CORRUPTION AND REGULATORY STRUCTURES

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1. Introduction

One of the key missions of the Centre for Regulation and Competition is to relate the design of regulatory structures and institutions to economic growth and thereby to the relief of poverty. The connection between corruption and poverty, or the lack of growth, is more often assumed, than demonstrated (Mauro, 1995, 1998), and if the question remains still controversial, I suspect that this is largely because commentators work with different definitions of corruption. The broader the interpretation of the concept, the greater the difficulties of relating the concept causally to economic performance indicators, and the more likely corruption is to be become intertwined with cultural values, and therefore connected with the social and political identity of a particular community.

In an influential paper, Williams (1999) has argued that economists working in this area often adopt too narrow a conception of "corruption" and that "instead of putting all our eggs in one conceptual basket, there is a need to examine a range of related concepts", including "rents and clientilism" (ibid, 511). I readily acknowledge that it may be difficult to know where to draw the line between "corruption" and "rent-seeking behaviour" (Mbaku, 1992). The latter term is generally used to refer to the process by which interest groups adopt (lawful) means to secure competitive advantages from the political process and is a phenomenon widely recognised as influencing law and legal institutions in industrialised societies and is the subject of a huge literature (surveyed in Tollison, 1982 and Rowley et al, 1988). Rent-seeking may, indeed, impose costs to the economy as high, if not higher, than those arising from corruption (narrowly defined).

In this paper, I nevertheless focus on corruption in the narrower sense, implying unlawfulness, and in the highly particularised environment of regulatory decision-making (see my definition and typology in section 2). I do so because I believe that the costs and the benefits to the economy of such behaviour in such a context can be more easily concretised (sections 3-4). The reference to benefits is important because I consider it wrong to regard all forms of corruption

as “evils” which must be uprooted if significant economic growth is to be secured. Indeed, even if the aim were total suppression, it would be absurdly naïve to expect it to be achievable in many societies, simply because it is too deeply embedded in the political and legal, as well as the administrative fabric. The selection of devices to combat corruption (section 5) must be sensitive to this problem. We may create highly sophisticated anti-corruption regimes, backed by draconian sanctions, but if there is difficulty in finding individuals to prosecute, and judges to condemn, the process is largely futile. The quest then becomes a less ambitious one, that of ascertaining how regulatory structures and procedures may be designed so as to reduce opportunities for (rather than to eliminate) the behaviour which is undesirable (section 6).

Corruption, whether given a narrower or a broader definition, is not of course peculiar to developing countries, empirical, as well as impressionistic, evidence revealing that some developing countries have a better record, in this respect, than developed countries (Mauro 1995).[2] Interestingly, the development of appropriate regulatory structures features prominently, alongside promotion of the rule of law and the constraint of corruption, in the agenda for developing countries articulated by the World Bank and other financial sponsors. And Western models of regulatory arrangements are often proffered as ideals which developing countries are advised to follow. An intriguing finding of this paper (section 6) is that designing regulatory institutions to limit opportunities for corruption directly contradict some of the received wisdom of those models.

2. Definition and Typology of Corruption

For the purpose of studying the impact of corruption on regulatory systems, I adopt the following definition: “the use of public office for private gains where an official… entrusted with carrying out a task by the public … engages in some sort

[2] See also the perceived corruption rankings recorded in Transparency International, 2002, based on perceptions of the degree of corruption as seen by business people, academics and risk analysts: Singapore (5th), Hong Kong (14th), Chile (17th) and Botswana (24th) come ahead of France (25th), Italy (31st) and Greece (44th) in terms of freedom from corruption.

of malfeasance for private enrichment" (Bardhan, 1997, 1321). Malfeasance implies illegality. While this may give rise to differences between jurisdictions, because "[w]hat is lawful, and therefore what is unlawful, depends on the country and culture in question" (Klitgaard, 1988, 3), the label of illegality is significant: there is formal recognition by the country in question that the conduct should not occur.

As regards corruption within the area of regulatory decision-making, Klitgaard (1988, chap. 2) refers to:

- *external corruption*, involving dealings between public officials and third parties; and
- *internal corruption,* deriving profits from the abuse purely of internal procedures.

The distinction may have significance for combating the problem since, in the second case, there is no collaborator who can be implicated. But, for the purpose of analysing the benefits and costs of corruption (the subject of the next section), it might be more helpful to distinguish between the following categories (for another classification, see Rose-Ackerman, 1999, 9-10).

a. *payments to execute socially desired outcomes* - the briber pays the official to carry out a routine task, such as the granting of a licence on the fulfilment of conditions stipulated;
b. *payments to exercise discretionary powers in favour of briber* - the briber pays the official for a discretionary benefit (e.g. a franchise or grant), to be conferred on the briber rather than on others seeking the same benefit;
c. *payments to avoid expected action to detriment of briber* – the official agrees not to proceed with some action which, if it takes place, would be detrimental to the briber (e.g. prosecuting for a regulatory contravention);

d. *payments to avoid illegal action by official* – the official agrees not to carry out a threatened illegal action (e.g. framing an innocent person) which, if it takes place, would be detrimental to the briber.

3. The Benefits of Corruption

Commentators may too easily take a moral stance on corruption and in consequence fail to recognise its objective value, particularly in developing countries. Let us begin by identifying incidents of corruption which may, in certain contexts, generate economic benefits (Klitgaard, 1988, chap. 2; Bardhan, 1997, 1322-1324; Rose-Ackerman, 1999, 10-21).

Some regulation may be inefficient, in the sense of generating welfare losses. The losses may be reduced by private transactions modifying the regulatory requirement (cf Ogus, 1994, 259-260). One example, within corruption *type c*, would be where an official accepts a payment not to prosecute an individual who has contravened an economically unjustified rule. Another is where price controls imposed on a good impede supply meeting demand; a transaction avoiding such controls will then enhance market efficiency.

Secondly, corruption may reduce the administrative costs of regulatory processes. If an official is able to reach the desired outcome by a shorter route, consequent on the briber's intervention, then those costs may be reduced. We are thus dealing predominantly with corruption of *type a,* an example being avoidance of delays in decision-making (Lui, 1985). But such a benefit might also accrue in cases of corruption *type b,* if readiness to pay the bribe is a reliable proxy indicator of the qualities which the official is expected to identify as a condition for the conferring of the benefit. This is admittedly not often a plausible hypothesis, but it can occur where, for example, creditworthiness is a criterion for the grant of a licence, or where, in competing for a public franchise, the briber's wealth implies an aptitude to pursue the activity in question.

We may note, thirdly, that unlawful payments to an official may enable some of the regulatory administrative costs to be internalised to the regulated industry. Applicable particularly to corruption *type a*, this may arise where, for

example, the fee payable by an applicant for a licence does not cover the full costs of the regulatory process; in particular the deficit may be borne by officials whose ordinary salary fails to reflect the social value of their input. The unlawful payment to an official may thus correct the inefficiency.[3] It should be noted that this argument is distinct from the distributional, and therefore non-economic, justification for corruption, that regulatory officials tend to be underpaid.

Of course, there are problematic aspects to these identified benefits (Rose-Ackerman, 1996). Illegal contracts are not enforceable in courts and that may induce opportunistic behaviour by either or both of the parties.[4] The second benefit, in addition to the stated assumption, presupposes an ability to identify the bribing capacity of other applicants: it also may motivate officials to create more delay, in order to attract more bribes. All three can create perverse incentives: the first to generate inefficient regulatory outcomes; the second to delay decision-making; and the third to engage in unlawful, rather than lawful ways of increasing income.

4. The Costs of Corruption

That corruption generates costs to the economy is more intuitive, but it is still important to identify them and specify how they arise. And it makes sense to start with the first category of "beneficial" corruption, where the conditions for the hypothesis are not fulfilled. So there are welfare losses in a *type b* situation, if the bribe induces the official to select for the an inferior, rather than well qualified applicant, for the advantage conferred by the regulatory decision. Likewise, for the purposes of *type c*, the payment may inhibit enforcement of regulation which is efficient, rather than inefficient.

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[3] "[I]n countries where it is difficult to raise money through taxes to pay officials a little bribery is no bad thing because it is one way of getting citizens to support public sector officials": Bowles, 2000, 478.

[4] Although the briber may indirectly have power over a defaulting bribee official by threatening to "blow the whistle": below, pp.9-10.

Then we can draw on the rent-seeking literature (cf Tullock, 1967) to recognise that the resources used in seeking to bribe an official, or by the official in attempting to secure corrupt payments, give rise to deadweight losses, in that they are activities which, from a social point of view, are entirely unproductive. A good example is the resources used to keep a transaction secret (Rose-Ackerman, 1999, 12). Indeed, by reducing the information available as to prices, this activity adds to the cost of efficient black market transactions.

Corrupt payments which are perceived to be necessary to secure a regulatory decision in *type* a situations, operate effectively as a charge on transactions, and as such can inhibit productive activity and investment. This is, of course also true for lawful taxation (Kaplow, 1996), but bribes unlike the latter cannot be set off against tax liabilities.

It is generally assumed that there are large negative externalities arising from corruption, facilitating, for example, crime (particularly organised crime – Rose-Ackerman, 1999, 23-24) and other illegal activity.[5] An uncertain business environment may also be included, although the same problem may of course arise in a system free from corruption if, for example, legal enforcement machinery is ineffective.

Viewing the matter from a dynamic, rather than static, perspective suggests further costs (Bardhan, 1327-1334). There are likely to be increasing returns to bribing officials, relative to productive investment. This is because, as the level of corruption grows, so the returns on productive investment decline, thus reducing the opportunity cost of further corruption - an argument derived from the rent-seeking literature (e.g. Murphy et al, 1993). The reasoning is independent of another set of arguments which have been used to explain the same phenomena and, in particular, the persistent and widespread character of corruption in some jurisdictions (Andvic and Moene, 1990). Just as the level of demand for network commodities (e.g. fax machines) is crucially dependent on expectation as to the

[5] "Whereas an occasional act of corruption may be efficient, corruption once systematised and deeply engrained never is": Klitgaard, 1988, 42.

demand from others (Shy, 2001), so the likely gains from corruption depend on the expectation of the number of others also corrupt. The cycle then becomes difficult to break; and a reputation of corruption may be inherited from previous generations, with little incentive for successors to become honest (Tirole, 1996).

Finally there are important considerations of equity which should not be overlooked. Quite apart from the moral perspective that discounts benefits acquired by illegal means, there is the expectation, confirmed by empirical findings, that corruption generally benefits the rich at the expense of the poor (Klitgaard, 1988, 41).

5. Devices for Combating Corruption

The discussion in the last section gives rise to two important implications, that regard should be had to the costs of constraining corruption; and that where the latter is widespread, it will not easily be uprooted by focusing on individual culprits. Both points suggest that advocated policies, notably those of reforming the civil service by depoliticising it, removing conflicts of interests, raising the quality of public officials recruited, increasing transparency and improving auditing and monitoring systems (Rose-Ackerman, 1999, chap. 5; Lederman et al, 2001) – strategies typically attempted to deal with corruption in Western societies – may be futile because the cost of securing major changes to deeply embedded cultural attitudes is simply too large. The second point seems insufficiently to be grasped in some of the literature, including those papers which treat corruption like any other illegal activity which is to be inhibited by use of the criminal law and other familiar law enforcement devices (Bowles, 2000). So, for example, there is the standard Becker economic model of crime, requiring the cost to the offender arising from conviction, when discounted by the probability of apprehension and conviction, to exceed the utility to be derived from the criminal act (Becker, 1968). When applied to the corruption situation, this suggests that the size of the penalty should, after discounting for the probability of escaping detection, be related to the amount of the bribe (Rose-Ackerman, 1998). However, the more problematic implication is that, given an assumed low level of

detection and conviction, the sanction from a formal conviction must be very high indeed if it is to have the desired deterrent effect (Polinsky and Shavell, 2001).

It takes two to tango and consideration can be given to constraining corruption by the briber, as well as the bribee. Relevant variables here include the relative costs of monitoring the behaviour of insiders and outsiders, and the relative elasticity of their respective behavioural responses to sanctions.

The mirror opposite of punishing illegal behaviour is to reward legal behaviour and it is sometimes argued that improving the level of salaries of officials would, to some extent at least, alleviate the corruption problem (Seidman and Seidman, 1994, 179). Of course, it may be right that where the income from lawful activity barely covers subsistence needs, the motivation to boost it from illegal activity may be greater than where a reasonable wage is paid. But why should higher earners not be equally tempted by a bribe? Indeed, the empirical data is ambivalent on the point (Eide, 2000, 361). More nuanced suggestions include bonding salary payments, perhaps in the form of pension entitlements, contingent on good behaviour; and relating the rewards to specific outcomes (Klitgaard, 1988, 77-78). There is evidence that making bonus payments to tax officials, based on how much they collect, raises the level of tax compliance (Bardhan, 1997, 1339). But there is also a risk that such policies will be counter-productive (Azabou and Nugent, 1988). The larger the reward paid to officials for making publicly desirable decisions, the more they will demand by way of bribes to make undesirable decisions – and if the state's ability to apprehend such behaviour is not raised, there will be an *increase* of corruption (Wade, 1982; Mookherjee and Png, 1995[6]).

The discussion in the last two paragraphs suggests that penalty and reward policies often founder because, given resource constraints in monitoring and detecting illegal behaviour, the probability of apprehension is too small. It may be possible partly to overcome this problem by a strategy of rewarding "whistleblowers"; for example, conferring on them an entitlement to a certain

[6] As they argue, to avoid this outcome, the reward must be higher than the briber is willing to pay.

proportion of the penalties levied, or at least reducing their costs by ensuring anonymity (Bardhan, 1997, 1338). Such an approach is likely to be most effective where the whistleblowers are potential victims of the corruption, as with attempted cases of extortion (Alam, 1995). Nevertheless, there are arguments suggesting that compensating whistleblowers may actually induce more corruption. First, it gives the briber a sanction, should the bribee fail to comply with the agreement, thus overcoming the problem that corruption contracts are not enforceable in the courts. Secondly, it may encourage gamekeepers to become poachers, by enabling bribers to threaten to frame innocent officials, and thus extort payments from them (Polinsky and Shavell, 2001, 19-20)

Promoting some form of competition between officials or institutions prone to corruption would seem to offer a plausible, and not too costly, means of combating it (Rose-Ackerman, 1978); and there is some empirical evidence to support this (Lederman et al, 2001). However the device tends to be more effective when the competition is between officials who confer benefits, rather than between those (for example law-enforcers) who impose costs (Rose-Ackerman, 1999, 51). Also care must be taken as to how competition is introduced: a series of alternative individuals or offices providing the same service, or perhaps overlapping services, would meet the objective (Bowles, 2000), but adding further layers of bureaucratic decision-making would simply exacerbate the problem (Lederman et al, 2001). Suggestions linked to the competition argument include using committees instead of single decision-makers; and regularly moving bureaucrats between various offices (Klitgaard, 1988, chap.3).

6. Design of Regulatory Institutions and Principles

I turn, now, from general strategies to constrain corruption to some of the more specific implications that the existence of corruption may have for the design of regulatory regimes. We need to see how institutional arrangements may be organised so as to limit the opportunities for corruption, or to render such opportunities less profitable. Some of the implications correlate well with

developments and tendencies occurring in industrialised countries (Vogel, 1996; Scott, 2003); others point in the opposite direction. Some remain ambigiuous.

For a good example of the latter, take the issue of privatisation, perhaps the most salient feature of regulatory reform in industrialised countries. A recent study of bribes paid to utilities in a number of transitional economies in Eastern Europe and Central Asia found that the replacement of public ownership by private ownership reduced the amount of corruption, since the owners of the privatised companies had more incentives than officials managing a public company to control it (Clarke and Xu, 2001). Nevertheless other studies of these phenomena have shown that the process of privatisation may make the disease worse before it becomes better (see, for example, the evidence drawn from China: White, 1996; Duckett, 2001). One reason is that a temporary combination of controlled “public” prices and market prices enables creates opportunities for highly profitable arbitrage (Bardhan, 1997, 1329); another is that the sale of assets can be used to benefit vested and corrupt groups (Huther and Shah, 2001).

Another much debated, though largely unresolved, question is whether a policy of decentralisation, again associated with Western regulatory thinking, facilitates or hinders corruption. On the one hand, it is argued that decentralised decision-making must by its nature be more transparent than when carried out at distance from the subjects affected – local information flows being more rapid – and therefore corruption is, in such circumstances, more difficult to conceal. (Lederman et al, 2001). On the other hand, if law enforcement is largely in the hands of a centralised authority, the very distance of the formal audit systems from the subject of investigation may limit its effectiveness: in remoter areas the authority of the law may simply not be recognised (Green, 1997, 67). Moreover, the “once-for-all” payment necessary to secure the cooperation of the central official may distort the economy less than the variety of payments at other levels: the bribee can control deviations from agreed patterns of corruption and render its effects less uncertain (Shleifer and Vishny, 1993). Bardhan (1997, 1325) uses this argument to explain why Indonesia (where corruption has been centralised)

has, in terms of economic development, been more successful than India (where bribery has been more fragmented), even though the perceived level of corruption in the two countries is not dissimilar.[7]

Deregulation is, of course, a major theme in Western regulatory developments and the first and most obvious, though not necessarily most significant, point is that, since many opportunities for corrupt transactions arise from regulation, a reduction in the amount or intensity of regulation should reduce the level of corruption (Lederman et al, 2001, 6). The argument is familiar from the rent-seeking literature (Bowles, 2000, 468-469), but in relation to developing countries, it should not be construed as implying a total removal of interventionist measures. The Western concept of a competitive market is often far removed from economic conditions prevailing there and attempts to impose it have not generally led to welfare improvements (McAuslan, 1997, 33). Rather, it is a question of understanding how an excess of regulatory opportunities for corruption may be dismantled (Platteau, 1996).

A prime example here is that of licensing systems which have tended to proliferate in developing countries (Guasch and Spiller, 1994), no doubt because prior to independence they facilitated control by the colonial governments and since have served the same function for the succeeding political elite. In some circumstances, licensing may be the optimal regulatory instrument for dealing with certain forms of information failure and negative externalities (Ogus, 1994, chap.10), but that does not justify a system imposing multiple licence requirements. And, in other circumstances, regimes imposing on-going standards on unlicensed activities will be sufficient to meet the regulatory goals.

A second possibility for positive deregulatory reforms arises from the use of the criminal law to enforce regulatory regimes (Australian Law Reform Commission, 2002). In industrialised countries, the heavy cost of securing a conviction in the criminal courts may reduce its effectiveness as a deterrent; and for this reason administrative sanctions may be preferable (Ogus and Abbot,

[7] In the latest Transparency International rankings, above n.7, India is 71st and Indonesia 96th.

2002). In developing countries, use of the criminal process has the added disadvantage that it creates a further opportunity for corruption. Evidence suggests that the level of bribes increases significantly when courts are involved in law enforcement (Green, 1997, 66-67).

In other respects, the need to constrain corruption suggests regulatory strategies which are incompatible with reforms taking place in industrialised countries. According greater discretion to regulatory rule-makers has, alongside decentralisation, enabled interventionist measures to be better targeted to local and diverse circumstances (Majone, 1996, 68-74). But, particularly in a developing country context where instruments of accountability may be weak, it also creates more opportunities for corruption than where regulatory requirements are the subject of clear and precise rules (Seidman and Seidman, 1994, 178). And a similar argument applies to the choice between formal and informal rules. In industrialised countries, there has been a movement to substitute the latter, generally in the form of guidelines, for the former, on the grounds of flexibility (Baldwin, 1995). In developing countries, there is evidence that regulatory practices based primarily on unwritten or informal rules are more prone to corruption than others (Lederman et al, 2001, 30-31).

Finally, and perhaps more controversially, there is the question of consultation processes. Within the Western tradition there has been an increasing emphasis on regulatees and third parties contributing to, and participating in, regulatory policy- and rule-making. The potential benefits, in terms of improved information flows and better transparency, are great, but direct access to regulatory officials does of course increase the opportunity for corrupt transactions. Failing adequate measures to render transparent the content of any such meeting,[8] it may be beneficial to restrict access, thereby adding to the transactions costs of negotiating corrupt deals.

[8] In the USA, to deter rent-seeking behaviour, all written communications between regulatory officials and outsiders must be placed on the record (Froud et al, 1998, 175).

7. Conclusions

In this paper I have adopted what may be described as a “micro”, rather than a “macro” approach to the concept of corruption. That has not blinkered me from recognising the huge problems in confronting something which is so deeply embedded in many political and administrative communities. Indeed, this very fact leads me to the conviction that the classic approaches to constraining corruption usually advocated in Western industrialised societies – raising the levels of sanctions and of monitoring; increasing the transparency and accountability of decision-making – will often be futile. The main policy implication of this is that it may be more cost-effective if reforming resources were concentrated on reducing the opportunities for corruption, rather than on attempting to suppress it altogether. My focus on regulatory institutions and procedures has enabled me to identify key aspects to these arrangements which if appropriately designed can achieve this goal. It is noteworthy that some of the design strategies that I advocate are inconsistent with the models of regulatory arrangements with Western institutions have in recent times been urging developing countries to adopt.

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