The Economics of Ethics: The Cost of Political Corruption

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Adam Smith, a patriarch of economics and author of its bible, The Wealth of Nations, expressed what has become a credo of free market faith: the public interest is often best served by allowing individuals to pursue their own self interests. Lately it seems some Connecticut politicians have been following Smith's doctrine to a fault. But the consequences are unlikely to have advanced the common interests of Connecticut's citizens. Indeed, the evidence suggests that the moral failings of political leaders carry significant economic costs.

Political Corruption

Public officials are supposed to be trustees of the commonweal, not political buccaneers seeking their own private gain. But sometimes, in what economists call a "principal-agent problem," those trustees forsake that obligation and misuse the power delegated to them in ways that advance their personal interests rather than those of the public.

The problem isn't just limited to chief executives—mayors, governors and presidents—accepting gifts or kickbacks. Legislators, too, can sell their votes to special interests in exchange for campaign contributions or other special favors. All such practices are morally reprehensible, often illegal, and they erode the public's faith in political institutions. But what are the economic consequences?

Grease or Grime?

Not everyone agrees that even a little graft is a bad thing. In the 1970s, political scientist Samuel P. Huntington wrote that "...in terms of economic growth, the only thing worse than a society with a rigid, over-centralized, *dishonest* bureaucracy is one with a rigid, over-centralized and *honest* bureaucracy." (See *Political Order in Changing Societies,* New Haven: Yale University Press, 1968: p. 69). In this view, political bribes and kickbacks can help cut through bureaucratic red tape and improve government efficiency. What's more, if the size of the bribe reflects the value of the "favor" to the briber, government's attention will naturally turn first toward those projects with the greatest net benefits. Those net benefits, of course, may accrue to a select few rather than the general public.

But the costs of corruption can be significant. First, political corruption increases the cost of doing business by at least the amount of the bribe paid to secure favorable treatment. Institutionalized bribery also introduces a new set of transaction costs—the costs of negotiating, monitoring and enforcing illicit agreements and avoiding detection by those not a party to the agreement. And since corruption involves the arbitrary use of discretionary power, uncertainty—that great bogeyman of business confidence—rises, and the business environment becomes less secure.

Second, political corruption undercuts free markets and hampers efficiency. Firms with political connections can be less cost-conscious since they are shielded from competition. Third, corruption distorts the allocation of resources toward projects that can generate (illicit) payoffs. Besides the undesirable efficiency consequences arising from this distortion, the effect is likely to aggravate social inequalities, because the poor and powerless suffer, by definition, a comparative disadvantage in securing special favors.

How States Rank in Political Corruption

Federal misconduct convictions per 100 elected officals, 1986-95
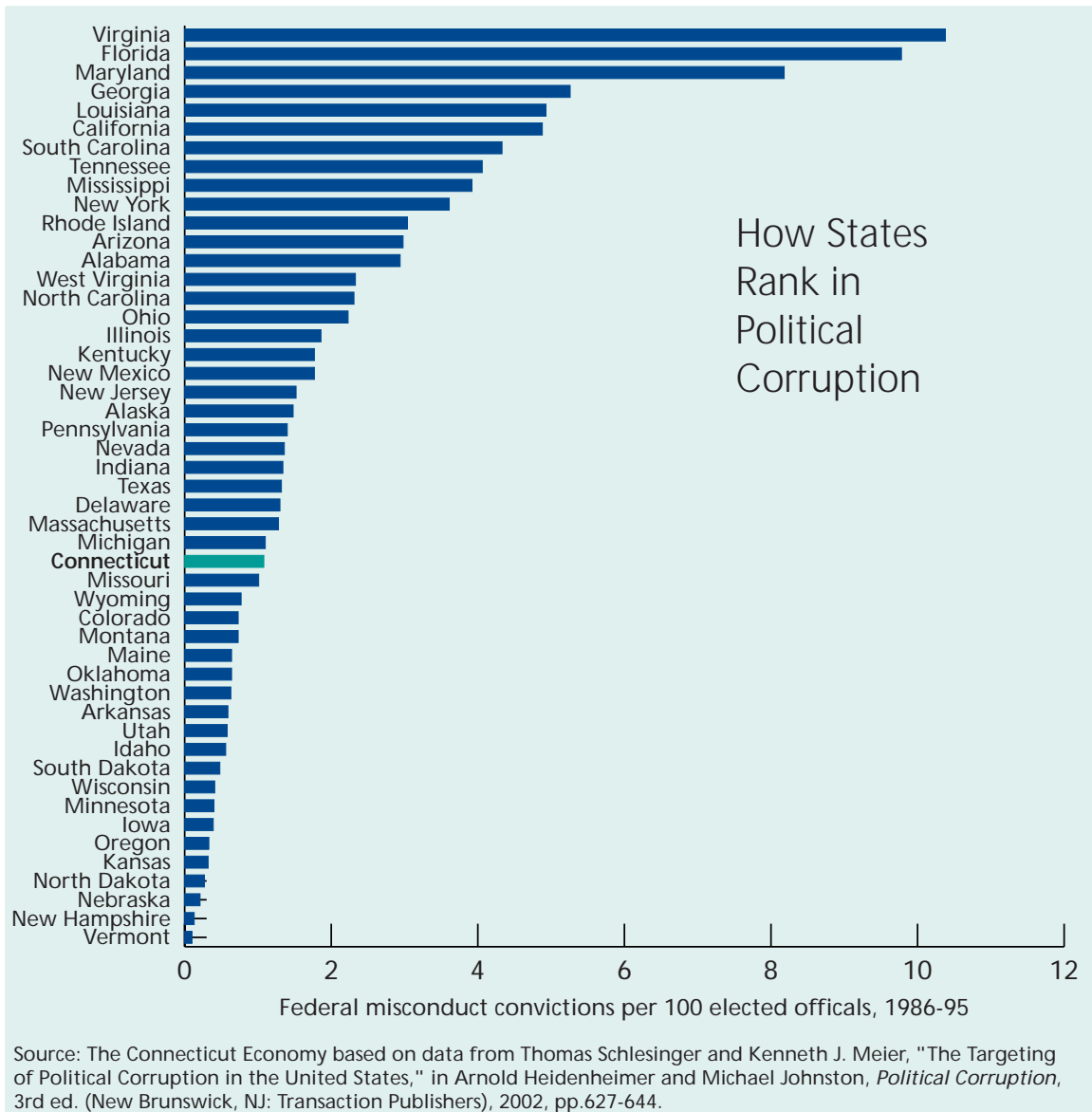
Quantifying the Evidence

If an economic case can be made both for and against political graft, the relative efficiency of corruption ultimately becomes an empirical issue. Which economies demonstrate the best economic performance, those with a track record of clean government or those with a history of dirty political dealings?

While there is no single all-purpose measure of economic performance, when it comes to gauging the health of a local or regional economy job growth is often a popular

choice. Maximizing an economy's ability to generate new jobs is certainly high on the political agenda since voters seem more likely to re-elect officeholders who oversee net job creation.

Quantifying political corruption is, however, difficult partly because the perpetrators work so hard to evade detection. But Thomas Schlesinger and Kenneth Meier have argued that the number of federal convictions of public officials for crimes involving corruption is a good proxy for the level of political corruption across states. The accompanying bar graph presents Schlesinger and Meier's state-by-state conviction data for the period 1986 – 1996, for 49 states (omitting Hawaii). The average across states was 2.12 convictions per 100 elected officials over the period. Connecticut posted a comparatively clean record of just 1.08 convictions.

Among the advantages these analysts claim for this measure is that it passes the smell test: Vermont, Minnesota, and Wisconsin place relatively low on the list while Maryland, Louisiana and Rhode Island rank relatively high. Plus, the measure appears to be statistically unrelated to the number of federal prosecutors and judges or the length of court backlogs. So high conviction rates are more likely to reflect corrupt activity than prosecutorial zeal.

If corruption was the only determinant of economic performance, we could compare the two and see how variations in the number of convictions affected the change in jobs. But there are many other possible influences on job growth, such as taxes, wages, education, GSP per capita and population change. So to determine the effect of corruption on performance, we must control for the influence of these other factors, something that multivariate regression allows us to do.

Crime Doesn't Pay

The accompanying table shows the results of a regression of job changes on corruption and these other possible causal factors. As expected, there is an inverse and statistically significant relationship between corruption and jobs. For each additional conviction per 100 elected officials, job growth declines by 1.1 percentage points (the 49-state average was a 22% increase in jobs over the 1986-95 period). A $100 increase in per-capita state taxes cuts job growth by 0.5 percentage points. And by expanding the

pool of potential workers, a one-percentage point increase in population produces a 0.8-point increase in the number of new jobs.

The remaining variables—wages, education, and per-capita GSP—had some surprising effects on job growth. Higher wages are not associated with a significant decrease in jobs and increases in educational attainment are not linked to a significant increase in jobs. Higher GSP per worker, which would seem to produce a stronger market for goods and services, turns out to be associated with reduced job growth, perhaps because high income areas often have higher rents and tighter regulations on business.

Since each of these explanatory variables is measured in different units, it could be difficult to determine which has the strongest influence on changes in job growth. But a simple statistical technique allows us to express each variable in a common unit so that the resulting standardized coefficients, shown in the table, measure the relative magnitude of the effects from each. These standardized coefficients suggest that population growth is as strong a positive influence on jobs as is the total negative influence from taxes, GSP and corruption combined. That's not to say corruption is a trifling matter. Among the negative factors in job growth, the effect of corruption was 30% greater than that of taxes, implying that honest government may be even more important than a favorable tax environment in sustaining strong economic performance.

Airing the Linen

To his credit, Adam Smith was not a slavish disciple of his own teachings. In an often overlooked volume, *The Theory of the Moral Sentiments*, Smith maintained that a peaceable and productive life in civil society isn't possible without moral constraints that place socially appropriate limits on individual action. Smith realized that the law, too, constrains our actions in ways that help to make markets and other social institutions work.

The question for Connecticut now is how to best improve the ethical and legal environment and avoid a repeat of recent scandals. The suggestions include tougher restrictions on, and penalties for, giving gifts to elected officials, and extending the statute of limitations on criminal violations. Here's another possibility.

If the problem actually is of the "principal-agent" variety, with elected officials secretly pursuing their own interests not those of their constituents, we might try bringing these activities into the open, letting the public be the arbiter of what's acceptable conduct. Requiring elected officials to make their personal finances public, for example, would offer voters an early warning sign of potentially unethical or criminal behavior. Toughening the ethics laws would no doubt help, but it's likely that wayward public officials would be penalized by public disapproval far sooner and more effectively under a regime of full disclosure than under a system that relies on investigators to uncover misconduct and on prosecutors to enforce the law.

Factors That Explain Job Growth Across States

Variable	Standardized Coefficient	Description
Corruption	-0.20	One additional conviction per 100 elected officials reduces job growth by 1.1 percentage points.
Taxes	-0.15	A $100 increase in per-capita state taxes cuts job growth by 0.5 percentage points.
Education	0.02	An increase in education produces no statistically significant increase in jobs.
Wages	-0.05	An increase in wages produces no statistically significant decrease in jobs.
Population	0.79	A one-percentage point increase in population produces a 0.8 percentage point increase in jobs
Per Capita GSP	-0.38	A $1000 increase in per-capita GSP lowers job growth by 1.0 percentage point.

Source: The Connecticut Economy based on data from Schlesinger and Meier,and from the U.S. Bureaus of Labor Statistics, Census, and Economic Analysis.