



Why is Corruption Tolerated?

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Abstract. It is maintained that a closer analysis of the features of the underlying contract reveals that under many circumstances corruption is in fact a rational and understandable reaction to institutional failures, which are often far from accidental. Sometimes it can even be considered legitimate, when instrumental in achieving goals shared by the vast majority of the electorate.

To this purpose, three different stylized institutional frameworks are analyzed: developed, totalitarian and transition countries. The origin, scope and consequences of corruption vary significantly across the different frameworks. The normative conclusions should therefore be adjusted accordingly.

Key Words: corruption, rent-seeking, discretionary power, institutions

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1. Towards an Economic Theory of Corruption

The term “corruption” generally identifies a transaction whereby an individual bound by a formal principal-agent contract takes advantage of his discretionary power in order to sell to a third party property rights that do not belong to him (Banfield 1975, Jain 1998, Murphy et al. 1993, Rose-Ackerman 1998).¹ This is typically the case of bureaucrats who use their power to reduce costs for some operators, but at the expense of others. Or who can raise the cost for individuals to interact with the state and are compensated for not doing so: for instance, when government officials demand extra payments before they 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-being.²

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 falling short of 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 involved.³

Although the above is neither particularly new, nor particularly worthy of note, the economic analysis of corruption does not go much further. In particular, the literature follows two main avenues of investigation. A first category of contributions attempts to

evaluate the quantitative importance of these practices, while other works analyze their consequences on—say—distortions and overall growth, income distribution, rent-seeking dynamics. Not surprisingly, nobody disputes that corruption is a deplorable phenomenon, and that we would be in a better world without it. A milder judgement sometimes applies when corruption develops in countries where the rule of law is totally absent, since in these cases moderately corrupt practices might still be preferable to arbitrary rule, if not violence. It is also frequently added, however, that mild corruption degenerates rapidly, so that the usual remarks on its evil effects eventually apply again.

These conclusions are hardly disputed. In particular, there is little doubt that corrupt practices have a negative effect on income and growth (Kaufmann 1997, World Bank 2000). Still, world corruption is widespread and thriving.⁴ Very little is being done about it and public opinion seems more interested in limiting excesses—the definition of which varies of course across countries—than in eradicating misbehavior. Not even self-proclaimed honest politicians believe that advocating policies consistent with a serious fight against corruption can be a strong enough issue to win an electoral context. Put differently, although corruption might be a good argument to discredit political opponents, it is seldom sufficient to win a battle.

The reasons for the lack of understanding have to do with the little attention paid to what could be labeled as the institutional economics of corruption. As a matter of fact, when there are large and persistent discrepancies between rules that are commonly perceived as welfare maximizing on the one side, and the actual state of the world on the other, mainstream economics tends to rely on public-choice analysis. Explanations are thus formulated by referring almost exclusively to the features of the interaction among rent-seeking groups (Ades and Di Tella 1999). When applied to the domain of corruption, this means that misdemeanor stems from the fact that citizens at large have inadequate incentives to monitor and fight against corrupt practices, which in turn are encouraged and even protected by interest groups. Put differently, the individual cost of fighting corruption is perceived to be greater than the individual benefits which can be accrued by eradicating it. Of course, opportunism might play an important role as well.

As aired above, this argument is not very persuasive, though. From a theoretical viewpoint, the public-choice line of reasoning regards the law-bargaining process, rather than the enforcement of assigned property rights. Surely, the norms created as a result of rent-seeking efforts create opportunities for corrupt behavior, but that should be considered for what it is, i.e. a byproduct of the rent-seeking activities, not their aim or an essential element of such activities.⁵ Indeed, public-choice theory does not claim that interest groups are formed in order to coordinate or promote corruption, but to promote or discourage legislation. In addition, from an empirical viewpoint there is no doubt that in democracy, elections or targeted policy-making could easily overcome the collective-action problem, if that were really the issue. In particular, it would be certainly feasible to suggest reforms in the judiciary and legal systems, whereby corrupt practices may be made easier to detect, subject to much harder punishment, or simply made redundant. But this has been hard to achieve so far.

The bottom line is that the interest group type models do not offer satisfactory insights into the economics of corruption and that by relying on it the economics profession has

failed to explain this phenomenon in a convincing way. In other words, most of the current literature focuses on descriptions of corruption, and sometimes engages in comparisons of corrupt environments with the representations of a perfect world, where social engineers are entrusted with the elimination of undesirable phenomena at negligible costs. Unfortunately, descriptions and exercises in comparative statics are poor substitutes for explanations.⁶

In contrast with the usual (mainly descriptive) approach, these pages argue that corruption is not the lamentable by-product of situations characterized by exceedingly high economic and political transaction costs (e.g. caused by monitoring problems, or a non-competitive election process (see e.g. Persson et al. (2001)) and the literature quoted there). Instead, the paper focuses on corrupt phenomena connected with courses of action designed to meet widely shared collective needs that cannot be satisfied otherwise. Many policies that are deemed desirable by the vast majority of the population imply substantial delegation of power to bureaucrats and politicians, who are of course tempted to abuse such powers. As will be discussed later on, in these contexts corruption is an effective way for the leaders to exercise such powers, and for the rest of society to restrain potential abuse. If so, corruption can then be considered legitimate, if not moral. From this viewpoint, it appears that in order to appreciate and explain the role of corruption in modern societies one must explain the role of corruption within the current institutional contexts; evaluate whether it is instrumental in achieving socially agreed-upon goals; and examine whether there are alternative mechanisms to achieve the desired goals. Put differently, the analysis of corruption cannot be carried out without taking into consideration both the shared preferences of large portions of the population and the prevailing institutional contexts. And since the institutional frameworks differ significantly across countries, the role of corruption and its legitimacy differ accordingly.

Rather than suggesting a (descriptive) taxonomy of all possible corrupt practices, the following section emphasizes two discrete situations, depending on whether corruption applies to a free market environment, or to the system of relations typical of—or leading to—redistributive patterns according to arbitrary rules. And contrary to the descriptive mainstream view, it will be argued that in the latter case corruption has little to do with violent or deceitful stealing made possible by exceedingly high monitoring costs. Section 3 then applies the results to corruption in developed, totalitarian and transition countries, while Section 4 draws some normative conclusions.

2. Corruption as a Signaling Mechanism

A market economy is a system of interactions where individuals acquire and communicate information about scarcity through prices and thus decide about their preferred employment of resources. Of course, the price system frequently deviates from the neo-classical ideal, because of disturbances provoked by transaction costs, non-competitive market structures, and/or 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. That includes involvement in corrupt conduct; which can be understood as a reaction to distorted signals, as a way to extract the rents allowed by the institutional failures, or as a device to moderate rent-seeking efforts.

In order to simplify the discussion, two classes of corrupt behavior 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 and the latter is due to the existence of discretionary power and potential rents.

2.1. Distortions in the Market Place

Distortions in the marketplace originate from normative constraints that affect the extent and conditions of exchanges. They may also derive 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 (Dixit 1996). All these potential shortcomings are of course well-known to economic actors, who try to develop technologies, institutional rules, legal devices and specifications in order to reduce transaction costs. When these remedies are not workable or insufficient, and whenever the cost of the transaction is greater than its benefits, operators abstain from acting.

In small, self-contained communities the relevance of the opportunistic problem 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, for sometimes sanctions can be and are ignored: especially when corrupt agents are able to exercise some kind of violence or deceit with modest opportunities for escape or retaliation. But of course, when this happens, the pertinent issue is the legitimacy of violence, rather than the (im)morality of corruption.

Opportunistic behavior in large communities is a different matter, since it may be harder to detect through direct monitoring. Unequivocal 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 and 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. In free-market economies managers are thus 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 revenues.

Of course, this does not rule out small-scale corruption, which may even amount to quite substantial figures. The constraints provided by competition 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 agent.

Clearly, the main conclusion is that the market cannot support much corruption, provided that competitive pressures are strong enough. Corruption may indeed exist, when the cost of eliminating it is greater than the benefits from its 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 inadequacies that may encourage or protect malpractice. 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, to guarantee 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 provides 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 does not.

As a consequence, although corrupt behavior is frequently deplorable, 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 also be shed on the interaction between market agents and the state, the latter being the only body able to hinder an efficient allocation of property rights, create rents and limit competitive pressure effectively, thereby allowing corruption to persist.

2.2. *Government Failures*

Most scholarly energies have been devoted to model public corruption (as opposed to private corruption), to estimate its size and consequences.⁷ 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 long-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 public context is easier to measure, for transactions take place anyway. Actually, corruption may create a market for transactions that would have never taken place in an honest environment.⁸

As briefly mentioned earlier on, the main methodological question with state-related corruption derives from the fact is that it is a reaction to deliberately distorted property-right assignments and monitoring obligations. From this viewpoint “greasing the wheels” would then become acceptable, if property rights are assigned inefficiently to begin with, and their trading is otherwise impossible—say, because it is forbidden by the law and monitoring is effective.⁹

This explains why the economic analysis of corruption depends heavily on the rules of the game (institutions) that define and affect the role of the state, since the state is the only authority legitimized to create and uphold rents. Thus, in this case corruption may indeed 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 strive to reduce the discretionary power of the policy-makers. To the analysis of these two elements we turn in the next section.

3. Three Different Institutional Contexts

As already mentioned in the initial paragraph, the theory of corruption presented in this essay posits that there are two categories of corrupt behavior. One relates corruption to the presence of transaction costs. As such, it can thus be assimilated to the many imperfections that characterize market transactions and is subject to being cut back by means of new technologies and new property-right assignments. The second category originates from the exercise of discretionary power within the state sector. More precisely, it is maintained that in order to explain corruption it is necessary to understand the role of the state sector, which often differs from country to country, following local preferences, history and culture as a whole. As institutional economics aptly reminds us, other individuals living under different institutional circumstances do not necessarily reject what certain individuals deem as undesirable or inefficient.

The following paragraphs consider three different institutional situations and explain the role of corruption in each of them. As will be made clear shortly, our general theory of corruption is very simple. Whenever it applies, the ultimate aim of corrupt practices is not just self-enrichment, but—and perhaps more important—curbing the discretionary power of those who are in charge of carrying out desirable policies. As a consequence, the functioning and the dynamics of corruption depend on how these practices meet the assigned goal, i.e. curbing discretionary power of state officials, politicians and bureaucrats alike; while taking for granted that state officials are desirable because their activities answer more or less shared needs. In this light, the evaluation of corruption in terms of traditional allocative efficiency is clearly misleading. For these kinds of exercises may surely be useful to explain the microeconomic cost of corruption, but not its existence.

For convenience the stylized frameworks are defined as characterizing Developed Countries (DCs), Totalitarian Countries (TCs) and Transition Countries (TRCs). These country 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. In particular, the typical DC environment is a modern democracy featuring a free-trade regime, a significant welfare state and pervasive regulation. On the other hand, for the purpose of the present paper a TC framework is assumed to be dominated by autocratic rule, and thus by very little competition in the political and economic markets. Finally, TRC conditions consist of a formal institutional vacuum provoked by the downfall of the centrally-planned regime. 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.

3.1. *Rent-Seeking and Dependence in Developed Countries (DCs)*

Modern industrialized societies are far from the free-market ideal. Law enforcement is often ineffective and the rules of the game frequently violate the principle of individual freedom. But this is not necessarily the result of violence. On the contrary, individuals often accept the creation of the welfare state and of other institutions in order to protect selected groups, or to reshuffle wealth and income streams to reduce uncertainty, even when that may

enhance rent-seeking activities. In order to achieve this goal, power is usually delegated to bureaucrats and politicians, who are however subject to fairly loose formal controls—mainly limited to the electoral process, once every four or five years (Colombatto and Macey 1999). Such controls are deemed to be insufficient and, according to the thesis put forward here, corruption is an appealing device through which political organizations can be monitored more effectively than just under formal rules. In this light, corruption should then be considered as a means to attain redistributive goals without suffering too much from the policy-makers' discretionary powers.

In general, corrupt practices take place according to two patterns, which often intersect with each other. One focuses on individual policy-makers, another one with political parties. Following the first pattern, corruption can be understood as an arrangement through which DC producers and (to a lesser extent) factors' owners induce selected policy-makers to become dependent on illegal income flows.¹⁰ As a result, their behavior becomes more predictable and the transaction costs connected with normal business practice are ultimately reduced. Clearly, under these circumstances DC corruption can be interpreted as a bottom-up process and its main aim is not directly connected with the rent-seeking mechanisms typical of the public-choice approach. Instead, it is designed to elicit predictable behavior and therefore reduce discretionary power.

Corruption acquires a different and less accepted meaning, however, when misconduct is taken advantage of in order to preserve power, rather than to pursue more or less widely shared objectives, such as redistribution and collective insurance. More precisely, the argument put forward here is that the nature of undesirable corruption in DCs is associated neither with the creation, nor with the extraction of rents. On the contrary, the role of the DC corruption problem may be better appreciated by relating it to the politicians' and high bureaucrats' desire to preserve and exercise power *per se*, to satisfy personal ambition, enhance status and personal prestige, take advantage of the opportunities offered by the welfare state.¹¹

This view is consistent with the fact that pressure groups do not need to offer large bribes 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, 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 behavior and thus increase the probability that the incumbent politicians lose consensus and power.

The second mechanism runs through political parties. More precisely, in most DCs political life and policy-making is dominated by political parties (and party fractions), rather than by homogenous majorities or particularly trusted leaders. When this is not the case, tensions usually emerge. Indeed, party systems are chosen not only as a means through which preferences are expressed, but also as a tool to guarantee institutional stability and consensus. Put differently, they are not only vehicles through which preferences are translated into the legislative process, but also actors themselves. As such, their actions are not only tolerated, but also welcome, even when they might weaken government effectiveness or the legislative process. That is, political parties are not only required to represent

the will of the voter during elections, but also to run the country along with other organs (like Government and Parliament). While performing this latter role, parties need rather significant financial resources. And in many Western European DCs bribes have therefore become a tolerated—if not outright accepted—instrument to finance a party-controlled institutional framework. There are alternatives, of course. But bribes are superior to official state transfers to parties for two reasons. First, illegal transfers make recipients more accountable to the electorate, whereas official payments would increase parties' dependence on the elected policy-makers and the bureaucrats, whose very discretionary power is to be curbed. In addition, they offer more opportunities for new entrants into the political system, against incumbents. The greater the dependence of a political party on bribes, the greater the importance of expected results as opposed to past electoral success. The latter being obviously nil for new parties and relatively modest for growing parties. Indeed, from this viewpoint corruption is an opportunity to decrease political rent-seeking (entry barriers)¹² and accelerate political change in democratic settings.

From this viewpoint DC corruption can thus be considered desirable, given the set of widely shared preferences for redistributive policies managed by political parties, at least to some extent. For corruption reduces transaction costs, makes agents' behavior predictable, and stabilizes the institutional environment. 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 expectations.¹³ But as long as corruption fulfills the role of making conduct predictable, and the party system is strong enough to guarantee stability, it is not intolerably harmful.¹⁴

The desirable checking and monitoring framework is provided by the (free) press and public opinion, rather than by the judiciary and rule-of-law principles. Extreme (i.e. intolerable) corruption in DCs is therefore due to misjudgment by the policy-makers, or the media, or both. 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 of public indignation, the rules of the game are hardly disrupted or changed. For the bribe actually amounts to what is necessary to raise the politicians' ambitions and needs, or the bureaucrats' income levels, so as to introduce dependence. Ultimately, the goal is to feed political parties, which in turn guarantee preservation of consensus and, more generally, of the welfare state and state-funded projects.¹⁵

The bottom line is that "crony capitalism" in DCs is in harmony with the shared preferences for substantial state intervention. It is 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 soon-to-be-forgotten 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 benefits a political party, rather than personal pockets.¹⁶ Put differently, corruption would become a social problem if it failed to moderate abuse in the exercise of power, or if other institutional devices were

found out to be preferable to that purpose, but failed to come to the surface and be adopted. That remains a challenging issue for political scientists, rather than for economists.

3.2. *Rent-Seeking and Loyalty in Totalitarian Countries (TCs)*

Corruption is a different story and serves different purposes in TCs, 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 DCs.¹⁷ As a matter of fact, it is a major concern for the TC policy-maker to make sure that competitive pressures do not build up and that his power remains undisputed.

As argued in greater detail elsewhere (Colombatto and Macey 1999, Mbaku 2000), within this framework the ruler relies on a relatively small elite that helps him run the centers of power and creates enough consensus in the functional and geographic areas where hostile 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. Instead, the creation of relatively large bureaucracies is often an appealing solution. These bureaucracies also include the lower ranks of the military, while appointments and careers are often biased according to tribal loyalties. 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 regime.¹⁸

In short, TC corruption takes place at two different levels and for two different purposes. At the upper level the autocrat creates rents that 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. It allows the ruler to accumulate personal wealth and possibly 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 otherwise look abroad for political and financial support. As a by-product, it creates a loyal structure of sometimes even highly qualified officials through which power is exercised.

At the lower level corruption is the way through which officials are bound to the ruling elite, and loyalties are purchased. Therefore, its assessment depends on the alternatives, given the constraints already described. The only other prospect for the ruler 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. That is hardly realistic, though, 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, fine tuning is probably preferable to generalized taxation, which in a TC would cripple the more visible companies and also create a new class of (highly corrupt) rent-seekers—the tax collectors.

More generally, DC efforts to cut down corrupt practices—say, by withdrawing international recognition—may be less desirable than it sounds when a totalitarian regime is the least of all evils. For instance, that applies to countries where ethnic differences and violent rivalries are significant, so that the perceived alternative to totalitarian rule is not Western-style political confrontation, but daily physical aggression. Unless the economic rules of the game are changed drastically—away from sanctions or official aid, towards economic liberal regimes and rule of law¹⁹—efforts to eliminate corruption would generate political instability. For 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 groups.²⁰

Two deductions follow, one from a positive viewpoint and one in a normative perspective. 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 level.²¹ In order to understand the second conclusion, one has to take into account that effective corruption requires repeated personal interaction, especially in the TC world. This is easier to obtain in small communities, whereas outsiders are almost always forced to make use of intermediaries in order to deal with local operators and carry out business. The cost of trading rises as consequence, so that corruption becomes more and more costly when the need to trade with the outside world intensifies, i.e. when the perceived opportunity cost of autarky grows. It follows that unilateral DC trade liberalization *vis-à-vis* TCs may be an effective way to make stable trade relations a priority in the developing countries and corruption a burden. 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, the TC context helps draw the line between rent-seeking and corruption. Rent-seeking occurs when individual freedom of contract is violated and wealth is transferred from one individual to another by means of physical violence or deceit. Of course, this happens frequently in TCs, when the autocrat simply acts like what has been defined as a short-sighted bandit and accumulates considerable personal wealth. And this often provokes deep resentment, similarly to what had already been noticed in the DC case, when it comes to “personal corruption”. Consistent with the simple general theory expressed at the beginning of Section 3, corruption is however tolerated and even accepted when a totalitarian society is weak. 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 and the alternative to totalitarian rule could be bloodshed. Similarly to the DC case, corruption then becomes the instrument to curb violent political conflict and unite the population around a leader. Contrary to the DC situation, the primary aim is not to

reduce the policy-makers' discretionary power, but to decrease the expected benefits from delivering discretionary power to potential new entrants. Hence, corruption becomes a way to discourage violent confrontation. Eventually, TC acceptable corruption disappears when the danger of political confrontation weakens. If the political regime also undergoes transformation, corrupt practices will then follow the DC patterns described earlier. If not, the days of the short-term bandit are likely to be numbered.

3.3. *Rent-Seeking in Transition Countries (TRCs)*

To a large extent, today's corruption in TRCs is inherited from their collectivist past, which is responsible for today's relatively poor governance and absence of the so-called "good civil society."²² Communism tolerated and to some extent even encouraged corruption for reasons that are fairly similar to those already presented in the DC and TC cases (enhance policy-makers' predictability, create diffused support for the ruling elites). Indeed, it is no accident that according to the traditional measures of perceived corruption many TRCs rank at the same level as most TCs. Two differences *vis-à-vis* the TC context are however worth to be stressed. One concerns the distinction proposed earlier on, between the upper level (the elite) and the lower level (the medium and lower layers of the bureaucracy). Under Communism this partition 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 almost unchecked greed. With few exceptions, this made sure that almost nobody actually became rich, of course; but it gave everybody the impression that by disrupting the system everybody had something to lose. As a result, corruption became an accepted way both to make bureaucrats' behavior predictable and to appease social tensions. If so, our general explanation of corruption would be confirmed.

The second difference regards the regime of central planning, which was of course neither about centralized decision-making, nor about real planning. As regards corruption, however, it is important to notice 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 central plan (which was in turn the object of a bargaining process), buy immunity against under-performance, set aside enough resources to be sold in the black market, both *vis-à-vis* consumers and other firms. Once again, corruption made sure that the system could work fairly smoothly (which is nothing new) and could provide a much longed-for sense of security and stability—which comes closer once again to the argument made in this paper.

Where and when the collectivist system broke down, new formal rules failed to come to the surface, and the vacuum was by and large filled by the informal rules of the game that were the essence of the socialist societies of the Soviet bloc. Corruption was of course an essential element of those rules. And it expanded further in the post-communist context: 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 2001:119).²³ It is hardly

surprising that corrupt behavior now reflects both the rent-seeking activities analyzed by the public-choice school, and the dependence patterns typical of a modern democracy.

Contrary to the DC and TC cases, however, TRC corruption originates from the weakness of politically organized groups, so that the bureaucracy rules, virtually uncontrolled (Kaufmann 1998b). In other words, TRC 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. It is certainly tolerated, even if reluctantly. It is tolerated because the alternative to TRC corruption is discretionary power. Reluctantly, because agents have failed to agree on a common target (say, the regulated economy, as it happened in much of Continental Western Europe).

The situation is perhaps different in those parts of the former Soviet bloc where transition never really took off and corruption runs much deeper, possibly being the worst in the world.²⁴ These are the contexts where new autocrats have replaced older rulers, but failed to enjoy the same stability as the old communist regime. The repeated-game feature has therefore 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. Under these circumstances corruption remains the only viable way to buy the discretionary power of the bureaucrat and carry out a modest amount of business transactions, whereas criminal organizations often represent the only effective authorities with an interest to enforce an agreement. By recalling what had already been claimed in the paragraph devoted to TCs, there is no doubt that under these circumstances the balance between corruption, which essentially satisfies the population's shared needs, and rent-seeking, which benefits the elites only, has shifted towards the latter.

All in all, it may be worth reminding that in these parts of the Soviet bloc the legacy of the socialist ideology, including nationalism, is much more problematic than corruption *per se*. Unfortunately, the massive scale to which illegal transactions apply in some TRCs seems to suggest that either these policies are legitimate, i.e. they are shared by the large majority of the population; or that they are the outcome of TC-style policies without autocrats as we commonly defined them. In the former situation the role of corruption is thus only a way to redistribute the rent, probably much less expensive than other rent-seeking and rent-extracting devices. In the latter situation corruption is an essential element of the political system. And crime virtually unavoidable.

4. Concluding Remarks

Corruption occurs 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 has usually become equivalent to evaluating the nature of transactions. Not surprisingly, when the institutional framework deviates from a satisfactory property rights system, which is based upon the enforcement of voluntary exchange, human behaviour based on self-interest, self-responsibility and self-determination, corruption becomes the rational reaction of the individual *vis-à-vis* distorted rules of the game. This leads mainstream economics to two

kinds of conclusions. Corruption is regarded as a response to bad policy making (rather than to bad politics) and is subject to being examined as a rent-seeking situation.²⁵

From the normative viewpoint, orthodox authors and agencies then tend to advocate action aiming at both preserving illiberal rules and restraining rational reactions (including corruption). Most undeveloped countries are therefore relentlessly encouraged to fight corruption, although their policies and institutions are much less forcefully questioned. A variety of detailed measures are dwelled upon: making the political process more transparent, strengthening the effectiveness and accountability of the judiciary, raising the bureaucrats' salaries, promoting civil servants' professional training and integrity. But of course, all this is not likely to go very far. And it doesn't. One cannot create a perfect world by *fiat* or wishful thinking, especially if the very origins of the observable imperfections are ignored. Let alone the acceptability of the very notion of a perfect world.

This paper does not deny the presence of rent-seeking in association with "bad politics"—whatever that may mean. It is nevertheless argued that new insights can be perceived by looking at corruption as a course of action whereby (1) discretionary power is willingly transferred to the policy-makers so as to allow them to carry out agreed-upon redistributive policies, and (2) formal checks on the policy-makers' activities are considered to be less than satisfactory. From this standpoint, the two mainstream normative conclusions mentioned above are therefore misleading, if not simply mistaken.

From a broader perspective, it has been pointed out that fighting illegal transactions *per se* makes little sense unless one has an explanation of corruption. Descriptions will not do. By labeling corrupt behavior as immoral and representing what a corruption-free world would look like, one does not go very far in solving the problem of corruption itself. As the new-institutional lesson has made clear, claiming that corruption is deplorable just because it is against the formal rules shows a very poor understanding of what economics is about. In particular, and contrary to the orthodox approach, tagging corruption as "immoral" misses the point. Morality is understood by individuals as whatever enhances their social cooperation, i.e. profitable and voluntary interactions, without prejudice for individual freedom. Hence, the alleged immoral nature of corruption becomes questionable if the rules of the game of a community deviate from those typical of a free society. And fighting corruption turns out to be a meaningful policy only if it is part of a strategy to change preferences, and thus make corrupt behavior redundant.²⁶

This is actually not far away from those who claim that corruption is just a rational reaction to illiberal rules of the game; which would be a plausible argument if such rules were actually systematically forced onto the population through a top-down, more or less violent process. As argued in the previous paragraphs, this may be sometimes true, especially in a number of undeveloped countries. Still, it is believed that illiberal rules are often times the outcome of a bottom-up process, whereby a large majority of the population may voluntarily decide to give up economic freedom in order to attain other goals—e.g. sharing the cost of uncertainty, enhancing physical security. Of course, different explanations apply to different institutional contexts. For instance, in DCs corruption is at least to some extent implicitly chosen by the electorate, whereas in TCs and TRCs the autocrats or the temporary elites offer it both to enrich themselves and as a way to reduce ethnic or social tensions. Indeed, the very fact that both Western societies (especially in Continental Europe) and

undeveloped countries often explicitly and overwhelmingly reject free-market policies and institutions seem to undermine the orthodox economics of corruption and support the view suggested here. Much remain to be done, of course, especially as far as the definition of the relevant institutional context is concerned—that is, relevant to the issue of corruption. This is not only a matter of formal rules, of course. Among the various possible areas of fruitful empirical investigation one may consider the DC context, where corruption differs considerably across countries: according to the Corruption Perceptions Index 2001 by Transparency International the distance between Sweden and Italy is roughly the same as that between Italy and Nigeria. In this very case our theory would thus suggest that the role policy-makers and political parties are expected to play in Italy and Sweden is radically different. In particular, such actors are expected to have greater decision-making power in the former country, perhaps to take into account more heterogeneous preferences (as suggested by Chapman (1998) with reference to the charitable sector), or perhaps as a consequence of the different role attributed to the welfare state (redistribution versus collective insurance).

In short, 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. Whereas if one judges that corruption is a desirable instrument to curb decision-making power or to reduce social tensions, then corruption should not be fought at all. Whatever version one believes, guaranteeing individuals freedom to move and to choose among institutional contexts is preferable to indulging in constitutional engineering.

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Notes

1. Some authors tend to focus on monetary payoffs to public officials. Although these are surely corrupt practices, it is worth stressing that they are by no means the only ones. Corruption can also occur in the private sector (see 2.1) and does not necessarily include monetary transfers. For instance, it often happens that political appointments are decided by taking into account expected future malpractice, or that public expenditure financed by general taxation is influenced by expected electoral behavior in restricted areas.
2. That also regards international civil servants, who are even less accountable than their national colleagues, as forcefully described by Hancock (1982).
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 politicians and bureaucrats end up as employees or consultants in companies and industries with respect to which they had previously played a public role.

As explained later on in this section, corruption should not be confused with rent-seeking. While the former refers to illegal activities to acquire benefits and privileges, the latter regards attempts to pass laws or to take advantage of the existing legislation so that such benefits and privileges can be attained legally. There is no doubt, however, that rent-seeking can and frequently does take place by means of corrupt practices.

4. See for instance *the Economist* (March 2nd, 2002:67–70; A Survey of Thailand, p. 5), which provides anecdotal evidence against the effectiveness of anti-bribery legislation in developed as well as in developing countries; and questions the meaningfulness of some rankings of international corruption.
5. This holds true except for one very important case, i.e. when the rent-seekers are the policy-makers themselves. See on this Section 3.
6. That also applies to totalitarian countries, where corruption is “explained” as a device by which the leader extracts rents and possibly buys loyalty from the elites. This only one part of the story, though. And it does not explain why corruption is tolerated and often even encouraged throughout all layers of the bureaucracy.
7. Orthodox analyses have been presented, among others, by Mauro (1997), Jain (1998), and Kaufmann (1998a), who assume a direct causal link between corruption and economic performance. See also Wei (2001) for further references to the available quantitative data.
8. See for instance Tanzi and Davoodi (1998), who plausibly claim that corruption tends to expand public investment, the quality of which however deteriorates.
9. Similar comments apply when assignment is not guaranteed/enforced. For instance, this is the origin of the so-called 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.
10. 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 downfall. 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.
11. De Jouvenel (1945/1993) discusses the meaning and consequence of power in this connotation at length. The emphasis on the link between corruption and the preservation of power may explain why this phenomenon 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.
12. Unlike Western Europe, US politics also relies heavily on campaign contributions. According to the line of reasoning presented here, this is due to the fact that the political services in the US are not really intended to provide a diffused welfare state, and are more clearly directed to creating rents for specific coalitions. In this respect, it may well be maintained that the thesis presented here is more apt to explain corruption in Continental Europe than in the US, where this term is understandably almost synonymous with rent-seeking.
13. This leaves little scope for corrupting the lower layers of the political class, which tend to be controlled by the party leaders through other means, e.g. by using state companies as cash dispensers with relatively soft budget constraints.
14. One may even wonder whether such kinds of transactions deserve to be designated as “corrupt” altogether. By looking at the definitions provided at the beginning of this essay, there is no doubt that a bribe or an illegal transfer of money violates a formal contract whereby the policy-maker should not steal. But one may wonder whether the bribe violates the agreed-upon need to illegally finance political parties. If so, the drawing the line between criminal corruption and acceptable corruption becomes a matter of intensity.
15. Public works is usually the main area where this funding takes place (Della Porta and Vannucci 1997).
16. Contrary to what is observed when corruption is about individuals, illegal payments to political parties do not provoke envious feelings; and can indeed be approved in so far as they aim 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.

17. 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.
18. 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 in that case control on productive activities would vanish.
19. Indeed, official aid and far too many so-called "co-operation projects" contribute to making corruption a highly profitable business. See Hancock (1989, especially part 5), Easterly (2002), Martens et al. (2001), and Zakaria (1997).
20. 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).
21. Clearly, this does not imply that a corrupt society is necessarily peaceful.
22. With exceptions, though. See the detailed analysis proposed by Kaminski and Kaminski (2001).
23. See also Kaufmann (1998b: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."
24. See Kaufmann (1998b), who quotes the *World Bank Survey* carried out for the *World Development Report 1997*.
25. See also Lederman et al. (2001), who not only subscribe to the view whereby corruption is by and large a matter of electoral and constitutional engineering, but also suggest that the state should mimic the market (competition among agencies) in order to reduce rents and thus corrupt practices.
26. See also Raico (2004, ch. 4), who also refers to Lord Bauer's thinking.

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