

Money versus Morality:

Is corruption just a matter of misaligned incentives?

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The problem of corruption

Corrupt transactions are, in the first instance, an economic problem. That is a fact. Corruption costs taxpayers money, it costs development money, it costs public resources. This much we know. This is, to some extent, measurable. Perhaps the most remarkable impact estimate comes from the World Bank Institute. They estimated several years ago that over one trillion dollars are paid in bribes each year. This translates into around 2 percent of global gross product. The number can be contested, but it is the magnitude that is significant. Compare it, for example, to total economic development aid laid out by the world's wealthiest countries each year. Official development assistance from OECD member states alone, rose to US \$106 billion in 2005. This remains a mere tenth of the World Bank's bribes figure. That total of one trillion paid in bribes comes to around 150 dollars per person, per annum, for every human on the planet. There are 1 billion humans whose total annual income is only twice this amount - that is 1 billion people who survive on under one dollar a day.

And that is just the bribes. Estimates of money laundered each year are of the same order. A big issue gets even bigger.

When people - particularly those in public office - accept bribes, they are abusing their position. That is unacceptable in and of itself. But they are often being paid to influence the decisions they have been entrusted to make on behalf of citizens or other stakeholders. And if they are being bribed, it implies that they will be making decisions that they wouldn't otherwise have made – presumably decisions at odds to the needs of their stakeholders.

So the billions spent on bribes each year are money that might have been otherwise invested, that could have been effective in driving economic development. But the amount spent on bribes doesn't capture the knock-on cost of the wrong decisions being made. For those of you familiar with thermodynamics, corruption isn't simply heat loss - a benign form of waste that the system must simply absorb. It is a disruption of the system,

one that diverts valuable resources towards investments that are not efficient, safe or sustainable.

A case in point is the Bataan nuclear power plant built in the Philippines. Completed in the 1980s at a cost of USD 2 billion, it has never produced a single unit of electricity, although it did apparently produce some sizeable kickbacks for friends of the Marcos regime.

We also know that corruption has an adverse effect on Foreign Direct Investment. In non-African developing countries, FDI is greater in volume than development assistance (in Africa it is less, but of a comparable scale). Studies confirm that foreign investors, particularly European and North American ones, are averse to corruption risks in countries where they do business. Corruption makes the return on their investment less certain as it exposes them to a variety of legal, fiscal and reputational risks.

Corruption is a vicious cycle. It is an economic problem, it hinders economic growth, distorts markets. This affects people on many levels. Taking lost opportunity costs as an example, corruption can mean that money is diverted away from social programmes such as health or education. This necessarily affects the quality and productivity of a nation's work force, incurring an economic cost.

So, we know that corruption can be economically damaging. And we know that it affects the conditions of people's lives.

When the public know that institutions are staffed by people who view their offices as self-service shops, what cause do they have to believe in those institutions or to play by the ostensible rules? Taken to the extreme, we are looking at the kind of disaffection that can breed alienation or even conflict.

Responses to the problem of corruption

Awareness of corruption isn't new. But analysing it as a systemic problem with real costs is, be it to development, to responsive government or to quality of life. Newer still are approaches, including the creation of Transparency International, that seek to track the impact of corruption empirically and to develop systemic approaches to combat it.

In Germany, where TI's international Secretariat is based, up until recently, it was not only legal for German companies to bribe overseas – the bribes were tax deductible. While

values may have been pointing in one direction, profits were pointing in another. Talk about misaligned incentives.

In the face of such an arrangement, the approach is clear. Put political pressure on German lawmakers to change the legal environment that makes bribery economically attractive to German companies. Align incentives with ethics.

In the past decade or two, much work of this sort has been done. Organisations such as Transparency International have helped push issues of corruption and transparency to the top of national and international agendas.

How did we go about this? We developed strategies based on the political, legal and economic dimensions of corruption.

The political dimension



We know that corruption is linked to politics, that it's a political issue because at the grand scale – where we find grand corruption - politics is about decision-making power, involving decisions that have large scale implications, financial and otherwise. Particularly in what are called weak governance zones, political leaders have access to massive amounts of money.

In Transparency International's annual *Global Corruption Report* in 2004, we looked specifically at political corruption, and in the book's introduction listed the alleged top ten embezzling leaders of all time, including luminaries such as Slobodan Milosevic, who later took TI to court over his inclusion in the book – and lost. Others topping the list came

from Nigeria (Sani Abacha), Indonesia (Mohamed Suharto) and the Philippines (Ferdinand Marcos).

We define corruption as 'the abuse of entrusted power for private gain'. And these embezzlers are stellar examples of that definition, using nearly unlimited power that they had been entrusted with, or wrested, for staggering personal gain – at the dire expense of the citizens of their country.

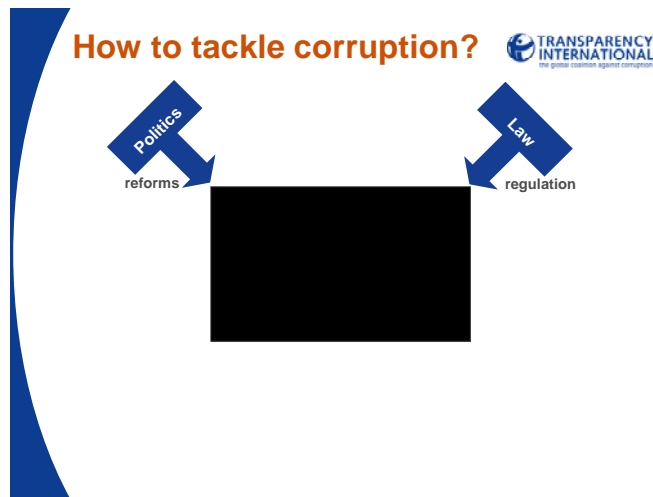
And these politicians also make decisions that have the power to make others very rich and so are targets for influence, illicit or otherwise, themselves.

So if you're going to change systems in which corruption occurs, you need to reform political institutions and political thought. These leaders are potential recipients of bribe money and potential instigators of reform. So they, and their way of thinking, are a natural target for any serious anti-corruption effort.

And part of this is getting the political infrastructure right, the framework within which politicians operate. Transparency International has done a great deal of work on this. We have introduced what we call the National Integrity System model, to enable discourse on the institutions that are essential to fighting corruption.

Key institutions include independent anti-corruption agencies. We've seen successful examples of these in Hong Kong, South Korea and Botswana. In Bangladesh, for example, where the commission seems to have been established without adequate independence and secure resources, the experience hasn't been such a happy one. But where the concept has worked, it has proven the model, which also includes institutions like an office of Supreme Audit and an independent Judiciary.

The legal dimension



We have advocated for international conventions and for national anti-corruption legislation, as part of the framework for tackling corruption.

There now exists a truly global anti-corruption convention, the United Nations Convention against Corruption, launched in 2003, which over 140 countries have signed, and 69 have ratified. This means that legislation is on the statute books, with the convention laying out mechanisms for whistleblower protection and asset recovery for countries looted by corrupt leaders. The Conference of States Parties in Jordan in December 2006 will look at how these regulations are going to be monitored and enforced – which is essential if this legal approach is going to be effective. Now we have experience of why monitoring and enforcement is vital.

Within the OECD, there exists the Convention for countering the bribery of foreign public officials which, for its signatories, requires them to criminalise the practice so long defended as greasing the wheels of commerce.

TI's Bribe Payers Index, which looks at the propensity of companies from leading export countries to pay bribes overseas, gives us reason to question the effectiveness of the OECD Convention on the bribery of foreign public officials. This is confirmed both by our own published reports on national compliance with the convention, which found a generally low level of progress across the OECD, and by independent research.

Who pays the bribes?



Cluster 1

Switzerland	7.81
Sweden	7.62
Australia	7.59
Austria	7.50
Canada	7.46
UK	7.39
Germany	7.34
Netherlands	7.28
Belgium	7.22
US	7.22
Japan	7.10

The TI Bribe Payers Index 2006

Cluster 2

Singapore	6.78
Spain	6.63
UAE	6.62
France	6.50
Portugal	6.47
Mexico	6.45

Cluster 3

Hong Kong	6.01
Israel	6.01
Italy	5.94
South Korea	5.83
Saudi Arabia	5.75
Brazil	5.65
South Africa	5.61
Malaysia	5.59

Cluster 4

Taiwan	5.41
Turkey	5.23
Russia	5.16
China	4.94
India	4.62

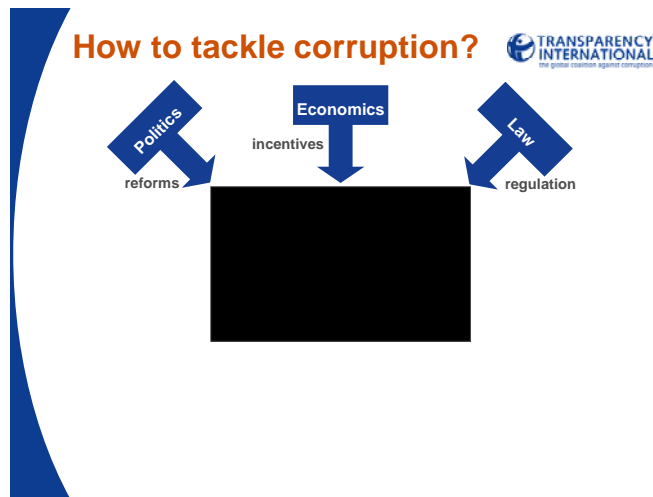
According to the *Bribe Payers Index* even companies from the cleanest countries (at least in this regard) such as the Swiss, show a marked propensity to pay bribes overseas. Despite the fact that such bribery is illegal in Switzerland, and despite the fact that corruption is simply wrong, the index suggests that many Swiss companies continue to bribe.

The rapidly expanding economies of China, India, Brazil and Russia did poorly on the same measure, which is cause for concern. A recent survey by Control Risks found that Brazilian companies suffered internationally because of their poor reputation; they had difficulty finding good business partners.

All four countries will also need robust foreign markets to trade with in five, ten and fifty years' time. And allowing foreign bribery to go unchecked undermines those prospects. Therefore, the fight against corruption is a long-term investment.

One of our goals is to make corrupt behaviour illegal, which increases the risks - balancing against any economic incentives to bribe. The law there is in part functioning as a way of changing the incentives and helping to align economic interest with non-corrupt behaviour, making it more attractive to act with integrity.

The economic dimension



We at Transparency International have looked at the role of economic incentives in development institutions such as the World Bank, in the civil service, or in the top ranks of corporations, where incentives have been a hot topic, and even more so since the collapse of Enron in 2002.

An earlier iteration of the Bribe Payers Index looked at propensity towards corruption by industry sector. The worst three were: construction, defence, and oil & gas. All are characterised by significant involvement by government, and by large contracts where a single award matters a great deal to an individual firm. These are not contracts they can lose and easily compensate for elsewhere. A single contract might mean 2,000 people they can't employ or twelve percent of global turnover. So the incentives to win are quite powerful.

Other efforts have brought together businesses from a particular sector, such as with the banking sector, in the case of the Wolfsberg Group, where TI served as a catalyst, to help draft new guidelines on Anti-Money-Laundering, and, of special interest to TI, on stopping the laundering of the proceeds of corruption.

Parallel to this, tools and resources have been introduced for the private sector generically as well. TI has been instrumental in forging some of these, such as the Business Principles for Countering Bribery. These give businesses a template for anti-corruption codes, and - critically - their implementation. Our approach has not been merely to assign blame, but to work towards solutions that allow all parties to exit a fundamentally unsavoury situation.

The dawning awareness of the business community to the anti-corruption imperative found its expression in the expansion in 2004 of the UN Global Compact, a voluntary

initiative with over 2,500 corporate members, to include the additional principle: “Businesses should work against corruption in all its forms, including extortion and bribery”.

The Compact has been accused of constituting a so-called “blue-wash” exercise by the private sector – allowing companies to launder themselves in the blue of the UN. These are real concerns, but the Compact may also provide a way of guiding behaviour through a voluntary channel rather than resorting to a system of penalties.

If you consider the World Bank, it is a core engine of development in low-income countries. And the policies it adopts can have a serious effect on the level of corruption in the projects it is funding.

We’ve been arguing that the Bank needs to look at the incentives for its staff. They lend money, that’s what they do. If you’re a lender, you’re measured by how much lending you’re doing. You’ve got an incentive to lend. The incentive is built into the system.

So what incentive is there *not* to lend if it’s all going to be lost in corrupt transactions. Perhaps it’s made known that the Bank will pursue cases of corruption and that there will be sanctions for those involved.

But if the average career stop at the World Bank is a few years and the average corruption scheme only comes to light some years after the fact, then the staff involved have already gone. And if you track them down, they may be two jobs on in a completely different area, with a boss that just isn’t interested in the fact that three or five years ago a loan their new staff member made, with the best of intentions, turns out to have been riddled with corruption.

So, in this case, incentives must be reconfigured so that it is not just volume of loans that counts but risk analysis and due diligence – that is to say, quality of loans issued and the environment that they are issued into; and sometimes rewards could be there for the decision not to lend. This requires careful management by the Human Resources function, and by, line management: a considerable challenge.

Another example. If I’m a customs official and I’m paid a hundred dollars a month but the system is such that I have some discretionary decisions that are worth a very great deal to other people, then there’s clearly an opportunity for me to explore whether I can use that

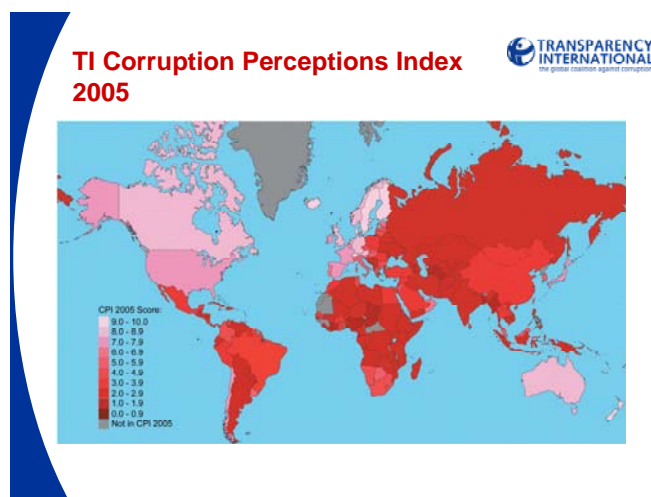
power to supplement my income. And if my basic income is inadequate then the system can even assume, in a way, that I will have to engage in corrupt behaviour to survive. The system provides an incentive for corruption. These are the pressure points we have targeted.

Great expectations

But despite many systemic advances, we have not seen the decrease in corruption globally that we had hoped for.

In some of the most corruption-prone environments, Nigeria, Kenya and Georgia, for example, we have had governments sail in on a cloud of hope only to be mired in distrust only a few years later. Statistically and on a global level this view is confirmed by the work of the World Bank Institute. Their governance indicators, which measure for corruption and freedom of expression among other values, show that governance worldwide has not improved overall. TI's Corruption Perceptions Index, which looks at perceived levels of domestic corruption, echoes this finding.

The Corruption Perceptions Index is TI's most visible product. You may have come across it leafing through the statistics pages of the Economist. It uses a range of expert assessments of the level of corruption in over 150 countries to assign each country a score from a highly corrupt 0 to a highly clean 10.



Bear in mind that by our definition of corruption - the use of entrusted power for private gain - it is the behaviour we are ultimately targeting and that the conventions, laws and anti-corruption commissions should be a means to that end. But, globally speaking, we haven't seen the improvements in behaviour we would hope for.

That early expectations were overly optimistic has become clear. There is an element of frustration in the anti-corruption community recently. We are measuring the problem of corruption, we are raising awareness, we are providing the tools necessary to combat it. So why does corruption remain such a big problem? A biennial gathering taking place in November 2006 in Guatemala, that brings together practitioners from civil society, law enforcement, academia, government is doing so under the banner "Towards a fairer world: Why is corruption still blocking the way?"

Course adjustment

This incongruence between expectations and outcomes indicates that perhaps we haven't been getting our analysis one hundred per cent right and that there are additional avenues we need to explore.

For much of our time we have been concerned with realigning incentives in order to reduce the profitability and thus incidence of corruption. We have been trying to activate economic and legal levers to do this. We have been exerting pressure on political actors. But despite our best efforts, we stand here and see a shortfall in overall progress and ask: why exactly *is* corruption still blocking the way?

One obvious answer is that enforcement has not been nearly sufficient. In the UK for example, there have been laws criminalising foreign bribery for over half a decade now, but to date not a single prosecution has been undertaken. I'd like to believe that is due to the inherent integrity of British companies overseas, but the facts indicate a gloomier picture.

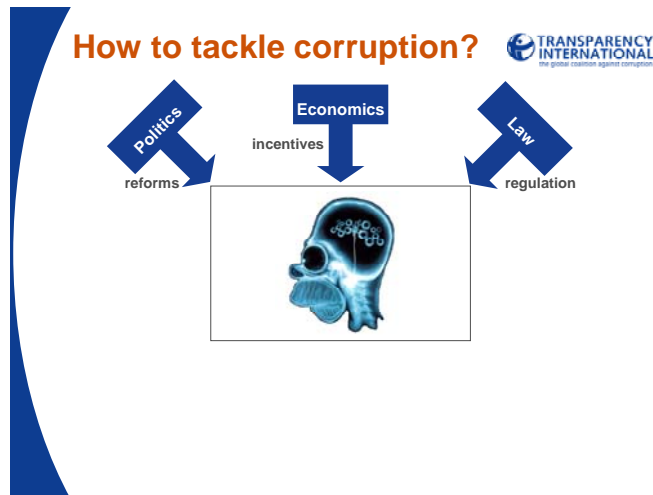
Corruption as human behaviour

Perhaps it is useful to remind ourselves of Transparency International's working definition of corruption: *the abuse of entrusted power for private gain*. This is essentially a description of goal-oriented behaviour. The goal: private gain. The behaviour: abuse of entrusted power. And this definition does not limit the phenomenon to public office. Nor does it necessarily distinguish between corruption out of greed and corruption out of need.

This definition does imply that corruption is fundamentally about power, its use in decision-making, and about behaviour and motivation. This in turn makes sense of using incentives, institutions, regulation and laws – because all of these influence behaviour.

But as we've already established this framework doesn't seem so far to have produced the desired outcomes.

So perhaps we need to add to what might be termed a technocratic approach and take a deeper look at the behavioural component of corruption, considering that behaviour, especially decision-making, is fundamentally about brain activity.



I wonder whether you recognise our representative human in the slide above. It is Homer Simpson, the everyman star of the long-running television cartoon series, *The Simpsons*. Anyone familiar with the show knows that it does a good job of integrating the big picture questions and life's little details. So I felt he was a good choice.

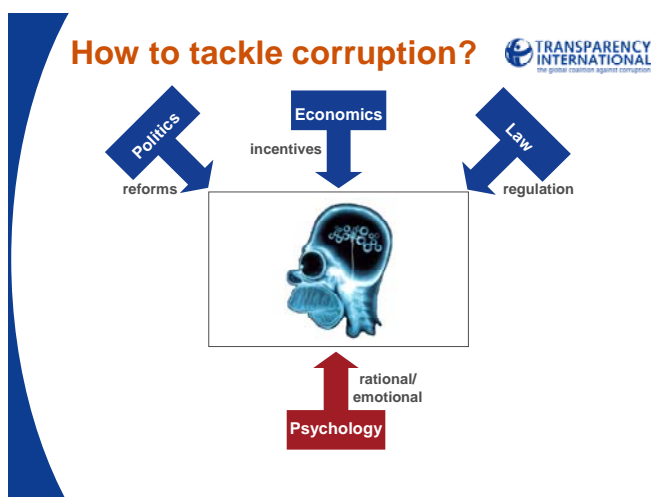
Understanding human behaviour is obviously a complex undertaking. The human decision-making centre is a mass of a hundred thousand million (or one hundred billion) neurons with multiple connections between them. That's complex.

One of the reasons tackling corruption is so difficult is that we're working against connections, not just in each human brain, but between human minds, linked in networks of clandestine behaviour. For instance, corrupt transactions are facilitated by lawyers and accountants, setting up off-shore companies through which to transmit illicit gains, for example, and creating the façade of legitimacy.

We started with laws and finance, but someone like Desmond Morris, for example, author of *The Naked Ape*, might have started from a completely different perspective. He would have focused first on individual and group behaviour; perhaps analysing the way it is guided by what we might consider soft incentives.

Incorporating a more behavioural approach ought not be so foreign to TI given the definition we've adopted. So let us consider how these approaches might help us analyse corruption.

Psychological approaches



The three approaches we began with, economics, law and politics, aim to influence how people make decisions – an ultimately psychological process. Why do most people in the UK wear seatbelts in cars? Because it was made compulsory. Changing the law here changed behaviour. But it doesn't always work. There are lots of other laws, such as mandatory speed limits, or not using a hand-held mobile phone while driving, that people don't follow.

The risks of driving without seatbelts were made palpable through advertising that went for simple, visceral messages. The risk of driving ten miles per hour faster than the speed limit doesn't really provide those types of nightmare scenarios.

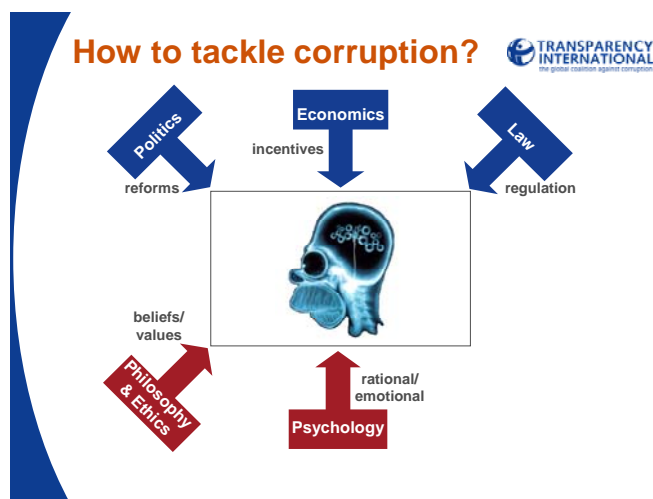
Except in the case of a series of adverts seen a while back. They feature a child saying: "If you hit me at 40 mph there's an 80 per cent chance you'll kill me. If you hit me at 30 mph there's an 80 per cent chance I'll survive." The ad finishes with the message: "30; there's a reason".

This is an example of rational argument combined with emotional appeal. The law here takes a back seat - no pun intended - and is a sort of sub-plot to the overwhelming prospect of killing a child and all the emotional consequences that entails.

Highlighting personal responsibility can be a very powerful way of changing behaviour. As I think the environmental movement illustrates. We must also find ways of communicating the meaning and significance of people's ethical decisions, so that what might previously have seemed like mundane decisions become confrontations with personal values.

New approaches have not only helped bring the impact of everyday decisions home to people, but also provided an infrastructure for acting on them. I am thinking specifically of the Fair Trade movement. Without Fair Trade products, brands and stores, consumers would have no simple options for expressing their convictions. Maybe we need to have "traded with integrity" products identified and made widely available.

Beliefs, values and ethics



While the finance part of my background makes me quite familiar with an approach based on numbers and remunerative incentives, the theologian in me asks how people's beliefs inform their actions, both individually and collectively.

In the case of values-based decisions like whether or not to bribe or accept a bribe, values and ethics can form a sort of threshold, establishing under what emotional and external circumstances - if any - you may say yes. Your social environment, the level of trust you have in those around you, how you see this affecting people you care about, will also come into play; but your values will be a fundamental guide in making these decisions.

An intriguing study was published some time ago by the Federal Reserve Bank of St Louis. They looked at the links between religious belief, and the propensity to engage in corrupt behaviour, and taking account of other factors which also seem to be correlated with corruption (such as wealth). In particular, they took the 'belief in hell' findings of the

World Value Series as a proxy for religious belief, and considered how this related to levels of corruption based on the TI Corruption Perceptions Index. Let me quote from their report:

"A belief in hell tends to mean less corruption and less corruption tends to mean a higher per capita income," they wrote. "Combining these two stories ... suggests that, all else being equal, the more religious a country, the less corruption it will have and the higher its per capita income will be."

Now I have to tell you that TI did not react to this study by launching a campaign to promote belief in hell as a way to fight corruption – though (for those who know a bit of church history), the prospect of TI perhaps being able to issue indulgences in exchange for donations did have some appeal to our fund-raising team!

But whatever we make of the findings of this study and others exploring such matters, there is plenty of evidence that what people believe and value is linked to how they behave.

Influencing people on this level is not quite as simple as slapping a few percentage points on tobacco tax. There is the immediate approach which is to tailor messages to the way people already think, to use existing values.

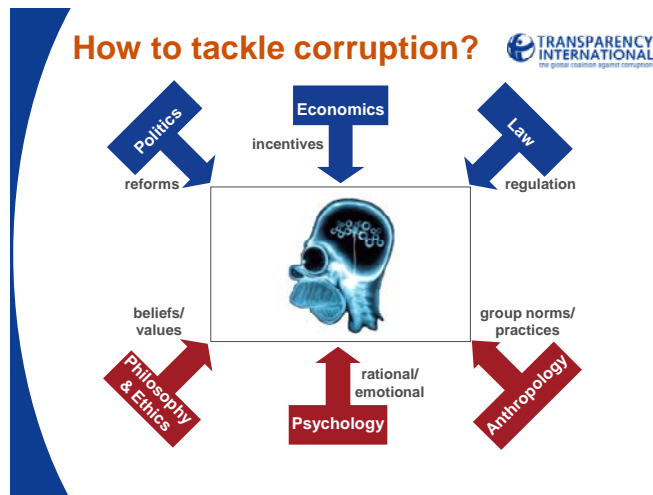
But there is a more long-term goal, which is to shape values and their application to decision-making. I think in many western countries we can see that the environmental movement, or the civil rights movement, have been quite successful in shifting people's values. For instance, in relation to recycling and climate change, and about torture and persecution. We've come a long way in just a hundred years on both of these fronts, though not without some opposition.

Of course corruption may be emotionally less direct than these other issues, but we have not nearly exploited all avenues for communicating the importance of integrity and transparency in terms that mean something to average people.

The advertising industry has made a science of plumbing the depths of the collective soul and identifying values that move people, whether those values are profound or superficial.

We too must identify people's values and build on these to promote integrity. It is not just through lecturing that this will be achieved, but by marrying information to existing values and desires.

Anthropological insights



We are also learning the importance of structures that extend beyond the formal institutions of government. In Kenya, for example, we have seen an ambitious, reform-minded government, with many of the 'right' institutional tools, fall seriously short.

What has become apparent is the pervasive influence of embedded networks. Informal associations that continued the exploitation of public resources long after the corrupt former regime had been voted out. This is an anthropological problem as much as it is a political one.

In the trial of former Enron heads Skilling and Lay, one of the witnesses was the former CFO Andrew Fastow. He made an interesting statement about the internal culture that prevailed at the firm before its downfall. When asked by the defence's lawyer if he had been a "hero for Enron when [he] stole from Enron?", he countered "That's what I believed I was being within the culture of corruption that Enron had, the culture that rewarded financial reporting as opposed to rewarding economic value."

In the book 'Lord of the Flies' by William Golding, we have a group of mild-mannered British school boys who turn to beasts in the absence of the former authority structure. They develop their own hierarchy, one with its own brutal traditions. These new and startling behaviours emerge, apparently independent of the ordered benign existence the boys had led before.

While a work of fiction, it illustrates how behaviours are context-dependent. Values may find their expression in one context and not another. Law-abiding citizens can under some circumstances be part of a murderous mob. History provides no shortage of examples here.

But why have Transparency International, and many others working on governance questions, focused more on economics, and legal and political reform, and not included these soft variables: the psychological, philosophical and anthropological dimensions? One reason might be that many of the people who got involved in anti-corruption were lawyers, economists and political scientists; whereas the psychologists, ethicists and anthropologists were rather thinner on the ground.

Perhaps another significant reason for the wide berth that many have given to cultural issues is to avoid relativising corruption, that is, to allow for cultural loopholes. Nor did people want to fuel any sort of racially based cultural discrimination. These concerns rightly persist, but we need to cast a wider net than we have been doing.

For example, take 'loyalty' as a value. Loyalty is usually regarded as a positive. But when we delve deeper, it becomes more complex: does loyalty for a manager in a developing country civil service mean acting in the interests of her extended family, and appointing them to jobs wherever she can? Or does it mean loyalty to the ethos of public service, and hiring strangers to fill positions? Loyalty may be a good thing, but we need to explore: loyalty *to whom?* Loyalty *about what?*

There have been attempts made to apply more behavioural models. An example would be the World Bank's anti-corruption Voluntary Disclosure Programme which one can see as an application of what is known as 'game theory' to encourage greater integrity and harvest valuable information about how corruption proceeds.

The programme essentially is supposed to offer concessions and some protection to companies who disclose the results of an internal investigation and who adopt a strict no-bribes policy going forward. There is a real threat that one company may blow the whistle on another in this process, providing an impetus to act first.

But this is still based on the *Homo Economicus*, the rational player, who soberly assess his options. In reality, people are arguably less rational in their decision-making – there is

plenty of evidence, such as from financial economics, to suggest that our perceptions of risk are not entirely rational. And if we are seeking to create some change in the way they are behaving it behoves us to take account of how people actually make decisions. This includes the weight people put on the expectations, opinions and anticipated behaviour of others in the groups in which they participate and to which they feel they belong.

This means looking beyond a strictly rational set of legal incentives, at the emotional biases, rules of thumb and the framing that behavioural economists such as David Kahneman tell us are so important in human decision making. If we can change those rules of thumb and chosen behaviour patterns, for example, that businesspeople or public officials use in making split-second decisions of an ethical nature, perhaps we could more successfully manage the threat of corruption.

Conclusion

I'd like to put a particular challenge to the professionals and professionals-to-be in the audience here at LSE. I challenge you to be honest with yourselves about who you are doing business with and why. Do you know why your client has the banking needs that they do? What are the ethical considerations in deciding whether to assist a client in establishing and operating a shell corporation?

The dynamics of corruption are intimately related to the subject matter that is taught at this venerable institution and the careers that its graduates will go on to lead. I hope that some of you will be inspired to investigate some of the questions that I've touched on today, the relationships between political reforms and human psychology, between anthropological pressures and decisions to behave corruptly, how what people believe and value affects how they live. We do not yet have answers to all the questions I have touched on; indeed, some are questions that we are only beginning to ask.

We need scientists, businesspeople and activists, but also advertisers, psychologists and philosophers who can work with us to delve deeper into questions of governance, who can help us discover new ways of thinking, new ways of approaching problems. This is ultimately a quest for better lives, for less suffering and for greater justice.