Endogenous Corruption in Emerging Industrial Relations

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Introduction: In the post-communist period corruption in Central and Eastern Europe is very rife according to all international surveys. Since corruption is a clandestine activity there is no statistics of the phenomenon, but surveys give almost identical position of the region in the cross-country assessments.

Many researchers have questioned corruption rankings offered by different international organizations. Even the definition of corruption is not an unambiguous one. The term covers a broad range of activities, and consequently there are several proposed definitions. The most commonly used is the World Bank definition, which describes corruption as an abuse of public office for private gain. Although it is a very broad definition that can comprise nepotism, outright theft of public resources, or diversion of state revenues - i.e. activities usually not labeled as corruption - the World Bank and a lot of researchers use it as a working definition. By stressing public institutions (offices), the definition almost inevitably avoids corruption in the private (or privatized) sector.

Our impression is, however, that privatization processes in Central and Eastern Europe create new incentives and new forms of corruption. Therefore, the definition of corruption has to be based on socially defined corrupt conduct. Namely, what determines corruption is whether a person, bound by principal-agent contract, takes advantage of his discretionary power and sells to a third party property rights that do not belong to him. Therefore, the abuse of office (not necessarily public) is indispensable but not sufficient condition for this type of corruption. The presence of a third party is essential, since it distinguishes an ordinary breach of principal-agent contract, as shirking or falling short of the assigned and agreed upon goal, from corruption.

Building on the existing public choice literature, and using game theory in the extensive form as a principal tool, we have explained a new form of corruption that emerges in privatized companies. Our main findings were assembled in a paper titled ENDOGENOUS CORRUPTION IN PRIVATIZED COMPANIES, submitted to the *European Journal of Political Economy* (*JEL* classification numbers: C78, D23, J51, P51).

Setting: The paper deals with corruption developed with the privatization process in transition economies. In addition to existing forms of corruption, a new form emerges when ownership claims are dispersed, capital markets underdeveloped, product competition hindered, and managers willing to behave opportunistically. In such an environment labor has a strong incentive to unionize in order to avoid restructuring and consequent loss of jobs. Managers, on their part, realize that unionized labor may protect their position in eventual confrontation with outside owners, so they promote friendly union leaders. Both sides find cooperation strategy strongly dominating other possible ways of conduct. Consequently, managers give special privileges to union leaders, who turn their blind eye to managers' misconduct.

Main findings: Mutual benefits are financed at the expense of outside owners who are clear losers in this game. This process is labeled endogenous corruption, and it creates new hindrances to the reform effort.

The endogenous corruption has devastating effects on factor allocation, since it hampers productivity and consequent price fall. Through commodity interconnectedness, it reduces profits in other industries and creates substantial efficiency losses for the whole economy. The endurance of the endogenous corruption mostly depends on the extent of market competition. With rising elasticity of demand for firm's products, rents must go down, resulting in less means for corruptive behavior. The suggestive conclusion is that active competition policy should be fostered. The conventional wisdom is that it is always useful to have strong competition on product and factor markets. Having a strong competition is even more significant in situations where endogenous corruption is widespread. A strong orientation toward liberalization and application of hard budget constraints is crucial in such circumstances.

Usual anti-corruption strategies do not help in the case of endogenous corruption. For example, one of general recommendations is to give support to whistleblowers. Similarly to public watchdog policies, one can say that, in many instances, it is certainly advantageous to have the insider information on particular misconduct. As stated in the paper, relying on the whistleblowers, may not work in an endogenous corruption case, since potential whistleblowers have substantial material interest not to raise their voice. The eradication of corruption requires a more subtle anticorruption policy where anticorruption devices are specifically tailored according to the source of corruption. The arguments presented in the paper could be a step in that direction.

In the final section of the paper potential remedies are discussed. First of all, an effective privatization strategy has to be devised in order to produce concentrated outside ownership for privatized firms. All privatization models that give an upper hand to insiders may be politically opportunistic and thus favorable in the short run, but in the long run privatization results in substantial endogenous corruption that may raise the overall level of corruption in the country. Nations that have already privatized greater part of the state controlled assets, should concentrate their efforts on developing commercial law that would limit inside-dealing, conflict of interest, and protect minority shareholders. Those nations will also have to raise accounting standards, increase transparency of corporate decision-making process, and foster the competition on the labor market.

In the long run the only viable policy against endogenous corruption seems to be the development of the new business elite. Instead of borrowing abroad and investing in companies infested with endogenous corruption, the government should invest in human capital. It should send bright students to the West, urging them to study particularly the commercial law, the accounting and auditing proficiencies, the business administration, the industrial policy and regulatory practices. Some of them will stay in the West, but many will return. With rising standard of living in their native countries, many more will return, as there is ample evidence along prospering countries from Ireland to South East Asia. Returns in real economic terms to investment in human capital are the highest, but more than that, a prolonged exposure to business practices in the counties known to have a transparent business environment should foster the eradication of the endogenous corruption.

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