

## COMBATING CORRUPTION: THE VALUE OF ECONOMIC ANALYSIS

Recent advances in economic analysis have helped to clarify why corruption is so detrimental to economic development and to the efficient functioning of mature economies. More significantly, this research has produced some general guidelines for how to combat corruption. Writing in the November 2003 issue of the *Economic Journal*, Dr **Toke Aidt** of the University of Cambridge emphasises the importance of getting incentive structures right and avoiding inefficient policy measures.

Corruption – understood as an act in which the power of public office is used for personal gain in a manner that contravenes the rules – is a persistent feature of societies around the world and throughout history. The sale of parliamentary seats in ‘rotten boroughs’ in England before the Reform Act of 1832 is just one historical example. Contemporary examples also abound – and not just in developing countries like Nigeria, India and the Philippines and transition economies like Russia.

While sociologists and anthropologists often focus on culture as a key determinant of corruption, economists emphasis incentives and view corruption as the outcome of a rational calculation. Corruption, then, arises if a combination of circumstances is present:

- First, the relevant public official (a bureaucrat, politician or judge) must possess the authority to design regulations or to administer them in a discretionary manner.
- Second, the discretionary power must allow extraction of ‘rents’ or creations of rents that can be extracted.
- Third, the incentive system embodied in political, administrative and legal procedures and institutions must be such that officials are left with an incentive to exploit their discretionary power to extract or create rents.

Thus, incentives are crucial both for understanding why corruption arises in the first place and for what can be done to reduce it. Proper incentives can be created by effective monitoring, by rewarding public officials with salaries above market alternatives and by penalising corruption when it is discovered.

Importantly, however, all these measures are costly to introduce: there is no free lunch. As a consequence, it can be optimal to allow corruption up to a point.

This does not, however, imply that corruption levels as observed in, for example, Russia or India are anywhere near to being optimal: there is no presumption that incentive structures have been adjusted appropriately. In an environment with ill-designed incentives, corruption carries large social costs.

This is because corruption and inefficient policy measures are two sides of the same coin.

Take the example of industrial licenses, a policy measure used in many countries to regulate entry into certain economic activities. To allow public officials to collect bribes, license holders must earn a 'super-normal' profit. Such scarcity rents, in turn, require that the number of licenses issued is inefficiently low.

In short, corruption feeds on super-normal profits that are created by the introduction of inefficient policy measures. It is the latter – the inefficient policy – that is the real cost of corruption and which is so detrimental to economic development.

This line of reasoning also demonstrates why the proposition that corruption can enhance efficiency by 'greasing the wheels' and allowing firms to circumvent cumbersome rules and regulations is misguided if not outright wrong. It simply overlooks the reason why these cumbersome rules exist in the first place.

Once it takes root, corruption can be very persistent. This is because incentives to accept bribes are very different in societies with high and low levels of corruption. One reason is that reporting of corruption is less likely to happen in an environment in which almost all individuals take bribes and so, it pays for each individual to accept bribes because the risk is smaller.

This makes it extremely difficult to combat corruption in societies with high levels of corruption, and sustained, large-scale reforms of the incentive structures are the only way to move a society away from a high corruption 'equilibrium' to one with low corruption. The example of the Hong Kong police force, however, demonstrates that it can be done.

ENDS

**Notes for Editors:** 'Economic Analysis of Corruption: A Survey' by Toke Aidt is published in the November 2003 issue of the *Economic Journal*.

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