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LEGALIZE IT:

An argument for formalizing petty corruption when state capacity is low

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ABSTRACT

Corruption in the form of informal payments to bureaucrats for public services are a major problem around the world. There are however few theories of how countries can get rid of corruption. I argue that petty corruption must be understood not only as a problem, but also as a way of financing public services when state capacity is low. If the state is unable to collect revenue from citizens and pay decent wages to bureaucrats, citizens and bureaucrats can engage in a direct transaction: informal payments in exchange for services.

Still, the unpredictability and secrecy of corruption has negative consequences for citizens. I therefore suggest that the situation could be improved by formalizing informal payments; a modest improvement for corruption-stricken societies, but in contrast to other suggested reforms, more feasible. The argument is illustrated with a study of the formalization of informal payments in Sweden during the 19th century.

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Introduction

It is by now a well-known fact that corruption in a society has negative consequences for economic growth, human development and generalized trust (Holmberg, Rothstein, and Nasiritousi 2009; Mauro 1995). Cross-country comparative research has also identified several correlates of corruption (Treisman 2007). However, while we know the characteristics of countries that are corrupt and of those that are not, how a country is to escape the corrupt category is still largely unknown. Since it has been convincingly shown that corruption creates a stable equilibrium in which continued corruption is the rational option for the involved actors (Persson, Rothstein & Teorell 2011), it has been suggested that it is necessary to implement a major reform during a short period of time to push a country out of the equilibrium (Aidt 2003; Rothstein 2011).

However, such a reform requires that political leaders are genuinely interested in curbing corruption, or in other words, that the political principal is benevolent (Aidt 2003). At the same time, “political will” is a very poor predictor of positive development, as it usually is used tautologically: unsuccessful and corrupt leaders surely must have lacked political will, while those that succeeded must have been truly committed to reform (Persson & Sjöstedt 2010). If one then assumes that political leaders not are benevolent, are any reforms possible?

It is hard to conceive of a reform initiated by corrupt political leaders aimed at eradicating “grand” corruption, in which lawmakers take bribes in exchange for setting policy that benefits powerful interests in society, since it is a form of corruption that benefits leaders directly. But another important aspect is the “petty”, bureaucratic, type of corruption, in which public employees take bribes in exchange for services that ought to be free. The political leaders may benefit also from this type of corruption if income from bribes are passed along upwards in the hierarchy. It is how-

ever also likely that this type of corruption impairs efficiency in the state apparatus, which may decrease the revenues that the leaders wish to extract.

In this paper, I argue that leaders (benevolent and non-benevolent) tolerate petty corruption because it is easy – it allows for funding the salaries of bureaucrats directly from citizens and requires minimal administrative capacity on behalf of the state. There may however exist a reform that acknowledges the underlying demand for petty corruption, but still improves the situation, for citizens, bureaucrats and leaders. It thus does not require a benevolent leader. The solution, I propose, is to legalize and formalize some kinds of petty corruption. Many undesirable consequences of corruption will still remain even after the reform, but it will address one of the central problems, as identified by among others Andrei Shleifer and Robert Vishny (1993:612): “...bribes differ from taxes in one crucial way, namely, unlike taxation, corruption is usually illegal and must be kept secret. Efforts to avoid detection and punishment cause corruption to be more discretionary than taxation.” Apart from the distortionary effects, secrecy and lack of regulation also causes uncertainty and unpredictability, which is harmful both to the well-being of individuals and investment (Wei 1997).

I illustrate the feasibility of the proposed solution by drawing on the example of 19th century Sweden. The records, I argue, show that lawmakers tolerated informal payments to bureaucrats because it was an easy way of financing the state. However, they also gradually made efforts to regulate, formalize and standardize these payments, which improved predictability for citizens, bureaucrats and the government. When that had been achieved, the government was able to gradually substitute these direct payments for fixed salaries for bureaucrats, financed by user fees. These user fees often came in the form of a stamp tax. Finally, user fees were replaced by income taxes, but that was almost a hundred years after the first reforms to regulate corruption. It had been impossible for the

early 19th century Swedish state to go from a system where bureaucrats extracted their salaries directly from the populace to a fully functional, tax-financed, modern bureaucracy. Success was ensured through the imperfect intermediate steps, which I argue holds lessons for countries plagued by corruption today.

The paper is structured as follows. First I review existing research on corruption elimination, theory on government behavior in relation to petty corruption, and then what the adverse consequences of petty corruption and what the likely benefits of legalizing corruption are. I then describe how this paper differs from older research (e.g. Leff 1964) that argued that corruption could be positive for development. I then proceed to describe the process of formalizing and then transforming informal payments to user fees in Sweden during the 19th century. The final portion of the paper discusses the results and concludes.

Why governments tolerate petty corruption

Research on corruption has the recent decades flourished, especially in the form of cross-country comparisons on aggregate levels of corruption (Treisman 2007). The design of political institutions has been shown to matter for the rule of law and corruption (Andrews and Montinola 2004; Tavits 2007). Theoretical and empirical research have also demonstrated that political parties play an important role in political corruption, as they can target goods to citizens in exchange for votes (Stokes 2005; Nichter 2008), or use patronage to reward supporters and stay in power (Folke, Hirano and Snyder 2011). All in all, political corruption has garnered much attention. Bureaucratic, or petty, corruption remains understudied in political science given that it is the form of corruption that most directly affects citizens.

One reason for this deficit in both empirical research and theory may be that there are few modern success stories from which to learn from. Hong Kong and Singapore are usually held up as such examples, while Latvia, Estonia, the United Arab Emirates and Bahrain were found to have reliably improved their World Bank “Control of Corruption” score between 1996 and 2004 (Treisman 2007). Theoretical insight from these cases has however been limited. For instance, in a review of corruption reform in Asian countries Quah (1999:485) states that “...for anticorruption measures to be effective, they must be properly designed (to attack the causes of corruption) , and they must be sponsored and upheld sincerely by political leaders.” Explanations for why Hong Kong and Singapore have succeeded tend to highlight determined and skillful political leadership as one of the key factors. While high quality leaders such as George Washington or Nelson Mandela may bring about positive changes in their countries, it is not much of a help to countries suffering from corruption today, especially since it seems nigh impossible to determine which leaders that have a genuine commitment to reform *ex ante* (Persson and Sjöstedt forthcoming).

In order to locate good anti-corruption policies, one should thus focus on theories that does not require leaders to want reform for reform’s sake. However, while Aidt (2003) categorizes theories deriving from Becker and Stigler (1974) as theories that assume a benevolent principal, the only assumption that one has to make about the principal is that revenue-maximization is the primary goal, which should be a fairly reasonable assumption (Levi 1988). In this perspective, the principal should have little interest to combat grand corruption, which benefits the principal directly, but more interest when it comes to combatting petty corruption. Timothy Besley and John MacLaren (1993) develop a model of wages and corruption among tax collectors. In their model, the government wishes to decrease corruption in tax collection, as citizens are able to bribe tax collectors to withhold taxes from the state. By curbing corruption, the government is able to increase revenue

and thereby its influence. The assumption that governments wish to do this is more cautious than to assume that governments wish to curb corruption simply because it is better for the country.

In Besley and McLaren's model, the government wishes to raise revenue through taxes, and employs tax inspectors to estimate the wealth of citizens. Citizens wish to avoid taxation, and are therefore willing to bribe the tax inspector to underreport the wealth for a sum that does not exceed what is due in tax. To avoid this, the government has two instruments at its disposal – wages and monitoring of tax inspectors. Both these alternatives are costly. Besley and McLaren consider three strategies for the government: to pay an efficiency wage, where wages are sufficiently high to deter bribe-taking, to pay a reservation wage, where both honest and dishonest tax inspectors will be interested in the tax inspection job, and a capitulation wage, in which case only dishonest individuals will be interested in becoming tax inspectors and bribery will flourish.

The chosen strategy depends on both the efficiency of monitoring and the amount of revenue that is possible to raise from the population. When monitoring is ineffective, the efficiency wage becomes higher, as the government must pay much more to make the loss of a job sufficiently deterring for the tax inspector. Besley & McLaren thus claim that inefficient monitoring leads to the capitulation wage strategy, in which the government pays very low wages, that only attract dishonest individuals who supplement their income with bribes. The only revenue that the government receives is the one resulting from direct monitoring of tax inspectors. As the taxable income of the population increases, the role for efficiency and reservation wages (the difference being that there is some corruption in the reservation wage scenario) also increases. Monitoring is however still a factor. Accordingly, capitulation wages should be expected to be found in countries where tax income relative to GNP is low (Besley and McLaren 1993, 130).

The main insight of Besley and MacLaren's model is the concept of capitulation wages, as it illustrates a situation in which the government has little interest in curbing corruption (in this case through raising wages) even though it does not profit from it. It is simply too costly, given the available capacity to monitor the behavior of the bureaucrats. Van Rijckeghem and Weder (1997) confirm this as they find that there is a tentative negative relationship between public sector wages and corruption, but that massive wage raises are needed to eradicate corruption. They do however not take monitoring levels into account, which is unfortunate, as Besley and MacLaren predict that wage increases will be ineffective if monitoring is at a low level. But if we assume that governments in corrupt countries have little monitoring capacity, it is not surprising that the estimated link between wages and corruption is weak on average.¹ Furthermore, as Aidt (2003) notes, capitulation wages seems to be the practice in many developing countries, lending credibility to the theory.

Besley and MacLaren's model concerns tax collectors, but there is good reason to suspect that many of the insights of the model are applicable also in other areas of the state apparatus. Consider the case of public service provision of for example health care. When it comes to tax collection, citizens and tax inspectors have a common interest in withholding revenue from the government. This is not really the case in the provision of public services, as citizens want something from the government. However, citizens would still like to receive this good for free, without paying taxes for it. The government wish to raise revenue through taxes, but do not want to spend more than necessary on wages for bureaucrats. The bureaucrats want wages, but do not want to put in too much effort in work. In order for the system to work, citizens must pay taxes, the government pay wages, and the civil servants provide public services.

¹ Another influential study of the relationship between public sector wages and bureaucratic quality is that of Rauch and Evans (2000), in which no statistically significant correlation between wages and bureaucratic quality is found. However, the indicator of wage levels used by Rauch and Evans is a survey question directed to country experts, asking about the salaries of higher officials in government agencies, relative to managers in the private sector. This indicator should thus not be as valid when measuring the impact of wages on petty corruption, as it mostly concerns lower level bureaucrats. Van Rijckeghem and Weder (1997) instead use average wage levels in the entire public sector as their indicator.

There are many similarities between the problem of public service provision and the problem of tax collection described by Besley and MacLaren. The government can attract hard-working and talented bureaucrats by offering high wages, but must still monitor the bureaucrats to ensure that they put in enough effort in work. If the government estimates that it not has the capacity to monitor the bureaucrats, it will lower the wages, and the bureaucrats will accordingly not work. This will in turn reduce the willingness of citizens to pay taxes, as they do not receive any public services. Furthermore, for bureaucrats and citizens, the situation constitutes a collective action problem, as civil servants do not want to work if no other civil servant does so, and citizens do not want to pay tax if no one else does so. This outcome constitutes quite a stable equilibrium, which it may be hard to escape, but it does not mean that no services are provided to the citizens.

In Besley and McLaren's model, the tax inspector and citizen collude on withholding revenue from the government. In this case, bureaucrats and citizens can collude in the decision to provide a service: the citizen can pay the bureaucrat directly, and the bureaucrat provides a service to the citizen. In this way, the government is kept out of the loop, and collective action problems are avoided.

Informal payments in the health care sector are a clear example of this process. The authors of a study of informal payments in Georgia concluded that "...people ultimately prefer to rely on services that can be obtained through direct market transactions, because that is the only way, they believe they would receive proper services." (Belli, Gotsadze, and Shahriari 2004, 117). And the reason for why services would not be provided otherwise is that the health care practitioners are severely underpaid: "Of course it [the informal payments] benefits the physicians, but we should not be angry with them, because they are highly qualified specialists, and given that the state cannot pay them, they have to search for other sources" (Interviewee, cited in Balabanova och McKee 2002,

259). The notion of the interviewee is confirmed by more rigorous studies – one of the “coping strategies” of underpaid hospital staff is to demand informal payments (Van Lerberghe et al 2002).

While these payments can be seen as user fees, it is important to differentiate them from official user fees. The crucial difference lies in who benefits from the fees. As a Bulgarian interviewee in a study by Balabanova and McKee (2002:248) pointed out, “income of a health facility and income of professionals are two different things”. When fees are paid to the health facility the civil servants only receive a fraction of the income generated for the facility, which means that both doctor and patient have an incentive for an informal exchange, in which the payment is somewhere in between the share the doctor would receive and the price the patient would pay if the payment was made formally (Belli, Gotsadze, och Shahriari 2004, 115).

Hence, both in service provision and in tax collection, citizens and bureaucrats have incentives to cut a deal which excludes the state. In Besley and MacLarens model, the government may choose to only pay capitulation wages and tolerate some corruption. In many countries, bureaucrats have insufficient wages and supplement their income with informal payments from their clients. International surveys of informal payments in health care reveal that they are widespread. Surveys at the turn of the millenium revealed that the percent that reported making informal payments to health care providers exceeded 80 percent in Vietnam, Sri Lanka, Pakistan and Moldova (Lewis 2007). The government could try to enforce a ban on informal payments, but would then have to raise the wages and monitor the behavior of bureaucrats to make sure they did not shirk. Furthermore, to finance the wages, the government would have to ensure efficient tax collection. Instead, many governments choose to only pay capitulation wages and *de facto* tolerate the informal payments. Minimal effort is then required on behalf of the government, but some public services are still provided to the citizens.

Adverse consequences of petty corruption

I thus argue that due to the demand for public services from citizens, and the convenience of the government, petty corruption arises and is largely tolerated. However, while the petty corruption solves one problem, it may have many undesirable features. In a seminal paper, Andrei Shleifer and Robert Vishny (1993) identify two main economic drawbacks of corruption. The first drawback relates to the quantity of goods produced, in a parsimonious model of corruption in the provision of complementary goods, such as permits needed from different agencies. The model should also apply to other basic goods, such as schooling and health care. Consider a monopolist agency that provides both goods, and sets the bribe prices of both. If the agency raises the bribe price on one good, it reduces demand for the other, and therefore sets the prices as to maximize bribe income and thereby output. On the other hand, the two goods may be provided by different agencies, or as termed by Shleifer and Vishny, independent monopolies. Each agency does not care about the demand for the other agency's goods, and thus sets the bribe price higher, which reduces overall demand. Shleifer and Vishny's (1993:606) conclusion is that "By acting independently, the two agencies actually hurt each other, as well as the private buyers of the permits." In a corrupt bureaucracy, each bureaucrat acts as an independent monopolist. If there were a joint monopoly, more goods would be produced, at a lower average cost for citizens.

The second drawback concerns the type of goods produced. In a regular market, demand and profit governs the production decisions. Suppliers produce goods that are profitable which there is demand for. But when the market is illegal, suppliers need to consider where the risk of detection is lowest. There is thus another factor other than demand that governs supply, and Shleifer and Vishny (1993:612) thus conclude that "Efforts to avoid detection and punishment cause corruption to be more distortionary than taxation."

A third drawback which is not explicitly discussed by Shleifer and Vishny, but by other economists, is that corruption is harmful not primarily through the direct cost of bribes, but because of the associated uncertainty. As put by Wei (1997:1) "...corruption, unlike tax, is not transparent, not pre-announced, and carries a much poorer enforcement of an agreement between a briber and a bribee. In other words, corruption embeds arbitrariness and creates uncertainty." Wei proceeds to show empirically that corruption-induced uncertainty is similar to massive tax hikes. Fisman and Svensson (2006) also show that increases in bribery rates are about three times more harmful to growth than increases in tax rates of the same magnitude. On a personal level, it seems reasonable to assume, and anecdotal evidence indicates, that bribery and uncertainty is unpleasant for individuals. Regarding informal payments in health care, an interviewed Bulgarian physician provided the following quote (quoted in Balabanova and McKee 2002:261):

"Often the price of these under-the-counter services is not set... It diminishes the self-esteem of the physician: to have money slipped into the pocket... the sum does not always correspond to what he did, but in many cases this is the only way of increasing income. In general, it is unpleasant for both sides."

Possible benefits of legalizing petty corruption

If the state is unable to monitor bureaucrats and raise sufficient revenue to pay decent wages, it is likely that petty corruption will flourish. The optimal solution is obviously to address the underlying problems of lacking state capacity, but since that is an almost insurmountable challenge, an improvement of the situation may be to legalize and regulate some sorts of petty corruption. By doing so, I argue, transparency, predictability and equality in service delivery may be improved.

The government should in such a reform act as a price-setter, and decide on appropriate tariffs for services. By doing so, it is possible that the problem of independent monopolies described by

Shleifer and Vishny (1993) would be alleviated. By determining prices centrally, taking the need for various services into account, total output can be increased. Both bureaucrats and citizens would gain from this. The absence of a supply and demand-driven price setting mechanism would obviously cause the system to work akin to a planned economy, which causes distortions in production decisions. For instance, it is likely that bureaucrats will attempt to produce services that have a high set price in relation to the service's production cost. However, since the bureaucrats often are monopolists, regulation is necessary. Furthermore, distortions caused by imperfect prices are probably less distortionary than those caused by the need for secrecy and actions undertaken to avoid detection. They can also be addressed by adjusting prices.

Finally, legalization and formalization of petty corruption would increase predictability and reduce uncertainty. Citizens can make better decisions on how to spend their income if they know what services cost beforehand. Furthermore, if the system is made legal, the state has a better chance of obtaining information about service utilization in different sectors, which makes it easier to plan for the state as well.

In health care, formalization of informal payments has been suggested as a possible way forward by several scholars (c.f. Ensor 2004; Lewis 2007), there are few reported examples of attempts to explicitly do so, and while there is much research on the effects of introducing user fees in health care, as well as some research on the abolition thereof, few studies investigate the impact on informal payments (Ensor 2004).

Barber, Bonnet and Bekedam (2004:201) report of a Cambodian attempt to formalize informal payments, and describe the objectives of the reform: "Formalizing and regulating existing under-the-table payments would assure patients of fixed prices. Furthermore, hospital fees could be estab-

lished at levels substantially less than the estimated under-the-table fees.” Flat fees were used for the most part, together with an exemption scheme for the poor, based on easily observable and understandable indicators (for instance the number of children and farm animals). While user fees not were retained by the staff, salaries were linked to a bonus scheme which rewarded presence at work and quality of service (Barber, Bonnet and Bekedam 2004:202). After the reform was introduced, utilization of in-patient services increased substantially, and available evidence according to the authors of the study seem to suggest that “Take Hospital effectively eliminated under-the-table payments and controlled out-of-pocket hospital costs for patients...” (Barber, Bonnet and Bekedam 2004:2006). User fees also contributed to about one-third of the hospital budget. One possible explanation for why utilization would increase could be the transition from independent to joint monopolies, as discussed by Shleifer and Vishny (1993): appropriate prices increase demand and therefore generate the same level of revenue.

Other descriptions of introductions of user fees have not been so rosy. In a comprehensive review of experiences of introducing user fees in Africa, Gilson (1997) concludes that there is a substantial risk that user fees will deter utilization, especially among the poor. Even when there are exemption schemes, they may fail because they are too complex and require too much administration. Moreover, user fees generally failed to generate substantial revenue. Fees were most successful when coupled with increases in quality and when they were retained locally. Based on the collective action argument outlined in the theoretical section, the last point is paramount. As Gilson notes (1997:278), the incentive to collect fees is undermined when they can not be used to improve quality locally, and citizens should also have less incentive to pay if it does not benefit them directly.

Gilson argues that user fees generally failed to generate substantial revenue because income of the users is so low, and it may be that user fees will do little in areas of extreme poverty. But in the

Cambodian case, it was estimated that informal payments made up about 45 percent of the hospital's monthly revenues. In that case, it is clear that user fees should be able to generate more cost recovery than the up to ten percent of expenditures reported in African countries (Gilson 1997).

Even though user fees may have undesirable consequences, such as suppressing utilization among the poor or incurring "catastrophic" expenditures, there may be few alternatives. In Uganda, public health was officially free until 1993, but district health authorities were then given the right to impose fees. However, before the reform, informal payments were widespread (Xu *et al* 2006). In 2001 user fees were abolished, and the government increased funding to compensate for the loss of revenue. After the reform utilization for the poor increased, but at a lower rate than in the years preceding the reform, and the probability that poor would be exposed to catastrophic health expenditure was not lower after the reform. Xu and colleagues speculate that this may be due to the fact that drugs became less available after the reform, and that patients therefore had to buy them themselves, seek out private providers, or even that informal payments returned to compensate providers for lost revenue (Xu *et al* 2006:873). Xu and colleagues also discuss the importance of retaining collected user fees at the local level. When fees are replaced with government transfers, problems of ensuring that sufficient funds actually reach the hospitals ensue, and are exasperated in corrupt settings.

To summarize, the theory suggests that it is difficult to achieve functional financing of public service provision, and that informal payments for public services may arise as a way to shortcut collective action problems and ensure some service provision. Given the limitations on state capacity, economic theory seems to suggest that some undesirable consequences of informal payments resulting from secrecy and lack of coordination could be avoided by formalizing and regulating the informal payments. The introduction of user fees in modern health care has had mixed results, but

retention of revenue at the local level seems crucial, which is expected from theory, as to avoid collective action problems.

In the early days of corruption research, well-known scholars put forth the proposition that corruption actually may be good for economic development. For instance, although he came to the conclusion that corruption in general is detrimental to political development, Joseph Nye (1967:417) argued that “Corruption has probably been, on balance, a positive factor in both Russian and American economic development.” My argument however differs from so called “revisionists” in important aspects, which necessitates a brief review of the early pro-corruption arguments.

Nathanial Leff (1964) has made the perhaps most prominent case for corruption. His point of departure is that governments often are ineffective and uninterested in fostering growth. Corruption may then serve to counteract the harmful impact of government in society, for instance by incentivizing bureaucrats to promote regulation that is beneficial to economic activity, or by serving as a “hedge against bad policy”. Corruption allows entrepreneurs to have an influence in policy-making, which should lead to better policies than those promoted by the government.

The major problem of Leff’s argument is that it fails to acknowledge that there are many players in the bribe game, and that it is a repeated game. For instance, he argues that corruption can reduce uncertainty in investment, as “the personalist and irrational style of decision-making, and the frequent changes in government personnel and policies add to the risks”. By bribing policy-makers, business-groups can ensure continued support in their economic undertakings. Leff thus hypothesizes that corruption encourages investment. However, if one entrepreneur can bribe a policy-maker, so can another. Only the entrepreneur that knows that she can afford the highest bribes can therefore be certain that her preferred policies will remain unchanged. Empirical research has also

disproved Leff's hypothesis, showing that growth is slower in more corrupt countries, and that an important reason is corruption-induced uncertainty (Mauro 1995; Wei 1997).

Because Leff sees governments as ineffective and misguided, anything that can reduce government influence becomes a good thing, even grand corruption (which not is the focus of this paper). This paper takes as its point of departure that a venal and corrupt bureaucracy in general is harmful and inferior to a well-functioning Weberian bureaucracy, which most available research seems to confirm. However, compared to a situation where no services are delivered to the public because the state lacks capacity to fund a bureaucracy, petty corruption may resolve some issues. Therefore, systems of informal payments naturally develop in the absence of well-functioning bureaucracies. If that is the case, I argue, it may be better to accept the situation and legalize and formalize this system, rather than to let it go unregulated. If instituting a modern Weberian bureaucracy was possible, that would however be preferable. But as that option normally is unavailable, legalization could be the best course of action.

A recent insight in research is that a corrupt state apparatus not is an exception to the rule of good governance historically, but rather the norm (North, Wallis and Weingast 2009; Persson, Rothstein and Teorell forthcoming). A good theory of how to eradicate corruption could therefore be more likely to emanate from the study of industrialized western countries that have managed to escape corruption, rather than from the study of corrupt countries. Promising work in this area include the work of James Hollyer (2011), in a study of meritocratic reforms in bureaucracies in Western countries during the 18th and 19th centuries, as well as Mircea Popa's (2011) study of the end of British "Old Corruption" in the 19th century. In the following, I take the same approach in a study of Swedish wage reforms during the 19th century.

The Swedish experience

In this section, I aim to demonstrate several points. First, that the Swedish government early on chose a system of financing the wages of bureaucrats that resembled a capitulation wage regime, reliant on semi-informal payments. The reason for doing so was, I argue, that the state did neither have sufficient monitoring capability to monitor the work effort of bureaucrats, nor funds to finance their wages. Second, that politicians of the time believed that regulation of the system would be beneficial. The third point is that the system was *gradually* transformed, first through heavier reliance on user fees (in the form of stamp taxes), and only later on into an almost entirely tax-funded regime with fixed salaries. The Swedish experience thus demonstrates the feasibility of a gradual approach, first through formalization, then substitution for user fees, and only then to taxes.

The capitulation wage regime

In Sweden before the 19th century, few bureaucrats received fixed salaries from the state. Instead, many employees were financed through decentralized systems. In the cases of the king's extended arm, the bailiffs, a decentralized system was consciously designed from above. The bailiffs were responsible for collecting taxes and upholding law and order. Between 1696 and 1855, the bailiffs took their pay directly from the peasants. Under this system, peasants were obliged to support some officials with goods. The delivery of these goods naturally incurred a cost for the peasant, who therefore could agree on a sum (subject to mutual agreement) of money to pay directly to the official instead. The official however had the right to demand delivery of goods instead of cash, which allowed him to get a better price from the peasants, who were fierce opponents of the system which they claimed led to extortion (Westerhult 1962:121 ff). But parts of the system of financing the wages for the bailiffs was not consciously designed. Bailiffs also had extra income in the

form of “sportler” (deriving from the latin word *sportula*, meaning gift). The sportler system evolved as a way to fund the bailiffs as new tasks were assigned to them over time (Westerhult 1965:124).

Other employees also had sportler, but the nature and size could vary considerably, as it was a term for any extra income that the civil servants received in their service. They could be percentages and provisions on raised revenue, but in most cases they were fees for written documents of various kinds, such as licenses or copies of verdicts from courts. It was then usually called “expeditionstaxa” (expedition tax), but fit under the umbrella term sportler.

For customs officials, a rate for sportler had been established in 1686. Due to inflation, the rate however soon became obsolete. In 1828, the customs board noted that unofficial rates had spring up “partly through mutual agreement between traders and customs servants, partly through forcible extraction by the latter”.² A representative of the Burghers in the Riksdag of the Estates³ of 1828/30 also claimed that sportler existed because of “personal benevolence and friendship for the customs officials”.⁴

There are many similarities between the situation outlined here and Besley and McLaren’s capitulation wage regime. The state pays very low wages, but bureaucrats still work because they supplement their income with informal payments, in this case called *sportler*. The difference is that in Besley and McLaren’s model, tax collectors and citizens collude to deprive the state of funds, to the benefit of both parties. Regarding informal payments, it is rather the case that citizens and state employees engage in a transaction where the employee provides the citizen with some service, and

2 Protocol of the Estate of Burghers, 1828/30, collection 6, page 834 ff.

3 In contrast to european practice, the Swedish Riksdag had four estates instead of three: Nobility, Clergy, Burghers and Peasants.

4 Protocol of the Estate of Burghers, 1828/30, collection 6, page 834 ff.

the citizen pays the employee directly. For instance, sportler to customs officials could be in the form of food during the trip for pilots that guided ships in the archipelago, or remuneration for carriers that carried ships' goods to the warehouse.⁵ Of course, other types of payments were not of this nature, such as tolls on goods, of which some parts went to customs officials (especially managers) and some parts went to the crown.

I hence argue that systems of informal payments can arise because of two different but interrelated reasons. One reason is because citizens demand services, and engage in private contracts with service providers, as in the case of health care provision. But systems are also attractive for rulers, because they are decentralized and place minimal demands on the administrative capacity of the state, an argument that will be developed in the next section. By tolerating informal payments, the ruler can provide some public services as well as obtain some revenue, as in Besley and McLaren's capitulation wage regime. Before the 19th century, Swedish rulers to a large extent chose this strategy.⁶

An obvious and important difference between bribes or informal payments for public services and the Swedish sportler is that sportler not were illegal. However, it is clear that they not were seen as entirely legal, and not were as accepted as formal user fees. A lengthy debate in the Riksdag of the Estates in 1834/35 illuminates the arguments for and against abolishing sportler. A member of the House of Nobility, Count Hamilton were in favor of abolishing sportler entirely, and especially in the courts: "Long have I found it inappropriate and contrary to the dignity of Agencies and Courts, to sell justice by the sheet", referring to sportler paid for various documents relating to trials.⁷ He

⁵ Swedish Collection of Laws, 1829, N:o 4.

⁶ During the early 17th century, the government also briefly experimented with outright tax farming, another decentralized system of revenue-generation, but the system met with hard opposition from the peasantry and was soon abolished (Hallenberg 2008).

⁷ Ibid.

proceeds to call sportler “repulsive” both for bureaucrats and for citizens. Many members of the Riksdag of the Estates agreed with Hamilton, for instance Count Cronhjelm: “The sportel-system, which hitherto has been practiced, is a system of extortion, that ill stand together with a civil servant’s situation in general and is as condemnable for those, who takes, as for those, who gives.”⁸ It is also clear from the debates of the time that the system was easy to abuse. In the Estate of the Clergy, the member and priest Mittag in 1834 related a story about a poor priest who was forced to sell a cow to pay the sportler for a document he had not requested.⁹

So why were sportler accepted? The main reason was because of the low demands it placed on the state. Mr Halling, a member of the Estate of Burghers and the Temporary Tax Committee, estimated that sportler all over the country amounted to about one million *Riksdaler*, a huge sum, and that they generally were undesirable, but that they could not be abolished at the time. The reason, according to Halling, was lacking administrative capacity, both in tax collection and resource allocation: “When one knows, with which difficulty it is associated, to properly distribute tax income, and how little, it is possible, to please everyone, is it not worth, to ponder the possibility, to find an easier way to collect a tax, that is indirect, and among which the issue at hand [sportler] also may be counted.”¹⁰

Sportler was thus seen as an indirect tax, which automatically was allocated to where there were needs – a convenient way of financing public activities for the state. Westerhult (1963:134) argues that an influential view of bureaucrats at the time was that they were entrepreneurs, who had a contract with the state to perform some duties, but their method of doing so was their concern. They could for instance hire assistants and deputies, but had to pay them out of the sportler in-

8 Protocol of the Estate of the Nobility, 1834/35, collection 7, p. 148 ff.

9 Protocol of the Estate of the Clergy, 1834/35, collection 6, p. 57 ff.

10 Protocol of the Estate of Burghers, 1834/35, collection 3, p. 107 ff.

come. Chester (1981:62) describes a similar situation in Britain during the time of “Old corruption”. Government officials were remunerated by fees collected for services, and “As the demands on a Court or an Office grew, so did the income derived from fees, so providing some or all of the money out of which to pay for more clerks and assistance.”

One reason for tolerating sportler was thus related to the difficulty of collecting revenue and allocating it properly. Another reason was that if the state were to abolish sportler and replace it with fixed salaries for bureaucrats, the bureaucrats would have less incentives to work, which would require more monitoring. When the government proposed to abolish sportler in the central government offices to the Riksdag of the Estates 1834/35, much of the scepticism was due to lack of trust in bureaucrats. Conceding that it in principle would be preferred if income in the form of the “generally inappropriate” sportler were to be exchanged for fixed salaries, the Riksdag’s State Committee feared that fees would exceed former sportler, and also that the state would be unable to monitor if the employees reported all collected fees. In sum, this could thus result in higher expenses for the state, as employees could receive a salary and still pocket the income.¹¹

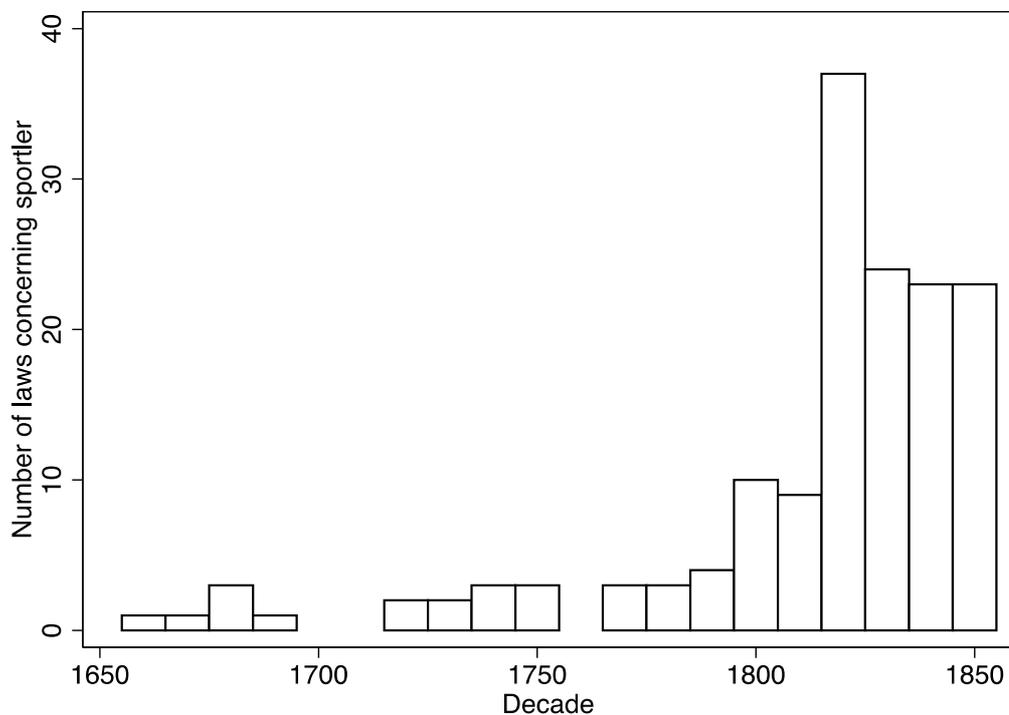
In his study of the English “Old Corruption”, Mircea Popa (2011:20) comes to the same conclusion: “A system in which the governance good is produced by unregulated monopolists is socially inefficient, but has the advantage of being largely self-enforcing. Taxpayers lose because monopolist government officials capture more rents for themselves, but do not have to pay the monitoring costs of a modern administrative system.”

¹¹ Statement from the State Committee N:o 80, appendage to the protocol of the Riksdag of the Estates 1834/35.

Formalization and regulation

The sportler system had evolved largely without legislation on the matter. The first mention of sportler in a registry of laws dates to 1661, in which a specification of the rates for “verdicts, letters and instrument, which by the courts in the country and in the cities are delivered” (Quiding 1865:86). The next law about sportler was passed in 1686 and specified the rates for customs servants. In 1720 rates for the Royal office were specified. A few laws were subsequently passed most decades until the beginning of the 19th century, when legislative activity increased dramatically, as can be seen in Figure 1. The bars represent the number of laws passed each decade, and in the decades where there are no bars, no laws were passed, according to an inventory of laws compiled by Quiding (1865).

FIGURE 1. LAWS CONCERNING SPORTLER PASSED EACH DECADE, 1660-1850.



Data source: Quiding (1865).

From the 1820's and onwards, legislative activity increased, and over 20 laws or directives were passed each decade. Some of them were merely clarifications of previously enacted laws, but still signal an increased interest in the question. However, my reading of the laws passed during this period is that most of the legislative activity not were aimed at prohibiting sportler. Rather, it was part of an effort to formalize and regulate it. One example can be taken from the customs. In 1829, new rates for sportler to customs servants was set by the king. In it were specified the amount to pay for various services performed by civil servants, from the writing of permits, to weighing of metals, to the carrying of goods from the ship to the customs house by the carriers.¹² In its appeal to the king for instituting the new rates, the Customs Board did not argue that the system was ideal, on the contrary, they noted that “under several circumstances it could be argued, that the abolition of income of this type were both for the public good and for civil servants desirable”.¹³ The argument was instead that sportler existed anyway, and it would be better to regulate it than to let it proceed unchecked. However, the Customs Board did not argue in favor of setting fixed salaries for the customs. Instituting fixed salaries would incur a large cost on the state, and would also make the state responsible for support during retirement. It was also argued that servants who received a fixed salary would put in considerably less effort.

Formalization however implies acceptance. The previously mentioned customs rates were opposed by the Estate of Burghers. They acknowledged that sportler existed, but also argued that it was mostly voluntary to pay, and that institutionalizing it with a new rate only would reinforce the practice, which would make it more burdensome for traders. The representative who brought up the

¹² Swedish Collection of Laws, 1829, N:o 4.

¹³ Protocol of the Estate of Burghers, 1828/30, collection 6, page 834 ff.

issue still thought that sportler was appropriate for services where extra effort was required on behalf of the official, such as the weighing of metals, and the provision of written documents.¹⁴

While formalization risks increasing prevalence of payments, it allows for regulation to prevent abuse. In the case of the new customs rates, the rates gave bureaucrats the right to demand sportler for provided services, but also imposed obligations on the bureaucrats. The law stipulates that the document containing the rates should be attached to the wall of each customs chamber, guardpost, weighing station and warehouse, so that everybody would know the rates. Furthermore, since the rates concerning written documents were specified in terms of the number of pages, the law also stated that each page must not contain less than 24 rows, with margins no more than three fingers wide, and with a style of hand that not should be unusually wide. A civil servant caught in breach of this regulation should pay a fine, of which one third went to the Crown and two thirds to the person who notified the authorities.¹⁵ Users of the service were thus rewarded for keeping civil servants in check.

Furthermore, since the law made it explicitly legal to demand sportler, the government could also demand more information about the amount of sportler raised. Customs offices were in the law required to send detailed reports about the number of vessels dealt with and the amount of cargo, as well as the sportler sums and how sportler were divided among custom servants. Formalization of the informal payments thus allowed for an increase in monitoring capacity. Later on, when fixed salaries were introduced for the majority of Swedish bureaucrats, many received compensation for lost sportler, based on the amounts previously collected by the individual bureaucrat.

¹⁴ Protocol of the Estate of Burghers, 1828/30, collection 6, page 834 ff.

¹⁵ Swedish Collection of Laws, 1829, N:o 4.

Transformation into user fees

The first step was thus to regulate and standardize sportler. This was gradually followed by the substitution of sportler for user fees in the form of taxes on stamped paper, so called *Charta Sigillata*, first in a reform of the salary system in the central government offices in 1834/35. Some important documents were before the reform required to be written on this stamped paper, which were associated with a fee paid to the crown, but guaranteed the documents authenticity. By substituting sportler for *Charta Sigillata* fees of the same amount, no extra burden would be placed on citizens, but the Crown would receive more income, which then could be used to pay fixed salaries to the civil servants.¹⁶

A short explanation of the concept of stamp taxes (also called stamp duty), as the *Charta Sigillata* are an example of, is here called for. Basically, stamp taxes are a fee levied on written documents, usually permits, deeds, bonds, and contracts of various kinds. The concept was invented in Holland in 1624 to raise revenue, and was adopted in England in 1694 and in the United States in acts of Congress in 1797 and 1813 (Powell 1935). Documents are either required to be written on specifically printed paper, or have stamps attached to them, to be considered valid. The main advantage of a stamp tax is that it is relatively easy to collect, since citizens have an interest in paying the tax, since they want their documents to be valid. In a report by the Commissioner of Internal Revenue in the USA in 1863, the commissioner claimed that the stamp tax was “among the most satisfactory branches of our excise law” (Cited in Powell 1935:228). It should however be noted that the British attempt to impose a stamp tax on the American colonies in 1765 was one of the factors that sparked the American revolution (Morgan and Morgan 1953), so the fact that they are convenient for the government does not guarantee their popularity.

¹⁶ Royal Proposition 1, appendage to the protocol of the Riksdag of the Estates 1834, collection 1:1, p. 4-5.

For citizens, the reform did most likely not lead to a reduction in amounts paid for services. The main change was in the way bureaucrats were salaried. Sportler may seem similar to user fees, but a crucial difference is that sportler are retained directly by the bureaucrat while user fees are administered by the institution, which causes collective action problems to arise. Bureaucrats can under such a scheme attempt to renege on work or withhold collected user fees. The main objection to the Swedish reform was thus that bureaucrats would work less diligently if their salary did not depend on their effort.¹⁷ In approving the reform, the Riksdag of the Estates stipulated that monitoring in the central government offices would have to increase. The Riksdag thus reasoned along the lines of the theory of Besley and McLaren: if the state is to invest in higher salaries, it also needs to invest in better monitoring.

Following the abolition of sportler among the central government offices, it was also abolished among customs servants in 1842¹⁸ and among many other branches of government in a big reform 1855-1860, in which fixed salaries were introduced for a majority of government employees. A member of the House of Nobility, Mr Palmcrantz, in 1860 proposed to abolish sportler wherever it remained and substitute it with fixed salaries financed through the sale of stamped paper,¹⁹ but the economy committee rejected the motion on the grounds that the only officials that by then were dependent on sportler as their primary income were judges in the country courts, the *Häradshövdingar*. Sportler reform would according to the committee have to be accompanied by wage reform, and as major reform just had been undertaken in which the country court judges had been exempted, it was not appropriate to attempt another such reform.²⁰ Sportler remained, but for offi-

17 Statement from the State Committee N:o 80, appendage to the protocol of the Riksdag of the Estates 1834/35.

18 Swedish Collection of Laws, 1842, N:o 42.

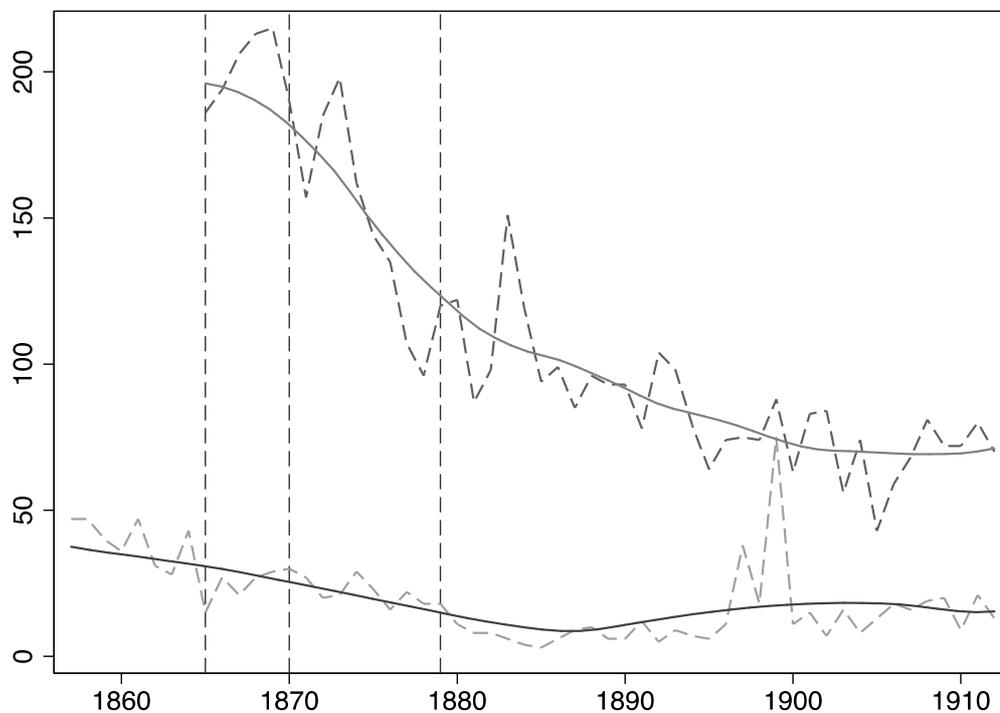
19 Protocol of the Estate of the Nobility, 1859/60, collection 10, p. 158.

20 Appendage to the protocol of the Riksdag, 1859/60, collection 4, part 1, N:o 53. Administration in cities and the country were clearly separated, and the country courts operated under different rules than the courts in the cities.

cials other than the country court judges it was after the reform only a minor supplement to the fixed salary.

As mentioned earlier, *Riksdag* representatives stressed the importance of pairing the wage increases in the central government offices 1835 with increased monitoring of the government officials. It is also telling that the encompassing wage reform in 1858-1860 was followed by a new criminal code that for the first time regulated misconduct in public office (Rothstein 2011). In Figure 2, I have compiled data on misconduct in public office from the official crime statistics between 1857 and 1912, dividing crimes into serious (bribery, etc) and minor (misconduct) offences. Both curves slope downward from the 1860's, indicating that discovered corrupt practices decreased during the latter half of the 19th century. The wage reforms were hence followed by increased professionalization of the bureaucracy, an observation that is consistent with earlier research on the timing of modernization of the Swedish state (Rothstein 1998).

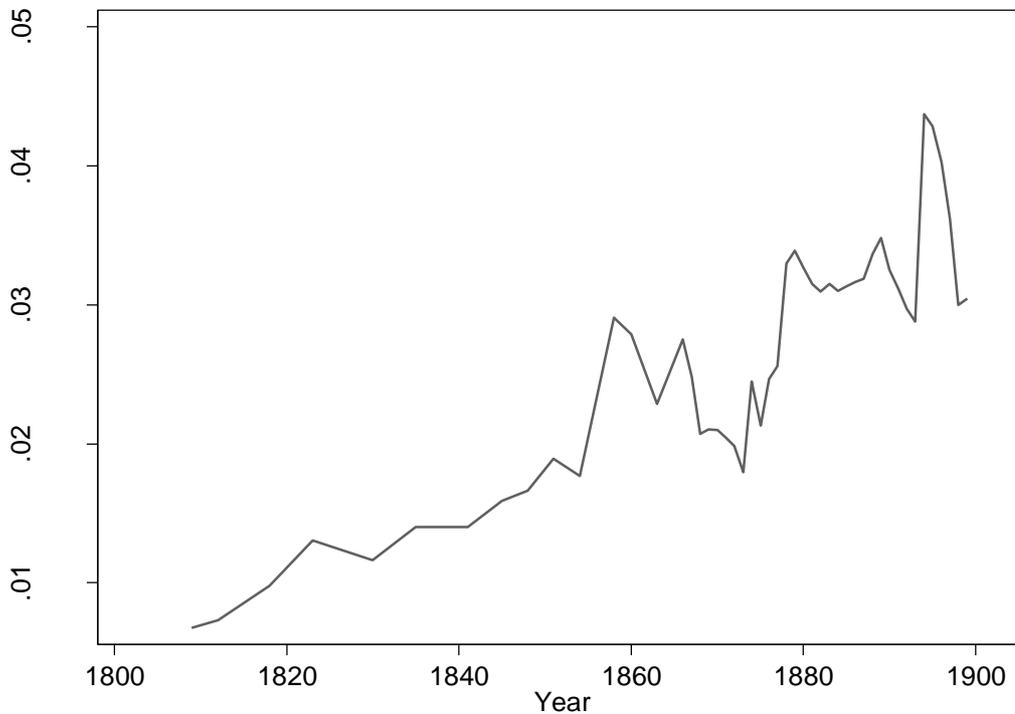
FIGURE 2. FREQUENCY OF MINOR (UPPER LINE) AND SERIOUS (LOWER LINE) CRIMES IN THE SWEDISH PUBLIC ADMINISTRATION, 1857-1912, WITH LOCAL POLYNOMIAL SMOOTHED LINES.



Data source: *Bidrag till Sveriges officiella statistik B: Rättsväsendet*, editions 1857-1912. Vertical lines represent changes in the reporting of the statistics.

By increasing the use of stamped paper in offices were sportler was reduced, critics in the Riksdag were assured that the higher wages would not burden their constituents (if they were not users of the services, that is) and also had the benefit of allocating resources to where they were needed. The importance of stamp taxes as a source of income increased during the entire 19th century, as can be seen in Figure 3, where I have plotted the ratio between stamp taxes and government consumption (for reference) between 1809 and 1899. The upward-sloping line demonstrates that while stamp taxes never were a major source of income for the Swedish government, it became more and more important during the entire 19th century.

FIGURE 3. STAMP TAX INCOME IN RELATION TO GOVERNMENT CONSUMPTION, 1809-1899.



Exchanging sportler for user fees in the form of stamp taxes requires more monitoring effort on behalf of the state. But the state may also profit in the long run, as surplus revenue is redirected from bureaucrats to the government. An argument put forth by several members of the Estate of the Nobility in the debate about sportler in the central government offices in 1834 was that while net revenue may be unchanged in the short run, sale of stamped paper was likely to increase in the future, something the baron Ehrenborg claimed that other European countries had profited from.²¹

Furthermore, poorly designed incentive schemes can be costly if conditions change. In England some fees to government bureaucrats were calculated as a percentage of money involved in transac-

²¹ Protocol of the Estate of the Nobility, 1834/35, collection 7, p. 209, and 11, p 283.

tions the bureaucrat handled, so called *poundage*. The system worked when handling larger sums of money was more laborious (due to the weight!), but when paper money became more common, the connection between poundage and involved effort for the official disappeared. During the American War, government activity increased tremendously, which led to massive incomes for the government officials whose income were based on poundage. Chester (1981:63) writes that £62,000 was paid in poundage in 1780, which highlighted the flaws of the system and led to calls for reform. The system was thus reformed when it started to deprive the government of major sums of money, a reason for reform highlighted also by other scholars (Popa 2011:19).

Discussion

The Swedish example thus demonstrates that an integral part of moving from a decentralized system where services are funded by direct payments to bureaucrats to a centralized tax-financed system are the intermediate steps of formalization and user fees. Formalization requires little in the form of benevolence from the ruler, but may also bring about improvements for economic efficiency and for citizens. It is clear from the quotes from Swedish politicians that an important reason for not abolishing sportler was that it actually worked. The system raised revenue by itself, and allocated the revenue to bureaucrats in positions where there were demand for services. With increased formalization, the benefits of the decentralized system remained, while problems of independent price-setting which could lower overall demand and secrecy were alleviated.

Collective action problems are present to varying degrees in the three stages of direct payments, user fees and tax financing. When service to a large degree is financed through direct payments, collective action problems are for the most part avoided. Citizens pay for the services they receive directly, and bureaucrats work for direct payment. With user fees, it is necessary that bureaucrats report fees to the institution, and that the institution uses the fees to finance the wages of the local

bureaucrats. If not, citizens and bureaucrats may revert to direct payments in the manner described by Besley and MacLaren, as they both profit from withholding revenues from the institution. Modern user fee-experiences corroborate this, showing that fee schemes fail when fees are passed on beyond the local service institution (Gilson 1997). Tax-funded systems entail the most collective action problems, as the link between payment (taxes) and service delivery is very long, and requires that citizens believe that others will pay taxes, and that bureaucrats trust the state (and their local service institution) to reward them for their work effort. I argue that if a too difficult funding scheme is attempted without the necessary monitoring capacity as well as the capacity to raise and allocate revenue, it is likely that informal, direct payments will be the result. If state capacity is lacking, it is thus better to attempt the first intermediate step – formalizing informal payments.

One major problem of formalizing informal payments for services that officially are free is however that set rates tend to work regressively, and place a heavy burden on the poorest. This problem was acknowledged by a Swedish member of the House of Nobility, Mr EhrenCrona, in 1720 when a new expedition tax was introduced. After being informed that poor would be exempted from the tax, EhrenCrona questioned how the poor would be identified, and the House then decided that those claiming to be poor would have to apply for testing of the claim at a royal government office (*Cancellie-Collegium*).²² Allowing for discretion in deciding who is eligible for exemptions is probably a recipe for corruption, as examples both from Vietnam and Russia show that exemptions primarily are distributed to those with connections to the bureaucrats (Ensor 2004). It seems crucial that exemption schemes are based on easily observable indicators such as those reportedly used in the Cambodian hospital referred to earlier (Barber, Bonnet and Bekedam 2004). For instance, Swedish records from 1912 show that midwives were paid directly for each delivery, and that payment

²² Protocol of the Estate of the Nobility, 1720, p. 235.

often was linked to the socioeconomic status of the family. In one case, the fee was 1 Crown for crofters and other poor, 4 Crowns for home-owners and 5 Crowns for landlords and officials.²³

Conclusion

In economics and political science, the study of corruption has ballooned the last 20 years. However, much of the existing research is focused on political corruption, or on corruption in general. Similarly, political corruption is hard to address, as it benefits those in power. Bureaucratic petty corruption remains understudied, which is unfortunate, as it is the kind of corruption that most directly affects ordinary people. The issue of informal payments has however received much attention in health policy research. I argue that the two fields have much in common and could benefit from greater exchange. When the capacity or political will to implement and enforce major reform of the type enacted in Singapore is absent, one way forward may be to formalize informal payments. A Bulgarian study showed that a majority of respondents were in favor of formalizing the informal payments (Delcheva, Balabanova and McKee 1997), and tentative evidence show that if done right, it may actually improve utilization (Barber, Bonnet and Mekedam 2004). Furthermore, in line with the recent push to understand the processes in which industrialized countries managed to reduce corruption historically, I argue that gradual formalization of informal payments and then substitution for user fees were crucial intermediate steps in the move towards Swedens now well-known and tax-financed welfare state.

²³ Contribution to the official statistics of Sweden, X) Salaries and pensions, I:9. 1912, p. 53.

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