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Mises, Hayek and Corruption

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Abstract

Tomáš Otáhal: **Mises, Hayek and Corruption**

Using the arguments of Ludwig von Mises and Friedrich August von Hayek, I argue that private ownership solves the economic problem of corruption. Since private ownership discourages entrepreneurs from rent-seeking, and privately owned media provide objective and unbiased information to citizens, any legal reform establishing and enforcement of private ownership also solves the corruption problem.

Key words

Austrian school, corruption, economic calculation, rent-seeking

JEL: B25, D73, D83, P16

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Introduction

Wars, revolutions, foreign interventions, political reconstructions, transitions, or policy reforms are all closely connected with corruption. Corruption, a phenomenon of human action (Mises 1996), thus seems to be a problem that indicates an inefficiency inherent to political institutions and cultures. Austrian economists traditionally explain the relationship of these phenomena to the establishment of efficient political institutions and their emergence in various cultures (i.e. Boettke 1993, Coyne 2008). However, do their arguments contribute to solving the corruption problem itself?

Ludwig von Mises (1881–1973) developed his argument against state ownership. He argued that making rational decisions about what to produce and what technology to use is impossible when prices neither reflect the demand, nordo they reveal the relative scarcity of resources. According to Mises, only a price mechanism based on privately owned means of production gives the entrepreneur[1] guidelines for a rational decision (Mises 1990).

While Ludwig von Mises addresses the question of entrepreneurial incentives, Friedrich August von Hayek (1899–1992) addresses the question of knowledge. He argues that knowledge exists in a dispersed form, so that a central planner is not able to sum up all relevant facts that are needed to calculate a rational outcome (Hayek 1980, chap. 2). For that reason, the dispersed local and tacit knowledge can be coordinated only when all the participants in the economic system can adequately respond to the prices that absorb and approximate all relevant facts. According to Hayek, the price mechanism based on private ownership ensures that all relevant facts are coordinated (Hayek 1980, chap. 3).

In this paper, I argue that the price mechanism based on private ownership not only represents the incentives and answers to knowledge problems of economic calculation, but it also solves the problem of corruption.[2] In other words, I reason that the arguments against state ownership developed by Ludwig von Mises and Friedrich August von Hayek could also be applied to recent corruption research. Of course, I do not argue that private ownership solves all problems with corruption, because real establishment of private ownership deserves some governmental control, however, I provide theoretical background for explanation how corruption can be reduced significantly.

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[1] For a calculation argument in the context of entrepreneurial discovery, see Kirzner (1985) and Otáhal (2008b).
[2] This argument was developed by Otáhal (2007).

Recent corruption research (i.e. Miguel and Fisman 2007, Svensson 2005, Reinikka and Svensson 2004, Brunetti and Weder 2003, Lambsdorff 2007, Harstad and Svensson 2011, Choi and Thum 2004) provides various microeconomic evidence of corruption. There is, however, only one theory, which explains the negative consequences of corruption for economic development. It is the theory of rent-seeking (Tullock 1967, Krueger 1974). While there are theories which explain the positive effects of corruption on economic development (i. e. Leff 1964, Huntington 1965), a theory which would provide rigorous welfare analysis does not exist at all. In this paper, I follow the theoretical arguments of Gordon Tullock and Anne Krueger to explain how Austrian economists (Mises 1990, Hayek 1980, chap. 2 and chap. 3) solve the problem of corruption. In general, I argue that private ownership solves the economic problem of corruption, because it discourages entrepreneurs from rent-seeking, which restricts economic development. For this reason, the question of a solution to the corruption problem is not a question of a particular anti-corruption public policy, but a question of the establishment and the enforcement of private ownership. My argument is thus fully consistent with political economy of general rules (Hayek 1960, Buchanan and Tullock 1962), since it suggests that corruption is rather a problem of the system than a problem of a particular behavior or public policy.

My methodological approach is fully consistent with the arguments applied in my reasoning. While recent corruption research applies rigorous mathematical modeling and testing hypotheses with statistical methods, I apply Austrian methodological approach based on common sense deduction. My method is also consistent with the theoretical approach explaining the importance and function of institutions that was pioneered by Ronald Coase (1988).[3]

Since there are many types of corruption, it is difficult to define corruption precisely (Svensson 2005, 20-21). For instance Susan Rose Ackerman (1999) distinguishes between high-level corruption involving elected and senior public officials and low-level corruption involving mid- and low-level bureaucrats. While the first category covers, in particular, financing of political parties and their election campaigns, parliamentary lobbying, and public tenders at any level of state administration, the second category refers to municipalities and all forms of public service provided by the state through regional and local agencies, as well as state-guaranteed health care service. Such level also entails informal links among private companies and low-level state bureaucracy. Miguel and Fisman (2007) provide evidence suggesting that the existing legal framework and culture jointly determine the attitude of people towards corruption. They tested how the cultures of different countries

[3] Analytical tools for mathematical analysis were provided by Budinský and Valenčík (2009a, 2009b).

influenced the behaviour of diplomats. They observed that culture and existing national penal code affected the diplomats' willingness to break the parking code in Manhattan. They found a clear relationship between these factors. Literature on political corruption (Heidenheimer and Johnston and LeVine 1999) suggests that culture mainly determines low-level corruption while the legal framework and law enforcement rather correlate with high level corruption, alternatively political corruption. My argument targeted to the legal reform primarily addresses high-level corruption or political corruption, rather than low-level corruption, or petty corruption.

The argumentation in this paper is as follows: First, I explain why corruption is an economic problem. Second, I explain the solution to the corruption problem. Third, I argue that the solution to the corruption problem in essence means the establishment of private ownership. Fourth, I provide some additional evidence illuminating my argumentation.

1 Why is corruption an economic problem?

First, it should be said that the literature which deals with the corruption problem defines corruption differently (Svensson 2005, 20-21). When the economic problem of corruption is addressed, most of the authors use the example of bribery even in the cases of high-level or political corruption (i. e. Shleifer and Vishny, 1993). However, there are many other forms of corruption like buy offs in public tenders, patronage, electoral fraud, embezzlement, nepotism, tax evasion etc. Nonetheless, the example of bribery is the most frequent.

High-level corruption, or political corruption illustrated by bribery all suggest that corruption, in essence, is a voluntary exchange of favours. There is a person who is being bribed and a person who is a provider of a bribe in exchange for some benefit (Treisman 2000, Lambsdorff 2007, Colombatto 2003, Otáhal 2007). As a result, the economic problem of corruption is that corruption harms a benefit of the third party which does not participate in the corrupt exchange at all.

The literature stressing the negative consequences of corruption for the third party (i. e. Lambsdorff 2007)[4] attempts to answer the question how corruption harms a benefit of the third party. For instance, Murphy and Shleifer and Vishny (1991) provide evidence suggesting that corruption allocates talented people to socially unproductive uses. They argue that when profits or potential profits are taken away from productive firms through corruption, entrepreneurs, instead of promoting research and development of their products, invest in securing their operation against

[4] Leff (1964) and Huntington (1965) argue that corruption positively affects economic development.

corruption. Choi and Thum (2004) argue that if corrupt officials are enabled to demand bribes repeatedly, entrepreneurs will pursue a "fly-by-night" strategy by adopting inefficient technology. This strategy allows entrepreneurs to flexibly react to the future demands for bribes or to shut down the operation. Murphy and Shleifer and Vishny (1993) show that corruption promotes an unproductive allocation of talent, technology and capital in such an extent that it reduces economic growth.

This summary suggests that corruption illustrated on the example of bribery is not the economic problem itself, since bribery, in essence, represents a particular exchange. Even though it consists of other forms like buy offs in public tenders, embezzlement of government funds, patronage, electoral fraud, nepotism, or tax evasion, the basic problem which economists connect corruption with is more profound. Corruption promotes a socially unproductive use of resources. In other words, the major problem with corruption is that it promotes rent-seeking (Tullock 1967, Krueger 1974, Otáhal 2008a). There is literature, which explains that corruption closes the economic system and degenerates society (i. e. Wallis 2004, North and Wallis and Weingast 2009). These dynamic theories of corruption, however, do not contradict the argument that corruption is rather a problem of the system that promotes rent-seeking than a problem of a particular behavior or public policy. Corruption is thus the way through which rent-seeking is realized (i. e. Krueger 1974).

2 How to avoid corruption?

In the previous section, I argued that corruption is an economic problem because it promotes rent-seeking. Nevertheless, lobbying can also promote rent-seeking. However, most of the available literature does not regard lobbying as corruption (i. e. Becker 1983).[5] The reason for this is that corruption illustrated as bribery, unlike lobbying, is illegal, so it must be done secretly (Shleifer and Vishny 1993). The secrecy of bribery implies that corrupt exchanges cannot be enforced by law, because a corrupt exchange does not follow legal rules. Gary Becker (1983) defines legal rules necessary for lobbying as follows: "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)[6]

[5] Gordon Tullock (1996) provides the explanation. He connects corruption with rent-seeking and uses the example of a congressman who favours an interest group in order to be reelected legally.

[6] Becker (1983) explicitly argues that legal lobbying can result in efficient legal system. From this point of view legal lobbying cannot be considered as corruption of any kind. Nevertheless, this conclusion was questioned

Harstad and Svensson (2011) argue that bribery, unlike lobbying, leads to hold-up problems that discourage firms from socially productive investments. They argue that public lobbying affects all firms in an industry and tends to be more permanent so that the corrupt state officials cannot commit to not asking for bribes in the future. Bribery, on the other hand, is concealed and does not follow law. It does not tend to be permanent, so the corrupt state officials can commit to not asking for bribes in the future. For this reason, bribery promotes more rent-seeking than lobbying. Moreover, lobbying, because it affects all firms in the industry and future entrants, it involves a joint action associated with the cost of collective action. Moreover it also involves the costs connected with political decisions. Bribery, on the other hand, because of its secrecy, favours the private benefit of one firm and encourages only the specific individual decisions of a corrupt official. Again, for this reason, the less costly bribery promotes more rent-seeking than lobbying.

Considering the differences between bribery and lobbying, we can easily find the solution to the corruption problem. The difference between bribery and lobbying suggests that when *bribery becomes public* and *follows a prescribed set of rules,* it becomes lobbying which promotes less rent-seeking. However, scholars, experts in the theory of corruption, may consider my conclusion to be a tautology. I do not oppose such objection, since it shifts the problem of solving corruption further. What then are the rules, which force corruption to promote less rent-seeking? Alternatively, what are the rules, under which corruption becomes an ordinary exchange?[7] I attempt to answer this question in the next section.

3 How do Austrians solve the corruption problem?

In the previous section, I argued that corruption, unlike lobbying, is done secretly and does not follow a specific set of rules. Therefore, it is suggested that corruption should be made public and made to follow the rules. Where are the calculation arguments then?

Literature proposing solution to the corruption problem argues that a transparent political process reduces corruption, because it provides citizens with information allowing them to control the political process. However, it is not assumed that corrupt officials would report the number of bribes, only that the information is available. Leeson (2008) provides evidence that in countries where media are independent of the government, people know more about politics, participate in the political

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many times by scholars of Virginia public choice who consider even legal lobbying as a kind of corruption since it harms benefit of the third party, alternatively social welfare (i. e. Tullock 1996, Lambsdorff 2002).

[7] Again, I use an example of bribery as a kind of corruption, which can take various forms. Bribery, in essence, is a particular exchange therefore the economic problem of corruption is rather problem of the system, where such corrupt exchange takes place, than of particular behavior or public policy.

process and go to the polls more frequently. In countries where the government owns a larger share of mass media and infrastructure, regulates the media industry and censors the content of news, people are more politically ignorant and apathetic. Brunetti and Weder (2003) also demonstrate that, in countries where mass media are independent of the government, the level of corruption is lower. When independent media or privately owned media provide independent information, citizens tend to participate in the political process and vote. This kind of control of the political process discourages state officials from corruption.[8]

In other words, in countries where mass media are privately owned, the political process is more transparent to the citizens. Objective, unbiased information is delivered to citizens because they require it with the assistance of monetary calculation. Privately owned media calculating profits recognize which information is demanded, and improve the quality of the service. Citizens are thus able to increase the control over the political process via buying quality information and to coordinate the political process in compliance with their demand.

As stated above, the major problem that economists connect with corruption is that it promotes rent-seeking. To make corruption follow the rules thus means to discourage firms from rent-seeking by removing rents. Shleifer and Vishny (1993) argue that barriers to entry create rents which encourage public officials to extract bribes. Thus, deregulation and simplification of rules reduce corruption and encourage entrepreneurial innovations. This, however, does not mean that deregulation is a universal cure. Only when corruption follows law it does not promote the socially unproductive use of resources. In other words, simple deregulation does not solve the corruption problem because no regulation could also encourage entrepreneurs to rent-seeking (Djankov and Glaeser and La Porta and Lopez-de-Silanes and Shleifer 2003). The question thus is, which rules discourage public officials from corruption?[9]

Ludwig von Mises and Friedrich August von Hayek answered this question. Only economic calculation based on privately owned means of production gives the entrepreneur guidelines for socially productive use of resources. Once the price mechanism based on private ownership is established, corruption is not a problem anymore, because private ownership discourages rent-seeking. The

[8] Reinikka and Svensson (2004) provide micro evidence supporting this hypothesis.

[9] De Soto concludes: ”ILD research confirmed the role of law in determining the efficiency of economic activities it regulates. It is in this sense that we shall define “good laws” and “bad laws”: a law is “good” if it guarantees and promotes economic efficiency and “bad” if it impedes or disrupts it” (DeSoto 1989, 132).

question of how to solve the corruption problem thus becomes a question of how to establish and enforce private ownership.[10]

4 Some additional evidence

To make my argumentation more robust I provide a survey of some empirical literature, which explores relation between privatization and corruption. In general, this kind of literature does not explore and test validity of my theoretical propositions but it reveals effects of privatization process as such. It thus rather implicitly assumes that my theoretical propositions are valid than rigorously explain why it is so. However, the evidence can be distorted particular institutional conditions.

Koyuncu and Ozturkler and Yilmaz (2010) use three corruption indices and six privatization indicators to test whether privatization contributes to a decrease in corruption in transition economies. They find highly statistically significant results in period between 1995 and 2008 for sample of 27 transition countries. To deal with reverse causality they include several instrumental variables like FDI, Governmental debt or Deflator. Similarly Clarke and Xu (2004) use enterprise-level data on bribes paid to utilities in 21 transition economies in Eastern Europe and Central Asia, and examine how characteristics of the utilities taking bribes and the firms paying bribes affect the equilibrium level of corruption in the sector. They find that the bribe payments are lower in countries where infrastructure is better developed. The extent of competition in the telecommunications sector, measured by the number of cellular operators in the country, according to Clarke and Xu (2004) also appears to reduce the equilibrium level of bribes.[11] And after controlling for capacity and competition, they also find that bribes are lower in countries where the utility companies have been privatized. The source of their data was World Business Environment Survey (WBES) conducted in mid-1999 by the World Bank and several other agencies, including the European Bank for Reconstruction and Development (EBRD).

Earlier Kaufmann and Siegelbaum (1996) examine the relation between corruption and privatization in transition countries. They discus several privatization strategies implemented in Central and Eastern Europe (CEE) and in Former Soviet Union (FSU). They used analytical framework of contract theory and property rights theory to provide some theoretical conclusions on how different patterns of privatization process affect the state of corruption in CEE and FSU and they argue that while the way of privatization fosters hidden paths of corruption, privatization itself appears to reduce it. Martimort and Straub (2009) provide theoretical explanation how privatization opens the door to

[10] The question of law enforcement and corruption is addressed by Hay and Shleifer (1998).
[11] Clarke and Xu (2004), however, focus rather on petty corruption than grand corruption.

more corruption. According Martimort and Straub (2009) various stylized facts suggest that the absolute welfare impact of changes in ownership in infrastructure sectors is unlikely to explain by itself the extremely high level of discontent observed throughout Latin America. They rather indicate that the political economy of the process may matter. Their model, which explains how burden of corruption is shifted from tax payers to consumers throughout the privatization process, reflects the skyrocketing discontent with privatizations expressed by citizens all over Latin America and the Caribbean region in Latinobarometro opinion surveys, which appears to be strongly correlated with both changes and absolute levels of corruption perceptions at the country level in period between 1998 and 2003. On the other hand, their analysis rather focuses on corruption once a given ownership structure has been chosen thus it neglects the fact that ownership transfers from the public to the private sector may itself be corrupted acts favoring groups, elites and close-friends of the power.

Previous empirical evidence suggests that the way how my theoretical propositions are applied in public policies is important for successful fight against corruption. Thus, theory and implementation of particular public policies implied by my theoretical argumentation are two separate things, which does not mean that the later is less important. Previous empirical evidence also suggests that the effects of privatization process can be distorted particular institutional conditions. Bjorvatn and Søreide (2005) analyze relation between privatization and corruption in more detail. They focus on how political preferences, and in particular the degree of government-level corruption, affect this process. They attempt to prove that the sale of the public asset under a corrupt regime may result in a highly concentrated industry structure and therefore reduced economic efficiency. Their analysis also attempt to demonstrate that the acquisition price is likely to be higher when the government officials are highly corrupt than when they are moderately corrupt or honest and they show that the price of these assets and therefore the potential for embezzlement may well fall as the officials' propensity to be corrupt increases. This theoretical explanation undermines positive effects of privatization on corruption, but on the other hand, it also elevates the importance of the particular institutional conditions since tendency to concentration of industry structures is determined by efficiency of institutional conditions, alternatively rules of the game.

Conclusion

Ludwig von Mises and Friedrich August von Hayek know how to solve the corruption problem. Because corruption promotes rent-seeking, they suggest a legal reform that would establish and enforce private ownership. The reason is that only private ownership ensures rational calculation which encourages socially productive entrepreneurial innovations and discourages rent-seeking.

Corruption promotes more rent-seeking than lobbying because it is done secretly and it is difficult to check and control. For that reason, Friedrich August von Hayek suggested establishment of private ownership, because only private ownership ensures that prices reveal relevant facts to entrepreneurs, and entrepreneurs, according to these relevant facts, can provide quality services to citizens. This is also relevant to the supply of information. When the mass media are privately owned, the entrepreneurs are better informed about the demand of citizens and thus provide citizens with objective, unbiased information. As a result, citizens, in accordance with the supplied information, are able to exercise control over the political process and coordinate it with their own demand.

However, even though our argumentation is theoretically correct, what is important to be mentioned is that it is necessary to provide further theoretical elaboration of the real application of our argumentation. Austrian economists provided branch of research, which attempts to explain how private property can be established. In compliance with modern corruption and economic development research the serious questions must be answered: What types of government institutions are suitable for private ownership? What types of government institutions are not suitable for private ownership and why? And of course, how efficient institutional transformation can be established? These questions deserve deeper comparative institutional analysis based on our theoretical background.

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