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Corruption, Rule of Law, and Economic Efficiency: Selected Anecdotic Evidence of Bureaucratic Corruption from the Czech and Slovak Republics

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Abstract

Ladislava Grochová, Tomáš Otáhal: **Corruption, Rule of Law, and Economic Efficiency: Selected Anecdotic Evidence of Bureaucratic Corruption from the Czech and Slovak Republics**

Can corruption improve economic efficiency? Classical political economists argue that corruption undermines the rule of law (Smith 2001, chap 5). The modern Public Choice proponents argue that corruption might influence the efficiency of the rule of law. While Chicago Public Choice scholars model how corruption improves efficiency of the rule of law and thus the overall economic efficiency, the Virginia Public Choice models explain how corruption reduces efficiency of the rule of law and thus the overall economic efficiency. In this paper, we present a brief survey distinguishing among arguments of the Chicago Public Choice and Virginia Public Choice schools on how corruption influences economic efficiency. We present selected quasi-experimental anecdotic evidence of bureaucratic corruption from the early period of transition in the Czech and Slovak Republics to support the argument that the Virginia Public Choice explanation is more realistic because it includes the influence of bureaucratic corruption.

Keywords

Bureaucracy, corruption, economic efficiency, Chicago Public Choice, Virginia Public Choice, rent-seeking, rule of law

JEL: D74, K42, P3

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Introduction

Can corruption improve economic efficiency? The economic theory of Adam Smith (1723-1790) assumes that the state is a necessary part of market organization. Economic theorists deal with the state as a precondition for a successful economic organization. Adam Smith in *Wealth of Nations*, however, criticizes the state interventionism (Smith 2001, chap 5) to suggest an alternative organization of the state that enforces rules protecting private property, and allows the emergence of private enterprises – the rule of law (Smith 2001, chap 5).

Classical political economists were aware of the danger that corruption poses for the rule of law, but they did not develop any appropriate analytical apparatus for dealing with this problem.[1] Almost one hundred years later, Public Choice theoreticians filled this gap and developed an appropriate analytical apparatus providing a solution to the corruption problem. As James M. Buchanan states: ”If I am allowed to use Thomas Kuhn's overly used word here, we can, I think, say that a new *paradigm* has been substituted for an old one. Or, to go somewhat further back, and to use Nietche's metaphor, we now look at some aspects of our world, and specifically our world of politics, through a different window.” (Buchanan and Tollison 1999, 11)[2]

Theoretical analysis of corruption extends the Public Choice theory, but it does not reach an agreement about how corruption reduces economic efficiency. While Chicago Public Choice scholars argue that corruption might lead to efficient regulation provided by the state and thus improve economic efficiency (Posner 1974, Becker 1983), Virginia Public Choice proponents argue that the state behaves rather as a benevolent despot than *homo economicus*[3]*,* so that the provision of rule of law by the state cannot be efficient unless the benevolent despot is constrained by the constitution (Buchanan and Tullock 1965, Downs 1965, Brennan and Buchanan 1977). Given the assumption of a benevolent despot, corruption reduces economic efficiency through rent-seeking (Tullock 1967, Krueger 1974).

In this paper we survey the Public Choice contributions to the economic theory of corruption, identify theoretical discourse among the Chicago Public Choice and Virginia Public Choice proponents and extend the more realistic Virginia Public Choice theory by a theory of corruption that explains how corruption

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[1] In this paper, we assume that corruption is a problem of the state rather than the market (Banfield 1975, Otáhal 2007).

[2] For recent survey of Public Choice literature with some implications for public policy, see Schwarz (2001).

[3] We define the benevolent despot as an agent who maximizes political power. *Homo economicus* is defined as an agent who maximizes utility in the market. However, when Virginia Public Choice speaks about benevolent despot it speaks rather about the means that benevolent despot uses to fulfill his interest than about behavior of concrete politicians and bureaucrats, because these are the same as other people. Benevolent despot thus rather represents the way how politicians and bureaucrats fulfill their interests using certain means provided by political organization.

reduces economic efficiency when bureaucracy is taken into account. We thus argue that in the world where bureaucracy provides public goods corruption reduces efficiency in every case, because bureaucracy is strong interest group seeking principally inefficient rules to be established. We do not necessarily claim that corruption is inefficient,[4] but we claim that Virginia Public Choice theoretical apparatus that explains negative effect of corruption on economic efficiency is more realistic because we simply do not live in the world without bureaucracy.

We have built on Lambsdorff (2002) who presents an argument based on uncertain effects of corruption on economic efficiency when rent provided by a politician-bureaucrat[5] is endogenous. Our argument is also based on Brennan and Buchanan (1977, 1981) theory of benevolent despot, rent-seeking theory (Tullock 1967, Krueger 1974) and Downs (1965) and Niskanen (1971) theory of bureaucracy. Our theoretical model implies that in the world where bureaucracy provides public goods, including the rule of law, politicians must cover the inefficiencies of bureaucracy. This provides the space for bureaucratic corruption and thus greater rent-seeking investments.

In the next section, we explain that the assumption of a politician-bureaucrat behaving as a benevolent despot means the behavior of *homo economicus* in an institutional framework, which does not transform private interest into public interest as efficiently as free markets (Buchanan and Brennan 1977, 1981). We define corruption analogically. Since corruption is in essence a particular type of exchange, the task of the theoretical analysis of corruption is to explain how such particular exchange reduces economic efficiency within the specific institutional framework.

In the second section we summarize the Chicago Public Choice theoretical arguments explaining effects of corruption on economic efficiency. According to this theoretical framework, competing interest groups might bribe politicians to induce politicians to create legislation that improves economic efficiency (Posner 1974, Becker 1983). This argument, however, assumes that politicians behave rather as *homo economicus* than as benevolent despots.

The third section explains Virginia Public Choice theoretical arguments. It argues that it is more realistic to assume that politicians behave as benevolent despots rather than *homo economicus*, because in the world where bureaucracy (Downs 1968, Niskanen 1968) provides public goods, the rule of law is also

[4] Becker and Stigler (1974) argue that legalized corruption improve economic efficiency. Friedman (1979) provides historical example that illuminates Becker's and Stigler's model. However, our argument rather falsifies Chicago Public Choice model with anecdotic evidence, which is valid for the most modern democracies in the world. We do not explore historical narratives we rather falsify validity of Chicago Public Choice models with recent observations.

[5] Politician-bureaucrat represents the government, which consists of both politicians and bureaucrats.

provided by bureaucracy. Since bureaucrats provide the rule of law inefficiently, politicians must levy undesirable tax to cover greater rent-seeking investments (Tullock 1967, Krueger 1974).

In the fourth section we build a rent-seeking model with corruption where rent is endogenous (Lambsdorff 2002). We argue that economic efficiency might be reduced when there is a low number of interest groups, including bureaucrats, competing for rents through corruption. This conclusion is illustrated on the case of transition in Central and Eastern Europe, where provision of the rule of law was inefficient despite the intensive competition among interest groups.

In the fifth section we support our theoretical arguments empirically with selected unique anecdotic evidence of bureaucratic corruption from the early period of transition in the Czech and Slovak Republics. The source of the presented evidence is mostly the Czech and Slovak newspapers which reported on political corruption. Early transition of Central and Eastern Europe might be referred to as a period of creation of new legislation within old bureaucratic practices when a lot of interest groups were able to compete for the creation of legislation. For this reason, we understand this time period in Central and Eastern Europe as quasi-experimental environment allowing relatively intensive competition among interest groups.

The conclusions present a brief summary and suggestions for public policy.

1. Public Choice Economic Analysis of Corruption

Brennan and Buchanan (1977) started the theoretical analysis of corruption. They developed a Leviathan model of the budget-maximizing or revenue-maximizing politician-bureaucrat. Assuming that the budget-maximizing or revenue-maximizing politician-bureaucrat represents a monopoly in provision of public goods, they argued that while tax payers are not uniform, progressive taxation might lead to a maximum revenue levied by the politician-bureaucrat. However, this only applies if it is efficiently set in constitution, otherwise it creates the danger of undesired tax revenue extracted from tax payers. Later Brennan and Buchanan (1981) argued that the task of the *homo economicus* microeconomic assumption is to provide an *as if c*ondition for testing whether particular institutions serve to transform private interests into public interests. Thus, according to Brennan and Buchanan (1981), it is more realistic to assume that politician-bureaucrat behaves as a benevolent despot. If we assume that the politician-bureaucrat behave as *homo economicus,* we cannot present that political organization transforms private interests into public interests as efficiently as freely operating markets.

Analogically, the difference between the behavior of *homo economicus* and corrupt behavior might be explained. Without the explanation of institutional conditions where corruption happens, the theoretical analysis of corruption would not make any sense because there would be no difference between *homo* *economicus's* behavior and corrupt behavior and thus no explanation how corruption influences economic efficiency (Otáhal 2006). This is also the reason why it is difficult to rigorously define what corruption is.[6] Most scholars use the simplest example of bribery as an illustration of corrupt behavior (*i.e*. Shleifer and Vishney 1993, Rothbard 2001, 172). In this short paper, we define corruption as bribery, which is a voluntary exchange between economic agents, where a bribe is the price paid by an agent buying a particular service provided by another particular agent. This is a wider definition of corrupt behavior, which allows us to synthesize several theoretical approaches. The economic problem of corruption then arises from the fact that when we speak about corruption, we usually do not assume only two parties in the corrupted exchange, but also a third party, whose interest is harmed if the corrupt exchange takes place (Otáhal 2007). The question of theoretical analysis of corruption therefore is: What are the institutional conditions which transform private interests of corrupt agents so that they harm third party's interest or, alternatively, public interest?

2. Chicago Public Choice Theory and Corruption

In a theory referred to as the theory of regulation, the Chicago Public Choice school presents the argument that corruption improves economic efficiency. The seminal paper on the theory of regulation is credited to Stigler (1971). He argues that the purpose of governmental control of economic organizations is not the protection of the public interest, but the protection of controlled economic organizations against competition. Stigler (1971) generally argues that: "…every industry or occupation that has enough political power to utilize the state will seek to control entry. In addition, the regulatory policy will often be fashioned to limit the rate of growth of new firms." (Stigler 1971, 5)

Peltzman (1976) follows Stigler and provides the general theoretical apparatus that applies to the economic analysis of the state protection. The process is effective because political agenda is not transparent, political issues in political campaigns are mixed and displeased voters are not motivated to spend resources for gathering information to oppose the interest groups.[7] In the Peltzman's (1976) model, interest groups[8] get their wealth transfer from voters through taxation.

In compliance with Stigler (1971) and Peltzman (1976), Posner (1974) argues that the source of regulatory inefficiency is the fact, that the regulatory agencies are not profit-seeking organizations. Since the

[6] Svensson (2005) argues that to define corruption rigorously might be so difficult that it might be worth to avoid the definition at all.

[7] This proposition is similar to Virginia Public Choice proposition referred to as rational ignorance (Buchanan and Tullock 1967, chap. 4).

[8] Olson (1971) develops the interest group theory in which interest groups influence political decision making independently on voters' preferences. Stigler (1971) uses a similar assumption.

regulatory agencies are bureaucratic organizations they are not interested in lowering costs.[9] More importantly, the problem with regulation is that the regulatory agencies are not able to recognize the costs of the regulated industry. Inability of the regulatory agencies to overcome the information asymmetry incites the interest groups to pressure politicians to create new legislation in a nontransparent political process. Posner (1974) even suggests that the competition between interest groups can thus result in efficient regulation.

Let us use the agency theory to show, how interest groups affect politicians' decision-making and thus the creation of new legislation in a nontransparent political process.[10] In Graph 1 there is a game tree of politician´s decision-making. The risk-neutral politicians decide about acceptance of a bribe. If they is not corrupt, they receive official remuneration *wn,* where *n* is a finite period of time. If the politicians are corrupt and their corruption is detected, they receive alternative remuneration paid by alternative employers *vn*. The alternative remuneration *vn* is received with probability *p*, which is the probability that politicians' corruption is detected by general public - the third party. If politicians' corruption is not detected, the politicians have a probability *1-p* of receiving *wn+b*, where *b* is a bribe. Graph 1 suggests that politicians are not corrupt if $w_n > v_n + \frac{1-p}{p} b$ because their opportunity costs from corruption are higher. If $w_n < v_n + \frac{1-p}{p} b$ the politician is corrupt and he can affect the legislation process in favor of interest groups.

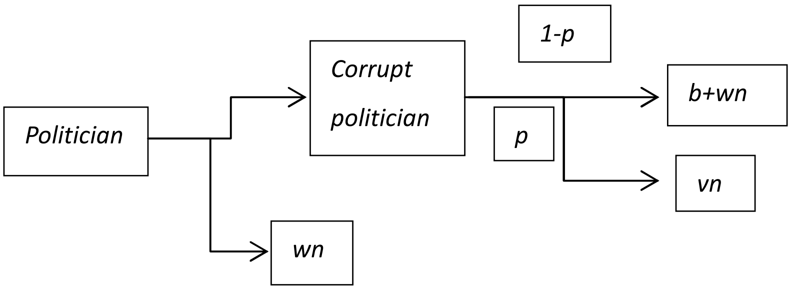
In Graph 2 there is a game tree of politicians' decision-making when general public - the third party - fines corruption. Again, if the politicians are not corrupt they receive remuneration *wn* where *n* is a finite period of time. If the politicians are corrupt, they receive *vn* with probability *p*, but in the case, when politicians' corruption is detected, politicians are also fined with *F, resulting in* costs of politicians' corruption *vn-F*. If the politicians' corruption is not detected, again, the politicians have a probability *1-p* of receiving *wn+b*, where *b* is a bribe. Graph 1 suggests that politicians are not corrupt if $F > (v_n - w_n) + \frac{1-p}{p} b$ because their opportunity costs from corruption are higher. If $F < (v_n - w_n) + \frac{1-p}{p} b$ the politicians are corrupt and they can affect the legislation process in favor of

[9] Rigorous theory of revenue maximizing bureaucrat is credited to Virginia Public Choice (Downs 1965, Niskanen 1968).

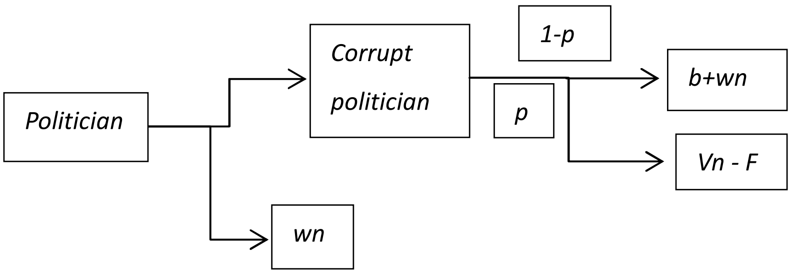
[10] The agency theory is used for instance by Banfield (1975), Becker and Stigler (1974), Rose-Ackerman (1975), Klitgaard (1991). Agency theory is also used by Bowles and Garoupa (1997), who combines corruption with Economics of Crime.

interest groups. The difference in this model is that the third party disposes of the coercive power so that it has a power to extract fines from the politicians. Both models describe politician’s incentive structure when politicians and interest groups tend to corruption.[11]

Graph 1: Game three of politician’s decision-making



Graph 2: Game tree of politicians' decision-making when government fines corruption



Later, Becker (1983) elaborates on Posner’s suggestion about efficient regulation. Becker (1983) assumes that the outcome of political competition is the result of competition among interest groups, not the result of voters’ decision-making. Becker (1983) in compliance with Peltzman (1976) explicitly argues that since the transfers from voters to interest groups through taxes create dead-weight loss, the interest groups will compete only if the outcome of the political competition brings them the rent that covers the costs of political competition and the dead-weight loss as well. Thus if dead-weight loss from taxation is too high, the interest groups will not be encouraged to enter political competition because the transfer will not cover losses. On the other hand, if the taxation from other interest groups covers too high dead-weight loss, the other interest groups will invest resources into changing the regulation. Thus the competition between interest groups reduces the dead-weight loss. From the perspective of the politicians' decision making, interest groups whose dead-weight loss is covered by taxation raise *b* to

[11] In both models we assume a situation when politician and interest groups tend to corruption which is illegal. We thus do not assume that interest groups lobby.

incite the politicians to create efficient regulation. From Beckers' (1983) perspective corruption leads to efficient regulation and thus improves economic efficiency.[12]

3. Virginia Public Choice Theory and Corruption

The Chicago Public Choice theory suggests that corruption might improve economic efficiency.[13] From the perspective of the Public Choice analytical apparatus this conclusion, however, represents the case when the politician-bureaucrat behaves as a *homo economicus* rather than a benevolent despot. Nevertheless, political organization is not a market, therefore the exchange behavior similarly to bribery ought to have less than efficient results within political organization.[14]

From the perspective of the Virginia Public Choice theory, the Chicago Public Choice conclusion is not realistic. This is because the behavior of the politician-bureaucrat is not, in reality, efficiently constrained by constitution. As Becker (1983) explicitly says: "Groups compete within the context of rules that translate expenditures on political pressure into political influence and access to political resources. These rules may be embodied in political constitutions and other political procedures, including perhaps "rules" about the use of force to seize power" (Becker 1983, 374). Within the assumption of an inefficiently constrained politician-bureaucrat, the Virginia Public Choice theory raises another question of theoretical analysis of corruption: How does corruption reduce efficiency?

Brennan and Buchanan (1977, 1981) suggest that a benevolent despot[15] might impose tax on private agents undesirably. Such undesirable taxation might induce bureaucracy which maximizes revenues to extract rents from politicians.[16] Therefore, both, the tendency of politicians to tax private agents undesirably and the tendency of bureaucracy to extract undesired taxation from politicians, represent

[12] This approach is highly criticized by Olson (1996).

[13] This approach was also suggested by Leff (1964), who argues that bribes help entrepreneurs (alternatively interest groups) to overcome bureaucratic obstructions or make bureaucrats more cooperative. Additionally, Huntington (1968) suggests that corruption is a phenomenon of modernization. For survey of corruption literature dealing with the positive vs. negative consequences of corruption on economic development, see Bardhan (1997) or Jain (2001).

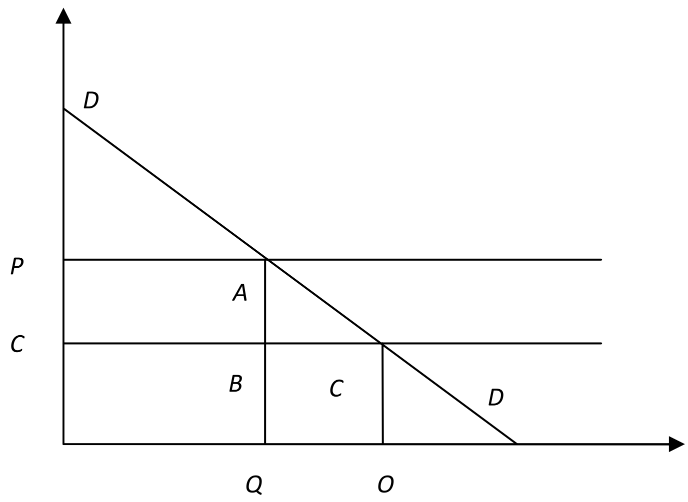
[14] Shleifer and Vishny (1994) also argue that provision of bribes to politician might improve efficiency. When managers of public firms provide bribes to politicians to overcome inefficient regulation, public firms might improve performance. Nevertheless, Shleifer and Vishny (1994) argue that public firms are subsidized. When politicians provide subsidies to inefficient firms in exchange for bribes or managers provide bribes in exchange for subsidies the affect of subsidies on *the third party's* utility might be negative. For Public Choice theoretical explanation how subsidies negatively affect firms' efficiency, see Kornai (1986), Kornai and Maskin and Roland (2003).

[15] This approach was more examined by Olson (1993), McGuire and Olson (1996), North and Wallis and Weingast (2009).

[16] Here, we assume that a government consisting of politicians and bureaucrats is divided between both politicians and bureaucrats. This approach is typical for Virgina Public Choice that models behavior of both politicians (political parties) and bureaucrats. Politician-bureaucrats representing politicians and bureaucrats together is a typical proposition for Chicago Public Choice.

rent-seeking. According to the Virginia Public Choice school of thought, rent-seeking is the reason why governments are inefficient (Tullock 1996). It is also the explanation of corruption inefficiency. Let us therefore explain how corruption reduces economic efficiency within a rent-seeking model.

Graph 3: Rent-seeking



Source: Tullock (1967)

Graph 3 presents the classical rent-seeking diagram. Let us assume that in a competitive market a product for which there is a demand *D* can be produced at cost *C.* Quantity *O* would thus be produced at price *C*. Let us suppose, however, that it is possible for politicians to change the regulations so that they protect this production against competition. According to the theory of monopoly (Varian 1995, chap.23), the area of triangle *ABC* is a death-weight loss (*DWL*), but rent-seeking theory (Tullock 1967, Krueger 1974)[17] maintains this is an underestimation of true costs.. Since inducing the politicians to change the regulations and changing the regulation itself is costly, rectangle *PCBA* might be counted as the costs of monopoly. Interest groups and politicians might invest resources into changing the regulations until the present discounted value of invested resources equals the present discounted value of the monopoly, taking risk into account as well. The rent-seeking theory thus suggests that the waste of monopoly might be much greater (*PCBA)* than explained by the standard theory of monopoly.[18]

According to the rent-seeking theory, a benevolent despot might change regulation in exchange for bribes so that it protects production against competition and thus waste resources on changing the regulation.

[17] For the dynamic rent-seeking theory see Buchanan (1980).

[18] For negative consequences of rent-seeking on economic growth see Murphy and Shleifer and Vishny (1993).

Interest groups might also waste resources on provision of bribes. However, modern governmental agencies use bureaucracy to change, control and enforce regulation.[19] To be more precise, let us thus include bureaucracy in the general rent-seeking model.

Downs (1965) defines bureaucracy as a relatively large organization, which is unable to objectively measure its profitability. Niskanen (1968) developed a theory of similarly defined bureaucracy.[20] According to Niskanen (1968), bureaucracy might influence politicians' decision-making as a relatively strong interest group. Politicians provide taxation to fund bureaucracy and bureaucracy maximize the budget funded by taxation. In this model, Niskanen (1968) argues that since politicians' perception of efficiency of bureaucracy is limited, bureaucracy might raise budget so that it is above efficient provision of public goods.

Let us assume that politicians' perception of efficient provision of public goods is equal to:

$B = B(Q),\ \ B' > 0, B'' < 0\ \ (1).$

Bureaucracy buys resources in competitive market, thus its cost function is similar to firm's cost function:

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[19] Stigler (1976) suggests that even the process of electing politicians might be ruled by bureaucracy.

[20] Chicago Public Choice (i.e. McChesney 1987) does not assume bureaucracy as an independent interest group, but rather an organization of value maximizing agents. This assumption, however, misses principal difference between a bureaucratic management and a management of private organizations.

Downs (1965) characterizes a bureaucratic management as follows. "An organization is a bureau if and only if it possesses the following four primary characteristics:

1. It is large; that is, the highest ranking members know less than half of all the members personally.

2. A majority of its members are full-time workers who depend upon their employment in the organization for most of their income.

3. The initial hiring of personnel, their promotion within the organization, and their retention therein are at least theoretically based upon some type of assessment of the way in which they have performed or can be expected to perform their organizational roles rather than upon either ascribed characteristics (such as religion, race, or social class) or periodic election by some outside constituency.

4. The major portion of its output is not directly or indirectly evaluated in any markets external to the organization by means of voluntary quid pro quo transactions." (Downs 1965, 439 - 440)

Niskanen (1968) characterizes bureaucracy as follows: ''The model outlined in this section [bureaucracy model] is based on the following two critical characteristics of bureaus: (1) Bureaucrats maximize the total budget of their bureau, given demand and cost conditions, subject to the constraint that the budget must be equal to or greater than the minimum total costs at the equilibrium output. (2) Bureaus exchange a specific output (or combination of outputs) for a specific budget. For this paper, thus, bureaus are defined by these two characteristics. "(Niskanen 1968, 293)

Crucial implication of both characteristics of bureaucracy is according to Niskanen (1968) following: ''A careful analysis would indicate that the same output could be achieved at a lower budget, but the analyst should expect no cooperation from the bureau since it has no incentive to either know or reveal its minimum cost function.'' (Niskanen 1968, 296)

This implication suggests that a bureaucratic management faces different incentives in comparison with private firms. Predecessor of this approach was Mises (2002) who argues that bureaucracy is principally inefficient.

$C = C(Q),\ C' > 0,\ C'' > 0$ (2).

Since politicians' perceptions of efficiency of bureaucracy is limited, only bureaucracy knows its cost function. Politicians perceive only total output or total costs of bureaucracy. This makes bureaucracy a relatively strong interest group.

Let us assume that bureaucracy does not turn funds back to the politicians. In this case an equality might be set up as bureaucracy's objective function.

$O_B = B(Q) + \lambda(B(Q) - C(Q))$ (3),

Let us derive first-order conditions

$$B'(Q) = \frac{\lambda}{1+\lambda} C'(Q) \quad (4)$$

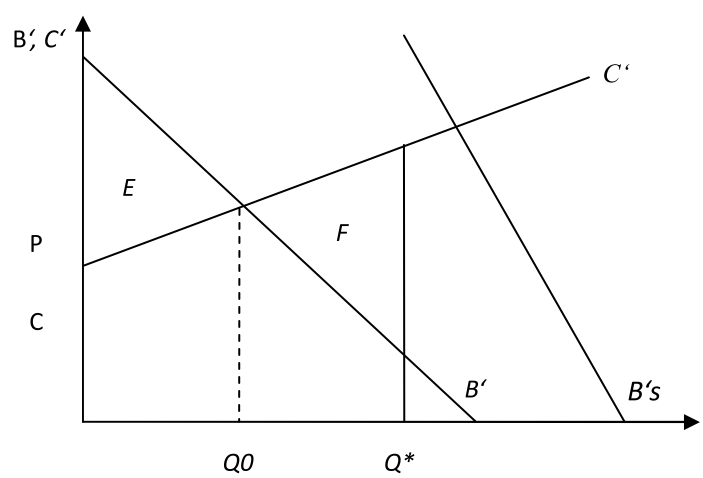
$$B(Q) = C(Q) \quad (5).$$

Nevertheless, efficient provision of public goods suggests that marginal public benefits of extra unit of bureaucracy's output are equal to marginal costs.

$$B'(Q) = C'(Q) \quad (6).$$

In equation (4), the Lagrangian multiplier represents the marginal utility of an extension of the bureaucracy's budget constraint. Since the Lagrangian multiplier is a positive number, the equation (4) implies $B' < C'$. Then the marginal public benefits of extra unit of bureaucracy's output are lower than marginal costs and bureaucracy's provision of public goods. This condition derived from equation (4) does not correspond with the condition of efficient provision of public goods in equation (6). For this reason, the provision of public goods by bureaucracy is inefficient.

Graph 4: Bureaucratic inefficiency



Source: Niskanen (1968)

Graph 4 shows a diagram of bureaucratic inefficiency. Niskanen (1968, 75) assumes that *B* and *C* are quadratic functions, thus *B′ and C′* are linear functions. According to the politicians' perception of efficient provision of public goods, the bureaucracy is supposed to extract funds for provision of *Q0*. Nevertheless, since the politicians' perception of bureaucracy's costs *C′* is limited and bureaucracy is a relatively strong interest group, it might request funds for provision of *Q** public goods. With the provision of *Q** public goods, bureaucracy receives consumer surplus of triangle *E,* which is equal to triangle *F.* Bureaucracy thus might invest resources into requesting *F* until the present discounted value of invested resources equals the present discounted value of the bureaucracy, taking risk into account. Thus, if corruption induces politicians to rent-seeking and politicians use bureaucracy to change, control and enforce regulations, the waste of politicians' rent-seeking is even greater.

Let us briefly summarize. According to the Virginia Public Choice analytical apparatus, benevolent despots might change regulations so that they protect production against competition in exchange for bribes and thus waste resources on changing the regulations. Nevertheless, in reality, regulations are changed, controlled and enforced by inefficient bureaucracy. Therefore politicians' attempts to change the regulations in exchange for bribes are even more wasteful. This again denies the Chicago Public Choice assumption of politicians behaving as *homo economicus,* because it suggests that when politicians are corrupt they are wasteful in order to cover their rent-seeking and bureaucratic rent-seeking costs by undesired taxation.

4. A Rent-seeking Model with Corruption When Rent is Endogenous

Previous arguments of the Virginia Public Choice proponents were based on the assumption that rent is exogenous. In this section, let us introduce endogenous rent (Lambsdorff 2002) into the general rent-seeking model (Mueller 2009, chap 15).

Let us assume that the probability that any interest group extracts the rent is assumed to be proportional to the interest groups' investment,

$$\pi_i(I_i) = \frac{f_i(I_i)}{\sum_{j=1}^{n} f_j(I_j)} \quad (1),$$

where $\partial \pi_i / \partial I_i > 0$. Investment in rent-seeking might exhibit constant returns as $\partial^2 \pi_i / \partial^2 I = 0$. Now, let us assume that investment in rent-seeking *I* with constant returns might be rewritten as $f_i(I_i) = I_i$.

Under the assumption that all rent-seekers are risk-neutral, each chooses a value of *I* that maximizes interest groups' expected gain *E(G)*.

$$E(G)=\left(\frac{I}{I+T}\right)R-I \quad (2),$$

where T is the impact of the total investment of the other *n-1* rent seekers, $T=\sum_{i\neq j} I_j$ and R is rent. Under the Cournot-Nash assumption that the other rent-seekers' investment remains fixed, the first order condition from equation (2) can be derived.

$$I=\frac{(n-1)}{n^2}R \quad \frac{R}{I+T}-\frac{IR}{(I+T)^2}-1=0 \quad (3).$$

If we assume a symmetric equilibrium, from equation (2), we get

$$I=\frac{(n-1)}{n^2}R \ (4).$$

Interpretation of the basic rent-seeking model (Mueller 2009, chap 15) is the following. Risk-neutral interest groups invest *I* given in equation (4), as long as this *I*, when substituted into equation (2), yields non-negative expected gain. The basic rent-seeking model (Mueller 2009, chap. 15), however, assumes that rent *R* is given exogenously. Under the assumption of endogenous rent (Lambsdorff 2002), the basic rent-seeking model is more realistic. Since real benevolent despots are not constrained by constitution efficiently enough, they might impose tax private on agents undesirably. From this perspective, benevolent despots may create rent.

To explain this theoretically, let us assume that the size of the rent *R* is positively dependent on total rent-seeking investments $I=\sum_{i\neq j} I_i+\sum_{i\neq j} I_j$. Then $R=R(I)$, with $R'>0$. This assumption corresponds with our argument that in the world where bureaucracy provides the rule of law inefficiently, benevolent despots might be incited to tax private agents undesirably to cover the inefficiencies bureaucracy. In our model, undesired tax presents a rent for the benevolent despots through which they also fund bureaucracy. Consequently, equation (2) might be rewritten.

$$E(G)=\left(\frac{I}{I+T}\right)R(I+T)-I \quad (2'),$$

under the same assumptions, we can also rewrite the first order condition derived from equation (2').

$$\frac{R'I}{I+T}+\frac{R}{I+T}-\frac{IR}{(I+T)^2}-1=0 \quad (3').$$

Assuming a symmetric equilibrium, from equation (2'), we get

$$I=\frac{(n-1)}{n(n-R')}R \quad (4').$$

Interpretation of equation (4') is that if *R* is larger (smaller) than 1 and *I* is larger (smaller) than *R.* an increase in the number of competitors *n* will decrease (increase) the total expenses for rent-seeking. In other words, with the assumption that politicians behave as benevolent despots, this model proves that in the case of a low number of interest groups engaging in corruption, rent-seeking competition through corruption reduces economic efficiency. This implication theoretically corresponds with a situation, where the rent is provided to a low number of interest groups with strong negotiating power – bureaucrats.

Let us illustrate this implication using a specific example. In Central and Eastern Europe after the collapse of the communist regime, a lot of interest groups were able to compete for the creation of legislation. However, in this period of replacement of old politicians by new ones, old bureaucracy remained relatively unchanged. Early transition of Central and Eastern Europe thus might be referred to as a period of creation of new legislation within old bureaucratic practices. According to some literature, even though this period was a period of increased activity of interest groups which led to corruption, efficient regulation was not set up. For instance, Jonson et al (2000) argue that the so-called "tunneling" was the result of weak political institutions, especially their inability to set and enforce an efficient legislative framework. Cull, Matesová and Shirley (2002) argue that inefficient law enforcement and inefficient regulations resulted in the problems of looting or asset-stripping.

Corrupt practices like theft, "tunneling" and asset striping provided evidence that bureaucracy participated on rents provided by earlier communist politicians. Communist politicians respected bureaucratic' claims on rents (Levy 1990, Shleifer and Vishny 1992, Anderson and Boettke 1997) As a result, later, when communist politicians were replaced, privatization of the state ownership officially targeted to general public led to the legalization of communist bureaucratic claims for rents in most cases. Bureaucrats were a strong interest group in the privatization process, therefore "tunneling" and asset striping together with other corrupt practices prevailed over the establishment of efficient legislation and regulation, i. e. efficient rule of law.

5. Selected Anecdotic Evidence of Bureaucratic Corruption in the Czech and Slovak Republics

To support our theoretical arguments empirically, let us present selected unique anecdotic evidence of bureaucratic corruption from the early period of transition in the Czech and Slovak Republics. The source of the presented evidence is mostly the Czech and Slovak newspapers which reported on political corruption. We believe that despite of newspapers' commercial bias, some publicly presented cases of bureaucratic corruption in the transition period of the Czech and Slovak Republics can provide clear and realistic illumination of the modeled political process.

The ever more negative perception of corruption in the Czech Republic was greatly affected by the scandal of Jaroslav Lizner and Viktor Kožený. Jaroslav Lizner was convicted of abusing the authority of a public official in connection with the privatization of the Klatovy dairy (KD). A tender for a 34% share in

KD during the second wave of the voucher privatization was canceled in July 1994 by minister Karel Dyba, because of doubts about the negotiation process with the winning company Trans World International (TWI). A representative of TWI, Luboš Sotona passed on a suitcase planted by the police to Lizner on April 31, 1994, containing 8,334,500 Czech crowns (Reed 1996, 225). The head of the center for the voucher privatization, the head of the central registry of securities and the member of the securities commission was thus the only high-ranking public official in charge of the voucher privatization convicted to 6 years in prison.[21] In 2004 he requested the reopening of the case, however this request was denied.

The name of Viktor Kožený stirred emotions in most Czech citizens, which often led to the condemnation of the privatization process based on the role of corruption in it. Viktor Kožený, the founder of the Harvard Company and Consulting (HC&C), became the owner of several important Czech companies after the first wave of the voucher privatization. During the year 1992, on eight occasions, he met with a former agent of the communist secret police and later with an employee of FBIS (the Federal security and information service), Václav Wallis. Reportedly, Kožený bought information from Wallis for about half a million crowns. In March 1994, Wallis was found guilty and sentenced to 37 months in prison. Subsequently, however, he was acquitted of any wrongdoing, because the alleged deal could not be proved.[22]

A subsequent anti corruption program "clean hands", which was part of the anti corruption initiative in 1998, was a specific answer of the Zeman government to the deteriorating perception of corruption linked to the privatization process in the Czech Republic. Based on this resolution, the government created an interdepartmental committee for the protection of economic interests. It was chaired by Stanislav Gross with a mandate to battle economic criminality and corruption. The committee was dissolved in the spring of 2000. According to a report by the European commission from the year 2000 (EC 2000), the institutions created under this initiative prepared 209 cases to be prosecuted, only 70 of which were investigated by the police. 18 cases were canceled, 10 were closed and only 6 made it to the court.

Another scandal involving a high ranking official in the Czech Republic was the "Srba" case. This case illustrates the connections of high ranking state officials and organized crime. Karel Srba allegedly traded without a mandate with the privileges for construction and reconstruction of governmental buildings,

[21] Lizner rejected the accusations, reasoning that "the costs associated with a privatization project are always a subject for discussion influenced by one´s political views" (Reed 1996, 224).

[22] Václav Klaus declared: "I regard as completely absurd the idea that Mr Kožený wanted to buy information of this type. The playing of this card is an ideological attack on the transformation of Czech Republic and an evil ideological attack on one of the foundations of the transformation process, that is, privatization." (Reed 1996, 231)

both at home and abroad. For example, according to the investigators, the company that was reconstructing the embassy in Zagreb (Block), paid Srba a five million crown bribe. "This amount was found in the car of Srba upon his arrest. The ex-secretary of the Ministry of Foreign Affairs of the Czech Republic defended himself, claiming that Jiří Sitár from Block only left the money for safekeeping" (Hospodářské noviny, 26th June, 2003). Srba was sentenced to eight years in prison not for corruption but for an attempt to murder a journalist Sabina Slonková. She presented a series of articles about the reconstruction of the Czech House in Moscow, managed by Srba, with unnecessary expenses for the state. Later, other corruption cases involving Srba emerged. However, none of the cases of corruption were proved, therefore he was cleared of all corruption charges. Jan Kavan, the head of the Ministry of Foreign Affairs, resigned, because he appointed Srba in 1998 to, paradoxically, guarantee the "clean hands" program of the Zeman government.

In Slovakia, the privatization process after 1993 was even more under political control. After the division of the Czecho-Slovak Federation, the Slovak government abandoned the route of voucher privatization and embarked on the road of direct sales. The higher discretionary decision power and more space for corruption was probably the ultimate motivation for the abandonment of the voucher privatization process managed by a system of automatic auctions (Tříska 2002). Clearly, the Slovak political elite was exposed to pressure directly calling for unfair advantages, something considered non-standard in a democracy by foreign observers. Thus, the Slovak privatization process illustrates not only the bureaucratic corruption mode of privatization, but also the behavior of politicians as benevolent despots.

According to the daily newspaper Hospodářské noviny (30th September, 2002), the HZDS representatives originally without any considerable assets, must have obtained most of the wealth from bribes and non-transparent privatization, since it could not be afforded from their official salaries. However, this will be ever harder to prove, since the only way to find the origins of their fortune would be to get official declarations of personal assets of the people involved. However, there was no such law in effect in Slovakia between 1990-1998.

The OECD report from the year 1999 (OECD 1998, 101) highlights the lack of transparency using the example of Slovnaft, the Slovak refinery, which was sold to an unknown company Colorin for 620 million Slovak crowns. The Fund of National Assets did not provide any specific information to the shareholders of the company during a general shareholder meeting shortly before the privatization.

At this point it is important to mention Ján Ducký. He was an interesting person, who later became publicly known. He was the former secretary of the Minister of Interior in the communist government and a minister in three Slovak governments, including the first transformational government. He allegedly lobbied for the Slovak entrepreneurs which he had known during the communist years who acquired wealth suspiciously easily (Týden 1999). During the years when Jan Ducký was the Minister of Economy, another company, Nafta Gbely was controversially privatized. He publicly denied any connections, even though he directly supervised the privatization process. The lucrative business was purchased by a company called Druhá obchodná with anonymous owners residing in an abandoned house in Bratislava suburbs. Nafta, originally being on a list of strategic companies not-to-be privatized at all, was sold for 500 million Slovak crowns, while its market capitalization was 3.2 billion Slovak crowns (Respekt 2001). Later it turned out that Nafta Gbely belonged to the regional chairman of HZDS in Trnava and a former waiter Vladimír Poór. In 1996 Ducký was dismissed from the ministry for embezzling billions of crowns in revenues from the Slovak state treasury by issuing illegal export licenses to several businessmen.

Jan Ducký, the former secretary of a communist ministry, minister in three HZDS governments and the manager of the profitable Slovak Gas Company was found dead in January 1999 in a corridor of a prefabricated house in Bratislava with three gunshot wounds in his head.

The most bizarre event demonstrating the political practices during the HZDS government was the abduction of Michal Kováč, the son of the Slovak president at that time. In 1995, he was transferred to Austria against his will. This operation was led by Ivan Lexa, the former head of the Slovak Intelligence Service (SIS) during the years 1994-1998. Lexa was accused of organizing the abduction and investigated, however after a direct order of the prime minister Mečiar, he was subject to amnesty in 1998. According to The Economist (2002), it was Lexa who was responsible for the execution of dirty political tasks initiated by the prime minister. The most serious accusation of Lexa was that he instigated the murder of Robert Remias, who died after a bomb hidden in his car exploded.

In 1998, the investigations of Lexa were reopened by the order of the new prime minister Mikuláš Dzurinda. In March 1999, at that time the member of parliament, Lexa faced three charges: i) abuse of power as a state official, ii) abduction of a Slovak citizen abroad and iii) robbery. The Slovak National Council stripped Lexa of his immunity. This could have been done only after the mandate and immunity commissions of the Slovak National Council agreed with prosecution of Lexa for the abuse of power as a state official in November 1999 and Lexa spent a few months in prison.

In May 2000, despite the ban on leaving the country, even with a diplomatic passport, Lexa left Slovakia. Slovak police initiated a nation-wide search for him in June 2000 and asked Interpol for help. In 2002 the former head of the secret service was deported from the Republic of South Africa to Slovakia and detained again.

"In fact, he was sunning himself at Umhlanga Rocks, a beach resort just north of Durban in South Africa, from a hotel owned by, guess who, his former secretary, who slipped the country around the same time as her boss, telling her mother she was off to Australia to learn English." (The Economist 2002)

According to The Economist (2002), most of the fortune of Lexa and other accomplices of Mečiar was stolen from the state. In June 2006, after lack of sufficient evidence to convict Lexa, Vladimír Mečiar supported his rehabilitation in the Slovak National Council.

Conclusions

In this short paper, we surveyed the theoretical discourse between the proponents of the Chicago Public Choice theory and the Virginia Public Choice school of thought on the relationship between corruption and economic efficiency. We explained that while the Chicago Public Choice theory admits that corruption might improve the efficiency of the rule of law and consequently also the economic efficiency, the Virginia Public Choice theory maintains that corruption induces politicians and bureaucrats to rent-seeking behavior and thus reduces the overall economic efficiency. We argued that the Virginia Public Choice theory argument is more realistic because it does not ignore the effect of bureaucratic corruption.

We explained the rent-seeking theory and bureaucracy theory using a theoretical model to present how corruption reduces efficiency. Our model suggests that in the world where public goods including the rule of law are provided by bureaucrats, their provision must be inefficient and thus funded from undesired taxation imposed by politicians behaving as benevolent despots. To illustrate our argumentation, we have proposed an advanced rent-seeking model with endogenous rent, implying that even though there is a low number of interest groups including bureaucrats competing for rents, economic efficiency is reduced.

To support this conclusion empirically, we have added a short literature survey of experiences with the establishment of the rule of law in the early stage of transition in Central and Eastern Europe. We have chosen this example as quasi-experimental social environment allowing relatively free competition among interest groups. We have also added selected anecdotic evidence of bureaucratic corruption from the Czech and Slovak Republics as unique anecdotic evidence that belongs to the early stage of transition in Central and Eastern Europe. Our quasi-experimental anecdotic evidence illuminates the reality of privatization process in the Czech and Slovak Republic. It shows that the reality of relatively intensive competition among interest groups was closely connected with bureaucratic corruption, which is principally inefficient.

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