


The
**Institutional Economics
of Corruption and Reform**

Theory, Evidence and Policy



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CAMBRIDGE



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Acknowledgements

This book is a twelve-year project, combining research efforts since 1994. At an early stage, some parts of it became highly prominent: The Corruption Perceptions Index, which was designed in 1995 and is compiled under my leadership at the University of Passau since then, on behalf of Transparency International. This index was not predominantly designed to serve as a tool for alerting politics and the public at large. Its initial aim was to serve as a starting point for academic research. Considerable progress has been made on this front of research since then – the empirical investigations reviewed here provide evidence on this.

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University of Passau, October 06

A road map to this book

Those who are willing to carry out corrupt acts lose the capacity to commit to honesty. This is the core argument developed and exploited in this book. Corrupt actors can neither commit to honestly serving the public nor credibly promise reciprocity to their corrupt counterparts. This thought is at the center of understanding the disastrous economic and social consequences of corruption. At the same time, this concept deserves to be placed at the center of reform. Bribe-takers and bribe-givers have a schizophrenic relationship to honesty. They betray their superiors and the public but attempt to signal reciprocity to each other – and often fail in doing so. A strategy for reform must exploit this failure. The Achilles' heel of corrupt transactions is that a briber often does not know what he will get in return. This is a crucial weakness of those who are willing to engage in corrupt transactions. Anticorruption can therefore take the tactic of a judo-fighter – someone who exploits his opponents' weaknesses.

The power of economic thinking started with the concept of the invisible hand. Competition substituted for benevolence by guiding self-seeking actors to serve the public. With respect to fighting corruption we do not have such a powerful mechanism. If something comes close to it, it is the corrupt actor's capacity to betray each other. This betrayal is a good thing. I call this the principle of the invisible foot.¹ The willingness to take bribes works against the corrupt actors. Anticipating this, even self-seeking individuals may have reason to commit to honesty rather than seek opportunities for bribes.

This book does not provide readers with recipes on how to fight corruption. Instead of designing a toolbox it rather presents a methodological approach that, I hope, will inspire anticorruption in the

¹ This term was originally invented by Brock and Magee (1984). They used the term to indicate welfare losses arising in rent-seeking competition. My usage is different here.

future. This is repeatedly supported by cases and examples. Chapter 1 presents methodological and quantitative details. How is corruption defined, how is it measured? Why did some older guiding principles for anticorruption fail? I argue that corruption is not eliminated by fighting on a different battleground, such as reducing government, decentralizing public decision-making, privatizing public property, or enhancing competition. Corruption is a genuinely new challenge that requires novel answers. The invisible hand of competition brings about good markets but not good governance. This is shown in Chapter 1.

Chapter 2 surveys some empirical evidence on anticorruption, including its sometimes poor performance, and starts to present the core concept of this book. Having dismissed many alternative approaches to fighting corruption, the principle of the invisible foot is elaborated.

Chapters 3 and 4 explore that the corrupt actors' lack of commitment to honesty is at the core of the welfare losses of corruption. In Chapter 3, this idea is developed for bribe-taking bureaucrats. There should be no doubt that bribe-taking is often a utility-maximizing strategy of a self-seeking bureaucrat. But the downside of one's willingness to take bribes is that such actors disqualify for professions where their commitment would be vital.

A similar thought arises for heads of government, as explored in Chapter 4. They might transfer public funds into their private pockets. But they are not trusted by investors if they disrespect law. The advantage from bribery turns against its actors. This is at the core of understanding the social costs of grand corruption, the type of corruption that takes place higher up in hierarchy.

Chapters 3 and 4 at the same time provide readers with an up-to-date assessment of research, both empirical and theoretical. Such an assessment is also provided in the various boxes of this book, which allow readers to obtain a quick grasp of empirical research. I hope such details do not distract readers from the core message of the book. There is a multitude of social costs invoked by corruption. This ascertains that we cannot avoid the negative consequences of corruption but must fight corruption itself. We are given no alternative but to devote our efforts to reducing corruption.

Chapter 5 asks whether we should facilitate or impede corruption. The answer appears straightforward in favor of the latter option.

But we must note that the traditional rent-seeking theory argued differently. It opted in favor of facilitated corruption because otherwise competition for preferential treatment would waste resources for lobbyism, engaging lawyers for lawsuits, or harassing politicians with public campaigns. I show that this conclusion is misguided – our effort must be directed toward increasing the transaction costs of corruption.

Chapter 6 shows how in practice corrupt actors attempt to secure reciprocity. This chapter might be misunderstood as a how-to-bribe guide for criminal actors. But learning how to arrange bribes is a fruitful starting point for reform. We must understand our enemies if we want to defeat them. We must understand corrupt actors' temptation to betray each other in order to encourage precisely this behavior.

Chapter 7 brings our thought to the international arena. The invisible hand of competition brings about good markets. But does it destroy good governance? This proposition, fortunately, would take things too far. The reason for ethics to survive market pressures relates to the skills required in corrupt transactions. I address this topic by raising an empirical question: do differences in skills affect trade? Are some exporters advantaged in entering corrupt markets? The answer is a clear yes. The skill of bribery is at the core of understanding some remarkable differences in trade patterns of large exporting nations. Ethical behavior can survive market pressure. Whereas some actors may refrain from corruption owing to moral concerns, others are simply untalented. One application of this finding relates to corrupt intermediaries. These offer expertise on corrupt transactions to the untalented. Certification should be offered to those intermediaries who are willing to commit to anticorruption.

Chapter 8 picks up the international perspective of Chapter 7 and confronts it with a challenging position. While I claim that transaction costs of corruption should be increased we hear investors complain about the unpredictability of corruption. Should we prefer corruption to be predictable? Is reliability and reciprocity always a good thing? This is not an academic debate. Politics is often involved in guaranteeing international reciprocity even when corruption was involved. I argue that this practice must be stopped. The unpredictability of corruption is precisely what may put an end to it. We must make sure that corruption remains a risky and capricious activity.

Chapter 9 brings us back to the question of how corrupt actors reciprocate. It shows that corrupt transactions are often embedded in regular, legal business transactions. These transactions can provide the breeding ground by establishing the trust and the reciprocity necessary to engage in illegal deals. This chapter is crucial for understanding that there is no “corrupt marketplace.” There is hardly ever a given demand for corrupt services and supply of such, with a going rate for bribery being determined in equilibrium. Corruption is restricted to insiders with established links. Corruption is open only to those who exploit long-standing relationships for a criminal career.

Chapter 10 summarizes. Other guiding principles for anticorruption such as repression, prevention, or transparency may run out of steam. The principle of the invisible foot should be at the core of anticorruption and provide future inspiration. A plethora of building blocks can emanate from this principle; this book does not try to be exhaustive in this regard. One focus that deserves recognition is the design of the legal system. Penalties may mark the starting point of a corrupt career. An asymmetric design of penalties may avoid this problem and inhibit corrupt reciprocity. This is only an example for the overarching principle of the invisible foot. To state it again: corrupt actors can neither commit to honestly serving the public nor credibly promise reciprocity to their corrupt counterparts. Reform is about exploiting this handicap.

Contents

<i>List of boxes</i>	<i>page viii</i>
<i>Acknowledgements</i>	<i>ix</i>
<i>A roadmap to this book</i>	<i>xi</i>
1 Introduction	1
2 Enemies of corruption	27
3 What is bad about bureaucratic corruption? An institutional economic approach	58
4 The dilemma of the kleptocrat: What is bad about political corruption?	81
5 Corruption and transactions costs: The rent-seeking perspective	109
6 Making corrupt deals: contracting in the shadow of the law	136
7 Exporters' ethics and the art of bribery	164
8 How confidence facilitates illegal transactions: An empirical approach	190
9 Corrupt relational contracting	209
10 Concluding thoughts	225
Appendix: Technical details to the Transparency International Corruption Perceptions Index	236
<i>References</i>	<i>256</i>
<i>Subject index</i>	<i>282</i>

List of boxes

Box 1	Corruption and the size of the public sector	<i>page</i> 4
Box 2	Corruption and decentralization	6
Box 3	Corruption and regulatory quality	10
Box 4	Corruption and competition among private firms	12
Box 5	Sources of the 2005 Corruption Perceptions Index	21
Box 6	Corruption and trust	29
Box 7	Corruption, values, and colonialism	32
Box 8	Corruption and gender	34
Box 9	Corruption and geographic preconditions	35
Box 10	Corruption and official wages	37
Box 11	Corruption and democracy	39
Box 12	Corruption and parliamentarism	41
Box 13	Corruption and voting systems	43
Box 14	Corruption and press freedom	46
Box 15	Corruption and the judiciary	47
Box 16	Corruption and income per head	72
Box 17	Corruption and growth of GDP	73
Box 18	Corruption, productivity, and quality	76
Box 19	Corruption and distorted budget allocation	88
Box 20	Corruption and inequality	91
Box 21	Corruption and the underground economy	95
Box 22	Corruption and investments	100
Box 23	Corruption and the composition of investments	104
Box 24	Different types of corruption and investment	105
Box 25	How to fix a football match, by Declan Hill	169
Box 26	Corruption distorting the private sector	174
Box 27	Hindering corrupt intermediaries	184
Box 28	Fighting corruption with asymmetric penalties, jointly written with Mathias Nell	229

1 | Introduction

There are several good protections against temptations,
but the surest is cowardice.

Mark Twain,
Following the Equator, 1897

1.1. Why this book?

Corruption, the misuse of public power for private benefit, turns out to be a relatively new challenge for social sciences. It has been an issue for politics and society for many centuries, but its systematic scientific treatment is rather novel. However, most researchers consider corruption to be just another application of preexisting theories without sufficiently considering their adequacy. This, I believe, is like putting new wine into old wineskins. Just as wine causes the skins to burst corruption ruptures preexisting theories. Just as we lose wine in old skins we may fail to understand corruption without considering its intrinsic dynamics and logic. Applying old theories then falls short of an adequate understanding of the phenomenon.

A lecture that I run on the economics of corruption starts with a game: students are supposed to derive a strategy of how to win a public tender when they have insufficient funding to take the official route.¹ I find myself time and again appalled by the variety of unusual, innovative, and totally criminal proposals. This is what corruption is about: someone violates the rules of the game in a way that was not anticipated by others. To apply models of perfect foresight, rational expectations, competition with a level playing field, and similar models are, hence, no longer enlightening. In this spirit, a variety of

¹ I owe this idea to Krassen Stanchev, Institute for Market Economics, Sofia, Bulgaria.

orthodox approaches to corruption appear less useful. Some examples are provided here.

There were some economists who started with the indisputable notion that corruption in the form of bribery represents a mutually beneficial exchange. Microeconomists consider such an exchange to be desirable and inevitable; functionalists assume that its mere existence indicates its useful function. Given that briber and bribee are better off after striking a corrupt deal, on what grounds can we claim that the deal is detrimental to economic well-being? But this notion disregards how corruption constrains decision-making. When officials cannot credibly promise to reject side-payments from clients, they are not trustworthy at the outset and may not be employed in the first place. Corruption turns out to be harmful even to those who have the chance of striking illegal deals.

For example, it may well be worthwhile to construct good-quality roads. But the government may choose to cancel the project if bad quality is expected to result from bribes being paid to inspectors. Or imagine that a fair and efficient tax system should be established, but tax collectors cannot be kept from taking bribes in exchange for turning a blind eye to underreporting. A country may have to continue living with the old system. If a state auditor cannot guarantee that she will not fake reports in exchange for a bribe, her contribution loses value. She may not be hired in the first place – even though an honest exchange would have been favorable to all.

Other researchers argued that instead of fighting corruption itself one should combat its causes, of which they claimed excessive government intervention, market restrictions, and a burdening bureaucracy to be most prominent. These arguments have been pointed out by early writers (Bayley 1966; Nye 1967; Huntington 1968; Leff 1964; Morgan 1964) and still make their way into modern economic textbooks such as Mankiw (2000: 123). Corruption is then nothing else but a symptom of inadequate state intervention (Ades and Di Tella 1999). This transforms the problem into something which is more akin to economic theories. State intervention is widely dealt with in economics. The standard recipe for containing corruption would be to get rid of government intervention. Take the case of Philadelphia's Department of Licenses and Inspections where officials accepted money from plumbing contractors in exchange for a quick approval of job-site work.

A standard 'tip' was \$20, a source said, and it could grow if a plumber was in a bind of some kind. "A lot of it would occur when a plumber would need to close an excavation hole where they'd buried pipe, and it couldn't be closed until an inspector approved it, "the source said." So you could stand around with your crew waiting, or you could page an inspector and get him out there real quick, and thank him for it." . . . the payments to inspectors have been suspected for years but that they were hard to crack since those paying the bribes were happy for the speedy service. (*Philadelphia Daily News*, March 14, 2001: "Plumbers Allegedly Bribed Inspectors")

The case reveals how regulation to obtain an inspector's approval induced corruption. But the case shows at the same time that simple recipes for cracking down on government regulation are not feasible. Inspections are necessary so as to guarantee the delivery of proper quality, and their abandonment is likely to do more rather than less harm, maybe even increase corruption further.

One of the biggest cases of systematic corruption also related to market distortions: in the Iraqi Oil-for-Food program between 1995 and 2003, oil was allowed to be sold only in exchange for humanitarian goods. The extreme public desire for much-needed goods not only provided ample opportunities to mark up prices but it also led to high-ranking UN officials turning a blind eye to massive corruption.² According to an estimate, Saddam Hussein's regime was able to collect as much as US\$1.8 billion. Of the 4,500 private firms involved in the program, close to half were involved in the payment of bribes. One paradigmatic case relates to a truck being sold by Daimler Chrysler. While the regular price would have been US\$130,000, the company charged US\$143,000 and passed on US\$13,000 to a Swiss bank account of an Iraqi official. Likewise, oil left the country too cheaply and kickbacks were paid in exchange. This case well fits standard economic modeling on the distortionary effects imposed by market restrictions. Such restrictions create opportunities for systematic corruption. But at the same time, the common economic advice to abolish market restrictions is far from obvious. The standard economic recipe would be to prevent the UN Security Council from imposing trade restrictions as a way of sanctioning countries; this is not at all a suggestion that will gain undisputed approval.

² The full report by the Volcker Commission is available at www.iic-offfp.org. Accessed November 2006.

The experience from the Iraqi Oil-for-Food program will rather lead to considerations of how better to monitor the purchases and control malfeasance.

These two cases are representative of many other incidences of corruption. Regulation is often an integral and much-needed part of government. Suggestions to avoid regulation are more revealing of a writer's negative attitude toward government, in general, rather than a useful contribution to reform.

For the last decade, most economists have been much less lenient on corruption than their predecessors and have clearly emphasized its adverse welfare consequences. But the remedies suggested have been embedded into economic orthodoxy. The thrust of some approaches has been to be critical of government *in toto*. If corruption involves a self-seeking government whose members attempt to enrich themselves, one needs to crack down on the government itself; see Becker (1994), and for a critical review see Orchard and Stretton (1997).

Boyko *et al.* (1996) suggest that privatization is a means of reducing corruption and increasing efficiency at the same time. A downsized "grabbing hand regime" would have less opportunities for milking the citizenry (Shleifer and Vishny 1998). This argument is well embedded into economists' belief in the market and distrust toward politicians, suggesting that corruption can be contained by minimizing the public sector. However, the findings reported in Box 1 are not supportive of this approach.

Box 1 Corruption and the size of the public sector

It has been suggested that the overall size of the government budget relative to GDP may be positively correlated with levels of corruption. This is shown by LaPalombara (1994: 338), who uses a sample of countries in which Scandinavian countries are disregarded by assuming them to be an exception. The reverse finding is reported by others. Elliott (1997: 182–3) reports for a sample of eighty-three countries that the size of the government budget relative to GDP decreases with levels of corruption. This is supported by Adsera *et al.* (2000). Gerring and Thacker (2005: 245–6) report insignificant results. Graeff and Mehlkop (2003) observe that corruption significantly decreases with government size in the high-income countries.

These considerations suggest that a more promising focus would be on particular types of government expenditures in their potential to cause corruption. In this respect it is suggested that redistributive activities as opposed to other government activities are more likely to cause corruption. La Porta *et al.* (1999: 242) show a positive correlation of the total government transfers and subsidies relative to GDP with corruption. However, the variable correlates too closely with total government expenses, bringing about the aforementioned problems. In sum, there is no convincing evidence on the size of government expenses as a cause of corruption.

Elliott (1997) concludes that types of government activities may be more important than the size of their budgets. Regressing corruption on the government's budget (relative to GDP) might also be affected by reverse causality: corrupt governments have difficulties in obtaining funding, be it through taxation or loans. See Box 21 for respective evidence. This lack of resources then forces them to operate on a rather small budget. Another criticism of the hypothesis put forth by LaPalombara is provided by Husted (1999: 342, 350, 354). He argues that governments are larger in societies characterized by a greater acceptance of authority. Such acceptance would be a cultural determinant of both corruption and the size of the government budget.

Overall, there is little correlation between the overall size of the public sector and corruption, as shown in Box 1. Privatization may have its clear economic advantages, but its effect on containing corruption appears ambiguous. This might be owing to privatized firms experiencing a "privatized" form of corruption. The bribes formerly taken from public servants would then be requested from the private firms' staff. Privatization also does not provide a guarantee that the newly founded units are no longer serving politically motivated interests. Similarly, whether a downsized government is less capable of milking the citizenry is equally questionable: privatized firms can be equally exposed to public interference and demands for bribes. What was formerly taken from state-owned enterprises is then extorted from private firms. More often than not, private firms pay more in bribes than their well-connected state-owned counterparts (Lambsdorff and Cornelius 2000: 76–7). Finally, many transition

economies experienced massive corruption in the course of privatization programs. This may be another reason why downsizing the public sector does not help in reducing corruption, at least not in the transition period. Long-term positive effects from privatization may certainly be possible, where competitive pressures are superior in avoiding inefficiencies and corruption, as opposed to bureaucratic control. But such advantages are likely to require best practice in the process of privatization.

On a similar note, some authors assume that decentralization could be a means for reducing corruption by ripping the state off its extortionate capacities and bringing government closer to the people. But the alternative to a large centralized public sector is sometimes a weak local government that is captured by strong local players. It requires little imagination that such a regime may be equally unattractive to investors, and similar adverse effects on welfare are quite likely to arise. As shown in Box 2 a simple economic “recipe” like decentralization does not unequivocally ameliorate the problems of corruption. The pros and cons of decentralization are an important issue. But they are the wrong battleground if one aims at containing corruption.

One issue highlighted by Box 2 is that arguments pertaining to decentralization seem to be dependent on how decentralization is precisely quantified. Apart from this, one cannot exclude that certain cultural determinants drive both decentralization and the absence of corruption. Countries characterized by civic cooperation and trust among people as well as those with well-developed subnational units may be in a position to decentralize and lower corruption at the same time.

Box 2 Corruption and decentralization

Some authors observe a positive correlation between corruption and a country’s size, measured by total population (Fisman and Gatti 2002; Root 1999; Treisman 1999). These correlations are robust to the inclusion of further variables. This might be taken as an indicator in favor of decentralization. Smaller countries might be in a better position to establish a decent administration and to monitor their politicians. Using the results from a cross section of countries might be taken as an indicator that decentralizing government power could be a means to curb corruption.

But Knack and Azfar (2003) provide a clear warning against these findings. They show that the correlation between corruption and population size results from sample selection problems. Ratings on corruption are only provided for those countries in which multinational investors have sufficient interest. These tend to be large nations and, among the small nations, only those that are well governed. Knack and Azfar (2003) conduct regressions for larger samples of countries and observe that the relation between corruption and population disappears. Damanian *et al.* (2004) show that population density decreases corruption in a sample of sixty-nine countries; it remains to be seen whether this finding survives the test for sample selection, as proposed by Knack and Azfar.

Another variable for measuring the extent of decentralization is presented by Huther and Shah (1998) and Fisman and Gatti (2002). The authors interpret the share of subnational expenditures in total public spending as a measure of decentralization. In a sample of eighty countries, this index correlates positively with various measures of good governance. Huther and Shah report a correlation with lack of corruption larger than 0.5. However, the authors do not include further explanatory variables. One cannot exclude that more developed countries are less corrupt and more decentralized at the same time. Biased coefficients are therefore possible. The approach by Fisman and Gatti (2002) makes use of the same variable on decentralization yet tests whether the outcome is robust to the inclusion of further variables. For a wide range of specifications, they find that fiscal decentralization in government spending is significantly associated with lower corruption. The authors also suggest that corruption may be larger when spending is decentralized, while revenue collection remains in control of the central government. They base their empirical findings on levels of corruption in local states of the United States. Arikan (2004) employs various measures on decentralization and observes mostly an insignificant relationship to corruption. A high ratio of non-central government employment to total government employment, however, seems to go along with lower levels of corruption.

Treisman (1999) takes a more direct approach to investigating the effect of decentralization. Rather than regressing corruption on total population, he distinguishes between federal and centralized