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September 2007 - No. 8
CMI CHR. MICHELSEN INSTITUTE
U4 BRIEF

Competition and corruption
What can the donor community do?

This Brief discusses how corruption might threaten the benefits of competition in a market. Corruption can result in too much market power for some firms and thus increase prices and negatively influence the supply of goods and services in the private sector. While improved competition is important to cut prices, to improve the business climate, and to reduce the impacts of corruption, better regulation of markets is also an achievable objective in many countries, and an area where aid agencies can exert influence.

Background and context

When the World Bank launched its comprehensive anti-corruption campaign in 1996, many believed this would be no more than a passing trend in the development community. More than ten years later, corruption is well recognized as a major obstacle for economic development. Anti-corruption has become a main priority of many development agencies. Composite corruption indices, such as Transparency International's Corruption Perceptions Index, have contributed to raise awareness on corruption. However, they have also

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created a very simplistic notion of corruption, including the prevalent misunderstanding that we can speak of general corruption levels within geographical borders. Corruption is a far more complex phenomenon. This insight is particularly important when addressing business-related corruption.

A number of empirical studies of corruption find a relatively clear connection between GDP levels and corruption – poor countries are more corrupt. The correlation has a logical underpinning, yet the causality between corruption and poverty is not sufficiently verified and the results are based on very general estimates of cross-country corruption levels. The conclusions seem to depend on the form of corruption. In particular, they are challenged when it comes to the ways in which firms might get a competitive advantage through corruption. There appears to be a strong connection between petty corruption and the quality of institutions (which again correlates strongly with GDP levels). There is also a significant correlation between political corruption and GDP levels. When it comes to tender-related corruption, however, it is difficult to establish a similar relationship, which suggests that countries with rather good institutions and high levels of GDP may experience high levels of tender corruption as well. Or, it might imply that poor countries are less exposed to these forms of crime, compared to middle-income countries with a more vibrant business community.

The risk of business corruption is dependent on such factors as business sector, technical and financial complexity, size of contracts, tender procedures, haste in the processes, trust in the business practices of competitors, etc. These are factors that all tend to vary significantly within rich as well as poor countries.

Figure 1 provides information about some of the ways in which firms might try to influence their competitive advantages. Many of the business practices can be legitimate under some circumstances, while being criminal in others. There are also grey-zone practices which are difficult to categorize as corruption, although they can be connected to such crime.

The complexity of business-corruption, combined with the difficulty of providing proof of crime, pleads for innovative ways to approach the problem. In particular, when designing counter-measures we need to consider the different ways in which firms might influence their competitive advantages through corruption.

The procurement approach

The improved understanding of market-related corruption as a separate but related challenge, has contributed to increased attention to procurement rules and tender procedures. Improvements in these procedures will usually lead to better price-quality combinations in public procurement when the officials involved are honest. In terms of anti-corruption, however, this approach is too limited. There are primarily two reasons for this:

First, it is very difficult to prevent tender-related corruption through procurement rules. Even among honest officials there may prevail a culture for manipulating procurement rules because they are sometimes seen as too rigid when 'the system' knows what to buy. Procurement procedures are technical and they will usually be subject to procedural control, and seldom to more thorough quality controls. Besides, in cases of corruption, firms' influence in order to get contracts will often commence long before the tender procedures start, and the benefits that firms might obtain will often be tied to promises of additional services, favorable ways of interpreting the contracts once the work has started, or renegotiation of contractual terms. Hence, what happens long before and after a tender is also critically important to understanding these forms of corruption.

Secondly, tender rules cannot replace anti-corruption efforts because the relationship between competition and corruption requires a much broader approach. There are many other ways for firms to gain competitive advantage through corruption; they do not have to be directly related to the firms' sales.

Corruption and competition

Table 1 offers an overview of the most relevant mechanisms by which firms might have an opportunity to gain competitive advantage. The achievement of a more profitable position can be due to corruption in all of these categories.

Figure 1: Practices that may be linked to corruption yet also legitimate and part of honest business conduct.

LEGAL — ***LEGAL GREYZONES*** — ***ILLEGAL***

Honest and professional business conduct
Ordinary marketing
Marketing targeted at specific individuals: exclusive excursions/ tickets/dinners, etc.
Unsolicited proposals, with all details of an unplanned project prepared
Middlemen and agents, 'personal relationships is what counts'
Gifts to political parties - by condition of a certain benefit
Quid pro quos - a way of covering corruption?
'Facilitation payments' - 'to get the procedures going'
Bargaining on opportunities for reconcessioning (profitable solutions for the firm)
Violations of rules of communication (as if they were not important)
Persuade politicians at home to put pressure on local gvms. (difficult to prosecute)
Acquire secret information about evaluation, use of 'fronts'
Misuse of 'facilitation payments' (makes corruption 'less illegal')
Expensive gifts to people involved in the tender procedure
Buy secret information about competitors' bids
Local partnership with relatives of people with authority
Bribes to individuals with influence on the procedure

DIRECT MARKET POWER *Competition law*	TRANSACTION COSTS *Production /upstreams/ Regulatory system*	POLITICAL PRESSURE *Shaping regulatory system/ allocation of benefits*
Cartel /market sharing	Bureaucratic rigidity. Taxation (variation in ability to operate)	Tender criteria
Mergers	Private-private corruption (vertical cooperation, access to resources)	Ad hoc involvement in cases of competition law
Absolute barriers to entry	Access to credit	Diplomatic pressure/ negotiations
Single-source supplier agreements	Corrupt legal system (variation in the enforcement of the law)	Variation in political risk and predictability of regulatory solutions

Table 1: Some mechanisms through which firms can gain market power

This is because in a democracy politicians are expected to exercise influence. Political influence on bureaucratic decisions is therefore widely accepted, even if the decisions are supposed to be made independently of politics. When political authority is misused for corporate or personal gain it is often difficult to prove. Often there will be a political argument available to support the decision (regional politics, protection of domestic industry, the importance of foreign investment, environmental concerns, employment issues, etc). From an anti-corruption perspective it is therefore critically important to be able to distinguish between welfare-improving political decisions, and those that are made to the benefit of individual firms and at the cost of welfare for the population at large.

Direct market power

The first category in table 1 refers to direct market power which can be created and sustained through trade barriers, manipulation of prices and collusion, acceptance of welfare-reducing mergers or acquisitions, or favorable agreements on sole-source supply to governmental institutions. While the firms involved obtain higher profits, the result is usually higher prices for consumers, or reduced quality or supply of goods and services. Market power may also have adverse effects on industrial development, as incentives to operate competitively are reduced. The ways in which firms can gain direct market power are those that usually are regulated by competition law. The role of competition authorities (bodies that are implementing and monitoring competition law) is thus a very relevant concern when it comes to business-related corruption in developing countries.

Production and transaction costs

While production cost advantages are significant for company profit, and sometimes also under the scrutiny of competition authorities, the relationship between corruption, production costs and competitive advantage is still a neglected concern. This is despite the extensive literature on corruption relating to the most relevant circumstances where this form of advantage can be reached. For instance, we have some empirical information about facilitation payments and how they are related to the business climate. However, whether the ways in which a firm handles bureaucratic corruption can provide it with significant advantage vis-à-vis other firms in the market is yet an under-investigated question. Similarly, the role of banks and the relationship between access to finance, transaction costs, corruption and firms' market power requires more knowledge.

Political pressure

The third category in Table 1 refers to political influence. Political corruption will be far more rewarding for those involved if it implies that a firm gains market power. The profits from which bribes are extracted will be higher because prices for products and services can be higher. If political influence is exerted on decisions taken at local, national or international levels, it will seldom be seen as corruption, however.

Legal versus illegal influence

Research on the different ways in which firms can influence their market position and how this in turn affects outcomes and welfare is still in its infancy. We may, however, distinguish between legal practices and illegal corruption. Table 2 illustrates some important differences between corruption and lobbying: bribery will usually imply a *violation* of the rules, while lobbying entails more permanent *changes* to the rules. In contrast to legal rent-seeking or lobbyism, where demands for beneficial treatment can be an annoyance for the public official, corruption represents some form of collusion, an illegal mutual agreement where both parties involved will benefit. A bribe is usually a payment as part of a trade, while the expenses associated with lobbying will often be wasted.

Although there are important reasons for distinguishing between firms' legal and illegal ways of obtaining market

Table 2: Legal versus illegal business practice

CORRUPTION	LOBBYING
Illegal	Part of democracy
Benefits those involved – *violation* of rules	Benefits a group – *change* of rules
Both parties benefit from the deal (collusion)	Often annoying for the decision-maker
A bribe is a compensation/ payment	Investment in lobbying is often wasted

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advantage, they may be difficult to categorize in practice. Better understanding of the relationship between unfair competition, firms' business practices and corruption is important to identify alternative approaches and counter-measures, since sanctionability on the basis of corruption can be difficult.

Policy implications: what aid agencies can do

Anti-corruption initiatives, whether they are targeted at political levels, facilitation payments in public service delivery, or specific institutions, seldom address industrial competition. Despite the obvious connection to firms' opportunities to gain profit, the problem of corruption is rarely treated as a competition-related challenge. It is important to recognize that business corruption is a separate form of corruption which involves far more activities than those related to the awarding of contracts and manipulation of tender procedures. Reforming procurement rules is therefore insufficient to control the many forms of business-related corruption. Nevertheless, procurement in general, and public procurement in particular, represents significant corruption risks, both in developed and developing countries. Reforming procurement procedures, and continued effort to make them more robust against corruption, are therefore important.

Most aid agencies are involved in activities to support private sector development. Hence, there is some basis for incorporating efforts to strengthening the regulation of competition in markets, and for linking this work to anti-corruption initiatives in the private sector. The presence and quality of antitrust and/or fair competition authorities vary significantly. In most developing countries they need to be strengthened in several ways: (i) in terms of the formal frameworks and competition law; (ii) the institutions' financial underpinning, (iii) their competence levels primarily in law and economics, and (iv) through political recognition of the value of independent competition control.

Aid agencies can make significant contributions in this respect, as the expenses needed to support these institutions financially are relatively moderate. In addition, relevant competence levels are high in most developed countries. There is much to gain merely by (i) gathering information about lessons learned from various contexts and countries; (ii) carrying out assessments of the role of competition authorities in economic development in general; and (iii) raising awareness of relationships between corruption, firms' market power and welfare.

Another required initiative is the support and establishment of complaint procedures, not only for complaints regarding clear-cut corruption, but also offering opportunities to complain about a broader range of unfair competition. In addition, control mechanisms which work independently of whether anyone is forwarding complaints, should be in place. Many firms are concerned about sanctions if they complain about corruption or unfair competition. Another concern is the risk of collusion, where none of the firms involved have incentives to complain. Control mechanisms should therefore have elements of self-initiation from the side of the authorities.

Aid agencies can do more to involve the private sector in these initiatives. Firms are players who know what might prevent them from being involved in corruption and they have a role in designing counter-measures. It is particularly important to gain more information about how firms operate in challenging business climates, while at the same time respecting legal obligations such as the last decades' introduction of international anti-corruption conventions.

And finally, governments should be encouraged to cooperate on the enforcement of these conventions, by having dialogues about such issues even if they are sensitive, by exchanging critical information about firms, their partners, and transactions, and by reducing diplomatic pressures on the outcome of international tenders.

Further reading

International Competition Network (ICN): information about competition authorities in various countries and initiatives to strengthen competition law
http://www.internationalcompetitionnetwork.org/

World Bank web-site on Developing Competition Policy: relevant papers and links
http://rru.worldbank.org/PapersLinks/Developing-Competition-Policy/

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