound fiscal basis and discredit reform. For example, in Mozambique interviews carried out in 1996 indicated that corruption had grown since the beginning of reform efforts in 1986. Overall taxes fell from 20 percent of GDP in 1993 to 17.6 percent in 1994 with import taxes falling from 5.1 percent to 3.9 percent of GDP (Stasavage 1996). Corruption is especially common when nominal tax rates are very high, as in the transitional states in Eastern Europe and the former Soviet Union (De Melo, Ofer, and Sandler 1995; Novitzkaya,

[13] *Far Eastern Economic Review*, April 20, 1996.

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Novitzky, and Stone 1995; Webster and Charap 1993). High nominal tax rates lead to bribes and other types of tax avoidance which lead to even more avoidance, and so forth in a vicious spiral.

Economic Impact and Political Legitimacy

The economic impact of bribes paid to avoid regulations and lower taxes depends on the efficiency of the underlying programs that are subject to corrupt distortions. Suppose a state has many inefficient regulations and levies burdensome taxes on business. Then, given the existing inefficient legal framework, payoffs to avoid regulations and taxes may increase efficiency (Leff 1964). Bribes can overcome excessive regulation, reduce tax payments, and allocate scarce goods (Rashid 1981). Even if the corrupt "market" has some of the problems outlined above, the result may still be superior on efficiency grounds to compliance with the law. This defense of payoffs is commonly espoused by investors in developing countries and appears in discussions of investment in Eastern Europe and the former Soviet Union as well. It is a pragmatic justification that grows out of frustration with the existing legal order. This argument is important because it attempts to justify corruption to obtain benefits to which one is *not* legally entitled. Bribers are better off than they would be in an honest system in which they had to comply with the law.

But are individuals and firms obligated only to obey laws that they judge to be efficient and just? Clearly, in industrialized countries such conduct would not be tolerable. American and European firms do not generally try to bribe their way out of environmental and health and safety rules or enlist the help of criminals to evade the law. Instead, such firms work to change the laws, make legal campaign contributions, lobby public agencies, and bring lawsuits that challenge laws and regulations. One can complain about the importance of wealth and large corporations in the political life of developed countries, but at least well-documented lobbying activities and campaign contributions are preferable to secret bribes in maintaining democratic institutions.

Some of these same firms, however, feel less constraint about violating laws in developing and transitional economies. Because the United States outlaws bribes paid abroad to obtain business, American companies face domestic legal sanctions.[14] But the perceived importance of that constraint suggests that multinationals do not always feel an obligation to obey the law in the developing countries where they operate. Survey

[14] The act is the Foreign Corrupt Practices Act, 15 U.S.C. §§ 78m(b) & (d)(1) & (g)–(h), 78dd-1, 78dd-2, 78ff (a)(c) (1988 & Supp. IV 1992). For a review of the case law, see Pendergast (1995).

evidence indicates a wide range of viewpoints among American business people. In one study 30 percent of the American managers surveyed stated that it was never acceptable to pay a "consulting" fee of $350,000 to a foreign official in return for a contract worth $10 million in profits. At the other end of the scale, however, 6 percent found the payment always acceptable (Longenecker, McKinney, and Moore 1988). Of course, it is not just the managers of foreign firms who have such beliefs. Domestic companies often operate in the same fashion.

There are two difficulties with a policy of widespread tolerance. First, one cannot rely on investors to pay bribes only to avoid inefficient rules and taxes. They will, instead, want to reduce the impact of all state-imposed burdens, justified or not. Of course, one can construct models in which the laws on the books are all payoffs to politically powerful groups with no public legitimacy (Brennan and Buchanan 1980; Stigler 1971). Then avoiding the burdens imposed by such laws seems a worthy goal. Unless one is a strong libertarian who believes that all state action is illegitimate, however, such a criterion would be impossible to implement. Should firms or individuals be able to defend against a charge of corruption with a showing that the law was unjust or inefficient? Should they be able to justify the bribery of politicians by claiming that the law they favored will enhance competitiveness? This would put a policy analytic burden on the law enforcement system that it is ill-equipped to handle in practice and that it is illegitimate to impose on the courts in theory.

Second, it seems strange indeed to tolerate business firms' judgments that a well-placed payoff is justified because it increases their profits. Such an attitude can do serious harm in nations struggling to build a viable state. These states need to develop effective mechanisms that translate popular demands into law, that provide a credible commitment to the enforcement of these laws, and that provide legal recourse to those facing extortionary demands. If investors and ordinary citizens make individualized judgments about which laws are legitimate, the attempt to create state institutions will founder. Bribery will determine not only which laws are enforced but also what laws are enacted. All states, even those that have most successfully curbed the power of special interests, enact inefficient laws, but no state could operate effectively if individuals could take the law into their own hands and justify doing so by reference to cost–benefit criteria.

The discussion thus suggests that corruption may be more tolerable not when it increases the efficiency of individual deals, but when it is carried out in clearly illegitimate regimes that can make no claim to popular support. Then even bribes to avoid taxes seem less harmful than

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in other contexts because the fewer resources available to the state, the less powerful it is. Still, costs do remain. The beneficiaries of corrupt transactions will be a strong constituency against reform because they will fear the loss of their special advantages. Furthermore, when a reform regime does take power, its efforts will be made more difficult if corruption has become systemic. One of the regime's first tasks must be to change the behavior of corrupt officials, firms, and individuals. Tolerating individual efforts to circumvent even burdensome laws is not consistent with state legitimacy.

Organized Crime and Corruption

Illegal businesses seek to operate securely by paying off the police, politicians, and judges or by permitting them to share in the profits of the illegal businesses. But such businesses are also especially vulnerable to extortionary demands. Law enforcement authorities – from the police to prosecutors and judges – can demand payments to overlook criminal law violations or limit penalties. If the evidence of criminal behavior is clear, such businesses will be unable credibly to threaten to report corrupt demands.

Of course, illegal businesses are hardly innocent victims. They often actively try to corrupt the police. They seek not only immunity from prosecution for themselves but also assurance of monopoly power in the illegal market. In both the United States and Latin America, gamblers and drug dealers have paid officials to raid their competitors or to restrict entry.[15] In Thailand some local public authorities shelter criminal enterprises both from competition and from the law (Pasuk and Sungsidh 1994: 51–97). In Russia those engaged in illegal businesses sometimes engage in outright intimidation of potential rivals, often paying off the police not to intervene in their private attempts to dominate the market (Handelman 1995).

The danger for economic development arises when organized criminal groups begin to dominate otherwise legal business. Southern Italy and the countries in transition in Eastern Europe and the former Soviet Union are cases in point. Several Latin American and Asian countries face similar risks. Organized crime groups can use the profits of illegal enterprise not only to assure the complicity of public officials but also to infiltrate legal businesses. The profits generated by illegal businesses,

[15] Rose-Ackerman (1978: 163); "Bribes and Publicity Mark Fall of Mexican Drug Lord," *New York Times*, May 12, 1996; "Mexican Connection Grows as Cocaine Supplier to U.S." *New York Times*, July 30, 1996; "Popular Revulsion Is New Factor in Chronic Colombian Drug Scandal," *Washington Post*, January 28, 1996.

earned without paying taxes, can then be reinvested in legitimate business and in obtaining public contracts (Gambetta 1993; Varese 1994).

The stakes are especially high in Eastern Europe and the countries formed after the collapse of the Soviet Union. Nothing less than the entire wealth of the state is up for grabs. The value of sharing in the privatization of a socialist state dwarfs the benefits of sharing in the privatization of a public utility in Western Europe or a steel mill in a developing country. Both criminal groups and legitimate business concerns seek to share in the wealth. If criminals can create an atmosphere of uncertainty and the threat of violence, they will drive competitors away, especially Western firms, leaving the criminal groups with a free field (Shelley 1994). In fact, FDI from legitimate business has not been large in the countries of the former Soviet Union and varies widely across countries.[16] One explanation for these results is the weakness of state institutions and the corruption and organized crime influence this generates.

Even in developed countries some legitimate businesses are especially vulnerable to criminal infiltration. Organized crime is both wealthy and unscrupulous. It is willing to use not only bribery but also threats and violence to enforce its contracts and get its way. In the most successful examples the legitimate businesses which operate under Mafia protection earn sufficient monopoly rents to make them supporters of continued organized-crime influence. Diego Gambetta and Peter Reuter provide a list of the factors favoring the emergence of Mafia-controlled cartels (Gambetta and Reuter 1995: 128). In the most favorable cases product differentiation and barriers to entry are low; technology is unsophisticated and labor unskilled; demand is inelastic; and the industry consists of a large number of small firms. Private garbage collection provides a good example. Entry is inexpensive – one need only purchase a truck. However, because garbage trucks operate alone on the public streets, it is relatively easy to intimidate unwanted rivals by attacking their trucks without attracting police attention. To minimize the risks for organized crime, but at a cost, the Mafia can pay the police to look the other way (Reuter 1987).

Similarly, whenever a business needs to obtain a license to operate, the

[16] Alexander Pivovarsky (1997–1998) cites data from the World Investment Report showing that in 1996 three countries in Eastern Europe (the Czech Republic, Hungary, and Poland) accounted for 68 percent of inflows in the whole region of Central/Eastern Europe and the former Soviet Union and 73 percent of the region's accumulated capital stock from FDI. In 1996 FDI stock per capita ranged from $6 in Belarus, $25 in Ukraine, and $40 in Russia to $1471 in Hungary and $556 in Estonia.

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ability to corrupt officials to gain approvals for yourself and deny them to your rivals yields an obvious competitive advantage. Labor unions, with or without organized crime connections, can use this tactic. For example, an official of the Roofers Union in Philadelphia was convicted of bribing an official of the Occupational Safety and Health Administration to harass nonunion roofing contractors [*United States v. Traitz*, 871 F.2d 368, 375 (1989)].

Legal businesses that benefit from prime urban locations are especially at risk in countries with weak or corrupted police forces. This includes restaurants and shops serving tourists and business travelers. Manufacturers can hide in out-of-the-way locations (Charap and Webster 1993), but service businesses cannot "go underground." If the police are unreliable, criminal groups may demand protection money where the funds are, in part, protecting the business from attacks by the group itself (De Melo, Ofer, and Sandler 1995; Webster 1993; Webster and Charap 1993).

Businesses, such as road repair and building construction, that do a heavy business with the state are also prime candidates for organized crime influence. If a government has been corrupted by organized crime in connection with its illegal businesses, it may be a relatively short step to make payoffs to obtain public contracts on favorable terms. In the extreme, organized crime groups manage cartels that share contracts and pay off public officials to buy their complicity or at least their silence. In southern Italy, for example, a survey reports that over half of the small- and medium-sized businesses reported that they withdrew from a public tender after pressure from criminal groups or their political allies.[17]

The wealth, unscrupulousness, and international connections of many organized criminal groups suggest the difficulty of control by any one country. The danger is that, rather than being a stage of development that will wither away over time, criminal activity becomes so intertwined with politics that it is difficult to tell them apart.

Conclusions

One defense of bribery focuses on the inefficiency and arbitrariness of many government rules and regulations. If administered by underpaid and unmotivated public officials, the incentives to pay bribes are high, and the benefits seem obvious – private firms and citizens can go about their business. Individual bribes sometimes not only benefit the payer and the recipient but also enhance overall efficiency or fairness. The existence of such cases, however, is not a valid argument for tolerating low-level official corruption.

[17] "Still Crooked," *The Economist*, February 5, 1994.

First, and most obvious, not all bribes have this result. Consider, for example, tax evasion, violation of environmental rules, certification of unqualified people for public benefits, and grants of immunity to organized crime. Second, if bribes do serve a valid resource allocation function, they should be legalized, and the fees made public. A market based on illegal payoffs is inefficient.

Third, the defense of bribery as a allocative tool is static. It assumes a given set of laws and public program requirements. Instead, corrupt officials, seeing the financial benefits of accepting bribes, frequently have the discretion to redesign their activities. They may create scarcity, delay, and red tape to encourage bribery. They may threaten the reluctant with arrest and criminal prosecution. In such cases individuals can justify payoffs as a way to avoid greater harms, but the systemic costs are serious. Furthermore, toleration of corruption in some areas of public life can facilitate a downward spiral in which the malfeasance of some encourages more and more people to engage in corruption over time.

Fourth, pervasive corruption undermines the legitimacy of government. Corruption in the provision of public goods and services and in the imposition of costs casts a cloud over governments seeking popular legitimacy. Bribery is not a stable, long-term substitute for law reform.