

Corruption: A Primer

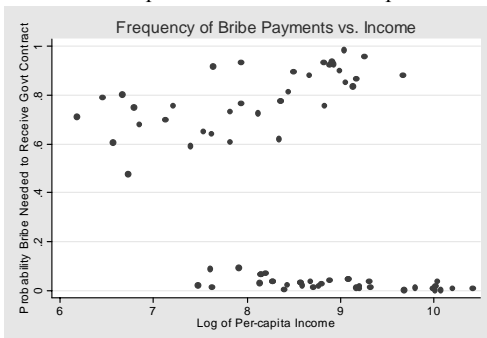
- What is Corruption?
- Are Poor Countries more Corrupt?
- Measuring Corruption
- Causes of Corruption
- Is corruption costly for firms?
- To Bribe or not to Bribe?

What is Corruption?

- “I know it when I see it...”
- Usual definition:

“Illegal use of public office for private gain”
- Slight modifications:
 - “Inappropriate use of public office for private gain”
 - “Deviation from accepted use of public office for private gain”
- Common forms
 - Bribery
 - Theft of state property

Are poor countries more corrupt?



- Data source: *World Business Environment Survey* (World Bank)

Approaches to measuring corruption

- Surveys
- Audit studies
- Fund ‘leakage’
- Business-Politics connections

Surveys: Pluses and minuses

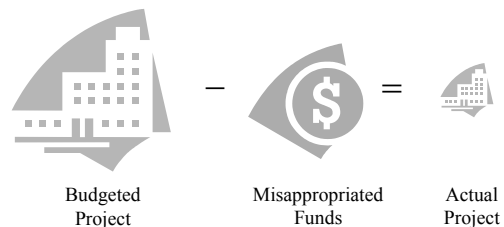
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- Comprehensive
- May be implemented across many countries
- May be implemented across many domains
 - Local vs. national
 - Telephones vs. power

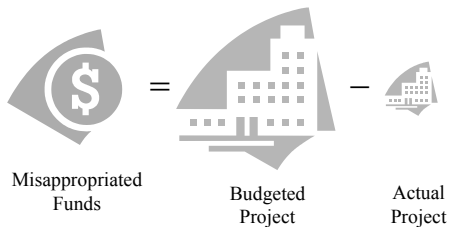
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- Different frames of reference
- Incentives for truthful revelation
 - Why would individuals understate/overstate bribes?

Audit studies – Basic Premise



Audit studies – Basic Premise



Audit study example: Roads in Indonesia



Measuring rocks

Measuring depth of road

Leakage study example: Smuggling in Hong Kong



High tariff goods have higher leakage rates (Fisman and Wei, 2004)

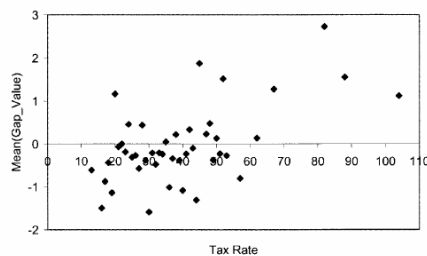
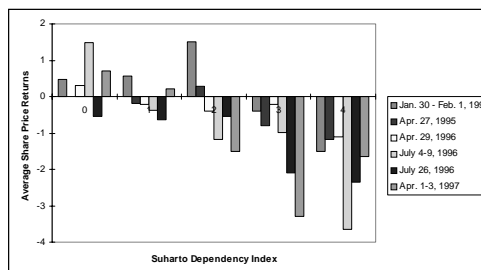


FIG. 3.—Relationship between mean(gap_value) and tax rates, 1998

“When Suharto catches a cold, shares in Bimantara Citra catch pneumonia”

-The Financial Times, January 1998

Well-connected firms have lower returns when Suharto gets sick



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Causes of Corruption

- Temptations
 - Onerous government regulations
 - Low public sector wages
- Weak constraints
 - Weak enforcement
 - Weak social sanctions (“culture”)
 - Norms of favoritism (nepotism, ethnicity bias)
 - Norms of gift-giving (guanxi, etc)
 - “Relationship building” in countries with relationship-based governance

Focus: Government Regulation

Government regulations/laws impose costs



Incentives to trade favors for bribes

- Examples
 - Import quotas / licenses
 - Bidding for government contracts
 - Government subsidized bank loans
 - Safety regulations (worker safety, driver’s license, etc)

Focus: Weak Enforcement

- Need effective institutions to catch and punish corrupt public servants
 - Courts
 - Police
 - Auditors (monitors, monitors of monitors, etc)
- Difficulties
 - These institutions are expensive
 - These institutions may be corrupt themselves
- Benefits of a good, solid dictatorship???

Focus: Social Norms

- Why are some actions by public servants or other individuals viewed differently in different societies?
- Why do many countries with similar income levels have wildly different levels of corruption?
- Equilibrium vs. Preferences
 - Do individuals in some societies just like corruption, or are some societies simply stuck in a bad equilibrium?

Example: Petty Corruption

- In Mexico City, we observe high rates of bribery among traffic policemen
- How do we explain this “culture of corruption”?
- Model
 - Fine costs \$10
 - Bribe costs \$5
 - Disagreement over whether bribe should be paid results in significant risks for both parties
 - Driver fears an angry policeman
 - Policeman fears sanctions from police chief

Example: Petty Corruption

| | | Driver | |
|-----------|---------------|-------------|----------|
| | | Offer Bribe | Pay Fine |
| Policeman | Solicit Bribe | (5,-5) | |
| | Collect Fine | | (0,-10) |

Example: Petty Corruption

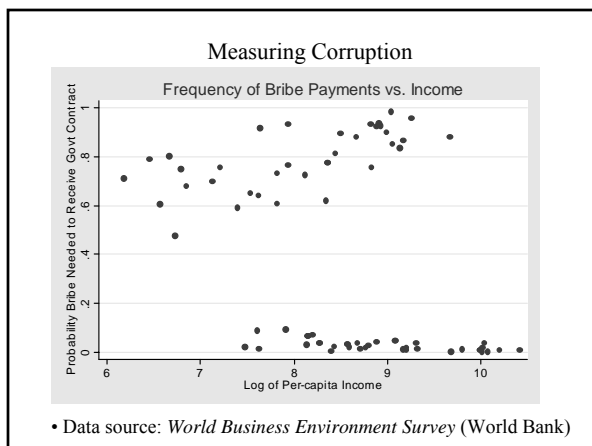
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Equilibrium that prevails will depend on beliefs about others' behaviors

- Culture as Equilibrium Behavior
- Otherwise identical societies may still arrive at different corruption equilibrium
 - *Beliefs* about others' behaviors define which equilibrium prevails
 - We can think of different beliefs and resulting outcome as different "culture"
 - Private and social preferences may diverge
 - Driver/policeman "prefer" corrupt outcome
 - Society may prefer other equilibrium
 - Solutions?



- Focus: Social Norms II
- Does background play any role in predicting behaviors?
 - How do people act if they may behave with impunity?
 - How do people act if they may behave with immunity?
 - Diplomats' parking violations

Focus: Social Norms II

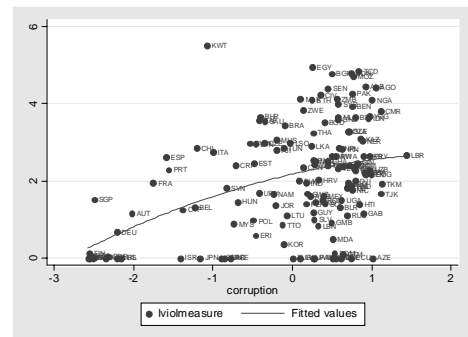
- “Diplomatic immunity is most commonly viewed as the best “free parking” coupon in town... diplomats can park as they please” (BBC)
- Diplomats may be issued tickets, but cannot be subpoenaed to pay or have their cars towed (pre-2002)
- Problem worldwide (New York, London, Paris, Seoul...)

| plate | name | date | time | description | location | fine | penalty | pay | country |
|--------|-----------------------|------------|-------|-----------------|---------------|------|---------|-----|--------------|
| 022PSD | | 11/24/1997 | 0200P | NO STD-LIMITS | 156 E 56 ST | 55 | 60 | 0 | ZIMBABWE |
| 020PSD | PERMANENT MISSION | 11/24/1997 | 0201P | NO STD-TRCK LOD | 137 E 56 ST | 55 | 60 | 0 | ZIMBABWE |
| 001PSD | ZIMBABWE UN MISSIOI | 11/24/1997 | 0201P | NO STD-LIMITS | 128 E 56 ST | 55 | 60 | 0 | ZIMBABWE |
| 042PSD | MAZEMO , LOVEMORE | 11/24/1997 | 0208P | NO STD-TRCK LOD | 222 E 56 ST | 55 | 60 | 0 | ZIMBABWE |
| 256YRD | PERMANENT MISSION | 11/24/1997 | 0220P | NO PRKG-LIMITS | 1076 45 AVE | 50 | 60 | 0 | RUSSIA |
| 040QSD | MISSION , MOZAMBIQUE | 11/24/1997 | 0221P | NO STD-LIMITS | 17 E 50 ST | 55 | 10 | 0 | MOZAMBIQUE |
| 001TMD | PERMANENT MISSION | 11/24/1997 | 0245P | NO STD-TRCK LOD | | 55 | 60 | 0 | ICELAND |
| 110DMD | SHAKERIAN , SHAHROI | 11/24/1997 | 0246P | NO STD-TRCK LOD | 45 E 19 ST | 55 | 60 | 0 | IRAN |
| 051CYD | | 11/24/1997 | 0247P | NO PRKG-LIMITS | 4 SPRING ST | 55 | 60 | 0 | CHINA (PRC) |
| 039KSD | LIJAREZ , JULIAN | 11/24/1997 | 0258P | EXPIRED METER | 1524 2ND AVE | 55 | 60 | 0 | MEXICO |
| 001LCD | VENEZUELA UN MISSK | 11/24/1997 | 0320P | DOUBLE PKG | 16 E 81 ST | 55 | 60 | 0 | VENEZUELA |
| 037JPD | BEDOU , EZZEDINE | 11/24/1997 | 0330P | DOUBLE PKG | 31 BEEKMAN PL | 55 | 60 | 0 | TUNISIA |
| 034QXD | PERMANENT MISSION | 11/24/1997 | 0331P | NO STD-TRCK LOD | 425 PARK AVE | 55 | 60 | 0 | PAKISTAN |
| 016TLJ | BARRY , ABDOLAYE | 11/24/1997 | 0338P | NO STD-TRCK LOD | 1167 BWAY | 55 | 60 | 0 | GUINEA |
| 008KOD | P M OF THE REPUBLIC | 11/24/1997 | 0405P | EXPIRED METER | 134 E 70 ST | 55 | 60 | 0 | SUDAN |
| 049TFD | MESDOLIA , ABDELKAC | 11/24/1997 | 0434A | OTHER | 333 E 38 ST | 55 | 60 | 0 | ALGERIA |
| 0151TH | P M OF THE ARAB REF | 11/24/1997 | 0434P | EXPIRED METER | 27 E 67 ST | 55 | 60 | 0 | EGYPT |
| 0010BD | MISSION , COSTA RICA | 11/24/1997 | 0438P | NO STD-TRCK LOD | 222 E 44 ST | 55 | 60 | 0 | COSTA RICA |
| 050AQD | SYRIA UN MISSION | 11/24/1997 | 0443P | NO STD-TRCK LOD | 303 E 44 ST | 55 | 60 | 0 | SYRIA |
| 024FJD | MOUBARAK , SAMIR M | 11/24/1997 | 0443P | NO STD-TRCK LOD | 236 W 47 ST | 55 | 60 | 0 | LEBANON |
| 108JFD | NIGERIA UN MISSION | 11/24/1997 | 0445P | NO STD-TRCK LOD | 304 E 44 ST | 55 | 60 | 0 | NIGERIA |
| 076QZD | SOLAEMAN , ROEDI | 11/24/1997 | 0450P | DOUBLE PKG | 325 E 38TH ST | 55 | 60 | 0 | INDONESIA |
| 007QSD | MISSION , MOZAMBIQUE | 11/24/1997 | 0513P | DOUBLE PKG | 425 E 50 ST | 55 | 60 | 0 | MOZAMBIQUE |
| 001FRD | MISSION , PHILIPPINES | 11/24/1997 | 0515P | NO STD-LIMITS | | 55 | 60 | 0 | PHILIPPINES |
| 041KVD | AL-MUHANNAN , EMAD / | 11/24/1997 | 0548P | NO STD-TRCK LOD | 134 E 43 ST | 55 | 60 | 0 | SAUDI ARABIA |

Most unpaid violations in NYC, 1998-2002 (Annual violations per diplomat)

| | | | |
|------------|--------|-------------|-------|
| KUWAIT | 246.22 | IVORY COAST | 67.10 |
| EGYPT | 139.59 | ZAMBIA | 60.40 |
| CHAD | 124.30 | MOROCCO | 60.00 |
| SUDAN | 119.06 | ETHIOPIA | 59.68 |
| BULGARIA | 117.53 | NIGERIA | 58.65 |
| MOZAMBIQUE | 110.72 | SYRIA | 52.65 |
| ALBANIA | 84.47 | BENIN | 49.78 |
| ANGOLA | 81.67 | ZIMBABWE | 45.57 |
| SENEGAL | 79.20 | CAMEROON | 43.55 |
| PAKISTAN | 69.40 | SERBIA | 38.03 |

UN diplomats from corrupt countries have more parking violations



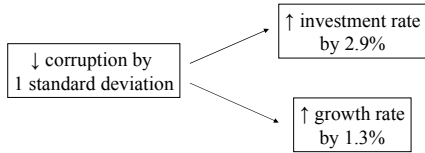
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Is corruption costly for firms?

- Resource allocation
- “Greasing the Wheels” vs. “Sand in the Gears”

Is Corruption Bad For Growth?



Could there be Social Benefits to Bribery?

- Argument #1: Bribes allocate resources efficiently
 - Bribery is like a sealed-bid auction
 - Bureaucrat solicits bids from many firms for contract
 - Highest bidder (briber) is the firm that will be most productive
 - Bribes ensure efficient allocation of projects across firms
- Argument #2: Bribes “grease the wheels”
 - States impose excessive regulations on firms
 - Bribery allows firms to sidestep these costly regulations
 - Society gains from bribes

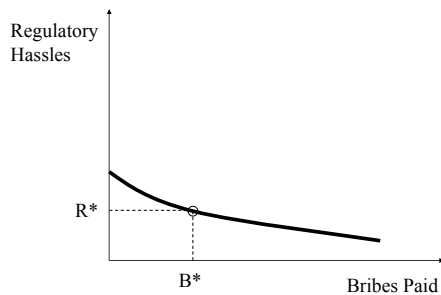
Problems with Efficient Allocation Argument

- What will bureaucrat do with the bribe?
 - In a public auction, most efficient firm still wins
 - Income to bureaucrat’s pocket instead of government programs
- Will most efficient firms really win contracts?
 - Bureaucrat may restrict entry in the bribe process
 - Preference for family/friends
 - Fear of punishment
 - Some firms may be legally or morally (culturally) constrained from offering bribes
 - Bureaucrat may choose firm most likely to pay future bribes, as opposed to most productive firm

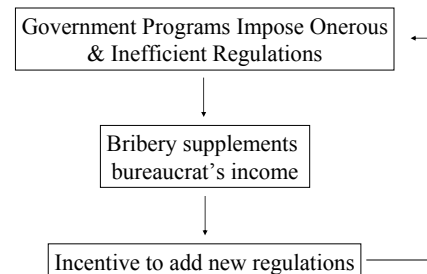
Problems with “Greasing the Wheels” Argument

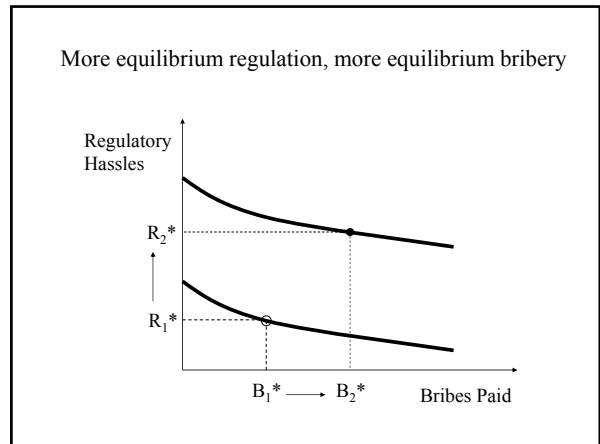
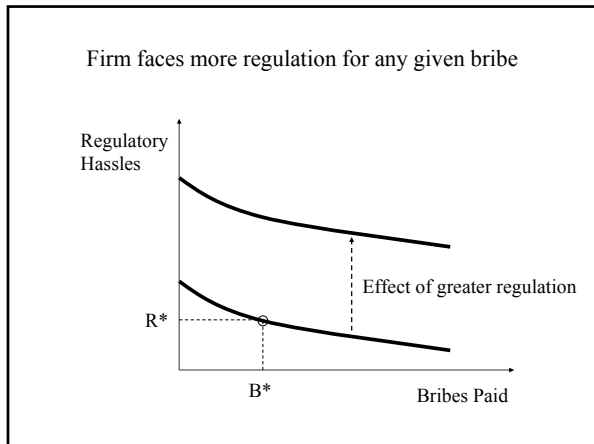
- Many regulations are good!
 - Drivers’ licenses for truckers
 - Safety regulations in factory
- Short-sighted solution to bad regulations
 - Sidestep a bad regulation today
 - Willingness to pay bribe observed
 - More bad regulations may be imposed
 - Country descends into regulatory swamp
- “Greasing the wheels” may create “sand in the gears”

Short run: Firm makes regulatory/bribery tradeoff

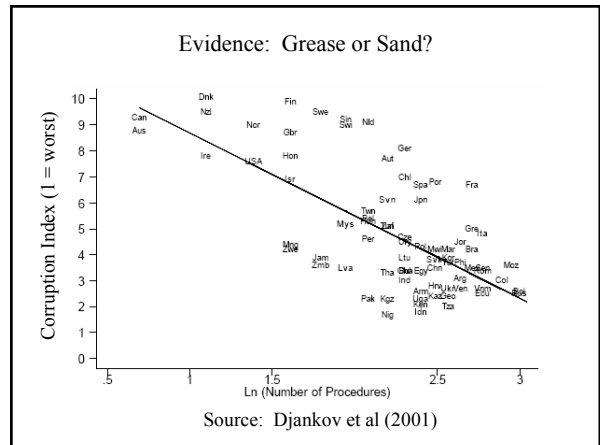


Bribe-paying Creates “Sand in the Gears”

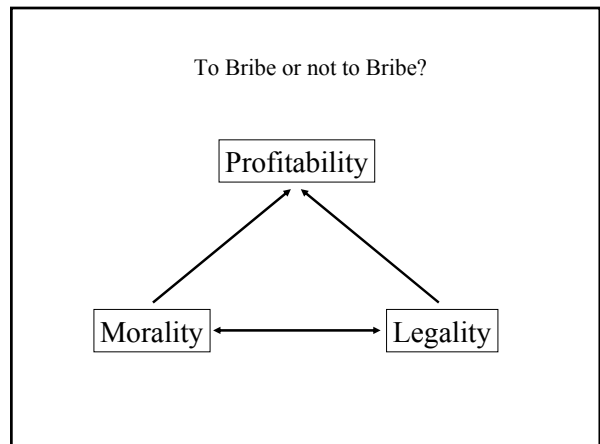




- Evidence: Grease or Sand?
- Kaufman & Wei (1999)
 - Firms in industries with higher rates of bribery spend *more time* dealing with regulators, not less
 - Djankov et al (2001)
 - Examine number of regulatory steps required to start a business in various countries
 - Find that high levels of corruption are associated with high numbers of regulatory steps



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Legality & Bribery

- Foreign Corrupt Practices Act (USA)
- Anti-Bribery Convention of OECD

FCPA: Basic Provisions

- U.S.-based companies and affiliates are forbidden from giving or promising foreign government officials either money or material items of value in return for assistance in obtaining or retaining business
- Applies to *intent*
- Includes payments to agents or consultants that will offer payments to foreign officials for prohibited purposes
- Applies to U.S. based firms; foreign firms that issue stock in U.S.; U.S. citizens, nationals and residents, regardless of employer
- Also enacts accounting rules, to make bribery harder to hide

FCPA: Exceptions/Loopholes

- Payments to facilitate or expedite “routine government action”
- “Payments that are legal under written laws of the host country”
- “Bona fide expenditures incurred for the promotion of products or services of U.S. business interest”
- Belief that a payment is not a bribe

FCPA: Difficulties in Enforcement?

“With legal conundrums surrounding the interpretation of FCPA, it is not surprising that the authorities have been lax in enforcing it. No chief executive has ever been convicted of a violation. From the date of its enactment in 1977 through to its amendment in 1988 only twenty-three cases were prosecuted. The enforcement of the provision is divided between the U.S. Securities and Exchange Commission and the Department of Justice. Before either of these agencies can act, they must establish that the defendant had ‘actual knowledge’ or a ‘firm belief’ that the unlawful activity is ‘substantially certain to occur’.”

-William Gamble, EMS

FCPA: Enforcement in Practice

- Maximum punishment
 - \$2 million (corporation)
 - \$100,000, 5 year imprisonment (individual)
- Since 1977
 - 30 convictions
 - Average fine
 - \$1.2 million (corporation)
 - \$15,000 (individual)
 - Jail Time: 2 incarcerations

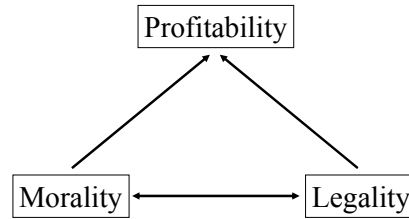
FCPA: Effect on U.S. Businesses Abroad

- Shang-Jin Wei (2000)
 - Compares U.S. FDI vs. FDI from other countries
 - Finds that corruption kills FDI generally
 - No special cost to U.S. firms due to FCPA

Anti-Bribery Convention of OECD

- Prior to 1997: few restrictions in other countries
 - Bribes often deductible!
- All signatories agreed to pass legislation similar to FCPA
- Requirements:
 - “Strong” penalties
 - Mutual legal assistance
- 31 countries have established anti-corruption codes to date

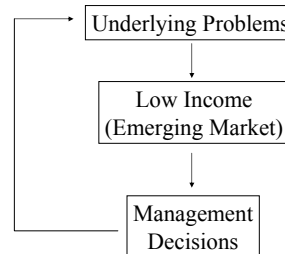
To Bribe or not to Bribe?



Morality & Bribery

- Common arguments to justify bribery
 - “If we don’t do it, someone else will”
 - “When in Rome...”
 - “We will reform the system from within”

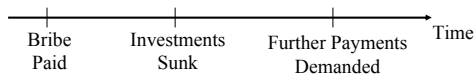
Morality & Bribery



- To bribe is to reinforce a bad equilibrium with real costs for local economy

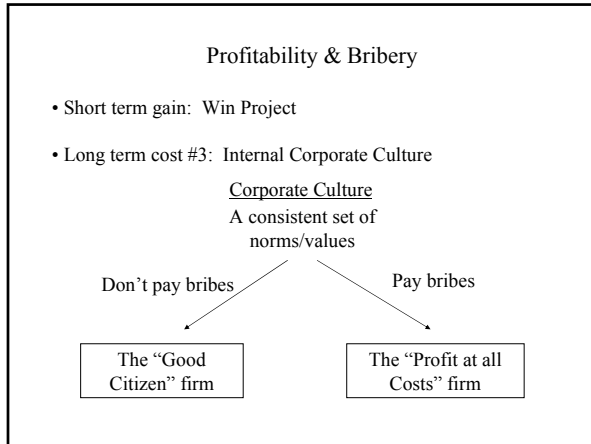
Profitability & Bribery

- Short term gain: Win Project
- Long term cost #1: Hold-up & Renegotiation
 - If counterparty wants bribe initially, it is likely that
 - counterparty’s incentives are based on personal gain
 - counterparty is relatively unconstrained by law
 - trust will be insufficient substitute for contract
 - Little to prevent renegotiation and hold-up



Profitability & Bribery

- Short term gain: Win Project
- Long term cost #2: Firm reputation for paying bribes
 - In future relationships with other counterparties, your firm may be seen as an “easy target”
 - Greater expectations that you will pay bribes
 - Little credible bargaining power to refuse when asked to pay a bribe (or in negotiations over how much)



Profitability & Bribery

- Firm culture that permits bribery may create/ reinforce other behaviors that may be undesirable

| | "Good Citizen" | "Profit at all Costs" |
|-------------------------|----------------|-----------------------|
| Customer Treatment | Quality | Opportunism |
| Time Horizon | Long | Short |
| Incentives | Loyalty | Stock options |
| Firm-Employee Relations | Trust-based | Contract-based |

- Tough Calls**
- Deciding whether or not to pay bribes is a question of firm strategy with legal, moral, and profit implications
 - Even if you "do not want to pay bribes", there are difficult gray areas
 - Relationship-building vs. graft
 - Facilitation vs. extortion
 - Gift-giving and "culture"
 - My advice to you
 - Do not break the law (consult attorney)
 - Be very careful about reputation
 - Make honest moral choices in gray areas
 - Always seek better options; don't be afraid to walk away

END