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**“An Economic Approach to Corruption”**

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**An Economic Approach to Corruption**



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# I

## **Corruption is a crime, but not all crimes are corruption**

Corruption is the performance of illegal, voluntary transactions between two parties (the agent and his/her customer) with a detrimental effect on a third party (the principal), whom one of them legally was supposed to serve.

A corrupt agent exercises power received from his principal in a way different from his commitment to the principal. In so doing, the agent disposes of the principal's wealth to his own benefit. A person can be an agent in one relationship and a principal in another. For instance, the CEO of a company is an agent of the shareholders, but the principal of the company's manager. Likewise, the manager is an agent of the CEO but the principal of his/her secretary.

There are two essential elements of corruption: An illegal voluntary transaction between two parties (the agent and somebody else) and unfaithfulness to a third party (the principal).

Without unfaithfulness to a third party, a crime will not qualify as corruption; thus, stealing or murder, for example, do not constitute corruption: There is a culprit and a victim (who may even be betrayed by the culprit), but the third betrayed party is missing. These crimes, consequently, do not constitute corruption.

The other ingredient of corruption is the existence of an illegal voluntary transaction between two parties that has a detrimental effect on a third party. Thus, stealing cash from the company vault is unfaithful to the company, but it is robbery, pure and simple, not corruption because there is no transaction between the dishonest employee and anybody else.

On the other hand, if an employee in charge of acquisitions strikes a deal with the supplier of raw materials to overcharge the company and then to split the loot, this is a crime that conforms to the definition of corruption.

Tax evasion is a crime, but it is not corruption. Bribing a tax-auditor, on the other hand, is corruption because there is a voluntary transaction (between the evader and the auditor) and a third party (the government) is betrayed.<sup>1</sup>

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<sup>1</sup> Tax evasion or the improper use of discretionary tax exemptions “fall under the definition of corruption only when there is a counterpart payment to the tax official responsible” Mauro, P. “The Effects of Corruption on Growth, Investment, and Government Expenditure: A Cross-Country Analysis” in Elliot, K. A., Corruption and the Global Economy (Institute for International Economics, Washington D. C., 1997), p. 87.

Failure to stop at a red traffic light or to comply with the speed limit is a crime, but it is not corruption. On the other hand, bribing a policeman to avoid the ticket is corruption.

Shleifer and Vishny define government corruption “as the sale by government officials of government property for personal gain”<sup>2</sup>. This definition contains the two elements mentioned above. Consider the robbery and subsequent sale of a government computer by a government official: There is a voluntary transaction between the dishonest official and the buyer of the computer, and a third party (the government) is betrayed. The examples provided by these authors, however, make it perfectly clear that their definition was mainly intended to include a wider variety of cases of corruption (“government officials often collect bribes for providing permits and licenses, for giving passage through customs, or for prohibiting the entry of competitors”, p 599). The permits and licenses, the passage or the prohibition, play the role of the computer in the previous example.

What makes these objects of corruption more interesting than computers is that they enable private agents to pursue economic activity that would be otherwise forbidden. Licenses and permits (even passports and visas) are needed to conform with legally imposed restrictions to private economic activity.

Unlike the computer, it is not always true that such restrictions serve any useful purpose. In the words of Tullock: “People say that corruption is taking action, not for its ostensible reason, but for the secret reason of private benefit –i.e., one pretends to favor the public interest but is in fact favoring his own pocketbook.”<sup>3</sup> It is possible that the main, if not the only, purpose of some of these permits and regulations is to give the corrupt officials the power to deny them and to collect bribes in return for granting the permits. In such case, the government is not the betrayed principal. It is, rather, a partner of the corrupt officials in betraying the electorate, the ultimate principal.

## II Corruption can grow everywhere, but the most fertile soil is located in the public sector

In the private sector corruption may arise despite efforts to prevent it. Companies have an incentive to make every effort to prevent dishonest employees from striking deals with customers or suppliers in their own benefit, against the interests of the company. An employee can perhaps take advantage of a faulty procedure in his/her own benefit, but a company will not deliberately create an administrative procedure with the sole (or main) purpose of creating corruption opportunities for its employees.

In the public sector, on the other hand, corruption is nurtured by the fact that useless restrictions on private economic activities, though detrimental to the communal well being, are virtually costless for public officials to impose and very valuable for their private counterparts to buy their way out. The incentives to actively fight corruption are, if any, much weaker than in the private sector where corruption is detrimental to profits and, therefore, it is more easily repelled.

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<sup>2</sup> Shleifer, A. and R. W. Vishny, “Corruption” *Quarterly Journal of Economics*, Vol. 108, N°. 3 (Aug., 1993), p. 599.

<sup>3</sup> Tullock, G. “Corruption Theory and Practice” *Contemporary Economic Policy*, Vol. XIV, Number 3 (July 1996), p. 11.

There is a close relationship between public sector intervention in the economy and corruption. The replacement of automatic, impersonal, market mechanisms by discretionary, bureaucratic, procedures brings about newly created opportunities for corruption. "If the government controls financial markets, foreign trade, access to foreign exchange, and access to many goods provided at subsidized prices (such as telephones, water, electricity, credit and imported goods), bribes will often play the role in allocating scarce goods and resources that prices are not allowed to play."<sup>4</sup>

Cheung argues that not only most regulations and controls are intended to generate opportunities for corruption, but that even those that were not deliberately invented for that purpose, once they were in place and were found by officials to serve that objective, they would be refined to better serve the objective of facilitating corruption. "In other words, regulations and controls are subject to the test of survival of the fittest, "fittest" in the sense that they serve the people in power, subject to the constraint that they can fool most of the people most of the time."<sup>5</sup>

### III

#### The economic analysis of corruption

"Since corruption is usually taken to be synonymous with evil, its mere existence is often a cause for concern. An economist, however, can arrive at that conclusion only after understanding corruption's impact on the efficiency and equity of the economic system. If its impact is benign, then the economist will argue for law reform since there are costs, both psychological and financial, in labeling illegal a practice that is actually functional."<sup>6</sup>

Economic analysis addresses two issues: Efficiency and equity. Efficiency is defined as the maximum level of achievement of a certain goal by using a given quantity of resources or, alternatively, the attainment of a given level of achievement of a certain goal by using the minimum quantity of resources.

In the case of production, it is said to be efficient when given resources yield the maximum quantity of a product or, alternatively, when a given quantity of a product is obtained with the minimum use of resources.

Likewise, gifts of cash are said to be more efficient than gifts in kind of the same value. The reason is that whatever satisfaction you can provide by giving a \$100 book, you can better provide with a \$100 bill simply because the recipient can still buy the book or buy anything else which he/she might like better than the book.

Economic analysis determines whether a course of action is more or less efficient than another, and can also identify and quantify the equity consequences of each. Economic analysis can assess, for instance, that an irrigation project in rural areas is less efficient than the provision of potable water and sewerage in urban areas (the benefits of irrigation are smaller than those of potable water and sewerage, for the same use of resources in each project). Economic analysis can also determine who benefits from each project and by how much. It can, for example, estimate that the irrigation project, despite having relatively low benefits will increase the income of poor peasants by 10%

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<sup>4</sup> Tanzi, V. "Comments" in Elliot, K. A., Corruption and the Global Economy (Institute for International Economics, Washington D. C., 1997), p. 167.

<sup>5</sup> Cheung, S. N. S., "A Simplistic General Equilibrium Theory of Corruption" Contemporary Economic Policy, Vol. XIV, Number 3 (July 1996), p. 3.

<sup>6</sup> Rose-Akerman, S. "Corruption and Development" Annual Bank Conference on Development Economics (The World Bank, Washington D.C., 1997), p. 1

while the potable water and sewerage project will benefit members of the urban middle class in an amount equal to 5% of their incomes.

Economic analysis, however, does not have the technical tools to determine which equity consequences should be preferred. The question “What is to be preferred: Increasing by 10% the incomes of poor peasants or by 5% the incomes of the urban middle class?” cannot be answered by economic analysis. Nonetheless, whoever has to answer such a difficult question will find it useful to know the quantities of these effects. His/her answer would probably be different if the effect on peasant’s incomes were 1% instead of 10%, or if the effect on the incomes of members of the urban middle class were 15% instead of 5%.

#### Voluntary transactions encourage efficiency; but illegal voluntary transactions may not

Consider Robinson and Friday on their island with given endowments of food and clothes for each one. What if Robinson possesses more food and a stronger preference for clothes than his neighbor who, in turn, is the owner of most of the clothes and has a very strong preference for food? If each were condemned to consume their respective endowments, both would be very unhappy.

Voluntary transactions will lead to a better-fed Friday and a better clothed Robinson with the same total quantities of food and clothes. Voluntary transactions lead to an allocation of goods in the island, which is more efficient than the original endowments.

The fact that corruption involves a voluntary transaction creates, thus, the presumption that corruption promotes a more efficient allocation of goods: Imagine a government official allocating a scarce benefit (few permits to operate, for instance) to many individuals using criteria other than willingness to pay (such as, for instance, first come first served until supply is exhausted).

The first in queue gets the permit even if he/she is not the individual who can carry out the operation at the lowest cost. With corruption, anybody down the queue who can operate at a lower cost would offer to pay a bribe equal to at most the cost differential to get the permit. If still another individual in the queue can operate the facility at a still lower cost, he/she will be willing to offer a still higher bribe to get the permit.

With corruption the permit will, then, automatically be assigned to the lowest cost operator (because he/she will be able to pay the highest bribe), whether or not he/she is first in queue, although he/she might have to pay a bribe to get it. But what is wrong with paying for what you want? That is, after all, the basis of the free market system. Corruption essentially transforms a “first come first served” rule into an auction, and an inefficient allocation of the permit into an efficient one.

Consider now the equity effect of corruption: Imagine that the permit was allocated following the “first come first served” rule, and subsequently the recipient of the permit was allowed to sell it to the highest bidder. Then the permit would end up in the same hands as in the case of corruption and, therefore, efficiency would be preserved. The distribution of wealth will, however, not be the same in both cases: Under the “first come first served” rule the price of the permit goes to the first in queue, while in the case of corruption, it goes to the public official making the allocation.

So far, economics seems to indicate that efficiency has been served by corruption: Society saved valuable resources when the lowest cost operator gets the permit. Economics also identifies an equity effect whose ethical value escapes the narrow limits of economics.

But the economic analysis is not yet finished. The illegality of the transaction has to be brought into the picture. This may make the official in charge of allocating the permits reluctant to deal with those individuals unknown to him for fear of exposure. "Only those who already have a close trusting relationship with government officials and politicians may enter the bidding"<sup>7</sup>.

The illegality of the transaction makes advisable to keep it secret and resources would unavoidably be spent on keeping the transaction secret. Moreover, the secrecy may even prevent the lowest cost operator from knowing about the possibility of bribing the official with the power to allocate the permit.

The agreement between the briber and the bribee, being illegal and secret, will be very difficult to enforce: The lowest cost operator would not know who to pay to but even if he/she knew, and paid, he/she would not know how many more bribers may show up demanding still more payments after his/her first payment<sup>8</sup>. Refusing to comply with each subsequent payment will render all the previous payments useless. Arbitrariness is almost unavoidable and increasing uncertainty will weaken efficiency.

This problem has given rise to "middlemen who receive commissions for bringing all the relevant layers of officials together to obtain their approval simultaneously. Although this type of arrangement has indeed occurred in China (according to Lawrence Tse of the Independent Commission Against Corruption and P. K. Lau of the Hong Kong Polytechnic University) these middlemen may be limited severely by the secret nature of corruption."<sup>9</sup> Of course, having to pay also middlemen further increases the costs of carrying out economic activity and further erodes economic efficiency.

Thus, illegality of the transaction seriously undermines, if not destroys, the presumption of efficiency in corruption: The successful bidder may not be, after all, the lowest cost operator.

Shleifer and Vishny ask "why bribery might be much more costly than its sister activity, taxation, and argue that the imperative of *secrecy* makes bribes more distortionary than taxes."<sup>10</sup> (In the economists' jargon "distortionary" means detrimental to efficiency).

Not all activities are equally capable of being kept secret. In the presence of corruption there will be discrimination in favor of those that are easier to conceal instead of the most efficient ones. Consider the provision of lunch to poor children in state-run schools. Bread and milk have well known prices; therefore giving this food to the children would hardly afford the school manager an opportunity to get a kickback. On the other hand, if he/she gave the children a uniquely prepared meal (normally, more expensive and of a poorer nutritional content), its cost would be easier to conceal. The supplier in turn would be happy to overinvoice for the lunches and kick back some of the profits to the manager (and his/her ministerial counterpart).

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<sup>7</sup> Rose-Akerman, S. "The Political Economy of Corruption" in Elliot, K. A., Corruption and the Global Economy (Institute for International Economics, Washington D. C., 1997), p. 42.

<sup>8</sup> For example, an importer might need several permits, provided by different agencies, to have access to foreign currency and to bring in, unload, unpack, transport and sell imported goods. Some of the different agencies that supply the complementary permits may be corrupt and the importer might not know which ones. Each one of which can stop, or delay, the process despite the fact that some other agencies already collected their bribes.

<sup>9</sup> Lui, F. "Three Aspect of Corruption" Contemporary Economic Policy, Vol. XIV, Number 3 (July 1996), p. 27.

<sup>10</sup> Shleifer, A. and R. W. Vishny, Ibidem, p. 600.

Besides the equity considerations arising from the transfer of money from the supplier to the corrupt officials, efficiency is damaged when more resources are used to provide less nutrition.

#### Unfaithfulness discourages efficiency

The second ingredient of corruption, unfaithfulness by the agent towards the principal he/she was supposed to serve, definitively discourages efficiency. The principal to prevent unfaithful behaviour from his/her agent would adopt expensive precautionary procedures.

It is not the agent's unfaithfulness *per se*, but the principal's fear of being a victim of it, what leads to costly procedures. The principal's fear that his/her agent might be unfaithful creates an incentive to incur in costs that would have been otherwise unnecessary.

The aggrandizement of the requirement to consider several offers from different suppliers before any purchase is authorized is an example. Although the procedure is, in principle, a good practice sometimes its application gets out of proportion, which entails unnecessary delays and other costs, out of the fear of kickbacks.

Honest risk taking by an agent will be hampered in an environment of distrust. It might be misinterpreted as lack of loyalty or an attempt to commit an act of corruption, with terrible consequences for his/her career.

An environment of generalized distrust discourages decision-making and risk-taking, with detrimental economic effects on society.

#### Efficiency losses make the damage greater than the bribe

The cost of corruption to society is not accurately measured by the amounts of bribes. These are collected on businesses that took place, on permits actually sold, on school lunches eaten by the children. But the amount of bribes collected fail to account for all the businesses that never materialized because of the unnecessary restrictions imposed by the bribe seekers, all the permits that were never granted, all the school lunches that were not delivered after the school budget became prematurely exhausted. All these represent significant losses regardless of the amounts of money that changed corrupt hands.

Table 1 summarizes the economic effects of corruption.



Table 1: Economic Effects of Corruption

	Effect on Efficiency	Effect on Equity
<u>First ingredient:</u> Voluntary illegal transaction between the corrupt official and his/her customer	The net effect is ambiguous: Voluntary transactions increase efficiency, but its illegality is detrimental to efficiency.	Wealth is transferred from the government and/or the customer to the corrupt official.
<u>Second ingredient:</u> Betrayal by the corrupt official to his/her principal	Decreases efficiency, as expensive precautionary procedures would be adopted. Also generalized distrust discourages decision-making and risk-taking.	Wealth is transferred from the government and/or the customer to the corrupt official.

Not all acts of corruption carry the two ingredients in the same proportions. In some cases the first ingredient may prevail like, for instance, selling permits or allocating goods (or foreign currency) at below market prices in exchange for bribes. In such cases, bribes are essentially payments that clear the market; bribes come to help prices perform a duty that the government does not allow the prices to accomplish. In other words, bribes would not even arise if the government let prices do their job: to clear the markets. Without ignoring the secrecy required by the illegality of the transaction, or the fear of unfaithfulness imposed upon the principal, the prevailing characteristic of the corrupt act is to clear a market.

In other cases, like obtaining a kickback in purchasing supplies, or getting a bribe to conceal tax evasion, the corrupt payment is not primarily a market clearing device: It does not facilitate the allocation of a good or service rendered artificially scarce by a government decision.

The efficiency cost of corruption will not be the same for all types of corruption. The magnitude of this cost depends on the following characteristics of the act of corruption:

- 1) Whether bribes are primarily market clearing devices. To the extent they are, they serve the useful purpose of fostering voluntary transactions; therefore, they improve the efficiency of the economy. Thus, bribing to get a permit has a positive side which bribing to conceal tax evasion, for instance, does not have.
- 2) The level of secrecy deemed necessary by all participants. The lower this level, the lower the restrictions to gain access to the voluntary transactions. Thus, if bribing is required to get a permit, it is preferable to have this condition known to everyone.
- 3) The principal's level of concern about unfaithfulness by his/her agents. The lower this level, the lower the precautionary costs incurred in order to prevent the agents' unfaithful behavior and the lower the cost incurred by the agent to conceal his/her illegal behaviour.

If corruption is primarily a market-clearing device, with little (if any) secrecy, and little (if any) concern by the principal about his/her agents' unfaithfulness, then corruption will be less costly (in terms of efficiency) than if those conditions are not met.

#### IV Corruption and growth

By its very nature, data on corruption is very difficult to get. A classical study by P. Mauro<sup>11</sup> uses a data set consisting of the *Business International* indices on corruption, red tape, and the efficiency of the judicial system for the period 1980-83. The indices are based on standard questionnaires filled in by correspondents stationed in 70 countries.

The only positive side of a corrupt transaction which might foster efficiency, the voluntary nature of the transaction, might perhaps prevail and make bribes efficient market clearing devices in countries where freely competitive prices are replaced by cumbersome, arbitrary and capricious bureaucratic regulations.

Mauro's study, however, finds that even in those cases the negative effects of corruption upon efficiency override its beneficial effects. He finds "that corruption lowers private investment, thereby reducing economic growth, even in subsamples of countries in which bureaucratic regulations are very cumbersome. The negative association between corruption and investment, as well as growth, is significant, both in a statistical and in an economic sense. For example, if Bangladesh were to improve the integrity and efficiency of its bureaucracy to the level of that of Uruguay ... its investment rate would rise by almost five percentage points, and its yearly GDP growth rate would rise by over half a percentage point."<sup>12</sup>

These findings do not lend support to the view that bribes can be not only reasonable, but enhancing efficiency when red tape or state control are strangling economic activity, eloquently stated as: "In terms of economic growth, the only thing worse than a society with a rigid, overcentralized dishonest bureaucracy is one with a rigid, overcentralized, honest bureaucracy."<sup>13</sup>

Shan-Jin Wei<sup>14</sup> stresses that corruption lacks transparency, is not pre-announced, and carries a poor enforcement of an agreement between briber and bribee. Therefore, corruption embeds arbitrariness and creates uncertainty. This, in turn, is very detrimental to efficiency and ultimately growth.

The degree of corruption-induced uncertainty varies according to the way bribe-demanding bureaucrats are organized: A bureaucrat in a monopolist position (i.e., holding the exclusive power of granting favors) would in fact have a reasonably transparent bribe schedule with acceptable assurance of results. It would be clear who to pay bribes to, how much to pay and what to expect once an appropriate amount of bribe is paid. After all, a bureaucrat in this position would like to take good care of his customers, in exactly the same fashion as any decent businessman. Once a bribe is paid, the customer gets full property rights over the government favor that he/she

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<sup>11</sup> Mauro, P., "Corruption and Growth" *The Quarterly Journal of Economics*, Vol. 110, N° 3 (August 1995), pp. 681-712.

<sup>12</sup> *Ibidem*, p. 683.

<sup>13</sup> Huntington, S. *Political Order in Changing Societies* (New Haven, CT, Yale University Press, 1968), pp. 69.

<sup>14</sup> Wei, S-J, "Why is corruption so much more taxing than tax? Arbitrariness kills" (Washington DC, International Monetary Fund Research Department Seminar, August 21, 1997), and "How Taxing is Corruption on International Investors?" *NBER Working Paper*, # 6030 (Washington DC, National Bureau of Economic Research, May 1997).

bought. Bribe payment would, in such a case, be like a tax except that the money ends up into the bureaucrat's pocket instead of the government treasury.

On the other hand, if no bureaucrat is in a monopolist position but many bureaucrats may show up at different times demanding independent bribes, all of them needed to get the desired result, then paying to any one of them would not give the payer assurance of getting the desired result. Who to pay to and total amount of money spent would not be well understood or known in advance by investors. Corruption implies greater uncertainty over total amount of money paid and eventual results than in the previous case. Corruption is, in this case, much more taxing than tax.

Wei's research quantifies the importance of arbitrariness and uncertainty in bribes on foreign investment by using 2381 individual responses to a survey conducted by the 1997 Global Competitiveness Report, including data on foreign investment from fourteen source countries to forty five host countries. The results show that "corruption in host country has a negative effect on inward foreign direct investment from all source countries in a way that is statistically significant and quantitatively large. An increase in the corruption level from that of Singapore to that of Mexico is equivalent to raising the tax rate on multinationals by over twenty percentage points."<sup>15</sup> (That is, if the profits tax rate on multinationals is thirty percent, increasing the corruption level as indicated is equivalent to raising the rate to over fifty percent).

## V The cost of corruption control and anti-corruption corruption

Strange as it may sound, the optimum (from an economic point of view) quantity of corruption is not necessarily equal to zero. "In seeking realistic reform it is important to realize that, like all illegal activity, the efficient level of bribery is not zero. Bribery is costly to control."<sup>16</sup>

The cost to control corruption must not be interpreted as just the administrative expenses paid to detect and punish bribe-taking officials. The full cost also includes the value of the economic activity that does not take place, or takes place in a cumbersome and more expensive way, because of the need to control and prevent corruption.

Surgery to remove a tumor or prevent its growth interferes with the normal function of the afflicted organ. Likewise, the procedures to control and prevent corruption interfere with regular, valuable, economic activity. This is a more important cost than the administrative expenses paid to detect and punish bribe-taking officials.

For example, if the control of corruption in customs requires a delay of several months in clearing cargo, some imports will be discouraged and fewer imports will take place. Although no administrative expenses had to be paid (a disputable assumption), to baffle imports is costly for the economy regardless of whether such imports would elicit bribes or not.

Other, more extreme, examples would be the cases of a public school built in a less than ideal jurisdiction, or a public hospital offering less than ideal facilities, in order to avoid bribes and prevent kickbacks. The additional number of students or patients,

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<sup>15</sup> *Ibidem*, p. 1.

<sup>16</sup> Rose-Ackerman, S., "The Political Economy of Corruption" in Elliot, K. A. *Op. cit.*, p. 33.

respectively, that could have been served in a school at the ideal location, or by offering the ideal hospital facilities, is a cost of preventing corruption that must be weighted against the benefits of preventing corruption.

From an economic point of view, the control of corruption should not be stretched beyond the point where additional controls would create more economic hardships than the ones generated by corruption itself.

Shleifer and Vishny<sup>17</sup> point out that corruption spreads because of competition both between public officials and between the consumers. If the officials have to bribe higher-ups in order to get jobs in the government, then the candidates who are able to collect more bribes will afford to win over the other candidates and get the jobs. "Competition between officials will assure that maximal bribes are collected."<sup>18</sup>

Likewise, competition between the buyers also spreads corruption. If an individual can buy a government service more cheaply than another buyer, the first one will outcompete the second. For instance, a company that gets imported raw material by paying a bribe at customs instead of the legal tariff (higher than the bribe) will outcompete another manufacturer who pays for the same raw material the legal tariff.

Cost-reducing corruption (like charging a bribe instead of a higher customs tariff) spreads and is expensive to control because it aligns the interests of buyers and corrupt officials. Thus, the former lack an incentive to expose the latter and corruption goes on undetected.

On the other hand, cost-increasing corruption (like charging a bribe on top of the customs tariff for not unduly delaying customs procedure, or bribing to win large contracts) pits buyers or frustrated contractors against corrupt officials and, therefore, does not go undetected so easily and is less expensive to control.

The control of corruption by following the ordinary procedure of appointing inspectors is prohibitively expensive. An endless string of inspectors would be necessary to control the inspectors who control the inspectors who...

The buyer's incentive to expose corrupt officials in the case of cost-increasing corruption is an inexpensive instrument to fight corruption. But in the case of cost-decreasing corruption such automatic mechanism does not operate.

Nonetheless, corruption in general, regardless of its cost-decreasing or cost-increasing variety, is automatically discouraged by the corrupt official's fear of being exposed by a colleague who can blackmail him/her. This can be called anti-corruption corruption. "When an auditor or a policeman bargains over a bribe with a person he has arrested, he has to take into account the fact that he may, in turn, be caught for taking this bribe and be involved in a similar bargain, but from the other side."<sup>19</sup>

After all, corruption emerges from legislating that certain things must be done in certain ways, or paying certain duties, or having a permit, which a buyer can circumvent by paying a bribe. But bribery is itself against the law, like not having a permit. Quite naturally, then, a corrupt official can circumvent a bribing accusation in exactly the same fashion as his/her customer not having a permit; that is, by paying, in turn, yet

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<sup>17</sup> *Op. cit.*, pp. 603-4.

<sup>18</sup> *Ibidem*, p. 604.

<sup>19</sup> Basu, J., S. Bhattacharya and A. Mishra, "Notes on Bribery and the Control of Corruption" *Journal of Public Economics*, Vol. 48, N° 3 (August 1992), p. 349.

another bribe. That is, corruption will endlessly sustain itself but it is costly to practice: A briber may suddenly become a bribee.

Anti-corruption corruption may be an effective deterrent of agreements between buyers and corrupt officials. Corrupt officials threatening to blackmail each other constitute a spontaneous phenomenon that automatically discourages corruption without imposing any additional implementation cost to the government.

Although corruption will endlessly nourish itself, nurture is expensive. That is, bribe takers reproduce themselves exponentially while imposing upon one another the cost of being potentially blackmailed by someone just like them.

Because corruption is costly to control and nourishes itself, it can hardly fade away. At the same time, because nurture is expensive it can hardly grow unbounded.

Corruption will unavoidably exist within these extremes. Whether corruption is rampant or near fading away will depend on the extent of discretion to regulate and control economic activity enjoyed by the public sector. "Fundamentally, therefore, the prevention of corruption must rest on the successful establishment of a system under which controls and regulations are difficult to introduce. The only system known to mankind that can perform this magic is a well-defined and firmly enforced system of private property rights."<sup>20</sup>

## VI Perverted Patronage

Patronizing painters, poets and other artists or scientists by rich and philanthropic members of society has been, and still is, a praiseworthy practice in many societies.

There is, however, a perverted version of patronage that became common in some Latin American countries, particularly in Argentina, in recent decades. It consists of an individual, a company, or a foundation, paying the salary, or a part of it, of a public official.

It is, in a way, the polar opposite of the more common case of a public official that is never present at his/her post, except on pay day; and really works everyday, and gets paid, in the private sector. This is essentially the (not uncommon) case of a public official stealing one or more government salaries. It is pure and simple robbery, not corruption. It has been privately estimated that over ten percent of all public employees in Argentina belong to this category<sup>21</sup>.

The case under consideration is just the opposite: A person that works in the government but gets his/her income mainly from the private sector, without working in this sector. There is no robbery. All there is, apparently, is a donation, out of generosity, from a private person (either natural or juridical) of somebody's salary to the government.

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<sup>20</sup> Cheung, S. N. S, *op. cit.*, p. 5.

<sup>21</sup> The fraud takes place in several ways; but one of the most common consists of a person getting a full time salary as, for instance, an advisor to a senator or a minister on Sunday evenings every other week (or perhaps, just once a month), while Tuesday mornings are devoted to sit at an office in a ministry doing nothing (or taking care of his/her own business) for which another full time salary is obtained every month. The rest of the time the person is honestly busy in attendance of his/her own kiosk or workshop, or employed in a private company.

This would indeed be the case if the beneficiary (i.e., the person whose government salary is paid by the private donor) did not feel to have acquired any obligations or commitments towards the donor, which may be detrimental to the loyal fulfillment of his duties in the government. Such commitments need not be explicit; they may not be suggested by the donor and may not even be part of the intentions of the donor, since the beneficiary does not really need a hint to realize that his/her luck depends on the prosperity of his source of income, the donor.

The condition to prevent the disloyal behavior of the beneficiary and his/her bias towards recommending or deciding systematically in favor of whatever may be convenient to the interest of the donor is total anonymity. The beneficiary must not know who the donor is. He/she must not even know what sector of the economy (i.e., agriculture, petrochemicals, construction, etc.) the donor is in.

If the anonymity condition is not fulfilled, even when the donor is perfectly honest and free of opportunism (a debatable assumption, of course), a conflict of interest will unavoidably exist for the beneficiary between serving the public interest or his personal interest, tied to the prosperity of the donor. Perverted patronage is a very subtle variety of corruption.

Perverted patronage is detrimental to efficiency and causes an economic cost to the economy that is greater than the profits received by the donor and, *a fortiori*, greater than what the beneficiary gets.

The donor's benefits arise from policies and procedures (such as exclusive permits, subsidies, preferential loans, tax exemptions) that make the donor's activity artificially profitable.

Although such policies might be intended to reach the donor only, they will unavoidably have effects beyond his/her activities. They will also affect activities other than the one carried out by the donor, like his/her suppliers of raw materials, or the suppliers' suppliers, who may not even contribute to the payment to the beneficiary (they may not even know the existence of a beneficiary), but still get additional profits over and above what the donor and the beneficiary get.

All these artificially profitable activities will attract resources, regardless of the donor's intentions, that will automatically abandon other activities, which thus result discriminated against, despite being genuinely productive.

Also, the production of goods that compete with the ones produced by the donor may be affected by policy decisions implemented or recommended by the beneficiary to protect the interests of the donor. These competing goods will now face unfair competition and their production will be reduced or may be pushed into bankruptcy despite being efficient and competitive.

This diversion of resources (which leave their more productive uses to go to other, artificially attractive, endeavors) is, precisely, the inefficiency caused by the perverted patronage: Capital investment, labor force, raw materials, etc. will abandon activities that are rendered unattractive simply because they lack a beneficiary that works for them. These activities will reduce their scale of operations or disappear altogether, despite being genuinely productive, thus creating an economic cost to society and spreading artificial benefits beyond the donor or the beneficiary of the perverted patronage.

Economic efficiency is eroded by the unproductive deviation of resources caused by perverted patronage. Wealth is destroyed, or its creation is prevented, in magnitudes greater than what accrue to the donor and the beneficiary.

The public official that is never present at his/her post, except at pay day, commits a robbery but he/she does not destroy wealth; simply transfers wealth from the government (the tax payers) to his/her pocket. On the other hand, the beneficiary of perverted patronage does not commit robbery, but destroys wealth over and above what he/she takes for himself and for his/her donor.

This is, of course, not intended as a justification of the former but to point out that the latter imposes a greater cost on the economy.

## **VII Summary and Conclusions**

This section briefly collects, in a summary fashion, the main points of the paper.

Corruption prospers more within the public sector than within the private sector. Useless restrictions on private economic activities, though detrimental to the communal well being, are virtually costless for public officials to impose and very valuable for their private counterparts to buy their way out. There is a close relationship between public sector intervention in the economy and corruption. Bribes come to help prices perform a duty that the government does not allow the prices to accomplish. In other words, bribes may be less ubiquitous, and may not even arise, if the government let prices do their job: to clear the markets.

Corruption has two ingredients: An illegal voluntary transaction between two parties and unfaithfulness to a third party.

The first ingredient has a positive and a negative side from the viewpoint of economic efficiency: A voluntary transaction promotes a more efficient allocation of goods, but the illegality of the transaction seriously undermines, if not destroys, the efficiency enhancing aspect of corruption as the corrupt agent engages valuable resources to cover up his/her illegal actions.

The second ingredient has just a negative side: The fear of being a victim of unfaithfulness leads to costly procedures that would have been otherwise unnecessary. Efficiency is unambiguously diminished when unnecessary costs are incurred.

Theoretical considerations and empirical evidence indicate that the negative effects of corruption upon economic efficiency prevail over its positive effects.

The cost of corruption to society is not accurately measured by the amounts of bribes. The amount of bribes collected fail to account for all the activities that never materialized because of the restrictions imposed by the bribe seekers. All these represent significant losses regardless of the amounts of money that changed corrupt hands.

From an economic point of view, the optimum quantity of corruption is not necessarily equal to zero: The control of corruption should not be stretched beyond the point where

additional controls would create more economic hardships than the ones generated by corruption itself.

Corrupt officials threatening to blackmail each other implies first, that corruption will endlessly nourish itself; and second, that nurture is expensive. That is, bribe takers reproduce themselves exponentially while imposing upon one another the cost of being potentially blackmailed by someone just like them.

Because corruption is costly to control and nourishes itself, it can hardly fade away. At the same time, because nurture is expensive it can hardly grow unbounded. Corruption will unavoidably exist within these extremes. Whether corruption is rampant or near fading away will depend on the extent of discretion to regulate and control economic activity enjoyed by the public sector

Perverted patronage is detrimental to efficiency and causes an economic cost to the economy that is greater than the profits received by the donor and, *a fortiori*, greater than what the beneficiary gets. Even when the donor is perfectly honest and free of opportunism (a debatable assumption, of course), a conflict of interest will unavoidably exist for the beneficiary between serving the public interest or his personal interest, tied to the prosperity of the donor. Perverted patronage is a very subtle variety of corruption.



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