The Causes, Consequences, and Cures of Corruption:

A Review of Issues

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Abstract: This paper reviews some issues related to the causes, consequences and cures of corruption. Section two highlights government intervention in the economy as the root cause. Section three discusses the consequences which include redistribution of income, social welfare loss due to reduced commodity transactions, and economic efficiency loss due to entrepreneurship being misallocated. Section four points out the importance of introducing competition among bureaucrats in the provision of government goods as the cure.

Key Words: corruption, government intervention, economic efficiency loss
1. Corruption

Since the beginning of the subprime crisis, there have been many voices calling for a bigger government, more regulations and interventions, especially in financial markets. Although government actions are naturally regarded as a must to correct market failures, their potential negative effects should be carefully measured before any active policies are implemented. In particular, it should be emphasized that government regulations are the root cause for corruptions.

According to Tanzi (1998): “Any realistic [anti-corruption] strategy must start with an explicit recognition that there are those who demand acts of corruption on the part of public sector employees and there are public employees willing for a price to perform these acts. There is thus both a demand for and supply of corruption\(^1\).” What are the causes of corruption in terms of demand and supply? This paper starts with answering such a question in section two. Based on two cases which illustrate the occurrence of corruption, it is claimed that the demand for corruption mainly comes from the will of firms to reduce costs associated with government regulations or to obtain opportunities to enter into regulated markets. Section three of the paper talks about the consequences of corruption. The first one to be discussed is redistribution of income, which usually increases income inequality. The second is social welfare loss due to reduced transacted commodity. It is a result of an increase in firm cost or of commodity markets being converted from a competitive one to a monopoly one. The third is loss in the economic efficiency, which is due to entrepreneurship being allocated to unproductive activities as well as the demands of secrecy. Section four discusses cures for corruption. In that part, the paper suggests introducing competition among bureaucrats in the provision of government goods, such as licenses or permits, to reduce the dependence of firms on corrupt practices.

\(^1\) Supply and demand are the basic forces underlying not only market transactions but also corruption activities. “If one wants to know how any event or policy will affect the economy, he must think first about how it will affect supply and demand.” N.Gregory Mankiw, *Principles of Economics*, 1998, P51, Published by Thomson Learning.
2. Causes

2.1 Definition:

Corruption has been defined in many different ways. The most widely accepted and the simplest, among others, is the one made by the World Bank: “it is the abuse of public power for private benefit.” This paper focuses on the economic sphere of corruption and restricts its discussion within the World Bank definition, to be distinguished from studies on those corruptions in private sectors (e.g. Huang, 2007).

2.2 Two categories of corruption:

Bliss and Tella (1997) divide most public-official corruptions into two categories. One is called cost-reducing corruption, as the corrupt agent reduces cost for producer and demands payment in return. The other is called surplus–shifting corruption, when payments are made for entering into a protected market where firms can get surplus profits. The two kinds of corruption can be illustrated by two stories respectively.

2.2.1 Cost-reducing story:

The first story is from Accmoglu and Verdier (2000). An official is employed by the government to measure the pollution quantity of some firms and decide the pollution tax on them. Because of the difficulty in perfect monitoring, the official could exploit the informational advantage to ask for bribes. In return, he lowers the amount of pollution to be reported as well as the pollution tax due for the firms. The firms, which want to save cost, are willing to offer a relatively small bribe to avoid part of pollution tax. Hence, the transaction happens.

Many corruptions happen in reality as in this story. When Custom official gives passage through customs with less or no duties, when scarce but essential goods are rationed to those who bribe the official, or when certain goods or services are sold at below-market prices, the bureaucracy reduces the cost for firms and gets the pay.

2.2.2 Surplus-shifting story:
The second story is from Ade and Tella (1997). It is about a matchbox seller. In a certain area, poor people can freely sell boxes of matches on streets. So the match markets can be regarded as a perfect competitive market with no surplus. Then there comes a large menacing man, demanding that match sellers hand over part of their taking for ‘protection’, which forces some sellers to exit. The ‘protection’ forms a barrier to enter into the market and brings surplus to the remaining ones who can get more for selling matchboxes thereafter. By charging fees for the protection, the man shifts at least part of the surplus from the sellers to his own pocket.

This story is by no means a fairy tale. Ade and Tella (1997) give evidence suggesting that corruption is indeed higher in countries pursuing active polices, such as policies intending to improve industry competitiveness. In most cases, these policies prevent companies from freely entering into certain industries, through providing limited licenses or permits. With imperfect monitoring, bureaucracies who are given discretion over choosing qualified firms have chances to seek rents from candidate firms. According to Shleifer and Vishny (1993), government officials often collect bribes for providing permits and licenses, just like the protection-providing man in the story.

2.3 Government intervention in economy as root cause of corruption:

It is noteworthy that in both examples, corruption arises from the power originated from government intervention in economy, no matter whether the regulation aims at internalizing the externality of firm pollution or at protecting domestic industries. Therefore, Gary Becker, a Nobel Laureate in economics, once made a comment in one of his Business Week columns: “if we abolish the state, we abolish corruption”. Corruption is rooted in activities of the state, especially those with the monopoly and discretionary power.

It should be emphasized that each policy has benefits as well as costs, some of which are explicit while others are implicit. Some market failures do not justify government intervention when possibilities of bureaucracy corruption is taken into
account (Acemoglu and Verdier 2000). So governments always face a tradeoff between market failure and corruption. And here is the assessment of George Stigler, another Nobel Laureate in economics, in *The Fortune Encyclopedia of Economics*: “in my view, however, the degree of ‘market failure’ for the American economy is much smaller than the ‘political failure’ arising from the imperfections of economic policies found in real political system.”

People respond to incentives. If potential benefits from corruption are big enough, government organizations and officials have incentives to create laws and regulations that enable them to become the providers of additional required permits and license, charging for them accordingly. They can also complicate the existing laws and regulations, to make monitoring more difficult. Labyrinthine government regulations are fertile grounds for government officials to extract rents, whereas in an economy where government’s role is minimal is less likely to breed corruption (Wei, 1999).

### 3. Consequences

3.1 *Redistribution of income and increase in inequality:*

In the two stories, both the demand part and the supply part are better off in the corruption transactions. The polluting firm gets taxes reduced. The firm in the protected market gains surplus profits. And the official in both cases grabs wealth in the form of bribes.

Notice that, in both corruption activities, redistribution of income and resource transfer occurs. The pollution inspector and polluting firms get earning which should be handed into the treasury. The selecting-firms official and the protected firm obtain surplus from higher prices paid by consumers. These redistributions usually increase income inequality. Because it is better-connected individuals in society, who belong mostly to above-middle-income groups, that are able to take advantage of these activities at the cost of the rest of the population. In several empirical studies (e.g. Gupta *et al.*, 1998), high and rising corruption has been found to increase income inequality and poverty.
3.2 Social welfare loss:

3.2.1 Cost-reducing story: resemblance between corruption and tax

Consequences of corruption include more than redistribution of income. Earlier papers on corruption have found the similarity between corruption and tax. As discussed in common economic textbooks, when commodity tax is levied on the firms, the average cost of each product rises and the quantity of transacted commodity is reduced, causing what is called the deadweight loss. One of the economic principles is that both parties benefit from voluntary exchanges. The logic underlying is that if an exchange is made voluntarily, the buyer values the utility of the goods higher than that of the money paid, while the seller values the utility lower, so both parties get satisfactory from the exchange. Taxes deter some of the otherwise mutually beneficial exchanges to happen, which cause loss in social welfare, or, the deadweight loss.

Corruption has the same effect. Suppose in the first story, with bribes submitted to the official in place of taxes, costs of the firms rise. This reduces the supply of commodity at each given price. Deadweight loss occurs due to decrease in equilibrium transaction quantity. Note also, with non-extreme demand elasticity, consumers and producers will burden the bribe together. So like taxes, the bribes reduce social welfare both in terms of consumer surplus and producer surplus. In short, with respect to social welfare, corruption operates as tax\(^2\) (Wei 1999).

3.2.2 Surplus-shifting story: commodity market converted from competitive to monopoly

In the surplus-shifting story, transactions are reduced also, yet for a different reason. The regulation reduces the number of firms and the competitiveness of the market. In a monopoly (or an oligopoly) market, firms have certain control on the price or over consumers. To maximize their profits and to pass the cost of bribes partly onto consumers, the firms under protection will charge a price higher than its marginal cost. This prevents some trades beneficial to the society from taking place, so deadweight losses are caused.

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\(^2\) Furthermore, similar with a tax on the proceeds of investments, corruption lower the private marginal product of capital, lower the investment rate and slow down economic development (Mauro, 1995).
3.3 More economic efficiency loss:

Till now, we have seen that corruption is more than a redistribution of income. It causes deadweight loss through cutting beneficial transactions in different scenarios. However, the evil of corruption can be still more. The social costs of corruption are conceived to be the sum of both deadweight loss and additional loss resulting from the competition to become a monopolist. The latter includes both entrepreneurship being allocated to unproductive activities and loss due to demands of secrecy.

3.3.1 Competition for monopoly: unaffected allocation efficiency

To a large extent, the efficiency on the corresponding commodity market relates to the way the official ration the licenses. First, suppose that the official designs a bribery game in which firms bid for a government license. Since the corrupt official awards the permits to those who pay the highest, the most inefficient firms will be driven out as only the firms with lowest-cost can afford the largest bribe. If the competition for monopoly is perfect, all the monopoly profits will be transferred to the official as bribes. In this case, bidding by private firms for government licenses maximizes the official’s income while not reducing further the allocation efficiency on the related commodity market (Bardhan, 1997).

3.3.2 Unproductive entrepreneurship: talent away from productive activities

However, hidden rules in the real world are more complex than this hypothetical bribery game. Many considerations other than the size of bribe are involved in rationing the resources, such as favoritism for a particular client or nepotism (Bardhan, 1997). In these cases, those firms that can provide low-quality goods with high price but are clever at ‘personal connection’ may have chances to get the license, causing more inefficiency in the economy.

Murphy et al. (1991) point out that distortion of economic resources happens when able individuals allocate their energies to unproductive activities, such as rent seeking and corrupt practices, rather than productive activities like innovation. Furthermore, according to Baumol (1990), the exercise of entrepreneurship depends
heavily on the rules of the game -- the reward structure in the economy. If through corruption, considerable wealth, power, and prestige could be obtained, those who are most ingenious and creative will put their wisdom into unproductive activities, which aggregates the distortion of corruption on economic efficiency.

3.3.3 Demands of Secrecy: more resources being allocated inefficiently

Besides misallocated entrepreneurship, some studies give emphasis to the distortion entailed by the necessary secrecy. In reality, after the firms bribe the officials, they commonly need to spend more to secure their positions, by, for example, modifying the balance sheet or bribe other officials. This further increases the distortion in economic resources allocation.

Shleifer and Vishny (1993) point out that the demands of secrecy will shift a country's investment away from the highest value projects, such as education and public health, to low value public projects like defense and infrastructure, if the latter offer better opportunities for secret corruption. The demands of secrecy also explain why more corruptions arise in public projects which are often supervised with less incentive than in private investment. Efforts and resources to avoid detection and punishment cause corruption to be more distortionary than its sister regulation, the tax.

3.4 Grease? Exogenous or endogenous

We sometimes hear about the ‘virtuous bribe’ story, which says bribes often work as ‘grease’ that speed up the operation of bureaucracy institution. As a conclusion of this part, the paper makes several comments on these kinds of talks.

The key to these discussions is whether inefficiency is an exogenous cause for or an endogenous result of corruption. Is bureaucracy rigidity really unavoidable, and can only be cured by bribes? Or is the inefficiency, as a matter of fact, the result of the expected opportunity to charge bribes?

As implied by the two stories, and as what has been emphasized repeatedly, in
most cases, corruptions are actually induced. If officials can cause administrative
delay, or if they can complicate the regulation, opportunities for charging bribes are
created. In fact, officials often have lots of leeway to customize the type and amount
of harassment on individual firms (Kaufmann and Wei, 1999). So instead of being the
remedy for rigidity, corruption is part of the reason for the inefficiency in bureaucracy,
and the ‘bribe grease the economy’ story completely reverses the cause and result.
Using data on a survey of nearly 2400 firms in 58 countries, Kaufmann and Wei
(1999) shows that, managers of the firms that pay more bribes on average spend more
rather than less time negotiating with government officials. This supports the idea of
“tailored harassments” and “endogenous obstacles,” refuting the hypothesis of
exogenous obstacles and beneficial “grease.”

4. Cures

4.1 Wages, supervision, and penalties: a decrease in supply

Different groups of people put emphasis on different ways to anti-corruption. Most of the comments by the media lay stress on strengthening supervision and public
monitoring. Lawyers may suggest that penalties on those being caught for malfeasance should be increased. Since Gary Becker (1968), many economic
literatures focus on the role of ‘efficiency wages’, which is the opportunity cost of
corruption. Wages, from the viewpoint of some economists, both attract and discipline
officials. For example, Assar Lindbeck (1998) attributes the low corruption in Sweden
partly to the fact that high-level administrators earned 12-15 times the salary of an
average industrial worker.

With regard to these measures, this paper makes several comments as following.
First, no matter whether to increase in wages, supervision, or penalty, big costs are
needed from government. Such a decision can be difficult for many developing
countries. Central governments of these countries commonly face a tradeoff between
the short-term cost to perfect the supervision and incentive system and the long-term
expected gain of less corruption. Second, increased penalties may induce more
corruption (Tanzi, 1998). Bureaucracy will bribe those judiciary officials, so that they may ignore or reduce the punishment on them. The third and the most important point is that, each of these measures could reduce the number of corruption cases, but in the meantime, increase the total money involved in each case.

This problem is similar as the illegal drug issue. Due to the inelastic demand of drug users, a severe hit on drug sellers will sharply raise the price of drugs and the total amount of money paid for drugs, resulting in more drug-related crimes. The case of corruption is just the same. If the resource that government rations are necessary for firms and individuals, such as licenses for entering into certain markets, firms and individuals are highly dependent on them, and their demand for corruption is inelastic. With increased monitoring, punishment or wages, the risk of officials’ being caught and punished increases. They will respond by reducing the supply of corrupt acts, yet, in the meantime, charging a bigger bribe. The equilibrium point will be fewer cases of corruption but with a higher bribe in each case. Because of the small demand elasticity, the degree of reduction in the number of cases is smaller than that of rise in bribe. As a result, the total amount of money paid in corruption will indeed be larger, which causes a greater loss of the whole society.

4.2 Competitive bureaucracy:

4.2.1 Reduction in demand and increase in elasticity

Rose-Ackerman (1999) suggests that an effective way to reduce corruption is to introduce competition at the level of the officials receiving bribes, to force corrupt officials to compete with each other. As in the second story, the official in charge of rationing permits is just like a monopoly supplier. The ‘consumer’ has no choice except not to ‘purchase’. If the same services or closely substitutable government goods can be accessed from two or more officials, the firms or citizens can decide from whom they should pay the services. They can simply turn to another, if not well-served by one official. Because of the availability of ‘substitutes’, dependence of firms on bribing officials in exchange of licenses decreases, and their demand
elasticity for corruption becomes larger. This can result in less corruption and smaller bribes simultaneously.

In essence, the competition reduces bureaucrats’ monopoly power and, turning the corruption supplier market from a monopoly to an oligopoly or a competitive market. There is possibility that officials will collude for ‘a uniform price’. Yet, as we know in the cases of Cartel on crude oil price, such a collusion equilibrium is hard to maintain. The more bureaucracies providing the same services, the harder such a ‘contract’ can be reached and kept, and competition between them is expected to drive the equilibrium amount of bribe down considerably (Bardhan, 1997).

4.2.2 Tradeoff between total social cost and the size of government

There is no such thing as a free lunch. Competition between bureaucracies could be achieved by granting several officials the jurisdiction, which used to be owned by one person. Yet, this requires employing new officials, which needs a larger amount of payment from the government.

With the increase in the number of officials, the payment by government rises, but the quantity of corruption reduced by each additional official may diminish. So, the government faces a tradeoff between the size of bureaucracy and corruption. The total cost of corruption for society, which consists of both bribes and payments for more officials may take a shape like the U-curve. There might be an optimal point for the number of bureaucracies and the size of government, which needs further studies.

5. Conclusion

It is emphasized in this paper that the regulatory state is at the root of the inefficiency due to corruption spawned by the regulations (Bardhan, 1997). Economists are never tired of pointing the importance of minimizing the institutionalized opportunity for officials to take bribe (Kaufmann et al., 1999). Considering the possibility of corruption due to difficulty in perfect monitoring, many policies will achieve much smaller benefits than expected and thus should not be
implemented. Through careful analysis and estimation, Ades and Tella (1997) reach the conclusion that, in the presence of corruption, the total effect of industrial policy on investment ranges between 56% and 84% of the direct impact. The result indicates it is more expensive to achieve certain objectives by active policies in economies where corruption is widespread.

Policies sometimes have effects that their architects did not intend or anticipate. So, before the implementation of one policy, an all-around estimation of the potential effects is necessary. It does not mean to have found the best policy, but people are likely to make better policies if they can expect better the results they will have. It does not deny the importance of government intervention in the economy, but any countries serious about fighting corruption should pay attention to the role of government in the economy. In particular, those areas giving officials monopoly and discretionary power which are hot beds for corruption.
References:


