1. Economic Causes of Corruption

The state intervenes in the economy to lay out a framework for economic and social activity—it establishes property and personal rights, provides police protection and national defence and promulgate laws governing private transactions such as contracts, firm organisation and marriage. It enforces the law and sets up courts, where private legal disputes can be resolved. The state may correct market failures and provide public goods that are not supplied by private markets. The state may redistribute income; equalise opportunities for education, health and employment; and reduce risk by providing pensions and unemployment and disability insurance. It may also further certain moral, religious or cultural values.

But the state can also be an instrument of repression. It can restrict the behaviour of individuals and groups beyond that needed to further public aims. It can benefit narrow but powerful groups with access to legislatures and chief executives. Top officials may organise the state to enrich themselves. Even when a state’s aims are broadly democratic, public policies can be implemented in wasteful and incompetent ways. Lower-level officials may take advantage of their power and insist on bribes. Government failure may be as prevalent as market failure. Both private individuals and public agents may seek to benefit personally from their privileged positions in the economy or the polity.

All states, whether benevolent or repressive, manage the distribution of valuable benefits and the imposition of onerous costs. The distribution of these benefits and costs is generally controlled by agents with discretionary power. Private individuals and firms who want favourable treatment may be willing to pay these agents. And what is wrong with paying for what you want? That is, after all, the basis of
the market system. The problem arises from the fact that the recipient is an agent. The agent is responsible to a principal whose goals will seldom line up with those of the “paying customer”. Low-level bureaucrats are agents of superior officials, ministers are responsible to the governing coalition, elected officials are responsible to the voting public, judges are responsible to legal norms. Payments are corrupt when they are illegally made to public agents with the goal of obtaining a benefit or avoiding a cost. This definition leaves room for different societies to set the border between legal gifts and illegal payoffs, but in thinking about where it ought to fall, one must ask whether payments to agents further or undermine public goals. For an overview of corruption cases throughout the world see Benaissa (1993).

Commercial bribery can also occur without the intervention of public agents. A supplier bribes a purchasing agent to induce a sale, a customer pays off an airline clerk to obtain access to first class, a firm’s public relations department pays a reporter to write a favourable story. Managers at the top levels of a corporation might be paid to provide inside information on upcoming deals to investors and stock brokers. Such incidents are quite common and create the same problem as the bribery of public officials. In both cases an agent is paid to put the interests of the bribe payer above the interests of the principal. Commercial bribery implies that the firm whose agents are taking bribes needs better internal controls. High-level, corrupt deals require public oversight to protect the interests of diffuse stockholders. This paper will not deal further with this type of malfeasance, but much of the discussion of official corruption also applies to purely private transactions.

In determining the implications of corrupt payoffs, it will be important to establish whether officials acted outside of their area of competence in return for the bribe or whether they are providing something the payer should have received without a payoff. Similarly, it is important to determine whether the underlying rules are clear. Does one know what an honest system would produce, or are the rules vague and constantly changing? How much discretion does the cor-
rupt official have? Can he or she modify the rules to create additional corrupt opportunities, or are the rules of the game a set of well-known and well-accepted background conditions? The consequences of corruption are obviously much worse if officials can produce additional opportunities for private gain. To make some of these issues concrete, consider the case of Pakistan, by no means the worst case, but one in which corruption indicates a poorly functioning state that imposes high costs on private business and citizens (box 1).

The most important situations in which corruption can dictate who obtains the benefits and bears the costs of political, judicial and bureaucratic actions include:

- **Bribes clear the market.** The government may be charged with allocating a scarce benefit to many individuals and firms using legal criteria other than willingness-to-pay.

- **Bribes act as incentive bonuses.** 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 increase the value of public employment. Thus job applicants may pay to obtain public sector jobs.

- **Bribes lower costs of doing business.** Those engaged in legal pursuits seek to reduce government-imposed costs, be they taxes, customs duties or regulations. Bribes are a way around restrictive rules. In addition, those engaged in illegal businesses want to avoid state intrusion into their activities.

- **Bribes transfer monopoly rents to private investors, with a share going to corrupted officials.** Governments frequently transfer large financial benefits to private firms through procurement contracts, privatisations and the award of concessions.

- **Bribery of politicians buys influence, and bribery by politicians buys votes.** Bribes can substitute for legal forms of political influence. Politicians may pay and receive bribes and illegal contributions.

- **Bribes can override legal norms.** The judiciary has the power to impose costs and transfer resources between litigants.
Box 1 Corruption in Pakistan

Corruption in Pakistan is pervasive and entrenched (Noman 1988). Cross-country surveys commonly rank Pakistan as worse than average in terms of its level of corruption and red tape (Mauro 1995). Overall political risk is in the middle range, better than some nations in Africa and the Middle East but among the highest in Asia (Piggott 1996). Although Pakistan's present government is committed to reducing corruption, its reforms have not yet had an impact. Corruption and poor governance limit economic growth and retard the development of a healthy private sector. Three types of evidence support this conclusion.

First, in a 1995 survey of 200 firms in manufacturing and commerce, corruption and crime were viewed as the fourth most important constraint. Seventy-eight percent of respondents acknowledged that they gave bribes to officials. The annual sums paid commonly ranged between 125,000 and 625,000 rupees (roughly $4,000–$20,000). Bribes as a percentage of gross sales were highest for microenterprises—at 2.45%, lower for small and medium-size firms, and higher again for the largest enterprises. The survey is consistent with the conclusion that bribery deters entry of new microenterprises but acts as a proportionate, not a progressive tax on the sales of growing firms (Rose-Ackerman and Stone 1996).

The government departments that gave firms the most trouble were tax, labour and customs. The sources of difficulty were corruption and bribes (80%), harassment, hassles, red tape and delays. The tax administration was viewed as severe a constraint as the level of taxes. Labour regulators were seen as petty and time-consuming rent seekers. Firms also complained about delays and high customs and duties, ranking those problems higher than corruption, possibly because corruption was a way to mitigate those difficulties.

Most business people, however, see corruption as a symptom of bad regulations, rather than as a solution to onerous government requirements. Firms indicated that they were willing to pay to increase government efficiency, and hence reduce corrupt opportunities. Firms would also be willing to pay an average of 2% of gross sales to simplify the tax system, even if their tax liability remained the same.

The second piece of evidence concerns the customs service. Corruption is concentrated at bottleneck points in the economic system, where public officials act as gatekeepers dispensing valuable benefits. One such bottleneck is the customs service, and, indeed, bribing customs agents is a
familiar alternative to smuggling throughout the world. Pakistan’s import tariff schedule has been so extensively modified by special-purpose exemptions, that duties are often impossible to determine ex ante, thus generating corrupt incentives. Data from Pakistani customs provide indirect evidence on corruption. As nominal tariff rates increase, the proportion of official rates that is actually collected falls. Furthermore, the variance of the collected tariff rate increases as more and more exemptions are given (Pritchett and Sethi 1994).

Corruption in exporting and importing can discourage business people from entering markets. In Pakistan importers did not report higher levels of corruption than non-importers. And firms that exported more than 20% of their sales paid less in bribes, measured both as a percentage of gross sales and per employee, than did non-exporters. The optimistic explanation for this finding is a government initiative to simplify taxes for exporters into a single fee that is an extremely small percentage of total sales. Interpreted in this light, the Pakistani government clearly has the ability to reduce discretion and corruption if it is willing to give such reforms high priority. The pessimistic interpretation should not, however, be ignored: firms producing for the domestic market may be protected by import barriers, enabling them to earn rents, some of which are being extracted by public officials in the form of payments (Rose-Ackerman and Stone 1996).

Third, the agricultural sector deserves more study because of its economic importance and political influence. Evidence of corruption in agriculture is less systematic but is, nevertheless, troubling. Irrigation is of central importance to Pakistani agriculture and represents an important aspect of public spending. The system is administered corruptly, at least in some parts of the country. In seeking to explain the outcome, observers point to the low salaries of public officials and working conditions that provide few incentives for good performance (Murray-Rust and Vander Velde 1994; Vander Velde and Svendsen 1994).

The solutions are to streamline and simplify tax, customs and regulatory laws; to improve working conditions and oversight in the bureaucracy; and to reform tax laws so that large-scale agriculture is no longer favoured.

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 to be considered separately.

**Payments that Equate Supply and Demand**

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

When the supply of credit and the interest rate 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 1993a; Webster and Charap 1993). In Lebanon a similar survey revealed that loans could not be obtained without the payment of bribes (Yabrak and Webster 1995). In some cases personal influence and corruption lead banks into high-risk lending, sometimes to borrowers who have no intention of repaying the funds. Then the problem is not scarcity, but a system with too few controls over the level and distribution of funds.
Multiple exchange rates often do not reflect underlying economic fundamentals, so there are incentives to pay bribes to get scarce foreign exchange at good rates. For example, Paraguay’s multiple exchange rate system led to corruption before recent reforms (World Bank 1994). Transparency International, on a mission to South Africa, identified the country’s twin currency system as a source of payoffs (Transparency International 1995). The financial rand was abolished in March 1995, a policy change that should have removed some of the incentives.\(^5\)

Similarly, the allocation of scarce import and export licences is a frequent source of corruption, with bribes linked to the value of the monopoly benefits conferred. According to one study of Nigeria, the regime in power in the early 1980s resisted free trade reforms favoured by the International Monetary Fund (IMF) because the existing import licensing system was an important source of payoffs and patronage. Eventually, however, when the Manufacturers Association of Nigeria finally began to push for its abolishment, the system was eliminated (Herbst and Olukoshi 1994, pp. 465, 481–82). The incentives to make payoffs are clear enough in these cases, but what are their efficiency consequences? Do they simply equate supply and demand, functioning much like prices in a legal market?

What if the Service is Scarce?

The simplest case is one in which the briber is qualified for the benefit he seeks but the official requires that he pay for it. Suppose the service is scarce so that the number of people qualified to obtain the service exceeds 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, though achieving a different distribution of revenue. Bribes raise the incomes of civil servants. Legal payments go into the government’s treasury. But even
that difference may be illusory. If the labour 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 both the corrupt market and the labour market are competitive, 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 waiting in line or persistence in petitioning officials.

Consider first, however, the ways in which inefficient or unfair results can arise even in this simple case. The goals of a programme may be undermined if services are provided only to those with the greatest willingness to pay. This will obviously be true for services designed to benefit the needy or the well-qualified. Thus the sale of import and export licences or restaurant licences could be efficient, but the allocation of subsidised credit, housing or university admissions by price would undermine distributive goals, even if those admitted are nominally qualified under the law. For example, corruption grew in public housing programmes in the United States, where the number of qualified households far outstripped the number of places in subsidised units. Another example: in India some states give a means-tested pension to the poorest people. The number who qualify exceeds the funds. Non-governmental organisations working with the poor report that applicants often must pay to qualify and then must pay postal workers to deliver the benefit checks.

Bureaucratic discretion exercised through bribery is costly given programmes’ goals. If a corruptly administered programme is meant to benefit the needy, the poorest applicants are unlikely to be able to obtain the scarce public service. One’s response to a finding of corruption should be to rethink how participants are selected, not condone bribery. If, for example, an honest system is characterised by costly queues, the public agency must redesign the way it reviews applications or set clearer, tougher standards of worthiness to reduce the gap between supply and demand.
Second, consider cases in which allocation to those with the greatest willingness to pay is acceptable. 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 1996; Cartier-Bresson 1995; Gambetta 1993; Rose-Ackerman 1978). The illegality of bribery induces participants to spend resources to keep the transaction secret. Thus information about bribe prices will not be well publicised. 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 themselves limit their dealing to insiders, trusted friends and relations to avoid disclosure. For all of these reasons, a corrupt system may be not only less competitive but also more uncertain than a legal market. Bribes paid may vary widely across participants. For example, surveys of business people in Pakistan and Ukraine indicate high interfirm variability (Rose-Ackerman and Stone 1996). And those who obtain services corruptly have no recourse if officials do not live up to their side of the bargain.

If officials must allocate a fixed number of licences each year or grant a contract with well-specified terms, then bribery is essentially redistributive unless the problems raised above prevail. But in practice many officials can exercise monopoly power by determining the quantity of services provided. They may be the only people with authority to issue a permit, overlook a violation of the law or grant a contract (Findlay 1991; Klitgaard 1988; Rose-Ackerman 1978; Shleifer and Vishny 1993). Officials, like private monopolists, may seek to set supply below the officially sanctioned level to increase the economic rents available for division between themselves and the bribe payers. Or, corrupt officials might seek to provide an increased supply of the service if the government has set the supply below the monopoly level. The market for commercial real estate in Russia is an example of a market in which a scarce and valuable resource is allocated by rent-seeking officials with wide-spread discretion (box 2).
Box 2 The Commercial Real Estate Market in Russia

The commercial real estate market in Russia is organised in a way that encourages corruption. Local governments own most commercial real estate—in 1995 the proportion was approximately 95%. The struggle for real estate assets is part of a broader conflict between the central and local governments. The subnational governments are winning. Even when the central government attempts to require that property be privatised, local governments simply refuse to obey—decrreeing that federal law has no force in their community.

Ownership rights are vested in local councils, which are legislative bodies. As a practical matter, however, the head of an administration has a great deal of personal influence in the management of real estate assets. One reason for the strong local authority is that the laws and decrees enacted by central authorities are ambiguous, leaving the rules unclear. In some local governments the committee for the preservation of architectural and historical monuments also has considerable power, since almost all buildings in the city center are on the register, and even unhistorical buildings can come under its purview. Although its formal powers are unclear, in practice these committees often have veto power over property sales. As the author of a report on the topic states, the committee “participates in the rental revenue streams either on a formal or informal basis” (Harding 1995, p. 7). Housing maintenance agencies must give their consent before a lease or sale occurs. In day-to-day contact with renters, they can “influence the allocation of space and collect rents”, probably also on “a formal or informal basis”. Local bureaus of technical inventory maintain property records. Although they lack formal authority, their monopoly over technical information gives them leverage. Other regulatory agencies with influence over the use of property are the land reform committee, the fire department, the sanitation and health department and the district administration. The lack of standard procedures combined with the weakness of leases means that these agencies feel little pressure to cooperate or to refrain from imposing additional demands after a lease is signed.

Commercial real estate allocation does not follow commercial principles. Present occupants are favoured, and rental rates are far below market prices. The user’s relationship to the head of the administration is often a factor determining rental rates. The low rents mean that “a huge economic rent

(Box 2 continues next page)
accrues to local officials” (Harding 1995, p. 10), and excessive demand is pervasive. Officials use their control over urban real estate not only to enrich themselves, but also to subsidise social organisations such as social clubs—charities that obtain space cheaply and then use it for commercial activity.

Harding (1995, p. 14) explains why reform will be difficult. The problem is not just the incentives for graft, but also a tradition of heavy government involvement in real estate. The stream of personal benefits that accrue to city officials clearly plays a large role in perpetuating non-commercial management. City officials benefit personally from controlling real estate allocation, in terms of both money and influence. But an important and related dynamic is often missed. Russia has a strong tradition of extensive government involvement in economic activity on every level. This tradition, which predates the Soviet era, leads both officials and citizens to expect that the government will actively intervene in business operations and economic development. While many of the formal institutional mechanisms for this practice were removed in the initial stages of transition, several levers remain: taxation, regulation and control of real estate.

Moscow and St. Petersburg have overcome the diffuse ownership structure in commercial real estate. These cities have a special enclave status that gives them greater legislative and administrative freedom. With access to outside technical assistance, they have restructured the management of their real estate assets. Unfortunately, this has simply permitted city mangers to exploit their monopoly power more effectively. The city is both primary developer and regulator, leading to conflicts of interest and favouritism towards “friendly” developers. “The corruption endemic in the development of this market is widely perceived” (Harding 1995, p. 19). Officials work for both private developers and the city, or they may receive a good apartment or shares in a development company.

In response to these problems in Russia Harding (1995) suggests several reforms. A mandatory programme requiring local governments to divest themselves of real estate would be best, but that is unlikely. The federal government should seek to uphold the legality of its buyout program that is being openly challenged by recalcitrant local governments. Harding also recommends a series of technical reforms to clarify the rules and move towards a more commercially viable market in urban commercial real estate.

What if Supply is Not Limited?

Instead of assuming that the service is scarce, suppose that it is available to all who qualify, like a passport or a driver’s licence, or a benefit like old-age pensions in the United States. Bribery is clearly not an efficient way to allocate the benefit, even to the qualified, but one might wonder whether bribery would occur at all in the absence of scarcity. It could if officials have sufficient monopoly power to create scarcity either by delaying approvals or withholding them unless they are paid bribes (Paul 1995). Officials with monopoly power will set supply to maximise their profits (Dey 1989; Shleifer and Vishny 1992, 1993). These attempts to create scarcity can generate bribes if applicants have no alternative source from which to receive the service and no effective means of appeal. Qualified applicants will pay less if they have other options and if denunciations are not very costly in time and money (Alam 1995; Cadot 1987). The greater is the discretion of officials and the fewer are the options open to private firms and individuals, the higher are the costs of a system that condones corruption, even when all those who obtain the service are qualified. The costs are the time and trouble imposed by officials in their efforts to create corrupt demands (Bardhan 1996; Klitgaard 1988).

What if the Briber is Unqualified?

Bribes are frequently paid so that unqualified people and firms can obtain benefits. For example, students might pay to alter the results of university admissions tests, or people might pay doctors to declare them eligible for disability benefits. Corrupt officials may give benefits to high bribers who are not qualified. Similarly, even those who are qualified may seek unauthorised gains or try to avoid costs. Shleifer and Vishny (1993, p. 601) call such a case “corruption with theft”—their archetypal example is a firm that bribes officials to avoid paying customs duties, but the range of examples is broader than those in
which the government loses revenue. It also includes cases in which a qualification process is undermined or a regulation violated. Clearly, the unqualified will often be those with the highest willingness to pay, since they have no legal way to obtain the service.

**Bribes as Incentive Payments for Bureaucrats**

Bribes may give low-level officials an incentive to do their job effectively. But when is tolerance of payoffs acceptable? In the cases discussed above, even when corruption served an allocative function, it was a second-best response. A legal sale would have been superior. Such is generally the case here as well, although some research suggests why the first-best solution will often be difficult to achieve.

Firms and individuals will pay to avoid delay. For example, if the government or a parastatal does not pay its bills on time, contractors or customers may offer a bribe to ensure speedy payment. In Argentina a scheme in which insurance companies bribed officials to get delayed claims paid by a state-run reinsurance company degenerated into a system of outright fraud against the state, organised by corrupt state officials and middlemen (Moreno Ocampo 1995). In many countries informal payoffs are required to expedite services such as obtaining a telephone connection, a passport or a driver’s licence. Sometimes the service is available only to the corrupt, not to the patient, honest citizen. In St. Petersburg in 1992 the going rate for a telephone installation was $200 (Webster and Charap 1993). An Indian newspaper recently published a list of the “fees” for a range of routine public services. A study of the informal economy in Ukraine reports the payoffs for a range of services needed by private businesses. Other data reveal the extremely high costs in management time of dealing with state officials (box 3).

Some scholars have constructed economic models in which bribes have desirable incentive properties. For example, payoffs to those who manage queues can be efficient (Lui 1985). Payments will give officials
### Box 3 Corruption in Ukraine

Weak and ineffective governments can impose two types of costs on businesses—the costs of seeking to comply with ambiguous and constantly changing rules and the costs of making illegal payoffs to avoid the rules or to induce officials to act. On the one hand we might expect that those who pay high bribes will report fewer problems in dealing with the government, since they have paid to avoid such difficulties. On the other hand, if payoffs reflect the success of bureaucrats in seeking and sharing in firms’ excess profits, high payoffs will correspond with high costs in dealing with government. Corruption may improve the efficiency of individual transactions when the state is weak and ineffective, but tolerance of corruption can make state performance even worse. Ukraine is in the second camp—invasive public officials are the norm.

A survey of business people in Ukraine revealed that the motivations for corruption were high tax levels complicated by an inefficient tax and regulatory administration, high uncertainty about the rules, discretionary licensing procedures and an invasive corps of field-level bureaucrats. For example, lower-level officials are empowered to calculate a company’s tax liability (often creatively) and issue stiff fines for violations (Novitzkaya, Novitzky and Stone 1995).

Because strict compliance with rules is extremely difficult and enforcement discretionary, there is ample room for negotiation. A mid-1994 survey of 75 small and medium-size enterprises documented the “unofficial” fees paid and the percentage of firms that reported paying them (Kaufmann and Kaliberda 1996). Such fees continue at high levels according to a similar 1996 survey. Most firms reported paying fees in connection with importing and exporting inputs and outputs. Phone lines almost...

(Box 3 continues next page)
amount equal to the revenue target. The larger the difference between nominal tax liabilities and the revenue target, the greater is corruption.

Flatters’ and MacLeod’s conclusions that such routine corruption be tolerated is extremely problematic. First, tolerance of corruption in an important agency such as tax collection may encourage its spread to other areas where the consequences are harmful. Second, the authors assume that officials have only limited discretion. For example, they

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**Box 3 (continued)**

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. According to Kaufmann (1997) the high cost of dealing with state officials through bribery induces many firms to operate in the informal sector and many others to underreport sales, costs and payroll to the authorities. The losses to the state are large and come in addition to the investment and new entrants that are discouraged.

An extraordinary amount of management time is spent dealing with the government, averaging 28% for the firms surveyed in 1994. By 1996 the percentage had risen to 37% (Kaufmann 1997). These figures are much higher than the percentages reported in other countries (although, of course, such comparisons are limited by differences in firm sizes and sectoral composition). Elsewhere, the percentages ranged from 7% in El Salvador to 15% in Brazil and Lithuania.

To improve the business climate and reduce corruption in Ukraine, Kaufmann (1997) recommends eliminating licences and permits, except for health and safety purposes, streamlining the customs service, reducing export regulations and other trading restrictions, eliminating price controls and deregulating the gas sector. He also recommends accelerating privatisation and thoroughly reforming the tax system. The goal is not just to reduce corruption but to induce more businesses to switch to the formal sector and to encourage new productive investment. To accomplish such changes, however, these proposals must be combined with reform of the civil service, reform of the way the government operates and changes in basic attitudes in both the public and the private sector.

assume that tax collectors discover the tax liabilities of citizens and firms, not create those liabilities as a bribe extraction device. If firms’ and individuals’ vulnerability to corrupt demands varies, an arbitrary and unfair pattern of payments would develop. This pattern would differ across taxpayers in a way that reflects collectors’ leverage, not the underlying tax rules. If taxpayers differ in their propensity and willingness to bribe and if the tax breaks given in return for the payoffs are not publicised, the result can be a system based on special favours given to some, but not others. The overall legitimacy of the government may suffer. At the very least the disadvantaged taxpayers will feel unfairly treated.

Third, there are alternatives to corruption that avoid the costs of illegal payment systems. Queues can be managed through a set of differential fees based on the value of speed to the applicant. The US passport office, for example, provides high-cost expedited service. The extra fees are not, however, pocketed by civil servants, though revenue collection offices are sometimes permitted to retain a portion of the funds they take in.

Corruption in tax collection can contribute to an uncertain business climate. Firms may pay bribes in an attempt to obtain certainty, in this case about their tax liabilities, but certainty may be illusory since corrupt deals cannot be enforced.7 The short-term impact of bribes may be to enhance efficiency in tax collection or business regulation. But difficulties arise when one looks at the issue systemically. Payments made by individual firms to increase certainty result in a wide variance in conditions across firms. For example, although they present no direct evidence of corruption, Pritchett and Sethi (1994) show that higher tariff rates are associated not only with lower proportional collections, but also with greater variance in rates actually paid. Potential entrants will view such an economic environment as risky and unpredictable. Nominal tax liabilities will be poor predictors of actual tax liabilities for a firm and for its competitors. Individualised attempts to reduce uncertainty can in fact increase uncertainty and
unpredictability society-wide. Ingrained corruption can also retard state reform. Firms that have benefited from payoffs will resist efforts to increase the clarity of rules and laws. They and their allies within the state apparatus will oppose reform efforts designed to make the economy more open and competitive.

In short, bribes can sometimes be characterised as incentive payments to public officials that substitute for legal reforms in the civil service system. But a policy of active tolerance, especially by outside aid donors such as UNDP, is likely to hurt the prospects for long-term reform and make it difficult to create a state that citizens view as legitimate. Payoffs that are seen as acceptable should be legalised, but not all “incentive-pay” schemes will actually improve bureaucratic efficiency. Some may simply give officials an incentive to create more delays and red tape, and to favour the unscrupulous and the well-off.

**Bribes that Reduce Costs**

Governments impose regulations, levy taxes and enforce criminal laws. Individuals and firms may pay for relief from these costs. Under public regulatory programmes firms may pay for a favourable interpretation of the rules or a discretionary judgment in their advantage. They may pay to avoid or lighten the regulatory load, or to clarify regulatory requirements. Corrupt incentives may be especially high for newly privatised state enterprises dealing with fledgling regulatory agencies that do not have a well-developed track record. Developing and transition economies with newly private public utilities must set up strong, apolitical regulatory agencies with transparent and open processes (Tenenbaum 1996).

In a federal government inconsistent rules can make payoffs difficult to avoid. A study of private enterprises in Brazil recounted the (perhaps apocryphal) tale of one entrepreneur who reported that he was visited by state and federal inspectors simultaneously. The goal of the joint visit was to ensure that the firm would be observed violating
at least one of the governments’ inconsistent rules on the placement of fire extinguishers (Stone, Levy and Paredes 1992, p. 29).

Taxes are always burdensome. Thus businesses and individuals may collude with tax collectors to lower the sums collected. The savings are divided between the taxpayer and the official. In some countries the wealthy pay few taxes. The Gambia, Ghana and Mozambique and are three such cases in Africa (Dia 1996; Stasavage 1996). In parts of Eastern Europe and the former Soviet Union where nominal tax rates are very high, business people report high payoffs (De Melo, Ofer and Sandler 1995; Novitzkaya, Novitzky and Stone 1995; Webster and Charap 1993). In Italy many allegations of corruption involve payoffs to tax inspectors for favourable audits. According to one source, tax avoidance is common in the Philippines, with the poor contributing twice as much as the rich. Jobs with the Bureau of Internal Revenue and the customs service are popular with recent university graduates because of the opportunities for payoffs (Far Eastern Economic Review, April 20, 1995).

Concerted reform efforts can yield substantial rewards. For example, in the urban centers of the United States at the beginning of the twentieth century reform-minded mayors frequently moved to increase the fairness of the property tax system. Seth Low in New York City introduced a plan to assess property at market value. The result was a reduction in the tax rate and an increase in revenues (Schiesl 1977).

Customs officials are particularly likely to engage in corruption since they control something that firms value: access to the outside world. Payoffs are used to reduce tariffs and export fees, and to obtain import and export licences. Sometimes the revenue losses from a combination of corruption and smuggling are large. In the Philippines one source estimated that 63% of imports pay no duty (Far Eastern Economic Review April 20, 1996).

Customs reform in Indonesia and Mexico came after widespread evidence of corruption.8 This is an area in which the prescriptions of the market-oriented economist and the anticorruption reformer coin-
cide. Free trade policies generally improve efficiency and reduce the economic rents available to corrupt officials. Tolerance of corruption leads to wide-spread inequities and inefficiencies. Corrupt incentives rise with tax and tariff rates. Corruption in internal revenue and customs services is common throughout the world. Case studies for a number of African countries illustrate both the magnitude of the problem and some promising avenues for reform (box 4).

**Tolerating Corruption at Home**

The economic impact of bribes paid to avoid regulations, supersede criminal law and lower taxes depends on the efficiency of the underlying programmes that are subject to corrupt distortions. Suppose a state has many inefficient regulations and levies burdensome taxes on business. Then, given the inefficient legal framework, payoffs to avoid regulations and taxes may raise efficiency. Even if the corrupt market has some of the problems outlined above, the result may still be greater efficiency than compliance with the law. This defence of payoffs is commonly espoused by foreign investors in the developing world and appears in discussions of investment in Eastern Europe and the former Soviet Union. It is a pragmatic justification that grows out of frustration with the existing legal order. The case is important because it is an attempt to justify corruption carried out to obtain benefits to which one is not legally entitled. Bribers are better off than they would be if they had to comply with the law. This case is analogous to Shleifer and Vishny’s corruption with theft.

But are individuals and firms obligated to obey only laws that they judge to be efficient and just? Clearly, in the industrial world individuals and firms are not entitled to decide on their own which laws to respect. Industry’s response to environmental, health and safety rules that it finds burdensome is not generally to bribe US officials or enlist the help of criminals to evade the law. Of course, some firms do act illegally, but scandals seldom involve firms with national reputations. Instead, such firms work to change the laws in Congress, make legal
Box 4 Evasion of Taxes and Customs Duties

Many developing and transition countries suffer from an inability to collect sufficient tax and customs revenue. Corruption of tax and customs officials and tax evasion through smuggling, organising off-the-books and fraudulent accounting all contribute to lost revenue. A vicious spiral can develop in which revenue shortfalls lead to ever higher nominal tax rates, which are then even more likely to be evaded. For any given type of tax or tariff there is likely to be a revenue-maximising rate beyond which increased evasion eliminates the expected revenue gains of higher rates.

The problem often cannot be solved simply by reforming tax and customs collection. Individuals and businesses may underpay taxes in part because they do not accept the legitimacy of the regime in power, believing that public spending choices are distorted by the corrupt search for private gain.

The extent of the revenue shortfall can be gleaned from a number of country studies. In The Gambia, before the military came to power in 1994, foregone revenue from customs duties and the income tax was 8%-9% of GDP (six to seven times the country’s spending on health). Income tax evasion alone amounted to 70% of the revenue due. A 1992 study found that only 40% of small and medium-size enterprises paid taxes, and that many individuals did not file returns. Underpayment of customs was facilitated by lack of clear guidelines and published tariff rates. Giving extensive discretion to officials encouraged corrupt payoffs designed to evade tariffs (Dia 1996).

In the 1980s Ghana tried an enclave approach to tax and customs reform by creating a new National Revenue Service. Prior to the reform, tax revenues were 4.5% of GDP. Corruption, moonlighting and other inefficiencies were common. Salaries were low and accountability poor. Under the reform the most corrupt officials were dismissed or retired. Wages and working conditions were improved. Higher salaries were accompanied by incentive systems to reward strong performance by individuals and by the agency as a whole. Revenue targets were established, and the National Revenue Service was given a bonus of 3.5% of tax revenue and 2.5% of customs revenue. Between 1984 and 1988 tax and customs revenue rose from 6.6% to 12.3% of GDP. The reforms illustrate the importance of combining improved base pay with incentives for good performance. The programme was not without problems, however. The rest of the civil service chafed at

(Box 4 continues next page)
the special treatment afforded tax collectors, and the Ministry of Finance objected to its loss of authority. The programme could not have gone forward without strong support from the top (Dia 1996).

An attempt to reform customs and tax collection in Zaire illustrates how an enclave approach can fail if credible reform is difficult to achieve. First, efforts to collect taxes lacked legitimacy because the government made large expenditures on projects that promised few development benefits. World Bank officials were also concerned about the possibility of large unrecorded extra-budgetary outflows—that is, corruption. Second, a project initiated with World Bank and French assistance was unable to undo fraudulent exemptions from taxes and duties. An initially successful effort to remove exemptions was soon overturned, and computers and files were destroyed. The project did not succeed in developing a cadre of professional tax collectors. Instead, it created new opportunities for rent seeking, and aid was eventually suspended (Dia 1993).

In Mozambique economic reform increased, not decreased, corruption. Interviews with private sector and donor representatives carried out in 1996 indicated that corruption was a serious problem and had grown since 1986. The available evidence suggests that bribes are paid to receive tariff exemptions. In 1995 customs collected 49% of the revenue they would have collected if no exemptions had been given. Customs officials had discretion to grant exemptions without guidelines. They created extra delays to extract payoffs. They also overestimated the value of goods and applied higher rates in an attempt to obtain payoffs. Overall taxes fell from 20% of GDP in 1993 to 17.6% in 1994, with import taxes falling from 5.1% to 3.9% of GDP.

Additional estimates of shortfalls due to tariff exemptions were found in a separate study by Low (1995). In Mali, Tanzania and Zambia the estimates were close to 50%. Of course, cross-country comparisons are difficult to make since the importance of exemptions is a function of the underlying tariff schedule. Still, these data indicate that a poorly controlled customs service can be costly. They are consistent with Pritchett and Sethi’s (1994) finding that both the proportion of goods granted exemptions and the variance in customs duties paid increases as nominal rates increase. Data from Jamaica, Kenya and Pakistan showed a consistent pattern (see table 2 in Pritchett and Sethi).

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 US political life, but well-documented lobbying activities and campaign contributions are still superior to secret bribes for maintaining democratic institutions.

**Tolerating Corruption Abroad**

Some of the firms that engage in legal political activities at home feel less constrained about violating laws in developing and transition economies. Since the Foreign Corrupt Practices Act in the United States outlaws bribes paid abroad to obtain business, US companies face a domestic legal constraint (for a review of the case law see Pendergast 1995). But the perceived importance of that constraint suggests that multinationals do not generally feel obligated to obey the law in developing countries. And it is not just multinationals that behave in this way. Domestic companies often operate in the same fashion.

There are two difficulties with widespread tolerance of such corruption. First, investors will not necessarily pay bribes to avoid only inefficient rules and taxes. They will, instead, want to reduce the impact of all state-imposed burdens, justified or not. Both individuals and firms will use bribery to obtain benefits to which they are not entitled. 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; Oxford Analytica 1996). Then, avoiding the burdens imposed by such laws seems worthy. Unless one is a strong libertarian, believing that all state action is illegitimate, such a criterion is not readily operationalised. Should firms or individuals be able to defend against a charge of corruption by showing that a law was unjust or inefficient? Should they be able to justify bribery by claiming that the law they favoured 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 is illegitimate in theory.
Second, we should not tolerate firms’ judgments that well-placed payoffs are justified because they increase profits. Such an attitude can harm nations struggling to build a viable state. These states must develop public choice mechanisms that translate popular demands into law, make a credible commitment to enforce these laws and provide legal recourse to those who think they have been wronged. If, instead, investors and ordinary citizens make separate 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 which laws are enacted.\textsuperscript{10} All states, even those that have most successfully curbed the power of special interests, enact inefficient laws. But no state can operate effectively if individuals are able to take the law into their own hands and justify doing so with 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 since, with fewer resources available, the state becomes less powerful. But costs remain. Those who benefit from making payoffs will form a strong constituency against reform because they will fear the loss of their special advantages. Furthermore, when a regime that wants to reform takes power, its efforts will be hampered if corruption has become systemic. One of the regime’s first tasks must be to change the behaviour of corrupt officials, firms and individuals.\textsuperscript{11} Tolerating individual efforts to circumvent even burdensome laws is not consistent with state legitimacy.

**Payments to Obtain Major Contracts, Concessions and Privatised Firms**

Corrupt payments to win major contracts, concessions and privatised companies are generally the preserve of large businesses and high-level officials. Although low-level clerks are sometimes bribed to reveal infor-
mation and some smaller businesses bribe to get routine supply contracts, the important cases involve substantial expenditures and can have a major impact on the government budget and the country’s growth prospects. These deals by definition involve top officials and frequently involve multinational corporations operating alone or in consortia with local partners. Moody-Stuart (1994) calls this “grand corruption”.

**Examples of Grand Corruption**

When the government is a buyer or a contractor, there are several reasons to pay off officials. First, a firm may pay to be included in the list of prequalified bidders and to restrict the size of the list. Second, it may pay for inside information. Third, bribes may induce officials to structure the bidding specifications so that the corrupt firm is the only qualified supplier. Fourth, a firm may pay to be selected as the winning contractor. Fifth, once a firm has been selected as the contractor, it may pay to set inflated prices or to skimp on quality.

Corruption in contracting occurs in every country, even those at the high end of the “honesty index”, such as Singapore and New Zealand. A few examples suggest the range of possibilities.

In Zimbabwe collusion between senior ministers in Posts and Telecommunications and a Swedish telecommunications company may have resulted in the circumvention of local tender board procedures. Kickbacks up to $7.1 million have been alleged (Economist Intelligence Unit, *Zimbabwe Quarterly Report*, June 1995). In an airplane deal between the Republic of Korea and several US companies, bribes were allegedly paid to President Roh Tae Woo. Multinational suppliers have been questioned, but deny involvement. Roh Tae Woo’s national security advisor acknowledged receiving money from businesses hoping to get arms contracts. He is accused of accepting $300,000 in connection with fighter plane purchases. In particular, the head of a Korean conglomerate was accused of giving $65,000 to the advisor. He admitted giving the money but said it was a gift.
A major scandal in Singapore, involving several multinational firms and a senior official of the Public Utility Board, concerned payments to receive confidential information about tenders. Five major multinationals implicated in the scandal were blacklisted. The official received a 14-year jail term.14

Industrial countries have recently been involved in similar procurement scandals. In Germany bribes were paid to win contracts worth 2.5 billion deutsche marks (DM) to build Terminal 2 at Frankfurt Airport. According to the public prosecutor corruption led to an increase in prices of about 20–30%.15 In the French Department of Seine-Maritime fourteen people have been charged with corruption in connection with contracts for computers. Civil servants distorted normal procedures for awarding contracts, leading to an estimated loss of 50 million francs, according to the French Department of the Interior.16 In Belgium senior figures in the Socialist party are believed to have accepted $1.9 million in bribes in connection with a defence contract.17

Not all procurement and contracting scandals involve large-scale construction or capital goods projects. Goods that are used up in consumption are prime candidates for payoffs, since it may be difficult ex-post to discover whether or not the goods were actually delivered in the proper quantity and quality. For example, in Malawi auditors found that millions of dollars of non-existent stationery had been “purchased” by the Government Press Fund. The agency had no approved written control system for local purchases.18 In Kenya the government lost about $1.5 million through irregular drug procurement by the Ministry of Health.19

Privatisation of state-owned enterprises can improve the performance of the economy and, in the process, reduce corruption. But the process of turning over state assets to private owners is fraught with opportunities for corruption and self-dealing. The sale of a large parastatal or public firm is similar to the process of tendering for a large public infrastructure project. Thus the incentives for malfeasance are similar. Corruption may undermine the efficiency rationale for
privatisation. If firms pay to preserve the monopoly power of the enterprise after it enters private hands, the result may simply be a transfer of profits from the state to the new owners. The employees of the newly privatised firm may then face demands from suppliers and customers seeking to share in the monopoly benefits.

**The Inefficiency of Large-Scale Corruption**

Is there anything distinctive about corruption in government contracting and privatisations other than the size of the deals? At one level they appear analogous to cases in which the government disburses a scarce benefit. Only now the benefit is valued in many millions of dollars. Under competitive conditions the highest briber will be the most efficient firm, and the winner will behave efficiently ex-post, irrespective of whether or not it used a bribe to obtain the benefit. The same caveats about bribes paid to obtain benefits or avoid costs apply here, although the efficiency goal seems less problematic in this context, and the benefit obtained is not itself illegal. Nevertheless, systemic corruption can introduce inefficiencies that reduce competitiveness. It may limit the number of bidders, favour those with inside connections rather than the most efficient candidates, limit the information available to participants and introduce added transaction costs. But does the scale of the corrupt deal and involvement of high-level officials change anything?

One essential difference is the likelihood that rulers are effectively insulated from prosecution. They are thus less restrained in their corrupt demands than lower-level officials. High-level, corrupt officials can secure higher shares of the gains than lower-level officials. Since deals involving major contracts, concessions and privatisations can noticeably affect the government budget and the country’s overall prosperity, the size and incidence of the payoffs are especially relevant. Another difference is that those who obtain licences and tax breaks by bribing low-level officials are rarely thought of as behaving inefficiently once the benefit is obtained. For the major deals considered here, the
contrary argument is often made. But is there anything to it? To answer this question, first consider the incidence of corrupt payoffs and, second, ask if corruption breeds inefficiency in firms that pay bribes.

An efficient corruption market. To isolate these distinct issues consider a logging concession obtained corruptly by a company that bid lower than its competitors. Suppose, to begin, that the corruption market is efficient so that it operates just like an idealised competitive bidding process. Then, we can distinguish between the impact of corrupt payments on government behaviour and the way corruption affects the efficiency of the concessionaire.

Suppose that as a result of corruption the government obtains less-than-fair-market value for the resources under its control. If corruption does not restrict entry and if the official cannot affect the size of the concession, the highest briber is the firm that values the benefit most. The most efficient firm offers the highest price in a fair bidding procedure. The losses are the dead weight losses of the extra taxes that must be collected and the foregone benefits of public programmes not initiated. Honest officials receive distorted information about the value of the concession and may in the future support fewer of them. A similar analysis applies to corrupt contracts and privatisation projects. The most efficient firm will be selected under competitive bribery, but the benefits to the government will be reduced. In the contracting case, for example, part of the cost of the bribe may be hidden in the value of the contract.

The bribe will be extracted partly from returns that would otherwise flow to the government and partly from the profits of the winning firm. In the idealised competitive case the winner is indifferent between winning the concession through an honest auction or winning through a dishonest auction. But in some cases the corrupt official may have more leverage than the honest one and be able to extract a larger share of the profits. The firm prefers to deal with honest officials. Alternatively, the corrupt official may be able to structure the deal so that it is more lucrative for the winning firm than an honest
deal. The corrupt official may design the concession to maximise profits, which can be shared between officials and the bidding firm. In so doing he may sacrifice values that would be reflected in an honestly negotiated contract. For example, in a timber contract environmental damage or harm to indigenous people may be ignored. The same problem may arise for privatisation projects. Thus corrupt officials can promise to preserve the monopoly position of a privatised enterprise or contract for “white elephant” projects that do not promote economic development.

Effect on firm behaviour. Now consider a firm that has obtained a secure long-term timber concession at a bargain price, even when the bribe is added in. If it operates in the international timber market, its subsequent actions should depend on that market. The fact that it has underpaid for the concession should not affect its production decisions. It still seeks to maximise profits, and the concession payment is a sunk cost. The cost of corruption is felt by the public first, but no inefficiency has been introduced into the international timber market. Even if the total payment is higher than that expected in an honest system, there should be no effect.

No effect on firm behaviour is an important result, but it is too simple to reflect reality. The missing operative terms are secure and long term. A corrupt system is not just one in which individuals in key positions can benefit at the expense of the state and ordinary citizens. Rather, corrupt deals introduce uncertainties into the economic environment. And those uncertainties can affect the way private firms do business. Difficulties may arise even if the most efficient firm wins. The corrupt nature of the deal may give the firm a short-run orientation.21 There are two reasons for this. First, the concessionaire (or contractor or purchaser of a privatised firm) may fear that those in power are vulnerable to overthrow because of their corruption. A new regime may not honor the old one’s commitments. Second, even if the current regime remains in power, the winner may fear the imposition of arbitrary rules and financial demands once investments are sunk. It may
be concerned that competitors will be permitted to enter the market or worry that its contract will be voided either for political reasons or for greed.\textsuperscript{22} Also, the firm is vulnerable to extortionary demands by those who can document the illegal payments. For these reasons the corrupt firm with a timber contract may cut down trees more quickly than it would in less-corrupt countries. It may also be reluctant to invest in immovable capital that would be difficult to take out of the country if conditions change. In electric power the most dramatic examples of this are the floating power stations established in several developing countries to make exit easy and relatively inexpensive. In short, both the timing of production and the input mix may be inefficiently chosen because of the corrupt nature of the system.

Furthermore, it is unlikely that corruption will be limited to a one-time payment. Instead, the winner may be the firm most willing to engage in ongoing corrupt relationships up and down the hierarchy to protect its interests. For example, if the timber concession includes a royalty per log that is calibrated by the type of timber, the firm may pay inspectors to misgrade the logs. It may also pay to cut down more trees than the concession permits. Under a construction contract the high briber may anticipate paying building inspectors to approve work that does not meet the nation’s safety standards (Park 1995). In fact, the expectation of a long-term relationship may be part of the appeal of signing with a corrupt firm in the first place. The corrupt firm may also retain some control by holding back promised bribes as a way to guarantee performance by the country’s officials. Thus a firm might sign a contract to deliver cement to a road building agency but pay bribes only if payments are received from the public authority. Frequently, such arrangements take the nominal form of consulting contracts with payments tied to the receipt of funds under the contract.

Even when the exploitation of a country’s natural resources is carried out efficiently by the corrupt firm, the struggle for rents can damage the economic and political systems. Talented people may concentrate their efforts on rent seeking rather than on productive
activities. This can occur on both sides of the corrupt transaction. Potential entrepreneurs may decide to abandon the private sector and become public officials charged with allocating rents. In a democracy people may seek political office, not to fulfill an obligation for public service, but to extract as many rents for themselves and their supporters as possible (Diamond 1993, 1995). Similarly, private business people may concentrate on the struggle for publicly provided benefits, be they mineral concessions or aid contracts, rather than on establishing productive enterprises. Considerable evidence suggests that a strong natural resource base may hinder economic development (Gelb 1988; Sachs and Warner 1995). This outcome is explained by the fact that individuals believe the most effective way to gain wealth is to try to take it from someone else or from the state, rather than to produce (Krueger 1974).

**Bribes that Buy Political Influence or Votes**

Corrupt elected officials can be voted out of office. But democracy is not necessarily a cure for corruption. In some systems corrupt politicians coexist with democratic forms even though citizens are aware of their practices. Corrupt payoffs are used, in part, to fund political parties and election campaigns. They fund general electoral activities, and in some countries the outright purchase of votes by politicians, although illegal, occurs quite openly. Conversely, some autocratic regimes manage to limit lower-level corruption with rents extracted by only a few top officials.

Modern political campaigns demand more resources than older style contests. Thus there is a demand for greater funding. In the absence of public funding the most convenient source of money is business interests that can benefit or be harmed by politicians’ decisions. Even if contributions from business can be made legally, both firms and politicians may prefer to keep the payoffs secret if a quid pro quo is involved. Voters cannot be expected to tolerate tax breaks or con-
tracts granted in return for payoffs. In some cases an entrenched system of illegal payoffs may undermine efforts to reform the funding of political campaigns. Studies of the political systems in France and Italy demonstrate how modern parties have lost their ideological focus and have come to be dominated by “business-politicians” (Mény 1996, p. 314; della Porta 1996). Many of the recent scandals there involved illegal campaign contributions. The same is true of the recent scandals in the Republic of Korea. When Tanaka Kakuei was prime minister in Japan, he developed a system under which businesses were assigned candidates to fund and elect (Reed 1996, p. 402).

The testimony of Italian political operatives in the recent anticorruption investigations reveals how corrupt practices can become entrenched in nominally democratic systems. Party leaders placed people who sought political careers in positions where the payment of bribes was routine. The construction industry was a particularly lucrative source of funds. Specialised “party cashiers” had the job of managing the collection of bribes and the distribution of contracts. Such people generally had no official government job but were the ones that business people turned to if they had a problem dealing with the government. They collected bribes for the party coffers, keeping some share of the gains for themselves (della Porta 1996).

On the other side of the transaction were political bosses who were especially concerned with mobilising the vote. This could be done, not just with campaign funds, but also with state resources, patronage jobs and other types of government favours used to create webs of obligation. It is not clear whether the work of the Italian magistrates has entirely undermined this well-organised system, but the revelations of illegal activities by top leaders has led to a major realignment at the top of Italian politics (della Porta 1996).

In some countries votes are purchased openly. This practice has a long history going back to England and the United States in the nineteenth century. Reforms have limited such payoffs in most industrial countries, but they remain a feature of electoral politics elsewhere. The
recent election in Thailand featured a long-standing practice of small payoffs to voters. An original twist included a post-election bonus if the candidate won. Politicians accused of amassing illegal campaign war chests in the Republic of Korea and Japan justified their actions by referring to the financial demands of campaigning in countries where voters expect gifts or other personalised benefits from candidates (Park 1995; Reed 1996).

In other countries executive branch officials purchase the votes of legislators. Special budgetary funds available to the executive with little accountability fuel this practice, especially in several Latin American countries. In Brazil, when President Collor’s impeachment was before the Congress, observers worried that his allies were trying to bribe the members to obtain a favourable verdict (Geddes and Ribeiro Neto 1992).

There are several avenues of reform to consider. One is publicly funding campaigns, maintaining well-enforced restrictions on private donations. Public funding must be generous enough so that candidates can avoid amassing illegal slush funds. A number of different proposals have been made to reform campaign spending in the United States that might be applied in other countries. This is not the place to review these possibilities, except to note that poor democracies will face more severe budgetary constraints than richer ones if they move to public funding.

Complementary proposals involve redesigning the electoral process to reduce incentives to give voters personalised benefits. Such changes will not affect the incentives of political parties to collect funds from wealthy supporters, but they will reduce the incentives for politicians to buy citizens’ votes. For example, under a nation-wide proportional representation system candidates have no individual districts to satisfy. Another example: some have argued that recent reforms of the Japanese electoral system should reduce incentives to provide personal favours to voters. Recent reforms of the Italian electoral system were designed with this idea in mind, although their success is questionable.
A final type of political change will be more difficult to carry out as a self-conscious policy since it involves a change in underlying political cleavages. Montinola (1996) argues that the shift from a multidimensional set of political issues to one that could be aligned along a left-right spectrum helped reduce corrupt incentives in Chile, since politicians could be more easily held accountable by the voters. This observation, if correct, is another argument supporting a government that is more streamlined and compact.

Payments for Judicial Decisions

Judges can affect the distribution of wealth through their decisions. Thus like any public officials with similar powers, they face corrupt incentives. These incentives are higher when judges are underpaid and overburdened, and have poorly equipped and understaffed offices. Even if judges are not themselves corrupt, clerks in charge of assigning cases and advising judges may demand or accept bribes. In some Latin American countries, for example, the lack of formal court fees creates incentives for court employees and judges to charge unauthorised fees (Buscaglia 1995).

Payoffs can be a way to speed up decisions in countries where delays and backlogs are great. A six-country study in Latin America found that delays and backlogs had increased dramatically between 1973 and 1993 (Buscaglia 1995, table 1), thus raising incentives to pay bribes. Bribes can also influence judges to make decisions in one’s favour. Occasionally, bidding wars have been reported, in which parties on opposing sides compete in making payoffs.25

A judiciary viewed as corrupt introduces uncertainties into the business climate. The law on the books may not mean much, and those with disputes will avoid bringing them before the courts unless they are certain that they will be the high bribers. Individuals with disputes find ways to circumvent the court system. They may hire private arbitrators or use other methods, such as the protection provided by
organised crime. Buscaglia (1995) reports that the judiciary in Latin America is so deficient that most business people try to avoid using the courts to resolve disputes. In Eastern Europe and in Russia murders of business people and bankers are common. Many appear to be execution-style killings that are part of a brutal private system of “dispute resolution.”

Reforming the judiciary requires more than a simple change of personnel. Unless underlying conditions improve, fundamental change is unlikely. The first step is to better pay and working conditions for judges and supporting personnel, accompanied by more systematically monitoring performance, both inside and outside the system. Information on delays by type of case and court could be collected and made public. Furthermore, judges may need additional training if they are to deal responsibly with the disputes that come before their courts. An improvement in the professionalism of judges should reduce the incidence of corruption.

One way to make the judiciary work more effectively is to establish laws that are well-drafted and relatively clear. Of course, courts cannot avoid exercising discretion, but clarity will both eliminate disputes and make judicial decisions appear less arbitrary. Some developing countries, for example, are functioning with laws written in the language of the colonial power that are difficult for citizens to understand. Even when language is not a problem, some countries continue to use obsolete statutes borrowed from industrial countries many years ago. Thus although some corrupt incentives can be reduced by reforming and upgrading the judiciary, comprehensive reform requires a complete review of the legal system.