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Remarks on Private-to-private corruption

Jens Chr. Andvig

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Besøksadresse: Grønlandsleiret 25
Adresse: Postboks 8159 Dep.
0033 Oslo
Internett: www.nupi.no
E-post: pub@nupi.no
Fax: [+ 47] 22 17 70 15
Tel: [+ 47] 22 05 65 00

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1. Introduction

The OECD's Anti-Bribery Convention may be regarded as the strongest international expression of the recent recognition of corruption as a major global issue. The convention aims to contain trans-border corruption by making it illegal for citizens and enterprises located in the countries that have signed the convention to get involved in corrupt transactions with officials abroad. Working out the convention the legal regulation of trans-border corruption has become harmonised across countries. Given the initial success, the question has been raised whether the convention should be extended or modified in some way. New policy instruments have been proposed; greater precision in how to deal with middlemen has been urged.

In this note I will only deal with issues related to the question of whether the scope of the convention should be increased to deal with private-to-private corruption, that is, should it be forbidden to bribe private officials abroad and should the laws that pertain to the matter be harmonised across countries and made compatible with the internal laws that regulate the matters in each country? In the following I will not go into the legal questions, however, and mainly deal with rather general economic issues.

2. Public and private sectors are both composed of formal organisations

Contemplate the following definitions which cover in a reasonable way what we have in mind when regarding the economic crimes we are considering:

An act is *corrupt* if a member of an organisation uses his position, his right to make decisions, his access to information, or some other of the resources of the organisation, to the advantage of a third party and thereby receives money or other economically valuable goods or services in ways that either are illegal or against the organisation's own aims or rules. An act represents *embezzlement* if a member of an organisation uses his rights to make decisions, his access to information or some of the other resources of the organisation to his own economic advantage, eventually to the advantage of some other members of the organisation, in ways that are either illegal or against the organisation's own aims or rules.

It does not matter in the definition whether that organisation is private or public. In both cases we are dealing with basically hierarchical organisations where members have some control of decisions or information valuable to outsiders who have interests that differ from the interests of its leadership or the principles upon which the formal organisations are built. The tasks performed in the public and private organisations may, of course, frequently differ, and both the incentives of the outsiders and the social and economic consequences will, of course, often be different, but the basic structure is the same: The scope of action for members has economic value for outsiders who may be willing to buy moves in their direction. Superiors will in most cases be unable to prove the breach of contract.

It is sometimes argued that the interests of owners of private enterprises and the role of profit will give stronger incentives to control such actions than the corresponding leadership of public organisations. Corruption will, after all, more often than not hit the owners economically, either directly through the

transaction or indirectly through a decline in the expected value of the enterprise. Moreover, the typical operations in private companies may be easier to control than the typical multi-objective activities in the public sector. Moreover, it is easier to fire people on the basis of simple suspicion in a private enterprise. Nevertheless, the scope of actions valuable to outsiders is obviously wide and potentially profitable also in private organisations. It is in principle impossible to overcome the informational asymmetry that rules between an incumbent of a position and his superiors also in private hierarchies.

Working in the direction that corruption might be even more frequent in the private sector than in the public one, is the fact that a larger number of people associated with private enterprises dispose cash, which reduces the transaction costs involved in private-to-private corruption. Difficulties here contain the frequency of internal public-to-public corruption. Agents are most of the time forced to reciprocate in kind. To some extent recent changes in public administration may have increased the number of pay-out points in public administration too, and is likely to have increased internal corruption in the public sector, but the difference is likely to remain significant. The fact that enterprises are allowed to keep more information secret than public organisations in most countries in the OECD area, makes it more difficult for the media to monitor private-sector corruption. At least inside the OECD area the prevalent expert opinion is that in general lower-level corruption is more frequent in the private sector. At top leadership level the situation may be different, however.

Note also that whatever other consequences corruption may lead to, it represents a breach of loyalty both public and private organisations demand for their efficient workings. Without such loyalty the internal transaction costs may increase drastically as each member of the organisation tries to carve out his/her maximum private return.

Since many of the same conditions will have an impact on any kind of formal organisations, corruption may be expected to be a more severe and more harmful issue not only in the public administration of, but also in private companies located in the poor countries compared to the OECD-area. Hence, many of the same development issues are as relevant for international private-to-private corruption as the ones dealt with when the OECD Bribery Convention is applied also outside the OECD area. Admittedly, for the very poorest countries the private sector is so weak that trans-border private-to-private transactions are not so frequent. However, the ongoing privatisation of public enterprises in many of these countries makes an extension of the convention more urgent even for them.

Summing up, at least when considering corruption outside the leadership level, the same reasons that may make the OECD Anti-Bribery Convention helpful to contain international corruption of public officials are relevant for private officials. The difficulties in implementation are also basically the same: Corrupt acts are in most cases difficult to prove as such, since they are normally performed in a complex setting where motives cannot be deduced directly from the chosen acts and the parties involved have no incentive to reveal the crime. Tight monitoring will in most cases prove prohibitively costly since it will reveal leadership's distrust which recent economic research has shown to be extremely detrimental to performance.

Regarding the rate of occurrence of this type of corruption, Pricewaterhouse Coopers's European questionnaire (Pricewaterhouse Coopers, 2001) is suggestive: They found that while only 11% of governmental and non-profit organisations had experienced any kind of economic crime the last two years, 28% of the private companies had. True enough, most of these crimes did not involve corruption (roughly 15% did). It is also interesting to note from their Norwegian questionnaire that more than half of the economic crimes were internal to the firm.

Coming to the leadership levels, the situation of politicians versus owners/top managers of private business is so dissimilar that any anti-corruption policy may not be automatically copied. Hence, if the Anti-Bribery Convention is mainly addressing the problem of trans-border corruption of politicians, its extension to private-to-private corruption needs separate arguments. I believe this is not the case and will postpone the discussion of leadership corruption towards the end.

3. Monopolistic competition and international corruption

The OECD convention aims, of course to cover a large number of different situations which give rise to corruption. I believe, however, that there are three situations that constitute the bulk of transactions:

- 1) A private company located in country A compete in country B for selling its goods or services. To win the competition it may bribe. It may also bribe in order to pass customs, etc. It may bribe directly or through middlemen, but the leadership of the supplying firm is aware of it.
- 2) A private company with headquarters in A locates new activities in country B. Doing so it both supplies and demands goods in country B. When selling its goods and services it has the usual incentives to bribe in order to win contracts.
- 3) In order to establish itself, to gain contracts, an international company (like the local one) may try to bribe in order to get advantageous laws, government decisions, etc., to engage in what has become common to call *state capture*.

In all three situations international private enterprises are involved. In the first two trans-border private-to-private corruption is likely to be as significant as the private-to-public one. State capture is, of course, a problem that basically will be untouched by measures directed against private-to-private corruption.

The main motivation for corruption in the first two situations is derived by the system of monopolistic competition being the dominating form of competition today with large-scale production. Here the marginal cost will normally be below the market price and every producer would like to produce more – if not the price would have gone down as sales were to be increased. This is likely to happen, however. While marginal income equals marginal costs when this price adjustment is accounted for, at a given price we have a perceived excess supply. By bribing the procuring agent, the supplying firm may increase the sale by one unit without causing a general decline in the market

price. He is able to price discriminate. The buyer is, of course, unable to resell the product to the market price without losing the bribe received.

Hence, it may often be in the direct interest of most sellers to bribe, while it is not in the interest of the buying company to pay a price above the market price. That is, in this form of competition the normal procedure is for the agent of the purchasing enterprise or government organisation to receive the bribe and for the seller to pay it. When the leadership of the selling firm is unaware of the bribe, the bribe has to be shared between the selling and procuring agent. Given the fact that more economic transactions are taking place between private enterprises than between private enterprises and governments, the economic importance of this form of private-to-private corruption is higher than the private-to-public one.

Since international trade has increased at a higher rate than national trade, and foreign direct investment (FDI) in a much higher rate than private investment in most countries, the practical significance of expanding the OECD convention to cover the different forms of private-to-private corruption has increased during the recent decade and is likely to increase even further in the future.

While it may be in the interest of the single supplying firm to bribe, to the group of suppliers the aggregate of the bribes paid out represents, of course, a loss. As buyers, each single, private enterprise is losing when its purchasers are bribed. In addition to the direct economic loss, the morale of its organisation is likely to suffer. In addition to the general loss of trust in private enterprise as an economic system, private-to-private corruption represents an aggregate loss for the group of multinational companies. Hence, in addition to all the ethical arguments it makes good economic sense for the group of enterprises which the International Chamber of Commerce (ICC) represents to support the proposal that the OECD's Anti-Bribery Convention should be extended to cover private-to-private corruption.

Let us now look into some, somewhat more specific situations to gauge the role and importance of trans-border private-to-private corruption.

4. International procurement of large, costly objects and services

Enterprises in industries such as international building and construction, design and engineering normally compete through a bidding process. Here, compared to other sectors, public organisations have a fairly large share of demand. Nevertheless, even in this case most economic transactions are also taking place between private enterprises. For some objects, like ships, private-sector procurement completely dominates. These bidding processes are rather easy to influence through bribes however well-designed the bidding process may be. So far, little empirical research has been done in this area.¹

In the case of public procurement, however, the World Bank has made an interesting inroad which raises several important questions for the OECD approach. The research focuses on transition countries and may not be gene-

¹ Andvig (1996) is a brief empirical study into private-to-private corruption in the oil industry. The theoretical analysis of corruption and international procurement that is applicable to both private and public procurement have recently progressed considerably.

ralised. Put simply, it shows that multinational companies when coming to a highly corrupt area, bribe as much or even more than local firms in order to gain contracts. This result, if it may be generalised, implies that the OECD convention may potentially have strong implications for the behaviour of the OECD-located enterprises and drastically change their behaviour, if followed. A larger share of the crimes to be monitored will then be committed in the poorer countries than what would be the case if the multinational enterprises had behaved in the same way with respect to corruption as they are supposed to do in their home countries.

At this point the research throws in another result that gives ground for scepticism. As late as 1999 the American firms are among the firms with FDI in the transition area that pay the highest share of bribes to gain contracts public procurement, 22 years after the implementation of the Foreign Corrupt Practices Act. This result is supported by Transparency International's exporter's index which gives US an intermediate ranking among the main exporting countries with regard to the tendency to bribe in order to gain contracts abroad.

Are these results likely to hold also in the case of international private procurement? In the case of the purchase of large, costly objects the top management and owners of private companies are likely to be involved. When owners are in control bribes make no sense, since they dispose the profits anyway, but corruption combined with fraud schemes is an exception. Top management may, of course, if they are in charge, have incentives to receive or demand bribed similar to those of public officials. The Enron case illustrate the importance of their role, but that was basically a combination of embezzlement and fraud, not corruption.

Studies from the oil industry show that manipulation of the technical aspects of the bidding process may give considerable scope and incentives for the bribing of a large number of executives involved even when the bidding process is organised by the private industry. Although the bidding process in most cases and for most oil companies is organised according to best practice rules, the most common procedure for bribing in the bidding process is so common that it has received a separate name, 'uplift'. Information brokers buy bid-information illegally, that is they bribe members of the project administration, and sell that bid information to the lowest bidder. Knowing the second lowest bid, the lowest bidder is able to lift his bid close to the second lowest bid, that is, to do an 'uplift'. Illegal bid information acquired through bribes could also be put to other uses, often more harmful to both competitors in supply, and to the oil companies themselves (Andvig, 1996)..

Some of the oil companies most concerned with their honesty trademarks considered the activities of illegal information brokering and plain, less organised forms of corruption so harmful that they established a joint security office dealing with the matter in the mid 1990s.

5. Industrial espionage and private-to-private corruption

Industrial espionage is another phenomenon that has received increased attention recently. It may be one of the main motives for corruption in a bidding process.

One of the major reason why private enterprises may earn substantial profits in the longer run, is their ability to legally protect key aspects of their production processes, their trademarks or design. Exceptional successful ones are likely to be copied or stolen. In order to gain access to such information competitors are willing to make large efforts. Some of them are illegal. Private-to-private corruption frequently occur in this context. Straight stealing of the information will often imply bribing of some of the employees. To hire key employees which possess the scarce information and pay them above market rate, may be a borderline case of corruption. It certainly involves embezzlement. If an employee quits and start on his own copying his former employer is more like pure embezzlement.

Great national interests may be involved in industrial espionage, and the private-to-private corruption that arises in this context may prove in practice to be one where international cooperation may prove to be the most difficult.

6. Private-to-private corruption in banking and insurance

Normally the focus on the discussion of international banking sector and corruption, is due to its role in facilitating large-scale private-to-public corruption; how easily the proceeds from that corruption may be collected and transferred to the bribee, that is, the role of money-laundering for corruption. However, ordinary corruption targeted towards international private banking is an issue of its own that may become even more important as stricter implementation of anti-money-laundering policies is likely to give rise to more corruption of this kind in international banking.

Note that corruption in the banking sector is different from what is the case in most other private sectors. It may in some ways be compared to ordinary corruption in the old socialist economies. There excess demand ruled, so it was the demander of a good that might be willing to bribe to get access to a good, not the supplier, as is the rule in the present international market economy. In the same way it is the demander of a bank's services that may in most circumstances be willing to bribe to get access to its resources, not the bank paying a customer to accept its services.

In the old banking system, as it operated in most market economies some years ago, when interest rates were held below their market values, one got even a straight excess demand situation. In principle ordinary borrowers had incentives to bribe in order to get the loans they were entitled to without fiddling with security information. Most of the customers would be private enterprises or private persons and most banks were private, so in form this would be private-to-private corruption. However, since most banking systems were national, these systems probably didn't give rise to much private-to-private international corruption, however.

Even in systems with market-determined interest rates, banks need to ration their loans, however, since otherwise one may pay back old loans by new ones ad infinitum. So the motive to bribe to get a loan may still be there, but the main reason for bribing is now to receive a loan one is not entitled to. The motives in this case for bribing bank employees will stretch from lack of sufficient security to large-scale, pure fraud operations. These are more easy to implement in an internationally open environment. The fraud schemes may, of

course, vary in nature and the financial instruments may be much more complex than simple loans.

Another incentive for bribing banks or bank employees is to be allowed to deposit money which is illegally acquired, when that itself has become illegal, that is after anti-money-laundering policies are introduced. When the banks' leadership allow such depositing and it is legal, no bribes are, of course, necessary. As the international anti-money-laundering policies become more strictly applied, it may prove necessary for the owner of accounts with a history of illegality to try to keep the origin secret also for the bank leadership, and bribe subordinate bank officials in order to keep it so. Such bribe operations are most easily done if so-called 'private banking' is still allowed since here one employee has long-term, multiple relations to a single, rich client.

Also in the case of insurance, the corruption to be observed is likely to be combined by fraud operations. It is obvious that almost all corruption in banking and insurance has to be private-to-private, much of it of trans-border kind, hence to be covered by the possible extension of the OECD convention. While the social and economic consequences of the private-to-private corruption targeted to the international financial industry is exceptionally serious, the legal need for it may be less than in other cases, since trans-border corruption in this case is likely to be combined by other forms of international economic crime.

7. Present trends in public management will make former public corruption private

Another reason for considering an extension of the OECD to cover trans-border private-to-private corruption is the present institutional trend towards privatisation, the wider scope of publicly financed international NGOs, and the new public management where it is not always clear whether a given organisation is public or private.

The trend towards privatising of the health sector may prove to be the most important one. It is well known that parts of the pharmaceuticals and medical supply industries constitute the group of private enterprises that most frequently apply bribing in their sales strategies which also is also are extremely international in scope. It is no reason to expect these industries to change their behaviour if a customer changes from being a public to becoming a private hospital. Neither are there reasons to expect that the potential harmful consequences will become less severe.

8. Monitoring issues which arises in the monitoring of private-to-private corruption

The fact that North Sea-located oil industry created a common organisation to deal with corruption in their procurement shows the need for international monitoring of private-to-private corruption. That the cooperation between the involved security offices has proved difficult to sustain, may indicate a need for private initiatives for coordinating monitoring across multinational enterprises to be complemented by similar coordination of public monitoring across countries.

Special monitoring issues arise because of private enterprises' economic incentives in keeping corruption secret and their ability to do so. Unlike many public organisations, private enterprises are given greater scope for keeping aspects of their organisations secret. Public exposure of a corruption case will often harm both the enterprise that bribes, or allows an employee to bribe, and the enterprise that employs the person bribed. Both the bribing and the bribed organisations expose a weakness that may harm their economic trademark value. Hence, they are often likely to want covered up their bribing and will try to avoid it being brought to court. Even to ask the economic police for assistance in clearing up a case may create risks for negative publicity. Publicity is inherent in any application of the OECD convention. It is, however, in most cases in the long-run interest of the enterprises to go public in such cases. Moreover, publicity without any legal possibility of punishing the offenders, which an extension of the OECD convention widens the scope for, is clearly even more harmful, also in the short run. Nevertheless such legal development is unlikely to change the nature of the publicity game. It will remain a n-person prisoners' dilemma type of game.

Positive informational spillovers exist in the monitoring of public and private corruption cases, since the suppliers of bribes will often be the same organisations given their high concentration into special sectors such as international construction and pharmaceuticals. Obtaining a larger sample of provable, likely and possible corruption cases from the same industry increases the probability that the monitoring agencies will be able to gain better insight into the criminal action patterns and persons involved.

A central issue in the monitoring of both private-to-public and private-to-private corruption is that the probability of being caught is likely to remain so low that any legal punishment measure will have only weak effects on the economic calculations of the offenders. The key measures, if any exist, are likely to be rather indirect: Changing attitudes and norms developed in business, law and engineering schools, reducing the strength of the social drive in getting rich, strengthening norms of loyalty towards private and public organisations, etc. But attitudes and norms are difficult if not impossible to create by direct policy measures. They have to develop in more spontaneous ways.

So, despite their circumscribed role, the most important public policy instruments remain the legal and public monitoring systems. The key to improvement in the public containment of international corruption (private and public), I believe, is cooperation between the various countries' economic police and the multinational companies' security people. The economic police will need to focus on a small number of key branches and to do active monitoring there. More important than the actual cases brought to court is that such a way of organising anti-bribery work may lead the agents to perceive that they are being watched by competent monitors, and therefore less frequently choose taking the risk of engaging in corrupt transactions. To rely on random whistle-blowing is likely to be less efficient in affecting behaviour, even if an equal or higher number of court cases per employee in the economic police may be the result.

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