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Strategic Public Investments to Manage Corruption Risks

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"The essence of morality [is] the cultivation of the right habits of the heart…"

Aristotle (as interpreted by Lucas & Rubel, 2004 p. 133)

I) Introduction

National Governments face a wide spectrum of choices to minimize the risk of corruption. These can be distilled into three main categories: Building Integrity, Increasing Transparency, and Improving Accountability.

One key to preventing corruption risks is to understand incentives that deter waste, fraud and abuse. The simple strategic framework presented here offers an illustration and guide to help shape government investments to counter corruption. This framework combines a philosophical view of corruption with an economic perspective. It couples views on ethics of the great German Enlightenment figure, Emmanuel Kant, with the utilitarian perspective attributed to the 19th Century English philosopher, John Stuart Mill.

Mill's utilitarian perspective reappears in a contemporary economic model of crime developed by Nobel Prize Winning Economist Gary Becker entitled: "Crime and Punishment: An Economic Approach." (Becker 1968) The theory of rational crime proposed by Becker requires that we place ourselves in the shoes of elected or appointed government officials, or public sector employees.

According to Becker, any individual with an opportunity to be corrupt evaluates the potential benefits of their actions against the expected costs if detected and punished. Becker conjectures "… individuals become criminals because of the financial and other rewards from crime compared to legal work, taking account of the likelihood of apprehension and conviction, and the severity of punishment." (p.176) The framework was later extended to include ethical costs of crime. (Block & Heineke 1975; Rasmussen 1996)

According to this approach two major factors help deter corruption of elected and appointed officials, government employees, defense contractors, and others. The first is a culturally- determined "Moral Burden": if individuals recognize corrupt actions as immoral and unethical, this deters corruption. The second major factor is the "Expected Punishment": if individuals recognize their actions are illegal, and that they may be discovered and lose their jobs, end up in prison or pay significant fines, this deters corruption.

Rasmussen (1996) discusses deterrence in terms of "internal motivation" (moral burden) and "external incentives" (expected punishment). Given this perspective, when evaluating whether or not to engage in corrupt practices individuals implicitly consider two costs: the moral burden of committing an illegal act, as well as the probability of being arrested and punished, and the severity of the pecuniary or non-pecuniary penalty.

In fighting corruption an important question is: Why is anyone moral? Answers from philosophy range from being true to one's own rational nature (Kant), because one aspires to human fulfillment (Aristotle), or because keeping one's contract with one's fellow citizens is necessary to prevent social chaos and warfare (Hobbes)…" (Lucas & Rubel p.116)

In Kant's conception "the moral agent must have an exemplary character, one which recognizes the rational demands of duty upon him even when there are no external incentives or constraints to compel, constrain, or otherwise shape his behavior." (p.184) Kant talks about "the Moral Law within" and "imperatives of duty." According to Kant "we are to do our duty regardless of the consequences." (p. 133) "…We are acting in a morally worthy fashion, and possess what Kant terms "a morally good will," only if we are…individuals who can be counted upon to do what we know we must and ought to do, even when there are no external forms of incentive or accountability in place." (p.161) "…We should not require external inducements or constraints to force us to behave morally." (p.162)

In sharp contrast to Kantian ethics is the so-called "Utilitarian" school of John Stuart Mill who recognizes that "…as fallible human beings we will not always be adequately motivated by…moral reasons for obeying the law…"(p.386) Contemporary thinking about the historically-conditioned, cultural grounding of morality needs to be mixed with "social and political responsibilities to establish justice, equality, and…rule of law …" (p.159)

On the one hand, ***Building Integrity*** supports the Kantian ethics view. Investing in ethics training, formal and informal codes of conduct, a culture of public service, reputation, ideals, core values, honor, loyalty, etc. increases the "Moral Burden" of corrupt actions.

On the other hand, ***Increasing Transparency*** and I***mproving Accountability*** reflects Mill's utilitarian perspective. For instance, utilitarians believe the guilty should be punished only if the punishment serves some deterrent (or preventative) purpose: "…to find the right punishment that will serve as the optimum deterrent…It is the threat of punishment that is the important thing." (p. 149)

There are three ways policymakers can increase the threat of punishment. Either by increasing: 1) the probability of detection, 2) the probability of conviction given detection, or 3) the severity of the punishment. This corresponds to the three components of law enforcement: 1) Monitoring violations of the law and identifying and arresting offenders (Transparency: the probability of detection); 2) An independent court system to assess guilt (Accountability: the probability of conviction given detection); and 3) A corrections system to administer punishment (Accountability: assessing penalties given a conviction).

II) Optimal Corruption

Since law enforcement is costly, given competing demands and tight budgets, the optimal level of enforcement will likely minimize, but not entirely eliminate corruption risks. ***Increasing Transparency*** (investing in institutions: budgeting and accounting systems, the systematic application of economic and decision tools, independent financial audits, monitoring and oversight, extra policing, etc.) increases the probability that corrupt actions will be detected. ***Improving Accountability*** (investing in judicial reforms, streamlining and enforcing laws, rules and regulations, etc.) increases the probability an individual will be convicted if detected, and influences the assessment of penalties.

As an illustration, consider key recommendations from the U.S. National Commission on Fraudulent Financial Reporting (the Treadway Commission)—established in 1987 in response to a wave of savings and loan bankruptcies, and the Sarbanes Oxley Act of 2002 passed in response to the Enron debacle and other major bankruptcies resulting from fraudulent accounting practices. The central recommendations can be categorized in terms of building integrity, increasing transparency, and improving accountability. Examples include recommendations and mandates: a) to build integrity—enhancing the ethical climate and emphasizing ethical values in business education and professional examinations; b) to increase transparency—strengthening financial controls, accounting and internal control systems, and improving auditing standards, peer review and fraud-prevention programs (e.g. increasing the power of the Public Company Accounting oversight Board); and c) to improve accountability—imposing substantial fines on fraud perpetrators and barring or suspending officers and directors involved in fraud, (Section 305 of Sarbanes Oxley specifically expands the scope of monetary penalties paid by CEO's and CFO's and increases jail terms for white collar crime).

Given its limited resources, every government's challenge is to find an optimum mix of investments to build integrity, increase transparency and improve accountability such as to minimize corruption risks, while preserving or increasing the efficiency and effectiveness of public programs and private sector performance. In guiding public management and investment decisions, this framework encourages good governance (building integrity, increasing transparency and improving accountability) to guarantee the most efficient allocation of public budgets that generate the greatest possible collective benefits for voters and taxpayers.

III) Conclusion

The expected cost to an individual of engaging in corrupt behavior consists of two components:

EXPECTED COST = ***MORAL BURDEN*** **+ EXPECTED PUNISHMENT**

Where: EXPECTED PUNISHMENT = (*Probability of Detection)* x (*Probability of Conviction if Detected)* x *PENALTY*

The governance challenge is to invest in an optimal mix of initiatives to:

1. ***<u>Build INTEGRITY</u>*** **–-increasing the *MORAL BURDEN* of bad behavior through ethics training, codes of conduct, a culture of public service, etc.;**
2. ***<u>Increase TRANSPARENCY</u>*****–-increasing the *EXPECTED PUNISHMENT* by raising the *Probability of Detection* through Institution Building (Strategic Planning, Budgeting and Resources Management Processes and Procedures, Government Accounting Systems, Financial and Management Audits, etc.) ; and**
3. ***<u>Improve ACCOUNTABILITY</u>*****— increasing the *EXPECTED PUNISHMENT* through legislative and judicial reforms that raise the *Probability of Conviction if Detected*, and the *PENALTY if Convicted*.**

The perspective offered in this essay combines philosophical and economic views of corruption. It couples views on ethics of the great German Enlightenment figure, Emmanuel Kant, with the utilitarian views of 19th Century English philosopher, John Stuart Mill.

Utilitarian theory predicts the likelihood an individual chooses to commit a crime will fall in response to an increase in either the probability or severity of punishment. Empirical work in the U.S. by Ehrlich (1973) demonstrates that increases in both the certainty and severity of imprisonment have negative impacts on crime rates. Interestingly, Turmbull (1989) finds evidence that, for most crimes, certainty of imprisonment has a greater effect than severity of imprisonment. Block & Gerety (1995) also find that prisoners are more easily deterred by increases in the probability of punishment than its severity.

Collectively, these studies help explain Becker's (1968) observation that "a common generalization by persons with judicial experience is that a change in the probability has a greater effect on the number of offenses than a change in the punishment." If these results can be applied more broadly, then strategic investments in government institutions that increase ***Transparency*** like the U.S. Government Accountability Office (GAO) or Congressional Budget Office (CBO) could generate powerful deterrent effects to reduce corruption risks in the public sector.

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