

Measuring Private Sector Corruption

How can donors engage effectively with new kinds of corruption – both in their home countries and in developing and emerging economies – and why is it important to act?



by Susan Rose-Ackerman

Download this brief with full bibliography from www.U4.no/themes/private-sector

Bribery requires both a payer and a recipient. Those who make the payoffs are frequently agents of private firms, and in the standard scenario, those who receive them are public officials. However, some payoffs involve no public officials at all. As the private sector grows in importance in developing and emerging economies, many corrupt opportunities are likely to involve private firm employees as both payers and payees. Such commercial bribery is a familiar feature of corruption in developed countries. Sales agents bribe purchasing agents to get business. Head office inspectors are bribed by lower-level employees or franchisees to misrepresent the facts. Labor union leaders are paid off by management to sell out the interests of the rank and file. Other corrupt behavior occurs inside single firms and harms outside investors and the public. No payoffs change hands, but managers hide private profits from investors and hide corporate losses from outside scrutiny.

Furthermore, as the private sector begins to thrive in many developing and emerging economies, opportunities to pay off public officials are likely to increase as well. Activities that used to take place entirely inside the state are now organized in the private sector, and this frequently requires the state to sign contracts with and award concessions to private firms. New regulatory authorities are created to manage the excesses of the unregulated market, and these may be subject to outright capture or to corrupt payoffs. Although certain types of corruption will decline as the private sector grows and consolidates, other new types involving private sector firms may increase.

What Role for Donors?

These two possibilities – more commercial bribery and new types of business/government corruption – suggest that aid and development agencies should try to identify and control these pathologies to be sure that they do not undermine the benefits of private sector development. Donor funds typically come from wealthy countries with strong private sectors. Private sector corruption is a familiar feature of their societies and has been the focus of law enforcement and institutional reform. Thus, efforts to control private sector corruption at home may be exportable to emerging economies just now strengthening their private sectors. In addition, some payoffs to public officials are made by multi-nationals from the home countries of donors. Thus, donor countries should both strengthen their efforts under the OECD Anti-Bribery Convention to prosecute domestic firms involved in overseas bribery and help the development of international transparency initiatives such as the Extractive Industries Transparency Initiative (EITI).

Good policy, however, depends on good information about the level and incidence of private sector corruption. Unfortunately, the data on private sector corruption is very weak. In response to this lack, on June 18, 2007 the World Bank Institute, along with the Zicklin Center at the Wharton School and the Hills Program on Governance, organized a workshop on Corruption and the Private Sector: Research Trends, Empirical Methods, and Measurement Challenges. I chaired a session on the challenges of developing measures of private sector corruption. The discussion was lively, but it could not hide the fact that almost nothing systematic is known about corruption that occurs entirely inside the private sector. In the United States, prosecuted cases provide some examples, but purely commercial bribery is not a federal crime in the United States. Cases such as those arising from the collapse of Enron, involve insider dealing in publicly held companies but miss other types of corruption. Outside of the political area, most federal corruption cases involve labor unions, and the states vary in the strength of their laws and the vigorousness of their prosecutions. These cases can help one understand the incentives for payoffs and the mechanisms used to keep them under cover. However, they provide no data on incidence. Sometimes, however, a unique data set allows a window into a particular type of business. For example, Jens Andvig (1995) was able to document corruption in the North Sea oil industry, but such material is unlikely to emerge very often. This lack suggests that multi-lateral donor agencies should explore ways to develop information on such corruption.

Businesses' corruption of state officials and officials' extortion of payoffs from business are better documented. We know something about the industries that are particularly

vulnerable to corruption and about how pervasive corruption and state capture affect business performance. Looking inside the firm, other research sheds light on the way internal organization and personnel policies constrain or encourage corruption. I consider each of these areas in turn. A major empirical challenge, however, is finding ways to measure commercial bribery and insider malfeasance. There is little in the existing literature that can offer much guidance there, and donor agencies could lead the way in developing useful metrics.

Corruption and Business/ Government Relations

Transparency International (TI) periodically produces a bribe-payers index (BPI). The BPI responds to the criticism that the annual TI Corruption Perceptions Index (CPI) targets countries where bribes are paid and ignores the multi-national firms involved in the largest and most destructive deals. The BPI survey asked respondents to identify the home countries of firms more or less likely to pay bribes. The index has a number of methodological problems tied to the uneven distribution of firms around the world, but the 2002 version did produce a table of special interest that disaggregated the data by industry and asked which sectors were most prone to corruption. The results in table 1 confirm anecdotal evidence and theoretical speculation that construction, defense, and oil and gas are high risk sectors, but the fact that no sector receives a score above 6 on a 0 to 10 scale suggests problems in all areas. Even some Norwegian firms, based in a country near the top of the CPI honesty scale, report that in international business dealings payoffs are made and contracts lost because of others' corruption. As in the BPI, reports of corruption are higher for construction and heavy industry and for oil, gas, and power than in other areas (Søreide 2006: 393).

Other surveys questioned businesses about the prevalence of corruption, red tape, and other constraints on doing business (see Rose-Ackerman 2004). The World Business Environment Survey (WBES), carried out between the end of 1998 and the middle of 2000, covered several thousand enterprises in 80 countries (Batra, Kaufmann, and

Table 1

How likely is it that senior public officials in this country [respondent's country of residence] would demand or accept bribes, e.g. for public tenders, regulations, licensing, etc. in the following business sectors?

[The scores are mean figures from all the responses on a 0 to 10 basis where 0 represents very high perceived levels of corruption, and 10 represents zero perceived corruption]

Total sample (2002)	
Public works/construction	1.3
Arms and defense	1.9
Oil and gas	2.7
Real estate/property	3.5
Telecoms	3.7
Power generation/transmission	3.7
Mining	4.0
Transportation/storage	4.3
Pharmaceutical/medicare	4.3
Heavy manufacturing	4.5
Banking and finance	4.7
Civilian aerospace	4.9
Forestry	5.1
IT	5.1
Fishery	5.9
Light manufacturing	5.9
Agriculture	5.9

Source: Transparency International, Bribe Payers Index 2002.

Stone 2003). Figure 1 indicates that corruption is second only to financing as a constraint on business in emerging economies. However, this research does not interact firm propensities to bribe with official demands for payoffs or consider if some industries are more corruption prone than others. All we know is that it is a problem for business.

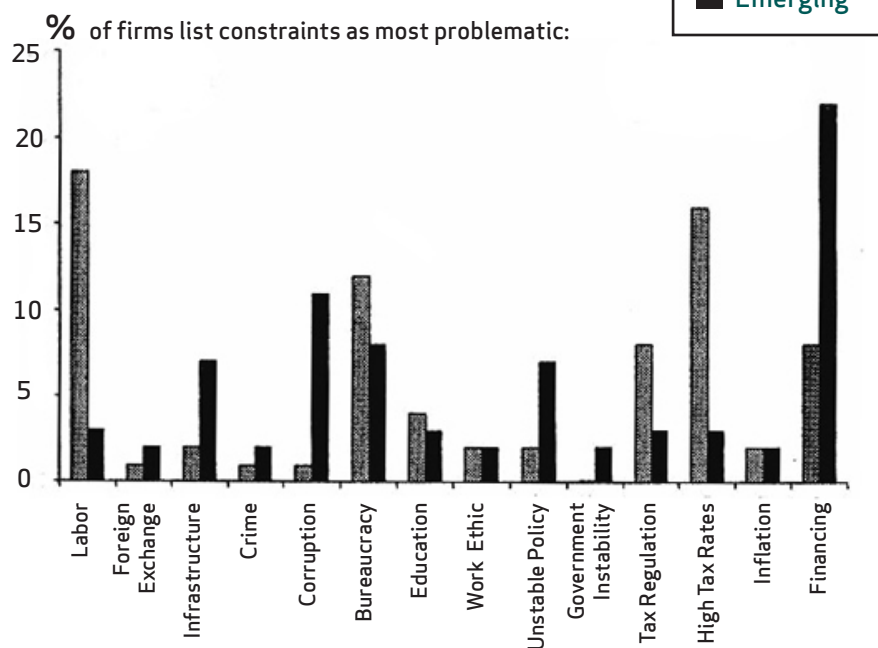
A little insight into firm specific factors comes from Svensson's (2003) survey of firms in Uganda. The level and incidence of bribery were positively associated with a firm's contact with the public sector for such matters as foreign trade, tax collection, and regulatory compliance. The level of bribes was a function both of the firms' ability to pay and of the expected cost of relocation. More corrupt firms had lower growth rates on average than others. This research suggests how corruption imposes differential costs on different types of firms and

demonstrates how it is connected to the underlying policies of the government. It implies that firms that can hide their profits can escape corrupt officials, but such firms can of course also escape legitimate tax collectors and regulators. This link between corrupt incentives and informal, off-the-books operation is highlighted in surveys of firms in Central and Eastern Europe (Hellman, Jones, and Kaufmann 2003, Hellman and Kaufmann 2004). When corrupt demands are pervasive as in Russia and Ukraine, wholly off-the-books enterprises are common, and such firms hide all of their output from the authorities (Johnson, Kaufmann, McMillan, and Woodruff 2000, Tables 1, 2). These results suggest that future research should distinguish between a firm's profitability and its bargaining power. Any study of the private sector's role in maintaining corrupt networks would need to consider the way corruption influences the very organization of businesses by inducing more off-the-books operation.

But outright payoffs are not all that matters. The World Bank distinguishes between administrative corruption and what it calls "crony capitalism" or "state capture." Country-specific research on such countries as Russia, Albania, Indonesia, and Malaysia confirms the importance of the distinction. Administrative corruption includes the use of bribery and favoritism to lower taxes, escape regulations and win low-level procurement contracts. "State capture" implies that the state itself can be characterized as largely serving the interests of a narrow group of business people and politicians, sometimes with criminal elements mixed in. Michael Johnston (2005) proposes a richer taxonomy that includes political systems that manipulate private firms for personal gain. He calls this "power chasing wealth" as opposed to "wealth chasing power." The World Bank would probably put both types in the "state capture" category, but they may have different implications.

Favored firms may not have secure legal property rights but may be able to obtain special treatment because of their insider status (Hellman, Jones, and Kaufmann 2003). This can promote economic growth, at least for a period of time. Rock and Bonnett (2004) conclude that between 1984

Figure 1
Key business environment constraints to the firm:
Emerging economies and OECD



Source: Executive Opinion Survey 2003. Kaufmann 2004.

and 1996 the large East Asian countries (China, Indonesia, Korea, Thailand, Japan) were characterized by strong centralized governments with long time horizons that were able to control corrupt networks. Rulers promoted growth by providing privileges to capitalists in return for kickbacks. These are special cases that appear to have been storing up problems for the future. The main risk is a change in the political leadership. For example, in Indonesia under President Suharto rumors about Suharto's health problems between 1995 and 1997 had a negative impact on the share prices of firms with high levels of dependency on Suharto and his family (Fisman 2001). State capture is a particularly serious problem in the countries of the former Soviet Union. The firms that do the capturing perform well, but overall economic growth suffers (Hellman, Jones, and Kaufmann 2003). Fries, Lysenko, and Polanec (2003: 31-32) document the differences between "captor" firms with insider status and "non-captor" firms. The former have higher growth rates of fixed capital, revenue, and productivity.

World Bank researchers define "crony bias" as the difference between the reported influence of one's own firm and business association, on the one hand, and the influence of those with close ties to political leaders, on the other. In a study using firm level data,

Hellman and Kaufmann (2004) find that firm managers who believe that the state is unduly influenced by a narrow set of "cronies" are more likely to withhold taxes, pay bribes, and avoid using the courts. These actions then help keep state institutions weak. Bribery and extortion are mostly a problem for medium-sized businesses. Large dominant firms have close relationships with top political leaders so that mutually beneficial deals are possible. These deals are often harmful to the overall growth and prosperity of the country and undermine efforts to establish the legitimacy and trustworthiness of the state.

In short, research on private sector corruption of the state needs to do two things. First, it needs to disaggregate the study along industry lines and consider the differences between domestic firms and those with multinational connections. Second, in comparing business/government relationships across countries, research needs to distinguish between situations where monetary payoffs are the dominant method of influence and those where connections and cronyism are dominant.

Business Organization and Corruption: Role and Responsibility

Turning now to the internal operation of large multinational firms, I consider

what we know about the ethics of business people and the way they handle conflicts between personal morality and the demands of their jobs. In previous work I argued that large multinational businesses ought to refrain from corruption as part of their obligation to the legal and political systems that permit them to organize and operate for private gain (Rose-Ackerman 2002; the discussion below draws from that publication). But this claim leaves open the question of what steps firms should take.

One simple response is a personnel policy that favors applicants with strong norms of personal morality. Such people, it is claimed, will resist corrupt demands. But personal morals are sometimes insufficient when challenged by the logic of the marketplace. Actors often face direct conflicts between profit and principle. Furthermore, some personal traits that are admired in private life work against the achievement of organizational goals, including the control of corruption. For example, modern management theory argues that business people should play a role as an employee that is not equivalent to their role as family member and friend. Thus a parent has an obligation to help his child develop into an adult but would violate his obligation as a manager if he favored his son's company in making purchases for his employer. Similarly, inside a firm, norms of friendship and group solidarity among workers may conflict with corporate profitability. Attempts to control such behavior by rewarding whistleblowers may fail because of empathy between workers (Greenberger, Miceli, and Cohen, 1987). In one survey, managers did not condemn co-workers who failed to turn in those who violated the rules (Jackson and Artola, 1997). To overcome this reluctance, top management may try to convince employees that peer reporting is part of their role. For example, in one study, students of business were more likely to report the cheating of other students after they were told that such behavior was their responsibility as members of an educational institution (Trevino and Victor, 1992).

Experimental work suggests that many individuals express strong norms of moral behavior but do not apply these norms to their behavior as the employees of for-profit firms. The search for firm profitability takes precedence over

their moral scruples. One of the pioneer studies in business ethics asked managers what they would do in response to fictitious ethical issues. When faced with an ethical dilemma, executives tended to opt for the profitable course of action if doing so would further company interests. For example, 52 percent of managers interviewed would hire someone just to obtain technological secrets, and 58 percent would bribe a foreign official in exchange for a business contract. In contrast, managers did not choose the unethical course of action if doing so hurt company interests. 86 percent of those interviewed, for example, stated that they would find padding an expense account unacceptable. In another experiment, over 70 percent of participants were willing to pay a bribe to get a sale for their firms. For many of the test subjects, ethics took second place to the fulfillment of company goals. Those willing to make payoffs were not significantly less committed to honesty and fairness in their personal lives than other participants (Baumhart 1961; see also Brenner and Molander, 1977; Vitell and Fetervand, 1987).

Nevertheless, managers are frequently influenced by personal values. A survey of actuaries and life insurance underwriters found that personal values and standards were the most important source of guidance when respondents faced ethical dilemmas (Cooper and Frank, 1992). Another study found that differences in behavior could be predicted by different values of managers. Based on survey responses, participants were classified as having primarily an "ethical" or "economic" set of values. The authors found that those who were "ethical" behaved ethically in morally ambiguous situations presented to them, while those identified as having primarily economic values based their decisions according to the impact on the bottom line (Barnett and Karson, 1987). American managers were more likely to act on the basis of their own moral codes of conduct than managers from other countries and were more likely to oppose bribery (Grunbaum, 1997; Tsalikis and LaTour, 1995; Nakano, 1997; Fritzsche, 1987; Fritzsche et al., 1995; Su and Richelieu, 1999). Behavior is often situation specific. Thus moral behavior is less likely if it imposes direct costs on the manager (Hoffman et al. 1998). The situational factors that can influence the likelihood of moral behavior range from personal costs to the size of the expected social consequences (Jones 1991).

These survey results imply that hiring "good" people is not sufficient. If the owners and top managers believe that their organization ought not to engage in unethical or illegal actions that enhance their firms' profitability, they must make their position clear rather than rely on their employees' moral scruples. Some lower-level managers, faced with a conflict between profitability and morality, will opt for profitability unless given strong signals to the contrary by owners and top managers. Others will follow personal affective ties at the expense of profitability and business ethics.

Conclusions

Donor agencies can help the development of good policy by sponsoring research that unpacks and analyzes the various types of private sector corruption. This work should build on existing experimental and survey work that focuses explicitly on firms doing business in developing countries and emerging markets and that studies foreign versus local firms and joint ventures.

It should seek to answer the following questions. Do multinational firms "solve" their ethical problems by partnering with local firms that "know the local market" and by asking few questions? Conversely, do foreign firms face greater pressures to make payoffs than local firms with good political and family connections? Do some foreign investors mistakenly assume that payoffs are necessary when, in fact, a strong public stand against them would be beneficial? Do such firms have unexploited bargaining power to resist corrupt demands than they fail to use in practice?

Moving to the business strategy of firms, what techniques do firms use to control corruption inside their own operations and which seem to work best? At the level of individual managers, how do they respond to the pressures they face and what types of incentives produce beneficial results?

Finally, returning to private-to-private corruption how can one understand the basic incentives driving such behavior? Does the profit motive of firms make it easier or harder to control corrupt payoffs than in public bureaucracies motivated by other goals and guided by civil service requirements?

None of these questions has been answered in a systematic way. Donor agencies are well-placed to sponsor research both at the industry/country level and at the individual level to trace the environment in which payoffs occur and to understand individual reactions to such demands. But research is not sufficient. Donor countries need to do more inside their own societies to work with international firms in industries that are especially vulnerable to corruption – both to encourage strong corporate codes of ethics and to enforce the OECD Anti-Bribery Convention. Furthermore, collective efforts to limit international bribery and increase the transparency of deals must be spearheaded by the home countries of multinational firms in collaboration with emerging economies where payoffs distort both procurement and regulatory policies.

Bibliography

- Andvig, Jens Christian.** 1995. "Corruption in the North Sea Oil Industry: Issues and Assessments," *Crime, Law, and Social Change* 28: 289-313.
- Barnett, J.H., and M.J. Karson.** 1987. "Personal Values and Business Decisions: An Exploratory Investigation," *Journal of Business Ethics* 6:371-382.
- Batra, Geeta, Daniel Kaufmann, and Andrew H. W. Stone.** 2003. "The Firms Speak: What the World Business Environment Survey Tells Us about Constraints on Private Sector Development," in G. Fields and G. Pfefferman, eds., *Pathways Out of Poverty: Private Firms and Economic Mobility in Developing Countries*, Amsterdam: Kluwer Academic Publishers, chapter 9. <http://www.worldbank.org/wbi/governance/pubs/firmsspeak.html>
- Baumhart, R.C.** 1961. "How Ethical are Businessmen?" *Harvard Business Review* 39:6-9.
- Brenner, S.N., and E. A. Molander.** 1997. "Is the Ethics of Business Changing?" *Harvard Business Review* 55:57-71.
- Cooper, R.W., and G. L. Frank.** 1992. "Professionals in Business: Where Do They Look for Help Dealing with Ethical Issues?" *Business & Professional Ethics Journal* 11:41-56.
- Fisman, Raymond.** 2001. "Estimating the Value of Political Connections," *American Economic Review* 91: 1095-1102.
- Fries, Steven, Tatiana Lysenko, and Saso Polanec.** 2003. *The 2002 Business Environment and Enterprise Performance Survey: Results from a Survey of 6,100 Firms*, Working Paper No. 84, European Bank for Reconstructions and Development, London, November.
- Fritzsche, D.J.** 1987. "Marketing / Business Ethics: A Review of Empirical Research," *Business and Professional Ethics Journal* 6:65-79.
- Fritzsche, D., et al.** 1995. "Exploring the Ethical Behavior of Managers: A Comparative Study of Four Countries," *Asia Pacific Journal of Management* 12:37-61.
- Greenberger, D.B, M.P. Miceli, and D. J. Cohen.** 1987. "Oppositions and Group Norms: The Reciprocal Influence of Whistle-blowers and Co-workers," *Journal of Business Ethics* 7:527-542.
- Grunbaum, L.** 1997. "Attitudes of Future Managers toward Business Ethics: A Comparison of Finnish and American Business Students," *Journal of Business Ethics* 16: 451-463.
- Hellman, Joel S., Gereint Jones, and Daniel Kaufmann.** 2003. "'Seize the State, Seize the Day': State Capture, Corruption, and Influence in Transition," *Journal of Comparative Economics* 31:751-773.
- Hellman, Joel S., and Daniel Kaufmann** 2004. "The Inequality of Influence," in János Kornai and Susan Rose-Ackerman, eds. *Building a Trustworthy State in Post-Socialist Transition*, New York: Palgrave, pp. 100-118.
- Hoffman, J., G. Couch, and B. T. Lamont.** 1998. "The Effect of Firm Profit vs. Personal Economic Well Being on the Level of Ethical Responses Given by Managers," *Journal of Business Ethics* 17:239-244.
- Jackson, T., and M. C. Artola.** 1997. "Ethical Beliefs and Management Behavior: A Cross-Cultural Comparison," *Journal of Business Ethics* 16:1163-1173.
- Johnson, Simon, Daniel Kaufmann, John McMillan, and Christopher Woodruff.** 2000. Why do firms hide? Bribes and unofficial activity after communism, *Journal of Public Economics*, 76: 495-520.
- Johnston, Michael** 2005. *Syndromes of Corruption*. Cambridge UK: Cambridge University Press.
- Jones, T.M.** 1991. "Ethical Decision Making by Individuals in Organizations: An Issue-Contingent Model," *Academy of Management Science* 16:366-395.
- Kaufmann, D.** 2004. *Governance Redux: The Empirical Challenge*, Washington DC: World Bank Institute. <http://www.worldbank.org/wbi/governance/pdf/govredux.pdf>.
- Nakano, C.** 1997. "A Survey of Japanese Managers' Views of Business Ethics," *Journal of Business Ethics* 16:1737-1751.
- Rock, Michael T., and Heidi Bonnett.** 2004. "The Comparative Politics of Corruption: Accounting for the East Asian Paradox in Empirical Studies of Corruption, Growth and Investment," *World Development* 32: 999-1017.
- Rose-Ackerman, Susan.** 1999. *Corruption and Government: Causes, Consequences and Reform*, Cambridge UK: Cambridge University Press.
- Rose-Ackerman, Susan.** 2002. "'Grand' Corruption and the Ethics of Global Business," *Journal of Banking and Finance* 26:1889-1918.
- Rose-Ackerman, Susan.** 2004. "Governance and Corruption," in Bjørn Lomborg, ed. *Global Crises, Global Solutions*, Cambridge UK: Cambridge University Press, pp. 301-344.
- Sørøide, Tina.** 2006. "Corruption in International Business Transactions: The Perspective of Norwegian Firms," in Susan Rose-Ackerman, ed. *International Handbook on the Economics of Corruption*, Cheltenham UK: E. Elgar, pp. 381-417.
- Svensson, Jakob.** 2003. "Who Must Pay Bribes and How Much? Evidence from a Cross Section of Firms," *Quarterly Journal of Economics* 118: 207-30.
- Transparency International.** 2002. Bribe Payers Index 2002, Notes and Tables. http://www.transparency.org/policy_research/surveys_indices/bpi or <http://www.asce.org/files/pdf/global/tibpi2002tablesqafinalenglish.pdf>
- Trevino, L., and B. Victor.** 1992. "Peer Reporting of Unethical Behavior: A Social Context Perspective," *Academy of Management Journal* 35:38-64.
- Tsalikis, J., and M. LaTour.** 1995. "Bribery and Extortion in International Business: Ethical Perceptions of Greeks Compared to Americans," *Journal of Business Ethics* 14:249-264.
- Vitell, S.J., and T. A. Festervand.** 1987. "Business Ethics: Conflicts, Practices and Beliefs of Industrial Executives," *Journal of Business Ethics* 6:111-122.