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The Political Economy of Corruption—Causes and Consequences

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Corruption occurs at the interface of the public and private sectors. Sometimes officials simply steal state assets. But the more interesting and complex cases occur when a private individual or organization bribes a state official with power over the distribution of public benefits or costs.

What determines the level of corruption? The question is a vexing one, especially since no comprehensive empirical research exists on the incidence of corruption or its impact on resource use and the distribution of income. Many officials remain honest in the face of considerable temptation, and others accept payoffs that seem small relative to the benefits under their control. Others, however, amass fortunes. The level of malfeasance depends not only on the volume of potential benefits, but also on the riskiness of corrupt deals and on the participants' moral scruples and bargaining power. The overall impact of corruption, however, depends not just on the size of payoffs, but also on their distortionary effects on the economy. But even when the impact is significant, the efficient level of bribery will not be zero. Bribery is costly to control, and reforms must consider the costs as well as the benefits of fighting it.

This Note examines the opportunities for illicit gain that exist in all countries. It asks what factors determine the size and incidence of bribe payments, and assesses the political, economic, and distributive consequences of corruption. A companion Note reviews strategies that can reduce corruption.

Economic opportunities for corruption

Bribes are paid for two reasons—to obtain government benefits and to avoid costs.

Paying for benefits

Governments buy and sell goods and services and distribute subsidies. More recently, many governments have sold state firms and provided infrastructure service concessions to private operators. All these activities can create corrupt incentives. When the government is a buyer or a contractor, for example, there are several reasons why a corrupt firm may pay off officials. A corrupt firm may pay to be included in the list of qualified bidders, to have officials structure the bidding specifications so that it is the only qualified supplier, or to be selected as the winning contractor. And once selected, it may pay for the opportunity to charge inflated prices or to skimp on quality.

Similarly, when governments sell goods or services at below-market prices, firms will often pay off officials for access to state supplies. In China, for example, where many raw materials are sold both at state subsidized prices and on the free market, payoffs reportedly are common.[1] When the state controls the supply of credit and the rate of interest, bribes may be paid for access. Businesspeople in Eastern Europe and Russia report that payoffs are often necessary to obtain credit.[2] And, when the state maintains multiple exchange rates at artificially low levels, firms often pay bribes to get scarce foreign exchange.

Corruption can also occur when spending on subsidies and benefits is too low to satisfy all who qualify, or when officials must use discretion in allocating services. People may pay to be judged qualified for a public benefit or to be selected to receive a scarce benefit. In the United States, for example, corruption has periodically surfaced in public housing programs. And in

India, observers report that even the very poorest must pay to obtain old age assistance.

Although privatizing state-owned enterprises reduces opportunities for corruption, the privatization process itself can create corrupt incentives. A firm may pay to be included in the list of qualified bidders or to restrict their number. It may pay to obtain a low assessment of the public property to be leased or sold off, or to be favored in the selection process. Before reforms to the process in Argentina, for example, privatizations allegedly favored those with inside information and connections, as have some privatizations in the former Eastern bloc.[3]

In all these types of government programs officials are likely to amass valuable information. Private individuals and firms may be willing to pay for information such as bidding specifications, the actual condition of soon-to-be-privatized firms, and the location of future capital projects.

Paying to avoid costs

Governments also impose regulations, levy taxes, and enforce criminal laws. As they carry out these functions, officials can delay and harass those they deal with, and they can impose costs selectively in a way that affects firms' competitive position. Under public regulatory programs, firms may pay for a favorable interpretation of the rules or a discretionary judgment in their favor. The incentives to do so are especially high when the regulatory requirements are unclear, giving much discretion to officials, or when regulatory agencies are new and unproven.

To reduce their tax payments, businesses and individuals may collude with tax collectors, dividing the savings with them. In some parts of Eastern Europe and the former Soviet Union, where nominal tax rates are very high, businesspeople report steep payoffs. In Italy, many allegations of corruption involve payoffs to tax inspectors. Customs officials are particularly likely to engage in corruption since they control access to the outside world, something that firms value highly. Recent customs reforms in Indonesia and Mexico were prompted, in part, by widespread evidence of this kind of corruption.

Firms and individuals everywhere will pay to avoid the costs of delay. For example, if the government or a parastatal does not pay its bills on time, contractors may pay to get speedy settlement. In many countries, informal payoffs are required to obtain even ordinary services such as a telephone, a passport, or a driver's license. In India, for example, a newspaper recently published the "fees" for a range of routine public services such as access to gas, telephone, power, and education services.[4]

Businesses selling outlawed goods and services are especially prone to extortion. Law enforcement authorities can demand payments to overlook criminal law violations or limit penalties. If the evidence of criminal behavior is clear, such firms are unable to credibly threaten to report corrupt authorities. Of course, illegal businesspeople are hardly innocent victims. They may purposely corrupt the police, seeking not only immunity from prosecution, but also monopoly power in the illegal market. In the United States, for example, gamblers and drug dealers have paid officials to raid their competitors.[5]

The size and incidence of bribes

The level of corruption is a function of the honesty and integrity of both public officials and private individuals. With these factors held constant, the size and incidence of bribe payments are determined by the overall *level* of benefits available, the *riskiness* of corrupt deals, and the relative *bargaining power* of briber and bribee. The level of benefits is determined by the nature of government programs, but corrupt public officials themselves often influence the supply of benefits up for negotiation. For example, they may be able to extract some of a contractor's profits by delaying payments or inventing ex post regulatory hurdles. They can threaten to enforce criminal and regulatory laws more vigorously than is the norm. They can also propose “white elephant” projects, or structure privatization projects or natural resource concessions to include high monopoly profits.

If the likelihood of detection and punishment is high, bribes may not be worthwhile. As the riskiness of corruption rises, the division of gains from corruption will depend in part on the briber and bribees’ relative tolerance for risk. It may also depend on whether the probability of detection and punishment is a function of the size of bribes. One possible result of stepped-up enforcement is a lower incidence of corruption, but an increase in the size of bribes paid.

Generally, the division of gains between the payer and the recipient of the bribe depends on their relative bargaining power. One aspect of this is their relative vulnerability to prosecution. For example, if firms are punished less severely than public officials, their threat to reveal a corrupt arrangement is more credible, and they ought to be able to garner a larger share of the monopoly gains of bribery. In such cases the size of the bribes is a poor guide to their distortionary effect.

The relative position of a potential briber also depends on whether there are other ways of obtaining the desired benefit. The potential briber might be able to obtain the same benefit by relocating to another jurisdiction or country, by following legal processes at some additional cost, or by using threats and intimidation rather than payoffs. Or it might be able to obtain a comparable benefit by applying to another official in the same government. This is a real possibility when many officials can provide a benefit, such as a license, a passport, or help in smuggling goods. Similarly, in a democratic legislature, where a majority would have to be bribed, no one legislator has much bargaining power. Individual payoffs will be low, but the overall incidence of corruption may be high. In general it seems that when firms have other options, they can more easily avoid making high payoffs and may be able to avoid corruption entirely.

The costs of corruption

How often do officials, private firms, and individuals take advantage of corrupt opportunities, and how much money is paid in bribes? Not surprisingly, there is little solid evidence on the incidence and magnitude of corruption. Surveys of businesspeople indicate that the problem varies widely across countries. And within countries, some public agencies—for example, customs and tax collection—are more of a problem than others. Surveys also suggest that where corruption is endemic, it imposes a disproportionately high burden on the smallest firms. But, importantly, the most severe costs are often not the bribes themselves, but the underlying distortions they reveal.

Inefficiency and unfairness

When payoffs are commonplace, government contracts, privatized firms, and concessions may not be allocated to the most efficient bidders. One might argue that the most efficient firm would be willing to pay the highest bribe, but this would not be the case if this firm happens to be scrupulous. Corruption favors those with no scruples and those with connections over those that are the most efficient. It produces inefficiency because the need to pay bribes is an entry barrier, and firms that make payoffs may expect not only to win the contract or the privatization auction, but also to obtain inefficient subsidies, monopoly benefits, and regulatory laxness in the future.

Corruption introduces other kinds inefficiencies into government contracting. Projects may be too large and too numerous if bribe revenues increase with the dollar volume of procurement. They may also be too technically complex, since corrupt payments are easier to hide in one-of-a-kind projects. Quality may suffer if contractors make payoffs to be allowed to cut corners. In privatizations there is a more subtle reason why the most corrupt firm will not necessarily be the most efficient. A corrupt bidder with inside access may persuade officials to badly manage a parastatal in order to lower its value. The insider then emerges as the high bidder. Such behavior is difficult to detect since, ex post, the privatization will appear to be a smashing success.

Officials may raise firms' costs by introducing delays and unnecessary requirements as a way of inducing payoffs. This can happen in contracting and auctioning, for example, or in the administration of regulatory and tax laws. Furthermore, the process of paying bribes is itself costly. For example, a firm might need to establish a web of offshore bank accounts to hide its illegal gains.

Corruption in contracting and privatizations also has distributive consequences. The gains of bribery accrue to winning bidders and public officials rather than to the state and ordinary citizens. To make up for high contract prices and the disappointing revenue generated by privatizations, the state must raise taxes or cut spending. Third parties may suffer in other ways too. Consumers may end up with low-quality products if bribes are paid to induce regulatory officials to overlook dangerous conditions or permit firms to reduce quality. Enforcement of workplace safety rules and environmental regulations can be compromised by payoffs.

Undermining political legitimacy

Systemic corruption undermines the legitimacy of governments, especially in democracies, where it can even lead to coups by undemocratic leaders. By contrast, nondemocratic governments can use corruption to maintain power by spreading its benefits. If most wealthy and powerful individuals are part of a web of corrupt payoffs and favors, the threat of exposure can help current rulers to maintain power. Thus, corruption need not be destabilizing, but it always runs against norms of open and fair dealing.

Conclusions

Although no definitive evidence exists, there are good reasons to suspect that even in high-growth countries, corruption is both unfair and inefficient. Corrupt countries can still grow, however, as long as corruption has not gone so far as to undermine economic fundamentals totally. For example, countries with mineral wealth can maintain living standards while officials siphon off a high level of payoffs. But recent econometric research suggests a negative association between growth and high levels of corruption.[6] Case study material from around the world indicates that illegal payoffs can increase the cost and lower the quality of public works projects by as much as 30 percent to 50 percent.[7]

Despite the costs of widespread corruption, they are a symptom of disease, not the disease itself. Eliminating corruption makes no sense if the result is a rigid, unresponsive, autocratic government. Instead, anticorruption strategies should seek to improve the efficiency and fairness of government and to enhance the efficiency of the private sector. The companion to this Note explores reforms that respond to these concerns.

1 Michael Johnston and Yufan Hao, "China's Surge of Corruption," *Journal of Democracy* 6:80–94 (1995).
2 Martha de Melo, Gur Ofer, and Olga Sandler, "Pioneers for Profit: St. Petersburg Entrepreneurs in Services," *World Bank Economic Review* 9:425–50 (1995); Leila M. Webster, *The Emergence of Private Sector Manufacturing in Hungary*, World Bank Technical Paper 229 (1993).
3 For examples from around the world, see Michelle Celarier, "Stealing the Family Silver," *Euromoney* (February): 62–66 (1996).
4 "Bribe Index," *Sunday Times of India*, December 17, 1995.
5 Allan Kornblum, *The Moral Hazards*, Lexington, Mass.: D.C. Heath (1976).
6 Paolo Mauro, "Corruption and Growth," *Quarterly Journal of Economics* 109: 681–712 (1995).
7 Robert Wade, "The System of Administrative and Political Corruption: Canal Irrigation in South India," *Journal of Development Studies* 18: 287–327 (1982), and Luigi Manzetti and Charles Blake, "Market Reforms and Corruption in Latin America: New Means for Old Ways," *Review of International Political Economy*, forthcoming.

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