Side Payments

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When two parties involved in a transaction exchange money that is not part of the transaction itself, the exchange is a *side payment.* It is typically made to induce the recipient to take part in the transaction.

The most notorious side payments are kickbacks and other types of bribes, but side payments can take many forms, some perfectly legitimate. For example, if several countries join a pact to reduce air pollution, a downwind country that has the most to gain from clean air may make a side payment to an upwind country to give it some incentive to participate in what would otherwise be a losing proposition.

Kickbacks and Commissions

Side payments raise ethical questions when they create conflicts of interest or provide incentives to break the rules. The classic example is a purchasing agent for a firm who receives a *kickback* from a vendor selected by the agent. The vendor "kicks back" to the agent some of the profits gained from the purchasing contract. This normally creates a conflict of interest, because it is in the firm's interest to award the contract to the most attractive bidder, while it is in the agent's personal interest to award it to the firm that will provide a kickback.

Kickbacks should not be confused with commissions. Someone who hires an agent, broker, or salesperson may pay that person a *commission* for services rendered. The purchasing agent's kickback is not a commission because it is paid by someone other than the party that hired the agent. Commissions normally do not create conflicts of interest but can do so in some circumstances. Real estate agents, for example, typically receive a fixed percentage of the sales price as commission. This may create a conflict of interest for an agent hired by the buyer, since it provides an incentive to negotiate a higher price than necessary.

There are several related types of payments that may or may not create conflicts of interest. An attorney who refers a potential client to a second lawyer may receive a *referral fee* from the second lawyer. This is not a side payment because it is not external to another transaction involving the lawyers, and there is no obvious conflict of interest. Financial advisors (or, more frequently, the banks that employ them) may receive a *retrocession payment* from a mutual fund when the advisor's client buys shares of that fund. This is a side payment but is not identical to a kickback since it normally goes to the bank rather than an individual. It can create a conflict of interest, however, since the bank may give its advisors incentives to recommend funds that pay retrocession.

Bribes, Extortion, and Facilitating Payments

A *bribe* is a payment that is intended to influence the recipient to make a decision that is not in accord with normally accepted criteria for making the decision. A kickback is a particular kind of bribe. Examples of bribes include payments to police offers to induce them to overlook a violation of law, or payments to government officials to obtain a more favorable ruling in tax negotiation. (The former can be viewed as a side payment because it takes place alongside a legal, albeit not a financial, transaction.)

Bribery can be distinguished from *extortion*, which is a payment demanded for something to which one is already entitled. A side payment demanded by an electrical inspector for a permit is an extortion payment when the wiring already meets code specifications. The same is true of payments to police officers who would otherwise report a more serious offense than actually committed, or customs inspectors who would otherwise indefinitely delay importation of legal goods. Small or routine extortion payments are often called *facilitating payments*. In many countries government functionaries are paid impossibly low salaries and are expected to make up the difference by collecting such facilitating payments.

The U.S. Foreign Corrupt Practices Act makes similar distinctions when it forbids U.S. citizens from bribing foreign government officials while permitting extortion payments and facilitating payments. However, the distinctions made here are not intended to correspond precisely with legal definitions.

It is sometimes unclear when gifts or entertainment should be treated as bribes, as when a potential vendor treats a purchasing agent to dinner at an expensive restaurant. Many companies bar their employees from accepting gifts valued at more than a certain amount or bearing no company logo.

Side Payments and Corruption

Bribes and kickbacks can be viewed as corrupting in the sense that they tend to undermine social norms or an economic system. Bribes can distract decision makers from their duty, and kickbacks may encourage agents to make economically inefficient decisions. However, many practices around the world that appear to be bribery, particularly to Westerner observers, may not be corrupting.

One example is the exchange of favors for the purpose of building a long-term relationship. This type of relationship is important in China, for example, where it is known as *guānxì* (a Mandarin Chinese word for "connection" or "relationship"). The gifts and favors are not quid pro quo and are therefore not bribes. Far from being corrupt, they build long-term, stable working relationships that are essential in a culture where mutual trust is historically more important than rules and transparency. Relationship-based business need not create conflicts of interest as it often does in the West. A purchasing agent may favor his friends, but since long-term relationships are the foundation of business, it may be in the company's interest for its agents do business with people they trust personally.

In much of the world, gifts may be culturally required to show courtesy, respect, or gratitude. It is important to know when gifts are appropriate so that they are not misinterpreted as bribes. Lavish entertainment may be a way of showing hospitality, which is a central value in many cultures.

Bribery is generally corrupting in both rule-based and relationship-based systems, but for different reasons. While bribery in the former encourages people to break the rules, bribery in the latter undermines the long-term and stable relationships on which a successful relationship-based economy depends. Bribery tends to be more common in relationship-based systems, since there is a constant temptation to take short cuts around the hard work of building mutual trust. Yet this should not be read as a signal that bribery is acceptable, just as prevalent cheating on such matters as income taxes in the West is no indication that that cheating is acceptable.

Further Reading and References

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