



## **What I like about this country is that it has a nice level of corruption!**

**Professor Michael Mainelli**

**4 October 2007**

Good afternoon Ladies and Gentlemen. I'm pleased to find so many of you so satisfied with our level of corruption that you can spare an afternoon to share your experiences.

[SLIDE: OUTLINE]

As you know, it wouldn't be a Commerce lecture without a commercial. So I'm glad to announce that the next Commerce lecture at Barnard's Inn Hall is on Monday, 12 November at 18:00, entitled 'Stealing The Silver: How We Take From The Dispossessed, The Poor And Our Own Children'. Please do slip any Gresham College person here a tenner if you want a space.

An aside to Securities and Investment Institute, Association of Chartered Certified Accountants and other Continuing Professional Development attendees, please be sure to record your CPD points at the end of the lecture or obtain a Certificate of Attendance from Gresham College.

## **A World Problem**

[SLIDE: A WORLD PROBLEM]

Well, as we say in Commerce - 'To Business'. Firstly, I'd like to conduct a small poll. Could I please have a show of hands from everyone who hates corruption? Would everyone who has bribed a government official please drop their hands? Would everyone who has sent an unbidden cheque to the police for their own speeding please drop their hands? Would anyone who has never paid cash to avoid VAT please drop their hands? Would everyone who has enjoyed corporate entertainment please drop their hands? Well, that certainly helps me understand this audience.

The inspiration for this afternoon's talk comes to us courtesy of a friend, Malcolm Cooper. Malcolm relates the story of being in Washington DC with a Nigerian taxi driver. Malcolm asked the taxi driver how he found the USA compared to Nigeria and his response was, 'What I like about this country is that it has a nice level of corruption.' It's a more profound statement than you might think. The statement implies that corruption is universal, but sometimes you can have too much corruption, and perhaps sometimes too little. So, while many Commerce talks are about the distribution of goods, today I'd like to discuss the distribution of bads.

Corruption is big, pervasive and important. In 2003 the World Bank estimated that \$1.5 trillion is spent every year on bribes, 5% of the world economy at that time. Of course, the World Bank would know as we were treated this past year to the controversy over Paul Wolfowitz and payments to his girlfriend. France convicted 30 executives of Elf, the oil major, in 2003. Russia's oil industry shenanigans could occupy several lectures. Brazil is consumed with 'Operation Razor', an investigation that has toppled one minister and looms over legislators, governors and even the President of the Senate. The International Olympics frequently features, for example Salt Lake City's bid for the 2002 Winter Olympics showed that 20 out of 110 International Olympic Committee members were bribed. 13 lost their posts in the ensuing investigations. The Iraq oil for food investigations indicated significant corporate and government corruption with some estimates between \$700M and \$2bn of which \$230M to \$240M went on bribes to Iraqis [The Economist, 'Economics Focus: Digging for Dirt', 18 March 2006, page 82]. Other investigations indicate that half of the 4,000 or so, mostly western, companies involved may have taken or paid kickbacks. Music companies have their payola's. Game shows and quiz shows their tampering. It's been a good summer to ponder where corruption might feature in the analysis of incidents such as lead paint in toys from China, animal diseases in Pirbright, the state of Zimbabwe, or closer to home, Northern Rock. The Copenhagen Consensus, a massive project to prioritise global improvement projects rates gains from reducing corruption around starting a new business as more beneficial for the global poor than improving infant and child nutrition or preventing climate change. [See Rose-Ackerman, 2004]

[SLIDE: MAURITIUS - TAKE A BOAT]

Bureaucracy helps to create corruption by providing opportunities. In the 1990's, the Ministry of Agriculture, Fisheries and Food's incorporated the Intervention Board (now the Department for Environment, Food and Rural Affairs' Rural Payments Agency). Among other responsibilities, the Intervention Board made subsidy payments to farmers in accord with the European Union's Common Agricultural Policy (CAP). The Intervention Board distributed about £700M per annum. Estimates of irregularity and fraud in British payments in the early 1990's were around £8M per annum. I hasten to add that the EU estimated total irregularities across Europe at £320M. To give you an idea of the scale in the UK, special investigations of 200 cases arising in 1991 to 1993 led to the recovery of £4.4M and 19 successful prosecutions. In the early 1990's, a colleague and I were invited to explore the distribution of payments to farmers in the UK under the beef export scheme, and the butter and starch subsidy schemes. We were given an interesting objective - try and see if you, naïve outsiders, can find a way to defraud the schemes. It was a fun challenge and we probably spent far too much time enjoying our role as agricultural hackers. We visited friends who ran margarine factories and asked where the butter industry was corrupt; we rang farmers in other countries for their views on British beef practices; and we explored the price relationships between starch and commodities.

One of the discovery tests we ran showed that the largest importer of British beef was, surprisingly, Mauritius. It's doubly surprising as there is plenty of South African beef to eat, if they eat beef. I've never visited, but those who know this beautiful island will support me when I say that of its one million inhabitants, 500,000 are Hindu and unlikely to eat beef, another 200,000 practice Islam and would only eat Halal meat, which wasn't what was claimed to be exported. So we learned one thing from our statistics, don't fly to Mauritius, take a boat. With 300,000 ferocious Christian and creole carnivores consuming so much meat, flying through the haze of barbeque smoke would be far too dangerous for any pilot. We have no idea whether the beef was being sold within the EU, to other less subsidised places or possibly not even leaving the UK at all. One thing we know for sure is that all that beef was not going to Mauritius. We didn't conduct the resulting investigations, but our suspicion was that falsification of export and import certificates was part of the scheme. I hasten to point out that in regard to corruption Mauritius is the fourth best African country out of 20 rated countries and, were it in Europe, would lie between Lithuania and Greece on the corruption ruler.

In a like manner, I've pondered the opportunities for corruption from the recent anti-money laundering bureaucracy. I imagine that if I were a criminal and all that stood between me and depositing or withdrawing lots of my money was convincing a bank teller that my identification was valid, I'd follow a

young underpaid teller to the pub at lunch. There I would explain my predicament. Then I would return to the bank after lunch, slip a dodgy passport across the counter with £1,000 in it, have it photocopied at low quality and obtain my access. Bureaucratic systems to prevent corruption can have unintended consequences.

Naturally, things are very corrupt abroad. According to a Control Risks/Simmons & Simmons 2006 survey of international business attitudes to corruption, a quarter of UK-based international companies said they had lost business to corrupt competitors in the last five years.

[[http://www.crg.com/PDF/corruption\\_survey\\_2006\\_V3.pdf](http://www.crg.com/PDF/corruption_survey_2006_V3.pdf)] We like dwell on really bad overseas corruption. Klitgaard relates his experiences with corruption in Equatorial Guinea in the 1980's:

'The government tries to get you in the funniest ways. For example, there are taxes for the 'biological inspection' of gin, chickens, you name it. Allegedly for testing purposes, they insist on taking two bottles of gin per case. Then they charge us a hundred and fifty cefas [about fifty cents] per chicken for 'inspection'. If we dopay, they'll hassle us. The chickens we import are frozen. Unless we pay them a bribe, they ask us to unfreeze them for testing. Then say they caget to it, and tell us to freeze them back up again. And so on till you pay.' [Klitgaard, 1990, page 69]

## Home Truths

[SLIDE: SQUEAKY CLEAN]

The UK is, of course, not a corrupt country. In fact, the exception that proves the rule is Al Yamamah. Al Yamamah is an ongoing arms sale dating back to the 1980s. Al Yamamah covers a variety of equipment, including Tornado fighter aircraft and now, Eurofighters. There have been numerous allegations that the Al Yamamah contracts were won as a result of bribes to members of the Saudi royal family and government officials. The UK's National Audit Office investigated the contracts in the 1990's but never released its conclusions - the only NAO report ever known to be withheld. The Serious Fraud Office also dropped an investigation on 14 December 2006, when the Attorney General, Lord Goldsmith, announced to the House of Lords:

'The Director of the Serious Fraud Office has decided to discontinue the investigation into the affairs of BAE Systems plc as far as they relate to the Al Yamamah defence contract. This decision has been taken following representations that have been made both to the Attorney General and the Director concerning the need to safeguard national and international security. It has been necessary to balance the need to maintain the rule of law against the wider public interest. No weight has been given to commercial interests or to the national economic interest.

[House of Lords Debates, Hansard, [http://www.publications.parliament.uk/cgi-bin/newhtml\\_hl?DB=semukparl&STEMMER=en&WORDS=lord%20goldsmith%20bae&ALL=BAE&ANY=&PHRASE=&CATEGORIES=&SIMPLE=&SPEAKER=lord%20goldsmith&COLOUR=red&STYLE=s&ANCHOR=61214-0014.htm\\_spmin0&URL=/pa/ld200607/ldhansrd/text/61214-0014.htm#61214-0014.htm\\_spmin0](http://www.publications.parliament.uk/cgi-bin/newhtml_hl?DB=semukparl&STEMMER=en&WORDS=lord%20goldsmith%20bae&ALL=BAE&ANY=&PHRASE=&CATEGORIES=&SIMPLE=&SPEAKER=lord%20goldsmith&COLOUR=red&STYLE=s&ANCHOR=61214-0014.htm_spmin0&URL=/pa/ld200607/ldhansrd/text/61214-0014.htm#61214-0014.htm_spmin0)]

However, in June 2007 BAE announced that the United States Department of Justice launched an investigation into Al Yamamah and the possible funneling of money to a Saudi prince using a US bank. So one of the UK's 30 largest companies is under prominent investigation for corruption.

And just to clear the air about the lack of corruption in the UK, I should mention the cash for honours

rumours. It's nice to see the UK repeating the US quiz show scandals of the 1950's. Ernie Marrs' 1959 song is rather appropriate even today, just substitute Parliament for Congress:

Yes, Congress discovered a long time ago  
The profits concealed in a questioning show;  
And Congressman Walter can tell you the tale  
About how quizzers get votes and contestants get jail.

[<http://folksongcollector.com/quizmasters.html>]

I might as well just rattle off a few other scandals while we're here, such as Lloyd's in the 1980's and early 1990's, the Maxwell pension funds, Banco Ambrosiano, endowment mortgages, split capital trusts, BCCI. Or that this year the FSA estimated nearly 25% of takeover announcements show suspicious price movements beforehand, indicating insider trading, or 'informed price movements' in the jargon. [<http://www.fsa.gov.uk/pubs/occpapers/op25.pdf>] Police investigations into UK corporate bribery run at around 150 a year. Few cases result in convictions, though we do see some high profile ones such as a Mars UK middle manager getting gifts and cash in return for approving false and inflated invoices. But these isolated cases do not reveal the scale of corruption. For example, a 2006 survey of corruption within the UK construction industry by the Chartered Institute of Building, 51% of 335 UK construction professionals felt that corruption is commonplace within the UK construction industry; 41% of the respondents said they had been offered a bribe. [[www.ciob.org.uk/filegrab/CIOBCorruption.pdf?ref=283](http://www.ciob.org.uk/filegrab/CIOBCorruption.pdf?ref=283)] In the UK property sector, agents operate on almost standard 7% kickbacks for referring small and mid-range clients to construction firms and builders. The estimated level of UK construction corruption is approximately £3bn. When I confronted one partner in a major firm with a case of staff corruption, he first denied it happened then blustered that it was unrealistic to pay his staff enough to act professionally. When he turned a blind eye his staff got plenty from kickbacks (think 7% on a typical £2M property project) and he did have to pay them so much. And everyone else is kicking back, are they?

We could talk about police corruption or judicial corruption or medical research scandals, and so on. Gosh, isn't mankind inventive.

[SLIDE: BLACKER THAN WHITE]

American politicians struggle to hire domestic help. Everyone who can bear working for them seems to be an illegal immigrant. Back in 1987, Italy's GDP overtook Britain's, il sorpasso, when Italy's statisticians decided that the black economy was too large to leave out of the official figures. In fact, if you consider black economies to be corrupt, then 15% to 40% of the world economy is corrupt. There are large market forces at work in black economies for general smuggling, especially across war zones or tense areas; illegal drugs; prostitution; firearms; false documents; copyrighted media; alcohol and tobacco smuggling, as well as 'speakeasies' and other licensed premises' corruption.

[SLIDE: NOT A FAKE COPY]

Copyrighted media and counterfeiting alone is enormous, \$500bn annually or 8% to 9% of world trade if you believe the aggrieved businesses. Having recently been in China, I loved the local honesty you can see in this slide. In Central China I was told, 'very good copy' and 'not fake, quality copy', and even 'original copy'.

Some of my friends have a little game about fakes, giving them authentic names - North Fake (North Face), Reeb-Off (Rebok), Nike-Like, pronounced Ny-kee Ly-kee (Nike) or Mustake (Musto).

[SLIDE: QUALITY COPY]

And just when you start to get jaded, it turns out that these Columbia trousers are authentic.

But it's not all one-way business. We have citizens with their hands in the till. According to research published in the July 2004 Economic Journal by Panayiota Lyssiotou, Panos Pashardes and Thanasis Stengos, 'black economy' activities by self-employed people in the UK amount to 10.6% of GDP, i.e. over £100bn. UK tax fraud is estimated at tens of billions, VAT fraud & carousels at anywhere from £2bn to £30bn, and benefit fraud, a snip at just £700M per annum.

## Transparent Definition

[SLIDE: TRANSPARENT DEFINITION]

No contemporary talk about corruption could ignore Transparency International. Transparency International is a high-profile, global network dedicated to fighting corruption. It was founded in 1993 by Peter Eigen. As ever, it is useful to start with a definition. For openers, we can use the definition supplied by Transparency International, corruption is:

'the misuse of entrusted power for private gain'

Transparency International differentiates between 'according to rule' corruption and 'against the rule' corruption. Facilitation payments, where a bribe is paid to receive preferential treatment for something that the bribe receiver is required to do by law, are according to rule corruption. A bribe paid to obtain services the bribe receiver is prohibited from providing is 'against the rule' corruption. Further, we have the demand side (bribe-takers) and the supply side (bribe-payers). Thus, Transparency International has an annual publication that focuses on the demand side, the Corruption Perceptions Index, and another on the supply side, Bribe Payers Index. Since first publication in 1995, the Corruption Perception Index has been very influential. But how does corruption work? I'm going to rattle off a few examples to get your minds going:

- “ shanty town dwellers without property rights pay off officials so their houses are bulldozed away;
- “ researchers fake results to gain academic kudos and further research grants;
- “ government regulators turn a conveniently blind eye, leading to 950 people injured and 22 killed in a fireworks factory explosion in the Netherlands in 2000;
- “ pharmaceutical companies offer free training or other benefits to doctors who prescribe their drugs;

- “ independent financial advisors get money or holidays or gifts for recommending that clients move to a new pension fund or insurance product or investment scheme;
- “ a health & safety inspector gets special favours for not closing down a filthy restaurant, or special favours for closing down a competitor;
- “ lawyers fabricate interests in order to launch class action suits;
- “ foreign companies put relations of government ministers on their boards for you-know-what;
- “ a marine safety inspector gets special favours from threatening to delist a safe vessel;
- “ an equestrian centre owner gets annoyed when a prospective employee she wanted to employ has no interest in getting paid in cash;
- “ just about anything to do with organized crime.

There are taxonomies of corruption, listing the various means, such as:

- “ bribery - using an item of value to influence the actions as an official or other person in discharge of a public or legal duty. The officials demand to get paid to do what they are already paid to do, or to bypass what they are paid to do;
- “ graft - officials gaining something of value for their normal work;
- “ extortion - the illegitimate use of force in order to threaten or inflict harm;
- “ patronage - favouring supporting with employment, special regulations or funds;
- “ nepotism and cronyism - favouring relatives (nepotism) or personal friends (cronyism), e.g. demanding that a relative be employed on a state awarded contract;
- “ embezzlement - theft of entrusted funds;
- “ kickbacks - money paid separately to an official agent in order to secure a contract or rig a bid.

[Source for much of the above:[http://en.wikipedia.org/wiki/Political\\_corruption](http://en.wikipedia.org/wiki/Political_corruption)]

[SLIDE: BANKING ON CORRUPTION]



To be honest, as opposed to how we usually are, corruption can be tough to separate from its time or locale. John Mortlock established the first bank in Cambridge in 1780. In 1783 he became an Alderman and changed the rules so that he held the post of Mayor of Cambridge 13 times until his death. Along with being Receiver of the Land Tax for Cambridgeshire and an MP, his offices allowed him to sell off city property at knock-down prices, divert taxes and appropriate city funds. After his death, his sons continued the traditions. Mortlocks were Mayors of Cambridge for an unbroken streak of 51 years. This expert on the subject provided one of the quickest ways to dismiss allegations of corruption - 'What you call corruption, I call influence'.

[ [http://en.wikipedia.org/wiki/John\\_Mortlock](http://en.wikipedia.org/wiki/John_Mortlock)  
&<http://www.waymarking.com/wm/details.aspx?f=1&guid=32ad259e-5c54-4ce0-92be-cf0ea4fc61f4>]

[SLIDE: SCHMIERGELD]

Another problem separating corruption from normal commerce is the concept that people need to be paid, and as the pay is insufficient, bribes are needed. In German, a bribe is Schmiergeld. The word means grease money. The term refers to the need for Post Coaches (Postkuche), and more often their occupants, to pay to have their axels greased when they stopped for a service. Of course, without grease, the wheels cease rolling. Today's grease money raises the income of an impoverished civil servant in return for speeding up the wheels of bureaucracy. Of course the solution is rather more obvious, pay people enough to not need bribes.

In cases like Mortlock in the 18th century or the third world today, people want to know what 'causes' corruption in some places and not others. It's a slightly nonsensical question. Corruption is everywhere, just varying in degrees of severity. If an opportunity exists, most of the time some people will take it. The key elements in people's decisions to commit a corrupt act are the opportunity on offer, the chance of suffering retribution and their own moral code. People talk about causes of corruption, but they're really talking about environmentally favourable conditions such as a low level of societal trust, weak judiciary, weak rule of law, poor accountability, over-regulation, excessive bureaucracy, barriers to entry, underpaid civil servants, exclusive guilds or elitist social structures.

[SLIDE: EQUALITY AND PROPERTY]

Yet two things stand out. First, the strength of property rights seems to be a clear theme. Pipes [Pipes, 1999] contrasts the different fortunes of the UK and Russia, basing his analysis on different concepts of property. In their highly influential work, *The Rise of the Western World*, North and Thomas note that 'economic growth will occur if property rights make it worthwhile to undertake socially productive activity'. [Douglass North and RP Thomas, *The Rise of the Western World*, Cambridge University Press, 1973, page 179] Corruption undermines property rights and thus impedes economic growth. Second, inequality matters. Many analysts note that countries with high equality, such as the Nordic countries, have very low rates of corruption. They also have higher average living standards. Inequality leads to loss of trust which leads to corruption. Uslaner [Uslaner, 2001] also points out that:

'Corruption, of course, depends upon trust - or honor among thieves. As it takes two to tango, it takes at least two to bribe. Corrupt officials need to be sure that their 'partners' will deliver on their promises (Lambsdorff, 2002a, 2002b). Lambsdorff (2002a) argues: '...if corrupt deals cannot be enforced, this can act as a deterrent to corruption itself.' Corruption thrives upon trust, but it cannot be based upon the notion of widespread goodwill and common interests in a society underlying generalized trust."

[Uslaner, 2001, Chapter 2 -<http://www.bsos.umd.edu/gvpt/uslaner/uslanerbulgingpocketch2.pdf>quoting

Lambsdorff, Johann Graf. 2002a. 'What Nurtures Corrupt Deals' On the Role of Confidence and Transaction Costs,' In Donna della Porta and Susan Rose-Ackerman, eds., *Corrupt Exchanges*, Nomos Verlag: Baden Baden, Germany; and 2002b. 'How Confidence Facilitates Illegal Transactions,' *American Journal of Economics and Sociology*, 61:829-854]

In short, 'I can trust you to cheat.' This same reasoning seems to underlie similar attitudes towards gambling contracts. Until recently gambling contracts were unenforceable. This led to tremendous amounts of trust, at least about payment, in the UK gambling world.

## Cost of Corruption

How much does corruption hurt? Is there a good way to estimate the costs of corruption. Transparency International says, 'The short answer is 'no'', there is no way to measure the costs, though Transparency International does categorise the costs as political, economic, social and environmental. Despite fancy statistics, supply and demand analysis and tricky surveys, bribes are not recorded, false 'investment' is impossible to separate from a mistake, non-monetary favours are hard to value, investment lost to perceptions of corruption is impossible to estimate, and contaminated land is monitored. If a corrupt official turned a blind eye to bad practices at the Bhopal disaster, or inspectors in Japan ignored earthquake vulnerable buildings, are the billions of losses attributable to corruption? Transparency International points out that 'The social costs of corruption are even less quantifiable. No one knows how much the loss of an energetic entrepreneur or an acclaimed scientist costs a country. Moreover, any estimated social costs in dollars would be inadequate to the task of measuring the human tragedy behind resignation, illiteracy, or inadequate medical care. A general scepticism vis-à-vis any attempt at quantifying the costs of corruption is thus warranted.' Any complex analysis trying to take into account pollution, land values, resettlements, medical costs, shortened lifespans, contaminated land, increased debt, foregone Foreign Direct Investment and many other factors can only help scale or compare, not be precise. What is clear is that the scale of corruption and the knock-on effects are large.

[SLIDE: COSTS OF CORRUPTION]

Markets are a game of cooperation, so corruption weakens the game. Corruption weakens in subtle ways, such as 'if kickbacks are easier to obtain on capital investments and input purchases than on labour, rulers will favour capital-intensive projects irrespective of their economic justification.' [Rose-Ackerman, 2004, page 323] White elephants and poor resource allocation decisions result. Even worse, contradictory evidence seems to pop up from time to time, such as Rock and Bonnet [Rock and Bonnet, 2004] finding 'that corruption slows growth and/or reduces investment in most developing countries, particularly small developing countries, but increases growth in the large East Asian newly industrializing economies. The latter finding provides solid empirical support to a country case literature that explains the East Asian paradox - the combination of high corruption and high growth - in terms of stable and mutually beneficial exchanges of government promotional privileges for bribes and kickbacks.' But if we carefully measure it and evaluate it, is corruption an economic problem? Yes, in several ways. In a Commerce lecture, we use this excuse to visit volatility and 'Agency Theory'.

Krastev refers to a corruption paradox contrasting pre and post communist societies in eastern Europe. I must confess that in the early 1990's I found eastern Europe rapidly grasped corruption on a large scale as I witnessed some computer companies paying kickbacks to financial institution officials. I must also confess that the eastern Europeans seemed to have willing western tutors. Krastev says that opinion polls show 'that more than 70% of Bulgarians, Poles, and Russians think there is more corruption today than in the days of communism. - The major reason why the majority of Bulgarians, Poles, and Russians perceive post-communism as more corrupt than communism is that the more inclusive form of corruption, blat, was



replaced by an exclusive form of corruption, bribery. In its essence, the replacement of blat by bribery marked the devaluation of communist social capital. As a result, corruption became the major instrument for producing social inequality in the post-communist societies.' And the competitive nature of bribery forces differentiation, not a flat rate. Other studies show that people react more to varying levels of corruption than they do to stable levels. 'I don't mind paying, but I do mind finding out that you got the same service for much less.' As in so many other areas of economics, relative social gains and losses matter more than absolute amounts. We hate two things - lack of choice and the capricious, but silently endure the fixed cost.

[SLIDE: OLFACTION]

This leads me to question the definition of corruption we encountered earlier - 'the misuse of entrusted power for private gain'. I sometimes think what we erroneously consider to be corrupt are situations where we are unable to ascertain the rules of the game. We are left open-mouthed and aggrieved when someone finds a novel way to win. If corruption is rotten and putrid, perhaps these rule bendings should be called 'olfactions'. A bit whiffy, but not a clear abuse of entrusted power. It would be a tough competition to be the most corrupt person in history, but the most olfactory might be Alexander the Great when he cut the Gordian knot. Alexander didn't bribe anyone to win (we think), but he did come up with a solution that was outside the rules. Partnoy relates a more recent tale [Partnoy, 2004, pages 268-269] about Frank Quattrone, a legally-challenged, \$200M a year investment banker at the heart of hyping tech stocks. 'When Peter Jackson, the CEO of Intraware, complained that soliciting investors during his company's IPO was going to make him 'feel like a mule', CS First Boston delivered a live mule to Intraware's lobby the next morning, complete with a sign urging the company to hire CS First Boston.' CS First Boston won the business. Competitors smelt an olfaction. We value stable rule systems, not volatility. We value stable prices, even bribes, not volatile ones. Volatility avoidance may outweigh the losses from corruption in some cases.

## Overtipping

[SLIDE: AGENCY THEORY]

It's a big bad world. So let's stop for a coffee and a small bite to eat. In Spanish a 'bribe' is 'la mordida', the bite. So the key question - do you leave a tip? In Agency Theory, tipping can be looked at as a principal-agent problem. Principal-agent problems arise between employers/employees, politicians/civil servants, stockholders/executives, and donors/charities. The problem is how to motivate one party, the agent, to act on behalf of another, the principal. The issues are clarity about what the principal wants, the cost to the agent of providing what the principal wants, and the cost of evaluating the elements of performance. In economic jargon, the conditions are that the principal-agent relationship exists in an environment of information asymmetry, uncertainty and risk. The information asymmetry leads to further problems of moral hazard, e.g. agents take risks without bearing the consequences, and adverse selection, e.g. being unable to find the good managers because the principal is unable to determine whether their representations are true. Paradoxically, a really smart person is someone who is intellectually below average for a job, but smart enough to get paid above average. Now that is adverse selection. The key approach to solving principal-agent problems is aligning risk and reward - risk/reward management.

So let's go back to leaving a tip. The restaurant owner is the principal. The principal wants staff/agents to provide good service. The principal's goals are slightly unclear - making a profit on customers, happy customers, portion control or moving tables through rapidly, all need balancing. The differential cost to the agent, the employee, can be high. There is a big difference in effort between moving a few plates from the kitchen to the tables, and providing high-quality, attentive service. There is moral hazard - the waiters/waitresses don't bear the cost of losing customers. There is adverse selection - most principals don't know if the waiter/waitress is any good till they try them. Finally, the cost of evaluating the elements

of agent performance are high. Does the principal want to hold a job appraisal after every table is served? The principal often decides that performance evaluation is best left to customers to provide in the form of a 'bonus', a tip. Tips also help reduce the moral hazard of losing customers to bad service and reduce the risk of adverse selection because, with bonuses available, the principal doesn't feel obliged to pay agents so much. We, the customers, might disagree - just pay your staff properly to do good work. Some cultures feel strongly that tipping is immoral. In China, outside of the tourist areas, tipping is rude and has whiffs of corruption and special favour. Inside tourist areas, tipping has led to newspaper and online discussions of a move to a more dissolute society due to Western influences.

[SLIDE: AGENCY PROBLEM]

Now the agents can start to play on information asymmetry - 'I'm so sorry the kitchen messed up your order, but I pulled a special favour with the chef and I've sorted it out now.' This leads to customers saying things like - 'oh leave the hard-working dear a big tip for all her efforts, though we're not coming back to this disorganized place again, are we?' The information asymmetry is two-fold, the principal never hears these statements and the customers have no way of finding out the entire problem was fabricated to enlarge the tip. Not all restaurants get this bad, but tipping fulfills Transparency International's definition of corruption if the waiter or waitress provides a differential service in aid of a tip - 'the misuse of entrusted power for private gain'. If the customer considers anything other than always giving a tip of standard size or percentage, no matter what the circumstances (or no tip ever), then the customer is gauging how to entice the misuse of the entrusted power of the waiter or waitress for private gain in the form of a better than average meal. Otherwise, why tip? Of course this implicit corruption would be worse if waiters and waitresses were so good about declaring their tips to the tax folk and restaurant owners so good about declaring their shares too. So next time you're in a restaurant I know you won't encourage corruption. But everyone else is tipping, aren't they?

Another good example is corporate entertainment. I regularly attend, and host, corporate entertainment events. Is this corruption? There is no direct connection between decisions made with entertainment relationships, but both sides do this in order to get to know each other, to establish favourable conditions for decisions and to build trust. To tease you some more on agency issues, imagine someone who applies for a two day a week job but doesn't need the money and has time to spare. This person indicates that he or she intend to put in more days than planned, say four days a week, and is selected because of this. Is the person corrupt and stealing a job from people who told the truth - that they needed more money to work two more days?

There are many areas where risks and rewards between principals and agents are misaligned. A telling example of the importance of the principal-agent problem is stock options. While it is true that less buoyant markets and new requirements to 'expense' options have lessened their attractiveness, it is arguable that options should ever be used for management remuneration. Options increase in value as share price volatility increases, thus rewarding managers who create volatility in their company's shares. Empirical studies show that shareholders value companies with lower volatility, so options perversely give managers incentives to decrease shareholder value. Thus options, ab initio, divide the interests of managers and shareholders. Genuine equity in 'restricted' stock and longer term incentives based on competitive benchmarks are, possibly, the way to go. Nevertheless, so long as options are an option (sic) quick-fixers will opt for these non-optimal methods. Yet options have clearly caused significant problems in the governance of our major corporations. Some of these behaviours are termed rent-seeking or the 'extraction of rents', when the agents extract value from others without making any contribution to productivity, such as by gaining control of land and other pre-existing natural resources, or by imposing burdensome regulations or other government decisions that may affect consumers or businesses.

[SLIDE: NO OPTION?]

So why do remuneration committees recommend options if they are such a bad idea for shareholders? Well, there are a lot of conflicts of interest. The remuneration committees are typically appointed, and remunerated, by managers not shareholders. The committee members wouldn't mind seeing some of these highly leveraged options themselves one day. And anyway, if the options pay out, the shareholders will have done well, won't they?

Frank Partnoy, in his wonderful book *Infectious Greed*, explores the many ways in which, in his opinion, the financial markets are corrupt. He depressingly runs through numerous scandals of the 1990's and early 2000's including the dot.com ramping, accounting scandals, rating agency conflicts of interest, mergers & acquisitions inflation, stock option shenanigans and many more. Partnoy's title comes from testimony to the US Congress by the former Chairman of the US Federal Reserve Board, Alan Greenspan. It's worth listening to at length:

'An infectious greed seemed to grip much of our business community. Our historical guardians of financial information were overwhelmed. Too many corporate executives sought ways to 'harvest' some of those stock market gains. As a result, the highly desirable spread of shareholding and options among business managers perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising. This outcome suggests that the options were poorly structured, and, consequently, they failed to properly align the long-term interests of shareholders and managers, the paradigm so essential for effective corporate governance. The incentives they created overcame the good judgment of too many corporate managers. It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed had grown so enormously.'

[16 July 2002, <http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm>]

And it's hardly ceased. At a dinner with Greenspan's predecessor, Paul Volcker, earlier this year, Mr Volcker highlighted inequality as an important source of greed and corruption. With corporate US and UK executive remuneration frequently hitting \$300,000 per day he questioned how executives can ever work. They have a full time job just spending their money.

Conflicts of interest are rife in finance - auditor and consultant, rating agency and rating consultant, expert and witness, industry insider and regulator. The typical response to conflicts of interest are elimination, disclosure, recusal and third-party audit. Sometimes one can just eliminate conflicts by removing a key party. Sometimes disclosure works, for example the changing requirements around 1990 to declare fees paid to auditing firms and identify audit fees separately from consultancy fees. Sometimes recusal works, removing oneself from decisions related to specific interests. Finally, third-party audit, or just the threat of possible audit, helps to promote transparency.

## Transparently A Paradox

Supposedly, the key tool in the anti-corruption toolbox is transparency. But is transparency an unreservedly good thing? In the UK, Royal Navy sailors have been very transparent about a recent incident, selling their stories to the press with the temporary support of the Ministry of Defence. This openness is in contrast to most other incidents but has led to objections, partially on the grounds that it was an abuse of position. The government has very transparent inflation targets and statistics, if you can be bothered to understand them. But the government changes them rather often, and almost always in ways that mean a naïve, direct comparison of present with past flatters the present. Is this the misuse of power for the gain of votes? The government procurement process is open and transparent, but it is frightfully difficult for foreign firms or small and medium-sized enterprises (SMEs) to win. The government uses framework agreements - go through a bidding process to win something the full nature of which cannot be revealed - that only large UK firms can be bothered to track and submit. There are government gateways, catalogues and approved supplier lists that seem both daunting and suspicious to smaller or foreign firms,

as well as providing opportunities for graft. The irony of course is that most government procurement processes are specifically in place to prevent corruption. The result is an oligopoly of government suppliers, while observers lament that the government is not using transparently better and more innovative solutions available from industry.

[SLIDE: COMMUNITY SERVICE]

I've always liked the idea that you should always be able to tell your grandmother what you're up to. If you can, then things are probably morally fine. Of course, I wonder why you catell your mother, and wonder even more what you're supposed to do if your grandmother is a convicted criminal. In a similar vein, and frustrated that a gift culture had become a corrupt culture, the President of Nigeria, Olusegun Obasanjo pointed out that traditionally in Nigeria 'a gift is made in the open for all to see, never in secret. Where a gift is excessive, it becomes an embarrassment, and is returned.' [via Transparency International - Olusegun Obasanjo, 'Positive Tradition Perverted by Corruption', Financial Times, 14 October 1994]

In her Reith Lectures in 2002, Onora O'Neill seriously questioned the limits of transparency. 'Transparency and openness may not be the unconditional goods that they are fashionably supposed to be. By the same token, secrecy and lack of transparency may not be the enemies of trust.' [http://www.bbc.co.uk/radio4/reith2002/lecture4.shtml] She pointed out that if we want to restore trust then we need to reduce deception and lies rather than secrecy. Some types of secrecy support deception, others do not. Transparency may destroy secrecy yet at the same time not constrain the deception and deliberate misinformation that undermine relations of trust.

## Solutions?

If transparency is not enough to reduce corruption, what else might help? A number of observers focus on reducing bureaucracy. Others stress that just reducing the state percentage of GDP or employment by the state will reduce corruption. The focus on the state ignores evidence that endemic corruption seems to pervade societies. Perhaps removing clear routes to corrupt positions might help. Randomness might feature. William F Buckley Jr once said, 'I would rather be governed by the first 2,000 names in the Boston telephone directory than by the 2,000 members of the Harvard faculty.' [http://www.nationalreview.com/buckley/buckley200403261331.asp] Given the correlation between inequality and corruption, some reformers promote anti-discrimination and women's rights as routes to lessen corruption. Others point out that democratic voice and accountability should work.

[SLIDE: WANGA MANGA]

One of the more creative solutions is 1 World Manga, a World Bank sponsored project to learn about global issues such as poverty, HIV/AIDS, global warming, child soldiers, girls' education and corruption through manga comic strips. Humour and ridicule are, at least, annoying weapons against corruption, particularly in hypocritical situations such as not realising gifts were illegal or that people might find your junket to a Caribbean clime somewhat dodgy. I have always had an intelligence versus integrity balance test. In a dodgy or seemingly hypocritical situation, such as not being aware you took a bribe, you can either be very intelligent in the way you wriggle, and thus demonstrate a complete lack of integrity; or I shall assume you have high integrity though innocently strayed, but clearly lack intelligence. And I know which is worse. To quote Graham Greene, 'Our worst enemies here are not the ignorant and the simple, however cruel; our worst enemies are the intelligent and corrupt.' [Graham Greene, *The Human Factor*, Everyman's Library, Part III, Chapter 3 (1978)]

There is no magic bullet. Rose-Ackerman wryly submits, 'The rich variety of experience is both encouraging and humbling - Existing research suggests that a number of factors must come together before government reform can succeed.' [Rose-Ackerman, 2004, page 322] Transparency International 'believes that corruption cannot be rooted out in one big sweep. Rather, fighting it is a step-by-step, project-by-project process'.

Reputedly (though I can find a source), the US Supreme Court Justice Louis D Brandeis said, 'Sunshine is the best disinfectant.' We could add that 'competition is the better disinfectant.' Corrupt societies are also societies where competition is thwarted. Competitors tend to have a motivation to reveal bad practices, on the other's part of course. Competition means that people have choice. Competition, in the long run, combines advancement with lower volatility. I heard harrowing tales of taxis in Freetown, Sierra Leone, where the corruption was so bad that there were bribes at every block, but the people take advantage of the implicit competition between countries to escape their predicament. Malcolm's Nigerian taxi driver was at least able to get to Washington DC. It is hard for us in a developed country to understand the despair of developing world corruption where there is no escape, no way out, and little prospect of sunshine or competition improving things.

I paraphrase Gordon Gecko's 'greed is good' speech:

'The point is, ladies and gentlemen, that corruption - for lack of a better word - is good. Corruption is right. Corruption works. Corruption clarifies, cuts through, and captures the essence of the evolutionary spirit. Corruption, in all of its forms - corruption for life, for money, for love, knowledge - has marked the upward surge of mankind.'

## Zero Tolerance?

[SLIDE: ZERO TOLERANCE]

I would replace 'corruption' with 'competition', and the speech would read rather well, but strangely, Gecko-paraphrased has a point.

If we treat corruption as solely an economic, not a moral problem, could we accept efficient corruption? Fair enough, if the peccadilloes and olfactions incentivise the supply of people who can wrinkle connections out of the system and meet the demands of society for improvement, is that a benefit of olfaction, if not corruption? If the little missteps give opportunities for people to gain privately from a little misuse of entrusted power, but lead to aligning interests, then does greasing the wheels help us move forward? Do we really want to remove all motivation for the movers, shakers and fixers?

[SLIDE: CIVILITY OR CORRUPTION?]

Would you like to live in a totally incorrupt society? Think about it. There is no such thing as a perfect society. There is no such thing as a stable environment. We may strive towards 'heaven here on earth', but this striving has led to increasingly intertwined and complex societal systems. Our systems need to evolve, but we don't know where to change them. If the systems were squeaky-clean, they might seize up completely - unable to evolve or be creative when faced with novel problems. 'Peccadilloes that pay' do motivate some to alter or bend the system. These people are rational agents helping to break down information asymmetries and getting other people to reveal preferences that lead to resource reallocation,

albeit not optimal because of the skews to decision-making within a corrupt environment. Perhaps there is a grey area between corruption and squeaky-clean sterility.

Economists, central bankers and the public hated hyperinflation. Our current UK inflation target is 2% based on the Consumer Prices Index (CPI), not zero. Less remarked upon is that economists and central bankers are terrified of zero inflation which would mean that we were only a knife-edge away from a deflationary spiral no one knows how to correct. Our corruption targets could be set similarly. Very low, but not zero.

I am deliciously troubled by a law firm advertising, 'If it's legal - we'll do it!' [Dickinson Dees], implying that the ethical framework is identical to the legal system. Persaud and Plender disagree, 'The nub of it is that much of finance is about promises whose fulfilment takes place over time. Those promises need to be sustained by trust, which cannot exist without an ethical framework.' [Persaud and Plender, 2007, page 18] I agree with their emphasis on ethical frameworks over, though not instead of, legal or regulatory actions.

In conclusion, on the one 'backhand' I'd like you to consider, theoretically, that some corruption will always exist and olfaction, however vile, may serve a purpose. On the other 'backhand', I'd like you to join me in zero tolerance revulsion in hope of a better future. Corruption gives us a clear scent of where evil lies. 'Fraud is good' only if it helps us to figure out what needs fixing. I am not tolerant of corruption, far from it, but I do recognise that we learn from it. Hyper-corruption lies on a slipperier slope than hyper-inflation. Jefferson said, 'The time to guard against corruption and tyranny is before they shall have gotten hold on us. It is better to keep the wolf out of the fold, than to trust to drawing his teeth and talons after he shall have entered.' [Thomas Jefferson, Notes on the State of Virginia (1787)] And do start tipping or everyone else will do it.

Thank you.

#### Further Discussion

1. Is there a Goldilocks level of corruption - not too much, not too little, but just right?
2. Would absolutely no corruption mean absolute gridlock?

#### Further Reading

1. KLITGAARD, Robert, Tropical Gangsters, Basic Books, 1990.
2. PARTNOY, Frank, Infectious Greed: How Deceit And Risk Corrupted The Financial Markets, Profile Books, 2004.
3. PERSAUD, Avinash D and PLENDER, John, Ethics and Finance, Longtail Publishing Limited, 2007.
4. PIPES, Richard, Property and Freedom, Random House, 1999.
5. ROCK, Michael T. and BONNETT, Heidi, 'The Comparative Politics of Corruption: Accounting for the East Asian Paradox in Empirical Studies of Corruption, Growth and Investment', World Development,



Volume 32, Issue 6, June 2004, pages 999-1017 -<http://www.sciencedirect.com/science/article/B6VC6-4CB075F-5/2/64b2ae8bb1a50ec3711d3083d9d32520>

6. ROSE-ACKERMAN, Susan, 'Governance and Corruption', Copenhagen Consensus: Chapter 6 in LOMBORG, Bjørn, Global Crises, Global Solutions, Cambridge University Press (2004) - [http://www.copenhagenconsensus.com/Files/Filer/CC/Papers/Governance\\_and\\_Corruption\\_300404\\_\(0.7MB\\_version\).pdf](http://www.copenhagenconsensus.com/Files/Filer/CC/Papers/Governance_and_Corruption_300404_(0.7MB_version).pdf)

#### Further Surfing

1. 'Corruption, Governance and Security: Challenges for the Rich Countries and the World' by Daniel Kaufmann, World Bank (September, 2004) - Chapter in the Global Competitiveness Report 2004/2005 - [http://siteresources.worldbank.org/INTWBIGOVANTCOR/Resources/Kaufmann\\_GCR\\_101904\\_B.pdf](http://siteresources.worldbank.org/INTWBIGOVANTCOR/Resources/Kaufmann_GCR_101904_B.pdf)

2. 1 World Manga -[http://youthink.worldbank.org/multimedia/gallery/manga\\_passage6/page04.php](http://youthink.worldbank.org/multimedia/gallery/manga_passage6/page04.php)

3. Agency Theory links -<http://www.istheory.yorku.ca/agencytheory.htm>

4. Black Markets - [http://en.wikipedia.org/wiki/Black\\_market](http://en.wikipedia.org/wiki/Black_market)

5. Corruption Online Research and Information System -<http://www.corisweb.org/>

6. GRECO, Group of States Against Corruption -<http://www.coe.int/t/dg1/greco/>

7. International Anti-Corruption Day -[http://www.unodc.org/unodc/event\\_2006-12-09\\_1.html](http://www.unodc.org/unodc/event_2006-12-09_1.html)

8. Intervention Board - <http://www.nao.org.uk/pn/959678.htm>

9. KRASTEY, Ivan, 'The Corruption Paradox: Why Post-Communism Is/Looks More Corrupt Than Communism' -<http://www.colbud.hu/honesty-trust/krastev/pub02.PDF>  
&<http://www.wiiw.ac.at/balkan/files/Krastev.pdf>

10. MCCOLGAN, Patrick, 'Agency Theory And Corporate Governance: Review Of The Literature From A UK Perspective' (2001) -<http://accfinweb.account.strath.ac.uk/wps/journal.pdf>

11. News and corruption, the relationship -<http://www.allbusiness.com/management-companies-enterprises/3955783-1.html>

12. OECD Fighting Corruption - [http://www.oecd.org/topic/0,3373,en\\_2649\\_37447\\_1\\_1\\_1\\_1\\_37447,00.html](http://www.oecd.org/topic/0,3373,en_2649_37447_1_1_1_1_37447,00.html)

13. RACHAMI, Jawad, 'Institutionalized Corruption: An Instrument of Governance in the Middle East and

North Africa?', Center for International Private Enterprise, 21 July 2003 -  
<http://www.cipe.org/pdf/publications/fs/rachami.pdf>

14. Regulatory Capture -<http://www.iipe.org/conference2002/papers/McMahon.pdf>

15. Surowiecki on 'When Is Corruption Good?' -  
[http://psdblog.worldbank.org/psdblog/2006/04/james\\_surowiecki.html](http://psdblog.worldbank.org/psdblog/2006/04/james_surowiecki.html)

16. Transparency International factsheet -  
[http://www.tisa.org.za/index2.php?option=content&do\\_pdf=1&id=38](http://www.tisa.org.za/index2.php?option=content&do_pdf=1&id=38)

17. United Nations Global Compact and corruption -  
<http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/principle10.html>

18. US View of Corruption -  
[http://usinfo.state.gov/dd/eng\\_democracy\\_dialogues/combating\\_corruption/anticorruption\\_essay.html](http://usinfo.state.gov/dd/eng_democracy_dialogues/combating_corruption/anticorruption_essay.html)

19. USLANER, Eric M., 'The Bulging Pocket and the Rule of Law: Corruption, Inequality, and Trust' (2005) -  
<http://www.bsos.umd.edu/gvpt/uslaner/uslanerbulgingpocketgoteborg.pdf>  
<http://www.bsos.umd.edu/gvpt/uslaner/corruption.htm>

20. World Bank introduction to corruption -<http://info.worldbank.org/etools/docs/library/35970/mod03.pdf>

21. World Bank Private Sector Development blog -<http://psdblog.worldbank.org/psdblog/corruption/>

## Thanks

I would like to thank all those people who helped me understand that corruption is a more interesting topic than one might think and kindly pointed me to sources or ideas. I would like to thank especially Malcolm Cooper, Axel Grijfmer, Ian Harris, Sanet Philips, Jan-Peter Onstwedder, Jobst Munderlein, Mark Yeandle and Andrew Hilton.

© Professor Michael Mainelli, Gresham College, 4th October 2007