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Corruption in the Public Finances

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I. Introduction

In recent years a lot of attention has been paid to corruption. The newspapers of countries with a free press have been reporting, almost daily, stories related to this topic. More importantly, because of corruption scandals, in some countries, governments have fallen, whole political classes have been replaced and prominent politicians have lost their positions or, in some cases, have gone to jail.

Corruption can have different definitions. Perhaps the simplest definition is that it is the abuse of public power for private gains. From this definition it should not be concluded, however, that corruption cannot exist in private sector activities. In large private enterprises, and especially when the managers are not the same as the owners, this phenomenon can also exist. In the above definition, a public official who uses his position to derive benefits for himself, for his family and friends, or even for his political party or tribe, is engaging in an act of corruption.

It is a controversial issue whether cultural factors play a role in the existence and prevalence of corruption. However, regardless of cultural factors, human behaviour universally responds to positive and negative stimuli or incentives. When incentives that increase the returns to acts of corruption exist, some individuals will become corrupt, regardless of culture. By the same token, when rules and laws are transparent, effective controls are in place, and acts of corruption are severely punished, corruption tends to decrease, regardless of culture. This implies that more attention should be paid to making rules and laws transparent and to the incentive structure that exists within public sector institutions, including the level of wages and the penalties for acts of corruption. There are examples of countries where corruption has been much reduced over time through determined actions on the part of the government; and there are examples of countries where the opposite has happened. This paper will focus on corruption in the public finances. However, section 11 will also deal with more general aspects of corruption.

II. Instruments and Effects of Corruption

Corruption affects and distorts what should be arms' length, or objective and unbiased, relationships between government officials and private sector individuals. Through the payment of bribes some individuals succeed in getting favourable treatment in their economic activities from public officials. Such a treatment can either reduce the costs for the economic activities in which these individuals are engaged or it can create new opportunities for them that are not available to others. Acts of corruption may be initiated either by private individuals or by government officials. When it is the latter, they may offer favourable treatment in exchange for a bribe or some other favour. When this happens corruption disrupts the competitive situation that exists in the market and may give a competitive advantage to some individuals or enterprises.

A different kind of corruption occurs when government officials demand payments to perform services, such as the granting of a particular authorisation, that the officials should perform routinely. For example, a recent article in the New York Times reported that in New York City some elevator inspectors had been arrested because they had demanded bribes from the owners of buildings, in order to validate that the elevators in those buildings were in good working order. Without the bribes the inspectors would refuse to give such a seal of approval even when there was nothing wrong with the elevators. Of course, it would have been even more damaging if the officials had taken bribes to validate the safety of unsafe elevators. Unfortunately, corruption of public inspectors to make them overlook irregularities in particular projects or in particular activities is a common problem that occasionally leads to serious consequences.¹

It is conceivable that under particular circumstances, government officials may create or invent additional rules and regulations with the explicit objective of giving themselves more instruments for extracting bribes from individuals. In some cases, this is easy because there is no publicly available version of these rules. The asymmetry of information between the officials and the citizens, and the multiplicity of rules and their frequent changes, make it often impossible or very costly for private individuals to ascertain whether, in fact, the regulation claimed by public officials to extract bribes is a legitimate one.

Recent attention toward corruption has been promoted by the globalisation of economic activities and information. With increasing frequency globalisation is placing individuals from countries less tolerant of, or less used to, corruption into contact with individuals from countries where corruption is a more common phenomenon. For example, this is the case with foreign investment or with public projects where foreign companies compete among themselves or with domestic companies for the projects. See Hines (1995) and Wei (1997). The fact that some industrial countries allow the payment of bribes to foreign officials to be business expenses deductible for tax purposes while others (the United States) do not, has intensified international interest in corruption and has led to calls by the OECD to standardise the tax treatment of bribes.² American companies and American policymakers have been especially vocal in their claims that American companies were discriminated against because they refused to pay bribes to foreign country officials. Estimates amounting to tens of billions of dollars in lost contracts by American companies have been reported.

Recent attention has also been promoted by the growing trend in the world toward more open societies with increasingly free and vocal media. As a consequence, behaviour that was not reported in the past, or that did not attract much public attention, is now closely scrutinised. Attention to corruption has also been stimulated by the growing concern for economic efficiency and competitiveness on the part of policymakers who have become aware that corruption reduces the ability of countries to compete internationally and, in its extreme forms, it affects the countries' macroeconomic situation. Both the IMF and the World Bank have recently become much more outspoken and forceful in their fight against corruption. See IMF (1997). The literature on corruption has centred on a basic and, for some, a debatable assumption, namely that the more involved is the government in economic activity and decisions, the greater is the potential scope for corruption. This assumption is particularly realistic when the government's role is not played just through its spending and taxing activities but is carried out through the use of regulations, authorisations, and other quasi-fiscal activities.³ In addition, the less transparent and clear are the laws and the regulations of a country, the greater is the discretion of government officials in interpreting and applying them. Furthermore, the lower is the relative wage of public employees, the greater is the Potential for corruption. Thus, clarity, discretion, and a reasonable wage Level are key factors in determining how much corruption there will be in a country. See Tanzi (1995).

In theory at least, corruption could increase efficiency when the existing rules are too rigid and stifling and when the bribes to be paid to get around these rules are not excessive and are predictable. In such circumstances, the economic agents who want to get around the rigid rules know whom to contact to get the desired decisions; they know the size of the bribe to be paid; and they have confidence that the bribed public official has the power and the incentive to comply with the terms of the implicit agreement. In other words, the official will not renege on the promise and no other official will appear to put obstacles on the activities of those who have paid the bribe. Thus, the services that can be bought with a bribe are available to everyone and at similar prices.⁴ In this case of (almost) transparent bribing, corruption may be less damaging to economic efficiency and growth as compared to cases where corruption is random and largely uncontrolled, such as it is reported to be in some former Soviet Union countries, including Russia. Some economists have viewed the former type of corruption as a kind of (almost) neutral tax that increases the cost of economic activity, but distorts little the allocation of resources and does not prevent efficient economic decisions from being taken. It just removes, for a fee, an obstacle to economic activity.

While there may be some truth to the above argument, its practical importance is exaggerated. It assumes that economic activity is damaged by the existing and unchanging rules so that the bypassing or the bending of these rules, obtained through the payment of bribes, removes an obstacle to growth without doing any damage. Unfortunately, corruption is like a cancer: it starts in one specific area, perhaps the area where the rules are in fact too rigid, and soon it begins to spread to other areas. In time, most activities become affected. When this happens, corruption becomes like a distortionary tax levied with uneven and random rates. Then, it is no longer just "oil for the mechanism" but it distorts economic decisions in ways that can be damaging to the economy. For example, it may encourage unproductive public spending or economically unproductive activities, because of the bribes or the "commissions" that some public officials can get on such spending or for protecting those activities. As mentioned earlier, it may encourage the creation of opaque rules and regulations and may even distort the structure of public institutions, thus increasing the range of possibilities for which corrupt public officials can get bribes. When regulations create the possibility of increasing incomes for some government officials, more regulations may be created or more government officials may become corrupt to get a piece of the action. Corrupting may also affect the claims that public employees make as to where to work. There are reports of countries where civil service applicants are not guided in their job applications by the interest or even the wage paid in particular jobs, but by the under-table payments that can be obtained in some positions. For example, in a South Asian country with a high corruption index, the number of applicants for well-paid foreign service jobs has fallen significantly in recent years, while the number of applicants for less prestigious and less well-paid jobs as income tax inspectors has increased sharply. In this country the index of corruption has also been rising.

While some of the more speculative literature of earlier years had hypothesised a positive connection between corruption and growth, recent, empirical literature has pointed to a negative correlation between corruption and growth. The reason why many economists now believe that corruption retards growth is because it affects economic variables that promote growth. For example, recent empirical work by Paolo Mauro of the IMF, using cross-sectional data, has shown that corruption decreases

total investment and expenditure in education. See Mauro (1997). Because these variables are important contributors to economic growth, corruption is assumed to decrease a country's rate of growth. Mauro (1995) has estimated the probable reduction in the growth rate that can be attributed to the impact of corruption on these variables. Work by Tansi and Davoodi (1997) more directly related to the impact of corruption on public finance has concluded that corruption increases public investment, and especially investment in unproductive projects, while it reduces its productivity and the productivity of the existing infrastructure. In particular, it reduces public spending in operation and maintenance so that a country's existing infrastructure can be used at only a fraction of its potential capacity: roads with potholes can carry less traffic than those in good condition.

However, corruption affects economic efficiency and, thus, growth in many indirect ways. Unproductive public investment may replace more productive investment even when the total is not affected; incompetent officials may move up to sensitive positions where the poorer quality of their decisions is damaging to economic activity; promotions within the civil service may not be based on merits thus leading to discouragement and bitterness on the part of more competent staff; public projects may be completed in a sloppy way, or they may never be completed; and so on. In some countries new roads were built so shabbily that they became unusable within a few years. There have been reports of countries where expenditure for operation and maintenance was intentionally reduced so that the infrastructure would deteriorate more quickly to the point where major new investments would be required, thus providing opportunities to some officials to get "commissions" from the companies that would undertake the projects.

Up to now, the topic of corruption has been addressed in broad terms. The next two sections will focus more closely on corruption as it affects the public finances of a country either through its impact on public revenue or on public spending. The net effect of corruption on the public finances is almost surely to increase the fiscal deficit while at the same time reducing the efficiency of public spending and of the tax system. The net effect of corruption on the public finances goes beyond the quantitative dimensions of its impact on the size of tax revenue and public expenditure that determine the fiscal deficit.

Corruption in the public finances reduces the ability of the government to pursue its basic public finance functions. It distorts the allocation, distributional, and stabilisation roles of the government. The effect of corruption on allocation is obvious. In the public finance literature, the role of the movement in the allocation of resources is justified in terms of the need for governmental action to correct for market failures. However, corruption creates market failures because of the differential treatment that individuals receive when some of them bribe public officials while others do not and because of the implicit monopolies that it may create. In some countries corruption has led to the creation of monopolies when some individuals have been given exclusive rights to engage in particular activities. The "crony capitalism" of the Marcos regime in the Philippines created several such monopolies but the practice is not limited to that experience or to that country.

The distributional role is distorted because those who benefit from corruption, and especially from high-level corruption, either as corrupters or as corrupted, are often better placed and better connected than those who do not. Corruption allows them to increase their real incomes. The stabilisation role is made more difficult because corruption, and especially corruption in the public finances, tends to decrease government revenue and to increase government spending, thus contributing to larger fiscal deficits. Additionally, corruption obfuscates the relationship that exists between policy changes and the final results of those changes. For example, it should be possible to predict that a given change in a tax rate may result in a given change in tax revenue. When corruption is present it becomes difficult, if not impossible, to do so. And it becomes difficult to predict the impact of a change in public spending on a given social output.

III. Corruption in Tax and Customs Administrations⁵

Those who have provided technical assistance in taxation to different countries have occasionally encountered cases where tax collection was much lower than any realistic estimate made, using available information on tax bases and tax rates. This difference reflects the known and common phenomenon of tax evasion. See Tanzi and Shome (1993). Of course, some, or much, tax evasion takes place when taxpayers manipulate their accounts or their declarations to reduce their tax payment. This kind of tax evasion takes place whether corruption on the part of tax officials exists or not. However, some tax evasion exists because of corruption. This is the part that is of interest to us here.

Examples of corrupt practices undertaken by tax administration officials in return for bribes would include:

1. provision of certificates of exemption from tax to persons who would not otherwise qualify;
2. deletion or removal of a taxpayer's records from the tax administration's registration, filing and accounting systems;
3. provision of confidential tax return information to a taxpayer's business competitors, creation of multiple false taxpayer identifications to facilitate tax fraud;
4. write-off of a tax debt without justification;
5. closure of a tax audit without any adjustment being made or penalties being imposed for an evaded liability;
- (6) manipulation of audit selection; and so on.

Examples of corrupt practices undertaken by customs administration officials in return for bribes could include:

1. facilitating the smuggling of goods across a national border to avoid tax and duty payments;
2. facilitating the avoidance or understatement of a tax or duty liability through acceptance of an undervaluation or misclassification of goods in the processing of a customs entry;

3. allowing goods that are held in a bonded warehouse to be released for consumption in the domestic market without payment of tax or duty; and
4. facilitating false tax and duty refund claims through certification of the export of goods that have been consumed in the domestic market or that have not been produced at all, and so on.

These are by no means exhaustive lists of corrupt practices in which tax and customs officials may engage. Indeed, where corrupt practices are widespread in a revenue administration, its officials are likely to be continually on the alert for new opportunities to engage in rent-seeking. In some countries, the highest bribes may be paid by a businessman to a senior tax or customs official, for example, to secure a formal certificate of exemption from tax or duty. In the same countries, different businessmen may prefer to rely upon their personal contacts with low level officials to secure the same treatment. In some countries imports by relatives of the most senior political personalities have been given blanket exemptions, thus costing the country large amounts in foregone revenue. Reductions in government revenue occur when corruption contaminates the tax and customs administrations, so that some of the payments made by taxpayers end up in the pockets of tax inspectors or customs officials rather than in the government treasury. In some countries corruption in the tax and customs administrations became so pervasive that drastic measures had to be taken. In Peru and Uganda, the existing tax administrations were dismantled and were replaced by new institutions with new personnel, new salary structures, and new organisational arrangements. In these cases, an attempt was made to provide better incentives and higher salaries to the new employees. In several other countries, the customs administrations were privatised by hiring the services of foreign companies which assumed control of the customs operations in exchange for a fee expressed as a share of customs revenue. Thus, an incentive was introduced for the foreign companies to maximise customs revenue.

Because of corruption, the tax burden as measured from the side of a taxpayer who has paid a bribe to the tax or customs inspectors is higher, and in some cases much higher, than the burden as measured from the side of the government, which excludes the bribe. The difference may lead some unwary observers to recommend increases in tax rates, or the introduction of new taxes, on the assumption that the country is tightly taxed. This difference in tax burdens may explain why the taxpayers of some countries complain about the heavy taxes they pay while the revenue statistics of those countries convey a different impression.

Many aspects of the tax systems may be affected by corruption. However, this phenomenon seems to be particularly significant in some areas. Prominent among these are the provision of tax incentives and the imposition of foreign trade taxes. In both of these areas, technical assistance work has revealed major cases of corruption. In this connection, it is important to emphasise that we are not dealing with the question of tax evasion in general, that may or may not require the collusion, and, thus, the corruption of officials of the tax or customs administrations. Rather, we are focusing specifically on cases where tax revenue is lost because of corruption, and, thus, where there is an active participation by government officials. Tax evasion that does not involve the contribution of corruption officials, does not fall in our area of concern. Total tax evasion in a country is often much higher than tax evasion caused by corruption.

In the provision of tax incentives some public officials, either in the Ministry of Finance, or in other ministries (such as industry or trade), have considerable discretion over the decision on whether to grant or not to grant a tax incentive to an investor. The decision often depends on subjective considerations, such as whether the investment is "necessary," or is in the "national interest." Thus, some official has to decide whether the investment meets these often vague conditions. Often the request for tax exemption for some economic activity is made by foreign companies and involves decisions by senior political figures.

The value of the incentive to the requesting investor can be very high because it is the present value of the taxes that would be saved over the life of the project. One can visualise the situation in which an often poorly-paid public official has to make decisions that may be worth millions of dollars to the investor.⁶ Furthermore, applications for tax incentives often require many contacts between the applicants and the officials so that there is ample time to develop a close personal relationship. In these situations, the offering of a bribe and the accepting of it are likely outcomes.

Political or high-level corruption has also played a significant role in the area of tax incentives. High level political figures (including presidents of countries or prime ministers) or their relatives or close associates, are occasionally involved in economic activities that can benefit from tax incentives. These political figures have the power to make, or to influence, the tax incentive decisions, that could save the investors, both domestic and foreign, much money at the cost of the country's revenue.

The area of tax incentives is often linked with that of foreign trade taxes because the incentives concern not just income taxes, but foreign trade taxes and especially import duties. Getting an incentive that exempts an enterprise from taxes on imported inputs or imported products can save it much money. Corruption affecting foreign trade taxes is an activity of both low-ranking bureaucrats and high-ranking political figures. When the latter are involved, it is often done through close relatives or associates. Serious cases of corruption in customs have been reported in the past couple of years in Morocco, Argentina, Brazil and several African countries. In Morocco, the head of the customs administration was jailed for major cases of smuggling. In Argentina, the existence of a parallel (to the official one) customs administration was reported. In Brazil, smuggling by officials in the navy, using military ships, was uncovered.⁷

In other countries corruption has involved collusion in the faking of invoices to get rebates on non-existing exports. In some cases, as in Kenya, the magnitude of these claims became very large, thus affecting the macroeconomic situation of the country.

Many of the factors that can lead to significant corruption problems in the tax and customs administration are common to other

areas of public administration. There are, however, some special factors that can make the task of addressing corruption problems in tax and customs administration especially difficult. If the tax policy and legislation framework of a country is highly complex, as is normally the case with the provision of tax incentives, the taxpayers may often have to deal on a face-to-face basis with tax and customs officials to obtain an explanation of how the laws apply to their particular transactions. In such circumstances, officials may have wide discretionary powers to determine such things as the appropriate tax rate, timing of a liability, tariff classification, or valuation to be applied to goods which are the subject of a transaction. Where such broad discretion's are available to officials, and taxpayers lack the necessary information they require to determine their own liabilities, opportunities for corruption are bound to arise.⁸

When high-level officials (say a minister or head of a tax or customs administration) have the authority to provide tax and duty exemptions under their discretionary powers, the provision of such exemptions (in return for some private benefit) can seriously undermine any notions of equity in a country's tax system. Moreover, where tax and duty rates are high, the incentive to engage in some form of corrupt behaviour will be greater. High rates of excise and import duty on tobacco and alcohol products imposed by a country have often given rise to major smuggling problems and the involvement of criminal organisations in these activities, including payments of bribes to customs officials.

In poorly organised tax and customs administrations, complex, bureaucratic procedures can even make compliance with basic obligations to file returns, lodge declarations, and pay taxes and duties extremely difficult. If taxpayers have to complete multiple forms and obtain multiple authorisations to complete a transaction at a tax or customs administration office, it generally will require visits to a number of offices to get appropriate official certifications, stamps and signatures. Where this occurs, opportunities for rentseeking by officials will invariably arise.

Corrupt practices in tax and customs administration do great damage to the revenue collection capabilities of a country. On the one hand, there is the direct loss of revenue from each individual collusive arrangement between a taxpayer and a tax or customs official. But more importantly, the long-term result of all these individual actions by corrupt tax and customs officials is to destroy any notions that taxpayers can be expected to voluntarily comply with their obligations under the taxation laws.

When corrupt behaviour is commonplace among tax and customs officials, the incidence of taxation can become completely arbitrary. When a tax or customs administration's systems and procedures are weak, there is little likelihood that a taxpayer's non-compliance will be detected and appropriate sanctions imposed. When, in addition, corrupt officials are regularly helping taxpayers to circumvent their tax and duty liabilities, voluntary compliance with the tax laws will necessarily continue to decline, with a consequent impact on revenue collections. If tax rates are raised to recover revenue lost through low levels of voluntary compliance, the only impact a tax rate increase may have is to increase the amount of the bribe that officials will ask for to facilitate the evasion of some or all of that increased tax liability. Looked at in this way, corrupt practices in tax and customs administration might be seen as a major impediment, perhaps the greatest impediment, to improving revenue performance in some countries.

If corruption problems in tax and customs administration are to be seriously addressed by a country, a commitment must be made at the highest political level to deal with those problems. If senior officials continue to engage in corrupt behaviours while embarking upon a campaign to eradicate similar behaviours at lower levels in a revenue administration, it is unlikely that such a campaign will succeed. Many of the measures required to build a modern professional tax or customs administration, where opportunities to engage in corrupt practices are minimised, are of an organisational and procedural nature. However, significant simplification of a tax system can lay the foundations for improvements in tax and customs administration that will reduce opportunities for corruption. A policy framework that provides for a limited number of taxes, with a limited number of rates, and minimum exemption provisions can make the task of administration of a tax system much easier for tax and customs officials. At the same time, if the system is more transparent, its requirements will be more readily understood by taxpayers. If reform of the policy framework is also accompanied by the introduction of effective penalty measures, this can provide a clear indication to taxpayers that their liabilities will be rigorously enforced in the future.

Simplification of declaration forms and filing and payment procedures can also reduce opportunities for day-to-day contacts between taxpayers and officials and thereby reduce opportunities for collusive behaviour. Importantly, the introduction of simplified procedures can also significantly reduce a taxpayers compliance costs and increase voluntary compliance.

The most important principle that stands behind the procedures and systems of modern tax and customs administrations is that of self-assessment (or self-declaration). This means that taxpayers should be entitled to present to a tax or customs administration their returns or declarations setting out their calculation of tax liabilities based upon their understanding of the law, as explained by the tax authorities. Of course, a tax and customs administration will always retain the right to challenge and audit taxpayers' self-assessment of their liabilities on a selective basis. By reducing contacts between taxpayers and tax officials, self-assessment is likely to reduce tax evasion due to corruption of tax officials. At the same time, it may, at least under some circumstances, increase tax evasion by the taxpayers acting on their own.

IV. Corruption In Public Spending⁹

Corruption increases public spending and distorts its allocation. It increases public spending: by promoting unnecessary or unproductive spending; by contributing to the overpayment for some services or goods that the government buys; by making payments to individuals not entitled to these payments; and in many other ways. A comprehensive discussion of this issue is beyond the scope of this paper. Here we shall limit our discussions to a few basic issues.

To properly address corruption in public spending, it is particularly useful to distinguish between *political* or *high level* and *administrative* or *bureaucratic* corruption. Corrupt behaviour that takes place during the budget preparation phase, a time when political decisions are made, reflects *political corruption*. Corrupt behaviour and/or corrupt activities that take place during the budget execution phase will be mostly *administrative corruption*.

Political corruption has particularly damaging effects on the allocation of resources because it tends to divert resources away from the functions to which they would have been allocated in the absence of corruption. Two recent studies by Mauro (1997) and by Tanzi and Davoodi (1997) have attempted to show quantitatively the extent to which corruption changes the allocation of spending. Both of these studies use cross-sectional data and regression analysis.

Mauro's main results can be summarised as follows:

- First**, he does not find any relationship between corruption and the level of public spending;
- second**, he does not find a significant relationship between corruption and public investment;
- third**, he finds that government expenditure on education is negatively and significantly associated with higher levels of corruption;
- fourth**, he finds that government expenditure on health is also negatively and significantly associated with corruption.

Mauro's inclusive finding about a correlation between corruption and the level of public spending is surprising, but it may be due to the fact that while corruption tends to increase public spending out of available resources, it also decreases government revenue. Therefore, the pressure on higher spending is balanced in part by the reduction in resources necessary to finance spending.

Tanzi and Davoodi's main results are the following:

- First**, and in contrast with Mauro's findings, higher corruption tends to be associated with higher public investment *when the government revenue-GDP ratio is added to the equation*;
- second**, high corruption tends to reduce government revenue, and, thus, it reduces the resources available to finance spending, including public investment;
- third**, high corruption tends to reduce expenditure for operation and maintenance; fourth, high corruption tends to be associated with poor quality of infrastructure, thus reducing the economic value of the existing infrastructure and its contribution to output.

Thus, the Tanzi and Davoodi paper shows that corruption can indeed have powerful effects on both the quantity and the quality of public investment. That paper discusses in some details the factors that make public investment a particularly vulnerable area to corruption and especially to political corruption.

Some of the major corruption scandals, such as those that shook Italy in recent years, have been connected with political corruption and public investment. The intellectual bias favouring capital spending, the controls that high level officials have on decisions concerning public projects, and the fact that in some way each investment project is unique and is subject to many kinds of designs, sizes, technology and other options, make public projects an area of public spending to be watched closely. The effects reported by both Mauro and by Tanzi and Davoodi have the consequence of reducing the rate of growth.

In many cases corruption in public spending is mostly connected with bureaucratic rather than political decisions. It is thus linked to budget execution rather than budget formulation. Budget execution involves several phases each providing different phases for corruption.

During the *budget appropriation* and *spending authorisation* phase there are various possibilities for *interventions* and *manipulations*. If the spending authorisation is not granted regularly, a ministry will not be able to make commitments and, therefore, goods and services will not be delivered on schedule. The official in charge of issuing spending authorisations might favour a given ministry in order to allow that ministry to contract suppliers which compensate the official with under-the-table monetary rewards.

In spite of the specific nature of budget laws regulating commitments, the *commitment* phase of the expenditure process is a fertile ground for corrupt activities. The most frequent, and perhaps the most damaging of these activities, is the partial or total disregard of *procurement laws* and *procedures*. Regulations regarding prices, quality, quantity, as well as terms of delivery, can be disregarded in favour of particular suppliers who are ready to offer bribes to corrupt officials. As the government is a major purchaser of goods and services, bending the rules in favour of a few suppliers can have a serious effects on others, distorting market forces and favouring individuals who are more efficient at bribing rather than at producing. Another possible case of corruption is the ordering of goods and services not authorised in the budget. Needless to say, because the size of the budget is given, commitment of resources for goods and services not authorised in the budget often pre-empt commitment for some that are authorised.

The task of officials entrusted with the *receiving and verification* phase is to check if all the regulations have been respected. The budget laws of many countries prescribe that if at the receiving and verification phase, it is discovered that goods and services not conforming to specifications or not authorised in the budget have been ordered, commitments must be cancelled. However, because of collusion among corrupt officials, verification procedures are not carried out and the existence of illegal commitments are often not revealed at this stage.

Corrupt behaviour during the *preparation and issuance of payment orders* phase is essentially the same as during the preceding phases. It is based on the disregard of laws, rules and regulations, principally for illicit monetary gains.

If cash is not available for payment when goods and services are delivered in due form, the government will incur arrears. The occurrence of arrears is a time-honoured practice in many countries so that suppliers often accept this inconvenience as a cost of doing business with the government. However, some suppliers will bribe officials in charge of issuing payment orders in order to get paid before the others. When some suppliers are paid first and others later, or not at all, the "ranking" of suppliers can have a detrimental effect on those enterprises not willing to pay bribes, especially in periods of inflation or when interest rates are high. Needless to say those who pay bribes will recuperate their "investments in bribes" by increasing their prices or by delivering substandard goods.

The *payment* phase can be exploited by unscrupulous officials for organising large scale fraudulent schemes involving payments to fictitious (ghost) employees (often deceased) or unauthorised entitlement payments to existing employees or to others. Regarding pension payments, at times corrupt officials will not initiate payments until "speed money" is offered and paid. It is not unusual that retirees are obliged to wait months or even years before their monthly checks begin to arrive. In some cases "speed money" is paid to "facilitators" who, for a fee, intervene to speed up the process.

In cases of severe cash shortages, when daily cash rationing must be imposed, the establishment of an order of priority among competing claims is essential. The official in charge of the tax, generally a high-level official such as a Deputy Ministry of Finance, has enormous discretionary powers, which can be used for corrupt purposes. By manipulating the allocation of cash resources for the purpose of favouring selected spending ministries and agencies, the official will be able to rearrange budget priorities for the year. Corruption has often accompanied the establishment of extrabudgetary accounts. The very purpose of establishing extrabudgetary, earmarked funds and special accounts is to exempt some transactions from standard budgetary procedures and controls. While it should not be assumed automatically that these resources will be misappropriated, misspent or stolen, it remains true that a lack of appropriate control procedures will create a fertile ground for corrupt behaviour. There is ample evidence to the effect that "little empires" were built with public resources through the use of extrabudgetary and/or earmarked funds. In some cases, these funds are flush with cash, while the official budget lacks resources for financing budgetary expenditures.

The literature on corruption has extensively discussed the consequences of the corrupt behaviour of officials and has emphasised its illegal and criminal aspects. However, while these aspects are important, other dimensions of corrupt behaviour should also be discussed. We have mentioned above the impact of corruption on the size and composition of total expenditure, but there are other costs. The total economic and social effects of corrupt actions might be very costly and out of proportion to the bribes received by corrupt officials in terms of resources wasted, the opportunity cost of resources misused, and the inefficiencies introduced in the system. Also, by diverting resources from their intended purposes, corrupt officials will change the allocation of resources as intended and approved in the budget. Thus, the decisions of the legislative body will be undermined and in the end the democratic process will be altered. This may be the most serious consequence of corruption, far more damaging than the personal enrichment of corrupt officials.

V. Concluding Remarks

Corruption has moved from being a phenomenon of little interest to being one of major concern. Many now recognise that a country with much corruption cannot have a truly efficient economy or a truly democratic state. Corruption can be a cancer for both democracy and the market economy and if not checked it can essentially kill both.

Corruption is tied to many activities of the government. It can be carried out at the political level, by the leaders or the most senior officials of a country; or at the administrative level, by the bureaucracy. In this paper we have been concerned mostly with corruption as it affects government revenue and government spending. Both political and bureaucratic corruption plays a role in the public finances. We have shown that it reduces government revenue while it tends to push for higher government spending, thus contributing to larger fiscal deficits. It also distorts the tax system and renders public spending less productive.

Like any other human action, corruption responds to incentives. Some incentives promote corruption, some discourage it.¹⁰ Governments must address these issues more systematically than they have done so far. They must do so by looking at the transparency of existing laws and regulations, at the quantity of them, at the structure of government institutions, at the level of wages, at the professionals of the civil service, at the penalty system for corrupt actions, and so on. In this process, the example provided by the leadership is very important. One should not expect to find a clear bureaucracy in an environment where political corruption is rampant.

Corruption in the public finances is an aspect that so far has received relatively little attention.¹¹ The organisers of this conference deserve credit for having placed this important topic prominently in the agenda of the conference. I hope that this will stimulate other experts to enter this undoubtedly complex area.

Notes and References

- [1] For example, a corrupt health inspector may overlook unsanitary conditions in a restaurant. Or a corrupt vehicle inspector may validate the use of a vehicle even when the vehicle has faulty brakes.
- [2] Also, some countries make the payment of bribes to foreign officials criminal offences while others do not.
- [3] Because the latter are more prevalent in developing countries, these countries tend to report higher indices of corruption.
- [4] At times, it has been claimed that the corruption that exists in some fast growing countries of South East Asia reflects these characteristics.
- [5] Some of the issues discussed in this section are dealt with in greater depth in Crotty (1997)
- [6] We have now some evidence of what we have always suspected, that low public sector wages may encourage some officials to engage in acts of corruption. See for the empirical evidence, Van Rijckeghern and Weder (1995).
- [7] In foreign trade smuggling covered by corrupt officials is at times tied to the import of narcotics or even weapons. Customs officials on the border between Mexico and the United States have often been accused of contributing to the smuggling of illicit drugs into the United States.
- [8] In these situations the interpersonal relationships mentioned by Tanzi (1995) come to acquire a particularly important role.
- [9] Some of the issues dealt with in this section are discussed in greater depth in Garamfalvi(1997) and in Tanzi and Davoodi (1997).
- [10] For an attempt to link incentives to corruption, see Chand and Moene (1997).
- [11] There are of course exceptions. See inter alia, CIAT (1995), Arias Minaya (1995) and Ul Haque and Sahay, (1996).
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