# 1 Introduction

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

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[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-offp.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.

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**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.

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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.

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**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.

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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. Damania *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 then regressing corruption on total population, he distinguishes between federal and centralized

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**Box 2**   (*Cont.*)

states. He reports significant evidence that federal states are more
corrupt than centralized ones. But Treisman (1999) argues that
this relationship falls to insignificance when other variables are
included. Adsera *et al*. (2000) and Panizza (2001) also fail to
obtain a significant impact. Damania *et al*. (2004) even report a
significant impact of federalism in reducing corruption. On the
contrary, Goldsmith (1999: 878), Kunicova (2002), and Kunicova
and Rose-Ackerman (2005) claim federalism to increase corrup-
tion, even when controlling for GDP per head. In a more recent
publication, Gerring and Thacker (2004) are also supportive of a
significant adverse impact of federalism on corruption. They dis-
tinguish between nonfederal, semifederal, and federal states and
mix these characteristics with the extent of bicameralism where no
or only a weak upper house exists, where the upper house is not
dominated by a lower house, and where nondominance goes along
with a different partisan distribution between the houses. The
authors find evidence against federal states and in favor of unitary
governments throughout a variety of regressions.

   Testa (2003) investigates differences between unicameral systems
and bicameral systems. She shows for a cross section of forty-three
democracies that bicameralism lowers corruption in rather eth-
nolinguistically homogenous states. But bicameralism increases
corruption in countries with a high level of ethnolinguistic frac-
tionalization. The suggested reason for this finding relates to
bicameralism hindering lobbyism (and corruption) by doubling the
legislators that a lobby must buy. But where two chambers differ
in politics, which is likely to arise in countries with high levels of
fractionalization, legislators are used to seeking compromises and
lobbyism may require few resources. The extent of fractionaliza-
tion is also investigated by Alesina *et al*. (2003). They show that
countries characterized by ethnic, linguistic, or religious fractio-
nalization are rated worse by PRS/ICRG with respect to the
political instability related to corruption.

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   Many economists point to one major cause of corruption: bad
regulation. Ill-designed institutions are considered to be at the
frontline of assigning adverse incentives to policy-makers, bureaucrats,

and the public in general. Box 3 reviews studies that are supportive of a close association between bad regulation and corruption. Such a viewpoint would accept that government serves useful functions and that, thus, downsizing government is not the vision for reform. Reform should rather avoid complicated rules or those that are difficult to administer and align with individual decision making. From this perspective, some "good" regulation may even be helpful in containing corruption. For example, privatization in Eastern Europe involved bribery because there was too little "good regulation," that is, too few legal requirements that restricted corrupt deals.

As a result, detecting bad regulation and misdirected state intervention can be helpful in becoming aware of areas where corruption is likely to occur. However, bad regulation and corruption are quite often two sides of the same coin. When local firms are given preferential treatment in public tenders, this may induce corruption, but it may also be the outright result of strong private interests that capture public funds. In other cases, corruption causes bad regulations, and not the other way round.

Quite striking is an example from Pakistan. The gold trade was formerly unregulated and smuggling was common. Shortly after Benazir Bhutto returned as Prime Minister in 1993, a Pakistani bullion trader in Dubai proposed a deal: in return for the exclusive right to import gold, he would help the government regularize trade – and make some further private payments. In 1994, the payment of US$10 million on behalf of Ms. Bhutto's husband was arranged. In November 1994, Pakistan's Commerce Ministry wrote to the bullion trader, informing him that he had been granted a license to be the country's sole authorized gold importer – a profitable monopoly position (*The Straits Times*, Singapore, February 1, 1998, "Paper Trails Points to Illicit Bhutto Hoard," and June 2, 1998, "The Scandals").

When monopoly rights are given in exchange for bribes, it is rather corruption that drives market distortions. Claims that the monopoly right should be abandoned so as to get rid of corruption appear misplaced, because at the core of the problem would be criminally innovative politicians and businesspeople, and their capacity of inventing bad regulations. A final concern: the difference between "bad" and "good" regulation is far from obvious. One criterion could be whether regulation creates opportunities for corruption. But in this case the argument becomes circular and we are not provided with a

causal theory of corruption. Overall, looking for "bad" regulation provides some hints for detecting corruption but it falls short of an overarching approach to reform.

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**Box 3**    Corruption and regulatory quality

Broadman and Recanatini (1999) show for a sample of transition economies in Europe and Central Asia that higher barriers to market entry lead to higher corruption. Djankov *et al.* (2002) are equally concerned with the nature of entry regulation. They determine the number of procedures required for starting a new business for a cross section of seventy-one countries, along with the necessary time and official costs. The authors find a strong correlation of these variables with a country's level of corruption for a variety of specifications and control variables. Svensson (2005: 29) finds a positive correlation between corruption and the number of business days needed to obtain legal status. These findings support the argument that entry regulation often does not serve to correct for market failure but brings about problems of its own.

Treisman (2000) finds that "state intervention" tends to increase corruption. The former variable is measured by a subjective index compiled by IMD. But as other explanatory variables enter into the regression, the relationship breaks down. Another correlation between corruption and a measure of policy distortion for thirty-nine countries is presented by the World Bank (1997: 104, 168). Unfortunately, the study lacks a precise definition of policy distortions. Also, the robustness of the results is not tested by including further explanatory variables.

Gerring and Thacker (2005) report a positive correlation between regulatory quality and absence of corruption. Ades and Di Tella (1997; 1999) provide a more detailed analysis of policy distortions. The authors use an index that measures "the extent to which public procurement is open to foreign bidders" and another index that measures "the extent to which there is equal fiscal treatment to all enterprises." Both variables, and also a corruption variable, are taken from the survey by IMD. Both variables significantly explain the level of corruption, even controlling for other explanatory variables. This leads the authors to conclude that policy intervention causes corruption. Goel and Nelson (2005)

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