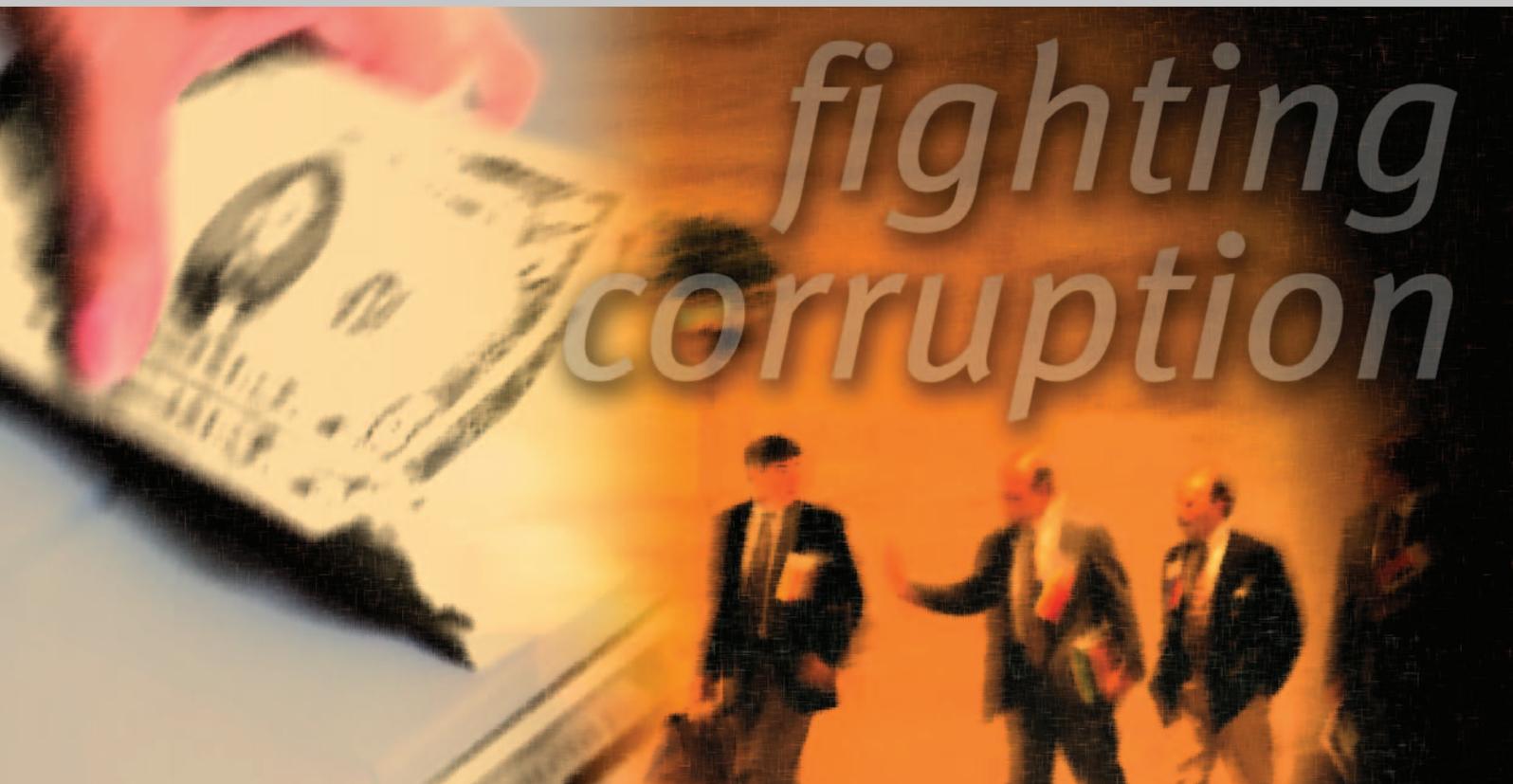


PROVIDING ANTI-CORRUPTION ASSISTANCE
TO SMALL BUSINESSES IN THE DEVELOPING WORLD

VOL I.



Corruption prevention
to foster small and medium-sized
enterprise development



UNITED NATIONS
INDUSTRIAL DEVELOPMENT ORGANIZATION



UNITED NATIONS
Office on Drugs and Crime

Corruption prevention to foster small and medium-sized enterprise development

Providing anti-corruption assistance
to small businesses in the developing world

Volume I.



Vienna, 2007

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Foreword

Corruption hurts all, but the pain is greatest among small and medium-sized enterprises (SMEs). They are usually the first to suffer in a marketplace where corruption exists. For reasons outlined in this report they are more vulnerable to corruption and, as a result, their profit margins and very survival are at stake when corruption takes hold. Since these companies are often the motor for development in societies vulnerable to poverty, the effects of corruption can be devastating.

To prevent corruption and foster the development of small and medium-sized enterprises, the United Nations Industrial Development Organization (UNIDO) and the United Nations Office on Drugs and Crime (UNODC) have joined forces to carry out this study, which looks at the nature and extent of the problem. This report is based on field-based assessments and a meeting of experts that discussed obstacles for SME development created by public and private sector corruption.

The next step will be to use these findings to draft practical guidelines to assist SMEs to strengthen their defences against corruption.

This project is a substantive outcome of a Cooperation Agreement entered into by UNIDO and UNODC in 2005. The Agreement is designed to establish a strategic partnership between both Organizations in order to improve their respective capacities to deliver technical assistance, carry out research and analysis, and assist countries in eliminating impediments to development.

Joint activities like this project contribute to strengthening the capacity of Member States of both Organizations to implement their commitment to support businesses to live up to the anti-corruption goals of the UN Global Compact, and give SMEs the tools to better cope with corruption. Thereby, this project assists business in a way that promotes economic and social welfare, reduces poverty and contributes to sustainable development—which is to the benefit of us all.



Kandeh K. Yumkella
Director-General, UNIDO



Antonio Maria Costa
Executive Director, UNODC

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INTRODUCTION

Corruption within and between public and private sectors has become one of the leading problems for businesses all over the world. The recent inclusion of an anti-corruption principle in the United Nations Global Compact, endorsed by more than 3,800 members, further emphasizes the ever-growing importance of the private sector in the global fight against corruption. Just to get an idea of the dimensions of corruption, it is worth mentioning that, according to the World Bank Institute, more than \$1 trillion dollars (US\$ 1,000 billion) are paid in bribes every year,¹ which means that each year the cost of corrupt activities is equal to a full 3 per cent of the world's gross domestic product.

Up until now, the primary focus of research both into the negative effects of corruption on the business community, and into methods of combating it, has been on large enterprises. The recent corporate scandals affecting business giants such as Enron or Parmalat have rocked financial markets and undermined investor confidence. As a result, they have received enormous attention from the general public and the media. However, it should be pointed out that of the 75 million companies existing across the globe, around 90 per cent are small and medium-sized enterprises (SMEs).²

No one doubts the importance of SMEs for long-term economic stability and the development of a functioning market economy, still less their labour absorption and job creation capacities. In particular, due to their very specific characteristics and the resulting constraints they must face, smaller business units are forced to make productive use of scarce resources, such as capital. As a result, they greatly contribute to the overall efficiency of domestic markets and to long-term economic welfare. SMEs are significant too for the positive role they play in the development of a favourable environment for innovation. Yet, despite the importance of SMEs, there has been little research into the issue of how to combat the effects of corruption on their development.

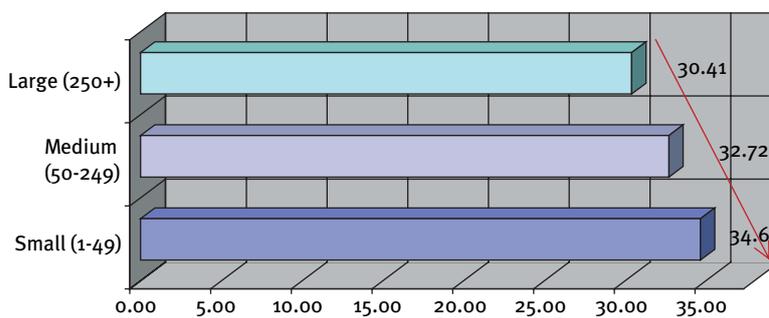
While corruption is detrimental to business for all types of company—large and small, multinational and local—it poses particular problems for smaller firms. Many factors influence the ability of entrepreneurs to set up and expand small businesses, such as financial issues, education, training, technology, access to information, property rights, infrastructure, and export possibilities, but corruption has been identified as a major obstacle to SME development. (see figure 1).

¹World Bank Institute (2004), The costs of corruption (article)

²Global Development Research Center, Resources for SMEs: www.gdrc.org/sustbiz/for-sme.html

Furthermore, it is also apparent that the problem is especially acute for SMEs located in the developing world and in countries in transition. According to the Business Environment and Enterprise Performance Survey (BEEPS), more than 70 per cent of SMEs in transition economies perceive corruption as an impediment to their business.³

Figure 1. Corruption perceived as a major business obstacle by SMEs and large companies (in per cent)



Source: World Bank, Investment Climate Survey.

It is clear that if SMEs were better able to cope with the corruption that they encounter, they would be in a much better position to fulfil their role with regard to the creation of economic and social welfare, and poverty reduction. In recognition of this fact, the United Nations Industrial Development Organization (UNIDO) and the United Nations Office on Drugs and Crime (UNODC) have initiated a Joint Project on Corruption Prevention to Foster SME Development. The project aims to begin the process of filling the knowledge gap, and to identify and implement the tools needed for SMEs to successfully defend themselves in a corrupt business environment.

This publication is part of the initial phase of the planned project activities, drawing on work coordinated by the UNODC Anti-Corruption Unit and the UNIDO Private Sector Development Branch. An important aspect of this work to-date was a meeting of experts, business representatives, and staff of relevant institutions, to discuss the obstacles for SME development created by public and private sector corruption, to identify successful corporate practices against corruption, and to develop tools tailored specifically to fit the needs of SMEs.⁴

The next phase of the project will be to conduct assessment missions and focus group meetings targeting SMEs in selected countries.

³WB/EBRD (2000), BEEPS, Question: How problematic is corruption in the business environment?

⁴The quotes highlighted in this paper were made by participants in this experts' group meeting that took place in March 2006 in Vienna, Austria.

BACKGROUND AND SUPPORTING UNITED NATIONS INITIATIVES

The United Nations Global Compact and its 10th Principle on Corruption

On 24 June 2004, at the UN Global Compact Leaders Summit, the addition of a 10th Principle against corruption was announced, sending the signal that the private sector shares responsibility for the challenges of eliminating corruption. Specifically, the principle states that “businesses should work against corruption in all its forms, including extortion and bribery” and joins the nine other principles promoting good corporate practices in the fields of human rights, labour and the environment.

The adoption of the 10th principle commits the more than 3,800 UN Global Compact participants not only to avoid bribery, extortion and other forms of corruption, but also to develop policies and concrete programmes to address these problems. When fighting corruption and implementing this principle, the members shall first of all introduce anti-corruption policies and programmes within their organizations and their business operations. In addition, they are also urged to report on their work against corruption in the annual “Communication on Progress”, and share experiences and best practices through the submission of examples and case stories. Furthermore, a collective approach is considered important, and it is suggested that members join forces with industry peers and other stakeholders.

The UN Global Compact strongly supports UNIDO’s and UNODC’s efforts to develop tools for SMEs in the area of anti-corruption, as more than 35 per cent of their participants are SMEs, many of which operate in the developing world.

The UN Global Compact has focused on the recommendation of tools for anti-corruption programmes and other measures to prevent corruption.⁵ In due course it will issue a collection of case studies of companies’ experiences related to internal implementation efforts. Furthermore, the UN Global Compact has already experimented with the approach of collective action for fighting corruption, using the network as a facilitator for national initiatives or dialogues around this issue.

⁵See joint publication with IBLF and TI, *Business against Corruption—A Framework for Action*

United Nations Convention against Corruption

The United Nations Convention against Corruption (UNCAC) was adopted by the General Assembly on the 31 October 2003 and entered into force on 14 December 2005. It is the first global legally binding instrument in that field which covers public and private, domestic and international corruption. The convention basically rests on four pillars: corruption prevention, law enforcement, international cooperation and asset recovery.

Preventive measures

This entire chapter requires State Parties to adopt measures to prevent corruption both in the public as well as private sectors, such as preventive policies and practices to combat corruption, including the establishment of anti-corruption bodies; safeguards that promote efficiency, transparency and recruitment based on merit; codes of conduct; enhanced transparency in the financing of election campaigns and political parties; and transparency and accountability in matters of public finance.

Article 12 in particular deals with preventive measures in the context of the private sector. Those include standards that provide transparency, clarifications of the operations of private entities and support of confidence in annual and other statements, and help to prevent as well as detect malpractices. State Parties are also required to take any necessary measures regarding the maintenance of books and records, financial statement disclosures and accounting and auditing standards, in order to prohibit the following acts:

- The establishment of off-the-books accounts
- The making of off-the-books or inadequately identified transactions
- The recording of non-existent expenditure
- The entry of liabilities with incorrect identification of their objects
- The use of false documents
- The intentional destruction of bookkeeping documents earlier than foreseen by law

Furthermore, States Parties are required to disallow the tax deductibility of expenses that constitute bribes and, where appropriate, other expenses incurred in furtherance of corrupt conduct. Effective, proportionate and dissuasive civil, administrative or criminal penalties shall be in place for failures to comply with those standards.

Criminalization and law enforcement

In this chapter, the Convention requires countries to establish criminal and other offences to cover a wide range of acts of corruption, if these are not already crimes under domestic law. The Convention goes beyond previous instruments of this kind, criminalizing not only basic forms of corruption such as bribery and the embezzlement

of public funds, but also trading in influence and the concealment and laundering of the proceeds of corruption. Offences committed in support of corruption, including money-laundering and obstruction of justice, are also dealt with.

In the context of the private sector, the Convention introduces active and as well as passive bribery, which is an important innovation compared to other international instruments. Beyond those offences, Article 22 urges State Parties to consider criminalizing, when committed intentionally, acts of embezzlement by persons who direct or work, in any capacity, in a private sector entity of any property, private funds or securities or anything of value entrusted to them by virtue of their position. This article aims to cover conduct exhausted within the private sector and which involves no contact with the public sector. Furthermore, article 26 of the Convention requires the establishment of liability of legal persons, which may be criminal, civil or administrative.

International cooperation

In this context, State Parties agreed to cooperate with one another in every aspect of the fight against corruption, including prevention, investigation and the prosecution of offenders. Countries are bound by the Convention to render specific forms of mutual legal assistance in gathering and transferring evidence for use in court and to extradite offenders. Furthermore they are required to undertake measures, which support the tracing, freezing, seizure and confiscation of the proceeds of corruption.

Asset recovery

Asset recovery, which constitutes a fundamental principle of this Convention, is a particularly important issue for many developing countries where high-level corruption has plundered the national wealth, and where resources are badly needed for reconstruction and the rehabilitation of societies under new governments. Several provisions of the Convention specify how cooperation and assistance will be rendered.

THE IMPACT OF CORRUPTION ON SME DEVELOPMENT

SME/Large business comparisons

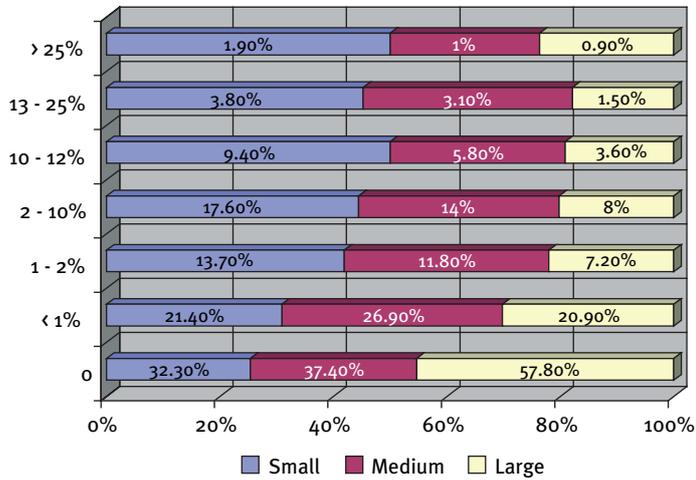
Available data strongly suggests that the smaller the firm is, the more likely it is to be affected by corruption. A country-specific example of this phenomenon is provided by a survey comparing the perceptions of corruption of small and large companies in the Philippines:

- More SMEs than larger businesses believe that corruption is “part of the way things work in the country”;
- In general, SMEs perceive corruption in the public as well as the private sector to be more pervasive than large companies;
- More SMEs than large enterprises state that they have been asked for bribes in order to obtain licences or permits from the local government and in relation to the payment of income tax;
- The majority of managers of SMEs are convinced that either all (26 per cent) or most companies (34 per cent) are involved in bribery to acquire government contracts (the respective percentages for large companies are only 17 per cent and 28 per cent).⁶

Figures from two different surveys show that SMEs pay much higher percentages of annual revenues in bribes to public officials (figure 2), and make additional payments to get things done much more frequently than large companies (figure 3).

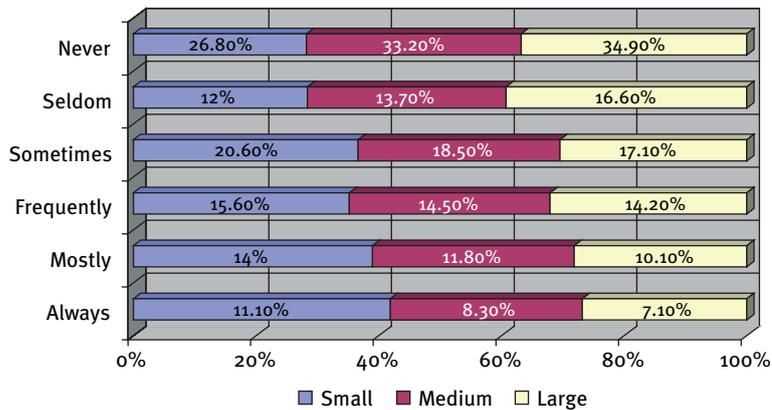
⁶Social Weather Stations (2000), Transparent Accountable Governance Project.

Figure 2. Percentage of revenues paid for bribes to public officials per annum



Source: WB/EBRD (2000), Business Environment and Enterprise Performance Survey

Figure 3. How often firms have to make additional payments to get things done



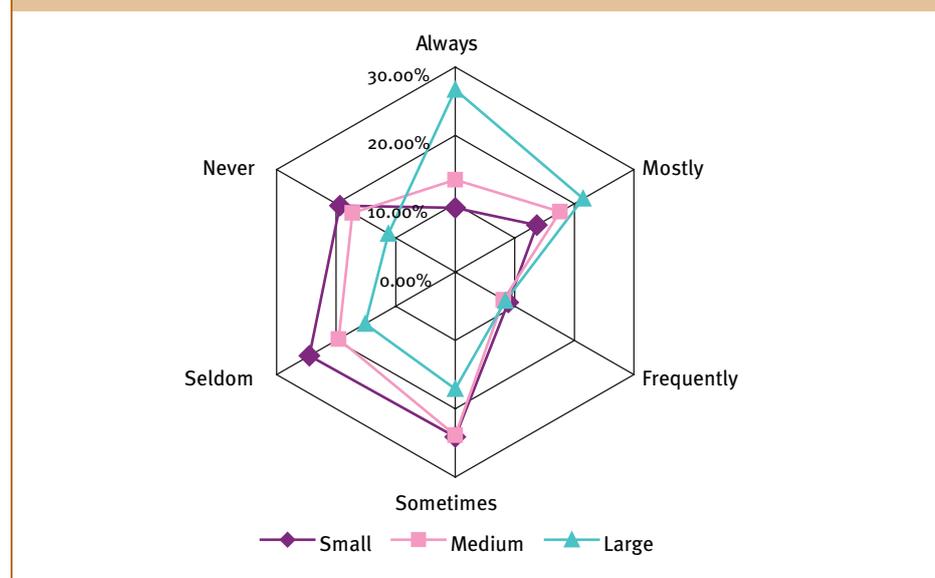
Source: World Bank, Investment Climate Surveys (ICS): <http://rru.worldbank.org/InvestmentClimate/>

In general, SMEs are more liable to be affected by corruption than large companies for the following reasons:

- *SMEs' structure*: Both the relatively greater degree of informality, and the closer relationships between staff in smaller companies, can create a culture where corruption is more easily tolerated.

- *SMEs' short-term vision and perspective:* Whereas larger companies have the capacity to look ahead and consider the long-term drawbacks of corrupt practice, it is a pronounced characteristic of the staff of many SMEs to only think about the present or very short-term future. Therefore, there is a tendency for SMEs to see the short-term benefits of corruption—in other words, they get what they pay for—and to not think about the hidden costs that will accumulate over time.
- *SMEs' limited financial resources:* Shortage of capital and smaller profit margins mean that SMEs in certain environments cannot always afford to refuse to pay bribes or other unofficial payments. The repercussions of refusing to engage in corrupt practices could put a SME out of business.
- *SMEs' inability to exert a strong influence over officials and/or institutions:* In comparison with larger companies, SMEs lack the bargaining power and influence to oppose requests for unofficial payments and similar solicitations, as they usually do not have strong ties and connections to higher bureaucrats or politicians. Consequently, corrupt officials do not have to fear much resistance or counteractions on the part of SMEs. For example, when a government official acts against the rules, the ability of a business manager to successfully appeal for the correct treatment without paying bribes depends to certain extent on the size of the firm and on its resulting influence (figure 4).
- *SMEs' capital structure:* Whereas larger companies are generally publicly quoted and are therefore dependent on the public perception of their prospects and are subject to even stricter stock exchange regulations, SMEs are often tightly held, without a clear line of separation between shareholders, management and board of directors.

Figure 4. Survey question



Source: WB/EBRD (2000), Business Environment and Enterprise Performance Survey

Note: If a government official acts against the rules, how often can you go to another official or his superior, to get the correct treatment without recourse to unofficial payments?

Forms of corruption affecting SME development

The most prevalent and well-known form of corruption affecting SMEs is bribery—the offering (accepting) to (by) a public official of any undue advantage in order that the official acts or refrains from acting in the exercise of his or her official duties. In this respect, SMEs are frequently faced with requests for additional payments for services they are entitled to anyway. Participants in the Expert Group Meeting highlighted the need to distinguish between acts of bribery that represent a burden to businesses, and those that are regarded as advantageous. For instance, a bribe provided with the aim of winning a contract, clearly represents an advantage or benefit to the entity paying it (at least in the short term), whereas an undue payment, required in order to get an electricity supply connection, is obviously a burden. This distinction was deemed important because the two types of transaction involve different incentives and disincentives, and different costs and benefits, and therefore have to be dealt with in different ways.

Bribery is not the only form of corruption that plays a major role in the sphere of SMEs. Embezzlement or misappropriation of funds by a company's own employees, extortion, fraud, nepotism,⁷ trading in influence, and protectionism, all have a significant *direct* influence. Unfortunately there is no data available comparing the relative importance or extent of these different forms of corruption with regard to SMEs. Establishing a clear picture of the extent of the problem is further complicated by the fact that, in developed as well as developing countries, SMEs are often involved in informal networks where favours, rather than cash, are exchanged.

Smaller businesses, in particular those situated in transitional states, also face corruption in the form of private enterprises paying bribes in order to change rules or legislation. The extent of this phenomenon in Mexico, for instance, is shown in a survey in which 20 per cent of the enterprises that took part indicated that they paid bribes to get laws changed (on average, they paid amounts equivalent to 6 per cent of annual income). Research suggests that it is larger companies rather than SMEs that are involved in this form of corruption, because they have the necessary bargaining power and resources to influence decisions at this level. Yet, even if SMEs are not as directly engaged in this kind of corrupt behaviour as their larger counterparts, they are still affected by its consequences.

A further point that was raised during the experts' group meeting is that in some countries corruption appears in combination with certain forms of organized crime. SMEs might therefore find themselves involved with a variety of corruption-crime related issues, making it difficult to single out and address the problem of corruption in isolation.

“Some SMEs see bribes as a percentage of an amount that they are expecting to get for offering goods and services. So they go to a public official and say ‘We know that if we are awarded this contract, then we will make a certain amount of money. So, make sure we get that contract and we’ll give you 5 per cent of that amount.’ The understanding is that there is a certain amount that will have to be paid as a bribe.”

Daisy Kambalame (African Institute of Corporate Citizenship, Malawi)

“Any discussion of corruption in business circles is a sensitive issue but especially when the subject is what can be called ‘state-hostage taking’. Many laws are made following interventions by business associations or big companies, and because of such interventions, you have a huge amount of exceptions from competition law.”

Jens Berthelsen
(Global Advice Network, Denmark)

⁷Nepotism is often defined as favouritism shown to relatives or close friends by those in power.

Parties engaging in corrupt transactions with SMEs

According to a series of interviews conducted with SME owners, the most damaging form of corruption for those businesses appears to be the “sale of rights granted by the government” (licences, permits, contracts, tax incentives or dispensations, etc.) by public officials for personal gain. In corrupt undertakings with public officials—which represent the party most frequently involved in corrupt transactions with SMEs—firms also pay to accelerate procedures, to evade laws and regulations—for example, social security and environmental regulations—and to avoid paying tax and customs charges. In some countries, corruption involving the police (extortion) constitutes a huge obstacle for SMEs in their business operations. Potentially, SMEs face corrupt conduct in all their interactions with the public sector when dealing with bureaucratic institutions at federal, regional and municipal/local level. However, in practice, smaller companies are mainly affected by the behaviour of local officials situated in their region. Even though there are huge differences between countries and among industry sectors, the crucial areas for small businesses when dealing with the corrupt requests of public sector officials are customs, licences, taxation, court cases and public procurement.

“Corruption is not exclusive to the public sector. We also find corruption within the private sector, in particular in relation to contractual relationships. This constitutes a huge problem for SMEs.”

Rachid Belkahia (Confédération Générale des Entreprises du Maroc, Morocco)

In addition to these purely public sector-related problems, SMEs also often face difficulties in the form of requests for unofficial payments from so-called natural monopolies or “network industries”. These are usually public services, such as the supply of electricity, water or gas, that are provided by private sector entities. SMEs cannot run their business without these services. SMEs are particularly vulnerable because, due to limited consumption, they lack bargaining power, and therefore have to play according to the rules imposed on them.

Furthermore, SMEs face problems of corruption when interacting with other private sector entities. Corrupt interactions occur within the private sector in terms of embezzlement by employees, and bribery or extortion of employees of larger companies in order to obtain contracts. Another example is corrupt bank officials who are often targeted to approve loans that do not meet basic financial criteria, and therefore cannot be collected later on.

When trying to identify the parties engaged in corrupt transactions with SMEs, it is also necessary to take middlemen into account, because companies do not always directly engage in acts of corruption with bureaucrats. One of the participants in the experts’ group meeting mentioned that marketing companies sometimes act as the bribe payers on behalf of SMEs.

Frequency of acts of corruption affecting SMEs

Available research data shows that corruption in the sphere of SMEs is not an exception. For example, a survey of SMEs in Croatia revealed that 86 per cent of the respondents had already faced corruption-related problems personally, as victims or as

witnesses.⁸ In another survey of SMEs in Mexico, 43 per cent of those that responded admitted that they frequently provided extra-official payments to public officials, and a further 35 per cent claimed they regularly made such payments.⁹

Data from the Business Environment and Enterprise Performance Survey (2000) shows that there is a difference according to firm size, meaning that the bigger the firm is, the less likely is it to be affected by corruption. Furthermore the European Social Survey¹⁰ revealed that self-employed entrepreneurs, or enterprises with no employees (e.g. accountants), are most vulnerable to corrupt practices because they lack the financial resources, the bargaining power and the networks and ties to national bureaucrats, to resist corruption.

When focusing on the frequency/prevalence of corruption, sector-specific differences are often regarded as important. According to the Bribe Payers Index published by Transparency International in 2002, the business sectors most frequently engaged in acts of corruption are public works and construction, arms and defence, oil and gas, real estate and property, telecommunications, power generation, mining, and transportation and storage. Companies operating in the forestry, IT, fishery, light manufacturing and agriculture sectors are seen as less affected.¹¹

One of the most damaging forms of corruption for SMEs is bureaucratic or administrative corruption, especially involving the public sector. Consequently, whether SMEs in one sector face more corruption than SMEs in another depends to a large degree on the extent to which the State controls or interferes in the respective sector. For example, although environmental legislation is currently a big issue in many transition countries, in some of them the legislation is simply not enforced, or environmental impact assessments are not compulsory. In such situations, there is then no need to bribe or influence environmental authorities. Such a course of action would only make sense in countries where the environmental authorities are really powerful and have an impact on SMEs.

Regulation is one of the key areas where the interests of business people and regulators stand in sharp contrast to each other, and as a consequence this is where many opportunities for corruption arise. The larger the amount or number of required procedures, the greater the opportunities for public officials to initiate, or respond to, acts of corruption, and the more likely it is that businesses will engage in corrupt practices in order to accelerate matters. Therefore, the likelihood of SME involvement in corruption increases in relation to the number of procedures required in order to do business in a certain sector. Another problem with complex bureaucratic procedures is that SMEs often simply don't have the time and/or the resources to inform themselves about all the necessary requirements. Consequently, they commit errors or make mistakes, and become easy and frequent targets for corruption.

"In general, one could say that globally there are these eight to ten sectors that are most frequently engaged in acts of corruption. But these sectors differ from country to country, depending on the size and the capacity of the State. One has to identify the differences between these various countries, as it is very much a discussion linked to the strength or weakness of the State, and the extent to which the State has intervened in a sector or sectors."

Jens Berthelsen
(Global Advice Network, Denmark)

⁸Kosanovic & Bussard (2001), *The Problem of Corruption in Small and Medium Enterprises in Croatia*

⁹Castillo & Ampudia (2005), *Diagnóstico sobre el Impacto del Fraude y Corrupción en las Pymes*

¹⁰Centre for Comparative Social Surveys, European Social Survey: www.europeansocialsurvey.org

¹¹Transparency International, Bribe Payers Index

However, it is not only the complexity of procedures that has a bearing on the frequency of corruption. One of the participants in the experts' group meeting pointed out that the number of people that are authorized to make a decision on certain matters is an equally important determining factor. The view is that if only one person is empowered to approve procedures, and if this person demands a bribe, then SMEs will be left with little alternative but to pay. A system where companies only have one person they can turn to is more vulnerable to corruption due to the fact that there are no controls by other officials, and it is easier for the one in charge to demand a bribe.

Reasons why SMEs engage in corruption

Among the commonly cited rationales for SMEs to turn to corrupt practices are concerns to maximize profit, to survive among competitors, to deal with bureaucracy and to establish themselves in new markets segments.

There is evidence¹² that the probability of engaging in corruption is linked both to the level of performance of a country's formal institutional infrastructure (legal system, courts, police, financial institutions, etc.), and to the prevailing norms of a country's informal institutions.

As far as formal institutions are concerned, data shows that SMEs make use of corrupt practices in order to take advantage of the perceived inadequacies of the infrastructure. There is a strong correlation between the probability of becoming engaged in corruption, and a lack of confidence in the judicial system. For example, if an SME manager anticipates that the risks of getting caught, prosecuted and sentenced are low, or if the entrepreneur doesn't believe that the judiciary will impose high costs even if a prosecution is made, then the likelihood of engaging in corrupt practices is high.

Engagement in corruption depends heavily on the costs and risks involved, and these differ from region to region. Corruption in business is an economic issue, and it will continue as long as the gains from corrupt behaviour exceed the expected losses that are, in turn, closely connected to the probability of being caught. Thus, the decisive issue in many cases is the cost-benefit ratio. In some geographical regions, corruption is more risky and therefore potentially expensive, while in others, the environment might facilitate engagement in corrupt undertakings.

The time factor is also an important determinant in this respect. Compliance with regulations and red tape at national, regional and municipal levels cause delays that, in turn, create financial costs. For SMEs, these costs are disproportionately high compared to those borne by larger companies. As a result, SMEs often resort to corrupt behaviour in order to speed up procedures, and thus reduce the cost of delays. Research data reveals that the more time needed to deal with bureaucracy and red tape, the higher the likelihood that SMEs will engage in corruption.

“Business ethics can be regarded as one of the important informal institutions. If SMEs perceive their business environment or competitors to be unfair, the likelihood of corruption is high. One SME manager might think, ‘If the others behave illegally, then I will have to too, if I am going to ensure my competitive advantage.’”

Vartuhi Tonoyan (Institute of Small Business Research, University of Mannheim, Germany)

¹²Tonoyan, Strohmeier, Habib and Perlitz (2006), *How Formal and Informal Institutions Shape Small Firm Behavior in Mature and Emerging Market Economies*

Empirical research also shows the importance of the availability of legal alternatives to bribes. If SME managers perceive their environment as wholly corrupt, and if they think that there are no legal alternatives for certain transactions, then the likelihood of them becoming involved in corruption is also high.

With regard to informal institutions, research shows that cultural values and social networks, trust towards friends and transaction partners to a certain extent explain differences in corruption engagement levels. Another side of the trust issue is that SMEs can develop corrupt relationships with bureaucrats over time, and come to find those bureaucrats to be “honest” bribe takers, that is, to deliver the services as agreed after having been paid a bribe.

The borderline between legal practices and corrupt ones is not always easy to define, and SMEs may not always have the capacity to distinguish between them. For instance, in some environments providing gifts in order to maintain good business relationships is common practice and allowed, while gifts that influence a decision are strictly forbidden. In general, there are many grey areas, and the variety of different customs and business practices from one region to another sometimes make it hard for businesses to distinguish between legal and illegal practices.

While it is clear that some SMEs, in some circumstances, make a voluntary choice about whether or not to engage in corrupt practices, it is also important to recognize other cases where SMEs have little or no choice. The most extreme example is when SMEs face extortion demands. More commonly, SMEs are convinced that corruption forms part of daily business and that it is not possible to survive without it. One possible explanation for this attitude could be the fact that in a region where corruption is endemic, SMEs that refuse to provide officials with additional payments, while most of their competitors do pay, will sooner or later face difficulties. For example, they will not get necessary permits and licences on time or even at all, they will not win public contracts, or they will not pass inspections or tests. As a result, the companies’ competitive position in the market will seriously decline. Experts stated that in the context where SMEs have—or perceive that they have—no other alternative but to respond positively to requests for bribes, the focus should be on ways to reduce the amount of corruption SMEs need to be involved in. Small companies should not be judged according to whether they are corrupt or not, but according to their efforts to reduce their involvement in corrupt behaviour.

“Everything that we have been discussing seems to be addressing corruption in relation to bribery—that is, where people have a choice whether to give or not to give. But in most parts of the developing world, corruption has moved from that level to a second level where people do not have an option. The rule of law, in most third world countries, is almost non-existent, and the structures of government and authority are rather weak.”

Alban Ofili-Okonkwo
(Aliban Group, Nigeria)

“Do SMEs have to engage in corruption in order to be competitive? There are no ‘Yes’ or ‘No’ answers. But what is clear is that it is always possible for the management to feel committed to reduce—not eliminate—the amount of corruption they need to be involved in. It is important not to see it so much in terms of whether you are corrupt or not, but to focus on whether you are moving away from corrupt behaviour towards transparent behaviour. It is always possible—regardless of the environment—to reduce involvement in corruption.”

Allan Bussard (Integra Foundation,
Slovakia)

Negative impacts of corruption on SME development

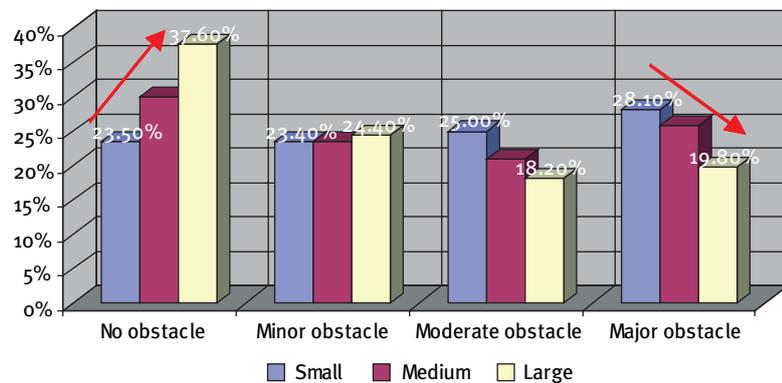
In a survey of SMEs in Mexico, more than 50 per cent of those interviewed saw their business severely negatively affected by corrupt practices (81 per cent referred to rising operating costs, 83 per cent to lost contracts, and 79 per cent to limited access to public procurement).¹³ With regard to the financial costs of corruption, data from the

¹³Castillo & Ampudia (2005), *Diagnóstico sobre el Impacto del Fraude y Corrupción en las Pymes*

BEEPS shows that about 53 per cent of all small businesses questioned said they paid up to 10 per cent of their revenues each year in unofficial payments to public officials. Fifteen per cent of them paid more than 10 per cent each year. (The respective figures for medium-sized enterprises are 53 per cent and 10 per cent, and for large enterprises 36 per cent and 6 per cent).

In assessing the impact of corruption on SMEs, participants in the experts' group meeting mentioned the importance of distinguishing between small stand-alone companies, and those that form part of a larger network or group of companies. The general perception is that the latter can often find it easier to afford the cost of engaging in corruption due to the financial backup provided by the larger company, or companies, that they are associated with. Furthermore, in terms of vulnerability to corruption, there are significant differences between national companies, foreign investment firms and state-owned enterprises, making it difficult to generalize about the problems SMEs face in this respect.

Figure 5. Corruption perceived as a problem in the business environment



Source: WB/EBRD (2000), Business Environment and Enterprise Performance Survey (BEEPS)

Acts of corruption also impose opportunity costs on small businesses. For example, a survey of SMEs in Hungary conducted by Gallup revealed that almost a quarter of the respondents had decided in the past not to make major investments because of the fear of having to pay bribes.¹⁴ Unfortunately, there is insufficient available data to identify to what extent corruption influences the decisions of SME managers to set up, expand, close down or to reinvest in their business, to look for customers abroad, to hire, dismiss and train workforce, to improve product quality, to invest in research and development, or to change location.

¹⁴Gallup Organization Hungary (2000), Corruption in the Sphere of Small and Medium-Type Private Enterprises

The author of a recent World Bank study stated that many businesses in the developing world prefer to operate in the informal economy because they do not want to get involved with the public sector.¹⁵ One reason for this is the financial cost of regulatory compliance and of dealing with bureaucratic obstacles. These costs are usually the same whatever the size of the business, and therefore, regulation at the federal, regional and municipal levels affects SMEs disproportionately. In other words, although the sums are the same, for the SMEs the costs represent a higher percentage of their profits than that paid by larger companies. In a legal and regulatory environment full of complex requirements, arbitrary decisions and frequent requests for bribes, companies are clearly discouraged from entering the formal sector, and formal sector firms might even be induced to “de-formalize” their operations.

In general, there is a lack of awareness among SMEs about the long-term hidden costs of corruption, such as sinking staff loyalty and retention, staff involvement in fraud, and damage to reliable supply chain relationships and investor confidence. SME managers are often unaware of these costs—that in the long term can be quite high—because of the short-term vision characterizing smaller businesses.

“One thing that we sometimes do not understand is the long-term effect of corruption. In the short run, companies might think that there is some corruption that might help them to be quicker and to be more flexible in the market. But in the long run, it will cost corrupt business people the same amount that they have saved, because of the negative consequences resulting from that behaviour, such as bad infrastructure.”

Lilia Carasciuc (Transparency International, Moldova)

¹⁵Djankov (2004), *Doing Business in 2005: Understanding Regulation*

TOOLS AND MEASURES (SUMMARY)

In the course of the two-day Expert Group Meeting on Small Business Development and Corruption, held in Vienna on 6-7 March, 2006, potential measures and tools were discussed to support smaller businesses to fight corruption in their business operations. Those include measures that are directed specifically at the SMEs themselves, and initiatives that need to be launched by other institutions tailored to the needs of small companies. This part of the publication will only provide an overview of the discussions that took place in this context and summarize the main aspects that arose. Detailed information will be provided in a separate document that will be published after a series of planned missions and focus group meetings on that particular topic in Colombia, Croatia, Indonesia and Malawi.

In general, private sector anti-corruption strategies are linked closely to corporate social responsibility (CSR) practices focusing on internal measures that are implemented by the individual company. However, when assessing appropriate tools for SMEs, the analysis provided in the first part of this publication clearly shows that more needs to be done in that respect. Even though internal measures are usually implemented more easily and quicker in SMEs than in large companies, internal codes of conduct and compliance programmes alone are in many cases not helpful for SMEs, as they usually lack either the resources or the market power to stand by their zero-tolerance policies. In particular, they risk being driven out of their market by competitors that do not adhere to such standards. One way to support those companies that do not have the power to tackle the problem alone is collective action.

Measures that need to be taken in order to enable SMEs to defend themselves in a better way when faced with corruption need to be taken at three levels, namely the micro, the meso and the macro level.

On the “**micro level**”, measures adjusting business practices to be applied internally by SMEs need to be addressed. Article 12 of the United Nations Convention against Corruption is specifically addressed to the private sector. It requires State Parties that take measures that prevent corruption involving the private sector, enhance accounting and auditing standards in the private sector and provide penalties for failure to comply with such measures. Such measures include, for instance, the development of standards and procedures designed to safeguard the integrity of companies, including codes of conduct promoting honourable business standards and the use of good commercial practices by contractual partners. The introduction of a code of conduct,

prohibiting all forms of corruption is the one of the main tools applied internally by companies in order to prevent and sanction corruption. Many large companies that are subject to greater public scrutiny have introduced some sets of ethical standards. However, the situation of SMEs seems to be quite different. Research findings reveal that in many cases smaller business units either do not feel comfortable introducing such codes, or do not expect any gains or advantages from doing so. One possible way of overcoming those problems could be the promotion of a code of conduct within a business association or an industry sector, instead of focusing on individual companies. This approach ensures that firms will not face competitive disadvantages when they no longer engage in corruption. Furthermore, by having a whole sector complying with certain standards, the impact on the business environment will be much greater.

Apart from codes of conduct, training employees was identified as an important measure for effective anti-corruption prevention to be introduced on the micro level. The drawback for smaller companies is that they lack the financial resources that often do not allow them to develop appropriate training materials, and face time constraints that prevent the conduct of regular training in an effective manner. For that reason, other institutions such as business associations, chambers of commerce or NGOs could play an important role in facilitating that process.

Another tool to detect, and thus help deter, corrupt conduct is an appropriate reporting mechanism, for example, a telephone hotline that allows reports to be made anonymously. Available toolkits recommend that companies set up such a facility, which may be internally staffed or outsourced to a service provider. However for smaller outfits this may not be practical or appropriate. Where there are a small number of employees working for a SME, and a relatively high degree of informality exists, anonymity might be difficult to guarantee. A further difficulty is that contracting a professional service provider for this purpose is often prohibitively expensive. These problems can be overcome if the task is fulfilled by an independent agency.

In addition to that, the setting up of human resources policies that adequately reward ethical behaviour and appropriately sanction corrupt conduct was mentioned in this context. Other measures to be introduced by SMEs include internal accountability and controls, financial recording and auditing, as well as external accountability requiring the public disclosure of information, so that watchdog groups and the media can monitor this information and complain in case of irregularities (compare with Article 12/2 UNCAC).

On the so-called **“meso level”**, the involvement of other institutions and organizations in the public and private sectors is of particular importance to the success of anti-corruption efforts in the sphere of SMEs, as these businesses typically face a variety of human, financial and managerial resource constraints. Apart from that, taking into consideration the fear of SMEs in certain regions of facing severe disadvantages in a corrupt environment if they decide not to engage in acts of corruption, the active involvement of other bodies as well as collective approaches are essential.

Business associations that bring together SMEs of a certain geographical region or business sector can support the anti-corruption initiatives launched by those

enterprises and compliment them. One of the most important ways that such associations can support SMEs is by acting as a focal point for, and a channel and coordinator of, collective action. They can also serve as platforms that reach agreements, make commitments to ethical standards, monitor adherence and carry out other joint actions to prevent corrupt practices. Furthermore, business associations can also assist SMEs by collecting information on reported acts of corruption, and establishing a complaints board for different industry sectors. The establishment of help-desks, giving advice to companies on specific cases or situations, is another option. In addition to organizing and facilitating collective action, business associations in some countries have launched forms of corporate citizenship awards for different firm categories in recognition of ethical business conduct and anti-corruption compliance. If linked to certain incentives—for example, easier access to financing—they can demonstrate an excellent business case. In some cases, some of the above-mentioned tasks might be carried out by trade unions instead of business associations. It may well be that in certain countries, and on certain issues, unions will have more influence and power, and can consequently achieve greater impact.

Non-governmental organizations (NGOs) can also assist SMEs to combat corruption by conducting research, publishing information, educating businesses, raising awareness, and by taking on certain tasks suggested for business associations above. The usefulness of NGOs in this respect usually depends on the strength of the respective NGO, and the level of trust that it commands in the business world.

In terms of improving business processes and ethics, encouraging entrepreneurship and promoting sustainable business growth, there are numerous examples of successful partnerships between SMEs and multinational companies, in particular those forming part of the UN Global Compact network. In the context of assisting SMEs to combat corruption, these relationships can be enhanced in a variety of ways. Bearing in mind that the business case is one of the most important elements of any anti-corruption strategy for SMEs, some kinds of imposed compliance standards might work quite well with smaller companies if their supply chain partners—in many cases their main customers—demand adherence to these standards as a condition for doing business with them. By including a special clause in business contracts, allowing for the ending of the contractual relationship in cases where the company (SME) or its senior management was found guilty of corruption, is another option. Furthermore, larger companies need to monitor their own employees, in particular in their dealings with contractors. Direct assistance can also be provided to SME subcontractors, by inviting their staff to attend ethics trainings for the employees in large enterprises. In addition to requiring certain forms of ethical conduct, larger companies can also assist SMEs in their individual corruption-related problems by utilizing their greater bargaining power and making themselves heard by the government. In particular, large multinationals that have invested a lot in a certain geographical region are good partners in this respect.

Access to finance is one of the most severe problems that SMEs face, particularly in the developing world. If financial institutions linked anti-corruption compliance to certain incentives in terms of financing, it would create an excellent business case. One possible support initiative would be to offer better loan conditions for companies that apply

certain ethical standards. Another would be to provide special credit facilities for SMEs that have launched legal proceedings in corruption cases in order to help minimize resulting losses or damage to businesses due to extensive delays.

Trade chambers were also identified as important players that could assist SMEs in their fight against corruption, for instance, by educating them in particular on the long-term costs of corruption, and help them to balance those against the short-term temporal gains that might arise. Sometimes chambers of commerce are assigned similar responsibilities and tasks as business associations. However, it should be borne in mind that such chambers are usually involved to some extent in national politics, and therefore might not be the right bodies to implement some of the already identified anti-corruption tools.

In a variety of surveys, SMEs have indicated that non-transparent laws and regulations, the inefficiency of courts, and a lack of transparency in public procurement systems and government spending, are the main factors that make corruption possible and create obstacles to the success of their business. Therefore the aforementioned initiatives that SMEs can take individually and collectively cannot replace or substitute a government's responsibility to create a clean business environment and an incorruptible public sector "**macro level**". Improving the business environment for SMEs requires a complex interplay between corporate and government action, and the creation of effective partnerships between the public and the private sector. Frequently mentioned public sector tools to prevent and control corruption include an effective legal and regulatory framework and social policies, enhanced transparency and accountability, and the elimination of government-created barriers that foster cultures of rent seeking.

While improvements in the fight against corruption at a national level will help businesses of all sizes, there are measures that can be taken that have particular relevance to SMEs. For example, certain funds could be made available in order to allow small businesses to go to court and claim damages caused by corrupt practices involving public officials. In cases when SMEs suffer financial or other economic damage as a result of acts of corruption, measures need to be taken to ensure that they have the right to initiate legal proceedings against those responsible for that damage in order to obtain compensation (UNCAC Art. 35). These and other similar measures that assist SMEs in funding matters constitute an incentive to SMEs to actually use the existing mechanisms in the justice system. Furthermore, it is important that appropriate measures to provide protection against any unjustified treatment for persons who report acts of corruption are in place, as foreseen in Art. 33 of the UNCAC. In this context immunities from criminal action in case of self-incrimination could be considered to encourage reporting of corrupt activities (UNCAC Art. 37).

Another common problem is the fact that in many cases SMEs are not even aware of the legal framework for dealing directly or indirectly with corruption in their respective country. SMEs frequently face difficulties in accessing information on relevant legislation and in tracking amendments and changes of laws and regulations. In addition, smaller companies might not have the necessary know-how to be either able to

interpret such legal texts correctly, or to make use of them when faced with acts of corruption. In order to increase awareness among SMEs in this respect, business associations, NGOs and other bodies that have better access to companies, can help by filtering the information and delivering it to them. Simple and accessible legal guides dealing with relevant issues that affect SMEs can also be made available. Furthermore, special consulting services should be provided to small businesses concerning anti-corruption law, and ways to report cases of corruption, to initiate legal proceedings, and to claim damages. The cooperation between the private sector and national authorities in general is of utmost importance, also in terms of reporting acts of corruption to national investigating and prosecuting authorities (UNCAC Art. 39).

Public procurement is widely seen as an area that provides fertile ground for corruption. A decrease of corrupt practices in public procurement would particularly benefit SMEs because in a corrupt system they cannot compete with large companies, even if they fulfil all the technical requirements. Article 9 of the United Nations Convention against Corruption deals with this issue. It requires State Parties to take measures to establish appropriate systems of procurement, based on transparency, competition and objective criteria in decision-making, that effectively prevent corruption.

Another subject mentioned was the role of the media in terms of awareness raising. SMEs are usually not granted as much attention by the media as larger companies, and this affects the behaviour of those firms and that of public officials towards them. The media cannot just play an important role when it comes to increasing the risk of getting caught for those engaged in corruption. It can also help with raising awareness and promoting good business practices. The most important moves would be to increase coverage of SMEs in general, and to cooperate with business associations and other institutions in terms of promoting their efforts.

Due to the fact that a multi-stakeholder approach is required in order to have a positive impact on SMEs' efforts to combat corruption, there is a need for coordination in order to avoid a duplication of efforts. The role of UNODC and UNIDO could be seen in supporting relevant institutions, organizations and set-ups that are lobbying to change the environment SMEs are operating in and to assist SMEs to cope with corruption by facilitating and encouraging collective action to take place in an organized and efficient manner.

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UNITED NATIONS
Office on Drugs and Crime

Vienna International Centre, P.O. Box 500, 1400 Vienna, Austria
Telephone: (+43-1) 26060-0, Fax: (+43-1) 26060-5866
E-mail: unodc@unodc.org, Internet: <http://www.unodc.org>



UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna International Centre, P.O. Box 300, 1400 Vienna, Austria
Telephone: (+43-1) 26026-0, Fax: (+43-1) 26926-69
E-mail: unido@unido.org, Internet: <http://www.unido.org>