

1 CORRUPTION, CHARACTER, AND INSTITUTIONS\*

2  
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5  
6 I. INTRODUCTION

7  
8 Traffic violations are a part of everyday life in Mexico City. In 2016, law  
9 enforcement officers issued about eight thousand traffic fines per day,  
10 mainly related to parking violations, running red lights, and exceeding  
11 speed limits. Yet, Mexico City's government estimates that the number of  
12 unreported violations is at least equal to the reported numbers.<sup>1</sup> In other  
13 words, there is plenty of bribing going on.

14 Police officers and citizens know the dance: the driver asks for mercy—  
15 because she was in a hurry, distracted, or not familiar with the neighbor-  
16 hood. The officer says he'd like to help, but he doesn't know how. He may  
17 mention the hefty official fine associated with the violation. Ultimately, the  
18 typical interaction ends with the driver offering the equivalent of twenty  
19 dollars and the police officer letting the driver go without a citation. Both  
20 acted in morally questionable ways and engaged in an act of corruption  
21 that reflects poorly on their character and integrity. Flawed individual  
22 character seems to drive the bribery.

23 Imagine the same driver traveling from Mexico City to San Antonio,  
24 Texas. While driving in an unfamiliar area, she runs a red traffic light and  
25 is stopped by a police officer. Do you think she will offer a bribe? After all,  
26 judging by her previous behavior, her character is not exactly exemplary.  
27 In this new circumstance, the last thing on her mind is figuring out how  
28 to bribe the police officer. She may try avoiding the ticket, but by means  
29 other than offering a bribe. Did our imaginary driver experience a moral  
30 enlightenment when crossing the border? Or was she simply adjusting to  
31 a different set of formal rules?

32 The example illustrates two alternative views of corruption and its likely  
33 causes: Is corruption merely a flaw of character, or is it a rational response  
34 to a given institutional environment? If both aspects are important, which  
35 one has more weight? These questions are at the heart of academic and  
36 public-policy literature on the subject, as I discuss in Section II. Scholars  
37 from various disciplines mainly side with the narrative that, ultimately,  
38

39 \* I thank the other contributors to this volume, as well as the journal's anonymous  
40 reviewer, for their insightful comments.

41 <sup>1</sup> Precise estimations are hard to obtain and there are discrepancies among sources.  
42 Quoted estimates are based on data from the Secretaria de Seguridad Pública de la Ciudad  
de México, <http://www.ssp.cdmx.gob.mx/>

1 corruption is a problem of character flaws. Policy prescriptions around the  
2 world are designed based on this understanding.<sup>2</sup>

3 In this essay I challenge this understanding, arguing that it is at  
4 best incomplete, and is dangerously misleading at worst. I argue that  
5 the prevalence of virtuous acts is profoundly tied to people's institu-  
6 tional environment and the incentive structure that derives from it, and  
7 that to understand the nature of corruption we should instead focus on  
8 three aspects of this connection. First, I observe that virtue itself is hard to  
9 come by. Second, I argue that it is not obvious that corruption is always a  
10 character problem, and understanding the institutional environment and  
11 circumstances (formal institutions and rules, as well as social and cultural  
12 norms) that encourage people to perform virtuous acts is extremely rele-  
13 vant in dealing with the problem of corruption. Finally, I explore ways in  
14 which the institutions that increase the transaction costs associated with  
15 everyday life also increase the prevalence of corruption.

16 I do not claim that the two explanations of the nature of corruption—  
17 character versus institutional environment—are mutually exclusive. My  
18 claim is more modest, but still important: by accepting that corruption is  
19 not merely a character problem and that formal and informal rules affect  
20 incentives in ways that make engaging in corrupt acts more or less likely,  
21 we can derive insights that can inform policy-makers working on anticor-  
22 ruption strategies. In developing this narrative, a first step is to examine  
23 the way corruption is characterized in the literature and to consider what  
24 that account may be missing.<sup>3</sup>

## 25 26 II. THE DEFINITION AND NATURE OF CORRUPTION

27  
28 The literature identifies three types of corruption<sup>4</sup>:

- 29  
30 1. *Grand corruption*. Political elites sometimes use their power  
31 and influence to craft public policies that economically benefit  
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36 <sup>2</sup> See Robert I. Rotberg, *The Corruption Cure: How Citizens and Leaders Can Combat Graft*  
37 (Princeton, NJ: Princeton University Press, 2017), 290–94 and 301–321; Laura S. Underkuffler,  
38 *Captured by Evil: The Idea of Corruption in Law* (New Haven, CT: Yale University Press,  
39 2013), 242–43. Notably, organizational behavior literature explores the importance of rules  
40 in promoting desirable behavior and good character. See Daniel Katz, "The Motivational  
41 Basis of Organizational Behavior," *Systems Research and Behavioral Science* 9, no. 2, (1964):  
42 1099–1743.

43  
44 <sup>3</sup> For a contrasting view, see Ferretti's paper in this volume. Her analysis suggests that  
45 institutional corruption can always be traced to corrupt individuals' actions, thus her "con-  
46 tinuity" theory. On my model, by contrast, people create institutions. In the process, because  
47 they have limited foresight, they can inadvertently institute opportunities and incentives  
48 that corrupt agents interacting with the institutions they create. Where my model is accurate,  
49 it explains rather than merely posits corruption.

50 <sup>4</sup> A. Jain, "Corruption: A Review," *Journal of Economic Surveys* 15, no. 1 (2001): 71–72.

1 individuals or groups and then take a share of the benefits.  
 2 A classic example is the executive branch granting generous  
 3 government contracts to friends and political allies. Kleptocratic  
 4 regimes are traditionally prone to grand corruption.

- 5 2. *Bureaucratic, or petty, corruption.* Public servants that have discre-  
 6 tionary power may use it to their advantage when dealing with  
 7 citizens and even other bureaucracies. Perhaps the most perva-  
 8 sive manifestation of this type of corruption is asking for bribes in  
 9 exchange for providing or expediting services the public is entitled  
 10 to. Examples are bribes asked and paid to avoid traffic tickets or  
 11 to get licenses. Notice this describes a transaction involving both  
 12 public servants offering special treatment and citizens paying for  
 13 getting it.
- 14 3. *Legislative corruption.* Sometimes political and economic interest  
 15 groups can influence the way legislators vote and what type of  
 16 legislation they enact.<sup>5</sup> In exchange for special privileges granted  
 17 by legislation, interest groups may offer not only bribes, but also  
 18 gifts, lavish travel for legislators and family, and other forms of  
 19 compensation.

20  
 21 Going further, J. S. Nye identifies three different dimensions of  
 22 corruption—namely, bribery, nepotism, and misappropriation.<sup>6</sup> Bribery  
 23 relates to cases such as grand, petty, or legislative corruption. Nepotism  
 24 refers to corrupt acts that assign valuable public resources based on  
 25 family or friendship relationships, rather than merit, while misappro-  
 26 priation speaks to acts of corruption where public assets are used for  
 27 private gain.

28 Corruption's multiple dimensions make the concept difficult to define  
 29 precisely. Further, attempting to define corruption in excessively precise  
 30 terms risks compromising the richness of the phenomenon. My purpose  
 31 here, then, is not to settle on a definite conception, but to suggest that  
 32 corruption has multiple facets. With that limited aim in mind, for my  
 33 purposes I define corruption as a situation in which a public servant has  
 34 discretionary power in allocating costs and benefits among citizens, an  
 35 exchange occurs between the public servant and citizen that involves both  
 36 demanding and offering a bribe, and this exchange provides a privilege  
 37 not readily available to citizens who do not pay the bribe. I also assume  
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 39  
 40

41 <sup>5</sup> In economics, this is called rent-seeking. See, Gordon Tullock, "The Welfare Costs of  
 42 Tariffs, Monopolies and Theft," *Western Economic Journal* 5 (1967): 224–32; Anne O. Krueger,  
 43 "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64 (1974):  
 291–303.

44 <sup>6</sup> J. S. Nye, "Corruption and Political Development: A Cost-Benefit Analysis," *The American*  
 45 *Political Science Review* 61, no. 2 (1967): 417–27.

1 the existence of economic rents<sup>7</sup> and the possibility of capturing them, as  
 2 well as a relatively low probability of getting caught and/or a low penalty  
 3 associated with that possibility. This working definition runs parallel to  
 4 the classic one coined by Rose-Ackerman: corruption is “the misuse of  
 5 public power for private or political gain”<sup>8</sup> and to a definition like Jain’s:  
 6 “[corruption] refers to acts in which the power of public office is used for  
 7 personal gain in a manner that contravenes the rules of the game.”<sup>9</sup>

8 Why should we care about corruption? Rothstein and others suggest  
 9 that corruption violates the principle of nondiscrimination in “the exer-  
 10 cise of public authority.” Morally equal individuals ought to receive the  
 11 same treatment from public officers. To make distinctions and offer prefer-  
 12 ential treatment in exchange for bribes or gifts—or based on family  
 13 or friendship ties—is to act in a corrupt way. Kurer relates this idea  
 14 of impartiality to aspects of distributional justice, and along with Lee  
 15 Kwan Yew finds corruption deeply troubling because it affects fairness,  
 16 transparency, and accountability—all factors that run against democratic  
 17 practices and ideals.

18 Underkuffler suggests that “corruption, as commonly understood, is  
 19 not simply a violation of law or the breach of a public duty; it is the  
 20 engagement in evil, the transgression of deeply held moral norms.”<sup>10</sup> For  
 21 her, corruption is a sin and a betrayal of trust: the corrupted have been  
 22 captured by evil, succumbing to “self-involvement, self-indulgence, the  
 23 loosening and discarding of the restraint of social bonds.”<sup>11</sup>

24 Parker presents a similar notion, stating that corruption “is marked by  
 25 immorality and perversion” and the corrupt person is “depraved; venal;  
 26 [and] dishonest.”<sup>12</sup> Rotberg advocates adopting “ethical universalism” as  
 27 the “only sustainable method of curbing corruption,” and suggests the  
 28 phenomenon is deeply rooted in poor moral character. Robert Brooks  
 29 describes corrupt transactions as “sins,” and engaging in corruption as  
 30 the manifestation of “moral weakness.”<sup>13</sup>

31  
 32 <sup>7</sup> An economic rent is the difference between the minimum payment needed to bring a  
 33 factor of production—labor, capital, or land—into productive use, and what is actually paid.  
 34 For example, let’s say that a person will be willing to work for 10 dollars per hour, but gets  
 35 paid 12 dollars per hour. The 2 dollar difference is an economic rent. Corruption can be used  
 36 to increase these excess payments by granting special privileges not available to others, such  
 as licenses, quotas, monopoly power, and so on.

37 <sup>8</sup> Susan Rose-Ackerman, *Corruption and Government: Causes, Consequences, and Reform*  
 38 (Cambridge: Cambridge University Press, 1999), 9. For a classic approach to the issue also  
 39 see Susan Rose-Ackerman, *Corruption: A Study in Political Economy* (New York: Academic  
 Press, 1978).

40 <sup>9</sup> Jain, “Corruption,” 73.

41 <sup>10</sup> Underkuffler, *Captured by Evil*, 223.

42 <sup>11</sup> *Ibid.*, 58.

43 <sup>12</sup> Wilmer Parker, III, “Every Person Has a Price?” in Barry Rider ed., *Corruption: The Enemy*  
 44 *Within* (The Hague: Kluwer Law International, 1997), 87.

45 <sup>13</sup> Robert C. Brooks, “The Nature of Political Corruption,” in Arnold J. Heidenheimer  
 ed., *Political Corruption: Readings in Comparative Analysis* (New Brunswick, N.J.: Transaction  
 Books, 1978), 56.

1 Rotberg also refers to Samuel Johnson's eighteenth-century definition  
 2 of corruption in which words and phrases such as "wickedness," "per-  
 3 version of principles," and "depravation" describe the concept.<sup>14</sup> Finally,  
 4 Heywood and Rose suggest that the issue of corruption is ultimately a  
 5 problem of lack of personal integrity.<sup>15</sup> In these conceptions, corruption is  
 6 a problem of character flaws.

7 An alternative to the above scholars' understanding of the nature of  
 8 corruption is to think of it as a vice, but one embedded in an environment,  
 9 especially an institutional environment, which includes informal rules—  
 10 such as cultural norms—and formal rules, such as laws and regulations.  
 11

### 12 III. THE ARISTOTELIAN VIEW OF HUMAN ACTION AND VIRTUE 13

14 Being virtuous is hard. According to Aristotle's *Nicomachean Ethics*, virtu-  
 15 tuousity requires not only that one does the right thing and performs a  
 16 noble action, but three additional requirements: full awareness, intention,  
 17 and firmness. The truly virtuous person knows what she is doing, intends  
 18 what she is doing and does so with conviction and determination. This is  
 19 a very high standard. Not surprisingly, according to Aristotle, not every-  
 20 body can be truly virtuous.

21 How can one become virtuous? By practicing. Virtue "is a habit dis-  
 22 posed toward action by deliberate choice, being at the mean relative to us,  
 23 and defined by reason as a prudent man would define it."<sup>16</sup> With practice  
 24 one may become a better person and eventually virtuous, despite oppo-  
 25 site natural passions or inclinations: "Virtues arise in us neither by nature  
 26 nor contrary to nature; but by our nature we can receive them and perfect  
 27 them by habituation."<sup>17</sup> In these and the following passages Aristotle is  
 28 referring to "hoi polloi," the majority of people.

29 Aristotle also suggests that becoming habituated in virtue requires  
 30 performing virtuous actions beginning at an early age. But how could a  
 31 person acquire virtue by habit if she is not already a virtuous person ha-  
 32 bituated to perform virtuous acts? Aristotle's answer—relevant for this  
 33 essay's narrative—is that acting virtuously and being virtuous are dif-  
 34 ferent things. The distinction between virtuous acts and virtuous charac-  
 35 ter is useful. The latter is the disposition to perform the former.

36 Acting virtuously is a necessary but not sufficient condition for being  
 37 virtuous. As I mentioned, knowledge, intent to act virtuously for its own  
 38  
 39

40 <sup>14</sup> Digital Edition of the 1755 Classic Dictionary by Samuel Johnson accessed on July 15<sup>th</sup>,  
 41 2017. <http://johnsonsdictionaryonline.com/?p=16540>

42 <sup>15</sup> P. M. Heywood and Jonathan Rose, "Curbing Corruption or Promoting Integrity? Prob-  
 43 ing the Hidden Conceptual Challenge," in P. Hardi, M. Heywood, and D. Torsello, eds.,  
 44 *Debates of Corruption and Integrity* (London: Palgrave Macmillan, 2015), 109–110.

45 <sup>16</sup> Aristotle, *The Nicomachean Ethics*, trans. W. D. Ross and Lesley Brown (Oxford: Oxford  
 University Press, 2009), 1107a.

<sup>17</sup> Aristotle, *Nicomachean Ethics*, 1103a.

1 sake, and firmness are additional necessary conditions. Individuals who  
 2 are in the process of becoming virtuous are constantly challenged by its  
 3 requirements. Every day, we have obligations to perform virtuous acts.  
 4 When choosing how to act, to some extent, we also choose how to navigate  
 5 toward virtue.

6 Again, choosing to repeat virtuous acts—practicing—is what makes us  
 7 better at performing these acts, and ultimately may transform us into virtuous  
 8 individuals. Julia Annas suggests that trying to become virtuous  
 9 is like attempting to become a master piano player: it requires constant,  
 10 daily hard work.<sup>18</sup> It also demands awareness, passion, and dedication.  
 11 But what informs choosing between alternative acts? Are there outside  
 12 elements that make it easier—or harder—to become a master violin  
 13 player? The answer is yes.

14 Aristotle suggests that legislation is a crucial factor in creating conditions  
 15 to habituate citizens to act virtuously: “It is difficult for one to be  
 16 guided rightly towards virtue from an early age unless he is brought up  
 17 under such [that is, right] laws; for a life of temperance and endurance is  
 18 not pleasant to most people, especially the young. For these reasons, the  
 19 nurture and pursuits of the young should be regulated by laws, for when  
 20 they become habitual they are not painful.”<sup>19</sup>

21 According to Aristotle, laws inform our choices and set mutual expectations  
 22 about proper conduct. Therefore, legislation may provide the  
 23 right amount of coercion so that individuals can overcome their passions,  
 24 and make the right choices. But is forcing people to act virtuously a true  
 25 measure of virtuosity? Not according to Aristotle’s conception of virtue.  
 26 That is why he also emphasizes the importance of moral education in  
 27 attaining virtue.

28 Through moral education we learn the reasons to appreciate and receive  
 29 pleasure from what is good, and to reject and be disturbed by what is  
 30 bad: “we should be brought up from our early youth in such a way as  
 31 to enjoy and be pained by the things we should.”<sup>20</sup> In this sense, virtue  
 32 benefits its possessor. We can learn why moral acts are worthy choices.  
 33 While an individual can be compelled by law to perform a virtuous act,  
 34 she can also learn to enjoy doing the right thing—hence the role of moral  
 35 education—and may continue choosing the right act. Acting virtuously  
 36 becomes a habit.

37 Aristotle is cautious about the permanent prospects of this marriage of  
 38 coercion and reason. He says that without moral education, “laws would  
 39 be needed for man’s entire life, for most people obey necessity rather  
 40 than argument, and penalties rather than what is noble.”<sup>21</sup> Humans need  
 41

42  
 43 <sup>18</sup> Julia Annas, *Intelligent Virtue* (Oxford: Oxford University Press, 2011), 16–19.

44 <sup>19</sup> Aristotle, *Nicomachean Ethics*, 11079b.

45 <sup>20</sup> *Ibid.*, 1104b.

<sup>21</sup> *Ibid.*, 1179b.

1 a constant reminder of what it means to be good and what that really  
2 entails. Here it is useful to remember that Aristotle is thinking of most  
3 individuals. Most people are not virtuous, and thus need coercion and  
4 knowledge—in his mind in the form of legislation and moral education—  
5 to navigate the path toward virtue.

6 At the same time, Aristotle is aware that legislation and moral education  
7 may not be enough to lead individuals to live a virtuous life. In his view,  
8 because virtuous action must be specific to the individual actor, and laws  
9 must be universal, it is impossible to enact legislation that goes beyond  
10 providing general guidelines of conduct. Additionally, while moral edu-  
11 cation provides valuable ways to assess choices, it is only through experi-  
12 ence that one can truly find one's own intrinsic motivation to be virtuous.  
13 Both law and education have their limits in both influencing and inform-  
14 ing the pursuit of virtue.

15 For example, a gap between the enactment and enforcement of legisla-  
16 tion may be incompatible with the incentive to seek virtue: legislation—  
17 even sound laws—in the hands of bureaucrats with discretionary power  
18 creates the incentive to act corruptly. And using moral reasoning to recog-  
19 nize the inadequacy of a choice may not be enough to deter the agents of  
20 the law from choosing the non-virtuous acts. The point is not that the law  
21 or reason may prompt corrupt acts, but that the incentive structure affects  
22 costs and benefits at the moment of choice and determines what actions  
23 the agents choose.

24 The driver in Mexico City may know that what she is doing is wrong  
25 and that it violates the law. She may even feel guilty. But this does not pro-  
26 vide enough of an incentive for her to act virtuously. In this sense, then,  
27 corruption is more than just a problem of a morally rotten individuals or  
28 legislation that fails to reverse the rot. It is also an institutional problem  
29 where many actors facing choices assess the costs and benefits of the op-  
30 tions under a given incentive structure. If choosing to do the virtuous act  
31 (not paying a bribe) imposes unreasonable burdens—and is not already  
32 pleasurable in its own right—then it is hard to facilitate the Aristotelian  
33 habituation process.

34 I suggest that in modern economic terms, Aristotle's points speak to the  
35 importance of incentive structures in inducing non-virtuous individuals—  
36 the majority of people—to perform virtuous acts. By influencing costs and  
37 benefits, not only legislation and moral codes but also social norms (among  
38 other institutions) can make some choices more palatable than others. This  
39 is true not only in economic respects, but also in relation to moral aspects of  
40 choice. Institutions and incentives, both internalized and external, affect the  
41 prospects of becoming a master piano player or a virtuous person.<sup>22</sup>

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44 <sup>22</sup> For an account of how acting on one's self-interest is related to morality, see Neera Kapur  
45 Badhwar, "Altruism versus Self-Interest: Sometimes a False Dichotomy," *Social Philosophy and Policy* 10, no. 1 (1993): 90–117.

1 Aristotle's account of virtue and virtuous acts helps us anticipate the  
2 potential for success or failure of anticorruption initiatives. Setting up  
3 an anticorruption program that assumes individuals are fully virtuous  
4 would be disastrous. In tackling corruption, it is more reasonable to recognize  
5 that most of the time we will not have individuals with perfectly  
6 virtuous character. A more useful way to think about the problem is to  
7 ask ourselves what type of institutions and rules discourage corruption.  
8 Then we can economize on virtue—that is, depend less on the existence of  
9 virtuous public servants and citizens—while incentivizing individuals to  
10 do the right thing.  
11

#### 12 IV. AGENCY PROBLEMS AND CORRUPTION 13

14 The economic theory of agency problems can inform a systematic exploration  
15 of the role of institutions. The theory analyzes situations in which  
16 one actor—the principal—delegates decision making to another actor—the  
17 agent. The principal then intends the agent to act and assign resources  
18 in ways conducive to achieving the principal's objectives. Classic examples  
19 of principal-agent pairs are a car owner and a mechanic, a patient and  
20 a doctor, and stockholders and managers. In these cases, the car owner,  
21 patient, and stockholders delegate authority to the mechanic, doctor, and  
22 manager, respectively, so the latter can then act and pursue the former's  
23 goals.

24 Several problems emerge within agent-principal relationships.<sup>23</sup> The  
25 main one is that they may create occasions for opportunistic behavior  
26 because of informational asymmetries and divergent interests.

27 The agent normally has better information than the principal about the  
28 agent's own skills and talents, how to allocate resources efficiently, what  
29 type of decisions would be better in pursuing the principal's interest, and  
30 how to evaluate alternative courses of action. Additionally, monitoring  
31 and evaluating the agent's behavior is costly. Taken together, these conditions  
32 incentivize the agent to act opportunistically. The most prevalent  
33 outcomes are that the agent exerts low effort in pursuing the principal's  
34 goals or completely deviates from pursuing them. The challenge is to  
35 design mechanisms that align the agent's goals with the principal's objectives.  
36 Economists have developed two concepts in studying the problem:  
37 adverse selection and moral hazard.

38 Adverse selection happens when asymmetric information and divergent  
39 interests are present *prior* to an exchange or contract between the two  
40 parties. Moral hazard occurs when the problems emerge *after* a deal is  
41 struck, thus modifying the agent's behavior.  
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44 <sup>23</sup> For a comprehensive review of the principal-agent theory see, Jean-Jacques Laffont and  
45 David Martimort, *The Theory of Incentives: The Principal-Agent Model* (Princeton, NJ: Princeton  
University Press, 2009).

1 Imagine a case of adverse selection. A seller, or agent, has a better under-  
2 standing of the value of a good or service than a buyer, or principal, does.  
3 He could potentially exploit this information asymmetry at the expense of  
4 the buyer. Used-car markets are prone to adverse-selection problems:  
5 owners know better than buyers the true condition of the used car and  
6 can take steps to misrepresent the car's quality to a potential buyer, in  
7 attempting to sell a "lemon"—a car in poor condition.

8 In general, this may prevent transactions from happening at all, because  
9 the principal anticipates a likely abuse. When the principal is certain about  
10 quality, the transaction will occur and will be a win-win event. But if the  
11 principal is uncertain of the true value of the good, then its willingness to  
12 trade decreases or completely disappears.

13 Principals' inability or high cost of screening agents makes the situation  
14 worse. Principals would like to know better what type of agents they are  
15 dealing with, while honest agents would like to signal they are trustwor-  
16 thy. Nobel Prize winner George Akerlof developed a framework to under-  
17 stand how to overcome adverse-selection problems in the "market for  
18 lemons" by using signaling and *screening* mechanisms such as reputation,  
19 all of which have at their core attempts to reduce asymmetric-information  
20 problems.<sup>24</sup>

21 In contrast to adverse selection, moral hazard is when the agent's behav-  
22 ior changes *after* the exchange occurs or the contract is entered into. Insur-  
23 ance and car-rental markets are good examples of moral-hazard problems.  
24 Once an insurance policy or a warranty is obtained, this may modify the  
25 buyer's behavior in ways at odds with the ideal type of behavior the seller  
26 would like to observe. Car insurance tends to incentivize reckless behavior  
27 because the insured individual would not bear the full cost of an accident.  
28 And people tend to be less careful with rental cars than with their own  
29 vehicles. Insurance and car-rental companies react by increasing premiums  
30 on and rates for "high risk" customers, such as drivers under a certain age.

31 In the moral-hazard case, it is the inability to *monitor*, or the high cost of  
32 *monitoring*, behavior that makes things worse. An agent may even try to  
33 conceal her "true type" to the principal, exploiting asymmetric informa-  
34 tion once an agreement is reached. Moreover, moral hazard may emerge  
35 even in the absence of asymmetric information if the agent realizes, after  
36 the exchange occurs, that it is in her interest to deviate from the principal's  
37 preferred behavior, even if that potentially imposes costs on the latter.  
38 In these situations, the principal lacks the necessary information to fully  
39 anticipate the agent's behavior.

40 Corruption research has used the principal-agent model to explore cor-  
41 ruption's origins and offer prescriptions. Ugur and Dasgupta present a  
42  
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44 <sup>24</sup> George Akerlof, "The Market for 'Lemons'," *The Quarterly Journal of Economics* 84, no. 3  
45 (1970): 488–500.

1 comprehensive analysis of one hundred fifteen corruption studies where  
 2 all “adhered to an explicitly-stated principal-agent approach to corrup-  
 3 tion, or their account was closely related to that approach.”<sup>25</sup> Similarly,  
 4 Persson, Rothstein, and Teorell as well as Ivanov and Lawson all find that  
 5 most anticorruption programs are designed based on a principal-agent  
 6 framework.<sup>26</sup>

7 The principal-agent approach to corruption assumes a group of actors  
 8 as the principal, delegating public tasks to another collective body, the  
 9 agent. Becker and Stigler’s analysis assumes that political rulers are the  
 10 principal and the bureaucracy is the agent.<sup>27</sup> Corruption emerges when  
 11 an “agent betrays the principal’s interest in the pursuit of his or her own  
 12 self-interest,”<sup>28</sup> exploiting the previously described informational asym-  
 13 metries. Rose-Ackerman suggests that bribery makes agents put their own  
 14 interests ahead of those of their principal.<sup>29</sup> Similarly, Klitgaard argues that  
 15 corruption occurs when an agent betrays the principal’s public interest.<sup>30</sup>

16 Anticorruption strategies informed by this framework fall within tradi-  
 17 tional ways to deal with principal-agent problems—namely, attempts  
 18 to align incentives and reduce opportunistic behavior. Examples include  
 19 screening to avoid hiring bad agents, and monitoring to assess their  
 20 behavior and performance. This approach to the study of corruption has  
 21 its critics.

22 Per the discussion in Section III, relying on the existence of virtuous  
 23 principals that will perfectly enforce anticorruption measures may not  
 24 be the best strategy. That would be to assume, using Persson’s term, the  
 25 existence of “principled principals.”<sup>31</sup> He argues that “we should expect  
 26 the key instruments to curb corruption in line with the principal-agent  
 27 anticorruption framework—that is, monitoring devices and punishment  
 28 regimes—to be largely ineffective since there will simply be no actors that  
 29 have an incentive to enforce them.”<sup>32</sup> Mungiu-Pippidi goes further and  
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 33 <sup>25</sup> Mehmet Ugur and Nandini Dasgupta, “Corruption and Economic Growth: A Meta-  
 34 Analysis of the Evidence on Low-Income Countries and Beyond”, MPRA Paper No. 31226  
 (2011).

35 <sup>26</sup> Anna Persson, Bo Rothstein, and Jan Teorell, “Why Anticorruption Reforms Fail—  
 36 Systemic Corruption as a Collective Action Problem,” *Governance* 26, no. 3 (2013): 449–71;  
 37 Kalin Ivanov, “The Limits of a Global Campaign against Corruption,” in Sarah Bracking, ed.,  
 38 *Corruption and Development. The Anti-Corruption Campaigns* (London: Palgrave Macmillan,  
 2007), 28–45; Letitia Lawson, “The Politics of Anti-Corruption Reform in Africa,” *Journal of*  
*Modern African Studies* 47, no. 1 (2009): 73–100.

39 <sup>27</sup> Gary S. Becker and George J. Stigler, “Law Enforcement, Malfeasance, and Compensa-  
 40 tion of Enforcers,” *Journal of Legal Studies* 3, no. 1 (1974): 1–18.

41 <sup>28</sup> Persson, Rothstein, and Teorell, “Why Anticorruption Reforms Fail,” 4.

42 <sup>29</sup> Susan Rose-Ackerman, “Governance and Corruption,” in B. Lomborg ed., *Global Crises,*  
*Global Solutions* (Cambridge: Cambridge University Press, 2004), 310–11.

43 <sup>30</sup> Klitgaard, *Controlling Corruption* (Oakland, CA: University of California Press, 1988)  
 23–24.

44 <sup>31</sup> Persson, Rothstein, and Teorell, “Why Anticorruption Reforms Fail,” 3.

45 <sup>32</sup> *Ibid.*, 2–3.

1 suggests that “more often than not . . . ‘principals’ may serve as a patron  
2 or gatekeeper for corruption, if not the actual *capo di tutti capi*.”<sup>33</sup>

3 As a response, these and other critics offer a different conceptualization  
4 of the problem of corruption suggesting that it more closely resembles a  
5 collective-action problem. More specifically, borrowing a concept developed  
6 by Elinor Ostrom, they suggest the existence of a collective-action  
7 problem of the second order.<sup>34</sup> In a nutshell, a second-order collective-  
8 action problem is a coordination challenge: I do what I do because every-  
9 body else is doing the same, even if all of us could be better-off acting  
10 differently. No one has incentives to deviate from current behavior, even  
11 if it is suboptimal, because they expect others to maintain their current  
12 course of action.

13 Rothstein puts it very clearly: “Why would agents that either stand  
14 to gain from corrupt practices or who can only lose by refraining from  
15 corruption at all be interested in creating such ‘efficient’ institutions?”<sup>35</sup>  
16 Underkuffler offers a similar notion: “If corruption is the usual medium  
17 of exchange in the world that citizens know, they will also know that they  
18 are in a serious comparative disadvantage if they fail to engage in it.”<sup>36</sup>

19 These problems can be modeled using analytical tools such as game  
20 theory.<sup>37</sup> A full exploration of the game-theory framework is beyond the  
21 scope of this essay, but the intuition behind it is simple: shared expecta-  
22 tions about how others may act may trap societies in inefficient arrange-  
23 ments. Corruption may be difficult to eliminate not only because agents’  
24 types and actions are difficult to monitor, but because an overall credible  
25 commitment in which *all* agents and principals stop taking and asking for  
26 bribes may not be possible to craft. The prospects for escaping the cor-  
27 ruption trap may collapse with the possibility of a few individuals not  
28 honoring the agreement, thus imposing costs on others who do. Trust is  
29 crucial.

30 The principal-agent and collective-action approaches to corruption are  
31 not necessarily competing explanations. On the contrary, they can be com-  
32 plements. It is possible that the collective-action problem of being stuck in  
33 suboptimal, corrupt equilibriums includes plenty of perverse principal-  
34 agent interactions. And agency theory can benefit from considering the  
35

36  
37 <sup>33</sup> Alina Mungiu-Pippidi, “Controlling Corruption through Collective Action,” *Journal of*  
38 *Democracy* 24, no. 1 (2013): 101–115.

39 <sup>34</sup> Elinor Ostrom, “A Behavioral Approach to the Rational Choice Theory of Collective  
40 Action: Presidential Address, American Political Science Association, 1997,” *American Political*  
41 *Science Review* 92, no. 1 (1998): 1–22.

42 <sup>35</sup> Bo Rothstein, “Anti-Corruption: The Indirect ‘Big Bang’ Approach,” *Review of Interna-*  
43 *tional Political Economy* 18 (2011): 228–50.

44 <sup>36</sup> Underkuffler, *Captured by Evil*, 225.

45 <sup>37</sup> For a basic introduction see Avinash K. Dixit and Susan Skeath, *Games of Strategy: Fourth*  
*International Student Edition* (W. W. Norton and Company, 2015). For an excellent applied  
account to collective action problems, see Gerald Gaus, “A Tale of Two Sets: Public Reason in  
Equilibrium,” *Public Affairs Quarterly* 25, no. 4 (2011): 305–325.

1 role of trust and coordination when dealing with corruption at large. After  
2 all, individual agents' decisions to act in corrupt ways do not occur in a  
3 vacuum, but within a larger social context.

4 Marquette suggests that "monitoring, transparency, and sanctioning—  
5 all variables that impact individual calculations of whether or not to  
6 engage in corruption—are also weighed against the potential influence  
7 of group dynamics that may impact on the likelihood of free riding."<sup>38</sup>  
8 Poor screening and costly monitoring may coexist with individual lack  
9 of incentives to deviate from others' corrupt behavior. Both theories offer  
10 valuable insights. Moreover, there is an underexplored insight from the  
11 principal-agent approach that helps us think about the corruption-as-a-  
12 character-flaw narrative. This insight is related to the *ex-ante* and *ex post*  
13 elements of agency problems.

14 A simple example to further clarify both concepts: Imagine a restaurant  
15 that offers an all-you-can-eat buffet. Now imagine patrons that overeat and  
16 while doing so waste food—a problem the restaurant's owner wishes to  
17 minimize. It is possible that the buffet attracts individuals that are already  
18 predisposed and had the intention to overeat without caring if they waste  
19 food. But it is also likely that some individuals were not planning to over-  
20 indulge, but once there and in the face of abundant food, they became  
21 careless and filled their plates beyond their appetite, resulting in waste.

22 Is this an adverse-selection or a moral-hazard problem? In other words, is  
23 overeating and waste an *ex ante* or an *ex post* behavior? The answer is impor-  
24 tant, because adequate strategies to prevent the problem may be radically  
25 different. The same question can be asked of the corruption problem.

26 Is corruption an *ex ante* or an *ex post* problem? An adverse-selection  
27 explanation suggests that public service may attract the already cor-  
28 rupted, those seeking to take advantage of their power for personal ben-  
29 efit. A moral-hazard account would be different. Individuals might not  
30 pursue public office to misuse their position, but once they have access  
31 to privilege-granting opportunities or are immersed in an environment  
32 where corrupt behavior is the norm, they choose to act in corrupt ways.  
33 It seems the adverse-selection narrative is closer to the poor-character  
34 explanation of corruption, whereas the moral-hazard problem is more  
35 closely related to the institutional-environment explanation. Let us fur-  
36 ther explore both possibilities.

37 Adsera, Boix, and Paine suggest that lack of accountability may increase  
38 opportunistic behavior among politicians and bureaucrats, thus increasing  
39 corrupt behavior.<sup>39</sup> This is a monitoring problem and characterizes  
40  
41

42 <sup>38</sup> Heather Marquette and Caryn Peiffer, "Corruption and Collective Action," *UK DLP*  
43 *Research Paper* 32 (2015): 16.

44 <sup>39</sup> Alicia Adsera, Carles Boix, and Mark Payne, "Are You Being Served? Political Account-  
45 ability and Quality of Government," *Journal of Law, Economics, and Organization* 19, no. 2  
(2003): 445–90.

1 corruption as a moral-hazard, institutionally driven problem. If this is the  
2 case, institutions such as checks and balances may serve to deter corrupt  
3 behavior. Similarly, political agencies may try to monitor bureaucrats.  
4 Shleifer and Vishny frame the problem as an *ex post* challenge,<sup>40</sup> and as  
5 Barro suggests, voters' ability to impose costs on government behavior  
6 *ex post* is critical in reducing incentives for corruption.<sup>41</sup>

7 Conversely, if the corruption problem is framed as *ex ante* (adverse  
8 selection), the challenge is preventing the already-corrupted opportu-  
9 nistic individuals from taking office and having discretionary control over  
10 valuable resources and corruption rents. Teorell suggests that reducing  
11 discretionary power may prevent individuals from behaving badly.<sup>42</sup> Poor  
12 institutions and suboptimal rules may increase the value of corruption  
13 rents, and thus adverse selection may be more prevalent. Of course, no  
14 politician or bureaucrat would readily admit tendencies toward corrup-  
15 tion. That explains the emergence of screening strategies such as asset  
16 disclosure before running for office, and supposedly independent anti-  
17 corruption monitoring agencies that review profiles before hiring public  
18 officers.

19 The ex-ante and ex post views of corruption are not mutually exclusive,  
20 and it is possible to observe both dynamics in the real world. However, as  
21 I elaborate in Section V, prevalent public-policy prescriptions treat corrup-  
22 tion as an adverse-selection problem: the problem is viewed as preventing  
23 the corrupt from taking control. Conditions that provide agents opportu-  
24 nities for rent extraction (that is, gaining wealth from citizens by virtue of  
25 the agents' power) without related risks attract corruption-predisposed  
26 individuals. In fact, some cultural contexts see entering corruption-prone  
27 institutions as the only way to gain wealth. Those seeking to enter bureau-  
28 cratic structures do so expecting to extract illegal rents.<sup>43</sup>

29 It is valuable to complement this view with an *ex post* analysis of cor-  
30 ruption. If uncertainty about behavior, costly monitoring, and asymmetric  
31 information are prevalent, corruption may be inevitable. If the existence  
32 of and prospects of appropriating economic rents are influenced by the  
33 institutional framework, then corruption may be better characterized as  
34 a moral-hazard problem. Choices are not merely determined by the char-  
35 acter of the individual but by the institutional framework that creates an  
36 incentive structure.

37 Under bureaucratic structures that have highly corrupted officers,  
38 low-level subordinates may not have another alternative than to adapt  
39

40 Andrei Shleifer and Robert W. Vishny, "Corruption," *Quarterly Journal of Economics* 108, no. 3 (1993): 599–617.

41 Robert J Barro, "The Control of Politicians: An Economic Model," *Public Choice* 14, no. 1 (1973): 19–42.

42 Jan Teorell, "Corruption as an Institution: Rethinking the Origins of the Grabbing Hand," *Working Paper Series No. 5*, The Quality of Government Institute, Göteborg University (2007).

43 Rotberg, *Corruption Cure*, 3–7 and 130–175.

1 to the institutional environment where corruption rents are demanded  
 2 across the organization. Imagine a police officer that is honest and willing  
 3 to perform virtuous acts entering a rotten corporation. If the corporation's  
 4 leadership demands bribe quotas from the officer in order to keep his job,  
 5 he faces a difficult choice. Acting virtuously may not be possible, or may  
 6 be dangerous. Furthermore, the corruption of some encourages additional  
 7 officials to accept bribes until all are corrupt, and only those willing to take  
 8 part in the corruption will remain in charge. This situation resembles what  
 9 we previously characterized as a collective-action problem.

10 Again, providing external incentives for honest behavior or establishing  
 11 mechanisms to increase the probability of detection and punishment may  
 12 also be ineffective. If the monitoring agency also is constrained by poor  
 13 institutions, prescriptions grounded in screening strategies such as trans-  
 14 parency may be inadequate and even counterproductive. Transparency  
 15 initiatives may offer dishonest agents something else to sell: the right to  
 16 have them look the other way.

17 Honest officials will get displaced if the corruption is prevalent at all  
 18 levels. *Ex post* corruption may then contribute to the survival of a subopti-  
 19 mal social equilibrium, a difficult one to escape.

20 Again, my argument is not that adverse-selection and moral-hazard  
 21 explanations are at odds. Both concepts are useful and should be used  
 22 carefully when assessing specific situations. But a portrayal of corruption  
 23 as character driven, and thus as an adverse-selection problem, is incom-  
 24 plete. Certainly, corruption may have a bad effect on individual character:  
 25 it may decay moral integrity.<sup>44</sup> But it is not obvious that poor character is  
 26 the only or main cause of corruption. Therefore, it is necessary to enrich  
 27 the adverse-selection framework with a narrative driven by rules and  
 28 institutions, such as the moral-hazard conceptual framework.

29 While some individuals may be fully committed to virtue and honesty  
 30 under all conditions, posing no *ex ante* or *ex post* challenges, others may  
 31 be more strategic in their choices. In addition to moral considerations, bal-  
 32 ancing other costs and benefits may inform individual choices regarding  
 33 corrupted acts. And in fact, under certain circumstances, corruption may  
 34 entail some benefits, both at the individual and the social level.

### 36 V. TRANSACTION COSTS AND ECONOMIZING ON VIRTUE

38 To be sure, as Rotberg suggests, "an occasional corrupt act, in isola-  
 39 tion, may be efficient, but routinized corruption never is, and is always  
 40 distortive."<sup>45</sup> Regarding the latter, Klitgard says corruption only increases  
 41 uncertainty among individuals about the "likely benefits of their  
 42  
 43

44 Underkuffler, *Captured by Evil*, 223–43.

45 Rotberg, *Corruption Cure*, 30.

1 productive activities,"<sup>46</sup> creating a misallocation of valuable resources  
 2 within a society. For example, corruption can both prevent the most  
 3 efficient service providers from getting access to government contracts  
 4 and impede the entry of new contractors. Rose-Ackerman and Palifka's  
 5 empirical work links high corruption with high income inequality, also  
 6 suggesting that corruption can increase the costs of transactions and  
 7 everyday life in a society.<sup>47</sup>

8 These arguments suggest little or no social benefits of corruption. But  
 9 are there any circumstances where corruption may be beneficial for a  
 10 society? Nye hints at such circumstances: "it is probable that the costs of  
 11 corruption in less developed countries will exceed its benefits except for  
 12 top level corruption involving modern inducements and marginal devia-  
 13 tions and except for situations where corruption provides the only solu-  
 14 tion to an important obstacle to development."<sup>48</sup>

15 There is something worse than an inefficient corrupt government:  
 16 an inefficient honest one. In the latter, nothing will get done, since over-  
 17 coming bureaucratic inefficiencies—that is, obtaining permits and dealing  
 18 with cumbersome regulations—may require the use of bribes and side  
 19 payments. Leef and Huntington's research suggests that a little corruption  
 20 may improve overall efficiency,<sup>49</sup> and Marquette identifies it as a means to  
 21 solve real problems that couldn't be solved using regular methods. Scott  
 22 also suggests that corruption may be the best—if not the only—way to  
 23 gain access to necessary public services.<sup>50</sup> I would add that in several con-  
 24 texts it may be the only way to avoid real harm.

25 The so-called functionality argument suggests that "corruption provides  
 26 an understandable method of allocating scarce goods, like a birth certifi-  
 27 cate, a medical practitioner's permit, a driving license, public jobs, or even  
 28 a massive construction contract."<sup>51</sup> Under these inefficient circumstances,  
 29 the overall efficiency gains may be greater than the social costs. The con-  
 30 cept of transaction costs can be helpful in exploring this possibility.

31 When exchanging goods and services, individuals incur direct costs,  
 32 most notably the price paid for such items. There are, however, additional  
 33 costs associated with exchange. Ronald Coase developed the concept of  
 34 transaction costs to identify the costs associated with reaching agreements,  
 35

36  
 37 <sup>46</sup> Klitgaard, *Controlling Corruption*, 42.

38 <sup>47</sup> Susan Rose-Ackerman and Bonnie J. Palifka, *Corruption and Government: Causes, Conse-*  
 39 *quences, and Reform* (Cambridge: Cambridge University Press, 2016), 33.

39 <sup>48</sup> Nye, *Corruption and Political Development*, 12.

40 <sup>49</sup> Nathaniel H. Leff, "Economic Development through Bureaucratic Corruption," *American*  
 41 *Behavioral Scientist* 8, no. 3 (1964): 8–14.

42 <sup>50</sup> James C. Scott, *Comparative Political Corruption* (Englewood Cliffs, NJ: Prentice-Hall,  
 43 1972), 37.

44 <sup>51</sup> Rotberg, *Corruption Cure*, 29. Rotberg further critiques the argument by saying that "there  
 45 is no added functionality in dysfunctionality." Additionally, he correctly points out the role  
 of corruption in granting fake licenses, permits, inspections, and so on, that may pose a real  
 danger for a society. This would be a case where corruption increases transaction costs.

1 implementing the agreements, monitoring counterparties, and enforcing  
2 contracts and exchange arrangements.<sup>52</sup>

3 When buying a good or service, buyers need to search for and process  
4 information about availability, quality, and so on. When opening a new  
5 business, entrepreneurs must obtain permits and follow regulations.  
6 When negotiating a contract, terms need to be defined and assessed. And  
7 if a contract is not honored, legal processes must be followed to enforce  
8 the terms. All these are examples of transaction costs.

9 Transaction costs are extremely important. Evidence suggests they are  
10 related to a society's ability to innovate, engage in commerce, and generate  
11 prosperity.<sup>53</sup> They are important enough to influence whether deals will  
12 be made, businesses opened, and contracts properly enforced. Thus, it is  
13 important to understand what factors may increase and reduce transaction  
14 costs. North suggests institutions are the main factor driving transaction  
15 costs. He defines institutions as "the humanly devised constraints that  
16 structure political, economic and social interaction. They consist of both  
17 informal constraints. (sanctions, taboos, customs, traditions, and codes of  
18 conduct), and formal rules (constitutions, laws, property rights)."<sup>54</sup>

19 Examples of formal institutions are legislation, regulations, and codified  
20 norms. Examples of informal institutions are social norms and cultural  
21 codes. Formal rules tend to have established formal enforcement structures,  
22 often associated with coercion mechanisms controlled and exerted by col-  
23 lective bodies—that is, states. Certain mechanisms enforce informal rules  
24 as well, but these tend to be more organic and informal, often based on  
25 conventions and reputational concerns. The distinction is not neat, but it  
26 captures some interesting features of both formal and informal institutions.

27 Institutions vary across societies: for example, regulations and cultural  
28 norms affecting behavioral expectations are distinctive. But regardless of  
29 their differences, they have something in common: they affect transac-  
30 tion costs. How is this related to corruption? I argue that corruption—  
31 particularly petty corruption—may emerge as a strategy to cope with  
32 inefficient institutions.

33 In other words, if institutional quality is poor, corruption may be the way  
34 citizens both reduce transaction costs and avoid potential real harm. And  
35 while Nye, Leef, Scoot, Marquette, and others have discussed the potential  
36 social benefits of corruption beyond the individual transaction, suggesting  
37 that corruption may be beneficial in some instances, they have largely missed  
38 the connection between transaction costs, corruption, and virtue.

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40  
41 <sup>52</sup> Ronald H. Coase, "The Nature of the Firm," *Economica* 4, no. 16 (1937): 386–405.

42 <sup>53</sup> See Douglass C. North, *Transaction Costs, Institutions, and Economic Performance* (San  
43 Francisco, CA: ICS Press, 1992); Douglass C. North, "Economic Performance through Time,"  
44 *American Economic Review* 84, no. 3 (1994): 359–68; David Schmidt, "The Institution of Prop-  
erty," *Social Philosophy and Policy* 11, no. 2 (1994): 42–62.

45 <sup>54</sup> Douglass C. North, "Institutions" *Journal of Economic Perspectives* 5, no. 1 (1991): 97–112.

1 Under inefficient institutions, performing the corrupt act may be the  
2 rational response. Choosing between alternative courses of action always  
3 involves an opportunity cost. That is also true when choosing between  
4 a morally right action and a morally wrong one. Sometimes the cost-  
5 benefit assessment may lead us to choose the non-virtuous act. For  
6 example, if paying a bribe reduces significantly the transaction costs of  
7 opening a business, acting virtuously—not paying a bribe—imposes an  
8 unreasonable burden on the business owner.

9 The cost of the bribe may be well below the economic benefits. In this  
10 scenario, being corrupt is not merely a problem of character, but one of  
11 high transaction costs derived from inefficient formal institutions. There-  
12 fore, choosing between acting virtuously and not may be contingent on  
13 the institutional environment affecting transaction costs.

14 Under these conditions, depending on citizens' virtue to avoid corrup-  
15 tion may not work. If acting virtuously is one choice among many, and  
16 a costly one, what is needed are institutions that economize on virtue  
17 while reducing corruption.<sup>55</sup> By this I do not mean to suggest that virtue is  
18 something for sale in a market transaction or a necessarily scarce resource.  
19 What I mean is that rules that rely less on the existence of fully virtuous  
20 individuals to prevent corruption may be more effective than institutions  
21 that assume such virtuous individuals as the starting point. As discussed  
22 in Section III, the assumption that individuals are fully virtuous can be  
23 very problematic when thinking of the majority of people.

24 Moreover, tolerating and engaging in corruption—choosing the non-  
25 virtuous act—may be the individually efficient path in societies with  
26 poor institutions that increase transaction costs for engaging in otherwise-  
27 productive activities. Appeals to doing what is right and using moral  
28 education to induce virtuous behavior will most likely not be sufficient.  
29 Under inefficient institutions that increase the transaction costs of making  
30 mutually beneficial exchanges, corruption may even be socially acceptable,  
31 because it helps in dealing with inefficient bureaucracies and cumbersome  
32 government regulation. What seems immoral for outsiders is acceptable  
33 and efficient for those engaged in corruption.

34 Critics such as Rotberg argue that “people accept it [petty corruption]  
35 because they see no way to avoid it.” Furthermore, “the total cost to  
36 society in cash and time wasted is still significant and damaging econom-  
37 ically. The practice also undermines the very structure of trust of every  
38 society so riddled with routinized petty bribery.”<sup>56</sup> He has a valid point  
39 and presents an important word of caution. We can elaborate it by further  
40 considering the ideas of transaction costs and institutions.

41  
42  
43 <sup>55</sup> For an account of the economizing approach, see Dennis H. Robertson, “What Does the  
44 Economist Economize?” *Economic Commentaries* (1956): 148.

45 <sup>56</sup> Rotberg, *Corruption Cure*, 32.

1 While petty corruption may have some positive overall effects, these  
2 effects may not be permanent and, more importantly, most likely are not  
3 linear, as shown in Figure 1.

4 In the left-hand segment of the curve (before the inflection point), more  
5 corruption reduces the transaction costs of making individually and socially  
6 beneficial exchanges. That is the situation previously depicted: inefficient  
7 institutions are overcome by engaging in acts of corruption. Here, acting  
8 virtuously may be extremely costly. Corruption is a means to make things  
9 happen: it facilitates the process, for example, of opening a business,  
10 getting a building permit, or obtaining a professional license. This is  
11 the world described by scholars such as Leef, Huntington, and Marquette.

12 In the right-hand segment of the curve (after the inflection point), more  
13 corruption increases transaction costs. In this case, officials asking for  
14 bribes make it extremely difficult and costly for ordinary citizens to carry  
15 out everyday productive activities. When a society generally enforces  
16 functional institutions, corruption may become a net loss. Instead of facil-  
17 itating transactions and economic exchanges, corruption impedes them. It  
18 becomes a source of wasteful special privileges where the gain of one per-  
19 son is the loss of another. Here, I agree with one of Rotberg's arguments:  
20 "Societally, corruption is clearly harmful. It distorts priorities, produces  
21 manifest class and personal inequalities, impedes economic growth, and  
22 often creates direct harm."<sup>57</sup>

23 It is not obvious that corruption is always socially damaging or always  
24 a positive net force. If paying a bribe reduces the transaction costs of  
25 obtaining an important benefit or reaching a relevant goal, it is hard to  
26 refrain from paying the bribe. Moreover, transaction costs are relevant in  
27 understanding whether corruption can yield benefits beyond individual  
28 transactions, positively affecting the overall performance of a society, and  
29 at what point those potential social benefits reach a limit.

30 To explain how exactly the inflection point is affected by institutional  
31 quality goes well beyond this essay's objectives. Answering that question  
32 may be a separate research program. But the considerations presented  
33 in this section about the potential effects institutions have on transaction  
34 costs and corruption may inform policy makers in important ways.

## 36 VI. SOME POLICY GUIDELINES

37  
38 This essay's narrative develops a few insights. First, there is a differ-  
39 ence between being virtuous and acting virtuously, and being virtuous is  
40 extremely hard. Thus, assuming fully virtuous individuals as the starting  
41 point to fight corruption is problematic and potentially misleading. Second,  
42 it is not clear that corruption is always a character problem. While public  
43  
44

45 <sup>57</sup> Ibid., 41.

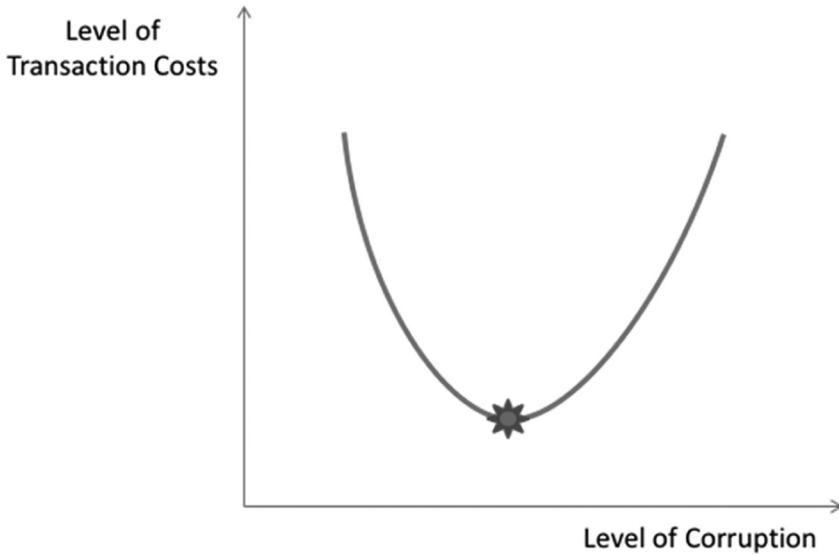


FIGURE 1. Transaction Costs and Corruption

office may attract corrupt individuals (an adverse-selection problem), an inadequate institutional incentive structure may induce the honest to act in corrupt ways (a moral-hazard problem). Third, if some forms of corruption reduce transaction costs, acting virtuously may become too costly a choice.

These insights can inform anticorruption strategies. The intention is not to provide a recipe that if followed will solve the corruption problem. The aim is more modest: to provide three general guidelines that, if followed, may increase the probability of success of anticorruption programs. I number them just for the sake of clarity, not suggesting a series of steps. And while explored separately, they are in fact complements whose success depends on the others.

(1) Doubt solutions that start with the assumption of virtuous public officers and citizens. Placing the burden of solving corruption mainly on reforming the character of those in charge is particularly problematic.

This runs counter to the main elements of policy prescriptions made by other scholars. For example, Rotberg ends his excellent book *The Corruption Cure* with a fourteen-step anticorruption program. The first step states, "The nation seeks, elects, or anoints a transformative political leader embodying the new political will; this leader will commit herself or himself to an all-out battle against corruption in and throughout her or his administration."<sup>58</sup> In his analysis, "The broad socialization of

<sup>58</sup> Ibid., 310.

1 the norm of ethical universalism is the ultimate goal of all anticorruption  
2 crusades.”<sup>59</sup>

3 While Rotberg alludes to some institutional changes, the character-  
4 based narrative dominates his program’s prescriptions, including a new  
5 anticorruption commission, auditor general, and judges, all composed of  
6 responsible individuals with skills, vision, and “implacable integrity.” It  
7 is not until step thirteen that an institutional reform is suggested—abolish  
8 and simplify regulations while reducing discretionary power—without  
9 an appeal to good character as indispensable.<sup>60</sup>

10 Now, of course strong and honest leaders would help in fighting corrup-  
11 tion. But where can we find such extraordinary individuals? As explored in  
12 Section III, placing our hope for change in the existence of virtuous individ-  
13 uals may not be for the best. In some sense, the existence of virtuous indi-  
14 viduals may be the consequence of effective anticorruption measures, not  
15 its precondition. Meanwhile, coercion to act virtuously may be necessary.

16 (2) Seek institutional changes that reduce transaction costs and oppor-  
17 tunities for abusing discretionary power.

18 As discussed in Section IV, not all individuals acting in corrupt ways  
19 do so because of poor character. Some are reacting to an inadequate  
20 existing structure that creates moral-hazard problems. Therefore, effective  
21 anticorruption programs should privilege institutional change that  
22 modifies such an incentive structure. This includes approaches seeking to  
23 reduce the economic rents of corrupt behavior, such as reducing both the  
24 range of policies that can be enforced by corrupted officials and their dis-  
25 cretionary power, and strengthening laws and enforcement mechanisms  
26 while offering better wages to public servants.

27 At the same time, we should simplify regulations and reduce transac-  
28 tion costs, particularly those related to everyday activities that impact pro-  
29 ductive exchanges among citizens, such as granting licenses and permits.  
30 If, as we explored in Section V, individuals use corruption to reduce trans-  
31 action costs, simplifying and eliminating cumbersome regulations may  
32 eliminate or at least reduce the need for bribes and side payments.

33 Now, it is important to recognize that institutional change faces its own  
34 very important challenges. For example, Pereira, Melo, and Figueiredo  
35 suggest that attempts to reduce discretionary power “can induce high  
36 officials to become even more corrupt as a means of co-opting their inner  
37 circle and ensuring their own economic well-being once they are out of  
38 office.”<sup>61</sup> Enacting more rigorous penalties and creating anticorruption  
39 structures may not be enough.

42 <sup>59</sup> Ibid., 38.

43 <sup>60</sup> Ibid., 312.

44 <sup>61</sup> Marcus André Melo, Carlos Pereira, and Carlos Mauricio Figueiredo, “Political and Insti-  
45 tutional Checks on Corruption: Explaining the Performance of Brazilian Audit Institutions,”  
*Comparative Political Studies* 42, no. 9 (2009): 1217–44.

1 In fact, if corruption is an adverse-selection problem and an attempt  
2 to reduce transaction costs, stricter laws may be counterproductive. They  
3 simply create something else to sell. This includes strategies creating anti-  
4 corruption and transparency agencies. As Rose-Ackerman suggests, the  
5 very institutions charged with creating and upholding the law tend to be  
6 the most corrupt ones: bureaucracies, legislatures, judiciary power, police  
7 corporations, and so on.<sup>62</sup>

8 If the concern is the misuse of public office, giving monitoring power  
9 to political actors could just aggravate the problem. New legislation and  
10 bureaucratic structures may create new incentives for agents that previ-  
11 ously did not have the ability to grant special privileges. Similarly, offering  
12 better salaries without pairing them with more effective monitoring and  
13 strict penalties for misbehavior may be useless. Society may end up with  
14 better-paid corrupt public servants.

15 Despite these challenges, changes in formal institutions must be pursued  
16 relentlessly as part of an effective anticorruption strategy. If, as described  
17 in Section IV, corruption has some elements of a collective-action problem,  
18 institutional change may appeal to a collective sense that corruption is  
19 ending, thus making the emergence of a credible commitment more likely.  
20 Here moral education may play an important role as well.

21 (3) Pursue a wide moral-education initiative as a complement to insti-  
22 tutional change.

23 A moral-education initiative may nurture a useful transformation  
24 in public perception, changing the belief that the only way to advance  
25 one's interest is to abuse others and to demand and offer bribes. This  
26 effort should target public officers and citizens at large. If corruption has  
27 some features of a collective-action problem, such as the ones described  
28 in Section IV, the education initiative may also help change expectations  
29 of what others will do when facing a choice between acting virtuously or  
30 corruptly. This can help craft a credible commitment to leading a society  
31 out of a suboptimal, corrupt equilibrium.

32 However, to succeed, this education program needs to do more than  
33 just promote the importance of acting virtuously on moral grounds.  
34 Appeals to doing what is right and not being corrupt may fall short if  
35 the new institutional incentive structures are not perceived as an effective  
36 change. This may hurt the legitimacy of the whole anticorruption  
37 program. In fact, Collier and Mungiu-Pippidi argue that a failed reform  
38 without effective institutional change may only create more outrage and  
39 cynicism in a society.<sup>63</sup>

42 <sup>62</sup> Susan Rose-Ackerman, *Corruption: A Study in Political Economy* (New York: Academic  
43 Press, 1978), 6–10.

44 <sup>63</sup> Paul Collier, "How to Reduce Corruption," *African Development Review* 12, no. 2 (2000):  
45 191–205; Alina Mungiu, "Corruption: Diagnosis and Treatment," *Journal of Democracy* 17,  
no. 3 (2006): 86–99.

1 Changing cultural norms and informal institutions is a hard and slow  
2 process. Education may help. A change in ideas about the effectiveness of  
3 honest behavior may impact informal institutions, including norms and  
4 beliefs. If ideas are transformed in the aftermath of effective institutional  
5 change, perhaps a virtuous circle may emerge, where citizens demand  
6 further changes. Then, even if politicians are not virtuous individuals, it  
7 would be in their interest to enact and enforce effective institutions that do  
8 not rely on corruption to reduce transaction costs.

## 9 10 VI. CONCLUSIONS

11  
12 Corruption must be studied as an interdisciplinary phenomenon. Eco-  
13 nomic, moral, and political incentives matter in understanding corruption.  
14 While total elimination of corruption may never be possible, changes that  
15 increase the overall efficiency and legitimacy of state and social institutions  
16 may have positive effects in this regard. In this sense, attempts to solve the  
17 problem of corruption are ultimately attempts to reduce transaction costs  
18 of prosperity-enhancing economic and social exchanges. The challenge in  
19 crafting effective anticorruption strategies is this: where do we start?

20 This essay's analysis suggests that if corruption is not merely a problem  
21 of bad character, assuming and placing the burden of solving it on the  
22 existence of virtuous individuals that will fight and resist the temptations  
23 of corruption may not be a good starting point. This caution likewise  
24 applies to programs mainly grounded on moral education and appeals to  
25 ethical transformations. A more effective strategy privileges institutional  
26 change, particularly a transformation of formal rules to reduce transac-  
27 tion costs associated with productive activities and to increase the costs of  
28 choosing corrupt acts.

29 Inefficient institutions—including inadequately designed or poorly imple-  
30 mented public policies—can incentivize non-virtuous action. We should  
31 favor institutions that economize on virtue in pursuing their objectives,  
32 reducing the opportunities for the vicious to profit and increasing the  
33 incentives for ordinary individuals to behave virtuously. If corruption is  
34 a way to deal with injustices—to avoid abuses of power—then offering a  
35 functional alternative to corruption is crucial to reduce it or eliminate it.  
36 But that poses an additional puzzle.

37 Where does institutional change come from? Inefficient public policies  
38 abound. Yet they do not change. Similarly, social norms that violate  
39 minorities' rights still exist without effective attempts to transform them.<sup>64</sup>  
40 And the type of corruption that increases transaction costs is rampant,

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44 <sup>64</sup> For a regrettable set of examples, see Andrzej Kulczycki and Sarah Windle, "Honor  
45 Killings in the Middle East and North Africa: A Systematic Review of the Literature," *Vio-*  
*lence Against Women* 17, no. 11 (2011): 1442–64.

1 particularly in the developing world. It seems institutional change in gen-  
2 eral is not easy to achieve, and transforming institutions prone to corrup-  
3 tion is no exception.

4 Rose-Ackerman's research shows that "corrupt rulers may seek an  
5 excessively large government as a means of extracting benefits for them-  
6 selves" or to have means to support allies by allocating jobs and other  
7 benefits.<sup>65</sup> Similarly, Tsebelis suggests that numerous veto players—  
8 actors whose agreement is needed for reform—with the capacity to exert  
9 significant pressure may prevent reform from happening, particularly if  
10 they benefit from a corrupt status quo.<sup>66</sup> If the status quo is entrenched,  
11 what makes reform more likely? Research from scholars such as North,  
12 Acemoglu, and McCloskey, among others, suggests a few likely sources  
13 of deep institutional change:<sup>67</sup>

14 First, a crisis may make the status quo unsustainable and create  
15 demands for change from powerful groups, such as the private sector,  
16 religious groups, and civil society. Crisis can trigger violent struggle,  
17 such as revolution or civil war. The problem here is that, violent or not,  
18 the direction of institutional change can go several ways, not neces-  
19 sarily transforming the status quo for the good. For example, corrup-  
20 tion scandals or the disclosure of big abuses may trigger reform, but  
21 this doesn't guarantee a positive outcome.

22 Second, it is essential that charismatic leaders emerge who understand  
23 that change is urgent, have the political will to pursue such changes, and  
24 are able to create coalitions that support such efforts. That said, as dis-  
25 cussed in this essay, relying on the existence of enlightened honest poli-  
26 ticians to solve corruption is problematic. Also, new research exploring  
27 how the character and values of political leaders impact reform processes  
28 is needed.

29 Third, we need a radical change of ideas within large segments of  
30 society. The rise of new ideas that reject an unjust and inefficient status  
31 quo, at the same time that better rules are crafted, accepted, and nurtured,  
32 may facilitate additional institutional transformations. Thus, real institu-  
33 tional change and moral education, as described in Section V, is needed.  
34 We still need a better understanding of the relative effectiveness of moral-  
35 education programs across societies.

36 The possible sources of institutional change are often intertwined.  
37 Their interactions are not always neat, and the path of change is not  
38

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40 <sup>65</sup> Rose-Ackerman and Palifka, *Corruption and Government*, 436.

41 <sup>66</sup> George Tsebelis, *Veto Players: How Political Institutions Work* (Princeton, NJ: Princeton  
42 University Press, 2002).

43 <sup>67</sup> Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge:  
44 Cambridge University Press, 1990); Daron Acemoglu and James Robinson, *The Role of Insti-  
45 tutions in Growth and Development* (World Bank Publications, 2010); Deirdre N. McCloskey,  
"It Was Ideas and Ideologies, Not Interests or Institutions, Which Changed in Northwestern  
Europe, 1600–1848," *Journal of Evolutionary Economics* 25, no. 1 (2015): 57–68.

1 easy to navigate. In overcoming these problems, character does matter—  
2 not by assuming its existence, but by nurturing its possibilities. When  
3 corruption is a disease, it may be that the cure lies not in the hands of a  
4 perfectly virtuous leader, but in the day-to-day interactions among reg-  
5 ular citizens who recognize that they can be made better-off by promoting  
6 a society with a new set of rules that privilege voluntary, productive  
7 exchanges over abuse, and where respecting such rules is the norm and  
8 not the exception.

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