

Chapter 2

Economic Analysis of Corruption

Abstract In this chapter, we contextualize and discuss the issue of defining corruption, endorsing a definition that focuses on the abuse of power. We also discuss how limiting the scope of corruption to the public sector contradicts the understanding that is common in the public and also in the economic science. Furthermore, we show how policies that are based on a concept of corruption that narrowly ascribes the phenomenon to the public sector, can reach simplistic conclusions such as that the extent of the public sector is invariably positively correlated with the occurrence of corruption. Such conclusions might drive policies that cannot satisfactorily address the problem of corruption, are conceptually flawed and are not backed by empirical analysis that enquired into the relation between the public sector and corruption. In this context, we also scrutinize the proposition that there is an evident trade-off between market failures and corruption. On the contrary, anticipating one of the main conclusions of this book, we argue that corruption is one of the causes of the persistence of market failures. The abuse of power for private gains in the case of environmental policies is an egregious example of how public institutions fail in dealing with issues that cannot be solved solely by market mechanisms because of corruption. Finally, the chapter also contains a discussion of basic concepts used throughout the book and of issues related to the measurement of corruption.

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2.1 Introduction

Corruption is an emotionally charged concept that inspires in most people immediate condemnation. These reactions can be channelled into supporting anti-corruption strategies to deal with the problem, but the specific strategies will depend on the definition and conceptualization of the phenomenon at hand. These definitions

can collide with what the public and international institutions have in mind when lamenting corruption and might also not fit with the analysis of some of the detrimental effects that corruption has on social welfare and with the formulation of sensible policies to deal with the problem.

Here we will discuss the definition of corruption and the fallacies intrinsic in understandings of corruption that are based on one-sided definitions, focusing in particular to the questionable characterization of corruption as something that has to do only with the public sector. This specific definition is popular with economists and, in most cases covertly, it underpins the simplistic conclusion that to decrease corruption it is sufficient to shrink the public sector, privatize or that there is a dilemma between market failures and corruption (e.g. Acemoglu and Verdier 2000; cf. Hodgson and Jiang 2007). In general, definitions based on conceptual fallacies can drive policy makers to apply specific measures that would have little potential to affect corruption if differently defined.

2.2 The Definition of Corruption

Corruption is a multifaceted concept that escapes monolithic characterizations. Corruption, as defined in the dictionary, epitomizes moral decay, is intrinsically bad and subject of unconditional condemnation: it is the “impairment of integrity, virtue, or moral principle”.¹ In search for definitions fit for the purpose of social sciences, alternative—and arguably more morally neutral and less comprehensive—definitions have been developed.

A social science approach will benefit from a definition of corruption that does not have a strong moral component because of the benefits of focusing on a set of behaviours (in this case corrupt behaviours) without being able to condemn them a priori. Morally charged definitions—for example—would make it very difficult to analyze the writings of those authors that argue that corruption satisfies societal needs and ultimately has beneficial effects on social welfare (e.g. Huntington 1968). A related issue is that the class of phenomena characterized as “corrupt” should be kept at an analytically manageable size. In many contexts morally defined corruption becomes a catch-all derogatory word and a definition of corruption that would include phenomena that are of very different natures would render such definition useless. In general, issues that are very diverse relate to different analytical tools in different ways and a definition of corruption that is too inclusive runs the risk of being meaningless.

Overall, the task of identifying *the* definition of corruption is not an easy undertaking because of the emotions the concept inspires and the fact that several different definitions exist.² As a result of these difficulties many social scientists

¹ “Corruption.” Meriam–Webster online, 6 November 2007.

² As Jain states, “one of the difficulties in studying corruption lies in defining it. While it may appear to be a semantic issue, how corruption is defined actually ends up determining what gets modelled and measured” (2001, p. 73).

simply shy away from any explicit definition of corruption (see Williams 1999; Lambsdorff 2007, pp. 15–16) and it is often difficult to understand what exactly different authors have in mind when they discuss corruption. Many times it is only from their analysis and conclusions that it is possible to appreciate what characterization of corruption they are using (e.g. see the discussion below on the public sector).

The diversity of approaches to corruption underpins the diverse definitions; the earliest approach being the legalistic one (Williams 1999). According to this approach, corruption is simply defined as the breaching of legal codes—defining public duties—in order to obtain personal advantages. However, the usefulness of this definition is disputable once the prominence of power in defining the law and the indeterminacy of the legal codes is recognized. The point was forcefully made by the schools of critical legal studies and legal realism (see Hasnas 1995).^{3,4} The first school emphasized how powerful interests can influence the development of legal codes, use them to justify the status quo and further pursue their welfare. In light of these considerations, legal provisions are a dubious benchmark for defining corrupt acts, and the fact that certain behaviour is not defined as corruption in legal codes might be better interpreted as an indicator of the influence of powerful interests rather than that of lack of corruption. A telling example of similar issues is the case of the decree that the Italian government enacted in 1993 to decriminalize illicit financing of political parties (known in Italian as the “colpo di spugna”). The Premier Giuliano Amato rushed through a government decree decriminalizing one type of corruption in order to salvage the members of his political party from judiciary prosecution. Eventually, the measure had to be withdrawn because of the public outcry that followed its approval by the government.⁵ If the proponents of this legislation had succeeded, according to Italian criminal law bribing political parties in order to obtain personal advantages would not be classified as corruption

³ In any case, the occurrence of corruption is often sanctioned by the law; in other words, often the act of corruption is a crime. In economics, a large literature has developed starting from the seminal work of Becker (1968) on crime and punishment. The application of such literature to the case of corruption is limited on the one hand by the fact that not all corruption is illegal. On the other hand, the case of corruption is peculiar because there is evidence that in some countries enforcement agents—the institutions in charge of punishment—are the worst offenders with respect to corruption, which limits the straight application of crime models (e.g. Pellegrini 2007). The inclusion of corruption in models of economics of crime can produce predictions quite opposite to the standard prescription of increased punishment and monitoring to decrease crime (e.g. Kugler et al. 2005).

⁴ Corruption itself can determine which and how many laws are passed and the roman historian Publius Cornelius Tacitus noted—as early as in the first century AD—that “now bills were passed, not only for national objects but for individual cases, and laws were most numerous when the commonwealth was most corrupt” (*Annals*, Book 3, Chap. 27). It is interesting to note that the current Italian prime minister—Silvio Berlusconi—has been charged of creating laws *ad personam*; i.e. he has been charged of creating specific laws to safeguard the specific interests of one individual. The beneficiaries of such legal measures include the prime minister himself and other close associates that now cannot be prosecuted in numerous corruption-related trials.

⁵ See Cinzia Sasso, “Borrelli e gli inediti di Craxi: Volevano frenare Mani pulite” *Repubblica*, 7 December 2007. <http://ricerca.repubblica.it/repubblica/archivio/repubblica/2007/12/07/borrelli-gli-inediti-di-craxi-volevano-frenare.html>, 25 May 2009.

anymore. This case exemplifies how misleading the reference to legal codes can be: the enactment of such regulation rather than causing a decrease in corruption might better be classified as a display of institutionalized corruption. Furthermore, the school of legal realism emphasized how the interpretation of legal codes plays a crucial role in sentences and there is little possible objectivity in “the law” per se.

Finally, a definition of corruption based on legal codes is problematic for comparative analysis when legal codes differ across countries and as a result we are comparing different phenomena. Just as an example of such differences in the legal characterization of corruption, in the United States, lobbying is a legal practice and enterprises can legitimately invest in it and these expenditures enter their balance sheet as any other. In most European countries the same practices fall under the rubric of corruption and are legally sanctioned. On the other hand, in the United States it is illegal for congress’ members to hire one’s spouse to help in the congressional work, while in many European parliaments that practice is common. Thus, it appears that the diversity of legal codes renders them a dubious benchmark for comparison across countries.

In sum, the legal definition is seemingly clear-cut and hides the difficulties of identifying corrupt acts according to one unambiguous standard. We prefer to discuss and opt for other definitions of corruption that do not hide the ambiguities of the subject, but are clear enough to narrow down the classes of acts defined as corrupt if compared to the moralistic definitions that appear in the dictionaries as mentioned above.

A simple definition of corruption as “the misuse of entrusted power for private gain” is adopted by international institutions (e.g. by the international NGO Transparency International and by the Danish Development Agency Danida).⁶ Such definition is a useful reference point, but the benefit of simplicity comes at the cost of some vagueness. This definition suffers from the ambiguity associated with the lack of examples and further classifications; we consider it as a good starting point to achieve a useful definition of corruption, but it needs to be complemented by a more articulated characterization and that is what we are turning to now.

We will complement the basic definition with a classic one from Nye that is narrower than the moralistic one, seemingly less clear-cut than the legal one, but more operational for the purposes of economic analysis: “Corruption is behavior which deviates from the formal duties of a public role because of private-regarding (personal, close family, private clique) pecuniary or status gains; or violates rules against the exercise of certain types of private regarding influence. This includes such behaviour as bribery (use of a reward to pervert the judgment of a person in a position of trust); nepotism (bestowal of patronage by reason of ascriptive relationship rather than merit); and misappropriation (illegal appropriation of public resources for private-regarding uses)” (1967, p. 419).⁷ This definition offers lucid

⁶ http://www.transparency.org/news_room/faq/corruption_faq, 3 June 2009. For Danida’s definition see <http://www.um.dk/en/menu/DevelopmentPolicy/AntiCorruption/>, 3 June 2009.

⁷ Similar definitions are also available in the encyclopaedia: “Improper and usually unlawful conduct intended to secure a benefit for oneself or another. ‘Corruption’”. *Britannica Concise Encyclopedia*. 2007. Encyclopædia Britannica Online, 6 November 2007.

classifications of corrupt behaviour, but fails to include corruption behaviour by people who are bestowed with power that derives from roles in private organizations (see the discussion in the next section). Putting together the general definition mentioned above with a corrected version of Nye's we propose the following definition: Corruption is the misuse of entrusted power for private gain; it is behaviour which deviates from the formal duties of a given role because of private-regarding (personal, close family, private clique) pecuniary or status gains; or violates rules against the exercise of certain types of private regarding influence. This includes such behaviour as bribery (use of a reward to pervert the judgment of a person in a position of trust); nepotism (bestowal of patronage by reason of ascriptive relationship rather than merit); and misappropriation (illegal appropriation of public resources for private-regarding uses).

The objective of endorsing this definition is not to identify *the* right definition, but of choosing a useful one for the purpose at hand.⁸ While concepts and their definitions cannot be said to be right or wrong and can be the basis of infinite discussions, we take the more pragmatic approach of finding a working characterization and highlighting its limitations.⁹ One of the main drawbacks of this definition is that there are grey areas around the notions of misuse of power and formal duties; that is to say that the concepts underpinning this definition do not have entirely univocal meanings especially when we look at different understandings that can arise because of cultural diversity. Choosing one characterization of these concepts, presumably from a model society, and casting in stone a single model of misuse of power and moral conduct would entail an ethnocentric approach (i.e. a western stipulation) (see Philp 1997; Roy 1970).¹⁰ At the same time, in the converse relativistic approach, in which norms differ according to the cultural context, nothing can really be called corruption, and it is not possible to pass normative judgments on any social phenomenon (this is also referred to as the cultural approach; Bardhan 1997). Whereas the understanding of duties and roles depends, to a certain extent on cultural norms, in most countries—where the policy framework prescribes a modern bureaucracy—norms are standardized and the concern about abuse of power for private gain is more or less universal and not confined to western societies.¹¹ In fact, in opinion polls of developing countries, corruption is often cited as the prime concern of respondents (Bardhan 1997, p. 1330). We find that—while a certain de-

⁸ It is also a definition that is coherent with the measures of corruption used in the empirical analysis in the rest of the thesis.

⁹ The point is made in Williams 1999, p. 511.

¹⁰ In this approach, standards developed by a particular type of society (i.e. the western society) are assumed to be the ideal and are employed to set the standards against which we can measure progress of any society. In the case of corruption, the model would be the working of western rich democracies and their understanding of duty and morality.

¹¹ We highlight that the indexes of corruption that we use throughout the thesis are aggregations of indexes coming from various sources. These sources include citizens' opinion polls and international experts' surveys and the high correlation in the original indexes indicates that cultural ambiguities with respect to the concept of corruption are not a serious issue (Kaufmann and Kraay 2007, p. 22).

gree of uncertainty is unavoidable—our definition benefits from the fact that these uncertainties are reflected in the language used (by avoiding reference to external and seemingly clear categories such as “the law”) and not focusing solely in the public sector fits in a social sciences’ concern with the analysis of corruption and its effects.

Additionally, we recognize that there can be extreme circumstances where the standards used to discern corruption as they pertain to misuse of power, duty and public role do not hold. For example, during revolutionary periods loyalties other than to the state are prominent and the idea of the state itself might be the object of contention. In such situations the concept of duty and hence of corruption—as defined here—is inadequate.

Now, we discuss some concepts related to corruption and its different forms. This discussion aims at clarifying notions used throughout the book and puts them in the context of the economic literature.

Social capital is one of the concepts associated with corruption. Social capital, as defined by Putnam, “refers to networks and the norms of reciprocity and trust that arise from them” (2000, p. 19). Putnam cautions us that not all forms of social capital have a positive impact and critically distinguishes between “bonding” and “bridging” social networks; the former are more likely to have negative externalities. Corruption results from bonding networks and is mentioned as a negative manifestation of social capital (Putnam 2000, p. 22). The fact that corruption might arise from networks based on trust and—through repeated interactions in corrupt transactions—might increase social capital has been analyzed empirically. The findings of this line of research suggest that while corruption might bond and contribute to trust among interacting parties it decreases trust in society in general (Seligson 2002).

Another concept related to corruption is bribery. This is the most obvious case of corruption where inducements are used in order to convince the bribed to change her course of action. The act can be ascribed to the will of the briber or to a request of the bribed. Corruption in the case of bribery is evident because there is a direct exchange where the action of the person in power is dependent on the payment made by the briber. We will use the concept of bribery—for ease of interpretation—in exemplifying different types of corruption.¹²

Shleifer and Vishny (1993) differentiate between corruption with theft and without theft. In corruption with theft the official demands a payment in order to offer a service that the briber should not get, or offers it for a price that is a fraction of the regulated price. Custom officials letting illegal goods (or legal goods without exacting import duties) enter the country in exchange for kickbacks represent examples of corruption with theft. The final cost of the operation for the briber might well be smaller than the cost without corruption and both parties might have an

¹² Familism and patronage are other forms of corruption where the duty is subverted not for immediate gain, but for allegiances to special networks. Of course, belonging to the network and contributing to it can ultimately lead to personal advantages.

interest in keeping the deal secret (i.e. they collude). The case of a custom official that requires an unofficial payment—over and above import duties—just in order to process paperwork is a case of corruption without theft. The latter type of transaction is characterized by divergent interests, because the briber would prefer to avoid the payment, hence there can be defection (i.e. the briber might denounce the bribed). The former type of corruption can be characterized as “collusive” and the latter “extortive”. Strategies to combat corruption have to take the differences between these types of corruption into account in order to elicit defection of some of the parties involved in the deal.

Another useful distinction, based on the status of the bribed, is between political corruption and bureaucratic corruption.¹³ In the first instance, the bribed is a policy maker that influences policies in exchange for a side payment. In the second scenario, the corrupt actor is a bureaucrat that does not implement the regulations that were set by her superiors.¹⁴ The different actors—politicians or bureaucrats—are likely to have different incentive structures (e.g. voters’ perceptions can be more influential in the case of a politician than for a bureaucrat) and at times conflicting interests. Also in this case, these distinctions can inform anti-corruption policies. In the case of political corruption, opposition figures and their parties can play an important role in effectively constraining corruption opportunities of government and majority members. In the case of bureaucratic corruption, politicians in general can be active in combating corruption that might otherwise fuel discontent among their constituencies.

2.3 Corruption and the Private Sector

Corruption can be either understood as a phenomenon affecting only the public sector, where the key element is the misuse of *public* power. Alternatively, corruption can happen also in the private sector and the power entrusted on and abused by the corrupt agent might also relate—for example—to corporations and NGOs (see Hodgson and Jiang 2007). Here we will present evidence of how the understanding of corruption by the general public includes the private sector, how economists who have dealt with the nature and the effects of corruption also at times included corruption in the private sector, and the way a biased understanding of corruption leads to fallacies in terms of policy prescriptions.

¹³ Similarly, a distinction can be made between grand and petty corruption. Grand corruption involves high level bureaucrat or politicians, for example it occurs when a sizeable payment is made to secure a large procurement contract (Rose-Ackerman 1999, p. 27). Petty corruption involves small payments to people at low level of hierarchies (see Lambsdorff 2005).

¹⁴ See also Bardhan (2006) who has similar and additional categorizations.

2.3.1 *Perceptions of Corruption*

In the first place, it is worth highlighting how corruption always involves multiple parties (typically the briber and bribee), and in most instances some of the parties will belong to the private sector. In the case of collusive corruption, the party from the private sector might even play a dominant role by soliciting the bribee to accept an unrequested payment in exchange for some undue advantage that the person in a position of power is capable of offering. These roles of the private sector do require tools to deal with the private agents involved in the transactions and the prominence of private sector is evident and relatively uncontested (see Shleifer and Vishny 1993).

Here, by arguing for a characterization of corruption that includes cases where none of the parties exercises a public role, we mean simply that cases in which the entrusted power that is being abused is of a private nature should fall under the rubric of corruption. Furthermore, we want to highlight how this characterization of corruption undermines the simplistic conclusion that the expansion of the private sector vis-à-vis the public sector (e.g. via privatization) will unequivocally imply a decrease of corruption given the fact that the interface between the private and the public sector will still exist—offering ample opportunities for corruption—and because corruption can continue to characterize the behaviour of agents belonging to the private sector. It might well be the case that the locus and the actors involved in corruption change without changing the nature of the transactions taking place.

The public at large, international organizations, and social scientists when analyzing corruption reveal that their understanding is informed by the fact that corruption is something that can affect also the private sector. This perception is exemplified by the findings of the *Global Corruption Barometer 2009* (Transparency International 2009): in a survey of the population of 69 countries—based on 73,000 interviews—it was found that the private sector is perceived in 12 countries to be the most corrupt when compared to political parties, parliament and legislature, the media, public officials, and the judiciary. These opinions, and the underlying understanding of corruption, stand in clear contrast with characterizations of corruption that focus uniquely on the public sector.

With respect to the way economists interpreted the problem of corruption, a long citation from Alfred Marshall is in order. In fact, Marshall already at the end of the nineteenth century noted that:

Every one is aware of the tendency to an increase in the size of individual businesses, with the consequent transference of authority and responsibility from the owners of each business to its salaried managers and officials. This would have been impossible had there not been a great improvement in the morality and uprightness of the average man: for even as late as the seventeenth and eighteenth centuries we find the great trading companies breaking down largely in consequence of the corruption and selfishness of their officials. (Marshall 1897, p. 130).

Marshall's concerns for the structure of firms, their hierarchies, and functioning shows how corruption within the private sector can affect the basic unit on which economic development is based. The role of firms and the rationale for their

existence was later re-emphasized by Ronald Coase who argued that to understand the nature of the firm we should look at alternative ways in which transactions could take place and compare the associated costs (Coase 1937). Re-phrasing Marshall, it seems apparent that transactions—and the associated costs—within firms were already a concern for him and that corruption might affect these transaction to the point of limiting the size of firms in corrupt environments. The size of firms is, in turn, associated with investment and productivity. This is an example of how economic analysis has shown that the abuse of power, entrusted in the private sector, can also lead to detrimental economic outcomes and that the concern with corruption in economic theory is not bound to the public sector.

Similarly, other aspects of corruption and of the ways corruption has been analyzed can be the bases for an extension of the analysis to the private sector. One example of these instances is the explanation of the association between high corruption levels and low investment levels because corruption acts as a tax on investment (e.g. Mauro 1995; Wei 2000). In this framework the investor would face public officials that exact bribes in order to allow the investment to take place and to facilitate the operation of the firm. The investor would discount such expenditures before taking the decision to invest and the impact of corruption would be analogous to that of taxation. We can easily extend these considerations to the private sector. The effect on investors of corruption within their own organization would be of the same nature: the siphoning of part of the revenues of the enterprise by its employees could also be seen as a tax on investment and would have similar impacts on future revenues and on investment decisions.

Transparency International itself—as mentioned above—endorses the operational definition of corruption as “the abuse of entrusted power for private benefit” that includes also the private sector. Nevertheless, its *Corruption Perception Index* uses sources that define corruption as the “the misuse of public power for private benefit”.¹⁵ Also the World Bank at times defines corruption as something pertaining only to the public sector, while it also discusses the problem of “corporate corruption”.¹⁶ These inconsistencies show the tension created by the fact that often the starting point of the analysis is corruption only in the public sector, but many ramifications and issues require the inclusion of corruption in the private sector. The definitional issues underlying this tension are often unexplored.

2.3.2 *Opportunities for Corruption and Anti-corruption Strategies*

Now we will present three examples of how reforms of public sector activities, namely privatization, do not automatically achieve one of their objectives: the re-

¹⁵ Cf. Lambsdorff 2008 and http://www.transparency.org/news_room/faq/corruption_faq, 3 June 2009.

¹⁶ Kaufmann 2004 and Kaufmann et al. 2005.

duction of corruption (see Estache et al. 2009). This issue is discussed here because one rationale of privatization is based on the belief that the public sector is often marred by corruption, while the private sector is not. The first two examples below show how privatization creates new interfaces between the private and the public sectors and large stakes are redistributed in the process creating incentives for corruption. The last example shows how the set of behaviour termed “corrupt” can continue unaltered after a state company is privatized.

The privatization process in the former USSR was marked by corruption and the sale of state assets offered an opportunity to grab and accumulate large fortunes by illegal means (e.g. Sachs 2005). This outcome is the apparent result of the mismanagement of the whole process and of the erroneous assumptions on which it was based (Black et al. 2000). The idea that substituting markets and private agents for the state would automatically enhance efficiency and solve the problem of corruption underlies the course of action (Boycko et al. 1996) and its failure. Many lasting problems were created: the whole privatization process, because of corruption, produced a class of tycoons whose fortunes are tainted by their illegal nature. To this day these entrepreneurs depend on complacency from the government to retain their holdings and this dependency has further fuelled the corruption that is still pervasive. Furthermore, many of the “new rich” have preferred to siphon their illegally obtained funds abroad, deepening the lack of resources for investment and damaging economic development prospects of the country. Among the many negative effects of carrying out the privatization program in such a fashion was the detrimental impact that corrupt privatization has had on the whole democratization process in Russia. Because of the nexus created between the “new rich” and the politicians and the fact that privatization and political corruption proceeded hand in hand there was been widespread disillusionment with many the changes associated with democracy.¹⁷

The second example is from the privatization of healthcare services in Italy. The state provision of health care in Italy has been renown because of its inefficiencies and corruption and the sector was at the centre of many of the judiciary cases in the anti-corruption trials known as “*mani pulite*” (clean hands) at the beginning of the 1990s. The trials—among many other facts—have shown how the national health service was buying medicines at inflated prices because of the collusion of employees of the Ministry of Health, of the minister himself, and pharmaceutical companies. Since then the presence of private health care providers has increased and many health services are now delivered by private companies that get reimbursed by the state. Unfortunately, recent judiciary cases have shown how the extension of private operations in the sector has not been able to stamp out corruption. For example, private health care providers have been able to get compensations for services that they had never provided or, even worse, they were providing un-

¹⁷ This is not to say that privatization of state enterprises should not have taken place, on the contrary we mean that the potential benefits of the privatization process were lost because of the way the process was mismanaged (Black et al. 2000).

necessary services (including surgeries) to unknowingly patients in order to obtain compensations for them.¹⁸

The third example is the privatized electric utility of Nicaragua. The generation companies have been privatized from the mid-1990s and formerly state-owned distribution companies were bought by a multinational company (Union Fenosa). The privatization process—as in the Russian case—has not been accompanied by the implementation of regulations to ensure that the potential benefits of the process would be realized (CEPAL 2003). Interestingly, one practice that is still common for employees of the distribution company is to collect bribes from consumers in order to forge consumption data and the resulting bills. Arguing that these are not cases of corruption since the company is now private, would imply some taxonomic changes (from corruption to theft, or fraud) without really addressing the problems.

The examples of privatization in Russia and Italy show how the size of the public sector might not matter for the spread of corruption and show how privatization might change the practice of corruption but not eliminate it. Overall, the examples show how the shrinking of the public sector might actually create opportunities for corruption (as in the Russian example), or change the locus of corruption to the public–private interface (as in the Italian example), or simply, if we were to define corruption as something that can happen only in the public sector, change the name of things without changing their nature (as in the Nicaragua example).

These examples represented different types of corruption and of processes at play. These differences and the ensuing problems related to privatization are obscured by an approach to corruption that focuses solely on the public sector or equates privatization with diminished corruption. Indeed, reforms such as privatization—if they are to succeed in reducing corruption—should be accompanied by anti-corruption strategies rather than rely on presumptions of automatic decreases of corruption. In other words, if expectations of corruption reduction in conjunction to privatization programs are not carefully worked out, the success in combating corruption can be purely semantic rather than substantive.

2.3.3 *Corruption and Market Failures*

It is worth noticing that—among social scientists—economists stand out as particularly critical of the public sector and this position is reflected by the fact that many economists agree with the notion that corruption is an issue belonging solely the public sector (Hodgson and Jiang 2007, p. 57). Simplistic characterizations of corruption simply see a choice between state intervention with its associated corruption and a private sector that can be marked by market failures but is intrinsically not corrupt (for an example see Acemoglu and Verdier 2000). The policy advice that

¹⁸ For an overview of the corruption problems related to healthcare in Italy, see Paolo 2008; for some of the most recent cases see <http://www.repubblica.it/2008/06/sezioni/cronaca/medici-arrestati/medici-arrestati/medici-arrestati.html>, 14 June 2009.

derives from this one-sided characterizations of corruption does not make sense in much the same way it would not make sense to suggest that the way to solve problems of fraud and theft in the private sector is to nationalize private companies.

Another fallacy is the fact that corruption might be the reason why the market failures exist in the first place especially when policy formulation is influenced by political corruption. Powerful interests can unduly influence policy makers into inaction and make them unresponsive to requests to regulate a sector and deal with societal demands. One of the main points of this book is that the lack of policies and regulations in the environmental sphere might actually be a result of corruption, rather than a way to deal with it. In this case there is no dichotomy, nor is there a choice between market failures and corruption: corruption actually is the source of market failures. We will transform the famous “because government intervention transfers resources from one party to another, it creates room for corruption” (Acemoglu and Verdier 2000, p. 194) into “because government intervention *and non intervention* transfers resources from one party to another, it creates room for corruption”. The point here is that in the presence of social problems inaction inevitably favours the status quo if compared to a situation where the state responds to societal needs regulating certain activities; i.e. by taking away the “right to pollute” enjoyed by some agents.

Finally, these considerations are backed up by the lack of consistent econometric evidence that corruption is associated in any systematic way to the size of the public sector in the economy (e.g. Lambsdorff 2007, p. 4–5; see the results in Chap. 3), nor of a relation between neo-liberal policies and corruption (Gerring and Thacker 2005).

2.4 The Measurement of Corruption

Several governance indicators are now available and provide the possibility to quickly gain an impression of the quality of many aspects of the institutional environment of countries. Furthermore, these data provide the opportunity for econometric analyses of the determinants and the impacts of corruption.

At the same time the availability of these indexes has also offered ample opportunities for their “abuse” (Williams and Siddique 2008). For example, many authors have been using data without fully understanding them and have incorrectly used them as proxy variables, the most famous cases being those authors that used the data of the “Corruption” variable from the International Country Risk Guide in econometric analysis investigating the effects of corruption without realizing that the variable is actually a measure of political risk associated with corruption rather than corruption per se (see the discussion in Lambsdorff, 1999).

The assessment of corruption levels across countries is a formidable empirical challenge as corruption is difficult to define uniformly, being culturally determined, and even more difficult to measure, because illegality implies secrecy. The individual indexes aggregated in order to create the proxies of corruption (or, more

precisely of its perception), range from Gallup's opinion surveys—where a sample of the polity is asked how common corruption is and at what scale it operates—to surveys of company executives that estimate the share of their companies' revenues that are spent in bribes.¹⁹ On the one hand, the high correlation of the aggregated indexes, originated from different sources, gives some confidence in the belief that they are correct proxies for corruption. On the other hand, it should be noted that the definition of corruption can be interpreted differently in different cultural contexts and that there can be “emotionally driven” answers to survey. Thus, when a corruption scandal is escalating, the interviewees will possibly overrate the level of corruption, just as when the economy is booming interviewees can have a more positive attitude about the government and the civil servants. While some of these concerns are taken care of by the way the polls are realized and aggregated, a margin of uncertainty is inevitable (see Kaufmann et al. 2005). Critiques of these indexes have, among other things, focused on the fact that they measure perceptions rather than “real” corruption levels. However, as it has been shown extensively in the empirical literature, even though these indexes may delineate the perception of corruption rather than its existence, it appears that perceptions have an impact on the economy and that the indexes have a high explanatory power when used as independent variables in econometric analyses (for a review see Jain 2001). Moreover, some of the sources, such as surveys of company executives' expenditure on bribes as a percentage of revenues, are more akin to estimates of corruption rather than simple polling of opinions.^{20,21}

2.5 Discussion

In this chapter we have discussed issues related to the definition of corruption and to its measurement. The objective is twofold: first we contribute to the literature on the meaning of corruption by showing how different characterizations can have a bearing on the anti-corruption policy options of choice. Second, we discuss the proposition that corruption is a necessary evil when dealing with market failure, showing that the dichotomy of market failure or corruption is conceptually flawed. Corruption is actually a cause of market failures rather than an alternative. Overall, we find that the root of the corruption problem is the abuse of power, regardless of the

¹⁹ For a full description of all the sources and of the aggregation methodology used by the World Bank, see Kaufmann et al. 2005; for sources and methodology of the Transparency International index, see Lambsdorff 2004.

²⁰ One example of a survey—including among the sources of our corruption indexes—containing such a variable is the “World Business Environment Survey” of the World Bank, available at <http://info.worldbank.org/governance/wbes/>.

²¹ For updated reviews of the use (and abuse) of governance indicators in economic studies see Kaufmann and Kraay 2007 and Williams and Siddique 2008.

nature of that power. Policies should focus on the root causes of this abuse and the conditions facilitating corruption rather than the nature of the power being abused.

To sum up, a definition of corruption that does not include corruption in the private sector (e.g. as in Nye's original definition; Nye 1967) leads one to the simplistic conclusion that to decrease corruption it is sufficient to decrease the size of the public sector. This conclusion is misleading in various ways: it ignores important strands of economic thought, goes against the grain of the common understanding of corruption in the public, and directs public action towards actions that would simply characterize one type of damaging behaviour (corruption) with other types of behaviours in the public sectors whose final result that is not in any way an improvement on the original state (e.g. by substituting corruption for theft or fraud).

The associated issue of the alternative between market failure and corruption is also based on a simplistic characterization of corruption where state intervention is always associated with corruption, while non-intervention might be associated with market failure. One of the main points of Chaps. 5 and 6 is that corruption can actually lead to non-intervention in terms of environmental policies; in other words corruption and market failures would go hand in hand rather than be alternatives.

Finally, we have introduced concepts and measures of corruption that are used throughout the book. Ultimately clarifying what we mean by corruption and what the features and limitations of the indexes we have used informs the reader of the meaning of subsequent analyses and of the caveats thereof.

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