

## ON THE CONTINGENT VICE OF CORRUPTION\*

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*Abstract: This essay develops a notion of “functional corruption,” adapted from sociology, to note that the harm of corruption appears to be contingent. In a system of dysfunctional institutions, corruption can improve the efficiency and speed of allocative mechanisms of the bureaucracy, possibly quite substantially. The problem is that this “short run” benefit locks in the long run harm of corruption by making institutions much more difficult to reform. In particular, a nation with bad institutions but without bureaucracy may be much more open to reform than a nation with similarly bad institutions but with “efficiently corrupt” bureaucrats. The idea of a “long run” is developed using the North, Wallis, and Weingast conception of open access orders. Corrupt systems are likely to be locked into closed access orders indefinitely, even though everyone knows there are better institutions available.*

KEY WORDS: Corruption, development, morality, political economy, violence

*While corruption usually meets with disapproval, it may have some redeeming features. It may make possible smaller or no salary payments to officials who, if carefully supervised, will still carry out their functions on a fee-for-service basis. The purchase of government jobs usually is thought to be corrupt, but in some cases, it has worked out quite well.<sup>1</sup>*

### I. INTRODUCTION

Is corruption bad? Is it immoral? Why? Is it enough that, in Tullock's words in the quote above, it has sometimes “worked out quite well”? That could never satisfy the ideal theorist, of course, but in practical terms attempts to reform corruption are likely to produce gains that are tiny or nonexistent. In a political world where improvements to the status quo are privileged as policy “solutions,” corruption may be a stable and self-perpetuating phenomenon.

The thesis of this essay is that corrupt acts by individuals in corrupt systems are morally permissible in the “short run,” but harmful to the

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<sup>1</sup> Gordon Tullock, “Corruption Theory and Practice,” *Contemporary Economic Policy* 14, no. 3 (1996): 6.

society, including the individual herself, in the “long run.” The differences between the immediate and more lasting effects of corrupt acts have to do not so much with time, but with the effect on expectations and social norms—once expectations about the benefits of corruption are “locked in.” This tension is a problem for the idea of “moral permissibility,” of course, because morality is not expected to be contingent in this way. To solve the tension, I introduce the concept of “lock-in,” used commonly in the institutional economics literature but much less commonly in philosophy, and show that the problem is quite similar to the conclusions reached, using a different approach, by Gerald Gaus when he says “it can’t be rational choice all the way down.”<sup>2</sup>

### A. *Some preliminaries*

The etymology of the word suggests why corruption has a negative connotation.<sup>3</sup> The origins connect with “corruptus,” the irregular past participle of the verb *corrumpere*, which literally means “to destroy, or spoil.” Figuratively, the Latin word meant to “seduce or bribe,” in an uncouth manner.

But is corruption always morally wrong? Is it ever morally permissible, or possibly obligatory? I try to answer these questions in this essay, using these theses:

1. Systemic corruption is always vicious, but *individuals* in a corrupt system may be morally permitted to choose corrupt acts. In fact, the *explanation* for the viciousness of corrupt systems is precisely that they make individual corruption reasonable. People who refuse to participate in the system appear unreasonable, and suffer harms such as the inability to run a business or buy a home. Corrupt acts in a corrupt system aren’t necessarily vicious, in the “short run.”
2. Corrupt acts are never morally permissible for individuals operating in ethically honorable systems. So while corruption may be reasonable in corrupt systems, corrupting an honest system is vicious.
3. The problem with permitting individuals to act in a corrupt manner is that it locks in the corrupt system, by creating rents for corrupt officials. The result extends the stability of what North, Wallis, and Weingast call “closed access orders.” What this means is that corruption is always vicious in the “long run.”<sup>4</sup>

<sup>2</sup> Gerald Gaus, “It Can’t Be Rational Choice All the Way Down: Comprehensive Hobbesianism and the Origins of the Moral Order,” in *Tensions in the Political Economy Project of James M. Buchanan*, ed. Peter J. Boettke, Virgil Henry Storr, and Solomon Stein (Arlington, VA: Mercatus Center, 2018).

<sup>3</sup> Online Etymology Dictionary, <http://www.etymonline.com/index.php?term=corrupt>

<sup>4</sup> Douglass North, John Wallis, and Barry Weingast, *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History* (New York: Cambridge University Press, 2009). The conclusions offered here do point in a pessimistic direction: to paraphrase Keynes, then, “In the long run, we are all corrupt.”

This distinction between “short run” and “long run” is common in economics, but requires explanation here. In economics, the “long run” is the shortest time period where all production inputs are variable, meaning that plant size or other physical constraints on capacity can be modified. If at least one factor is fixed, that is a “short run” situation. For present purposes, if the individual can take the system as given, and if no individual acting alone can change norms, that’s the “short run” and even a moral person might have reason to act corruptly. But in the “long run” all norms are variable, at least potentially, and so corruption is vicious.

The simplest version of the claim I want to argue is that, in a pathological economic and political system, corruption is the lubricant for social intercourse. Of course, such social intercourse may be furtive, and seem tawdry to an outsider. But it may be the only way to coordinate activity. Examples come readily to mind: in a traditional caste system, there are enormous costs in foregone productivity, as when a Dalit or Shudras woman with great talent is prevented from attending university to become an engineer. Provisions might be made to work around the imperatives of the caste restrictions, but only by corrupting the system itself.<sup>5</sup>

Alternatively, in a creaky system of state-owned enterprises or highly protected private monopolies, the costs of honesty are likely the death of a business and the firing of its employees.

The pressures for companies dealing with the government to succeed, even to survive, can generally be seen as leading to various types of informal, often illegal, means of political power, designed to provide more assured access (and favorable outcome) to otherwise difficult-to-obtain (illegal?) goods and services. In this sense, the Philippine expression *lagay* (“speed money”) or the Indian phrase *khilana para* (“feed him”)—both meaning corruption—ring true: money or some other means of influence [expedites] an otherwise lethargic regulatory or political decision (or alter[s] a negative decision) to particularly preferred ends.<sup>6</sup>

<sup>5</sup> The difficulties faced by Dalit women, even those who win entrance to universities, are discussed in Samson Ovichegan, “‘Being a Dalit Female’: Exploring the Experiences of students at one elite Indian university,” Centre for Public Policy Research Working Papers Series, Paper No: 7, King’s College London (2017). Alternatively, of course, it is possible to argue that the caste system itself is a corruption of society, because it confers unearned privilege on some groups at the expense of others. Consider—as a simplified example—a system where it is morally permissible for some groups to “jump” a queue (as in the American south under “Jim Crow,” where “white seats” in the front of the bus might be empty, but “black seats” were full, so African-Americans had to stand). This system, like any caste system, is corrupt but not surreptitious, raising questions about the definitions given by the Ceva essay in this volume.

<sup>6</sup> Peter DeLeon, *Thinking About Political Corruption* (New York: Routledge, 2015), 29. Interestingly, Elijah Millgram made a suggestion that is speculative, but bears directly on the claim made in this essay. I am arguing that, in the short run at least, paying “speed money” is not only permissible but actually obligatory for functioning in the society. Millgram wondered

The consequence is that the “salary” of many public officials is actually negative. A passage from a recent *New York Times* article on illegal “sand-mining” in India is worth quoting at length:

Criminality and graft have come to be seen as such incontrovertible facts of life in India that, in my experience, people seldom mind discussing them openly. [Real estate agent Girish Kasana] brought a particularly well-informed perspective on the realities of how Indian cities are built. “Everything is corrupt,” he said.

Construction is the business where criminals have the best opportunities to launder the most money, he explained, and a cascade of bribes go [sic] “to the topmost levels in the government.” . . . To get a typical government construction commission, he explained, you pay 6 percent in bribes up front. Then, after the first payment, you pay another 7 percent, half of which goes to the state’s top politicians. The development authority’s junior engineer gets 3 percent. The associate engineer gets 1.5 percent. The senior manager gets 3 percent, and so on—until the total reached an astonishing 30 percent. “When this is given, then almost anyone can be managed,” Kasana said. “This is the system. This is India.”

“The thing to do is to get a job in the authority,” my translator joked. “This can also be done,” Kasana said. To get a job as a junior engineer, he said, requires a bribe of 10 million rupees.<sup>7</sup>

There are two parts of this passage that are useful for the purpose of illustrating my claim in this essay. The first is that “almost anything can be managed.” In a system notorious for being slow, inefficient, and deadly to entrepreneurship, corruption actually enables quick action. If you have a good idea and financial backing, you can build apartments, create new factories, or set up a new business. The system is terrible,

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if perhaps this might be the origin of practices such as “tipping,” which is (probably apocryphally) claimed to have originated as a payment “to ensure promptness.” Waiters in Europe and Australia do not expect “tips,” and may find small tips insulting, since it implies that the only reason the service was provided was for a relatively small amount of money rather than professionalism. I would want to make two observations in this regard: First, professionalism is not a very good inducement, it would appear, in Germany and Central Europe at least, because the service is usually terrible by American standards. Second, I have never seen a waiter pretend to be insulted by a large tip. Perhaps the implication that one can “buy” favoritism for a *large* payment is not insulting?

<sup>7</sup> Rollo Romig, “How to Steal a River: To Feed an Enormous Building Boom, India’s Relentless Sand Miners Have Devastated the Waterways That Make Life There Possible,” *New York Times*, March 1, 2017. <https://www.nytimes.com/2017/03/01/magazine/sand-mining-india-how-to-steal-a-river.html>

but corruption makes it function much less inefficiently than would otherwise be the case.<sup>8</sup>

The second point is that the rewards (for example, the benefits of occupying an official place in the system) lock in inefficient institutions.<sup>9</sup> Having discretion to award a permit, or to sign an inspection form, means that enormous rents are created, and capitalized in the “price” of jobs. A junior engineer who bought an “asset” expects that asset to be protected by the government, and will fight to see it protected. The fact that this asset is a revenue-producing job, holding up entrepreneurs for payment makes it no less valuable in the Indian system. But then any attempt to rationalize the system will be met with bitter reactions from those who benefit from the existing system, and who would not profit enough from a rational, legal system to make up the difference.

India, and many systems with “bad” political and economic institutions, have what North, Wallis, and Weingast called a “closed access order.” A transition to an open access order, where the state fosters permissionless innovation in a way that results in rapid economic expansion, benefits the entire society in the sense that it creates a much larger total GDP and higher average income. But the transition robs the rent-owners in the closed access order of the value of their (corrupt, *de facto*, and sometimes even *de jure*) “right” to sell access. As North, Wallis, and Weingast put it:

If the constellation of economic interests regularly changes because of innovation and entry, politicians face a fundamentally different world than those in a natural state: open access orders cannot manipulate interests in the same way as natural states do. Too much behavior and formation of interests take place beyond the state’s control. Politicians in both natural states and open access orders want to create rents. Rent-creation at once rewards their supporters and binds their constituents to support them. Because, however, open access orders enable any citizen to form an organization for a wide variety of purposes, rents created by either the political process or economic innovation attract competitors in the form of new organizations. In Schumpeterian terms, political entrepreneurs put together new organizations to compete for the rents and, in so doing, reduce existing rents and struggle to create new ones. As a result, creative destruction reigns

<sup>8</sup> The question of whether rent-seeking can be “efficient” is contentious. Tullock raises the question (Gordon Tullock, “Efficient Rent-Seeking,” in J. Buchanan, R. Tollison, and G. Tullock, eds., *Towards a Theory of the Rent-Seeking Society* [College Station: Texas A&M University Press, 1980]) quite clearly, but things have gotten murkier since. In fact, Tullock later (Gordon Tullock, “Back to the Bog,” *Public Choice* 46 [1985]: 259) notes that the “the market doesn’t clear, even with free entry and competition.” See also Michael Munger, “Tullock and the Welfare Costs of Corruption: There is a ‘Political Coase Theorem,’” *Public Choice* 181, nos. 1–2 (2019): 83–100.

<sup>9</sup> Though it is common in the economic history literature to call this “lock-in,” a more appropriate reference might be Gordon Tullock’s “transitional gains trap.” Gordon Tullock, “The Transitional Gains Trap,” *Bell Journal of Economics* 6, no. 2 (1975): 671–78.

in open access politics just as it does in open access economies. Much of the creation of new interests is beyond the control of the state. The creation of new interests and the generation of new sources of rents occur continuously in open access orders.<sup>10</sup>

This means that inefficient, closed access orders are “locked-in,” because rent owners cannot credibly be promised anything close to the present value of the stream of rents they enjoy under the existing system.<sup>11</sup> It is difficult to “buy out” these rents for three separate reasons: (1) it is perceived that such payments, which might be large, are unjust or simply too expensive. (2) Current rent-owners have no reason to expect that the promise to pay or compensate is credible. Once power is redistributed and a new system implemented it is unlikely that the compensation will actually be carried out. (3) Finally, no one has enough information to know for sure if the proposed “superior” arrangements will actually be better. What Douglass North calls the “feedback” condition for rational political choices is never satisfied.<sup>12</sup>

It is useful to offer a definition of “corruption,” to fix ideas. I will depart from the typical economists’ definition (e.g., Schleifer and Vishny), which rests on “the sale by government officials of government property for private gain.” Instead, I will use the definition offered by T. S. Aidt, building on J. G. Lambsdorff:

[Corruption is] a special *means* by which private agents may seek to pursue their interest in competition for preferential treatment by government officials or politicians and where the “means” are valued by the recipient. The primary example of a “special means” is a bribe—a monetary payment in return for preferential treatment. The use of personal contacts (favouritism) according to the principle “you help me and I will help you” is another example.<sup>13</sup>

<sup>10</sup> North, Wallis, Weingast, *Violence and Social Orders*, 71.

<sup>11</sup> For a general account, and history, of the notion of “lock-in” see W. Brian Arthur, “Competing Technologies, Increasing Returns, and Lock-In by Historical Events,” *Economic Journal* 99 (1989): 116–31.

<sup>12</sup> As Douglass C. North (“Economic Performance Through Time,” *American Economic Review* 84, no. 3 [1994]: 360–62) describes “lock in”:

Why do economies once on a path of growth or stagnation tend to persist? Pioneering work on this subject is beginning to give us insights into the sources of path dependence. But there is much that we still do not know. The rationality assumption of neo-classical theory would suggest that political entrepreneurs of stagnating economies could simply alter the rules and change the direction of failed economies. It is not that rulers have been unaware of poor performance. Rather the difficulty of turning economies around is a function of the nature of political markets and, underlying that, the belief systems of the actors. The long decline of Spain, for example, from the glories of the Habsburg Empire of the sixteenth century to its sorry state under Franco in the twentieth century was characterized by endless self-appraisals and frequently bizarre proposed solutions.

<sup>13</sup> T. S. Aidt, “Rent-Seeking and the Economics of Corruption,” *Constitutional Political Economy* 27 (2016): 142–57; quoted material is from p. 143. The older source is J. G. Lambsdorff, “Corruption and Rent Seeking,” *Public Choice* 113 (2002): 97–125.

The useful thing about this definition is that it focuses on the particular means or pathway through which competition is filtered by institutions.<sup>14</sup> In brief, in this essay I want to argue that in a closed-access order, corruption is the only way to get things done; permissionless innovation, creative destruction, and innovation are all largely precluded. But this means that, in a closed access order, corruption can be good, in the short run, sometimes. Closed access orders create rent streams that come to be seen as entitlements, and these depend on corruption continuing, which blocks transition to a more rational and productive set of institutions. So corruption is bad in the long run, always.

## II. CORRUPTION IN “BAD” SYSTEMS: FUNCTIONAL CORRUPTION

We generally disapprove of corrupt acts. In fact, it appears that we have innate, and in fact evolved, brain architectures that nearly force us to react angrily to seeing others violate social norms.<sup>15</sup> However, there may be several moral considerations operating at once, and things that are objectively “corrupt” if no one does them may be perfectly socially acceptable in a context where, as the saying goes, “everyone does it.”<sup>16</sup> That doesn’t mean that there is no such thing as morality, but it may imply that our reaction to corruption is deeply contextual.

Further, it may be easy—because humans are clever, and in fact this cleverness is likely also evolutionarily adaptive—at coming up with facile justifications for why, though an action might generally be unacceptable, in this case it is pragmatically allowed, and perhaps even conditionally morally permissible.<sup>17</sup>

There are many acts that we might think of as corrupt, or almost corrupt. When I was in college I had a job as a night manager of a “Burger Chef,” a downscale fast food restaurant in Winter Garden, Florida.<sup>18</sup> A city cop would sometimes come by at about 10:30, when we were counting up

<sup>14</sup> Of course, the “special” part of this choice of means has no positive, and may have a negative, meaning. As David Schmitz, “Corruption,” in S. Rangan, ed., *Performance and Progress* (New York: Oxford University Press, 2015), 490–564, argues, the very commodification of policy and desensitization to improper means that corruption causes is corrosive to moral norms that arose in a setting where these activities were not commodified.

<sup>15</sup> For some of the brain science on this reaction and its implications see Jonathan Haidt, “The New Synthesis in Moral Psychology,” *Science* 316 (2007): 998–1002.

<sup>16</sup> James Dungan, Adam Waytz, and Liane Young, “Corruption in the Context of Moral Trade-offs,” *Journal of Interdisciplinary Economics* 26 (2014): 97–118.

<sup>17</sup> On the human capacity to fabricate contingencies see Dan Ariely, *The Honest Truth about Dishonesty: How We Lie to Everyone—Especially Ourselves* (New York: HarperCollins, 2013).

<sup>18</sup> Burger Chef’s claim to fame is that they invented the “Happy Meal” now so popular at McDonalds restaurants around the world. At Burger Chef, it was called a “Fun Meal” (introduced in 1972) and it had a Funburger, fries, a drink, a cookie, and a prize. McDonalds didn’t introduce their own version until 1979. Burger Chef sued, but the concept was not specific enough to sustain a copyright infringement action. I would guess that I have assembled more than 10,000 Fun Meal boxes in my life.



receipts from the night in preparation to close. The cop could have been all sorts of places, but he came by Burger Chef. I had the front staff make sure to give him a big greeting, and to have a fresh pot of coffee ready to give him a cup, along with a fried apple pie. At first we didn't let him pay when he pulled out his wallet; later, he stopped even offering.

The policeman would show up apparently randomly, different nights of the week, but always just before closing time when we were counting money in the back. Once when the owner of the store was in late and saw our little ceremony he waited until the cop had left and then called me into his office. I could see he was furious.

But not the way you might think. The owner said, barely avoiding yelling: "If a cop comes in just before closing time, you give him a g\*\*\*\*\*n fish sandwich and fries, *plus* a coffee and a pie!" The owner had several stores in not very nice areas, and having a police car parked out front near closing time on random nights, but fairly frequently, was cheap insurance.

Was it corrupt? I think most people not in that situation would say yes.<sup>19</sup> The policeman should have paid, and we should not have offered. As DeLeon put it:<sup>20</sup>

For the owner of a diner to give a free lunch to a cop on the beat could easily be construed as low-level bribery, but it might just as justifiably be viewed as a form of direct taxation to pay for a retainer, services rendered, or maybe little more than a tip for overtime; similarly, a bribe might be considered a user's fee for overcoming bureaucratic bottlenecks. No harm, no foul.

Robert K. Merton blamed corruption on the culturally corrosive influence of wealth:<sup>21</sup>

Fraud, corruption, vice, crime, in short, the entire catalogue of proscribed behavior, becomes increasingly common when the emphasis on the culturally induced success-goal becomes divorced from a coordinated institutional emphasis. This observation is of crucial theoretical importance in examining the doctrine that antisocial behavior

<sup>19</sup> A number of news accounts claim that Tim Horton's, the coffee and doughnut shop in Canada and several northeastern U.S. states, had an open policy of giving police free food and coffee. But when police investigated embezzlement charges against a cashier, she claimed that the police were biased by having received the free stuff. It is a corrupt, or at least corrupting, practice. Hayley Mick, "Officers' Free Coffee Led to Raw Deal, Suit Says," *Globe and Mail*, April 18, 2006. <https://www.theglobeandmail.com/news/national/officers-free-coffee-led-to-raw-deal-suit-says/article1098092/>. This "Reddit" discussion from Guelph, a bedroom community 25 kilometers outside Toronto, describes the practice as being routine, even expected, but not mandatory. [https://www.reddit.com/r/Guelph/comments/18w0wb/anyone\\_work\\_at\\_tim\\_hortons/](https://www.reddit.com/r/Guelph/comments/18w0wb/anyone_work_at_tim_hortons/)

<sup>20</sup> DeLeon, *Thinking about Political Corruption*, 31.

<sup>21</sup> Robert K. Merton, "Social Structure and Anomie," *American Sociological Review* 3 (1938): 676.



most frequently derives from biological drives breaking through the restraints imposed by society. The difference is one between a strictly utilitarian interpretation which conceives man's ends as random and an analysis which finds these ends deriving from the basic values of the culture.

Thus, there are individual goals that can be constrained by formal rules, but "society" can also construct and perpetuate what are essentially soft, moral constraints that people still perceive as binding.<sup>22</sup> If these moral norms are transgressed, society has considerable resources—shame imposed by peers, guilt felt by violators, shunning, and so on—to enforce these "other" rules.

But what if society's other rules sharply constrain economic activity? What if it is perceived that the government and its officials are themselves acting in ways that raise obstacles to business and obtaining the necessities of everyday life. Merton argues that in this circumstance corruption can be "functional," meaning that society may simply look the other way rather than sanctioning transgressions, because everybody knows, citizen and official alike, that corruption makes the system work better?

Johnston also notes the benefits of functional corruption in dysfunctional systems:<sup>23</sup>

Corruption . . . was a way for elites to build their political backing in society and to win cooperation in both parliaments and bureaucracies, a way for entrepreneurs and investors to break through bureaucratic bottlenecks, an informal price system in tightly regulated economies, and a cushion against the worst social dislocations of development.

Thus, in a socialist or primitive command system, corruption actually creates a space where the price mechanism can function. The size of this "grey" or "black" market can be allowed to grow or shrink as the needs of the society change, creating wealth for many participants and allowing citizens to obtain food, clothing and other necessities in a way the forestalls actual revolution while preserving the formal powers of the state apparatus.

Johnston goes so far as to spell out a set of sufficient (though not necessary) conditions under which Merton's "functional corruption" will occur.<sup>24</sup>

<sup>22</sup> *Ibid.*, 678–80; see also, Robert K. Merton, *Social Theory and Social Structure*, (Glencoe, IL: Free Press, 1949).

<sup>23</sup> Michael Johnston, *Syndromes of Corruption* (New York: Cambridge University Press, 2005), 23.

<sup>24</sup> *Ibid.*, 135–36.

- First, the “fruits” of government action, or the costs of inaction, must be sufficiently large that there is excess demand for these services. Thus, there must be some reason to want new telephones, to build new factories or apartment buildings, or to need permits to engage in some economic activity. This means that the state needs considerable “capacity,” in the sense that it can enforce sanctions that would otherwise prevent economic activity, and that it can deliver services (roads, electricity, telephone connections) when mobilized to do so.
- Second, these benefits or escape from these sanctions can only be obtained by “dealing” directly with the government. Organized mafias that act as intermediaries can either replace, or thwart, the development of functional corruption. Thus, the state is obliged to secure its Weberian role as the monopoly provider of security and the sole legitimate user of violence and force. This is another kind of state capacity, and it represents a stable alternative to the development path of seeking to negotiate an “open access order,” as we will later see.
- The “routine process” by which needed benefits are created, recognized, or conferred is time-consuming, inconvenient, expensive, and possibly uncertain. Alternatively, sanctions are arbitrary and devastating. These conditions may be endogenous, of course, to create a maximal difference between those who “pay to play” and those who try to avoid paying bribes or speed money.

Calling these sufficient conditions means that corruption *will* (not *can*) emerge. In such systems, functional corruption is a necessary lubricant for social intercourse and economic interaction.<sup>25</sup>

Corruption is an informal kind of political influence that can break through this bottleneck...It can speed things along, make favorable outcomes much more likely, and cost less than legitimate forms of influence...The basic pressures and tensions that make corruption so advantageous and tempting are products not of the kinds of people to whom we entrust public power, nor necessary of flawed institutions, but rather of governments’ basic relationship to society.<sup>26</sup>

This calls to mind Adam Smith’s famous distinction about “good” and “bad” people, as opposed to good or bad systems. Smith was describing the British East India Company, but he could as easily be talking about citizens with corrupt governments, or even individual corrupt officials themselves:

<sup>25</sup> The “will not can” distinction is made by DeLeon, *Thinking about Political Corruption*, 28.

<sup>26</sup> *Ibid.*, 33.

I mean not, however, by any thing which I have here said, to throw any odious imputation upon the general character of the servants of the East India company, and much less upon that of any particular persons. It is the system of government, the situation in which they are placed, that I mean to censure; not the character of those who have acted in it. They acted as their situation naturally directed, and they who would have clamoured the loudest against them would, probably, not have acted better themselves.<sup>27</sup>

So is “functional corruption” acceptable? As I will argue in the next section, the answer is no. But at the same time we can understand why people might excuse others, and certainly themselves, from the requirements of acting in ways that are not corrupt. Corruption is “good,” or at least acceptable, in a Pareto sense insofar as it benefits those who engage in the corrupt acts and harms no one else. In fact, if “the system” depends on corruption to get anything done it may appear that everyone benefits from the increased economic activity. Corruption can facilitate *exchange* in ways that are Pareto improving.

The problem is that the expectations of corrupt actions become part of the architecture of the social order itself. As in the case of the “junior engineer” in India, the right to collect extra-legal fees outside the system is capitalized as part of the “value” of the job to its incumbent. Any attempt to change the system will be thwarted by the need to compensate the incumbent for the rents that led to the efforts, and probably side payments, that allowed that person to acquire the job in the first place. Thus corruption is a problem, and is morally bad, insofar as it creates and fortifies an institutional order that prevents *institutional* changes that would imply Pareto improvements.

The distinction that I am making between short run and long will be unfamiliar to anyone not steeped in economics, so let me try to clarify it. The “short run,” in terms of my analysis, is a situation where institutions are fixed and the only cooperative activities are exchange of items already determined. The “long run” allows for larger and deeper innovations, both in terms of items being exchanged and the institutional setting in which cooperative activity can take place.

For example, as we will see in the next section, in a system where the only form of electronic communication between individuals is analog telephones, it may actually be economically beneficial to almost everyone involved to allow black market “bidding” in the forms of bribes to speed delivery of service to those persons or businesses with the highest values for this access. Compared to not allowing such bribery, in fact, a system

<sup>27</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* [1776] (Indianapolis, IN: Liberty Fund, 1991), Book IV. Section vii, p. 107.

with bribes will allocate telephone access more efficiently and will create higher levels of economic activity.

On the other hand, the fact that the business of allocating access to landlines is so profitable, in terms of bribes offered, will mean that potentially Pareto-improving changes to a system of cell phones will be fiercely opposed by those who profit from the existing locally optimal but globally inefficient system. Cell phones completely cut out the bureaucrat who must allocate physical landlines, and sharply reduce the ability of the authorities to hold up service.

As Merton put it:

[T]he functional deficiencies of the official structure generate an alternative (unofficial) structure to fulfill existing needs somewhat more effectively. . . . [But] I trust it is superfluous to add that this hypothesis [i.e., functional corruption] is 'not in support of the political machine.' The question of whether the dysfunctions of the machine outweigh its functions, the question of whether alternative structures are not available may fulfill its functions."<sup>28</sup>

In nations with "bad" institutions, corruption may be a rational response to dysfunctional or badly structured state capacity when there are substantial economic benefits to finding a "work around." That likely means that the system of socially transgressive and furtive delivery of benefits and protection from sanctions itself becomes formally institutionalized, or nearly. Both the citizens who depend on cozy relations, and the government functionaries who depend on income, are likely to resist efforts at reform. And we are left to compare what is "seen"—a system that works, and in which government bureaucrats make a comfortable, reliable living, and phones and other services are delivered in an understandable and predictable way—with what is "unseen"—a system where technological advances disrupt old ways of doing business, and in which rapid economic growth delivers only uncertain benefits to any particular citizen. There is no way to guarantee that the current winners, at the inferior local optimum, will have anything like the same level of relative status, or even absolute income, at the new, superior global optimum.

Merton's rather breezy conclusion—"alternative structures may fulfill [the services now delivered through functional corruption] without necessarily entailing its social dysfunctions"—is thus too optimistic. No one is confused, and having some development aid specialist come over and lecture about "social dysfunctions" will just bring laughter; compared to what? What can the nation that depends on functional corruption actually do about it?

<sup>28</sup> Merton, *Social Theory and Social Structure*, 126.

### III. CORRUPTION AS AN EXTENSION OF LIMITED ACCESS ORDERS

North, Wallis, and Weingast (2009; hereafter NWW) is modestly subtitled "A conceptual framework for interpreting recorded human history." A short summary of their thesis is useful at the outset of this section.

The major question of development, including the creation and maintenance of institutions in which corruption is effectively controlled, might be asked in either of two ways. First, why is it that many nations fail to develop "good" institutions and thriving economies? Second, why is it that some nations succeed in developing "good" institutions and thriving economies? I understand that this posing of "two" questions where one is just the negative of the other seems facile, but they are in fact completely different questions.

The approach to answering is going to depend on whether the analyst believes that the "natural" state of human society is development and progress, or stasis and entropy. The account of much of modern economics is that the development of institutions to facilitate exchange is Pareto-improving. Consequently, barring some cultural pathology or social barrier, functional markets will always develop and prosperity will always ensue.

But this does not seem to be a very good empirical description of the world we live in. Many, and in fact most, nations seem to bump along at or near the bottom of the range of growth paths implied by their endowments of population and natural resources. Perhaps the phenomenon needing explanation is not failure, but success. What is it that the relatively few successful nations had that the failed states lack?

NWW claim that the surprise is development; the "steady state" for most of humanity is failed institutions and corruption. The central fact of human society is the "state," or the centralized system of organization that solves the most fundamental problem, providing social order.<sup>29</sup> In particular, the state must prevent or contain the human capacity for violence, while itself monopolizing and focusing the means of exerting violence. Most states fail in both core functions, failing to prevent violence internally and failing to limit and safeguard its own capacity to exert violence. Citizens hurt each other, in myriad ways, and agents of the state itself harm or threaten to harm citizens in ways that violate the formal rules and constitutional provisions on which state power is ostensibly founded.

The problematic transition, then, lies in the ability of a state to move from a system where order is imposed top-down to a system where order emerges from permissionless innovation by individuals or private groups as groups of citizens and other people outside the nation order and reorder themselves into temporary, highly decentralized structures such as

<sup>29</sup> It is possible to debate this claim, of course, and say that the state is not actually a necessary feature of social orders. However, for the sake of a discussion of geographically extensive land areas with political governance, the notion of the state is empirically indispensable at this point in human history.

firms, voluntary associations like non-profits, and other kinds of weakly connected voluntary communities. As has now become part of the jargon, such systems of emergent order must facilitate *permissionless innovation* without extracting rents or blocking the development of the order by requiring permissions in the first place.<sup>30</sup> The problem, of course, is that the state's capacity to exert violence gives it, or its agents, the formal and also the informal power to exact payments in exchange for permission, permits, or simply the withholding of threats of force.

NWW argue that both historically and for good theoretical reasons the "types" of state organization fall into one of three basins of attraction. Any system, once established, has considerable inertia and internal mechanisms for continuity, and can only be changed through wrenching transformations that often, at least in historical experience, involve violence and destruction of the essential institutions of the old society.

- *Primitive social orders*, or hunter-gatherer societies with traditional charismatic or hereditary rulers.
- *Limited access orders*, which have dominated the last 10,000 years.
- *Open access orders*, which have arisen only in the past 300 years.

Limited access orders contain violence by political manipulation of the economic system to generate rents. These rents are created by using rules and decrees to limit entry by competitors, and by using the capacity for state violence to defend those rents, while collecting the tax revenues or tribute created by economic agents competing for those rents. The very survival of limited access orders depends on the ability of the state to create rents and then reliably to generate a stream of future rents by making a credible commitment to use violence to protect the rents that it is selling. If any other agent has access to the means of focusing violence, those rents are jeopardized, so the individuals who receive rents have large incentives to suppress organizations that might commit violence or foment social change. Rent "owners" have no choice but to support the current regime.

Open access orders, by contrast, foster the creation of emergent orders, and constrain violence and sustain social order through political and economic competition rather than rent-creation. Open access orders have developed in about two dozen countries, and all are both economically and politically developed.

To be sure that the distinction is clear, these latter two types of orders—limited access orders and open access orders—are entirely separate and generally internally stable equilibria. Limited access orders depend on restricting competition to survive; open access orders depend on human generated competition to grow.

<sup>30</sup> For a review, see Adam Thierer, *Permissionless Innovation: The Continuing Case for Comprehensive Technological Freedom* (Arlington, VA: Mercatus Center, 2016), esp. 7–11.

To see how this approach illuminates the problem of corruption, it is useful to understand North's distinction between "institutions" (the human devised rules of the game that shape and direct human activity) and "organizations" (the optimizing responses that emerge spontaneously in response to the incentives and constraints presented by the institutional setting). Each of the three "institutions"—primitive, limited access, and open access orders—evoke a different set of organizational responses. As NWW put it:

Organizations are groups of individuals, more or less directed toward a common goal. Most human activities involve a degree of cooperation among individuals and, because cooperation and coordination directly affect productivity, the ability to support complex, sophisticated organizations is central to economic growth. The institutional structure of a society determines the kind of organizations that can be created and sustained. Primitive social orders cannot support complex organizations. Limited access societies support complex organizations, but restrict the number of complex organizations. Limited access orders create and distribute rents by limiting the ability to create organizations. Open access societies support open access to organizations. This fosters economic and political competition, and it results in a rich array of complex economic and political organizations.<sup>31</sup>

The reason that this insight is important for present purposes is that limited access orders are locked into the preservation of rents that prop up the power structures in the state and create rents—artificial value, but extremely profitable to the "owners"—in the "economy." The "junior engineer" in the Indian system who saved up to make a payment of 10 million rupees expects to get a return on that "investment," and that return takes the form of being able to collect fees and speed money for the years it takes that engineer to save enough to be able to buy a position as a senior engineer. Again, NWW note the difference; limited access orders actually "preclude" the development of markets, permissionless innovation, and long-term development. This is not simply a difference at the margin, but fundamental game-changer for development:

The characteristic way in which a social order structures human organizations also produces predictable features of the larger society. *Limited access orders exhibit systematic rent-creation, market power, privileges, and differences between elites and others; they also preclude thriving markets and long-term economic development.* Open access orders exhibit systematic competition, entry, and mobility; they also foster thriving markets and long-term economic development.<sup>32</sup>

<sup>31</sup> North, Wallis, and Weingast, *Violence and Social Orders*, 38–39.

<sup>32</sup> *Ibid.*, 39; emphasis added.



The theory advanced in this section relies on the observation NWW make about limited access orders. The ability of the state to control and focus violence enables it to create and protect rents. These rents might take the form, in early times, of a monopoly on the “right” to sell salt, or tea, or spices, within the area controlled by the state. This right is valuable, and since it is excludable the state can auction off the right in exchange for revenue.

These formal rent-protected revenue sources may sustain a state for long periods, but in every case they preclude innovations and creative destruction of providing these services in new, better, or cheaper ways. This feature of limited access orders alone might sharply constrain economic development, because it stultifies innovation. But there is an additional implication I am trying to draw out, in the way that limited access orders also foster and then preserve corruption.

This implication has to do with the signals provided by a properly functioning price system. Even a *monopolized* price system will reflect accurately differences in demand and the opportunity costs of resources, though it will incur the costs of deadweight loss and limited innovation that are well-known for monopolies generally.<sup>33</sup> But limited access orders cannot be expected even to generate “efficient” monopoly prices! Schleifer and Vishny argue that the real problem with using bottlenecks, permitting, and other artificial scarcities to create rents is that the price mechanism is almost completely suppressed. Most transactions will be based on an exchange of favors, or the pursuit of political advantage, rather than being based on the scarcity signals contained in prices.<sup>34</sup>

A limited access order where elites charged monopoly prices would be much more prosperous and dynamic than a society where many rent-holders obtained their rents through corruption. In a corrupt system, goods and services are allocated based on political advantage. Each “price” charged is actually the sum of the value being paid, the waiting costs of the purchaser, and the rent represented by the difference between these values and the shadow price represented by the “consumer surplus” of the purchaser or supplicant.

Elites and rent-controllers will generally charge less—possibly much less—than market-clearing prices to secure political goals and to satisfy prior promises of quid pro quo arrangements. The result is that prices cannot carry out their function, which is the impersonal coordination of

<sup>33</sup> For an extreme version of the efficiency costs of monopoly, see Harvey Leibenstein, “Allocative Efficiency vs. X-Efficiency,” *American Economic Review* 56 (1966): 392–415. But one can have a much less pessimistic view of monopoly, and still think artificially created monopolies reduce growth and limit dynamic adjustments.

<sup>34</sup> Andrei Shleifer and Robert Vishny, “Corruption,” *Quarterly Journal of Economics* 108, no. 3 (1993): 599–617.

the behavior of individuals.<sup>35</sup> “Natural” states (as NWW call primitive and limited access orders) cripple the ability of prices to coordinate impersonal activity, to enable permissionless innovation, and to convey information about the appropriate margins where cost, demand, and scarcity indicate activity should be focused.

The problem, then, connects to a general argument about the efficiency of cooperation and competition in different settings. Economists have often argued that competition is always beneficial, and that prices always “work” to allocate resources efficiently. But competition can be diverted from the dynamic creation of products and services resulting in effective creative destruction, and toward rent-seeking competitions to protect inefficient economic organizations against creative destruction.<sup>36</sup> If the form that competition takes is to seek the attention of powerful state actors in protecting artificial rents against new entrants, and if the form that price signals take is to measure out the cost of obtaining such protection, the actual functions of the markets are co-opted and corrupted beyond recognition.<sup>37</sup> What looks like competition is diverted into the particular means—bribes, favors, and the strategic erection of tollbooths near bottlenecks—that characterize limited access orders. Corrupting the market function of prices corrupts the society.

#### IV. LOCK-IN LIMITED ACCESS ORDERS

There are two threads of argument, made separately, that in this section will be tied together.

The first thread is the claim that a nation with dysfunctional or malformed institutions can be improved by corruption. If access to basic services, licenses, and permits is controlled by a grossly inefficient bureaucratic

<sup>35</sup> Douglass North has always insisted that it is the impersonal coordination of human activity that makes markets and prices valuable. See, for example, Douglass North and Robert Thomas, *The Rise of the Western World: A New Economic History* (Cambridge: Cambridge University Press, 1973), and Douglass North, *Institutions, Institutional Change, and Economic Performance* (New York: Cambridge University Press, 1990). Of course this claim echoes the long-held view of Ludwig (von) Mises, “Profit and Loss,” in *Planning for Freedom* (South Holland, IL: Libertarian Press, 1952); also found in Friedrich A. (von) Hayek, “The Use of Knowledge in Society,” *American Economic Review* 35 (1945): 519–30; Israel M. Kirzner, *Market Theory and the Price System* [1963], edited and with an Introduction by Peter J. Boettke and Frédéric Sautet (Indianapolis, IN: Liberty Fund, 2011).

<sup>36</sup> The necessity that “property” must entail a kind of open competition that fosters “creative destruction” is implicit in North, Wallis, and Weingast, *Violence and Social Orders*. But see also David Schmidtz, “Functional Property, Real Justice,” keynote speech given at *Property Rights in Central and East European Countries: Developments after the Transformation Process*, (Presented November 13, 2009, Berlin, Germany). [https://shop.freiheit.org/download/P2@230/8197/E\\_ELF\\_Schmidtz\\_24\\_4S\\_Internet.pdf](https://shop.freiheit.org/download/P2@230/8197/E_ELF_Schmidtz_24_4S_Internet.pdf).

<sup>37</sup> This was in fact the original argument made about rent-seeking as a kind of destructive competition that distorts price signals and locks in inefficiency. For a review, see Robert Tollison, “The Economic Theory of Rent Seeking,” *Public Choice* 152 (2012): 73–82. Kevin M. Murphy, Andrei Shleifer, and Robert W. Vishny, “Why is Rent-Seeking So Costly to Growth?” *American Economic Review* 83 (2009): 409–414, demonstrate the specific barriers that the particular form of rent-seeking we think of as “corruption” plays out, to devastating effect.

system, it is best to resort to speed money and make the system more efficient. In fact, if the value created by the activity is sufficient, a bureaucratic bottleneck can be overcome. We might think of this as an application of the "Coase Theorem": the value created being large guarantees that the activity will take place. The details of how bureaucratic obstacles are overcome are essentially epiphenomenal; entrepreneurs simply treat those obstacles as one more problem to be worked around. Institutions of grey or black markets *will* emerge if Merton's three conditions of "functional corruption" are satisfied.

The other thread might be labeled the "transitional gains trap" or "lock-in." This is two problems in one: problem A is that attempts to give money to particular groups will create rents or special benefits attached to certain features. For example, farmland for the very poor might be subsidized. But then the value of the asset associated with the rent will rise, capitalizing the rent. That means that the subsidy has no net effect, because the poor person now earns a normal return on the now more expensive asset that capitalizes the rent. But if the government then tries to eliminate the program, policy, or informal practice there is a substantial and possibly devastating loss to the "owner," who suffers a capital loss. Having paid more for the asset in the first place, there is no lasting benefit but there is a cost if the rent is removed.

Problem B is that corrupt systems have exactly this "transitional gains trap" feature, such that any successful attempt to eliminate corruption will impoverish an entire class of bureaucrats, experts, and other "mandarins" who worked for years to acquire their current positions. The reason they worked or bribed their way into these positions is that they produce substantial revenues in the form of fees and bribes. The fact that the state itself does not formally sanction or approve these "assets" does not reduce their value. Eliminating corruption, even if in principle it is potentially Pareto-improving, becomes nearly impossible unless the state can buy out the holders of asset titles in the informal, corrupt economic system.

To summarize, then, corruption (1) makes bad institutions more tolerable, and may go a long way through a Coasian logic toward rendering them efficient; but (2) locks in bad institutions because of the transitional gains trap. This means that we might expect countries with problems with corruption to find that any kind of effective reform is very difficult. Corruption is not as growth-inhibiting as you might expect, under some circumstances. But efforts at reform will usually be diverted, exhausted, or even co-opted.

Corruption may facilitate exchange and efficiency *given* a set of rules, but it will make changing the rules or institutions of the society much more difficult, even if that change dramatically expands the overall size of the economic pie. Paradoxically, at least to an outsider, attempts at reform may engender moral outrage of insiders, because the attempt to change "the rules" is both an economic threat and "just not how we do things." As Brennan and Buchanan put it: "The rules to which they tacitly agreed when they decided to participate have been changed. They have

not implicitly promised to obey the new rule, so they cannot be accused of unjust behavior if they violate it.”<sup>38</sup> The corrupt bureaucrat was violating the formal law, but following the informal rules, in charging a “fair” level of speed money in exchange for the accelerated delivery. The attempt to end corruption amounts to an attempt to force a return to the law at the expense of the rules everyone has become accustomed to, and around which they formed their expectations.

As Douglass North put it:<sup>39</sup>

What the analytical framework modifies is the rationality assumption. What it adds is the dimension of time. . . . The rationality assumption of neo-classical theory would suggest that political entrepreneurs of stagnating economies could simply alter the rules and change the direction of failed economies. It is not that rulers have been unaware of poor performance. Rather the difficulty of turning economies around is a function of the nature of political markets and, underlying that, the belief systems of the actors.

This conclusion is what I have tried to support here. The original form of the “lock-in” of institutions is economic, because the corruption of the system creates economic rents. But as time passes the rules are locked-in by expectations. We follow “the rules” simply because they are *the rules*.<sup>40</sup> But this takes a considerable amount of time to internalize, meaning that in the “short run” corruption is impervious to efforts at reform. The problem posed by North, Wallis and Weingast is elegantly simple, but perplexing: while in economics the “long run” is simply the shortest amount of time when all inputs are variable, in political economy the “long run” is the period required to break, modify, and lock in new institutions. The “short run” can therefore last a very, very long time.

#### A. *An empirical comparison*

To get a (simple) view on the problem I put together data on growth rates over the period of 2010–2015 from World Bank sources. I divided parts of the data (the sample is only 40 countries, for reasons I will explain) into four categories, and presented them in Table 1.

<sup>38</sup> Geoffrey Brennan and James Buchanan, *The Reason of Rules: Constitutional Political Economy* (New York: Cambridge University Press, 1986), 120.

<sup>39</sup> North, “Economic Performance through Time.”

<sup>40</sup> I am not simply invoking a “taste for following rules.” As Gerald Gaus, *The Order of Public Reason* (New York: Cambridge University Press, 2011), chap. 3, argues, there are substantial reasons to expect a pattern of behavior (he calls it “rule-following punishers”) to evolve as part of an adaptive brain architecture. It is not (just) that the corrupt system benefits some; understanding a system that is predictable and—in its own way—fair appeals to our moral intuitions. Reformers thus confront openly angry, even sanctimonious, bureaucrats who demand to know why “their” benefits are being taken away.

TABLE 1. *Fraser Institute Freedom Index with GDP/Capita Growth Rates*  
 Panel A: Good property rights AND low corruption

Finland	0.2
Singapore	2
Switzerland	0.8
Hong Kong	2.4
Luxembourg	4.8
Qatar	3.6
New Zealand	3.4
Norway	1.6
Ireland	12
Japan	1.2
<b>MEAN</b>	<b>3.2</b>

Panel B: Bad property rights AND out-of-control corruption

Ukraine	-10
Guinea	-8.3
Argentina	2.4
Chad	1.8
Angola	3
Burundi	-3.9
Haiti	1.2
Yemen, Rep.	-28
Libya	-20
Venezuela	-4
<b>MEAN</b>	<b>-6.58</b>

Source: World Bank: <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>

Panel C: Relatively good property rights AND bad corruption  
 (large positive property rights minus corruption score)

South Africa	1.3
Jamaica	1
Guatemala	4.1
Trinidad	-0.6
Mexico	2.5
Uruguay	1
Honduras	3.6
Ecuador	0.2
Kenya	5.6
Peru	3.3
<b>MEAN</b>	<b>2.2</b>

Panel D: Bad property rights AND moderate corruption  
(large negative property rights minus corruption score)

Hungary	3.1
Croatia	1.6
Nicaragua	4.9
Uzbekistan	8
Spain	3.2
Albania	2.8
Turkmenistan	6.5
Georgia	2.8
Indonesia	4.8
Bosnia-Herz	3
<b>MEAN</b>	<b>4.07</b>

To form the categories, I used two different indices in the Fraser Institute's *Economic Freedom of the World*.<sup>41</sup> The information presented is in no way a "test" of any hypothesis, but is rather intended to illustrate differences in corruption and other institutions.

The first category (Panel A) is the "good" countries. These nations have the highest sum of the "good property rights" and "absence of corruption" indices. They may have (as in the case of Qatar) other problematic institutions, in the sense of political repression, but they have good economic institutions and noncorrupt state apparatus. The mean growth rate in this category is 3.2, and the level of GDP per capita is well above the world average.

The second category (Panel B) is failed states, the nations with the lowest sum of the property rights and corruption indices. These are nations with both terrible property rights protection and appallingly corrupt institutions. Perhaps unsurprisingly, these countries are a hot, awful mess. The average growth rate is substantially negative, with only Argentina and Angola showing any kind of movement. The uncertainty that comes from lacking property rights and constant abuse by corrupt officials is the closest thing in the modern world to Hobbes' "state of nature."<sup>42</sup>

The third category (Panel C) represents the nations with the largest difference between property rights and corruption, measured by the Fraser Institute indices. That is, these nations have (on paper) pretty good property rights rules, but are infested with corruption, particularly (as in the

<sup>41</sup> James Gwartney, Joshua Hall, and Robert Lawson, *Economic Freedom of the World* (Vancouver, BC: Fraser Institute, 2016).

<sup>42</sup> It should be noted that absence of data on one or more of the three variables of interest (property rights index, corruption index, growth rate 2010-2015) deleted many nations from data set. These include such appalling places as Cuba, North Korea, and Somalia, among others.

case of South Africa) in some regions or some sectors of the economy. The result is a mean growth rate of 2.2 percent, with corruption sucking the vitality out of the creative impulses of entrepreneurs who are unable to capitalize on “good” institutions because of “bad” government.

The final category (Panel D) represents those nations with the largest negative difference between property rights and corruption. That is, these nations have pretty terrible property rights rules, but moderate corruption.<sup>43</sup> If corruption were always bad, we would expect the nations in Panel D to perform worse than those in Panel C. But that is not the case. The absence of protections in the sense of “bad” property rights rules is mitigated by access to corrupt work-arounds. The growth rate for the nations in Panel D is a healthy 4 percent.

If we were to classify China, it would belong in Panel D (though measuring averages of either property rights or corruption as an average across such a vast and diverse country would be nonsensical). The Chinese system is moderately corrupt, with old corrupt systems (nepotism, local norms of privilege for some families) remaining as a stubborn residue under new forms (cadres of the Communist Party who look the other way, or actively invest, when new and essentially private business enterprises are formed using “public” property and capital). Still, given how dysfunctional the formal institutions are in many areas it is hard to begrudge the positive effects that functional corruption have had. Half a billion Chinese citizens have escaped poverty in less than forty years, even though property rights are vague and contested. The problem, of course, will be escaping from the locked-in commitments made to corrupt officials, who can easily block reforms to any kind of open access order. In other words, China has progressed rapidly, and has done it in perhaps the only way that was feasible. But, what now?

## V. CONCLUSION

This essay has argued that corruption, while morally questionable as a first-best “institution,” may be indispensable for mitigating the influence of bad institutions. Functional corruption, using Merton’s formulation<sup>44</sup>, can always be expected if three conditions are met:

- There is enough economic opportunity to attract entrepreneurs, and there is enough state capacity to provide the services entrepreneurs require. In particular, the state can enforce sanctions that would otherwise prevent economic activity, and it can deliver services (roads, electricity, telephone connections) when mobilized to do so.

<sup>43</sup> One surprise here is Hungary. Hungary has relatively “good” property rights, but appalling corruption. It appears that the corruption is largely perceived as a means of working around other problems with the state, however, and so corruption is an effective means of bypassing bottlenecks.

<sup>44</sup> Merton, *Social Theory and Social Structure*.



- The state is strong enough, and organized enough, to control access to these services or solutions to hold-up problems, meaning that the state can secure its Weberian role as the monopoly provider of security and the sole legitimate user of violence and force, keeping mafias and organized crime from threatening property rights or extorting protection money.
- The “routine process” by which needed benefits are created, recognized, or conferred is time-consuming, inconvenient, expensive, and possibly uncertain. Alternatively, sanctions are arbitrary and devastating.

However, while participation in corrupt practices may be morally permissible in a system where such practices are widespread and accepted as “part of doing business,” there is a pernicious consequence. Accepting corruption as conventional erodes respect for rule of law, and creating the informal state capacity to make functional corruption work in the first place creates a set of rent-producing entitlements that lock in corrupt institutions because of the transitional gains trap.

The result is that the transition from limited access orders to open access orders, the key transition for economic and political development, can be thwarted, possibly indefinitely. Even if open access orders are (potentially) Pareto superior, in the sense that they create dynamic economies that foster permissionless innovation that dramatically increase “the size of the pie,” there is no way to compensate the stakeholders who depend on particular rents in the limited access order.<sup>45</sup>

Perhaps more importantly, there is also a deeper problem. As Gaus argues, “It can’t be rational choice all the way down.”<sup>46</sup> It is asking a great deal for everyone to know and obey the law (as opposed, possibly, in the Hayekian distinction, to statutes or formal rules).<sup>47</sup> Asking them to know at the same time whether the law is good is too much. In the “short run,” as I have used the term, the acceptability of corrupt acts may yet be in flux, and the expectations of those in authority are not locked-in.

<sup>45</sup> The Kaldor-Hicks “potential Pareto” may suffice as an abstract ethical standard. But if a society now uses some form of corruption to incentivize and compensate their bureaucracy, “potential” is not enough. The functionaries will want to know, specifically, how they are going to get paid, how much, and whether this promise is credible.

<sup>46</sup> Gaus, “It Can’t Be Rational All the Way Down.”

<sup>47</sup> In Volume I of *Law, Legislation, and Liberty* (Chicago: University of Chicago Press, 1973), Hayek said:

Legislation, the deliberate making of law, has justly been described as among all inventions of man the one fraught with the gravest consequences, more far-reaching in its effects even than fire and gun-powder. Unlike law itself, which has never been ‘invented’ in the same sense, the invention of legislation came relatively late in the history of mankind. It gave into the hands of men an instrument of great power which they needed to achieve some good, but which they have not yet learned so to control that it may not produce great evil (72).

But once everyone knows “that’s the system,” then those practices become both part of what is allowable for me and what I expect of you. As North argued<sup>48</sup>, the rationality assumption does not allow us to impose rational changes in institutions or moral norms.

Thus, while it is tempting to see corruption in a static sense as only contingently vicious—everybody does it, and it actually enhances growth in nations with bad institutions—the very Coasian nature of corruption as a work-around prevents growth in the longer term, dynamic setting. The transaction costs of transition for limited access orders infested with corruption to open access orders are prohibitive. Corruption is vicious.

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<sup>48</sup> North, “Economic Performance Through Time.”