

ECONOMIC APPROACHES TO ANTICORRUPTION

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Introduction

Fighting corruption has played a prominent role in research in the last 15 years. Countries where bribery and embezzlement among public servants and politicians are effectively contained allocate capital more efficiently, grow faster, preserve the environment, attract investors, avoid inequality in income and wealth, enhance trust in politics and foster happiness among its citizens (Lambsdorff 2007). The empirical evidence is strong and has focused attention on the necessity of good governance.

At the same time there is little consensus on how to contain corruption. Some economists have advocated the idea that corruption is necessarily a consequence of bureaucracy and government. Downsizing the public sector was thus seen as a remedy. The resulting implementation of privatization and deregulation has often failed, however, and even led to increased rather than decreased corruption. Political reform, such as strengthening participatory government, democracy and decentralization, are guiding principles in their own right, but do not necessarily offer the silver bullet that helps reduce overall corruption. Instead they can generate transitory problems that may easily go along with increased corruption.

Legal reform has been given considerable attention lately, particularly in connection with criminal law. Milestones include the 1997

OECD convention, where all member states committed themselves to enact laws criminalizing the bribery of foreign officials and in 2003 the United Nations Convention Against Corruption, where 140 signing states agreed to fight corruption in all of its forms.

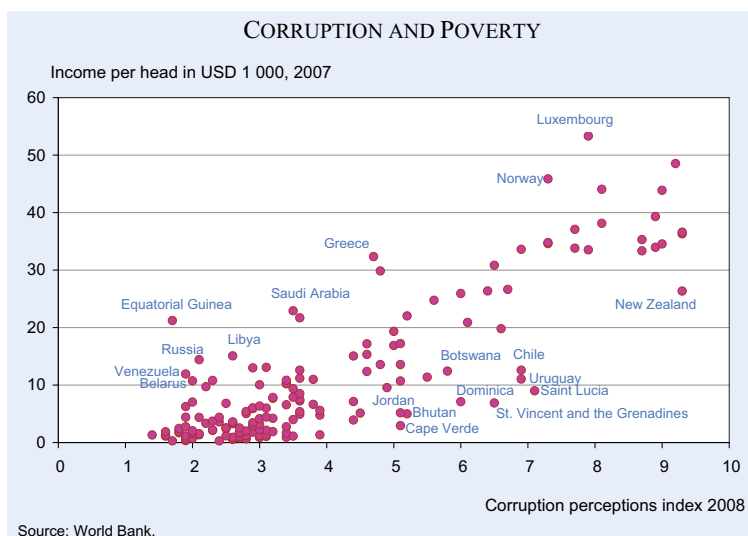
There is a widespread consensus that incentives for citizens, businesspeople, politicians and public servants must be created that discourage bribery. It should be turned from a high profit and low risk strategy to a risky activity that promises only little gain. But what are the risks that corrupt actors are exposed to? And how can we modify them? There is little doubt that severe penalties and high risks of detection are crucial. But can such an approach be successful when prosecutors are not independent, judges poorly paid, lobbyists masters of camouflage, businesspeople in search of legal loopholes and politicians willing to offer benefits for a price?

Approaches to anticorruption

Given the difficulties of fighting corruption, the chances for good governance frequently appear rather poor, particularly when observing how costly it may be to pay high salaries in the public sector and maintain necessary control mechanisms.

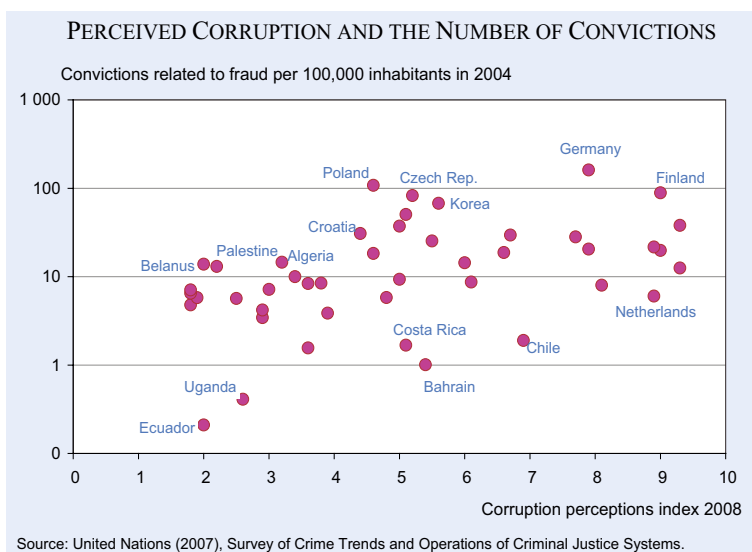


Figure 1



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Figure 2



This may explain why, as shown in Figure 1, there is a strong correlation between poverty and corruption. Rich countries such as Luxembourg, Norway, Denmark, Germany or the United States perform much better than poor countries such as Zimbabwe, Afghanistan or Myanmar. Some outliers, however, are also noteworthy. Countries endowed with raw materials such as Saudi Arabia, Equatorial Guinea and Russia are rich but marked by higher levels of corruption. Other countries such as Chile, Jordan or Botswana are rather poor but still successful in containing corruption. Can they teach us a lesson?

Data on convictions related to fraud are also illustrative (even when recognizing that definitions and aggregation may differ from one country to another). More convictions suggest that a higher level of deterrence is achieved. This helps reduce perceived levels of corruption, as shown in Figure 2. Yet, the correlation is rather poor. One is tempted to reason that convictions in court may explain only a small fraction of the risk faced by potential perpetrators. It is noteworthy to see Chile again as an outlier. The number of convictions is rather small relative to the country's success in containing corruption.

Corrupt reciprocity

In addition to deterrence there are numerous other preventive measures that are salient in reducing corruption. These range from eliminating distorting state intervention, simplification of rules and procedures, to administrative rules or procurement law. I want to discuss one aspect that has become the fo-

cus of scrutiny lately. Corruption is an arduous type of business, and one approach for reform concentrates on rendering corrupt transactions even more troublesome.

Bribe paying companies are often betrayed. After receiving a payment, public servants and politicians fail to deliver the promised service. Other companies are extorted, threatened with criminal prosecution or forced to pay another bribe. The Wall Street Journal (31 January 2007) reported the prosecutorial investigation of M. Kutschenreuter, an executive manager at the German Siemens.

A former Saudi-Arabian local representative, whose contract had been cancelled by Siemens, he allegedly blackmailed the firm. He requested more than USD 900 million as hush money and threatened to pass on documents about corruption in telecommunications contracts to the SEC. In negotiations both sides agreed on a payment of USD 50 million.

This case study is symptomatic for corrupt transactions. The risks of mutual betrayal are manifold, as the following cartoon illustrates. Corruption requires criminal expertise. Money flows must be camouflaged, measures against blackmailing must be taken, and, foremost, the enforcement of promised services must be ensured. Those who engage in this business



"A man of principle. He accepted the bribe but he wouldn't give me the license because that would be against the rules" Source: Laxman, Times of India

delve into a criminal sphere in which networks are as important as mutual trust. Trust, on the other hand, must be complemented by credible threats to retaliate malfeasance (Gambetta 2009).

This is well illustrated by another recent case, documented on 26 June 2007 by the *Süddeutsche Zeitung*. In a recent trial in Munich, Germany, Holger Pfahls was charged with accepting bribes while holding a position of a defense secretary under former Chancellor Helmut Kohl from 1989 to 1992. He was accused and found guilty of accepting the equivalent of almost EUR 2 million from German-Canadian businessman Karlheinz Schreiber for pushing through a deal to deliver 36 Fuchs armored vehicles to Saudi Arabia. In court Mr Pfahls is quoted as giving the following description of the alleged briber (own translation): “Schreiber told me that I was just one out of many who receives bribes. When Schreiber hates someone, his hatred is so profound that he wants to destroy him, even if that means his own demise. On the other hand, he is a real buddy, highly talented in creating a pleasant atmosphere.” Mr Schreiber has mastered the skill of creating a pleasant trusted atmosphere while at the same time threatening retaliation, forcing his counterparts to honor their promises.

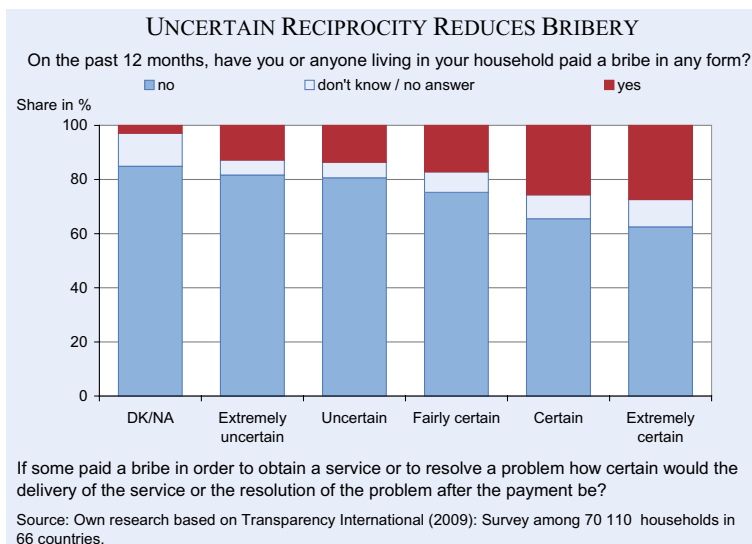
Empirically there is also a strong correlation between the likelihood to pay a bribe and confidence in corrupt reciprocity. Figure 3 shows data from a 2009 worldwide survey of households (Transparency International 2009). Households in 66 countries were asked, first, whether they paid a bribe in the last 12 months and, second, whether the delivery of the corrupt service is certain after making such payments. As shown, the likelihood of paying bribes increases with the certain-

ty of delivery. Among households that are extremely certain about the delivery 28 percent pay bribes. But only 13 percent of households pay bribes if they are extremely uncertain whether a bribed public official will deliver the corrupt service.

This finding provokes a novel approach to reform. The frequency of bribery can be reduced by rendering reciprocity uncertain, by undermining the stability of corrupt transactions. I labeled this method for anticorruption “the principle of the invisible foot” (Lambsdorff 2007, 2009). The wording is chosen in line with the well-known economic principle of the invisible hand. Outcomes desired by society can be achieved without altruistically motivated individuals. In the words of Adam Smith (1776, 16): “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.” The invisible hand of market competition assures the desired outcomes. A mechanism is in place that substitutes for a lack of individual morality.

This poses the question whether we have a similar mechanism at our disposal for ensuring good governance. Can there be good governance without benevolent politicians and without altruistic public servants? Competition does not represent this type of mechanism, because corrupt politicians may have an edge over their competitors in gaining funding, recruiting loyal followers and organizing majorities for their goals. But the principle of the invisible foot may give rise to hope. Actors who are willing to engage in corruption often end up being the victims of betrayal. They may fail to profit from bribery and lose their reputation for honest business. Abstaining from corruption may then be motivated by self-interest. Temptations to give or take bribes may be rejected not due to moral concern but because of the inherent uncertainty that surrounds such deals.

Figure 3



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Perspectives for reform

A plethora of proposals emerge once we approach corruption from this perspective. For example, due to their uncertainty, corrupt transactions are often arranged by specialized agents experienced in camouflaging, avoiding extortion, giv-

ing legal appearance to seemingly corrupt deals and enforcing illegal transactions. Intermediaries enjoy the advantage of being return customers. While a stranger may easily be cheated, intermediaries promise future business and can spread an individual's reputation as either being a cheater or an "honest" criminal. Making life harder for intermediaries could thus be an important approach to reform (Lambsdorff 2011). Intermediaries may be required to register their business and be subject to annual auditing, which would prevent them from passing on parts of their commissions as bribes.

Equally important is the observation that not all penalties and types of deterrence are advisable. This is particularly apparent with rigid gift-taking limits. Such measures may render the minor sinners dependent on a briber. After an innocent error they can become hostage to someone who was giving them a gift beyond the allowed limit. For many this marks the beginning of a corrupt career. Their initial perpetration makes them reliable partners for future corrupt transactions. The gift-limit rule serves to strengthen the stability of future corrupt transactions rather than to help the minor sinners protect their integrity. Instead of rigid rules it would be better to train employees how to deal with conflicts of interest, to sort out possible previous mistakes and to regain a life of justice. Conversely, those who bribe public servants and make them dependent deserve less backslapping.

Gender equality

Gender equality has been found to be closely related to the success in fighting corruption. There is significant evidence that a larger share of women in the working population and in parliament goes along with lower perceived levels of corruption, alas, with uncertain causality (Swamy et al. 2001). But causation has been ascertained in experimental investigations, which revealed that women differ in their reaction to bribes. While men have a tendency to reciprocate, for example by delivering a contract to the briber, women are willing to act opportunistically, taking a bribe while cheating the briber (Lambsdorff and Frank 2011). Women are commonly found to exhibit a high sense of fairness and the avoidance of behavior that contributes to inequality. But they were not found to apply a higher moral standard in corrupt transactions; rather they had a reduced sense of reciprocity.

Men, on the other hand, are more willing to reciprocate but also to retaliate if they are cheated, even if this is costly to them. This suggests that women may be preferable for routine inspections, in workplace situations that are comparable to the anonymous setting that was tested in the experimental laboratory. Men, on the other hand, may need more rigid gift-limit rules, given that they cannot take gifts without an inclination to reciprocate.

The four-eyes principle

Subjecting individual decisions to peer review is a standard organizational method. Individuals often tend to follow narrow, selfish interests which may overshadow the pertinent concerns. Having a second, independent person supervise important decisions is thought to ensure that a control mechanism is in place. Reports on anticorruption in the public sector thus often emphasize a rigid application of the four-eyes principle as a method for containing corruption. Bribing two, it seems, is more demanding than bribing just one decision maker.

What appears most intuitive to the layman has been critically challenged by laboratory experiments. Schikora (2010) employs a game similar to the one by Lambsdorff and Frank (2011), where bribe-takers can cheat the briber. He compares one treatment played among individuals with a treatment where bribe-takers decide in groups of two. Only if both agree to the bribe will it be accepted. Nonetheless there is more bribery in the group version. This is because the game is played repeatedly and as a result issues of reputation become salient. The experiments show that groups follow a maximizing strategy more than individuals do and are better at cultivating a reputation for reliable reciprocity. The mutual control exercised between two actors backfires, because rather than serving the public it is employed to uphold the actors' corrupt reputation. Thus research casts doubt on naive expectations regarding the four-eyes-principle. How peer review should be organized to better contain risks of corruption will thus be food for future research.

Asymmetric penalties

Bribery differs from many other forms of crime in that it involves two perpetrators. It suffices for law enforcers to convince just one of the perpetrators to collaborate and self-report. Take a simple thought experiment. A briber is allowed to keep the awarded

contract and entitled to claim back the bribe if he reports the infraction to prosecutors. Bribery and subsequent reporting is turned into an attractive strategy. Such a provision would be quite unfair, but also quite effective. A bribe-taker will recognize these incentives and, fearing the increased probability of detection, be inclined to reject bribes (Yadlin 2006). Self-reporting combined with leniency would thus be a valuable tool in destabilizing corrupt transactions. In contrast, if both briber and bribe-taker face identical penalties, these embed the two perpetrators into mutual dependence and silence.

But leniency programs must be fine-tuned so as not to backfire. Feess and Walzl (2004) warn that incentives given to those who report should not be excessive. What is even more important is how to deal with perpetrators who deceive each other. Imagine that a briber is still waiting for his contract to be awarded and is fearful that the bribe-taker may cheat. Will the briber be entitled to obtain leniency in exchange for reporting? Obviously, this type of leniency would backfire. If those who are cheated are invited to report, bribe-takers will not dare cheat. This type of leniency would enhance corrupt reciprocity and support the enforcement of bribe transactions (Buccirossi und Spagnolo 2006).

There are two models for taking care of these concerns. One approach would be to penalize bribe-giving but not bribe-taking. In the 1990s in Chile the payment of a bribe was a criminal offense, but accepting a bribe was not unless accompanied by an abuse of office. Even today Chile's *Codigo Penal*, the criminal code, is strict with respect to extortion, misappropriation, falsification of information and fraud but little punishment is added when these infractions are carried out in exchange for a bribe (Rose-Ackerman 2010, 222). The advantage is that bribe-takers are free to cheat bribers, without fears of reprisal. This model can also be linked to leniency towards bribers in exchange for reporting. As long as they do not receive the promised contract they are not in a position to threaten the bribe-taker.

Another option would be to reverse the onus of proof and grant leniency to any perpetrator, the briber or the bribe-taker, who can prove to have cheated their counterpart. While this option would also destabilize corrupt transactions, currently there is no country or institution where experience with such provisions has been gathered. More research is required to develop this thought experiment into rules that can be implemented.

Contract penalties

Monetary fines linked to business contracts can also be helpful in containing corruption. For example, the general terms and conditions of purchasing of the Deutsche Bahn AG (Allgemeine Einkaufsbedingungen AEB) set a fine of up to 7 percent of the gross accounted sum to be paid by a contractor who pays a bribe. Similar provisions can be found in the US Sentencing Guidelines. Also the "integrity pacts" by Transparency International incorporate similar types of fines. In my opinion a fine of 30 times the amount of the bribe would be adequate. Such a value would correlate with the advantage achieved by the bribery, i.e., a light penalty for the flowers given to a low-level clerk and severe sanctions for transferring large sums of money to key decision makers.

Another advantage of such fines is that they are borne by companies, not individuals alone. Companies will lose the incentive to induce their employees to pay bribes. Not only would the employees risk penalties, the companies would also face the risks of monetary fines. There are further advantages to such fines. The circumstances for detecting a malfeasance can be taken into account. Imagine a manager who hears about allegations of a bribe paid by a subordinate to secure a contract, contrary to the manager's policy. But should the manager investigate the case further, as required by his supervisory duty? Imagine that his company would have to pay a fine. Wouldn't it then be in the corporate interest to destroy all evidence rather than bringing them to light? Monetary fines are then at risk of generating adverse incentives.

The downside effects of monetary fines can be avoided by granting leniency in cases of self-reporting (but keep in mind that leniency may not be granted if the company was cheated and the paid bribe was not reciprocated). Such provisions would enhance the manager's incentives to investigate the allegation, in order to secure lenient treatment for the company. This is an advantage of fines as compared to blacklisting, where potential leniency is possible only at the discretion of prosecutors or the procurement agency. It is also superior to provisions that render the contract obtained by help of bribery null and void, as such provisions do not deter unsuccessful bribery that was not reciprocated. Monetary fines are also superior to liability for damages to the principal and the competing bidders, as they can be made dependent on a company's effort to come forward with evidence and report the infraction.

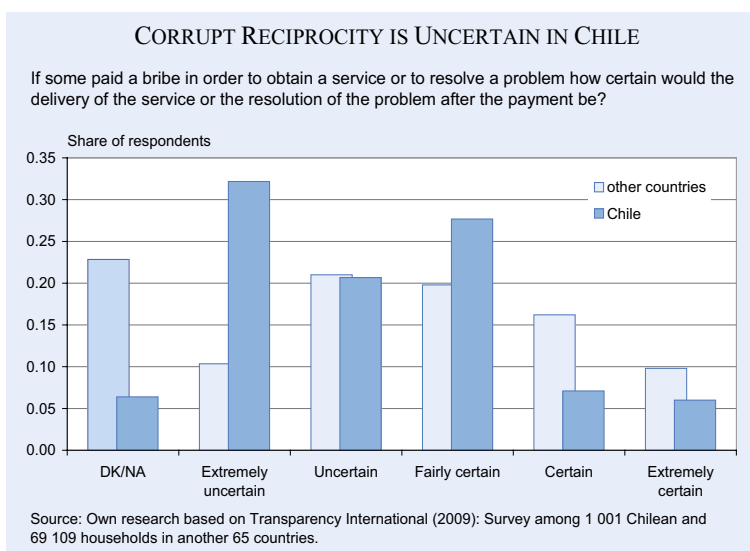
Conclusion

As this article explained, corruption is not only reduced by deterrence such as is provided by a strict criminal code and a high risk of detection. It is also undermined by the risk that bribes may not be reciprocated.

Why is Chile successful in fighting corruption? Why is it widely perceived to exhibit low levels of bribery despite being rather poor and not diligent in convicting fraudsters? One explanation might be its described policy of penalizing bribe-giving but not bribe-taking, which makes it attractive to take bribes without reciprocating them.

Indeed, as shown in Figure 4, Chileans are particularly uncertain with respect to corrupt reciprocity. More than 32 percent respond that after paying a bribe it is extremely uncertain whether the promised favor will be returned. Among 66 countries this was the second highest value. A policy that effectively inhibits corrupt reciprocity rather than exercising zero-tolerance towards gift-takers is likely to explain Chile's success. Rather than focusing on a policy of zero-tolerance, a more tricky avenue is advisable.

Figure 4



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