ANTI-CORRUPTION HELPDESK

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EVIDENCE OF THE IMPACT OF FACILITATION PAYMENTS

QUERY

What is the evidence of the damage caused by facilitation payments and what are the most effective counter-arguments to those who wish to allow them?

PURPOSE

The UK government is allegedly considering allowing facilitation payments in overseas business transactions. What is the evidence of the damage caused by facilitation payments and what are the most effective counter-arguments?

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SUMMARY

Facilitation payments typically refer to small bribes paid to public officials by private citizens to speed up bureaucratic processes and access services the payer is lawfully entitled to. Facilitation payments are universally prohibited in the national laws or public service regulations of countries where they are paid, but some countries allow the payment of small bribes to foreign officials to access services.

Although some authors have argued that facilitation payments can "grease the wheels" of commerce by reducing transaction costs induced by cumbersome regulations and administrative processes, there is a large body of evidence indicating that such an approach is costly, harmful for firms' growth and productivity, legally risky and ultimately economically inefficient for companies. Evidence shows that they have a detrimental long term effect on the operations companies, undermine their internal culture and ethical standards, and make them preferential targets for more and greater demands.

At the country level, there is also evidence that facilitation payments have a corrosive' effect on the overall governance environment and the efficiency of the state apparatus, erode the ability of the government to collect revenues from formal tax channels, and ultimately undermine sustainable economic development and the rule of law.

1 EVIDENCE OF IMPACT

Definition

Facilitation payments typically refer to small payments, usually made to bureaucratic officials by private citizens (individuals, company owners or business managers) to speed up administrative processes, obtain a permit, licence or service such as installing a telephone line, clearing custom duties and other basic services. As such, they can be considered as a form of petty corruption (Argandona 2004). The general understanding is that facilitation payments only cover payments made to a public official for him or her to perform their regular function, without resulting in a preferred treatment given to the bribe payer. Some definitions further specify that such payments must be small and only made to induce a lawful decision or action in which no discretion is involved.

In other words, contrary to forms of grand corruption, facilitation payments are not made in view of obtaining or retaining a business or an undue advantage and cover bribes given to access a service the bribe payer is lawfully entitled to. They are usually made for the purpose of expediting or securing the performance of routine, non-discretionary acts by government officials (Nichols 2009). While the amount paid may be small in absolute terms, companies may seek to avoid other significant costs (including time costs) by resorting to such payments.

There is a broadening consensus that facilitation payments are a form of corruption. In essence, there is no clear distinction between facilitation payments and bribes, as the payment of the alleged small sums does confer a benefit others may have to wait for should they choose not to pay the facilitation payment. They also represent an "abuse of entrusted public power for private benefit", even if they do not aim at granting an undue benefit to the payer.

Most countries where such payments are paid prohibit them in their national laws or public service regulations (Trace International Inc 2009a). However, some countries do not always criminalise the payment of such bribes to foreign officials (Nichols 2009) and provide an exception for "small facilitations payments". According to Trace International[1], countries that permit facilitation payments are Australia, New Zealand South Korea and the US.

For example, the US Foreign Corrupt Practice Act (FCPA) was amended in 1988 to introduce an exception for "facilitating or expediting payments made to foreign officials to expedite or secure the performance of a routine governmental action". For a payment to fall within this category, it must be intended to produce governmental action to which the payer is lawfully entitled to without making such payment. It does not include any discretionary decision by a foreign official. However, there is no clear line separating facilitation payments from bribes. According to US authorities, it depends on the amount of money involved, the frequency of the payments, to whom it is paid and the accurate reporting of the payment in the company's internal accounting system (Martini 2011).

Even if some countries provide a legal exception for facilitation payments made to foreign officials, the OECD has recently called for the prohibition of facilitating payments abroad that are currently still permitted under the anti-corruption laws of several member countries. Recognising the 'corrosive' effect of facilitation payments on sustainable economic development and the rule of law, this OECD 2009 recommendation calls on member countries to review their "policies and approach" in order to effectively combat the phenomenon. This recommendation also encourages companies to prohibit the use of such payments in their internal control, ethics and compliance programmes. The OECD further recommends that such payments be in all cases accurately accounted for in the companies' books and financial record (OECD 2009).

Impact of facilitation payments: overview of evidence

The impact of such forms of bureaucratic corruption in monetary terms remains largely under-studied, although it is the form of corruption that most directly affects companies in their daily interactions with government officials. While there is a general consensus about the pernicious effect of facilitation

[1] *Trace is a non-profit membership association providing anti-bribery compliance solutions for multinational and their commercial intermediaries: www.TRACEinternational.org*

payments, only on few studies distinguish them from other forms of bribes and have collected hard data on the potential cost and impact of such payments on companies, citizens, economic growth and the overall governance environment.

The impact of facilitation payments for companies

Aggregated cost for citizens

Petty bribery cannot be considered as such, when the cost of small and repeated unofficial payments is aggregated on a national or a global scale. While each individual payment may be small, the frequency and repeated nature of such payments as well as the aggregate sums of companies and households paying bribes on a regular basis adds up to very high amounts (Bohorquez and Devrim 2012). For example, the Index of Corruption and Good Governance for Mexico indicates that Mexicans paid the equivalent of € 1.9 billion in bribes to access basic services in 2010.

In addition, petty bribery to access public services that citizens and firms are in principle entitled to is the kind of corruption that most directly affects citizens' standards of living, especially the poor, as small payments to access public service ultimately represent a high percentage of their income. For example, the above mentioned index for Mexico shows that, while Mexican households with an average income spent an estimated 14 per cent of their monthly incomes in bribes, households with the minimum income spent up to 33 per cent of their monthly income. A survey on experience of corruption in the Western Balkans also confirms that lower income groups pay more bribes than wealthier citizens (Bohorquez and Devrim 2012). As such, petty corruption can impede universal coverage of public services, as these cannot be guaranteed to those who cannot afford to pay (Bohorquez and Devrim 2012).

Aggregated costs for companies

At company level, the aggregate cost of facilitation payments for companies can add up to substantial sums. Firm level surveys conducted in Africa in 2006 and 2007 indicate that petty bribery could cost companies the equivalent of between 2.5 and 4.5 per cent of their sales (Clarke 2008). While the accuracy of reporting by firms is questioned by some authors, this could cost average manufacturing firms more than communications (telephone, fax and internet) and transportation (excluding fuel) costs and represent about 10 to 20 per cent of labour costs.

Some studies also show that smaller firms are likely to be more severely affected by the impact of petty corruption than bigger firms. A 1999 survey conducted by the European Bank for Reconstruction and Development found that bribes paid by smaller firms (with less than 49 employees) amounted to 5 per cent of their annual revenues. Bribes paid by medium sized firms (with between 50 and 499 employees) amounted to 4 per cent of their annual revenues while those paid by larger firms (with more than 500 employees) amounted to less than 3 per cent of their annual revenues (Asher 2002). As small and medium enterprises (SMEs) provide the bulk of employment in many economies, especially in developing countries, this can have far-reaching effects on economic growth and development.

There is also a wide consensus that administrative costs related to red tape, entry and operational procedures are positively correlated to levels of corruption, the quality of a country governance and level of transparency (Morisset and Lumenga Neso 2002). A database of administrative costs faced by private investors in 32 developing countries indicates that a high level of corruption is associated with higher administrative costs and longer delays for companies and investors.

The aggregated costs involved in the repeated payment of small bribes can ultimately limit the amount of resources available to invest and increase the productive capacity of the firms, especially for SMEs. While not specifically looking at the impact of facilitation payments, some authors find that excessive regulation, red tape and other forms of regulatory burden - which are closely associated with bureaucratic corruption - act as a hindrance to entrepreneurship, decrease firms' incentives or increase costs of expanding their productive capacity (Alesina et al 2005).

Impact of facilitation payments on firms' productivity and growth

There is a large body of evidence that corruption is likely to adversely affect economic growth, through its impact on investment, taxation, public expenditures, human development, firms' growth and productivity, innovation, and efficiency. As facilitation payments are considered as bribes, but the literature does not distinguish between the impact of facilitation payments and other forms of bribery. A recent Helpdesk answer on the impact of corruption on economic growth and business activity provides an overview of available evidence in this regard and can be accessed on request through the Helpdesk: tihelpdesk@transparency.org.

Although some economists have argued that facilitation payments can reduce transaction costs by running around cumbersome regulations, there is a large body of evidence indicating that bribery is ultimately economically inefficient for companies (Strauss 2013).

For example, a well-known World Bank study looking at the relationship between bribe payments, management time wasted with bureaucrats, and cost of capital, found, as early as 1999, that small bribes do not necessarily reduce red tape, contrary to the general assumption that they can help mitigate the effect of cumbersome bureaucratic processes and "grease" the wheels of commerce in countries with low quality of governance. The research found that firms that pay bribes are likely to spend more management time (and not less) with bureaucrats negotiating regulations, as corrupt officials tend to target their demands on companies that have paid bribes before. Firms that bribe also face a higher, not lower, cost of capital (Kaufman and Wei 1999). The study concludes that bribery is not an effective strategy to alleviate red tape if bureaucrats can choose the regulatory burden and the red tape delay to extract bribes.

More recent empirical evidence at the micro level tends to confirm these findings and shows that corruption increases the time spent by managers dealing with red tape and hamper firm growth (Fishman and Svensson 2007). Based on a dataset providing information on the estimated bribe payments of Ugandan firms, a 2007 study explores the relationship between bribe payments, taxes, and firm growth in Uganda. Findings indicate that both the rate of taxation and the rate of bribery are negatively correlated with firm growth, with a one percentage point increase in the bribery rate resulting in a three percentage point reduction in firm growth. Bribery appears to have a much greater negative impact on growth than taxation.

Another recent study challenges the assumption that facilitation payments can have a positive effect on firms' productivity by mitigating the impact of red tape, and weak institutional and regulatory frameworks. Based on enterprise data from the Business Environment and Enterprise Performance Surveys (BEEPS) survey for the economies of Central and Eastern Europe and Central Asia, a 2010 World Bank working paper looks at the comparative impact of informal payments to government officials to ease day to day operations of companies on firm productivity, referred to as "bribe tax", compared to the effect of red tape, referred to as "time tax" (De Rosa, Gooroochurn and Görg 2010). The study finds that only the "bribe tax" seems to have a negative impact on firm-level productivity, while the effect of "time tax" appears insignificant, which challenges the argument that facilitation payments are effective in achieving higher productivity by helping companies circumvent cumbersome bureaucratic requirements. Regression analysis also shows that firms that do not pay bribes in environments with high corruption and inefficient legal frameworks experience higher productivity.

Impact on the operations of companies

Beyond actual monetary costs, facilitation payments have a detrimental long term effect on the operations of private organisations (Argandona 2004):

- Facilitation payments impose additional costs on companies and citizens to access services that they are entitled to. As already mentioned, although the amount of each individual payment may be small, the total cost for the company or citizens may be significant.

- Demands for payments can also grow in the future, as the culture of paying bribes spreads across the organisation and the company gains the reputation of being ready to make such payments when solicited.

- Facilitation payments are often a slippery slope to more serious forms of corruption. According to Daniel Kaufman, there is likely to be a high correlation between grand corruption and the proliferation of facilitation payments (Kaufman 1998). Other authors consider that, companies that make small payments are also more likely to face demands for larger bribes, as they become targets for bribe extortion (Bray 2010).

- Facilitation payments are also likely to undermine the company's internal culture as well as undermine the ethical standards and governance structures of organisations and public administrations. For example, a 2008 PwC report based on a survey of 390 senior executives in 14 countries shows that in addition to potential damages to the firm's reputation, corruption tends to create a company culture of unethical behaviours and attitudes. Companies failing to prevent bribery are also highly vulnerable to theft, fraud, and financial statement manipulation (PwC 2008).

A 2009 benchmarking survey on facilitation payments conducted by Trace International confirms this last point, with almost 60 per cent of respondents reporting that facilitation payments pose a medium to high risk of books and records violations or violations of other internal controls (Trace international Inc 2009a).

Impact on the overall governance environment

Impact on the regulatory environment and the efficiency of the state apparatus

Anti-corruption literature considers that facilitation payments also have a longer term detrimental effect on public institutions and a country's overall governance and regulatory environment. They are likely to affect the efficiency of the whole state apparatus in the longer term, as they create incentives for politicians and public officials to create more regulations, restrictions and administrative procedures in order to have more opportunities to extort small payments from citizens and companies.

Corrupt bureaucrats have few incentives to address inefficiencies and bureaucratic obstacles that fuels petty bribery. Facilitation payments are likely to create a vicious circle that breeds inefficiencies in public service delivery, as the practice of not advancing matters until facilitating payments have been made spreads across the public service (Argandona 2004).

In a study analysing the levels of regulatory burden and corruption, Dzhumashev (2008) concludes that not only does corruption not reduce excessive red tape but also exacerbates rent-seeking behaviours, leading corrupt bureaucrats to create artificial barriers for the private agents by making up ad-hoc procedures and requirements. They seek to extract rents by attaching excessive red tape to the public good they are providing, which results in less public input being provided at a higher cost to the private agents. They can also make the regulations difficult for private agents to comply with, which tend to increase non-compliance and ultimately breeds bribery.

Such rent-seeking behaviours can also be "institutionalised" across the public sector, leading to structural forms of bureaucratic corruption, which permeate all levels of public institutions, feed corrupt bureaucracies and facilitate the creation of organised corrupt networks. In some countries for example, junior officials have to hand out a portion of the facilitation payments they collect to their superiors, who themselves have to pay a cut of their gains to their superiors, stretching to the highest levels of the bureaucracy (Argandona 2004; Bohorquez and Devrim 2012).

Impact on taxation

Widespread bureaucratic corruption also undermines the ability of the government to collect revenues from formal tax channels and is likely to create inefficient, discretionary and arbitrary revenue collection systems (Asher 2002; Morisset and Lumenga Neso 2002).

There is wide consensus among researchers that corruption has a significant negative impact on tax revenues, and findings from developing countries indicate that often more than half of the taxes that should be collected cannot be traced by government treasuries due to corruption and tax evasion (Nawaz 2010). Companies that pay bribes to avoid tax payments or customs duties deprive local governments of much needed revenue and contribute to entrench corrupt practices across the whole public sector (Bray 2010). In addition, while bigger companies may be able to afford the extra costs of paying off officials, smaller companies or ordinary citizens often cannot, undermining the fairness and transparency of a country's revenue collection system.

Furthermore, extra-payments that companies are subjected to when interacting with government officials are assimilated by some authors to irregular “tax-like” levies imposed at the local level and lower levels of bureaucracy, in addition to legally imposed taxes. These payments are considered to increase the tax burden of companies in an arbitrary and capricious manner, while reducing tax revenue collection that can be collected on objective grounds, with a detrimental effect on equity and efficiency in revenue collection and resource allocation (Asher, 2002).

Impact on state legitimacy and the rule of law

There is also a broad consensus that perceptions of corruption erode citizens’ confidence in public institutions and political processes, undermine social trust and the legitimacy of state institutions, and ultimately has a corrosive impact on the rule of law and democratic processes. While not specifically looking at bureaucratic forms of corruption, several studies and cross-country comparisons have confirmed such linkages (Seligson 2003; Jong-Sung You 2005; Andreev 2008).

As petty bribery affects citizens and firms in their daily interactions with public services, they are more likely to directly shape citizens’ perceptions of corruption in a given country, with a detrimental effect on public confidence in state institutions and government legitimacy. A 2006 study empirically exploring perceptions of corruption and trust in political institutions in Mexico confirms the strong correlation between trust (both interpersonal and political) and corruption, indicating that experience of corruption fuels lack of trust in government, leading to the public routinely dismissing government promises to fight corruption, and, perceiving higher rather than declining levels of corruption (Morris and Klesner 2006).

Going a step further, a recent paper challenges the argument that facilitation payments may be less “unethical” than bribes made to gain a business advantage because of their corrosive impact on the rule of law (David-Barrett 2012). The author distinguishes between the “primary harm” of bribery resulting from the mis-allocation of resources and the “secondary impact” of bribes resulting from the violation of the rule. Any bribes - irrespective of who the payer is, whether the bribe is big or small, or whether it aims at easing bureaucratic procedures or securing an undue advantage - demonstrates to the public that the rules are not consistently applied in line with the law. By nature, the violation of public office rules because of an inducement undermines the rule of law.

While at first glance facilitation payments may seem less harmful than other types of bribes in terms of their primary impact on resource allocation, the author argues that facilitation payments could even be more harmful in terms of their impact on the rule of law, as they represent a *more systematic* violation of the rules. This, in turn, is likely to erode public trust in state institutions, damage market and investor confidence, and encourage the public to pursue their interest through informal channels, making it ultimately impossible to implement public policy and further weakening the rule of law. From this perspective, the impact of facilitation payments on the rule of law cannot be considered as trivial or less harmful than other forms of bribes.

2 THE CASE FOR PROHIBITING FACILITATION PAYMENTS

A few key messages can be drawn from the evidence of impact outlined above.

Facilitation payments are bribes

Anti-bribery legislation is based on the basic assumption that paying bribes is ethically questionable, violating core values of fairness and equity by “buying” an undue advantage or granting a preferential treatment (Strauss 2013). Demanding a bribe - irrespective of the amount and whether it grants a lawful or unlawful advantage - is and remains a form of “abuse of public power for private benefit” that results in a distortion of the market. Such practice is prohibited by law or public service regulations in all countries where the bribe is paid and breaks the law of at least one country, irrespective of the size of the payment and the intended (lawful or unlawful) outcome.

Facilitation payments fuel bureaucratic, inefficient and corrupt public administrations

The need to make facilitation payments supposes that the public official does not perform the duties entrusted to him as efficiently as he or she is expected to do, in order to extract bribes. They create incentives for public officials, regulators and bureaucrats to increase the regulatory burden to extract bribes from companies and citizens. Such rent-seeking behaviours fuel inefficiencies across the public organisation, spread across the public sector and discredit the public administration at large. Governments may end up including facilitation payments as part of the remuneration of public officials, creating a vicious cycle where the public official has to extract bribes to compensate for low wages.

Facilitation payments are not an efficient way of easing the bureaucratic and regulatory burden

Bribery is ultimately economically inefficient for companies, with a negative effect on firms' growth, productivity, innovation, business operations and ethical culture. The above mentioned evidence indicates that facilitation payment is not a good business practice. In aggregated terms, facilitation payments are costly, acting as a hidden tax on businesses and introducing uncertainty, risk and delay in the performance of business and government operations (Trace International 2009b). Contrary to the "greasing the wheels of commerce" argument, facilitation payments increase - and do not reduce - transaction costs, in an unpredictable and arbitrary manner, as they are made for government actions that involve no discretion and should be performed anyway by the public officials in the course of his duty (Strauss 2013). In addition, they set a permissive tone that undermine the company's ethical standards and lead to more and greater demands.

Facilitation payments are legally risky for companies

Permitting facilitation payments overseas while prohibiting them domestically creates double standards and undermines international legal standards (Trace International 2009b).

Prohibiting all facilitation payments removes a dilemma faced by companies that must comply with both their national laws - which may allow exception for facilitation payments - and the law of the country in which they are operate - which do not allow such payments. While facilitation payments may be allowed by national laws (such as the FCPA), companies still face the risk that these payments will be prosecuted by local authorities. The above mentioned Trace International survey found that 35.2 per cent of the companies assessed a government investigation to be "moderately likely", 16.9 per cent considered it to be "highly likely".

Moreover, companies making facilitation payment must accurately record them on the company's books, which make companies "officially" record payments that are prohibited by another country. Business people are reluctant to officially record of the company's book a violation of the local laws and face the dilemma of producing false records in violation of their own laws or documenting a violation of local laws (Trace international 2009). Eliminating the facilitation payments exception resolves this problem.

As facilitation payments may be subject to interpretation, they are difficult to control, as it may be difficult for employees to make the distinction between facilitation payments and bribes paid for non-routine services. This lack of clear definition and guidance on facilitation payments puts companies at risk, and many companies categorically prohibit facilitation payments because they "do not want to take the risk that an employee or intermediary will misunderstand the difference between bribes and facilitating payments". In view of both this lack of clarity and the growing trend for imposing record penalties for violations of anti-corruption laws such as the FCPA, companies are increasingly reluctant to avail themselves of the facilitation payment exception, even though demands for such payments are common in many countries (Strauss 2013).

Allowing the facilitation payment exception creates confusing double standards for multinationals

Allowing facilitation payments to foreign officials creates doubtful double standards. For multinationals with subsidiaries, this increases the risk of violating the laws of a country where the subsidiary is located and can imply that they develop and implement different compliance programmes, based upon the location of each offices (Trace International 2009b).

Facilitation payments can be eliminated without harming the company

Eliminating bribery is possible for companies and some multinationals have managed to effectively refuse to participate in bribery schemes. In the above mentioned benchmark survey, 76 per cent of the respondents believe it is possible to do business successfully without making facilitation payments, with sufficient management support and careful planning, while over 93 per cent revealed that their job would be easier, or at least no different, if facilitation payments were prohibited in every country (Trace International 2009a). In addition, Trace International also interviewed 100 companies engaged in international businesses to learn how they had managed to stop paying small bribes to government officials and found that none of these companies had experienced major or prolonged disruption in their business activities (Trace International 2009b).

Eliminating facilitation payments worldwide levels the playing field for companies

An argument against introducing such bans is that in some countries, facilitation payments are extortionate in nature and banning them could completely prevent corporations from doing business in many countries. Such a ban could also disadvantage companies who are not paying bribes vis-à-vis their less ethical competitors. However, such forms of bribery can only be practiced because of legislative gaps in different countries' anti-bribery regimes. A universal anti-bribery regime harmonising the ban on facilitation payments worldwide would contribute to level the playing field and ensure that no company could legally offer such payments (Strauss 2013).

Facilitation payments undermine the rule of law and can potentially threaten national security

The proliferation of facilitation payments and bureaucratic forms of corruption is likely to erode the ethical fabric of society, create a culture of unaccountability among the whole population and have a corrosive longer term effect on people's trust in legal, administrative and judicial processes (Argandona 2004).

There are also some security concerns associated with the practice of facilitation payments in the face of international terrorism threats. When immigration officials can be paid for processing work permits and visas, borders can no longer be safe and national and international security laws can be by-passed (Trace International 2009b).

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