

# Corruption in Latvia: Survey Evidence

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## 1. OVERVIEW

In 1996, the President of the World Bank offered to support member countries in the battle against corruption. Latvia was among the first to accept Mr. Wolfensohn's offer, and the first Government-sponsored (World Bank-supported) Workshop in February 1997 adopted a three-pronged strategy of prevention, enforcement, and education. The anti-corruption program continued to gather momentum even through changes in government, and the program was unveiled at a public Conference in June 1998.

A key element of the World Bank's approach to corruption is to help countries to unbundle "corruption", a vague and menacing-sounding term for abuse of public office, into its constituent parts; to isolate the underlying causes, illuminate the agencies and organizations most affected, and to evaluate corruption in the context of the reform of political, legal, and public-sector institutions. Toward these ends, a system of diagnostic surveys focusing on corruption in the public sector was developed<sup>1</sup> and implemented in the summer of 1998. Three surveys, targeted at households, enterprises, and public officials, sought to add specificity to the policy dialogue, to provide the hard numbers to confirm or refute popular conceptions about corruption in Latvia, and to provide a baseline against which to measure future progress in the battle against corruption.

This report presents the main findings of Latvia's diagnostic corruption surveys. The purpose of the report is not to pass judgment on Latvia but to highlight the complexity of the corruption problem, its causes and consequences, as evidenced in responses to the surveys. Our hope is that the report be taken in the proactive way in which it was intended – looking to the future and what needs to be done, rather than dwelling on the past and what can not be undone.

The information provided by the surveys *contribute* to our understanding of corruption in Latvia, but the survey evidence in isolation is not definitive – it should be considered in conjunction with other views provided by analysis of the incentives and opportunities generated by the governance framework, by qualitative assessments and the opinions offered by civil society in public conferences, and by the practical views of implementing organizations. As this report is based on survey evidence, it focuses primarily on lower level corruption in the public sector. High-level corruption, including political corruption, are more difficult to detect in surveys (as discussed in Section 2), but are every bit as important as low-level corruption. It is for practical purposes only that we

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<sup>1</sup> The Latvia surveys were modeled on surveys implemented in Albania and Georgia. Although the surveys varied to some degree to account for country-specific differences, an attempt was made to keep the surveys consistent enough to allow cross-country comparisons.

orient this report toward the lower-level corruption faced by households, enterprises, and public officials, rather than grand corruption.

The survey evidence suggests that corruption in public service delivery is a serious concern.<sup>2</sup> The trend appears to be getting worse, and more importantly, certain aspects of public sector service delivery suggest an environment that is fostering an expansion of corrupt practices. While private sector enterprises do not complain too loudly about corruption as a problem of doing business (relative to other problems), they do complain about the regulatory<sup>3</sup> environment, particularly the excessive discretionary powers of regulators – current research on corruption suggests that excessive discretion is an important cause of corruption. The surveys also present clear evidence of certain “vicious circles” that point to increasing entrenchment of corruption, expansion of the unofficial economy, and deterioration in the quality of government services. Particularly worrying is the practice of public officials buying jobs, a corrupt activity in itself that serves to further entrench corruption within state institutions.

The surveys demonstrate clearly the powerful incentives for enterprises and households to cooperate in corrupt transactions. Households find that everyday necessities such as housing and health are not ensured unless some unofficial payments are provided, and there is considerable evidence that enterprises that engage in corruption grow faster and invest more than those that refrain.<sup>4</sup> Honest enterprises have difficulty competing against their less-honest competitors, and honest managers must spend more of their time dealing with government officials. These empirical observations should in no way be interpreted to mean that corruption serves a useful purpose as “grease,” since the benefits to the enterprises or households do not accrue to society. The point, rather, is to illustrate the forces that perpetuate systemic corruption. Indeed, cross-country evidence suggests very strongly that in countries with more severe corruption problems, enterprise managers tend to spend *more* time dealing with bureaucracy, not less.

Surveys are very useful for pinpointing corruption “hot spots,” agencies and organizations in which corruption is particularly severe. To some degree corruption is pervasive across organizations, but the surveys suggest that it is particularly bad in the customs service and the road police, both of which have a large impact on enterprises and households.<sup>5</sup> Households further expend considerable resources in bribes related to health and housing, while enterprises spend large amounts on telephone line installation, fire and sanitary inspections, and lease of state-owned office space.

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<sup>2</sup> Corruption in Latvia appears to be less of a concern than in countries further East for which comparable information is available.

<sup>3</sup> We use terms such as “regulations” and “regulatory environment” somewhat loosely to refer to required interactions between the state and enterprises.

<sup>4</sup> Although the relationship is clear, the direction of causality is not. This issue will be discussed in a later section.

<sup>5</sup> While customs and the road police appear to have severe problems of corruption, the tax administration and the ordinary police come across in the surveys as relatively less corrupt (though far from “clean”).

A repeated theme emerges from the survey data: excessive discretion on the part of regulators is both a cause of current corruption and a formidable obstacle to development in itself. Latvia's anti-corruption program wisely views anti-corruption as not just toughening standards for public servants, but dampening the underlying economic forces inspiring corruption, as well. The survey evidence demonstrates the importance of regulatory reform as an integral part of a successful long-term solution to the problem of corruption.

## **2. METHODOLOGY**

The diagnostic corruption surveys were carried out by the World Bank and Latvia Facts in June and July of 1998. Altogether, we surveyed 1,100 households, 438 enterprises, and 218 public officials. Each of these populations provide a different perspective on the extent of corruption, its causes, and consequences.

Households are particularly knowledgeable about the widespread low-level corruption that affects them in their everyday lives, and the opinions expressed by a representative sample of households provide an indication of how society perceives the problem of corruption, its causes and consequences.

Enterprise managers are much more likely to interact with government regulatory bodies, tax and customs authorities, and the courts. They generally have deeper pockets than households, and are therefore potentially rewarding targets for corrupt public officials. At the same time, they are more likely to be informed about the modalities of corruption, when it is in the enterprise's best interest, when it is not, and how to avoid it when it can be avoided. Enterprises provide a view of how corruption affects the business environment, competition, investment and growth.

Public officials provide the insider's view on the causes of corruption and the organizations which have the worst reputation among civil servants. Public officials can also provide insight into a specific form of corruption that only they know about firsthand – corruption within the civil service itself and the manner in which the demand side of corruption is organized.

Individually, each of the surveys – households, enterprises, and public officials – provides information on corruption from different perspectives. The three surveys together present an even more powerful tool for understanding the overall dimensions of the problem and the specific micro-structure of corruption.

Ultimately, surveys can reflect only the information that respondents are willing to provide. For most types of surveys (e.g., public opinion research) respondents are

happy to give their honest views, and simple factual questions (e.g., education) are usually answered honestly. But the subject matter of corruption is particularly sensitive. Even with reassurances of confidentiality, households, enterprises and public officials may be reluctant to provide honest answers to certain direct questions about corruption. We addressed this difficulty in several ways: (1) For most of our questions, we used phrasing that lets the respondent show knowledge about corruption without admitting involvement in corrupt practices. For example, in the evaluation of corruption among various government agencies, we asked enterprises to give ratings based on their “perceptions” of corruption. We also asked questions aimed at gauging how frequently the enterprise interacts with each organization, allowing us to infer the accuracy of those perceptions. (2) For some questions, we used phrasing that casts the guilt for the corrupt activity squarely on the other party. For example, households were asked about times when they have been forced to make unofficial payments, while public officials were asked about situations when corrupt enterprises offer bribes.

The results in this report demonstrate that many respondents were not shy about discussing corruption. For obvious reasons, however, surveys are relatively better at uncovering evidence of small-scale corruption than of high-level corruption. This difficulty is unavoidable. But since the underlying societal factors that would cause small-scale corruption to grow could be linked to those that influence high-level corruption,<sup>6</sup> learning about the former can throw some light on the latter. It remains important to compliment the surveys with analysis of the political process and policy-making framework.

Surveys are very well suited for analyzing quantifiable interactions. This report attempts to quantify levels of corruption based on information that can be measured, such as flows of bribes. For this reason, much of the report focuses on the direct cost of bribery, rather than the less easily quantifiable dead weight loss to society from corruption. By no means does this imply that the direct cost of bribery is the only issue. Every bit as important are the other damages that society suffers: the productive activity that did not take place, the environmental or health costs when standards are evaded, and the losses stemming from reduced competition and mis-allocated resources, to name a few.

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<sup>6</sup> Paulo Mauro summarizes: “Country-specific studies and anecdotal evidence suggest that high-level and low-level corruption tend to coexist and reinforce each other.” “Corruption: Causes, Consequences, and Agenda for Further Research,” Finance and Development, March 1998, p. 13.

### **3. HOW BAD IS CORRUPTION IN LATVIA?**

There are two challenges to answering such a broad, if frequently asked, question. First, corruption exists in varying degrees around the world – the answer to the question depends upon the benchmarks against which Latvia is evaluated. Second, “corruption” is an intentionally broad term that includes such diverse acts as theft of state assets, bid-rigging, petty bribery, and political payoffs – the answer to the question may depend on which element of corruption is being examined.

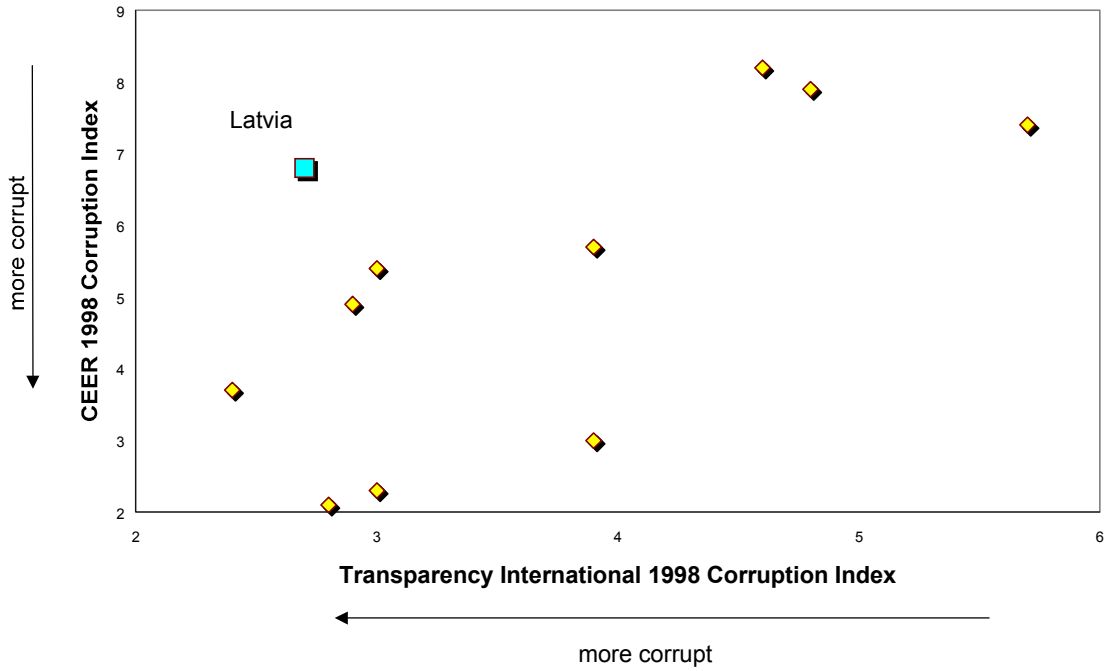
One benchmark we may consider is the overall level of corruption in Latvia relative to other countries. Several organizations generate cross-country indices of corruption based on surveys of foreign investors or corruption experts. Unfortunately, such indices are not consistent with each other, so the answer to our opening question is sensitive to the index selected. Two recent indices are the Transparency International corruption perceptions index, and the Central and East European Review (Wall Street Journal) corruption index. Among a group of eleven transition countries<sup>7</sup> rated by both organizations, Latvia appears relatively corrupt by the TI index, and relatively uncorrupted by the CEER index. (See Figure 1.) The Latvia surveys upon which this report is based were also used in Albania and Georgia, so the surveys themselves allow a cross-country comparison among these three countries. Among these three, the surveys indicate a smaller overall level of corruption in Latvia than in the other two – in Latvia corruption is less frequent and appears to be less of a hindrance to business development – but given the widely recognized systemic corruption in those other two countries, Latvia may find little solace in this fact.

A second benchmark for evaluating the overall level of corruption is the trend – is the problem getting better, worse, or staying about the same? For this sort of question, the surveys are well-suited. (See Figures 2 and 3). When asked whether corruption has gotten better, worse or remained the same over the past four years, nearly 60 percent of households and enterprises responded that it has gotten worse, and half of those said it has become “much worse”. Only 10 percent of respondents declared that corruption has gotten better. The same response pattern applies to both “high-level corruption” and to “kukuldosana,” or low-level palm-greasing.

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<sup>7</sup> The other ten countries depicted in Figure 1 are Russia, Ukraine, Bulgaria, Romania, Yugoslavia, Belarus, Slovak Republic, Poland, Czech Republic, and Estonia.

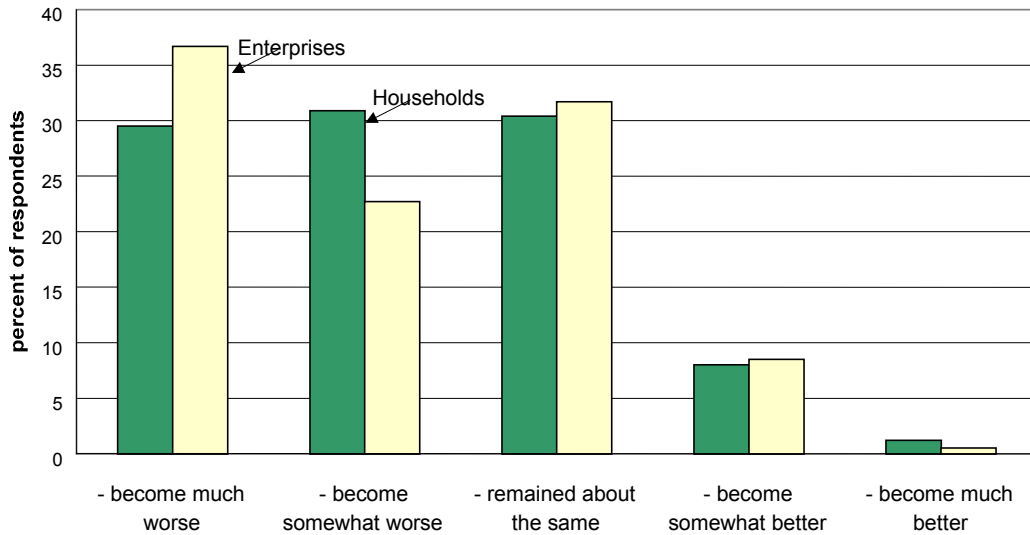
Figure 1. Cross-Country Corruption Indices



There are other reasons to believe that corruption threatens to become worse. Enterprises report that complex regulations and excessive discretion by bureaucrats are major obstacles to doing business. This is worrisome because those same factors are listed by enterprises as major causes of corruption, and because current international research suggests that excessive discretion in the regulatory environment is a cause of corruption. Thus, while enterprises do not rank corruption as a leading obstacle to doing business in Latvia, they do suggest that there is excessive discretion, a factor known to be a *cause* of corruption.

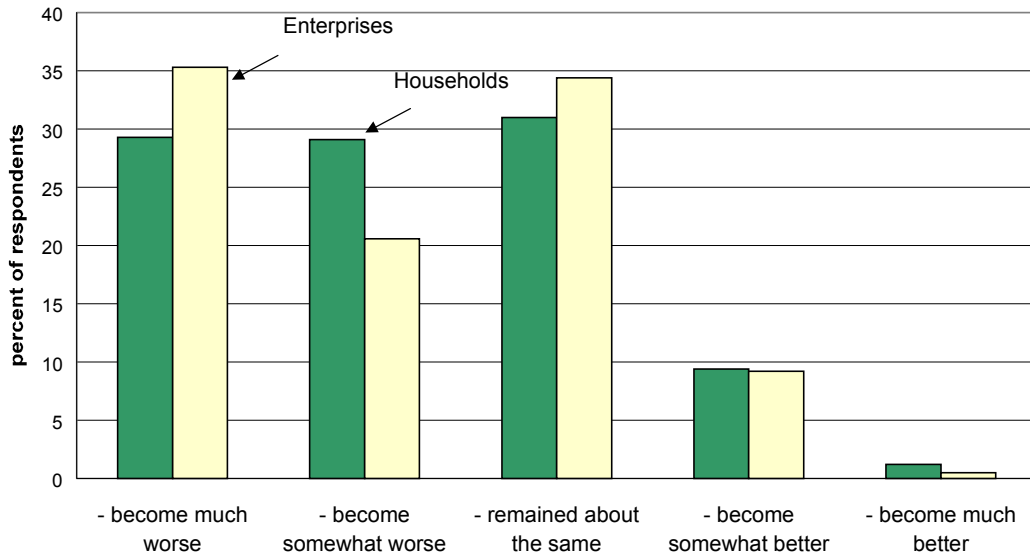


**Figure 2.**  
**"Has the problem of 'high-level corruption' over the past four years . . ."**



based on a World Bank - Latvia Facts survey of 1,075 households and 428 enterprises in June 1998.

**Figure 3.**  
**"Has the problem of 'low-level corruption' over the past four years . . ."**



based on a World Bank - Latvia Facts survey of 1,075 households and 428 enterprises in June 1998.

Notwithstanding comparisons to other countries, the survey data indicate a mixed picture of corruption in Latvia. When asked the main obstacles to doing business in Latvia, enterprises did not place corruption high on the list. However, 30 percent of enterprises expressed a willingness to pay additional taxes to wipe out corruption. These

responses indicate that corruption takes place on a substantial scale, though it may not be the worst obstacle to the conduct of business in Latvia.

There is further reason for worry. When asked their perceptions of how frequently specific types of corruption occur in Latvia, enterprises, households and public officials all related that corruption is very frequent. Thirty-seven percent of enterprises and 13 percent of households reported having made unofficial payments. On an organization-by-organization basis, enterprises and households that have had contact with government agencies report that unofficial payments are required a third to a half of the time from some agencies. The average enterprise spends 2.1 percent of monthly turnover on bribes and the average household spends 1.2 percent of monthly income on bribes. Time spent on negotiating bribes is also a significant cost.

#### **4. WHICH ORGANIZATIONS HAVE THE WORST CORRUPTION PROBLEMS?**

Among the strengths of data-oriented corruption diagnostics is the ability to assess the levels of corruption within particular organizations. As we discuss in the next section, corruption will be the most severe in organizations where the nature of the work facilitates corrupt behavior. Thus, the purpose of this section is to highlight the organizations facing the greatest challenges, not to pass judgment on the leadership of those organizations.

Throughout this report we will refer to a series of charts that illustrate various aspects of corruption and service delivery within specific organizations. There is, of course, a degree of measurement error associated with any individual survey question and for this reason no single chart should be taken as the best evaluation of the levels of corruption within organizations. It is best to view all of the evidence and isolate the consistencies and inconsistencies before reaching conclusions. In this section we will highlight these conclusions.

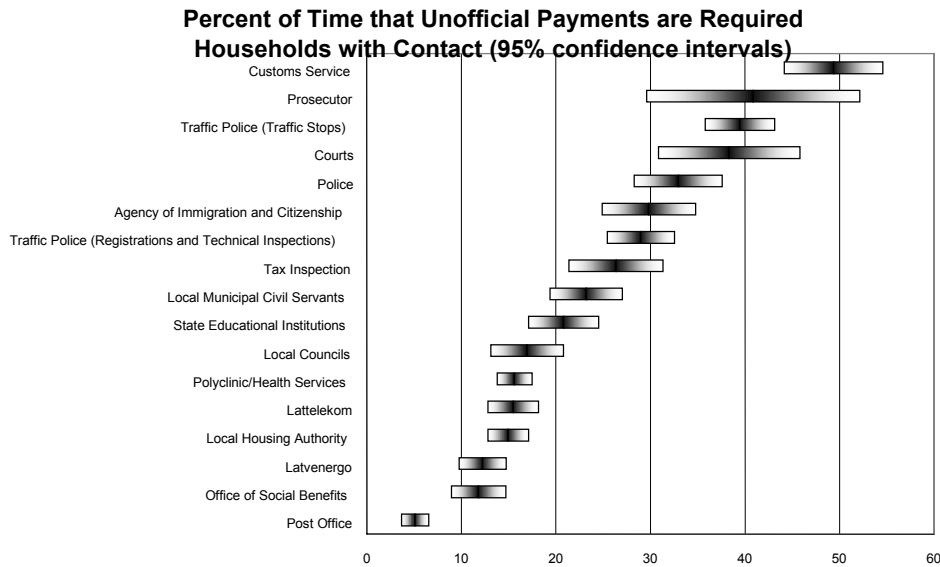
##### **BRIBE FREQUENCY**

Figures 4 and 5 show the perceptions of households and enterprises regarding how frequently bribes are required for specific agencies. (These charts are based only on the responses of households and enterprises with at least annual contact with the agency.) According to enterprises, the organizations that most frequently avail themselves of the opportunity to extract a bribe are the road police (33 percent of the time) and customs (21 percent). According to households, customs (48 percent), the road police (39 percent) and the court system (38 percent) most frequently extract bribes when given the opportunity.

(Households generally assessed the frequency of bribe-taking to be higher than enterprises.)

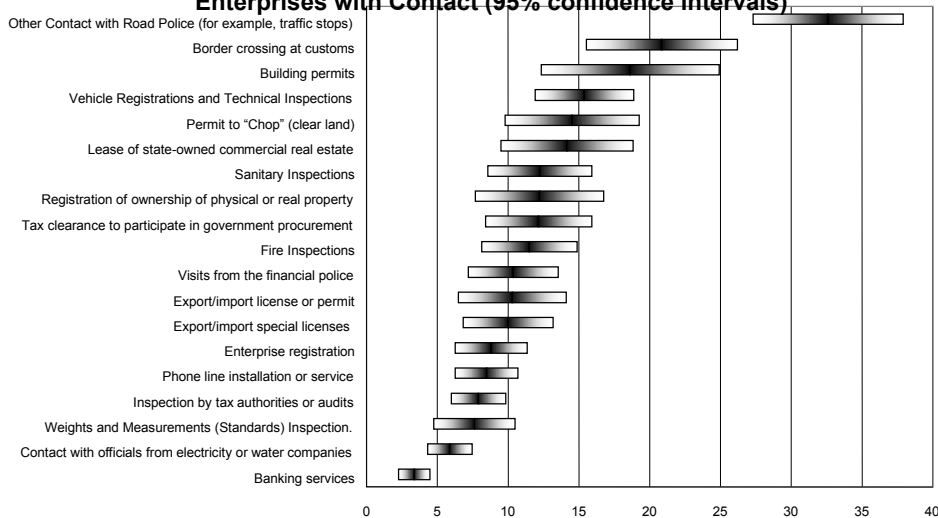
Figure 6 shows the perceptions of households, enterprises, and public officials on how frequent various types of corrupt practices are. Households, enterprises, and public officials all gave higher average frequency ratings to “avoiding trouble from the traffic police” than to any other type of corruption. The frequency ratings given by public officials are generally lower than those of enterprises and households, especially in the case of two forms of corruption: public officials hiring people in exchange for money, and public officials stealing or using state assets for their own use.

**Figure 4.**



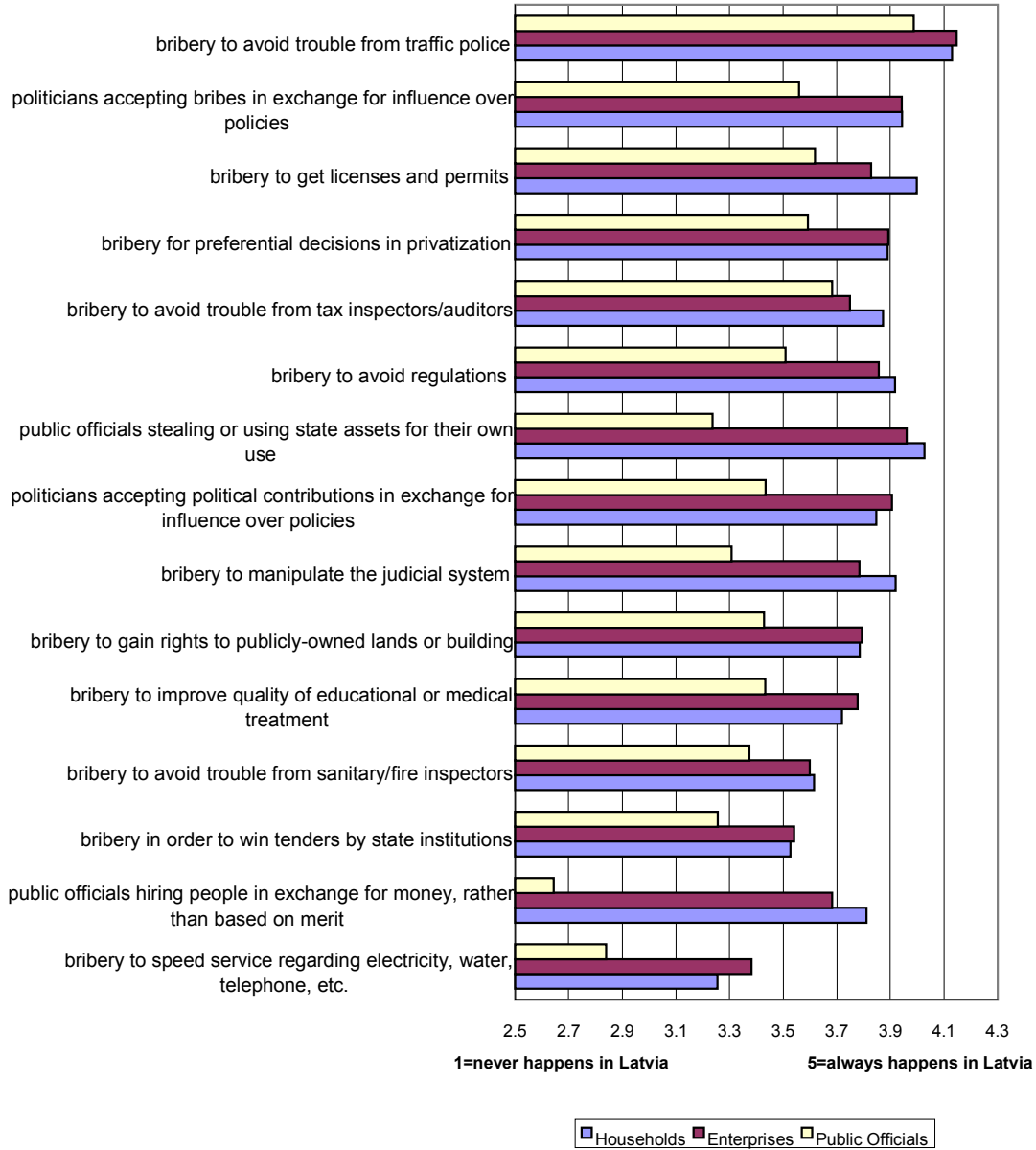
based on a World Bank - Latvia Facts survey of 1,100 households in June 1998

**Figure 5.**  
**Percent of Time that Unofficial Payments are Required  
Enterprises with Contact (95% confidence intervals)**



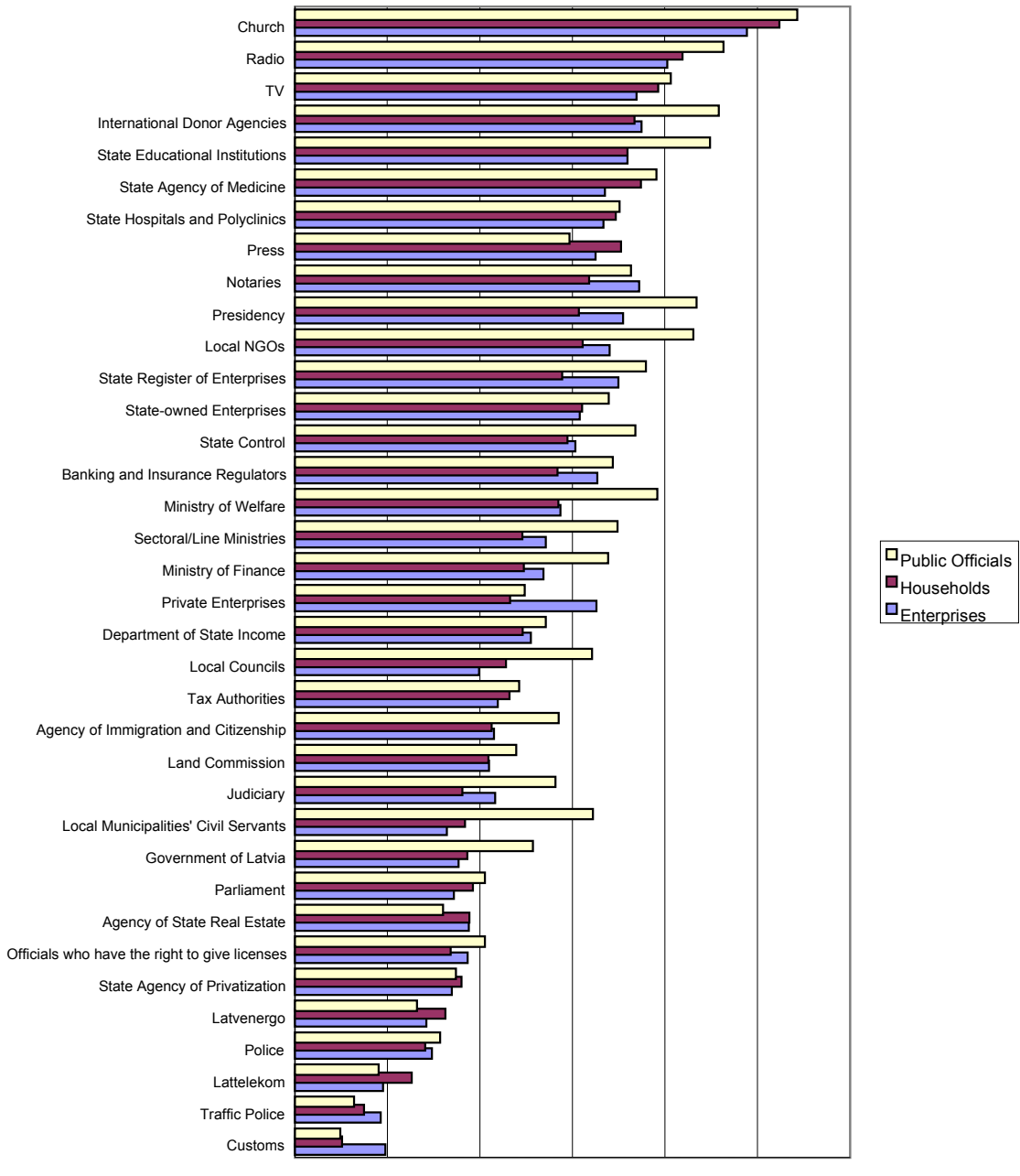
based on a World Bank - Latvia Facts survey of 438 enterprises in June 1998

**Figure 6. Overall opinions on frequency of corrupt practices**



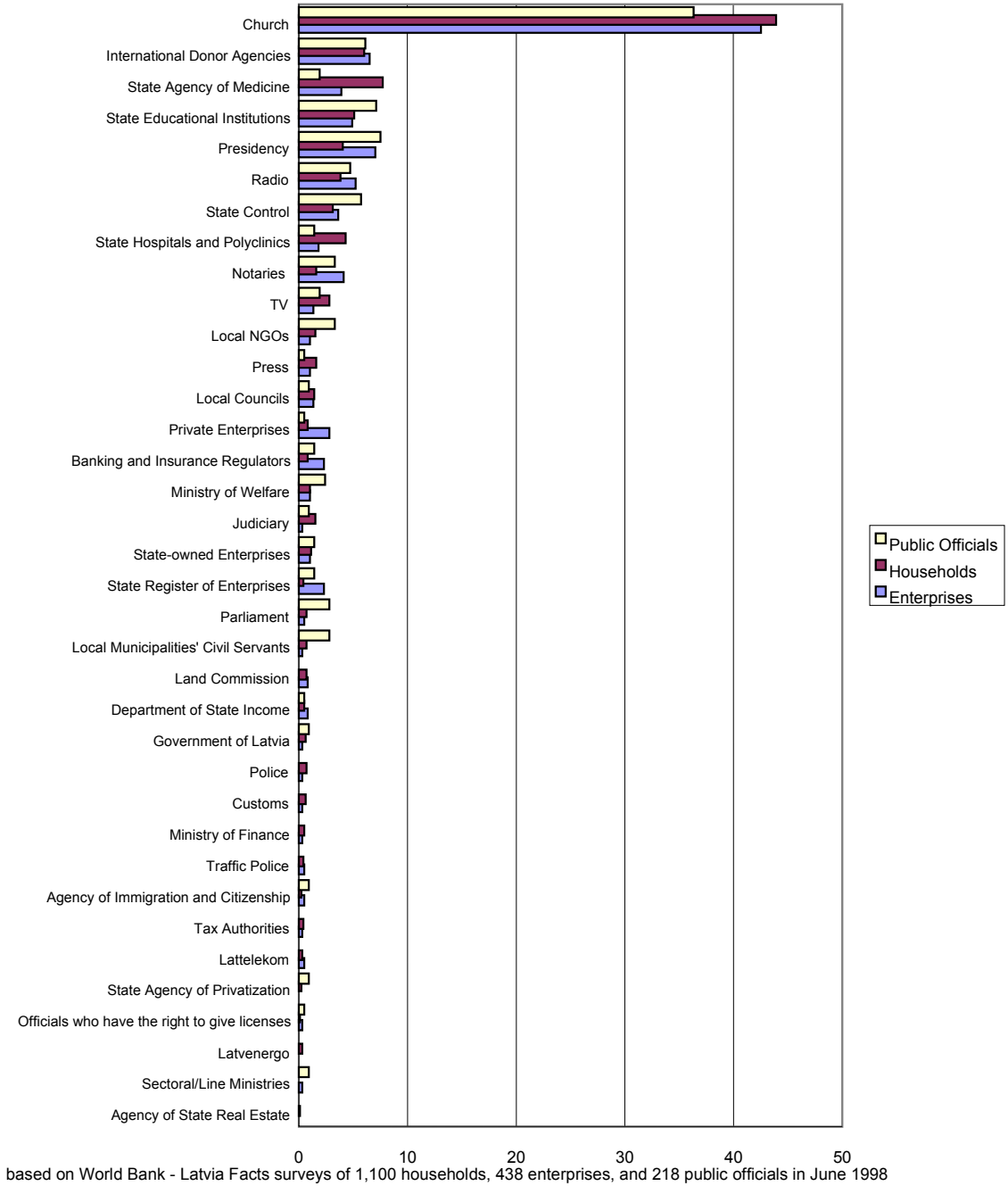
based on World Bank - Latvia Facts surveys of 1,100 households, 438 enterprises, and 218 public officials in June and July of 1998.

**Figure 7.  
Ratings for Honesty and Integrity**

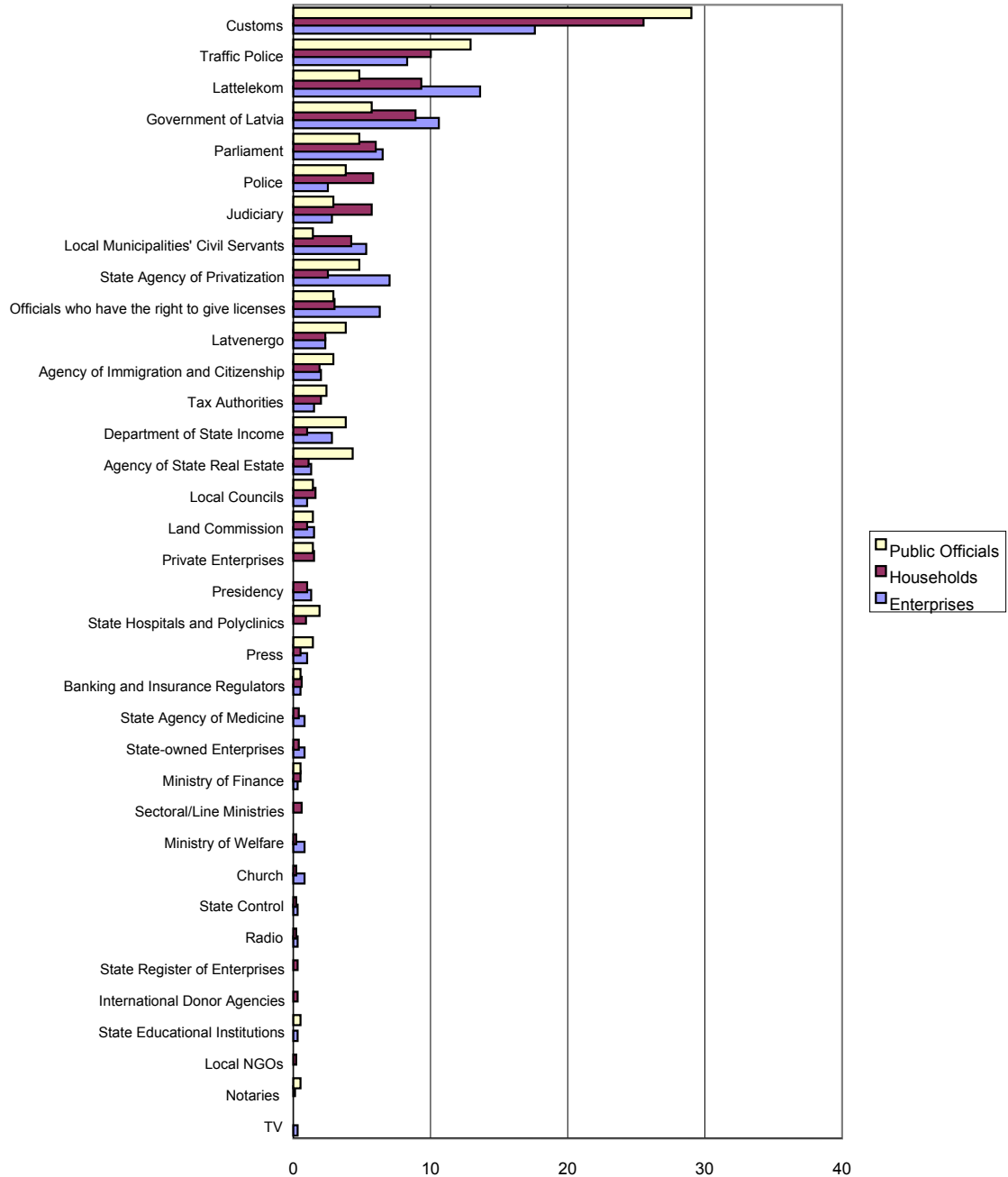


based on World Bank - Latvia Facts surveys of 1,100 households, 438 enterprises, and 218 public officials in June 1998

**Figure 8.  
Percentage Votes for "Most Honest"**



**Figure 9.**  
**Percentage Votes for "Most Corrupt"**



based on World Bank - Latvia Facts surveys of 1,100 households, 438 enterprises, and 218 public officials in June 1998

## HONESTY AND INTEGRITY

Figures 7 through 9 show how various organizations, governmental and non-governmental, are rated by survey respondents in terms of their honesty and integrity. Public officials, enterprises, and households seem to be in broad agreement about the three organizations with the least amount of honesty and integrity: traffic police, customs, and the telephone company.<sup>8</sup> While the government of Latvia did not score too badly in the overall ratings of honesty and integrity, it did find itself among the top four selections for the “most corrupt” organization for all three sets of respondents. The most popular selection for the “most honest” organization was the Church.

## IMPACT ON HOUSEHOLDS AND ENTERPRISES

The direct impact of corruption on households and enterprises can be measured in two ways. First, we can estimate the *aggregate* impact of corruption, the total bribe flows from households and enterprises to various organizations. Second, we can estimate the *average* composition of bribes by households and enterprises, broken down by organizations. Figures 10 through 13 illustrate the composition of bribery expenditures formed according to each of these weighting schemes. For households, it is clear that much of the bribes they are forced to pay, both in the aggregate and for the average household, go to traffic police and for the provision of health services. Bribes to local officials, courts, and customs are more important in the aggregate than they are for the average households – only a subset of households find it necessary to pay these types of bribes, but when they are paid they tend to be large. For the average enterprise<sup>9</sup> in Latvia, the road police represents the single largest recipient of bribes because many smaller enterprises do not encounter the other organizations (situations). Fire and sanitary inspections represent large portions of the bribe flows both by the average enterprise and in the aggregate. Bribes to the road police (frequent but not large) represent a smaller share of aggregate bribe flows than they do for the average enterprise. Telephone line installations, border crossings, and lease of state-owned office space all are more important in the aggregate than for the average enterprise, for the same reasons outlined above – these services are needed by a smaller subset of enterprises, but the amount of the bribes tend to be high.

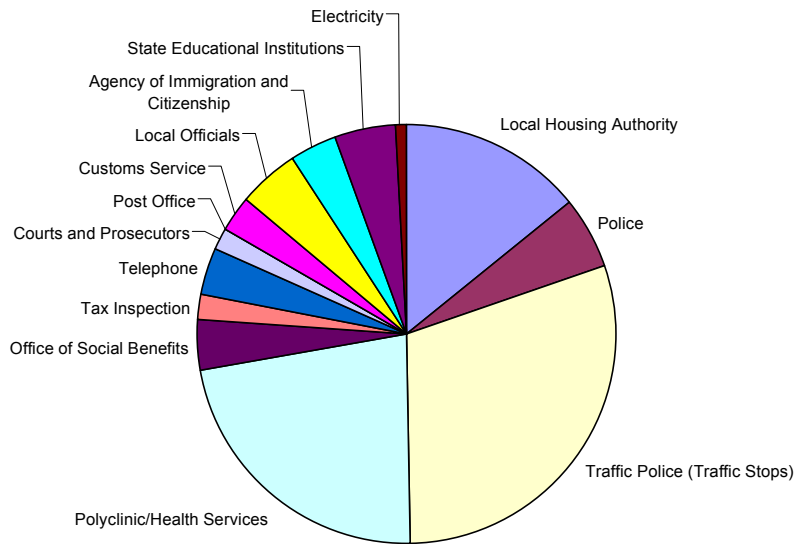
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<sup>8</sup> Lattelekom remains a statutory monopoly although it has been partially privatized. Due to its size, its importance for infrastructure and development, its status as a statutory monopoly, and the newness of the institutions of telecom regulation, we include Lattelekom among the list of state agencies and organizations, as we would any large state enterprise.

<sup>9</sup> Although the survey question clearly referenced the bribes that enterprises have to pay, it is possible that some managers provided responses based on their own experiences as individual drivers, rather than the experience of the enterprise.

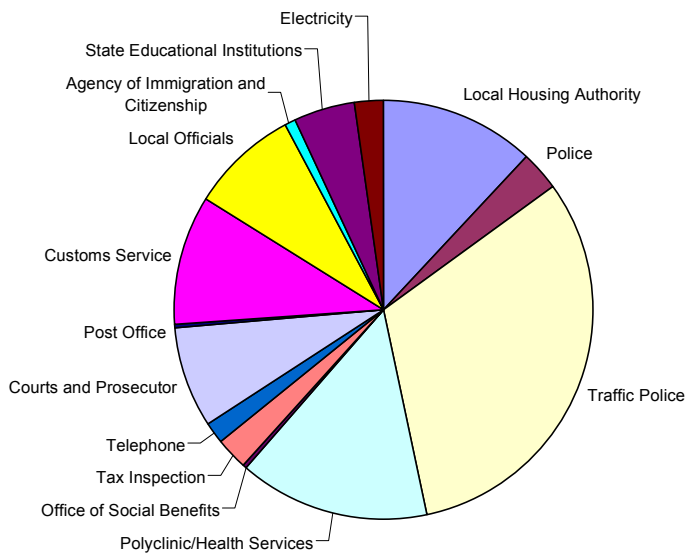


**Figure 10.**  
**Average Household Bribe Expenditures**



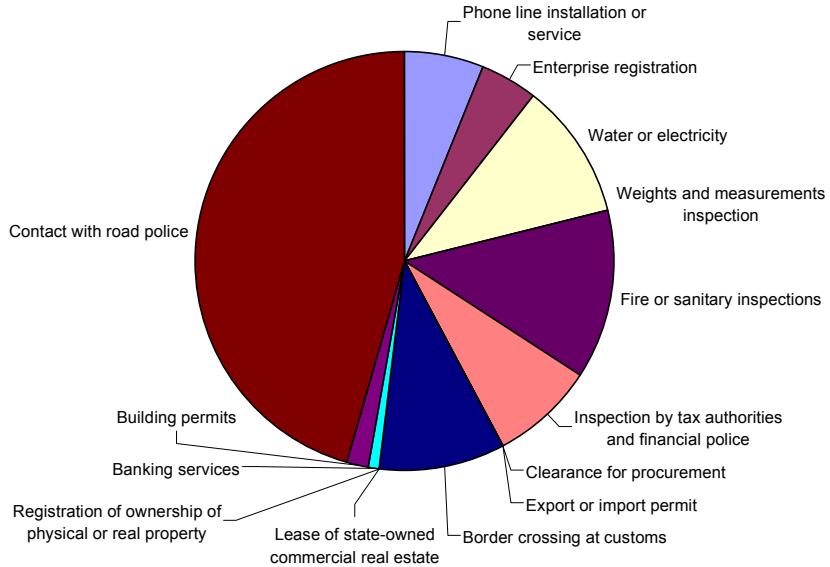
based on a World Bank - Latvia Facts survey of 1,100 households in June 1998.

**Figure 11.**  
**Aggregate Household Bribe Expenditures**



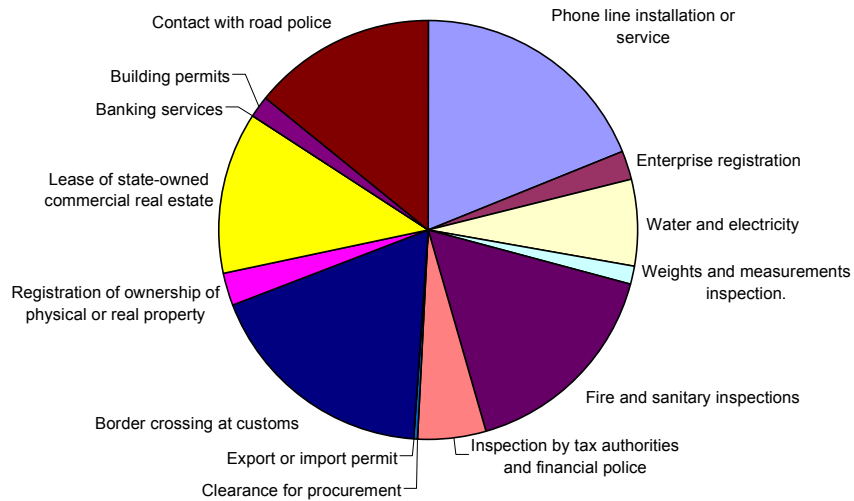
based on a World Bank - Latvia Facts survey of 1,100 households in June 1998.

**Figure 12.**  
**Average Enterprise Bribe Expenditures**



based on a World Bank - Latvia Facts survey of 438 enterprises in June and July 1998.

**Figure 13.**  
**Aggregate Enterprise Bribe Expenditures (liers)**



based on a World Bank - Latvia Facts survey of 438 enterprises in June and July 1998.

### SUMMARY: THE WORST OFFENDERS

Through multiple questions on multiple surveys, customs and traffic police repeatedly find themselves cited as the most corrupt and least honest organizations, the ones having the largest impact on the economy as a whole and for individual households and enterprises. Lattelekom is rated as one of the least honest, and telephone line installation is declared by enterprises to have a large aggregate impact. Leasing state-owned office space is among the top six government-enterprise interactions for frequency of bribery, and is in the top five in terms of the aggregate bribe flows from enterprises.

While health-related services are the second largest component of household bribe flows both in the aggregate and for the average household, health-related organizations receive relatively high marks in terms of honesty and integrity. (See Figures 7 through 9.) A similar story is told by another question on the household survey. “Bribery to improve quality of education or medical treatment” was ranked among the least damaging among 15 types of corrupt practices. Interviews suggest that while bribery in education and health sectors is a frequent practice, it is viewed as necessary given the levels of funding to those important sectors, and corruption in education and health may be more egalitarian in approach, the level of the bribe depending primarily on the income of the person paying the bribe. (However, there is some indication that the poorest households are deprived of certain educational services, as discussed in Section 6.)<sup>10</sup>

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<sup>10</sup> Gifts were also considered as bribes as long as there was an implied *quid pro quo*.

## **5. WHAT ARE THE CAUSES OF CORRUPTION IN LATVIA?**

### **THE INHERITANCE OF THE PAST**

From an historical perspective, the origins of corruption in Latvia can be traced to the centralized Soviet system from which it emerged: a system in which economic, political and judicial power was unified in a single state authority and where corruption was widespread. The legacy of this system can be seen in the undue influence of private business interests over public policy, the relatively weak judiciary, and the patterns of petty corruption in official interactions with businesses and the public. The movement after independence towards constitutional separation of powers has not yet been fully achieved in political and administrative life, exacerbating the threat of conflict of interest and corruption in high-level decision making.<sup>11</sup>

Due in part to this historical legacy, economic power in Latvia has become increasingly concentrated in a small number of conglomerates. Business and political interests have become intertwined in a complex and non-transparent way, and businesses are increasingly active in political parties. Excessive concentration of economic power, due in part to weak enforcement of competition legislation, drains efficiency from the economy and presents the risk that Latvia could become more prone to high-level corruption. These problems are further exacerbated by Latvia's geographical position on trade, transit and money-laundering routes from neighboring former Soviet countries, and by the expansion of Latvia's unofficial economy – a breeding ground for crime and corruption.

Latvia's historical and geographical legacy has supported the expansion of corruption. But it is the incentives and opportunities facing today's public servants, enterprises, and households that determine the extent and damage of corruption today. In the remainder of this section, the nature of these incentives and opportunities are explored.

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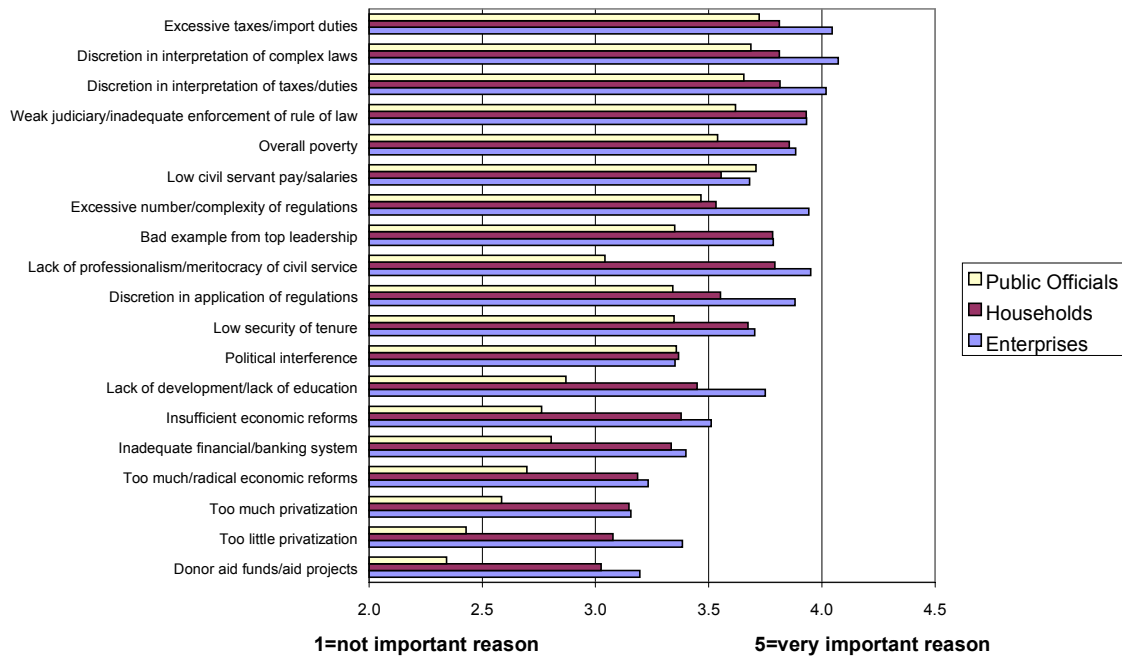
<sup>11</sup> This tendency was recognized early on in the transition from the Soviet system by the Latvian Parliament with the passage of the Anti-Corruption Law, which attempts to regulate conflict of interest and detect income and assets earned corruptly.

## INCENTIVES IN THE PRESENT

Corruption stems from the interaction of several related factors. First, there must exist large *rents* to be extracted and divided among the parties to any corrupt activity. (“Rent” refers to the net benefit to some activity.) These rents are the pay-offs to corruption. Second, the public officials must have *discretion* in their activities. This discretion to make decisions, while necessary to a degree for the efficient execution of their duties, affords them the ability to profit from their positions. Third, the degree of *accountability* must be low. A lack of accountability limits the probability that a corrupt official will get caught.

The survey responses (see Figure 14) illustrate very clearly that there is no single cause for the problem of corruption in Latvia. Many factors are blamed, in varying degrees. For convenience, we will classify the reasons for corruption (according to survey respondents) into the overlapping categories of rents, discretion, and lack of accountability.

**Figure 14. Opinions on the Reasons for Corruption**



based on World Bank - Latvia Facts surveys of households, enterprises, and public officials in June and July of 1998.

## Rents

Enterprises, households, and public officials all agree that “excessive taxes and import duties” are among the major causes of corruption in Latvia. Not surprisingly, enterprises expressed the strongest concern for the levels of taxes and import duties, a concern that is echoed in other survey questions dealing with taxes. Indeed, the lament about excessive taxation as a *cause* of corruption may merely reflect the general distaste

for high tax rates. Enterprises report that the main problem of doing business in Latvia is that “taxes are too high” (Figure 15), and the single biggest complaint they have about the system of taxation is that the rates themselves are too high. (Taxes will be discussed later. See Figure 24).

The relationship between the rents and the level of corruption is evident in other forms of enterprise-state relations, as well. As discussed in Section 6, the surveys show that enterprises that lease space from the state, and those that have received direct subsidies or centralized credit, are more likely to have paid bribes. Rents exist in each of these cases, since an enterprise has much to gain or lose from a decision by a public official.

### **Discretion**

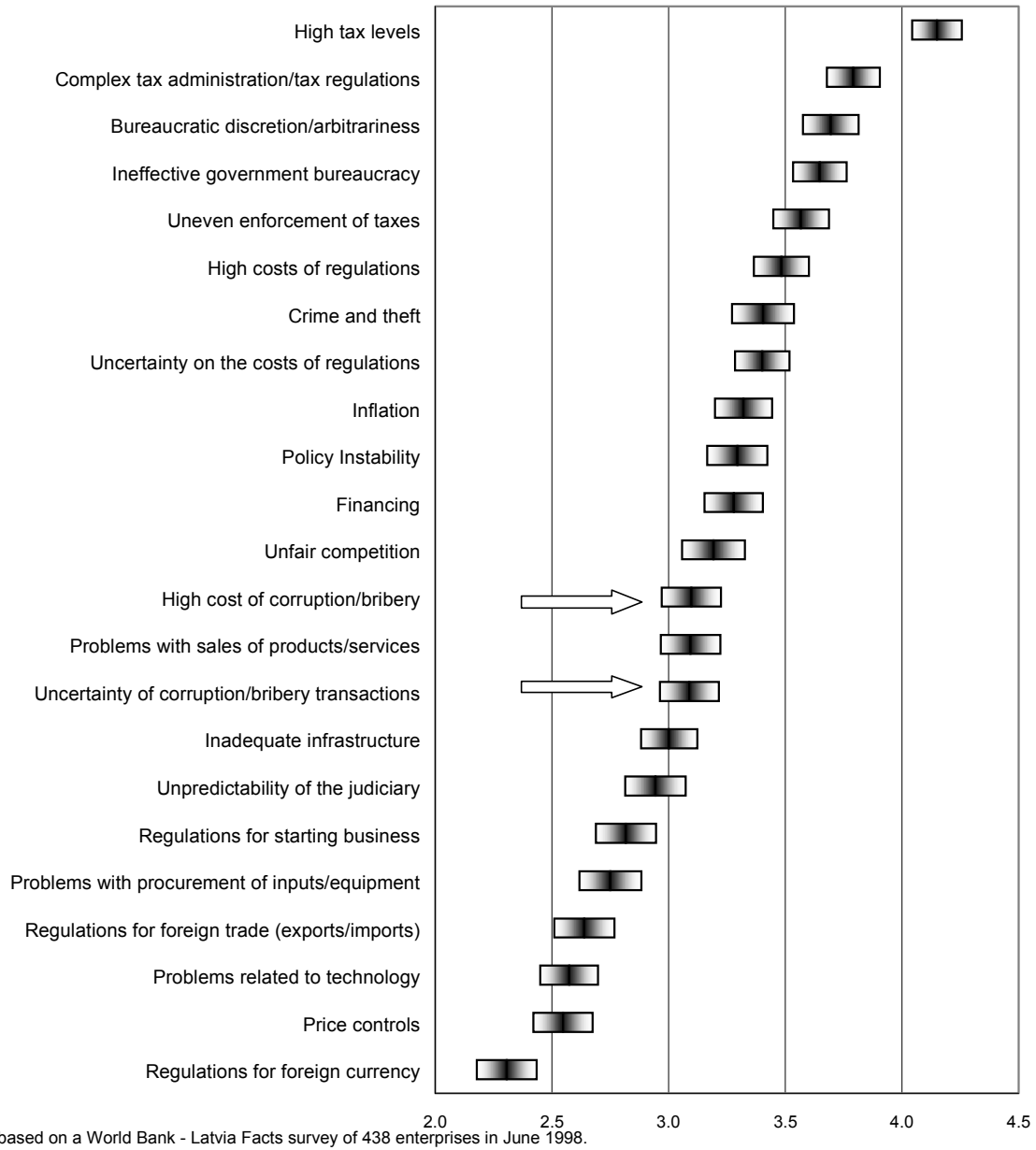
In Latvia there is considerable evidence that excessive discretion on the part of bureaucrats is a major contributor to the growing problem of corruption. Enterprises name “discretion in interpretation of complex laws” as the most important cause of corruption, with “discretion in interpretation of taxes and duties”, and “excessive number and complexity of regulations” also among the top reasons cited. (See Figure 14). Current research suggests that complex laws and regulations that allow discretion on the part of enforcers are key determinants of corruption.<sup>12</sup> To take a simple example, high tax levels combined with discretion on the part of tax inspectors, generates a system whereby the inspector has the power to save or cost enterprises huge amounts of money – it is in both the inspector’s and the enterprise’s interest to reach a side agreement (bribe) to reduce the amount of the tax payment.

The importance of excessive discretion is echoed in the enterprise reports of the problems doing business in Latvia. While the main obstacle was reported to be the high tax level, immediately following were several obstacles related to the complexity of tax administration and tax regulations, general bureaucratic arbitrariness and discretion, ineffective bureaucracy and the high costs of regulation. (See Figure 14)

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<sup>12</sup> E.g., Simon Johnson, Daniel Kaufmann and Pablo Zoido-Lobaton “Corruption, Public Finances, and the Unofficial Economy” 1998: “... the problem lies with the *discretionary* application of *tax* and *regulatory* regimes in many countries.” (p. 1)

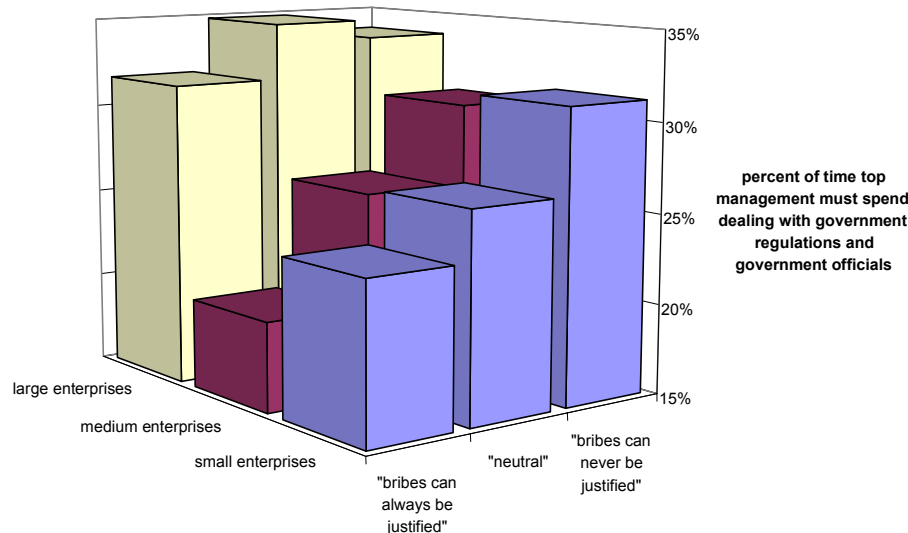
**Figure 15.**  
**"How problematic are the following for doing business?"**  
**1=Not and obstacle 5=Very strong obstacle**  
**(95% confidence intervals)**



The impact of the regulatory environment on enterprises can be illustrated by considering the time cost of dealing with taxes, regulations, and bureaucracy. For the average enterprise, the senior manager must devote 27 percent of the workweek attending to government regulations or officials from state or local government institutions. There also appears to be evidence that enterprises with higher moral opposition to bribery must pay a price in terms of time spent dealing with bureaucracy. Those believing that “bribery can never be justified” have to spend more time dealing with bureaucracy than those who believe that “bribery can always be justified.” (See Figure 16)

**Figure 16.**

Managers who aren't willing to give in to bribes must spend more time dealing with government regulations and institutions.



based on a World Bank - Latvia Facts survey of 438 enterprises in June and July of 1998.  
 notes: Enterprises were provided a ten-point scale with 1 = "bribes can always be justified" and 10= "bribes can never be justified". Responses of 1, 2, and 3 were grouped as "always"; 8, 9, and 10 were grouped as "never"; and 4, 5, 6, and 7 were grouped as "neutral". Small enterprises have less than 10 full-time employees, medium 10-50, and large more than 50 full-time employees.

### Accountability and Conditions in the Civil Service

Systematic corruption feeds on itself. When corruption is widespread there is little accountability for corrupt practices; there is little fear of “whistle-blowers”, public officials may feel that “everybody is doing it”, and they may even be benefiting from corruption by others.

Public officials, not surprisingly, are more likely to blame corruption on “low civil servant salaries” than enterprises or households. A low salary, indeed, may help an otherwise honest civil servant justify abuse of public office. However, there is tremendous variation in levels of corruption across government agencies and organizations. Unless postal workers are paid much more than the traffic police or



customs officials, the level of salaries can not explain why the level of corruption is so much lower in the post office than in the traffic police and customs (see Figure 4).<sup>13</sup>

Public officials are less likely to blame “lack of professionalism in the civil service” than enterprises or households. (See Figure 14.) Public officials also diverge from enterprises and households in their opinions about how frequently corruption of all forms occur (Figure 6), and how damaging corruption is to society (Figure 17). Yet, public officials report that 30 to 65 percent of public officials in various organizations take their jobs mainly for the “unofficial benefits”, and 15 to 45 percent actually pay money for their jobs. (See Section 7 and Figures 26-27.) Furthermore, when middle-level bureaucrats receive bribes, half are reported to share the bribes with colleagues or supervisors. Survey respondents from all three groups suggest that “bad example from top leadership” contributes to the problem of corruption. All of these facts suggest a culture of corruption with little accountability. (These issues will be discussed further in Section 7, below.)

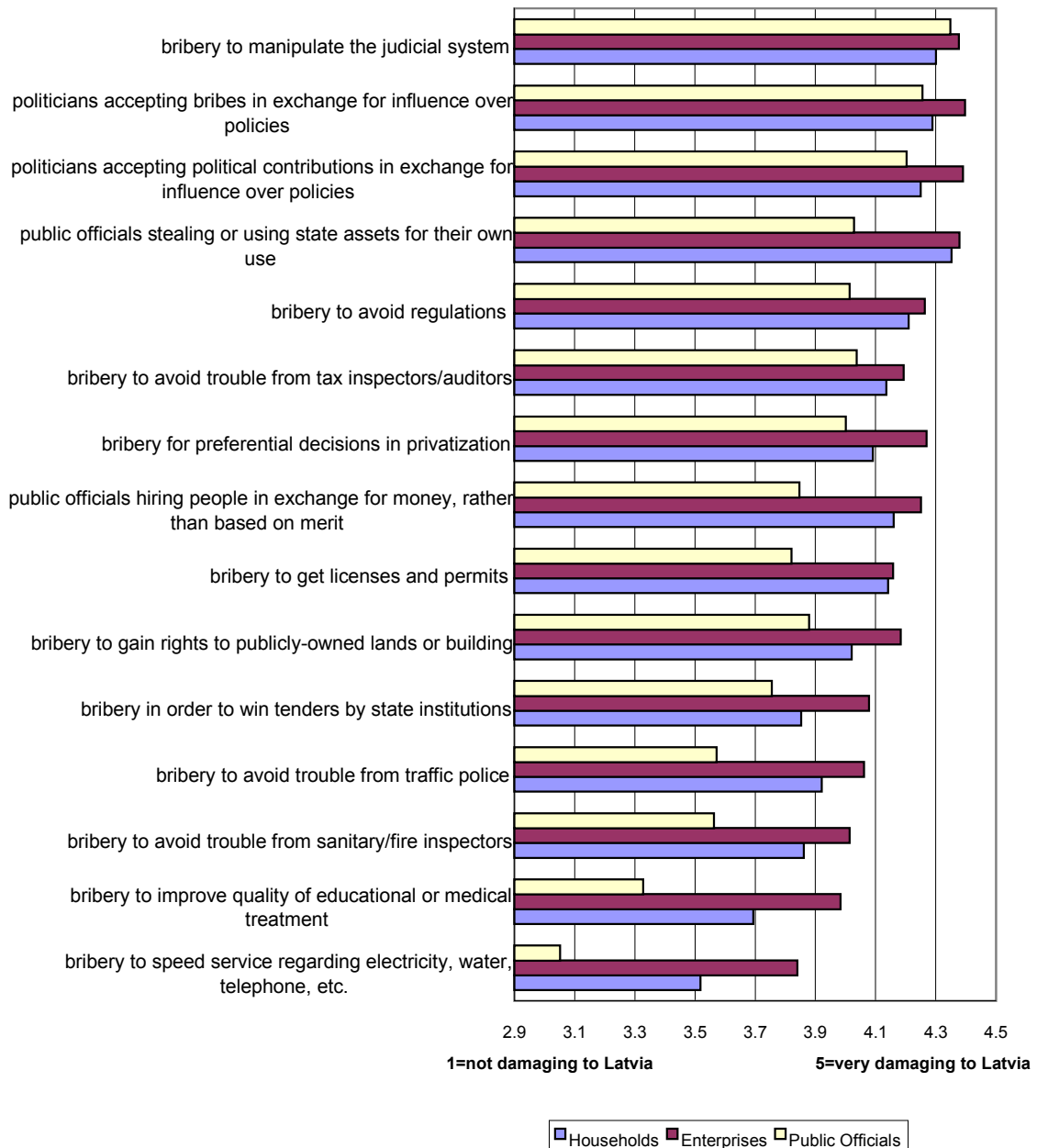
### SUMMARY OF CAUSES

The surveys illustrate how corruption is generated by the interplay of rents, discretion, and lack of accountability. Certain *rents*, such as those associated with taxation and Government procurement, exist in every economy and can not be eliminated. But other rents, such as those stemming from subsidies and centralized credits, cause distortions in the economy and fuel corruption. When rents do exist, they will only lead to corruption when public officials have the power of *discretion* allowing the rents to be captured. The surveys show that excessive discretion and bureaucracy is viewed as a major obstacle to doing business and a major cause of corruption. Lastly, several empirical observations – denial of the damage caused to society, blaming corruption mostly on low salaries, admission that many civil servants take jobs for the unofficial benefits, and sharing bribes with colleagues – suggest that a worrying culture of corruption within the civil service may be hindering *accountability*. Fighting this culture is a necessary step in the battle against corruption, a step supported by the education component of Latvia’s anti-corruption program.

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<sup>13</sup> By far the organization viewed as most honest is the Church (see Figures 7-9), an organization not likely to have salaries so much higher than customs and the traffic police.

**Figure 17. Overall opinions on the damage caused by corrupt practices**



based on World Bank - Latvia Facts surveys of 1,100 households, 438 enterprises, and 218 public officials in June and July of 1998.

## **6. WHAT ARE THE EFFECTS OF CORRUPTION IN LATVIA?**

Corruption disrupts society in numerous ways. Efficiency suffers when resources are mis-allocated, when regulations are not enforced or improperly enforced, and when scarce human talents are wasted on corruption. Equity suffers when corruption allows for uneven tax incidence and regulatory compliance, and when corruption deprives poor households of government services. Corruption further causes the decay of certain institutions that hold society together, namely the system of law enforcement and jurisprudence. We can not possibly discuss (or even imagine) all of the ways that corruption harms society because they are too numerous. Yet, a brief discussion of the impact of corruption on society helps to illustrate the importance of the task currently facing reformers.

### **WHO BEARS THE BRUNT OF CORRUPTION?**

The surveys of enterprises and households provide detailed information about characteristics of the respondents. In this section we will examine the enterprise and household characteristics that are correlated with the propensity to fall victim<sup>14</sup> to, or engage in, corrupt practices, and with the impact on those enterprises and households.

#### **Enterprises**

In many respects, the data show evidence of a uniform penetration of corruption within the business community. There does not appear to be any statistically perceptible difference in the propensity to become involved in corruption according to sectors of operation, legal form of ownership (shareholding company, limited liability company, proprietorship, etc.), size<sup>15</sup> (as measured by employment or by level of turnover), or respondent's nationality.

There are, however, several enterprise characteristics that are correlated with the propensity to be involved in corrupt activities. All of these indicators suggest, not

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<sup>14</sup> Most corrupt acts have at least two participants; some enterprises and households may not be victims so much as beneficiaries of corrupt activities. Our goal is not to make the distinction between victims and beneficiaries, but to sift through the data on corruption incidence for clues on key issues of reform.

<sup>15</sup> Corruption's impact on micro-enterprise is discussed in the section on households, below.

surprisingly, that enterprises with greater interaction with state officials are more likely to bribe.

Enterprises that have ever been owned by the state, wholly or partially, are much more likely to have paid bribes even after controlling for the impact of size. Enterprises with local government ownership are more likely to have paid bribes, although the sample did not include many such enterprises so the conclusion is somewhat tenuous. There is some indication that enterprises that have received direct subsidies or centralized credits are more likely to have paid bribes, although there were few such enterprises in the sample. There is no indication that enterprises that have received “tax holidays or tax exemptions” are more likely to bribe, but those enterprises that had received such treatment paid significantly more as a share of revenues. Enterprises that lease space (e.g., office space or a workshop) from a state institution are also significantly more likely to have paid bribes, as are enterprises engage in international trade. (Exporters, in particular, are more likely to have paid bribes than non-exporters.)

The survey of enterprises also makes clear the strong statistical relationship between enterprise “success” and the propensity to pay bribes – enterprises that have paid bribes have grown faster than those that have not. Enterprises with higher employment growth in the past three years pay a larger share of turnover in bribes, although the level of statistical significance is somewhat weaker. Enterprises forecasting growth in the future are also (slightly) more likely to have bribed in the past. And as discussed below, enterprises that had invested in the past two years, and those forecasting a major investment in the next two years, are also more likely to have bribed.

There are several interpretations of the relationship between “success” and the propensity to become involved in corrupt activities. First, successful, growing, enterprises could be targeted by corrupt public officials as prime candidates for bribery. Second, certain enterprises may attempt to work the system of corruption to their advantage. Third, it stands to reason that growing enterprises must interact more frequently with government officials, and in doing so, they are more likely to find it necessary to pay bribes.

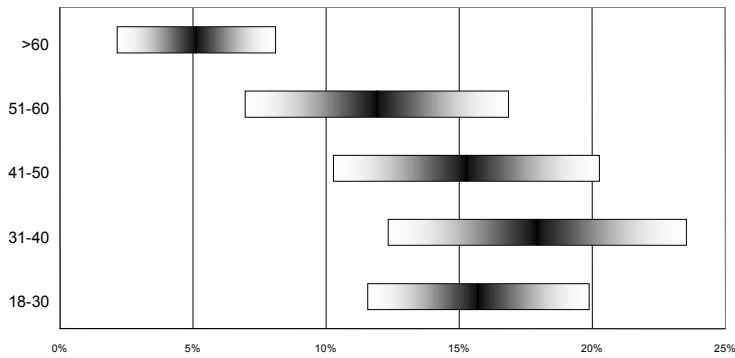
### **Households and Micro-enterprise**

The household survey helps isolate the household characteristics that are related to corruption. The sample was stratified according to geography, age, gender, and nationality. The question of nationality<sup>16</sup> is an important one for Latvia, but the surveys make clear that corruption knows no nationality, at least in Latvia’s case. The propensity to pay bribes was entirely uncorrelated with nationality. It was also uncorrelated with the gender of the respondent, whether or not the household owned land, and whether or not the household owned its own dwelling. There are, however, several household (and respondent) characteristics that are correlated with the propensity to have paid bribes, and they are discussed below. (See Figures 18 through 20.)

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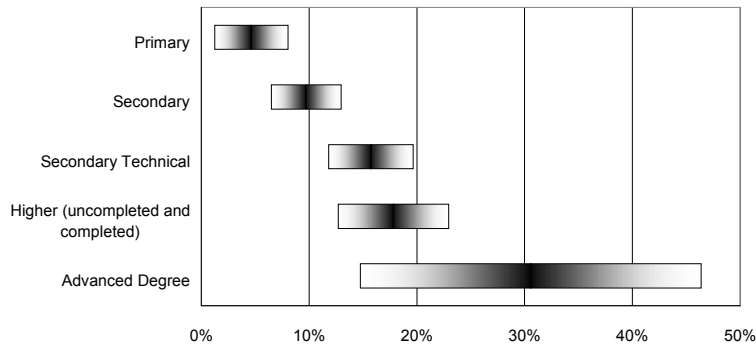
<sup>16</sup> Sixty-one percent of household respondents were Latvian, 28 percent were Russian, and the remainder were of other nationalities.

**Figure 18.**  
Propensity to Pay Bribes by Age (95% confidence intervals)



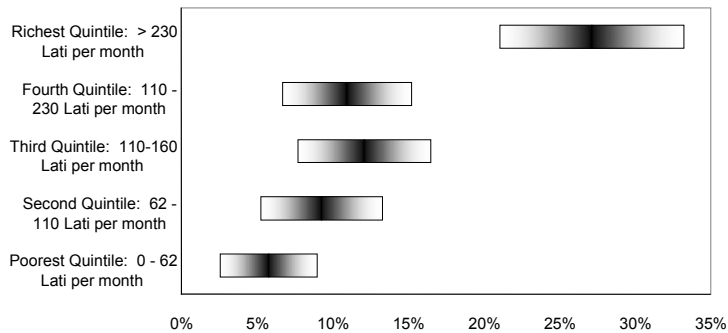
based on a World Bank - Latvia Facts survey of 1,000 households in Latvia in June 1998

**Figure 19.**  
Propensity to Pay Bribes by Level of Education (95% confidence intervals)



based on a World Bank - Latvia Facts survey of 1,000 households in Latvia in June 1998

**Figure 20.**  
Propensity to Pay Bribes by Income Quintiles (95% confidence intervals)



based on a World Bank - Latvia Facts survey of 1,000 households in Latvia in June 1998

## *Age*

Younger respondents are more likely to have paid bribes than older respondents, even after controlling for other household characteristics such as automobile ownership. The pattern is especially evident in the small propensity to bribe exhibited by respondents over 60 years old. The highest propensity to bribe is among those in the 31-40 age group. The relationship between age and the propensity to pay bribes is partially explained by the fact that the elderly have interactions with fewer state organizations (particularly the police and traffic police), but even after controlling for the number of interactions, we find that younger people are more likely to have paid bribes than older people. (See Figure 18.)

## *Education*

Education is correlated with the propensity to bribe, even after controlling for automobile ownership, and the overall number of interactions with the state. Those with higher levels of education are more likely to have bribed than those with lower levels of education. (See Figure 19.)

## *Automobile Ownership*

Automobile ownership and possession of a driver's license are very important for explaining which households bribe (and why). Households that own cars are much more likely to have bribed (20 percent versus 8 percent), and respondents that have drivers licenses are more likely to have bribed (19 percent versus 10 percent), adding to the evidence that corruption among the road police is the most important for the average household.

## *Income*

The incidence of corruption across income levels is important for assessing corruption's true impact on society. The household survey suggests that rich households have a greater propensity to pay bribes, but this propensity appears to be peculiar to the richest quintile of the population. (See Figure 20.) Furthermore, the greater propensity of rich households to pay bribes seems to be driven largely by the fact that rich households are more likely to own automobiles.

But the propensity of rich and poor households to pay bribes may itself be masking the true impact of corruption on the poor. The poorest households may be unable to pay the bribes necessary to ensure quality services and may therefore receive sub-standard treatment from the public sector. Indeed, households in the poorest 30 percent of the population had significantly fewer interactions with state educational institutions than those in the richest 30 percent. (This is true for the overall sample and for the subset of households that have children under 16.)

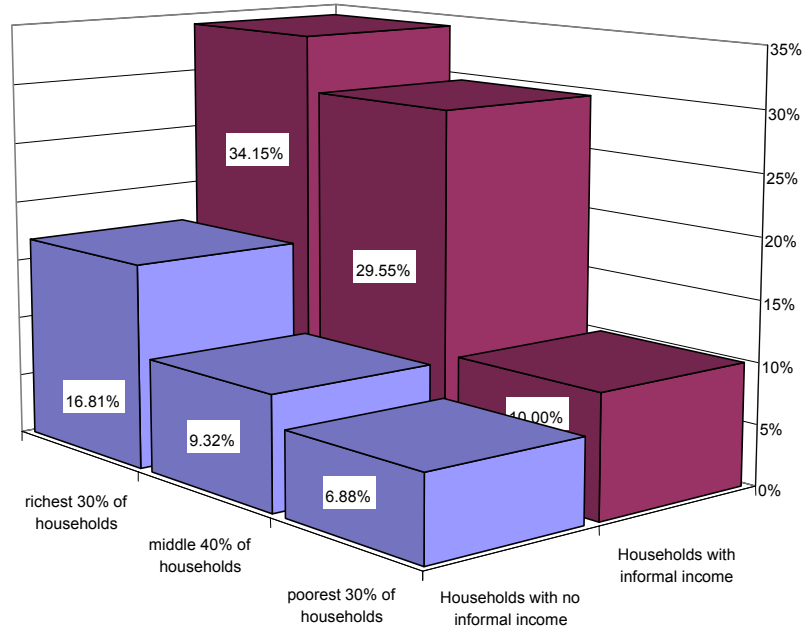
While rich households are more likely to have paid bribes than poor households, the impact relative to their income is smaller. That is, poor households pay a larger fraction of their income in bribes than do rich households.

### *Micro-enterprise*

The income effect described above is largely caused by micro-enterprise. Households that engage in small scale business activities are much more likely to have paid bribes than households that rely on formal wage employment, pensions or public assistance. While such “micro-enterprise” households can be found among all income groups, those in the lower income group tend to pay larger fractions of their income in bribes than those in the higher income group. Households with informal income are nearly three times as likely to have paid bribes in the two months before the survey, and pay nearly five times as much as a percent of their income. (See Figures 21 and 22.)

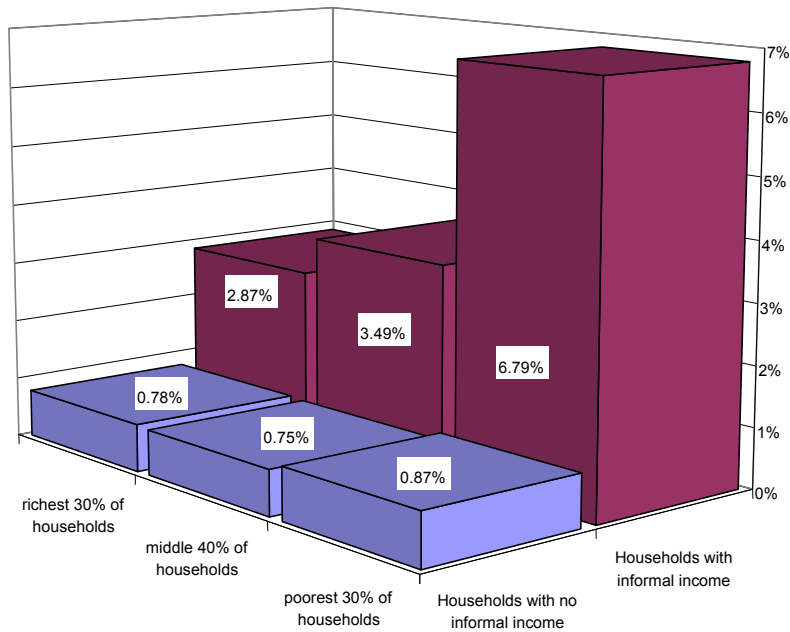
That bribery is more prevalent among households engaged in micro-enterprise is no surprise. Such households engage in social interactions of both households and of enterprises. Micro-entrepreneurs are still less likely to have bribed than formal sector counterparts. But the main message is clear: micro-enterprise, a natural and very effective defense against poverty, is hampered by corruption.

**Figure 21.**  
**Percentage of Households that Pay Bribes**



based on a World Bank - Latvia Facts survey of 1,100 households in June 1998

**Figure 22.**  
**Percentage of Household Income Paid in Bribes**



based on a World Bank - Latvia Facts survey of 1,100 households in June 1998



## THE UNOFFICIAL ECONOMY

Corruption and the underground economy go hand-in-hand. Corrupt practices (and incomes) are obviously kept “underground” in that they are hidden from authorities, but the connection goes much deeper. Excessive discretion by bureaucrats in interpreting complex laws and regulations push enterprises toward the unofficial economy to avoid those laws and regulations. At the same time, enterprises that are operating unofficially usually could not do so without the complicity of officials who turn a blind eye to the practice. The potential benefits of operating unofficially are very large. Officials who have the discretion to either report the enterprise or turn a blind eye can either cost or save the enterprise a lot of money – the spoils of corruption are expansive when the unofficial economy is expansive.<sup>17</sup> (Latvia’s unofficial economy has been estimated to be approximately 35 percent of the official economy in 1995.<sup>18</sup>)

### Competition

Enterprises that operate unofficially earn an obvious competitive advantage over those that operate officially, but the impact of that advantage is staggering. Enterprises estimated that their unofficial competitors earn a 60 percent increase in profits by not paying taxes, not getting appropriate licenses and registrations, and so on. (See Figure 23.) In another question on complaints about the tax system, the second most frequently cited complaint, garnering over 20 percent of the votes, was that “enterprises that avoid paying taxes get an unfair advantage over their competitors.” (See Figure 24.) Only complaints about the level of tax rates were more frequent.

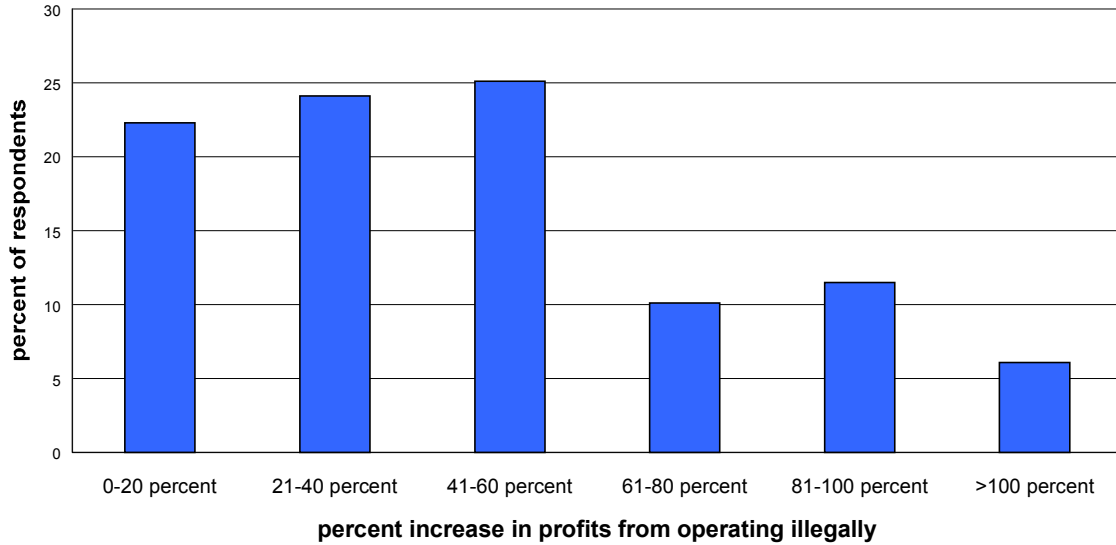
The implications of this vicious circle are clear. Enterprises that operate unofficially get unfair advantages over those that operate officially. In highly competitive sectors where margins are slim, the smaller costs of unofficial enterprises allow them to set prices well below their law-abiding competitors. The evolutionary effect is to drive honest competitors from the market, or drive them toward illegality. The result is reduced competition and an even larger unofficial economy, and greater availability of rents for officials willing to turn a blind eye, perpetuating the vicious circle.

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<sup>17</sup> This vicious circle has been explored by Simon Johnson, Daniel Kaufmann and Pablo Zoido-Lobaton “Corruption, Public Finances, and the Unofficial Economy”. 1998. “The unofficial economy accounts for a larger share of GDP when there is higher bureaucratic inefficiency and discretion, and also when firms experience a higher tax and regulatory burden and more bribery and corruption.”

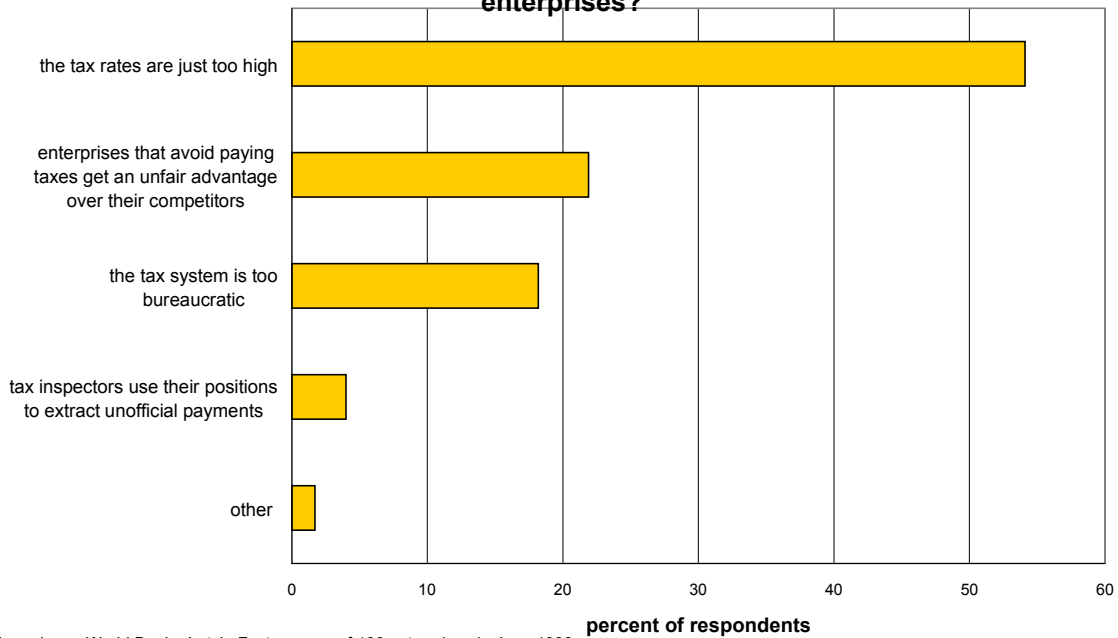
<sup>18</sup> Simon Johnson, Daniel Kaufmann and Andrei Shleifer, “The Unofficial Economy in Transition,” Brookings Papers on Economic Activity 2: 1997. 159-239. The estimate of the size of the unofficial economy is based on changes in electric power consumption, and changes in official GDP.

**Figure 23.**  
**The percentage increase in profits that an "illegal" competitor can gain by not paying taxes, getting appropriate licenses, etc.**  
**Perceptions of Enterprises**



based on a World Bank - Latvia Facts survey of 438 enterprises in June-July 1998

**Figure 24.**  
**Which problem with the tax system is the most important for enterprises?**



based on a World Bank - Latvia Facts survey of 438 enterprises in June 1998

## **Distortion of the Tax System**

The system of taxation becomes grossly distorted with widespread corruption for several reasons, and, conversely, the distorted system of taxation fosters corruption. (1) Revenues suffer, as certain bribe flows (e.g., to customs) offset revenues that would have flowed into the state treasury. Moreover, the mutually supporting ills of corruption and the unofficial economy means that enterprises report a smaller portion of their true tax revenues. Abating the problem of lost revenues could make it possible to lower the tax rates. (2) The high compliance costs (particularly due to the lack of standardized tax forms and procedures) permits corruption and may drive enterprises into the unofficial economy. (3) Taxation becomes inequitable, since certain enterprises evade taxation. Enterprises may well tolerate higher tax levels if they knew that their competitors were complying and if they were not harassed by the uncertainty of bribe demands by corrupt public officials.

Enterprises were asked a hypothetical question: how much more as a percent of revenues would you be willing to pay in taxes if all corruption were eliminated? Seventy percent of enterprises said “zero”, a clear testament that while corruption may be widespread, many enterprises have learned how to work within the system<sup>19</sup> and even benefit from corrupt activities. (Even among the subset of enterprises that have paid bribes, less than 30 percent would be willing to pay additional taxes if corruption were eliminated.) But among the subset that were willing to pay more, the average enterprise reported a willingness to pay 15 percent in additional taxes to eliminate corruption. Overall, including the enterprises willing to pay nothing, the enterprise sector revealed a willingness to pay an additional 4 percent in taxes if all corruption were eliminated. This is a clear lower bound on the lost revenues from corruption, since many enterprises benefit from corruption – greater illumination of the hidden economy would increase tax revenues even further.

## **Reduced Quality of Government Services**

Among the more subtle costs of corruption is the deterioration in the quality of government service delivery. At its worst, the quality of services may be intentionally reduced in order to generate rents for corrupt public officials. But even in the absence of such a specter, the quality of government services degenerates due to the interaction between corruption and the unofficial economy. A decline in the quality of government services reduces the benefits to enterprises of operating officially,<sup>20</sup> driving more and more enterprises into the unofficial economy. Expansion of the underground economy in turn reduces tax revenues leading to a further deterioration in the quality of government services. This vicious circle is made yet more complicated by the practice of officials paying money for their jobs. Government agencies in which corruption is particularly profitable (i.e., those with access to large rents and the discretion to extract them) will

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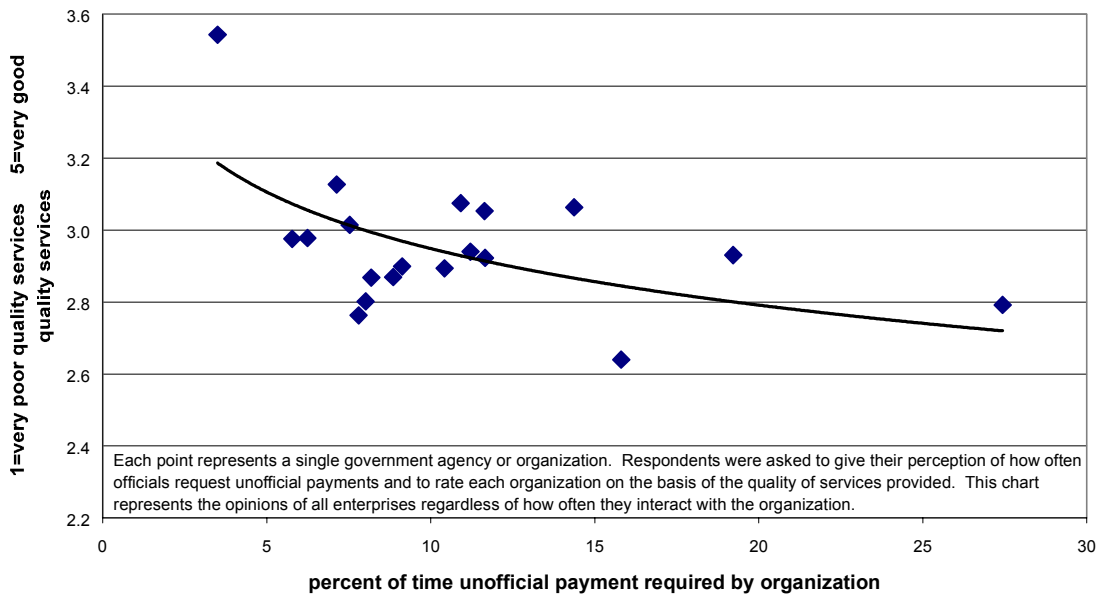
<sup>19</sup> In one interview, the enterprise director remarked “The system is stable.”

<sup>20</sup> Simon Johnson, Daniel Kaufmann, and Andrei Shleifer “The Unofficial Economy in Transition”. Brookings Papers on Economic Activity 2:1997.

attract people who are willing to pay for their jobs rather than those who are most capable to deliver quality services,<sup>21</sup> entrenching corruption within these agencies, a matter discussed below.

The survey data provide some good examples of this vicious circle in action. Enterprises and households evaluated the quality of service delivery and the frequency with which bribes are demanded for 19 and 17 different government agencies or organizations, respectively. Agencies that were rated as less corrupt were generally the agencies providing the higher quality services. (See Figure 25). The public officials survey also showed that the various positions and organizations in which people are more likely to pay money to get their jobs, are also organizations which more frequently demand bribes. (Discussed below. See Figures 26 and 27.)

**Figure 25. Corruption and the Quality of Government Services.  
Perceptions of Enterprises**



based on a World Bank - Latvia Facts survey of 438 enterprises in June and July of 1998

## INVESTMENT

The survey evidence demonstrates how corruption impacts on enterprise growth and investment. Corruption, and the excessive discretion in the regulatory environment that goes with it, create barriers to entry, limiting the power of competition as a stimulus for investment and efficiency. The excessive discretion in bureaucracy further imposes malignant evolutionary forces on enterprises – if enterprises are to invest and grow, they must succumb to corruption.

<sup>21</sup> Andrei Shleifer and Robert W. Vishny “Corruption”. *Quarterly Journal of Economics* August, 1993.

One of the most costly bribes paid by enterprises is that of telephone-line installations. The impact for the average enterprise is small, since most enterprises are not expanding, but the aggregate impact is large due to the sizable amounts paid by the subset of enterprises getting new telephone lines installed. (See Figure 13.) A second enterprise expense that is much larger in the aggregate than for the average enterprise is that of leasing state-owned office space. Again, only a subset of enterprises must make such unofficial payments, but when they are made they tend to be large.

Enterprises that are expanding and investing usually find it necessary not only to expand their facilities and obtain telephone connections, but to collect more licenses and permissions, as well. Growing enterprises have more interaction with public officials and must make more unofficial payments. The enterprise survey demonstrates that enterprises that have made a major investment in the past two years are more likely to have made bribes, and those that are planning to expand or planning a major investment in the next two years are also more likely to have paid bribes.

Eighteen percent of enterprises that had previously planned a major investment had decided against it, usually because of a lack of financing. (See Table 1.) But the second most frequent reason for canceling investment was due to the uncertainty in complying with government regulations, including uncertain additional payments. This response was more important than the costs of the regulations themselves, more important than shocks to demand, and even more important than taxes. The high cost of regulations and unofficial payments, and the uncertainty surrounding them, were selected by 27 percent of the respondents as the reason they had canceled investment plans, a larger fraction even than the lack of financing.

**Table 1. Why enterprises that had been planning a major investment decided against it.**

Reason for not investing	Percent of Respondents
No access to loans/credits	22.7
Uncertainty in complying with government regulations (including uncertain additional payments)	18.8
Insufficient demand for my product(s)	14.7
Taxes	14.7
High costs of complying with government regulations (including additional payments)	8.0
Civil unrest/civil war itself	2.7
Insecure property/theft	1.3
Other (specify)	17.3

## **7. SPECIAL ISSUES**

In this section, we explore in greater detail the level and characteristics of corruption in education, health, the traffic police and customs. We will also explore certain issues of particular importance for public sector reform, such as corruption related to taxation, the civil service, and procurement, as well as one branch of government that is of paramount concern for the development of civil society, the judiciary.

### **EDUCATION AND HEALTH**

Education and health are particularly important public services for households, and the data provide an interesting story of corruption. On the one hand, both education and health get relatively high ratings among 28 organizations for honesty and integrity by households (see Figures 7 through 9), ranking alongside the Church and the media. In another question, households rated how frequently they think various types of corruption occur and how damaging they are when they do occur. (See Figures 6 and 17.) While both were termed “frequent”, bribery in the education and health sectors received good scores relative to most other types of corruption, and in terms of damage to society, bribery in education and health was reported to be the second least damaging type of corruption.

But it is very clear that the relatively “good” standing of education and health in the minds of households stems not from a positive perception of education and health institutions as much as it stems from a very negative perception of the degree of corruption in other institutions.

Ranked against other public sub-sectors, education and health are in the middle for the “percent of time that unofficial payments are required” but due to the frequent interaction with these organizations, the total bribe flows are large, especially for health services. The bribes that households must pay for medical services and education are important both in the aggregate and for the average household. (See Figures 10 and 11.) These two categories of bribes alone represent a fourth to a half of the total bribe flows from households.

### **JUDICIARY**

Corruption in the judiciary has the potential to do far more damage to society than corruption elsewhere. An independent, impartial, judiciary is often cited as a fundamental institution supporting civil society and a well-functioning market economy. When judicial decisions become suspect due to corruption, businesses reduce productive

activities, particularly those with greater potential for disputes, such as long-term investment contracts or the production of complex goods.<sup>22</sup> More importantly, the overall level of law obedience (criminal and civil) will be diminished.<sup>23</sup> Moreover, when disputes do arise they will more likely be addressed outside of the overall framework of laws. Although some forms of informal dispute resolution may be very effective, others (e.g., violence) are quite troubling. Lastly, since the final word in a law-based anti-corruption program resides with judicial bodies, a tainted judiciary may also limit the success of anti-corruption programs. In this section we will examine corruption within the Latvian judicial system.

The importance of the judiciary was clearly reflected in the survey responses of all three sample groups. Households, enterprises, and public officials all rated bribery in the judicial system as among the most damaging forms of corruption for society, even though it was not among those cited as the most frequent. (See Figures 6 and 17).

According to households, weakness in the judiciary and inadequate enforcement of the rule of law is the single most important reason for corruption (Figure 14), and households give a very low rating to the judiciary for honesty and integrity (Figure 7). In a separate question focusing on organizations that households in particular are likely to interact with, households that had some contact with the courts reported that bribes to courts and prosecutors are very frequent (up to 40 percent of the time), outdone only by the traffic police and customs.

However, the perception of households may be worse than the reality. Fourteen percent of enterprises and eleven percent of households had actually been involved in a court case, most of them civil cases. Ten percent<sup>24</sup> of the informed enterprises and 14 percent of informed households (i.e., enterprises and households that had actually been involved in court cases) reported that they had received some indication that they were expected to make unofficial payments to judges, bailiffs, prosecutors or other court officials, citing amounts ranging from 50 to 2,000 Lati for enterprises and from 15 to 2,000 Lati for households.

The degree to which corruption is entrenched within an organization can be gauged by how sure a briber can be of the outcome once a bribe has been paid. It appears that both the costs and the benefits of corruption in the judiciary are highly uncertain in

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<sup>22</sup> The sector that gave the highest level of importance to “corruption” as a problem of doing business was the electricity, gas, and water supply sector.

<sup>23</sup> Recent research suggests that fear of punishment is less important for explaining whether or not people obey the law than a belief in the fairness of the judicial and law enforcement process. Tom R. Tyler, Why People Obey the Law, New have: Yale. 1990.

<sup>24</sup> It is possible that the percentage of enterprises asked for bribes is underreported. This particular question was more direct than most of the questions, and some enterprises might have felt uncomfortable in revealing that they were asked for bribes in courts cases – as matters of public record, tracking down court cases in which enterprises were involved would not be too difficult, so the perceived risks of revealing truthful information were high.

Latvia. Of the sub-sample of enterprises (households) that were actually involved in court cases, 72 percent (56 percent) said the cost of the bribe was not predictable and 54 percent (50 percent) said that the outcome of the case once the bribe was paid was not certain.

As we have stressed throughout this report, inefficiencies in the delivery of public services widen the scope for corrupt activities and for this reason we have been evaluating not just levels of corruption but the overall quality of services as well. According to enterprises,<sup>25</sup> the most important problems with using courts appear to be that “the time from filing a claim to the time the judge renders his or her decision is very long” and “decisions are not enforced”. The relative competence of the judges and lawyers are somewhat less problematic and “unofficial costs” do not seem to be more burdensome than “official costs.” (But then, one would hope that they were significantly *less* burdensome!)

Several facts taken from the data suggest that the corruption problems within the judiciary may reside more at the lower level, clerical, position than among judges. The uncertainty of the outcome once the bribe has been paid may suggest that many bribes are directed at clerks for speeding up processing – the time being filing a claim and the time the decision is rendered was cited as the biggest problem with using courts.

#### **CUSTOMS AND INTERNATIONAL TRADE**

The customs service, by nature of its work, is a governmental organization with great scope for corruption and in many countries the customs service has one of the worst records for corruption. Latvia is no different.

According to enterprises and households, border crossing at customs require unofficial payments more frequently than nearly all interactions with the state. Enterprises report that more than 20 percent of the time, a border crossing at customs requires an unofficial payment, while households report that unofficial payments are required up to 40 percent of the time. (Households generally reported bribes of all sorts to be more frequent than reported by enterprises.)

The poor ratings that customs received for frequency of corrupt practices carried over into the survey respondents’ perception of honesty and integrity. (See Figure 7) Customs received the lowest rating for households and public officials and nearly the lowest rating for enterprises. Customs tops the rankings of “most corrupt” for all three surveys: 18 percent of enterprises, 26 percent of households, and 29 percent of public officials chose customs as the most corrupt organization from a list of 36 different state and non-state organizations. (See Figure 9).

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<sup>25</sup> The patterns are similar for both “informed” enterprises (those who have actually been involved in court cases) and the enterprise group as a whole.



As described in a later section, a measure of the profitability of being a corrupt public official, and a measure of the pervasiveness of corruption within an organization, is the frequency that officials in that organization actually pay money for their positions. Public officials were surveyed about how pervasive the practice of paying money for jobs was, and customs topped the list – public officials estimated that 40 percent of customs officials buy their jobs. (See below, Figures 26 and 27)

The enterprise survey suggests that the level of corruption at border crossings is much higher than the level associated with obtaining licenses for exports and imports. Among informed enterprises, export-import licenses and permits require unofficial payments 10 percent of the time, while border crossings require unofficial payments 20 percent of the time.

This basic pattern holds up very strongly among various subsets of enterprises that are in the best position to evaluate how frequently trade-related bribes are required. According to the small subset of enterprises that actually obtained an import or export license in the year before the survey, bribes are required 9 percent of the time for licenses and 21 percent of the time for border crossings. According to a second small subset of enterprises whose primary market is international, bribes are required 5 percent of the time for licenses, and 24 percent of the time for border crossings. According to a third subset of enterprises who have imported or exported in the past two years, bribes are required 9 percent of the time for licenses, and 24 percent of the time for border crossings.

## TAXES

Enterprises everywhere dislike taxes. They dislike taxes even more when the quality of government services is poor, and dislike them the most when they feel their competitors are not paying. In the Latvia enterprise survey, these facts are very clear. The most important obstacle to doing business in Latvia, by a large margin, was cited to be that “taxes are too high”, followed by “complex tax administration and regulations.” (See Figure 14).

The complexity of taxation also forces enterprises to expend resources dealing with that complexity. The average enterprise spends nearly as many person-days dealing with taxes as with all other permits and regulations combined. The survey of enterprises found that the average enterprise employs six person days per month dealing with taxes. If one were to extrapolate to the entire private enterprise sector in Latvia, and value the time at the average wage, the result would be staggering: nearly 8 percent of GDP. This is an exaggeration, as the extrapolation is based on full-time employees and many enterprises may hire large numbers of part-timers, but the general point is clear. The complexity of tax administration and tax regulations requires the expenditure of large amounts of human resources.

Although enterprises dislike the levels of taxes and the bureaucracy of administration, a separate survey question found that they also strongly disliked the fact that unofficial competitors get away without paying taxes and thereby receive a competitive advantage. Twenty-two percent of enterprises thought the effect on competition was *worse* than the high rates or the bureaucracy, suggesting that this is a significant concern of enterprises. (See Figure 24)

The complaints that enterprises have about taxes raise concerns about the potential for corruption within the tax administration. First, the incentive for an enterprise to operate illegally is large. Second, honest enterprises suffer twice: once when they pay their taxes, get their licenses, etc., and again in the marketplace as illegal competitors can easily undercut margins. As operating illegally usually involves a degree of complicity with corrupt government officials, the gains to illegality may be closely tied to the levels of corruption. And even for enterprises that are operating officially within the tax system, there is great potential for mutually-beneficial arrangements between tax inspectors and enterprises (bribes to reduce the level of taxes).

Another reason for concern is the greater propensity to have paid bribes reported by enterprises that have received “direct subsidies and subsidized credits”, and the larger share of turnover paid in bribes by enterprises that have received “tax holidays or tax exemptions.” Subsidies, credits, and tax benefits all confer financial gains to enterprises and require discretionary action by public officials, and it is no surprise that such treatment is statistically associated with corruption.

Given the tremendous scope for corruption within tax administration, the survey evidence does not paint an entirely bad portrait of corruption within tax administration. In terms of the frequency with which relevant officials require unofficial payments, inspection by the tax authorities receives a relatively “low” score, some 6-10 percent of the time (Figure 5), and the level of unofficial payments does not seem to be a major concern of enterprises about the system of taxation (Figure 24). Tax clearance to participate in procurement requires unofficial payments somewhat more frequently, but relative to other enterprise-state interactions, the frequency is still fairly low (Figure 5). And while tax inspectors are still reported to have paid for their jobs some 26 percent of the time, this is far less than their revenue-generating cousins in the customs administration. (See below, Figures 26 and 27.)

## **POLICE**

The road police is one of the most problematic government organizations. Enterprises and households alike rate the traffic police as one of the organizations that demands bribes most frequently. According to enterprises that had contact with the road police, unofficial payments are required 30 – 35 percent of the time, higher than any other organization. A similar story was told by the household survey. Respondents with driver’s licenses and cars reported that 30 percent of the time they encounter traffic police, a bribe is suggested by the police officer. (See Figures 4 and 5.) As discussed in Section 6, two household characteristics that are significant in explaining which

households pay bribes (and how much) are whether or not the household has a car and whether the respondent has a driver's license. A larger portion of the bribe flow from households to public officials flows to the traffic police than to any other single organization. (Figure 11.) The problems with the traffic police are most severe in the case of traffic stops when, presumably, drivers have little choice but to pay the demanded bribe.

The ordinary police (criminal investigations) seem to be less tainted by corruption than the road police. While the frequency of bribe-taking by the police is high, the aggregate impact and the impact on the average household is much smaller than for the road police. (Figures 10 and 11.)

### THE CIVIL SERVICE

Most of this report has focused on corruption involving public officials on the one hand and enterprises or households on the other. In this section we examine the issue of corruption within the civil service itself, the degree to which public positions are awarded in exchange for bribes and the degree to which corrupt practices are condoned within organizations.

#### Buying Jobs

The practice of awarding civil service positions in exchange for bribes has direct implications for civil service reform – an efficient bureaucracy cannot stand for such practices – but it also has important implication for understanding how entrenched the system of corruption is. Some important research on corruption<sup>26</sup> suggests that the practice of awarding jobs in exchange for money ensures that maximal bribes will continue to be collected. Officials that have paid for jobs must extract bribes to earn a return on their investment; the ability to extract bribes in turn increases the benefits of the position and applicants willing to pay for the positions will win out over those not willing to pay. Paying for positions also may have the effect of legitimizing corruption in the minds of the civil servants that paid for their positions. Indeed, Latvian public officials believe all forms of corruption to be less damaging to society than do enterprises and households. (See Figure 17.)

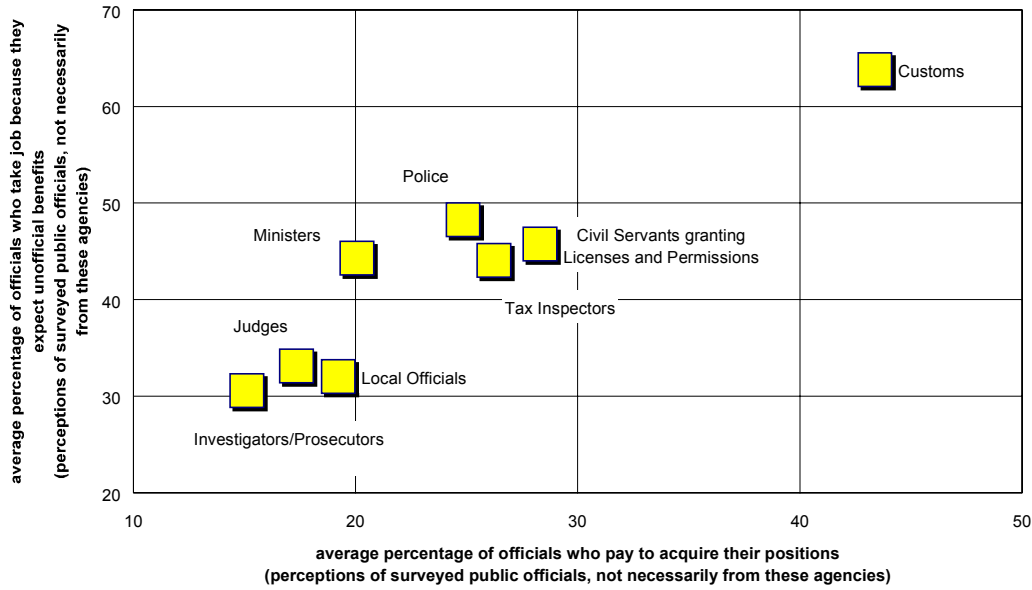
Figures 26 and 27 show that this vicious circle is alive in the Latvian civil service.<sup>27</sup> The organizations in which positions are bought most frequently are (a) the organizations for which officials usually take the job expecting unofficial benefits, and (b) the organizations that most frequently demand bribes. Estimates of the percentage of officials who pay to acquire their positions range from 15 percent for investigators and prosecutors to 43 percent for customs officials. The estimates of the percentage of

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<sup>26</sup> E.g., Shleifer and Vishny "Corruption" *Quarterly Journal of Economics* 1993, p. 604.

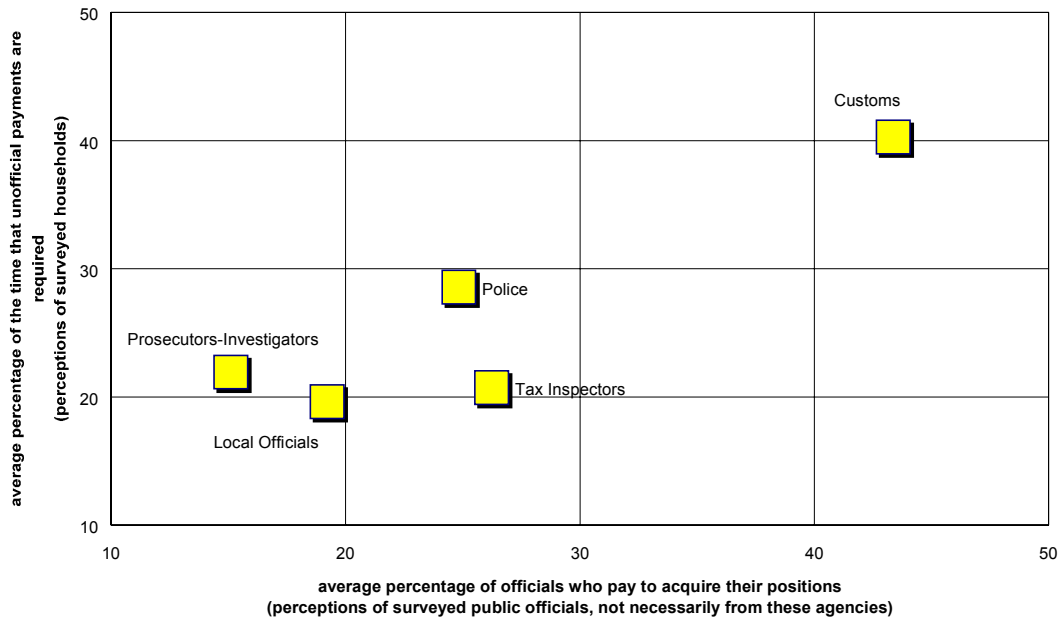
<sup>27</sup> The charts are based on surveys of public officials (expressing perceptions about all organizations, not just their own) and households.

**Figure 26.**  
**Buying Jobs for the Unofficial Benefits**



based on World Bank - Latvia Facts surveys of 218 public officials and 1,100 households in June 1998

**Figure 27. Buying Jobs and Extracting Bribes**



based on World Bank - Latvia Facts surveys of 218 public officials and 1,100 households in June 1998

officials who take jobs because they expect unofficial benefits are even higher, 31 percent for investigators and prosecutors, and 64 percent for customs officials.<sup>28</sup> Even very high-level officials are reported to engage in this practice – 20 percent of Ministers are said to buy their positions – a reminder of the importance of high-level corruption in Latvia. It should be noted that, as evident in Figure 6, public officials’ perceptions of how frequently jobs are awarded in exchange for money differs markedly from those of enterprises and households. Public officials believe that such practices occur much less frequently than enterprises or households.

### **Sharing Bribes**

Latvian public officials reported that when middle-level bureaucrats extract bribes, half share it with colleagues or supervisors. This is a worrying signal of entrenchment of corruption within the public sector. It is also a cause for concern about the effectiveness of an anti-corruption campaign. Superiors can not be counted on to discipline corrupt officials when the superiors themselves are benefiting, and colleagues can not be counted on to “blow the whistle” when they are benefiting, as well.

## **TENDERS AND AUCTIONS**

Sound public sector procurement and asset disposal practices are key to ensuring the efficient use of fiscal resources. Because of the large amounts of money that are frequently involved, public sector procurement provides great potential for corruption. Not only does corruption waste budgetary resources directly, it also reduces the quality of the assets or materials purchased with public money. In the longer run, a reputation for corruption in tenders and auctions reduces the pool of bidding companies to those that are willing to pay unofficially to secure the contracts or win auctions.

In Latvia, the evidence on corruption within public sector tenders and auctions is mixed. In the first instance, it appears that companies that bribe in their other activities are somewhat more likely to participate in tenders and auctions and are slightly more likely to win. Enterprises also rated Latvian government tenders and auctions as significantly “less fair” than those organized by private companies or by international organizations. (See Figure 28.) Problems with tenders and auctions appear to be reducing the pool of participants: Only sixteen percent of surveyed enterprises had participated in a tender or auction in the past two years, while 12 percent had considered participating but decided not to. In the second instance, the problems with public sector tenders and auctions appear to have less to do with direct corruption within the tenders and auctions themselves than with other inefficiencies. Among those who had declined to participate

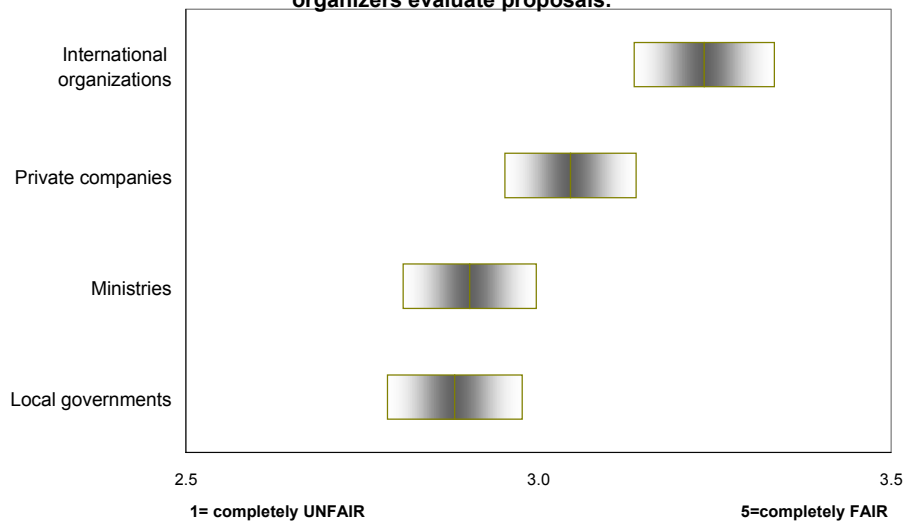
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<sup>28</sup> Surveyed public officials gave lower estimates for officials in their own positions, saying that only 8 percent pay to acquire their jobs, and only 16 percent take the jobs because they expect unofficial benefits. This could imply that their perceptions of corruption within other organizations is exaggerated or it could reflect their own fear of revealing the level of corruption within their own organization.

in a tender or auction,<sup>29</sup> the main reasons given are that sole source contracting is easier (with or without unofficial payments) and that competition is unfair, although the latter is probably a reference to corruption. (See Figure 29.) The apparent preference for sole source contracting, even if having to pay unofficially to win, may indicate that while public sector tenders and auctions are not without problems, sole source contracting is likewise beset with problems.

While corruption involving procurement and asset disposal are not the only reasons for the lack of faith in tenders and auctions, an improvement in the transparency and oversight of public sector tenders and auctions, coupled with requirements for strong justification for sole source contracting, will help ensure greater efficiency, greater competition, and better use of scarce budgetary funds.

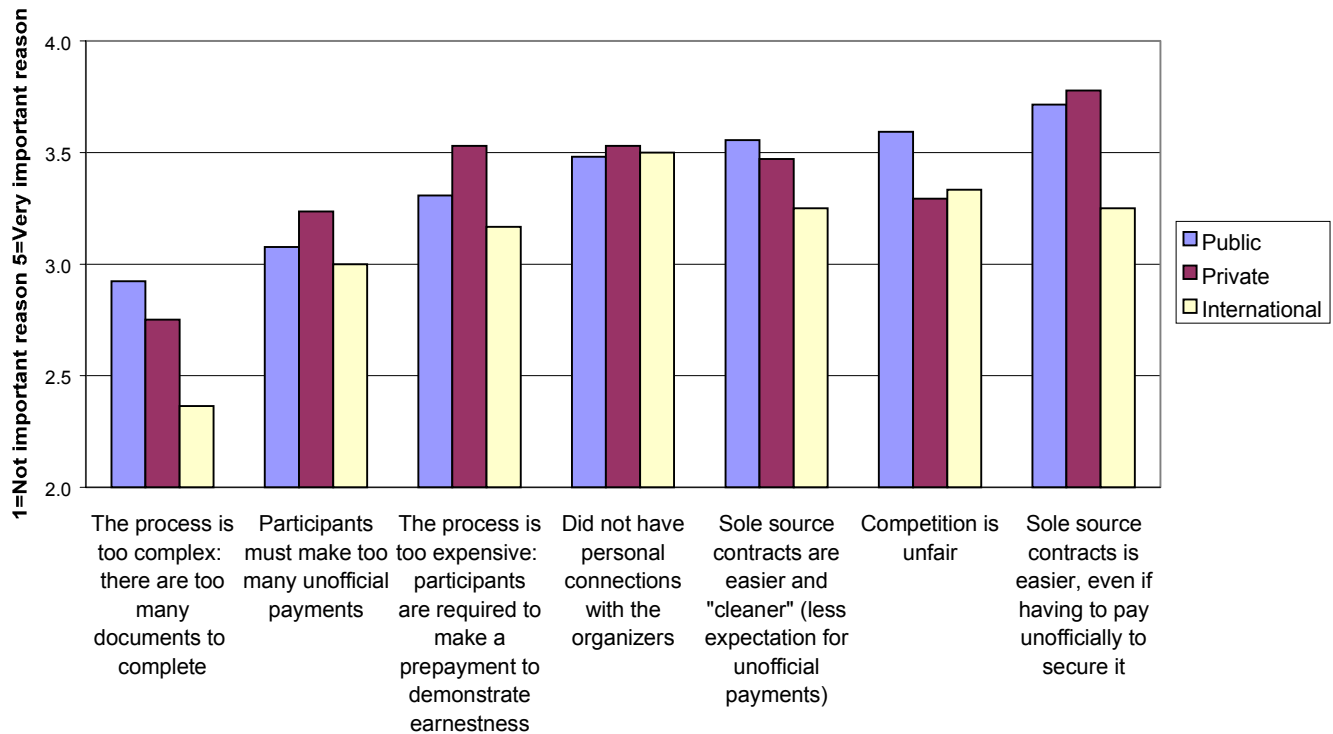
**Figure 28. "Please evaluate the fairness with which different tender organizers evaluate proposals."**



based on a World Bank - Latvia Facts survey of 438 enterprises in June 1998

<sup>29</sup> We are basing this section on the responses of enterprises that decided not to participate in a tender or auction in which they had otherwise planned to participate; we excluded the responses of enterprises for whom tenders and auctions are not relevant to their business.

**Figure 29. Reasons for Not Participating in Tenders and Auctions  
Opinions of Enterprises who did Not Participate**



based on a World Bank - Latvia Facts survey of 438 enterprises in June and July of 1998.

### IS CORRUPTION “NORMAL”?

The answer to this question is important for understanding how effectively an anti-corruption strategy could be implemented. Enterprises and households were asked whether they disagree or agree with the following statement: “a system whereby people could anonymously report instances of corruption would not be successful because corruption is a natural part of our lives and helps solve many problems.” Only 30 percent of enterprises and 37 percent of households disagreed with this statement, whereas 45 percent of enterprises and 43 percent of households agreed. Public officials told a similar story: over sixty percent of the time that a bribe is paid by an enterprise to a public official, it is not unilaterally initiated by either of the two parties; either both sides know in advance what is needed, or it has just been accepted as such a common practice that “there is no other way to accomplish what needs to be done.”

Although corruption seems to be accepted as “normal” by much of the population, the surveys suggest that the public perception may be worse than the reality. In the case of the judiciary, for example, households perceived that bribes were required 30 to 40 percent of the time (Figure 4), yet only 14 percent of the households that were involved in court cases actually received some indication that a bribe was desired. A perception that “everybody is doing it” can perpetuate the system of corruption. Publicizing the fact

that everybody is *not* involved in corruption could be an effective part of the education component of Latvia's anti-corruption campaign.

### **COMMITMENT OF THE GOVERNMENT TO FIGHT CORRUPTION**

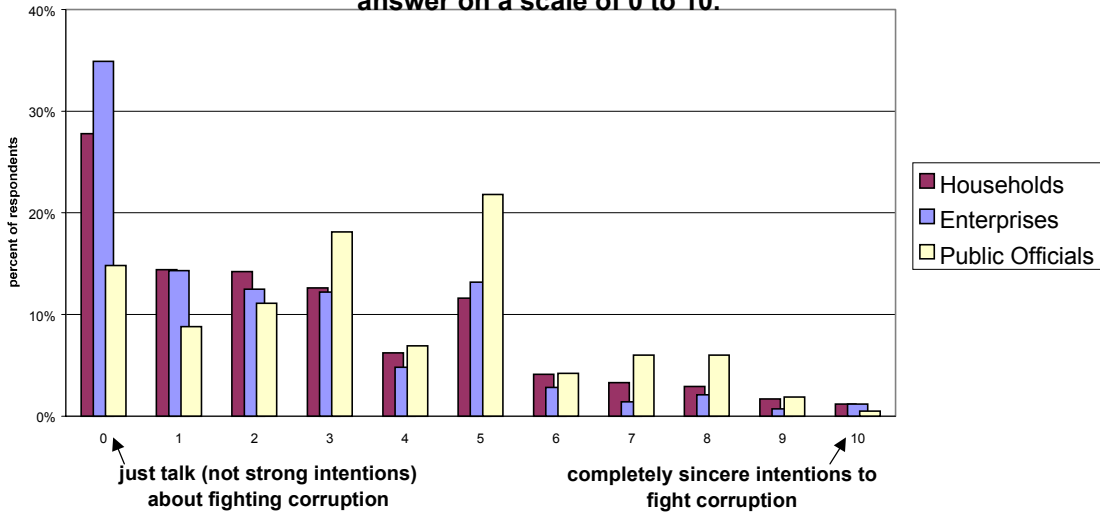
Explicit high level leadership and commitment to fight corruption are essential. Without true commitment from leadership, policy reforms will not be effectively implemented and the public's confidence in the anti-corruption effort will erode.

Whatever the true level of commitment on the part of leadership, the public does not seem to feel that the commitment of government in general is credible; households, enterprises and public officials made this clear when asked to evaluate their perceptions of how genuine the intention to fight corruption is. (See Figure 30.) On a scale of zero to ten, with zero indicating that there is absolutely no intention to fight corruption, and ten indicating a completely sincere intention to fight corruption, 35 percent of enterprises, 28 percent of households, and 15 percent of public officials gave scores of "zero", while only 1 percent of each group gave scores of ten.

While top level commitment is necessary for the success of the anti-corruption program, it also goes hand-in-hand with the public's confidence in the national government, as illustrated in Figure 33. The direction of causality is not clear but the strength of the relationship is – enterprises with a small degree of faith in the national government are also the most skeptical about the sincerity of the anti-corruption program. A sustained anti-corruption program may help solidify faith in the national government and strengthen the democratic process in Latvia.

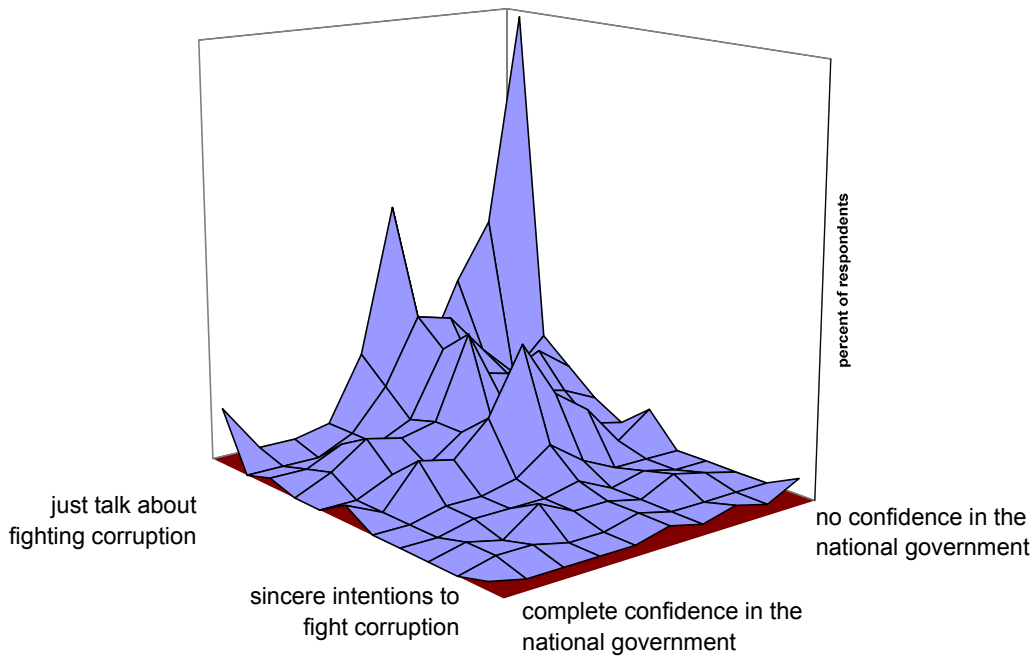


**Figure 30.**  
**"Do you perceive that there is a genuine sentiment among public officials or the government in order to combat corruption, or is it just a lot of talking to make the public think they are serious? Please answer on a scale of 0 to 10."**



based on World Bank -- Latvia Facts surveys of 438 enterprises, 1,100 households, and 218 public officials in June and July of 1998

**Figure 31. Confidence in the national government and sincerity of intentions to fight corruption**



based on a World Bank - Latvia Facts survey of 438 enterprises in June and July of 1998