The Institutional Economics of Corruption and Reform:
Theory, Evidence, and Policy

About this book

This book investigates corrupt transactions from a new institutional economic perspective. Full of case studies and empirical research this book reaches beyond the current state of the art. It shows that, more than deterred by penalties, corrupt actors fear the opportunism of their criminal counterpart. This insight provides new insights to our thinking about corruption and its detrimental effects on society. Foremost this viewpoint provides novel inspiration to reform.

About the author

Johann Graf Lambsdorff is Chair in Economic Theory at the University of Passau (Germany) and a research consultant to Transparency International, He is the father of the Corruption Perceptions Index, which he orchestrated since 1995. He published widely on new institutional economics and corruption in leading international journals.

www.uni-passau.de/lambsdorff
or www.ICGG.org

List of Boxes on Empirical Research

To Maria, Philipp, Frederik and Felix

Acknowledgements

This book is a 12-year project, combining research efforts since 1994. At an early stage some parts of it became highly prominent: The Corruption Perceptions Index which has been 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. A considerable lot has been achieved on this front of research since then – the empirical investigations reviewed here provide evidence on this.

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A roadmap 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 serve 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. Anti-corruption 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 seeking 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 which, I hope, will inspire anti-corruption in the 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 anti-corruption 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 anti-corruption, 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 not doubt that bribe taking is often a utility maximizing strategy of a self-seeking bureaucrat. But the downside of ones 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 become distrusted by investors due to their disrespect for law. The advantage from bribery turns against its actors. This is at the core

[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.

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 towards 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. It does so on purpose. Learning how to arrange bribes is a 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 behaviour can survive market pressure. While some actors may refrain from corruption due 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 anti-corruption.

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 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 to understand 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 anti-corruption such as repression, prevention or transparency may run out of steam. The principle of the invisible foot should be at the core of anti-corruption 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 serve the public nor credibly promise reciprocity to their corrupt counterparts. Reform is about exploiting this handicap.