

Discretionary Power, Rent-Seeking and Corruption

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September 2001

Abstract

This article considers corruption as a breach of contract between a principal and an agent. This does not necessarily imply that corruption is immoral, for the nature of the violation actually depends on the features of the underlying contract. In this light, under many circumstances corruption turns out to be a rational and understandable reaction to institutional failures, which are often far from accidental.

To this purpose, three different stylized institutional frameworks are analyzed: developed, undeveloped and transition countries. Contrary to the mainstream approach to corruption, it is here argued that the origin, scope and consequences of corruption vary significantly across the different frameworks. Normative conclusions should therefore be adjusted accordingly.

I am grateful to A. Brzeski, R. Daniels, H. Hoppe, A. Jovanovic, K. Leube, G. Libecap, F. Mojaver, M. Morelli, S. Pejovich, R. Raico, S. Strøm, Ch. Watrin and M. Zöllner, who read previous versions of this paper and let me have very valuable comments.

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1. Are policies against corruption really meaningful?

The term "corruption" generally identifies a transaction whereby an individual bound by a principal-agent contract takes advantage of his discretionary power in order to sell to a third party property rights that do not belong to him¹. That is, corruption occurs when an individual, bound either explicitly or implicitly by a contract, violates the terms of that contract for private gain. This is typically the case of bureaucrats who use their power to reduce costs for some, but at the expense of other agents. Or who can raise the cost for individuals to interact with the state and are compensated for not doing so, like government officials who demand extra payments before they will implement or enforce the law.

Of course, there also exist situations whereby the bureaucrat enjoys discretionary power that he can rightfully exercise within set limits. Under these circumstances, corrupt behaviour occurs when authority is abused and the constraints violated. For instance, when an official is required to use his own judgement in the public interest, but in fact pursues his own personal advantage at the expense of the general well-being². This possibility actually opens up a category of corrupt behavior that has been relatively little explored. This is due to the fact that the content of an implicit social contract in the public interest turns out to be a matter of personal interpretation, the violation of which is also a matter of personal interpretation. Hence, in these circumstances corruption would be

¹ See Banfield (1975) and, more recently, Jain (1998) for a complete discussion of the various definitions and behaviours. Among others, Rose-Ackerman (1998) provides a clear overview of the damaging effects of public corruption.

² That also regards international civil servants, who are even less accountable than their national colleagues, as forcefully described by Hancock (1982). It must be noted, however, that the demarcation of public interest is always pretty vague, let alone the definition of a social contract. Hence, lobbying and rent-seeking are often no less moral than the usual electoral competitions, following which majorities acquire the right to exploit minorities (or vice-versa). As a consequence, the notion of abuse - and thus of corruption - often turns out to be a matter of perception and evaluation by public opinion, rather than a shameful violation of a formal rule.

an arbitrary concept. The existence of a private gain is surely not enough to denote a civil servant's behavior as illegal or detrimental to society.

Surely, corruption does not belong to the public sphere only. The employee of a private company who violates his contract with the employer or the shareholders in order to pursue his own gain can also be considered corrupt. Nevertheless, it is not the same thing as shirking or not meeting the assigned and agreed-upon goals. For neither shirking, nor professional ineptitude imply a deliberate attempt to obtain one's own interest by getting a third party involved³.

The crucial element is however the same. That is, the phenomenon of corruption is linked with the misuse of discretionary power in order to violate an explicit or implicit agreement. As such, it can be considered equivalent to a breach of contract. It is thus reprehensible from a social point of view, since it inhibits social interaction. In particular, the following elements seem to be always present. First, there exists the possibility of creating and extracting rents. Second, these opportunities are provoked by the lack of a competitive framework, due to the existence of barriers to entry, or to relatively high monitoring and enforcing costs. Finally, rent-seeking opportunities are exploited by interacting with third parties and violating the original principal-agent contract. From this standpoint, it thus seems clear that the recipes to eliminate corruption coincide with the design of institutional frameworks that enhance competition, intensify monitoring, and therefore minimize the expected benefits of rent-seeking. These are indeed the basic conclusions suggested by mainstream analyses (Tanzi, 1998).

However, although describing what a corruption-free world would look like may be an interesting exercise in neo-classical economics, it does not go very far in solving the problem of corruption itself. It is frequently overlooked that corruption is a reaction to the existing rules of the game, and that most of such rules are derived from the patterns of individual behaviours, from the needs individuals make known through their actions.

In particular, and contrary to the orthodox approach, labeling corruption as "immoral" misses the point. Morality is understood by individuals as whatever enhances their social cooperation. According to a free-market perspective, social cooperation usually refers to profitable

³ This definition of corruption also excludes nepotism (hiring friends and relatives irrespective of their merits); but includes the sale of appointments, both to friends and to total strangers. It also includes revolving-door agreements, whereby some politicians and bureaucrats end up as employees or consultants in companies and industries with respect to which they had previously played a public role.

and voluntary interaction among individuals, without prejudice for individual freedom. Therefore, from this perspective corruption is certainly undesirable, for it violates assigned property rights and agreed-upon property-right transfers. Social cooperation may hence be undermined. Nevertheless, corruption is not necessarily immoral if the rules of the game deviate from those typical of a free society, but originate - say - from a socialist environment where the state is called upon to play a dominant role. In other words, corruption should be understood as a behavioural pattern that always appears as a consequence of an institutional failure, which may however be unavoidable if other goals have to be attained⁴. As such, it is a process with no ends *per se* and thus with no moral (or immoral) value. That is, corruption cannot be right or wrong. Instead, the focus should be on the institutional framework, which can be more or less desirable; and might well generate wrong sets of incentives, inappropriate behavioural patterns and therefore disappointing economic performance⁵. This explains why fighting corruption is a policy only if this term refers to a strategy to change the institutional rules of the game, and thus make corrupt behaviour redundant.

This way of analyzing corruption discloses at least two avenues of fruitful investigation. The first concerns the nature of corrupt behaviour as a system of market signals driving human action. The second one regards the conditions under which corruption may be desirable, leaving aside all attempts to establish value judgements associated with (necessarily arbitrary) moral standards. The next section tries to address the first issue. Section 3. applies the results to corruption in developed, undeveloped and transition countries, while section 4. draws some (limited) normative conclusions.

2. Corruption as a signaling system

Consistent with the teaching of the Austrian School, a market economy is a system of interactions where individuals acquire and communicate information about scarcity through prices and thus decide about the employment of resources. Of course, the price system frequently deviates from the neo-classical ideal, because of disturbances provoked by transaction costs and/or of

⁴ For instance, everybody is aware that widespread state intervention easily leads to extended abuse (corrupt practices). Yet, most people do advocate a large welfare state throughout continental Europe.

⁵ It is apparent that this approach draws heavily on Lord Bauer's thinking. See Raico (2002, ch.4) for a thorough analysis of the principles of Bauer's theory of economic history and economic development.

government interference and failures. When this happens, individuals are then induced to act in ways that do not reflect their preferences in full, or find it profitable to behave dishonestly, including involvement in corrupt conduct.

In order to simplify the discussion, two classes of corrupt behaviour will now be considered, one taking place in the market place and the other originating from government action. As will be made clearer shortly, the former is due to the existence of transaction costs, which allow opportunistic conduct; while the latter is due to the existence of rents.

Distortions in the market place

Distortions originate from transaction costs. These may reduce access to information, limit the possibilities of agreeing upon a mutually beneficial arrangement, raise the cost of enforcing contracts, encourage opportunistic behaviour and corruption. All these potential shortcomings are of course well-known to agents, who try to develop technologies, institutional rules, legal devices and specifications in order to reduce transaction costs. When this is not possible, and whenever the cost of the transaction is greater than its benefits, agents refrain from acting.

In small, self-contained communities the size of the problem outlined above is relatively modest, since firms are small, third parties are in limited numbers, income flows readily observable, i.e. more or less transparent. In short, opportunistic behaviour is easy to detect and sanctions tend to be rather effective - isolation and ostracism, for instance. This does not rule out corrupt behaviour altogether. But when wrongdoing occurs, corrupt agents find it advantageous only if they are able to exercise some kind of violence and thus avoid the social sanctions. In some cases, even religious sentiments are exploited to this purpose.

Opportunistic behaviour in large communities is a different matter, in that it may be more difficult to detect through direct monitoring. Direct sanctioning may also be more problematic. Nevertheless, a large community where freedom to move and to trade is substantial can experience strong enough competitive pressure to reveal corrupt behaviour or to develop incentives to reduce it through indirect action. The market will penalize private companies affected by corrupt managers. Investors will abandon them, and they will ultimately become vulnerable to takeovers, whereby many among the incumbent managers will lose their jobs and therefore the possibility of breaking their principal-agent contract again. This explains why managers in free-market economies are bound to be honest out of self interest. The short-term gains they can reap by taking advantage of relatively high transaction costs are smaller than the present value of the future benefits they can acquire by enhancing the principal's profits.

Of course, this does not rule out small-scale corruption, which may even amount to quite substantial figures. The competitive principles at work are however by and large the same. The cost of corrupt behaviour will drive out firms that have not been able to keep misconduct under control, either because legislation makes it difficult to fire those responsible for it, or because the internal organization is ineffective in reducing opportunistic behaviour. This happens, for example, when the managers have chosen production techniques that may be efficient from an engineering viewpoint, but raise the expected benefit of corrupt behaviour for the agent⁶.

The bottom line is that the market cannot support much corruption, provided that competitive pressures are strong enough to create incentives to keep it low. Corruption may indeed exist, of course; when the cost of eliminating it is greater than the benefits from eradication. But - once again - its extent is limited by the entrepreneur himself as long as (1) he is vulnerable to competition and (2) he is free to operate without normative restrictions or judiciary inefficiencies that may encourage or protect corrupt behavior. Surely, corruption originated by transaction costs does not require state intervention or specific legislation apart from what is required to enforce voluntary agreements among the parties involved or to award compensation for breach of contract; that is, the rule of law. When one of the contracting parties believes that the expected cost of corruption is too high, then the transaction will not take place. There is nothing else to add. The free-market process will provide itself the necessary self-adjustment mechanism, whereby the true (deadweight) cost of corruption is in fact concentrated in the production which could take place, but doesn't.

As a consequence, although complaints about corrupt behavior in the market place are certainly justified, they are meaningless if they lead to policies to enhance monitoring technologies. And they miss the point if they neglect to consider that choices may sometimes be inefficient from a technological standpoint, but still justified from the need to minimize transaction costs. For a producer in a competitive environment will always try hard to minimize production costs, i.e. the sum of transformation and transaction costs. More important, the analysis of corrupt behaviour in the market place should lead to the analysis of those situations whereby corruption-minimizing contracts are inconsistent with the existing legislation. And light should be shed on the interaction between market agents and the state, the latter being the only body able to hinder an efficient

⁶ See Williamson (1985) for an early discussion on the issues of asset separability, asset specificity and the effectiveness of corporate governance.

allocation of property rights, create rents and limit competitive pressure effectively, thereby allowing corruption to persist.

As regards the damages provoked by private corruption, they are quite similar to – and related to the existence of – the welfare shortcomings of an imperfect world, where information is imperfect and opportunistic conduct characterizes a vast number of economic agents. As a result, unjustified transfers of income take place, and production is distorted towards industries where – *ceteris paribus* – corrupt misbehavior is easier to control. As such, corruption is surely "bad". However, it is not *per se* the cause of inefficient economic performance. Contracts do not fail to materialize because of opportunism, but rather because of exceedingly high transaction costs. Once again, the limit to corruption is the ability to reduce transaction costs, which boils down to entrepreneurship, individual freedom, the ability of the judiciary to enforce contracts.

Government failures

Most scholarly energies have been devoted to model public corruption (as opposed to private corruption), to estimate its size and consequences⁷. The reason for such an interest is twofold. On the one hand, it is clear that the rent-seeking efforts of individuals generate higher rewards when dealing with other individuals, as opposed to an impersonal process – i.e. the competitive market – that cannot exercise any discretionary power, let alone warrant significant and lost-lasting rents. Hence, the predicted size of the phenomenon is correctly deemed to be of greater importance in the public realm than in the private one. Furthermore, observable corruption in the private market tends to be negligible. Otherwise transactions would not take place altogether, as pointed out earlier on. It follows that private corruption is harder to detect and its consequences virtually impossible to estimate.

These problems are of less relevance when government failures come into the picture. As for the first point, property rights and competitive pressures no longer check interaction with state agents. The incentives to reduce misconduct are thus relatively soft⁸. They depend on the consequences of judiciary action and, before that, on whether the judiciary is at all induced to take

⁷ Orthodox analyses have been presented, among others, by Mauro (1997), Jain (1998) and Kaufmann (1998a). As remarked in the text, all these investigations rather naively assume a direct causal link between corruption and economic performance. See also Wei (2001) for further references to the available quantitative data.

⁸ Garello (2000) has recently analysed the checks provided by the consumer-electors *vis-à-vis* misconduct by state officials.

action. This usually happens either because honest people publicly denounce corrupt behaviour, or - more frequently - because corrupt agents have lost the race for rents to other, equally corrupt operators, and act out of sheer envy. More frequently, however, corruption takes the form of a repeated game among the same agents with fairly long-term rent-seeking strategies⁹. The losers turn out to be fragmented, relatively harmless interest groups (taxpayers). Hence, what some observers call the "culture of corruption" is probably less a question of low ethical standards, than a clear understanding of transaction-cost economics and of the logic of collective action.

With regard to measurement, the consequences of public corruption are easier to quantify because transactions take place anyway. Actually, corruption may create a market for transactions that would have never taken place in an honest environment¹⁰. In addition, one can try to guess the inefficiencies of corruption by comparing agents' behavior in a corrupt environment with one in a "cleaner" framework.

As mentioned earlier on, the main methodological question with state-related corruption is that this phenomenon is no longer the effect of a certain category of transaction costs. Instead, it is a market reaction to deliberately distorted property-right assignments and monitoring obligations. Although traditional analysis usually considers whether corruption is harmful, the real issue is to compare a corrupt state of the world with a feasible alternative. For instance, "greasing the wheels" makes sense if property rights are assigned inefficiently and their trading is otherwise impossible - say, because monitoring is effective; or if property rights are assigned imperfectly¹¹. But of course, this judgement should be modified if the alternative is a better allocation of rights (and equally effective monitoring)¹².

⁹ See for instance the excellent detailed description of corruption practices in Italy provided by Della Porta and Vannucci (1999).

¹⁰ See for instance Tanzi and Davoodi (1998), who plausibly claim that corruption tends to expand public investment, the quality of which however deteriorates.

¹¹ This leads to the hold-up problem (Sumner, 1996), whereby a desirable activity involving sunk costs is abandoned or not performed because producers are afraid of changes in the regulatory framework.

¹² It has been conceded that in principle a moderate amount of corruption could be useful to keep the bureaucratic machine working, but that sooner or later even a small amount is bound to spread out like cancer (Tanzi, 1998). A similar view is also maintained by Rose-Ackerman (1998, p. 521), according to whom *the cases in which corruption enhances the efficiency and improves the allocation of public services are limited* and documented by Della Porta and Vannucci (1997,

This explains why the economic analysis of corruption depends heavily on the rules of the game that affect the role of the state, since the state is the only authority legitimized to create and uphold rents. In the end, corruption may be understood as an essential element of the rent-seeking game, whereby the policy-makers try to appropriate part of the rent, and other agents try to reduce the ex-post discretionary power of the policy-makers. These two elements are deemed crucial in order to assess how corruption works and whether it may be reduced. To their analysis we turn in the next section.

3. Three different rent-seeking games

The following paragraphs consider three different institutional situations. For convenience they are defined as characterizing Developed Countries (DCs), Undeveloped Countries (UDCs) and Transition Countries (TCs). It should however be emphasized that the difference among them is not geographic location or the level of per-capita income as expressed by GDP-per capita figures. Instead, these three blocs are distinguished according to what individuals understand as the legitimate role of the state, the desirable presence of rents and therefore what is generally perceived as tolerable corruption. Although it would be beyond the scope of this paper to analyze the dynamics of corruption, the purpose of the following pages is to underscore the different nature of corruption in these different institutional settings. In particular, the DC environment is a modern democracy featuring a free-trade regime, a significant welfare state and pervasive regulation. On the other hand, the UDC framework is dominated by autocratic rule, and thus by the absence of competition in the political and economic markets. Finally, TC conditions consist of an institutional vacuum provoked by the downfall of the communist system. The Party-controlled nomenclature has been replaced by an unaccountable bureaucracy and by a political class that is often obliged to find a workable compromise between socialist legacies and free-market rhetoric.

1999).

This widely-held view assumes that corruption is some kind of exogenous disease that progressively undermines the rule of law, raises the costs of market exchange and becomes part of a political system. Clearly, it contrasts with the approach presented in this text, whereby corruption is the instrument according to which the rent-seeking game is played. In particular, whereas legislation is responsible for rent-creation, corruption makes rent extraction possible. As will be argued later on, "greasing the wheels" can still be a meaningful phenomenon, but its interpretation should differ from the orthodox one.

Rent-seeking and dependence in Developed Countries (DCs)

The market for rents in DCs focuses on the attempts carried out by private agents who try to secure protection against competitive pressure or the constraints imposed by the rule of law. This applies to the goods market, e.g. when weak incumbent producers try to be shielded from - or supported against - other producers and new entrants. And it also applies to the factor markets, where - say - owners of labour and capital try to obtain rewards in excess of the factors' competitive marginal worth. Hence, the core of the analysis is (1) to identify the agents who are legitimized to create rents by changing what could be defined as the spontaneous property right allocation and (2) the ways through which such rents are traded. Although corruption usually refers to the latter phenomenon, it actually depends on the features of the former¹³.

The free-market context obviously eliminates the essence of state corruption, since the state would not be legitimized to create rents, let alone trade them. But of course, modern industrialized societies are far from the free-market ideal. Individuals often accept the creation of rents in order to protect selected groups, or to reshuffle wealth and income streams to reduce uncertainty.

If so, one may then wonder why corruption - trading in non-owned, but not illegal, property rights such as rents - should be a problem at all. In fact, corruption originating from rent-seeking purposes tends to be considered a lamentable but inevitable cost implied by state intervention in economic matters. As such, it looks as a relatively minor problem to be taken care of by the judiciary.

Corruption acquires a different and more consequential meaning, however, when misconduct is taken advantage of in order to preserve power, rather than to use power. More precisely, the argument put forward here is that the most important purpose of corruption in DCs is neither the creation, nor the extraction of rents. It depends instead on the desire to preserve and exercise power *per se*, to satisfy personal ambition, enhance status and personal prestige, maintain the welfare state. All this is of course different from the notion of "discretionary power"¹⁴.

¹³ See on this McChesney (1997, especially ch.4), where empirical investigation supports a rigorous theoretical analysis of the law-bargaining process.

¹⁴ De Jouvenel (1945/1993) discusses the meaning and consequence of power in this connotation at length. This phenomenon may explain why corruption is perceived to have stayed constant through time, although rents have been reduced as a consequence of trade and capital-flow liberalisation. In fact, the yearning for power has not diminished in modern societies, and thus the potential for corrupt behaviour has not lessened, either.

As suggested to me by Steve Pejovich, the limited-term proposal recently discussed in the

According to this view, pressure groups do not need to bribe decision-makers in order to get what they want. Many decision-makers are eager to comply with the coalitions' requests anyway, as long as that enhances their popularity with the electorate. On the other hand, in stable societies¹⁵ the making of many morally dubious rents is likely to be declined even if substantial opportunities for rent-extraction could be created. The reason is that transparency in the DC context is high enough to expose socially-illegitimate rent-seeking behaviour and thus increase the probability that the incumbent politicians lose their power.

The above explains to which extent policy-makers are willing to go when accepting bribes, which may be very far indeed, especially when political parties are considered necessary to preserve the welfare state. As regards the demand for corrupt officials, it is here claimed that corruption takes place in DCs on two accounts. First, bribes are offered in order to reduce the discretionary power of the policy-makers. It is a device through which DC producers and (to a lesser extent) factors' owners induce selected policy-makers to become dependent on illegal income flows, which may even imply exposure to future blackmail¹⁶. Surely, it may be desirable to create a class of dependent policy-makers so as to make their behaviour more predictable and ultimately reduce the transaction costs connected with normal business practice. Put differently, DC corruption tends to be a bottom-up process. It comes from below and its main aim is not directly connected with rent-seeking. Rather, it is designed to elicit predictable behaviour and therefore reduce discretionary power.

As regards the second aspect, it seems apparent that in most DCs political life is ruled by political parties, rather than by majorities. It is not the aim of this paper to discuss the desirability of party-rule as opposed to majority rule. Nor is there enough space to discuss the different outcomes of the political process as a function of the different constitutional systems generated by a modern

USA reflects similar concerns.

¹⁵ A "stable society" is here meant to be one where the political class and the top layers of the bureaucracy are by and large composed by the same people over time. It follows that these agents tend to behave as far-sighted, reliable "bandits".

¹⁶ Dependence is a broader concept than vulnerability, in that vulnerability is generated by the fact that the policy-maker's misconduct can be exposed, thereby leading to his possible political collapse. More frequently, however, substantial bribes encourage the corrupt decision-maker to raise his living standards, his image and prestige, the range of his political clientele. In this light bribes create some kind of addiction (dependence), which is strongly linked with these external income streams.

democratic regime. Nevertheless, it is a fact that if a party system is chosen not only as a means through which preferences are expressed, but also as a tool to guarantee institutional stability¹⁷, parties are surely legitimized when asking for financial resources, even in violation of the formal law. In this light, in many Western European DCs bribes become the instrument to finance a party-controlled institutional framework. Hence, the average citizen tolerates corruption to the benefit of the party system (but less so when individual party members or leaders are involved). That is manifest when scandals break out, or when taxpayers are knowingly overburdened by far too expensive public works.

Thus, DC corruption can indeed be considered efficient, in that it reduces transaction costs, makes agents' behaviour predictable, stabilizes the institutional environment. Excesses are always possible, sometimes even too frequently. The desirable checking and monitoring framework is however provided by the (free) press and public opinion, rather than by the judiciary and rule-of-law principles. Hence, extreme corruption in DCs is due to misjudgment by the policy-makers, or by the media, or both. Surely, corruption in DCs can be widespread and selectively deep, but not necessarily exceedingly high or harmful. It is likely to be widespread and deep since predictability requires that enough top politicians and a significant portion of the middle and upper bureaucracy behave according to expectations¹⁸. But as long as corruption fulfills the role of making conduct predictable, and the party system strong enough to allegedly guarantee stability, it is not intolerably harmful. The so-called deadweight losses typical of the rent-seeking literature are then relatively modest, especially if the corruption mechanism is considered standard practice and the top politicians exercise effective control on the lower layers. In other words, within this framework deadweight losses are not really deadweights, in particular if the alternatives are taken into account. Scandals may and do break out, of course, as a result of efforts of the judiciary to enhance its role and power; or of brilliant journalistic investigation. But although political careers can be destroyed as a consequence, the rules of the game are hardly disrupted or changed.

This conclusion is also consistent with other, admittedly scattered empirical evidence put

¹⁷ Andrzej Brzeski pointed out to me that this is indeed a sensitive issue. For the parties themselves repeatedly emphasise their role in this respect, and magnify threats to “business as usual”.

¹⁸ This leaves little scope for corrupting the lower layers of the political class, which tend to be controlled by the party leaders through other direct and indirect means, e.g. by using state companies as cash dispensers with very soft budget constraints.

forward in the mainstream literature. If corruption were the price to be paid in order to create or transfer rents, it would imply very substantial amounts of money - higher, say, than in the undeveloped countries. Indeed, the bribe would amount to the discounted value of the future expected income flows generated by the privilege, which in DCs are likely to be higher than anywhere else. However, the DC experience does not seem to reflect such large amounts. According to the view presented here, this is due to the fact that the bribe actually amounts to what is necessary to raise the politicians' ambitions and income need, or the bureaucrats' income levels, so as to introduce dependence. Ultimately, the goal is to feed political parties, which in turn guarantee preservation of the welfare state¹⁹. As a consequence, the sums involved also depend on the political structure of the system, party discipline, cultural proximity to the welfare-state and collective-insurance ideologies.

Two additional points deserve to be mentioned in the DC context. They both regard the assumptions leading to corrupt conduct in DCs and the policies to fight it. As for the first, it is worth reminding that DC corruption is based on the generalized consensus about the violation of individual freedom for the sake of reducing individual uncertainty. Individual decisions under competitive pressure are thus transformed into a collective cost under milder competitive conditions. This leads to corrupt practices as a way to create inertia in the behaviour of state officials - politicians and bureaucrats alike. It also implies that salaries in the public sector tend to be low, so that dependence is greater. And that the layers of the public administration are multiplied, so as to expand the chances for redistribution, reduce civil servants' responsibility, and increase the opportunities for the higher layers of the system to control the lower layers through promotion and little or no need for explicit (illegal) monetary transfers. In short, corruption does not run against the shared yearning for a welfare state. Indeed, by reducing discretionary power, this conduct makes sure that consensus is preserved and even expanded. There is no doubt that the notions of individual freedom and self-enhancement are better served when responsibility is clearly allocated and competitive pressure is greater, so that corruption is unnecessary. But these concepts hardly reflect today's priorities in most DCs; hence, corruption remains essential. This leads to the second point.

When the scope and the suggested policies to fight DC corruption are examined, one should

¹⁹ Public works is usually the main area where this funding takes place (Della Porta and Vannucci, 1997).

assess to what extent corruption denotes the creation and purchase of rents; and to what extent corruption signals the need to reduce state officials' discretionary power. When rent-seeking is the name of the game, then corruption can only be reduced by cutting down rent-seeking, through free trade, free movement of resources, institutional competition. By fighting corruption irrespective of the competitive context, success can only be modest²⁰. The size of the rent-seeking activities would not be affected to a substantial extent, but more difficult trading would probably make distortions more harmful. For instance, regulation with the scope of building consensus on demagogic grounds would no longer be kept under (some) control if the victims were denied the possibility of buying their way out²¹.

The bottom line is that "crony capitalism" in DCs is consistent with the shared preferences for a strong welfare state and also a way to make sure that such preferences are met and satisfied by the administration. Hence, the occasional outcries against corruption are the result of envy, rather than of moral disapproval following miscalculated excesses. Indeed, and clearly consistent with the approach put forward in these pages, public opinion often perceives judiciary rigor as some kind of persecution, not as an essential component of a rule-of-law system. As mentioned earlier on, it is a fact that money misappropriation is more or less tolerated when it goes to the benefit of a political party, rather than directly to personal pockets²².

In short, given the preferences prevailing in the DC world today, the best thing one can do about corruption is accepting it as an efficient way to reduce discretionary power within a system

²⁰ That also applies to high developed countries, of course, such as France, Japan and the UK (see "Failure to fight bribery irks US", the **Financial Times**, June 29, 2001)

²¹ Of course, this applies to a situation where the law-making market regards the possibility of creating a rent, rather than to one where the politicians exploit their power to drop a rent-creating bill.

²² For this kind of corruption does not elicit envious feelings, which tend to be directed towards individuals, rather than organisations; and can indeed be approved in so far as it aims at tightening party discipline, and therefore predictability.

Borderline cases abound, though. Consider, for instance, situations whereby a producer bribes a politician or a bureaucrat in order to be a privileged supplier of goods and services paid by the state at prices way above market levels. This is of course a rent-related case of corruption if the process goes unnoticed and the proceeds are withheld by the politicians or the bureaucrats involved. It becomes however a tolerable way to reduce the officials' discretionary power if the bribe is channelled into the parties' pockets or shared within the administration and creates the level of dependence necessary to keep the state machine going at an acceptable pace in the desired (and predictable) direction.

dominated by welfare-state principles. Whereas corruption is to be fought and effectively kept under control through free trade and judiciary power (to contrast violence, enforce contracts) whenever bribes are aimed at acquiring rents²³.

Of course, the view suggested in these pages is not fully consistent with the traditional public-choice normative approach to corruption, either. Since public-choice scholars consider corruption a way through which state officials take advantage of transaction costs in order to create and secure rents, effective monitoring activities and higher salaries in the public sector are invariably suggested as feasible solutions to eliminate misconduct. Although the public-choice story may well apply to UDCs and TCs - as argued in the paragraphs that follow - it is here believed that the nature and scope of corruption in DCs are quite different from the UDC and TC reality. These practices are not just a failure to cope with significant transaction costs. In the DC environment they are also an efficient way to balance the necessity to transfer power to state officials in order to allow them to run public policies on the one hand and, on the other, the fear that such delegated authority can be transformed into highly discretionary power.

Rent-seeking and loyalty in Undeveloped Countries

Corruption is a different story and serves different purposes in undeveloped countries (UDCs), which are here meant to be those where economic and political freedoms are limited. In these cases the ruler and/or the ruling elite do not have to face a competitive political process. The implicit social contract between the ruler and the population is thus considerably weaker than in DCs²⁴. As a matter of fact, it is a major concern for the UDC policy-maker to make sure that competitive pressures do not build up and that his power remains undisputed. Since corruption is a consequence of the limitation on economic and civic freedom, leaders have an incentive to maintain those limitations.

Within this framework, the ruler has then to rely on a relatively small elite to help him run

²³ This analysis omits references to criminal violent activities, though. For instance, the acquisition of public works through threats is more than just a theoretical possibility. But for the purpose of this paper corruption is considered to be the outcome of a voluntary transaction between individuals, which can then be enforced through violent means. The voluntary nature of the transaction itself is however what makes the difference between corruption (and crony capitalism) on the one hand, ordinary crime on the other.

²⁴ The contract is weak, but not necessarily absent. For instance, autocrats may be tolerated (and in some cases even welcome) when they represent an alternative to foreign occupation or civil war; and guarantee enough income to allow physical survival.

the centers of power and create enough consensus in those functional and geographic areas where pressures could come to the surface (the military on the one hand, urban concentrations on the other). Of course consensus cannot be created through economic development, for that might enhance new powerful interest groups that may eventually challenge the leader. Hence, the creation of a large bureaucracy is often an appealing solution. Civil servants will be offered a minimum but secure income, and also the possibility of making extra money or - more generally - enjoying extra benefits through corruption, conditional upon the benevolence of the ruling class. Put differently, the development of the low and middle layers of a large bureaucracy is the way through which the autocrat builds consensus (or makes sure that support for potential opponents remains modest). This is attained by keeping the wage rate low and tolerating corruption, which is therefore rightly perceived by the bureaucrats themselves as an act of benevolence by the regime²⁵.

In short, UDC corruption takes place at two different layers and for two different purposes. At the upper level the autocrat creates rents which are then sold for cash to selected foreigners or given away to the domestic elite in exchange for loyalty. In this case corruption is thus essential in two respects. It allows the ruler to accumulate personal wealth and possibly to enjoy benign-neglect demeanor as far as the international community is concerned. This implies protection both against public opinion at large, and against potential domestic opponents who might look abroad for political and financial support, in exchange for rents once the coup is accomplished. Furthermore, it creates a loyal structure of sometimes even highly qualified officials through which power is exercised²⁶.

At the lower level corruption is the way through which officials are bound to the ruling elite. Whereas in the previous situation the rent-seeking nature of corruption is obvious, within the

²⁵ Low "official" wage rates actually serve two other purposes, apart from developing a demand for corruption. One is to allow the expansion of the size of the bureaucracy, given a constrained budget. In addition, it allows a more efficient pay system, whereby employees are actually remunerated according to their abilities to "serve" the community.

Of course, the best solution would be to pay the bureaucrats and let them do nothing. But that would present two problems. Control on productive activities would vanish, and a typical UDC fiscal system would never be able to raise enough revenue to pay the bureaucrats in full.

²⁶ As mentioned in the text, at the upper level corruption tends to take place between the ruler and the foreign counterparts, or between the highest bureaucrats and the foreign counterparts. These bureaucrats act mainly as mere intermediaries in order to cash in bribes on behalf of the ruler. They can also collect bribes to the benefit of the lower layers, or on their own behalf. But even in these cases they are subject to the benevolence of the ruler.

present framework it is rather the way through which loyalties are purchased. Therefore, its assessment in terms of efficiency depends on the alternatives, given the constraints already described. The only other opportunity would be to raise wages and thus taxation. This choice would however be less effective in two respects. It would not necessarily reduce the degree of corruption unless the judiciary was strengthened, which is hardly realistic, for the ruler's discretionary power would end up by being challenged and eventually curtailed. Moreover, petty corruption is often based on individual bargaining, which tends to develop into repeated interaction aimed at extracting moderate amounts of surplus, without driving the counterpart out of business. Although fine-tuning in this domain is far from perfect, especially if the turnover in the bureaucracy is frequent, it is probably preferable to generalized taxation, which in a UDC would drive the more visible companies out of business and also create a new class of (corrupt) rent-seekers - the tax collectors²⁷.

As regards cutting down corrupt practices, the wisdom of this goal is not necessarily obvious. Unless the economic rules of the game are changed drastically - away from official aid and towards economic liberal regimes²⁸ - efforts to eliminate corruption would generate political instability, as new potential autocrats would use the anti-corruption campaign as a way to delegitimize the incumbent rulers and possibly attain international prestige for themselves. Indeed, there is reason to believe that an autocratic government - even a new one - is bound to use corruption as an essential instrument to retain power and launch anti-corruption campaigns both as a way to assert control on the lower-layer bureaucracy, and as a threat to rising interest groups²⁹.

²⁷ Of course, this statement is not intended to belittle the current role of the Revenue Office in UDCs. Its current role is however different from that resulting from what would result from the blind application of the efficient-taxation textbook recipes. In the latter case the Revenue Office would extract rents from the privileged few, after having destroyed what is now known as the underground economy. The implicit contract between the autocrat and the population would be broken and the ruler's authority jeopardised.

In the former situation, which applies to today's UDCs, the bulk of the relatively modest revenue still comes from the companies controlled by upper rent-seekers, but tolerance for long-run corruption at an individual level makes sure that small-size business survives and allows people to enjoy a minimum, tolerable living standard.

²⁸ See Hancock (1989, especially part 5) and Zakaria (1997).

²⁹ For instance, this would apply to the recent "call to stamp out rampant corruption within party ranks" by the Chinese leaders, who are at the same time encouraging private businessmen to join the Party ("Anti-Corruption call marks China party anniversary", the **Financial Times**, July 1, 2001)

Two conclusions follow. First, when civil war and ethnic rivalries are more than a remote possibility, a "balanced" corrupt society is sometimes the only way to keep domestic turmoil at a tolerable level³⁰. Second, efficient corruption requires repeated personal interaction, especially in the UDC world. Of course, outsiders are almost always forced to make use of intermediaries in order to deal with local agents and carry out business. That increases the cost of trading, so that corruption becomes inefficient when the need to trade with the outside world becomes more important, i.e. when the opportunity cost of autarky is perceived as higher. It follows that unilateral DC trade liberalization *vis-à-vis* UDCs is surely a way to make stable trade relations a priority in the developing countries. That will not cancel corruption altogether. But as trade and production expand, the demand for jobs in the bureaucracy would fall and the opportunities to replace bribes with higher salaries rise. In a nutshell, corruption is understandable and even acceptable when a society is weak, and hardly goes beyond very limited geographical boundaries. That is, when individuals do not have enough incentives to suffer the cost of developing the extended networks upon which cooperation and specialization are based. But when the benefit of doing so becomes high enough, UDC corruption becomes obsolete. It can then disappear, or - more likely - it can be replaced by other kinds of misconduct, as explained in the section devoted to the DC case.

Surely, that will change the rules of the game for the autocrat, who would no longer be legitimized just for his ability to avoid conflict, but as long as he enhances growth (rule of law).

Rent-seeking in Transition Countries

To a large extent, today's corruption in TCs is inherited from their collectivist past, which is responsible for today's relatively poor governance and absence of the so-called "good civil society"³¹. Communism tolerated and to some extent even encouraged corruption for reasons that are fairly similar to those already presented in the UDC case. Indeed, it is no accident that the traditional measures of perceived corruption rank many TCs at the same level as UDCs. Two differences are however worth emphasizing. One concerns the distinction proposed earlier on,

³⁰ Clearly, this does not imply that a corrupt society is necessarily a peaceful society. Much depends on the balance between upper-level and lower-level corruption. The former must be used to enhance the discretionary power of the autocrat, supported by the low power (but high monetary returns) of the elites. In turn, the lower layers of the (corrupt) bureaucracy must be wide and cut across the various strata of the population.

³¹ With some exceptions, though. See the detailed analysis proposed by Kaminski and Kaminski (2001).

between the upper level (the elite) and the lower level (the medium and lower layers of the bureaucracy). Under Communism this was replaced by the notion of nomenklatura, whereby all layers of the bureaucracy were more or less free to use their discretionary power in order to enrich themselves, subject to constraints set by the Party. That meant that the rules were more or less the same for almost everybody and that corruption was indeed a game characterized by repeated interaction inspired by unchecked greed.

The second difference regards the regime of central planning, which was of course neither about central decision-making, nor about real planning. What is important to notice from the viewpoint of corruption, however, is that the interaction leading to the formulation of the central plan used to take place mainly among bureaucrats, who were sometimes part of the administration, sometimes part of the production structure. The purpose of this bargaining game was to satisfy the plan (at least from a formal viewpoint), buy immunity against under-performance, set aside enough resources to be sold in the black market, both *vis-à-vis* consumers and other firms.

When the collectivist system broke down, new formal rules failed to come to the surface; but the informal rules of the game that were the essence of the socialist societies of the Soviet bloc remained in place. Corruption was of course an essential element of those rules and it expanded further in the post-communist institutional vacuum: especially in those countries, *corruption belongs to the broad category of phenomena when formal institutional rules become inactive and people's activities become guided by concerns external to the organizational mission* (Kaminski and Kaminski, 2001, p.3)³². It is hardly surprising that corrupt behavior now reflects both the rent-seeking activities typical of a regulated economy, and the dependence patterns typical of a modern democracy. As a matter of fact, in most Central European TCs politicians use the bureaucracy to build up consensus and loyalty; whereas the private sector bribes the decision makers - politicians and bureaucrats alike - in order to attain predictability through dependence. Indeed, it appears that both the DC bottom-up process and the UDC top-down processes are at work in much of the TC world.

The situation is perhaps different in other parts of the former Soviet bloc, where reform never really took off and corruption is much worse, possibly the worst in the world³³. In these cases

³² See also Kaufmann (1998b, p.525): *the scope of arbitrary discretion by politicians and bureaucrats at all levels increased markedly with the demise of the Communist Party with its clear lines of command and discipline.*

³³ See Kaufmann (1998b), who quotes the World Bank Survey carried out for the World

new autocrats have replaced older rulers. However, the new rulers do not enjoy the same stability as the old communist regime. The repeated-game feature has weakened substantially and the time horizon of the typical rent-seekers has shortened. As a consequence, self-enforcement has become more difficult, demand (and supply) for criminal services has increased. In the end, the legitimacy of the formal institutions has been suffering serious setbacks. Under these circumstances corruption is accepted, for it turns out to be the only viable way to buy the discretionary power of the bureaucrat and carry out business transactions, whereas criminal organizations often remain the only effective authorities with an interest to enforce an agreement. Contrary to the DC and UDC case, however, Kaufmann (1998b) is probably right in saying that TC corruption originates from the breakdown of politically organized groups, and from the bureaucracy itself, virtually uncontrolled. In other words, TC corruption is neither a top-down process driven by politics, nor a bottom-up process driven by business, but rather a short-sighted effort by the bureaucracy to exploit the lack of rules and acquire personal wealth as quickly as possible.

Once again, it is hard to say to what extent TC corruption may be efficient. Moderate corruption probably is, if one understands this term widely enough. That is, "moderate" should not refer to the value of bribes out of GDP (or to other similar variables), but rather as the way to reduce the discretionary power of the policy-maker. This actually seems to be the case in many Central European TCs, but it can also apply to some kinds of corruption in the former Soviet Union, where the legacy of the socialist ideology, including nationalism, is much more problematic than corruption *per se*.

On the other hand, and similarly to what has already been argued earlier on, corruption is not efficient when it aims at creating or preserving rents, like protectionism, industrial policies, sector-specific regulation. Or when it becomes the instrument through which short-term bandits of all sizes enrich themselves. The massive scale to which these phenomena apply in some TCs seems to suggest that either these policies are legitimate, i.e. they are shared by the large majority of the population (as in Montenegro, for example), or that they are the outcome of UDC-style policies without autocrats (as in Russia, perhaps). In the former situation the role of corruption is thus more or less neutral, for it is only a way to redistribute the rent, probably much less expensive than other rent-seeking and rent-extracting devices, thereby implying lower deadweight losses. True enough, corruption undermines the credibility of the institutional system. It generates further corruption and

prevents work ethics from coming to the surface. One should wonder, however, whether the institutional system had much legitimacy in the first place, and whether ethical behaviour can be created by international agencies, aid and monitoring on corrupt practices.

On the contrary, in the latter situation corruption is an essential element of the political system. It actually enables the bureaucrat to stay in power and - more important - to protect himself from the danger of being removed from office. Crime is of course also despicable, but unavoidable. Indeed, one cannot even rule out that at least some criminal organizations involved in corrupt practices benefit from immunity from - if not outright collusion with - the upper layers of the bureaucracy, including the military, the police, the judiciary. When this is the case, IMF-style recipes surely look good on paper³⁴, but are little more than wishful thinking in practice.

4. Normative Conclusions

The literature tends to refer to corruption whenever an illegal but freely-agreed-upon payment to an agent takes place in violation of a principal-agent contract. As a consequence, analyzing corruption easily becomes equivalent to evaluating the intrinsic legitimacy of voluntary transactions. From a subjectivist standpoint that is solved by making sure that third party' property rights are not damaged. This can be achieved by securing a competitive framework (freedom of entry, freedom of choice, freedom from coercion). Consistent with Lord Bauer's vision, corruption thus reflects an institutional framework away from credible property rights, enforcement of voluntary exchange, and human behaviour based on self-interest, self-responsibility and self-determination. Corruption is then the rational reaction of the individual *vis-à-vis* distorted rules of the game.

The discussion suggested in this paper is consistent with the main positive thrust of the traditional argument, but differs as far as the normative implications are concerned. Whereas the mainstream approach maintains that it makes sense to pursue policies aimed at both preserving illiberal rules and restraining rational reactions (including corruption), this contribution claims that corruption is an essential element if illiberal rules are to be preserved. In DCs corruption is however a much more deplorable phenomenon, for it is to some extent implicitly chosen by the electorate, whereas in UDCs and TCs it is imposed by the autocrats or by the absence of the rule of law as well as of the law itself.

³⁴ See for instance Wolf and Gürgen (2000).

This leads to the issue of what should be done about corruption. The mainstream approach has relatively little to say. In all countries the standard recipe boils down to making the political process more transparent, to enhance the effectiveness and accountability of the judiciary, to raise the wage rates and integrity of the civil servants. But of course, a perfect world cannot be created by *fiat*, especially if one ignores the very origin of the observable imperfections. Let alone the acceptability of the very notion of a perfect world.

Contrary to most prescriptions, the argument developed in this paper suggests two categories of corruption, which should be taken into account separately. One kind aims at curbing the discretionary power of the policy-makers, especially when the vast majority of the population deems their action otherwise as desirable. In this case bribing should be legalized, publicized and tax-deductible, as any other production cost incurred by a firm. Furthermore, politicians should have the power to remove bureaucrats at their discretion. This would not eliminate hidden bribes, but would make politicians more accountable to the electorate and the bureaucrats more accountable both to the politicians and to public opinion, whatever that may mean. This proposal would not eliminate bribes, either. And rightly so, since although bribes may be criticized out of envy, they still remain desirable and elicit individual action to its effect. Rather, these suggestions should be understood as a plan aiming at reducing the incentive to transform a "greasing the wheels" activity into a second category of corruption - related to straight rent-seeking.

Rent-seeking or rent-enhancing misbehavior dominates UDC corruption, and is most likely to occur in many TC contexts as well. In these cases the name of the game is keeping the autocrat in power. Eliminating corruption would of course be desirable, but as realistic as asking a ruler to engage in political suicide. Giving people the possibility of choosing with their feet and bribing their way out of a corrupt country is a more efficient solution. Once again, the best way to curb corruption is not by introducing additional monitoring and regulatory bodies, but by making it redundant and ultimately obsolete.

Put differently, if one agrees with the notion whereby corruption is a lamentable reaction to distorted institutions, then the normative economics of corruption coincides with policies designed to remove distortions. That may however be difficult, either because the vast majority of the population deems distortions desirable, or because a minority enforces such distortions upon the majority by means of violence. When this happens, guaranteeing individuals freedom to move and to choose is preferable to indulging in constitutional engineering.

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