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Corrupt Relational Contracting

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# Corrupt Relational Contracting

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## Abstract

Because corruption must be hidden from the public and is not enforced by courts it entails transaction costs, which are larger than those from legal exchange. This suggests that corrupt contracts are primarily relational contracts where legal exchange serves as a basis for sealing and enforcing corrupt agreements. Legal exchange not only provides for corrupt opportunities, but for the necessary enforcement mechanisms. Examples of such legal exchange are long-term business exchange, belonging to the same firm or political party or being embedded in social relationships. The latter may even comprise the engagement in charitable institutions. Reform should not only focus on limiting opportunities for corrupt behavior but also on impeding the enforcement of corrupt agreements.

JEL classification: L14; K42; D23

Keywords: Corruption; Secrecy; Transaction costs; Opportunism; Reputation; Trust

## 1. Introduction

"Why are so many politicians lawyers? – because everyone employs lawyers, so the congressman's firm is a suitable avenue of compensation, whereas a physician would have to be given bribes rather than patronage."

Stigler (1971)

Corruption, no doubt, is regarded as one of the modern evils. It is carried out by those with a criminal intention and motivated by greed. Yet, if life were so simple, why is reality sometimes providing some disturbing contradictions to the simple-minded viewpoints? Why, in particular, do we face a significant pattern where corrupt people tend to be involved in a variety of charitable institutions? Why are many bribers and bribees engaging in a variety of regular business transactions where they are regarded as trustworthy and honest partners? Our viewpoint of them as criminals clearly contradicts their social engagement. The trust they are given in business relations is not well related to their misuse of entrusted power.

A straightforward argument, certainly, would point out that corrupt actors must be entrusted with power prior to misusing it. There must be opportunities for corrupt misbehavior. These opportunities commonly arise where public office holders are in a monopoly position, have discretion in interpreting, applying or changing the law and are lacking accountability, (Klitgaard 1988: 75). This often takes place in the area of public procurement or where excessive government regulation interferes with market forces. Since elected politicians are entrusted with power while appointed bureaucrats have informational advantages over their superiors, they can also misuse their position for corrupt purposes. A certain level of trust is therefore a basic prerequisite to corruption. But what motivates corrupt people to misuse this power? One hypothesis would suggest that these are just hypocrites. They may seek to profit from a reputation for altruism and commitment while in reality self-

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seeking is all what guides them. Social engagement would simply serve to camouflage their true intentions. The trustworthiness they are given would purely relate to their capacity to disclose their true corrupt goals. Indeed, some truth will commonly be behind this explanation. Nonetheless, this paper provides an alternative avenue for understanding the questions raised above.

A recent corruption scandal in Germany involving Günter R., an ex-SPD MP from Bielefeld, is particularly of interest to present a sketch of the issues that we are aiming to treat in this paper.<sup>1</sup> The news that Günter R. was arrested on the charges of corruption fell like a bomb right into the heart of his hometown, Bielefeld. Hadn't he been almost the living example of a "good man" for years and years? His social commitment had been exemplary. He was engaged in a series of charity organizations, NGOs and non-profit organizations with a particular emphasis on education. The Bielefeld Public Prosecution Office's division for economic crimes accused him of having abused these positions for his self-enrichment amounting to six-digit figures in DM basis in a period spanning 1995 to 2000. One of the foundations, whose chair was held by Günter R., operated a non-profit company for innovative living and training projects in co-operation with the German youth hostel association. These projects involved a considerable activity of construction. The Bielefeld senior public prosecutor commented that Günter R. was in a position to influence the assignment of these projects, owing to his political position at the time. In mid-1990s, the acquaintance between Lutz-Peter B., the managing director of a construction enterprise, and Günter R. grew closer. This acquaintance pushed the non-profit targets of the Bielefeld politician to the background. He clearly had a clean hand to mediate certain contracts to the former's enterprise. Over-invoicing was used excessively to hide the crimes. Against these invoices, the non-profit organizations led by Günter R. paid exaggerated sums, the kickbacks being divided between him and the managers of the mentioned enterprise. The illegal cash flow was also masked by the fact that Günter R. received wages for his alleged activity as a "construction supervisor".

What conclusions should one draw from this case and countless similar ones? While some hypothesis would suggest that these people simply disguise their true nature and use their position to camouflage their corrupt transactions, this study shows that social engagement, trusted relationships within firms, and a reputation for honesty are not at all in contrast to corrupt dealings. Quite to the contrary, they can form an integral part of it. This paper suggests that there hardly exists such a thing as a purely corrupt relationship. Corrupt deals can be part of a relationship, but commonly these relationships entail also a variety of legal transactions, and even charitable ones.

This study aims to examine the link between completely legal relationships and illegal ones. This link, basically, relates to the fact that corrupt arrangements go along with high transaction costs. Corrupt relationships are instable. They entail that sticking to one's word may be dominated by betrayal and fraud. Sometimes corrupt agreements even end up in mutual denunciation. Pre-existing legal relationships can lower these transaction costs and serve as a basis for the enforcement of corrupt arrangements. Investigating corruption with the help of New Institutional Economics is a rather novel approach, which has only been picked up recently, Husted (1994), Rose-Ackerman (1999: 91-110), della Porta and Vanucci (1999), Vanucci (2000), Schramm and Taube (2002) and Lambsdorff (1999, 2002a and 2002b). This study contributes to this recent avenue of research.

In order to establish the link between corruption and legal exchange we will start with a brief review of the new institutional economics framework (section 2). We then discuss how this framework is applied to the context of corruption (section 3). This entails some more thorough investigation on contract enforcement and the risk of denunciation. On the basis of

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<sup>1</sup> Süddeutsche Zeitung, "Langjähriger Bundestagsabgeordneter in Haft" January 11, 2002.

three case studies it will be illustrated, how legal exchange can serve as a basis for sealing and enforcing corrupt deals (section 4). A final section concludes and provides policy recommendations (section 5).

## **2. The Contribution of the New Institutional Economics**

### **2.1. Transaction cost analysis**

Since Coase (1937) it is standard to assume that exchanging goods or services goes along with transaction costs. A crucial cause for their existence is that information is substantially incomplete. A good deal of time and material resources are therefore spent for searching the right contract partner, gathering enough background information about the market conditions, work out the details of the contracts, and to seek measures – legal or informal – to cover the parties against opportunistic behavior. Another aspect of the transaction costs is that there is a significant indirect association between their level and the level of mutual trust among the contract partners, (Furubotn and Richter 1998: 49). That is, the less trust among contractors, the more time, effort and money must be spent to organize an exchange. This explains partly why, in the case of large transaction costs, contractual relationships tend to be sticky in that most transactions are carried out repeatedly with well-acquainted business partners rather than with anonymous market participants. As will be treated shortly, the situation tends to be even stickier in the case of corruption where the direct means of advertisement and establishment of trust are not open to potential corrupt partners and the need for secrecy increases the transaction costs and makes it even more costly, as well as risky, to seek new partners. As a result of transaction costs, the neoclassical concept of exchange between anonymous parties can be far from reality.

Due to the limited information people have, human agents are subject to what is called “bounded rationality”. This suggests that people’s information to assess market opportunities to predict the future is necessarily incomplete. Especially noteworthy from the point of contract design is that people have only limited ability to pre-specify responses to future events. Furthermore, not knowing everything, people do make mistakes and each person may possess a qualitatively different piece of information, that is, not everyone knows the same thing. It is straightforward to link the term “bounded rationality” to the assumption that transactions are costly to carry out, as the two concepts are largely intertwined. Adherence to the assumption that transactions are costly leads one naturally to accept that human beings have a limited and non-uniform ability to acquire and to process information and that they have to spend their time and resources to secure this end.

Williamson (1985) also defines a related concept, that of opportunism, as self-interest seeking with guile and defines this concept broadly so as to include intended forms of deceit such as lying, stealing, distorting, obfuscating, disguising etc. Opportunism requires that information is distributed asymmetrically. Given the presence of *ex-ante* asymmetric information, the problem of adverse selection may appear depending on the contract design. For example, applications to job positions may be fraught with adverse selection when qualifications can be concealed and those who invested most in their education cannot be distinguished from others. A similar argument is viable for the case of *ex-post* asymmetric information and the problem of moral hazard. When contract partners can obfuscate their true effort, they are likely to shirk and devote little time to their actual job, providing less input than what was initially contracted. These examples of concealing one’s qualifications or obfuscating one’s true efforts are examples of opportunistic behavior. Contract partners may act unreliably; yet, the degree to which the contract partner is trustworthy cannot be assessed easily. In order to cope with this situation, *ex ante* screening efforts are made and *ex post* safeguards are created, (Williamson 1985: 64).

The problem of informational asymmetry is not only one between the contracting

parties but also vis-à-vis outsiders. Even if both contracting parties are well informed about each other and the efforts exerted, they may not be able to communicate this to a third party. While an employer may know about the shirking of his employee, he may fail to prove this to a court. The issue of informational asymmetry therefore becomes even stronger, because deviations from contracts must not only be observed by partners but also be proven to outsiders. Some issues become non-contractible not because partners differ in the extent of their knowledge, but because they differ in their ability to prove an accusation to outsiders, (Hart 1987: 168).

## 2.2. Relational contracting

Informational asymmetries and the risk of opportunism suggest that resources should be devoted to gathering as much information as possible. Yet, there are transaction costs involved for this purpose. Gathering information becomes particularly dear in the case of long-term contracts. Here it becomes difficult to anticipate the various eventualities that may occur during the life of a relationship. There arise costs of deciding and reaching an agreement about how to deal with such eventualities, the costs of writing the contract in a sufficiently clear and unambiguous way so that the terms of contract can be enforced as well as the legal and other costs of enforcement, (Hart 1987: 166). Given these costs, it becomes preferable to live with limited information. Thus, it is uneconomic or even impossible to anticipate all contingencies and contracts will be naturally incomplete. As a matter of fact, the information that parties have on the agreed-upon process tends to increase during the contract execution stage compared to the outset, (Nelson and Winter 1982: 96-139). Particularly with regard to long-term relationships such as labor contracts this suggests the writing of contracts, which are initially incomplete. When further information is obtained in the process of exchange, contracts can then be further specified. Consequently, leaving certain gaps in the contract design appears to be a perfectly rational approach to make the contracts flexible enough to fit any contingencies. As it is far too costly, if not impossible, to try to cover all contingencies from the outset, it does not contradict the nature of rationality to leave contracts incomplete. Then, the parties will act on the basis of what indeed materializes, instead of what might materialize. This suggests a “relational” type of contract. The duration and the complexity of contracts increases progressively such that the relation evolves to resemble “a mini-society with a vast array of norms beyond those centered on exchange and its immediate processes”, (Macneil 1978, 890 as cited by Williamson 1985: 72). Based on Macneil’s work, Williamson recognizes that between the neoclassical and relational contracting schemes there is clearly a shift of emphasis from the original agreements in the former to the entire relation as it evolves through time in the latter.

Contracts are relational to the extent that it is impossible to reduce the terms of agreement to well defined obligations, (Goetz and Scott 1981: 1091). Instead of well-defined obligations partners now anticipate trouble as a normal outcome, seeking certain measures – apart from legal ones – for their resolution, (Macneil 1974: 738-40). The relational nature of the contract in such cases becomes more binding than the legal guarantees – if they exist – on a contract since the contractual parties will rarely resort to legal enforcement mechanisms if they have an interest in staying “in” the business for any longer. Defined as such, relational contracts tend to be “implicit, informal and non-binding. [...] transactions [...] embedded in a structure of relations [...] and long term business associations.”, (Furubotn and Richter 1998: 158).

Another noteworthy aspect of the relational contracting is that due to their incomplete nature, the contracts make part of a continuous relationship. Also the negotiation stage assumes a continuous character, since it is the implicitly or explicitly stated intention that settling new arrangements takes place by negotiating over future transactions. The term continuous is employed in the sense that there is no strictly defined and pre-specified

beginning and ending terms of the relations. This continuity of enforcement and re-negotiations keeps the relationship fairly stable, (Macneil 1974: 753).

While the neoclassical analysis of exchange assumes anonymity of exchange partners, relational contracting suggests that the identity of the people engaged in transactions matters. Certain transactions are bound to remain within a closed group of associates. Such cost minimizing transactions require an initial investment in transaction specific resources. Hence, one refers to this as a specialization of identity. Identity matters because engaging in a certain transaction necessitates the negotiation of certain rules, norms or codes of conduct among the related parties. However, once the identity of the contracting parties change, the whole process starts over, implying new transaction costs. Furthermore, the identity specific exchange relationships are themselves deterrent against opportunistic behavior, as cheating now would spare the parties from future benefits of the ongoing relation, (Ben-Porath, 1980: 1-6). Yet, individuals tend to conduct their relations within their own group, not only because of the transaction costs of finding new partners, but also because effective sanctions can be imposed more efficiently within a small group.<sup>2</sup> Accordingly, reliance on reciprocal business relationships and group enforcement mechanisms is more likely when the nature of the contract is such that effective legal enforcement is either undesirable or unlikely, (Klein, Crawford and Alchian 1978).

Writing of incomplete contracts necessitates certain specialized *ex post* governance mechanisms to ensure contract enforcement. The design of relational contracts requires the provision of private guarantees to make contracts binding. Among these are making credible commitments and establishing mutual trust among contracting parties. Contracts could be either of a self-enforcing nature or enforced by third parties – courts or private arbitrators. From the transaction costs point of view, the use of legal enforcement mechanisms is neither a desired, nor necessarily an efficient solution for the contracting partners. Nevertheless, legal enforcement of contracts – alternatively referred to as court ordering – is still available as a last resort in extreme cases. First, using the legal mechanism is costly. Therefore, private enforcement mechanisms may entail cost-saving solutions in relation to the former. Furthermore, resorting to legal enforcement mechanisms presents indirect costs since these jeopardize the relational basis of contracting and put future contracting opportunities at stake. In other words, it is the prospects of future profits that keeps relational contracts enforced privately. Another aspect of legal enforcement is that it is a risky process: Since contracts are incomplete, the judges will have to fill in for the missing provisions of the contracts. Yet, as they are lacking the inside information on the intent of the contracting parties, the legal enforcement can prove to be nothing but an expensive gamble for both parties. In sum, the real world situation is such that legal enforcement mechanisms are kept at a distance from the relationship for as long as the parties have an interest in carrying on with their relationship. Private guarantees will be instrumental in containing bad behavior. People tend to devise private complementary solutions as safeguards to prevent the *ex-post* contractual opportunism, (Williamson 1985: 47). Given the incomplete nature of contracts, the enforceability problem is that of making incomplete arrangements ‘binding’, and credible.

There are numerous tools at the hands of the contracting parties to ensure the enforceability of their deals. The first of these is to design self-enforcing agreements to contain *ex ante* and *ex post* opportunism. One way of securing the desired *ex-post* contract bondage is to hand out collateral to the other party, which is to be kept upon failure to meet contractual obligations. The collateral, or alternatively called hostage, could take the form of an exchange of valuable assets to cover the vulnerable party against the potential opportunistic behavior of the contract partner. Apparently, pre-contract and post contract investments are

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<sup>2</sup> See Schramm and Taube (2002) for an interesting discussion of the Chinese Guanxi networks and how the efficiency of the sanctions are jeopardised as the group size increases.

made to secure a favorable contractual setting. Parties invest on cultivating a sustainable business relation as an end in itself.

Especially in the case of relational contracts, where there is a repetition of contracts, a stable exchange appears possible as the parties would have a chance to apply various sanctioning mechanisms to punish deviant behavior. Regulation can be another tool leading to stable outcomes. Regulation is a form of third party enforcement, whereby an element acting as an agent of both suppliers and consumers of a particular good, tailors some 'implicit' rules and codes of conduct. These regulate the relationship by defining an implicit etiquette to follow, hence making it possible to establish a long-term relationship, (Furubotn and Richter 1998: 162). Vertical integration is no doubt a strong form of coverage against post contractual opportunism. A standard example to vertical integration is illustrated in a relationship between a printing press owner and a newspaper publisher. A contract between these two parties would render the latter vulnerable to opportunistic behaviour of the former. Since a newspaper has to hit the stands on a daily basis, opportunistic behavior by the press owner can impose a considerable volume of losses on the other party. This explains why the newspapers tend to have their own printing press to contain opportunistic behavior by the press owner, whereas a publishing house printing fiction books would possibly not have its own printing press, (Klein, Crawford and Alchian 1978: 298-301). Reputation is yet another factor that stimulates contract enforcement. Contracting parties could be valuing the gains from future streams of incomes that would owe to the trust and the brand name they would instil on the other parties more than their one-off gains from cheating, (Klein, Crawford and Alchian 1978: 312). In the case of a destroyed reputation, doing business becomes more costly in the future.

Contract enforcement mechanism can be purposefully designed with an aim to contain opportunistic behavior. However, the causality may also run in reverse direction, that is, relationships might be conducted exclusively among people with an already established degree of social embeddedness so as to ensure the honoring of contracts. Presence of social embeddedness, such as being colleagues in a certain institution or network, makes opportunism a more unlikely outcome. Being embedded in a social relationship facilitates containing opportunism thanks to the presence of safeguarding mechanisms, (Granovetter 1992). Social embeddedness, such as family and kinship ties, is a condition that outlives the duration of contracts. Furthermore, these cannot be changed easily. Therefore, an individual would have an interest in staying loyal to his group, even when the temptation for opportunism is great.

### **3. How to make corrupt deals**

In a variety of respects, an analysis in legal contracts can fruitfully be applied to corrupt contracts. There are apparent parallels: Partners may cheat each other; there might be informational asymmetries; safeguards against opportunism must be supplied; hostages, trust, and vertical integration may be helpful means to design a corrupt transaction; social embeddedness may facilitate corrupt deals. And since all these mechanisms go along with transaction costs there will remain unresolved contractual problems between partners.

But with regard to transaction costs and enforcement mechanisms there are also differences between corrupt and legal deals. Corrupt deals are sealed in secrecy. The *sine qua non* phenomenon of secrecy has two major implications: First, this legal resolution of disputes over contracts is completely out of the feasibility set. Therefore, contract enforcement relies on private ordering. Whereas in the case of non-corrupt contracts, we have argued above that legal resolution continues to be an alternative. Second, transaction costs associated with sealing corrupt deals are substantially higher. Transaction costs that we referred to earlier, such as costs of searching partners, negotiating and enforcing contracts all have to be carried out away from the eyes of the public. Transparent means, such as advertising, are not available

so these have to assume specific alternative forms, which boost the associated costs. Furthermore the corrupt deals have an aftermath, unlike the legal ones, where the parties are mutually dependent on one another, since they hold secret information about the other party.

### 3.1. Seeking partners and negotiating contracts

The initial stage for sealing a corrupt deal involves seeking a partner. This stage covers the public agent's advertising for his/her corruptibility and the private party's attempts for discovering the willingness and the criminal capabilities of the public agent. Apparently, these cannot be carried out in the open. Other approaches to spreading this type of information must be sought. For instance, having a lavish life style way ahead of one's official income can be a sign of ones corruptibility to third parties, (della Porta and Vanucci 1999: 56-59).

Willingness to enter a corrupt deal can be sought via the use of middlemen to divert the risks away from the corrupter. The criminal capabilities of a public agent is just as important as illustrated by the following citation: "Sometimes the bribee cannot deliver not because he wants to cheat, but because there is a multiple veto power system in operation, which makes centralised collection of bribes in exchange for guaranteed favours very difficult. One high official in New Delhi is reported to have told a friend: 'If you want me to move a file faster, I am not sure if I can help you, but if you want me to stop a file I can do it immediately'", (Bardhan 1997: 1324). Furthermore, there may be moral or cultural obstacles that may prevent one from entering corrupt deals. Even under the assumption that the public agent is willing to enter a corrupt deal, it might still be the case that he lacks the necessary criminal capabilities, since making corrupt deals is quite a specialized field, which has its own jargon and unwritten codes of conduct.

On the grounds of contract negotiation, offering of bribes involves substantial risks. First of all, the size of the bribes is a crucial issue. The public agent will be making a cost benefit analysis weighing the reputational gains from denouncing the offer against the material gains from accepting it. This will entail a corresponding cost benefit analysis for the corrupter where he weighs the risk of denunciation against the losses due to paying more than necessary for a certain service, (della Porta and Vanucci 1999: 195), (Lambsdorff 2002a: 6). Furthermore, a transaction cost perspective suggests that the destination of bribes reflects the corrupter's perception of the distribution of power. The crucial decision of whom to bribe and by how much is dependent on the information concerning the dynamics of decision-making, the gathering of which could also be a source of boosting transaction costs. The involvement of many agents in decision-making also increases the transaction costs for the corrupter, (della Porta and Vanucci 1999: 40-41).

In line with the earlier analysis related to relational contracting, contracts are bound to be specified incompletely in the cases of corrupt deals. This gives the corrupt parties a maneuvering ground to take advantage of possible opportunistic prospects in the future. However, it is also necessary to hide evidence from the strong arm of the law in case of denunciation. More often than not, bribe payments are concealed in the form of a loan, a charity made to a certain cause, or a US-education provided to the relatives of the public agent, (Lambsdorff 2002a: 7).

The fact that contracts are not precisely written to the minute details has already been treated earlier in this paper. This is an issue that already applies well to legal contracts. In the case of corrupt contracts, there may be additional reasons to keep contracts vague. Any specification made during contract negotiation may run counter to camouflaging a corrupt service as a mere side aspect of a friendship. The transaction must appear to be caused by philanthropy, but the specifications reveal the presence of a quid pro quo. A case study from Israel illustrates the point: Former Israeli Prime Minister Netanyahu and his wife were charged with accepting the moving and cleaning services of contractor Yaakov Amedi for three years without making any payments. This suggests that actually a bribe was camouflaged



in the form of a gift. In return, Amedi was allegedly slated to receive a government contract, after Netanyahu's expected re-election. Amedi has since become a prosecution witness. Media reports say that the contractor submitted a US\$110,000 bill after Netanyahu was defeated in elections and it became clear that Amedi would not get a government contract. Netanyahu rejected payment, inducing Amedi to bring the case to court.<sup>3</sup> The partners apparently did not specify whether Netanyahu would return the favor in any case or only if he is re-elected. Considering the political consequences of such a denunciation, it is evident that the public party of a corrupt deal has more to lose from denunciation compared to the private party. While the contractor only lost a potential government deal, Netanyahu received a major blow, threatening his chances for future re-election.

### 3.2. Enforcing corrupt agreements

There might – and most frequently do – occur time lag problems in corrupt acts as the bribe payment and the deliverance of the agreed-upon benefits do not occur simultaneously. Therefore, there is a strong presence of uncertainty as to contract enforcement in the nature of corrupt deals. Among a series of problems that could block the way of realization of anticipated effects of corruption are simply a change of mind or a change of office, which might render the corrupted official unable to stick to the contract, (della Porta and Vanucci 1999: 42). If there are prospects of negotiating further contracts with the same people over time, both the transaction costs and risks associated with the advertising, gaining trust and forming a capital of common knowledge are substantially reduced. The process of seeking partners, negotiating and enforcing contracts displays considerable risks of denunciation in each stage, which forces corrupt relationships to have a closed nature vis-à-vis the outsiders. Therefore, the very illegality of corruption makes it imperatively an identity specific transaction.

As mentioned in the beginning of the section related to making corrupt deals, one cannot go to the courts and demand legal measures to ensure the honoring of a corrupt deal. Similar to the case of searching a corrupt partner, where open advertising was not possible, parties resort to alternative methods to ensure contract enforcement. Among these are trust, repetition, reputation, hostage taking, reciprocal obligations, etc. Especially interesting to note is that in the case of corrupt deals, otherwise desirable norms such as honesty and reputation could lead to adverse consequences because they facilitate corrupt deals, (Rose-Ackerman 1999: 96-7), (Lambsdorff 2002b).

Since in most situations, the timing of corrupt payments and the delivery of corrupt services do not overlap, hostage taking is an instrument employed as a contract enforcement tool. The principle is that one of the parties gives a valuable asset to the other, which could be kept in the case of a non-performance of the contract. A most typical example is that public servants may ask for part of the bribe in advance before setting out to make the necessary arrangements for the services. This disallows the bribers from reneging, but it may then provide the public servant with a potential to behave opportunistically. In the absence of a careful planning of the volume of hostages, these may create unintended incentives for the holder's opportunistic behavior (Rose-Ackerman 1999: 35 and 102). Moody-Stuart (1997: 15) provides an interesting discussion on how down payments for legal deals can serve as a collateral for corrupt side-agreements.

The notion of trust stemming on personal ties such as family, kinship, business links and friendship fits the analytical framework of this study well. Trust is a crucial element in corrupt deals as legal enforcement of contracts is not possible. Given the presence of trust, parties may blur the distinction between gifts and bribes to outsiders, yet keeping the meaning

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<sup>3</sup> See The Associated Press, 28.3.2000, "Police: Look Bibi!"

quite explicit inside the relationship. This type of dealing is not available between complete strangers, (Rose-Ackerman 1999: 98).

In order to cover the parties against *ex-post* opportunistic behavior, corrupt deals are more often than not sealed between parties with a considerable degree of reputation. Especially, a reputation for honesty plays a crucial role when it comes to sealing corrupt deals. As the risk of being cheated is considerably higher in illegal deals, the reputation for being an honest criminal who always sticks to the deal may help establish trust. The existence of trust and reputation suggests that it is less costly to carry out repeated transactions with well-acquainted business partners. In this context, the price to be paid for cheating would be exclusion from the relationship for good. It is indeed very difficult to establish one's reputation, especially on such slippery grounds, yet it is fairly easy to destroy it, (della Porta and Vanucci 1999: 56-61). Therefore, it is fair to say that reputation and trust interplay with repetition to restrain corrupt deals to insiders.

Reputation and repetition also come into play when discussing contract enforcement. A corrupt actor is most likely to care about his reputation since a good reputation of not resorting to opportunism will make him a respected business partner for those who seek his services. In order to clarify the distinction between reputation and repetition, we need to observe the following: the former concerns future profits with other clients, whereas the latter is related to future profits with the already existing partner. The need to maintain one's reputation will act in and of itself as a contract enforcement tool. Repetition also lends itself to a similar analysis. If the relationship is to endure, the parties will not be tempted easily to take the easy profit opportunities at the expense of future losses. Both sides of the coin will be taken into account while discussing repetition. Obviously, it can be analysed as a contract enforcement tool operating through implicit threats of terminating future business co-operation. When it comes to corrupt deals, the very topic of our discussion, the threat can go so far as to menace the ongoing legal ties between the partners, (Lambsdorff 2002a: 16).

Seeking third party enforcement could be another viable option. In this case, the third party should have enough power to secure the payment of the bribe by the private party and the fulfilment of the service by the public agent, (della Porta and Vanucci 1999: 46). Regulation could be another contract enforcement device, in cases like Italy, where corruption exceeds a certain threshold, certain unwritten rules, or codes of conduct, seem to appear spontaneously. In such cases these invisible norms tend to gain credibility, as one may be under impunity when one breaks the written rules, yet punishment is guaranteed when one does not pay heed to the invisible norms. Contracting under such circumstances, all actors would be discouraged from denunciation and accept the status quo of giving and taking. Besides discouraging denunciation, such norms facilitate exchange of corrupt deals. Certain etiquette of corruption will be in place to minimize the costs of negotiations and the related risks, (Vanucci 2000).

### 3.3. The aftermath

In the realm of corruption, the analysis of contracts requires a further treatment of denunciation. Illegal and hidden by their nature, corrupt deals put the partners of such deals at the mercy of one another. Even long after the service in question is rendered, the partners remain in a binding relationship of mutual dependence, which can also serve as a basis for extortion or hush money. There can be numerous motives for denunciation of corrupt deals: On the one hand, the asymmetric nature of penalties on parties can serve as a motivating factor, especially when there are monetary inducements from third parties, ready to pay for inside information. On the other hand, denunciation can be used as a threat when one of the parties has more to lose from a potential exposure of involvement in corrupt activities. This is typically the case with the public servant, who risks losing his job for good in case of exposure. Therefore, a typical pattern emerges where the private party makes a generous offer

at the initial instance of corruption, after which the relationship between the private party and the bureaucrat evolves on an unequal basis, (Lambsdorff 2002a: 19-22)

A case study from Peru illustrates these points in action. In 1999, a corruption scandal had outburst in Peru as videotapes showed former spy-chief Vladimiro Montesinos bribing congressmen. The crisis led to the imprisonment of Montesinos and the flight of former President Alberto Fujimoro to Japan to avoid trials on a series of charges including corruption. In his prison cell, where he awaits trial, Montesinos is reported to have demanded a sum of US\$700,000 from an electoral official so as to keep his mouth shut about a vote rigging scandal. A lawyer from among the official's staff was abducted to Montesinos' high security prison cell in Lima, where he was instructed openly by the former spy-chief to hand over \$700,000 to him so as to keep quiet. Montesinos gave the official 72 hours to prepare the money and wait for the final instructions. Yet, the lawyer made the threats public, the hush money was not paid and the former spy chief was put into isolation afterwards.<sup>4</sup>

The Montesinos case illustrates an openly stated demand for hush money. Apparently, after being imprisoned, the former spy-chief discovered that as someone already alleged with a variety of offences ranging from bribery and arms smuggling to ordering murder, the road was open to him to extort hush money from his former corrupt partners. The case illustrates a threat of denunciation as well as how the parties' valuation of corrupt deals may change radically under a change of environment where the initial contracts were designed. It would be quite unrealistic to expect Montesinos to come up with a similar threat, had he been able to retain his influential position in administration. In that case, he would have as much to lose from denunciation as the official.

As argued above, the aftermath of the corrupt deals is a problematic issue as the parties engaged in a corrupt deal become mutually dependent due to the secret information they keep about one another. It is this hidden information that sets the ground for extortion of hush money. Besides the Montesinos case, the following case from Germany sheds light on the problem: A staff member from the Christian Democratic Party's office in Hesse was alleged to have embezzled DM 1 million from the party's funds. But, he was given impunity since he held some crucial information as to the party's illegal hidden accounts. While this is not clearly a case of corruption, illegal party financing can come close to that. To prevent the staff member from denouncing the hidden accounts, the party even took over some of his gambling debt. All this raised allegations that these payments represented some sort of hush money.<sup>5</sup>

#### **4. Linking Corruption to Legal Exchange**

Corrupt contracts go along with much higher transactional difficulties than legal contracts. There exist a variety of mechanisms that partners in a corrupt deal employ to lower these transaction costs, to find each other, to enforce the deal and to safeguard against denunciation. A variety of these are discussed in Husted (1994), Lambsdorff (1999, 2002a and 2002b), della Porta and Vanucci (1999), Vanucci (2000) and Rose-Ackerman (1999: 91-110). Here we focus on one such mechanism: linking a corrupt deal to an established legal relationship. The presence of a perfectly legal relationship between two parties may set a fertile ground where corrupt deals may flourish. Corruption in this case is not a single act between anonymous partners. Rather, it is embedded into a complex relationship. Corruption mostly comprises implicit, informal and non-binding agreements, which are enforced only by being rooted in long term business or hierarchical associations. Corrupt contracts are primarily relational contracts.

There are commonly a variety of means available to business partners to sanction each other. They can destroy each other's reputation, end profitable future exchange, penalize each

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<sup>4</sup> Reuters, "Montesinos Exercises Power from his Jail", Wed, Nov 7, 2001

<sup>5</sup> See *Süddeutsche Zeitung*, 4.2.2000, "Hessische CDU zahlte angeblich Schweigegeld".

other when provided with hierarchical control, or turn the friendship into a relationship with mutual accusations. Threatening such sanctions helps the enforcement of legal deals. In the presence of already established legal relationships, the parties might find it tempting to collude for proceeding with a corrupt deal. For as long as such sanctions are available, they can also be used to enforce a corrupt agreement. For anonymous partners it will be difficult to carry out a corrupt transaction. But for those, who already have the aforementioned sanctions at their disposal, it will be much easier to link their corrupt transaction to the established legal relationship. Parties may initially start off with a legal relationship, which later deteriorates into one where also corrupt deals are carried out. The presence of trust in this case facilitates the process considerably. A crucial hypothesis of this study is therefore that corrupt transactions are often linked to legal ones.

Based on the survey of new institutional economics and its extension into the domain of corrupt deals, developed so far, we will propose some further case studies in this section to show how the theory applies to the real life. After describing the case studies from the international media, we attempt to interpret partners' actions with the help of new institutional economics. We argued that such a viewpoint helps us understand the incentives motivating corrupt partners, as well as a series of errors they committed. One crucial hypothesis we pursue by doing this is that corrupt transactions are often embedded in social relationships where also a variety of legal transactions are carried out. The first of these case studies illustrates how personal relations, friendship in this case, can be used as a basis to carry out corrupt transactions.

#### 4.1. Banking in Potsdam

As of 1992, Leonard A., director of Bayerische Vereinsbank in Potsdam, was tired of working in hastily erected provisional accommodations – like most of his competitors who had rushed into former East Germany's banking market after reunification. Instead, he dreamt of a luxurious office in the best area of the city of Potsdam, on a site owned by the city where construction was still blocked by pending restitution claims. There was yet another problem: One of the major competitors of Vereinsbank also showed interest in the property, hence drawing attention to the area. In order to work around these impediments A. sought out his friend and tennis partner Detlef K., city official for construction and housing since 1990. He let their personal relations play a role in the quest for the site. Consequently, A. obtained a construction permit before ordinary procedures had been finalized and his bank was preferred over its competitor when the city sold the building site. In exchange, Vereinsbank gave K. a legally certified option for buying an exquisite mansion for a price considerably below the market prices. The contract was formulated such that K. did not participate directly as a buyer; instead he was only given an option to buy the aforementioned dwelling. The winds, however, changed for all participants. First, the city mayor Horst G. rotated the personnel in the city office for construction and housing. In the meantime, higher authorities from Vereinsbank declared the option for K. void. This had an impact on the friendship between the two tennis partners. What other explanation could there be for the fact that years later, two friends of K. accused A. for demanding personal gratification in exchange for giving out bank loans, providing taped evidence? A. fought back by denouncing the former illegal deal with K. While A. was serving a 30-month prison term, K. was expelled from office in 1998.<sup>6</sup> A local newspaper reports that the event came into light as A. was “coincidentally” charged for extortion from a Potsdam building contractor.

This is but one case where former legal relations serve as a basis to strike a corrupt

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<sup>6</sup> See Der Tagesspiegel, 16.12.1997, “Ex-Bankchef wegen Erpressung verurteilt”, Der Tagespiel, 29.11.1997, “Staatsanwalt prüft Ermittlung gegen K.”, Main-Echo, 13.1.1998, “Potsdams schillerndster Politiker läst Stadtberhaupt wanken” and Lambsdorff, [1996:56].

deal. In A.'s case, seeking a city official with the sufficient criminal capability to deliver him the corrupt service would be a costly and risky undertaking. Offering bribes in the open might as well have backfired. However, he had an established relation with the right official, which happened to be his tennis partner K. Therefore, he did not have to invest resources into seeking a partner or into inquiring the partner's criminal capacities. Resources were spent into organizing a contract for K. to buy a mansion below market prices, a hidden agreement that would pass for the actual payment for the corrupt service under consideration. Here one sees clearly the inevitable need for secrecy, a distinguishing feature of corrupt deals. Furthermore, the case also displays the contradictory nature of corrupt deals. On the one hand, these tend to be pretty stable thanks to the mutual interests of the parties; on the other hand, they are vulnerable. The relationship seems to have ended to be fruitful as G. decided to rotate his officials and K. ceased to hold this critical position. Since no public servant is expected to hold a certain office for an infinite period of time, the relational contracting is doomed to end some day. The question is whether whistleblowing will take place in the end or not. As K. was suspended from his influential position, the deal offered to him was declared void. This put an end to the transaction cost saving nature of the relationship and denunciation followed. Whatever it was that brought the two partners together in the illegal relationship was seemingly not strong enough to sustain the emerging pressure and be maintained despite the loss of means of prospective co-operation.

#### 4.2. Frankfurt's red-light district

A 33-year old police officer, assigned to the monitoring of the drug scene at the main station of Frankfurt, Germany, initiated a personal relationship with a brothel manager as well as with a prostitute from Colombia. Apparently, there was a divergence of viewpoints between how the parties viewed one another. While the officer naively believed in the sincerity of the relationships, the brothel manager and the prostitute seemed to have valued him basically as a contracting party from the outset, valuable for the information which he could access and deliver. The officer shared the information about the warranted persons in the environment with the brothel manager and passed on certain other tips, such as informing the brothel manager about an impending police raid on the Red Light district in search for three prostitutes from South America, who were illegally active there. No wonder the three prostitutes had gone on a trip on that specific date. The officer first came into contact with the manager when he searched the brothel for drugs and dealers in 1997 and developed a personal relationship with him from 1998 onwards. Then he started showing up frequently at dinners, and participating at some parties with the women from the brothel. The official got involved in intimate relationships with three women from the environment. Upon the official's arrest in May 28, 2000, the brothel manager is reported to have fled to Spain. As to the financial aspects of the relationship, the official rented three dwellings. These were then sublet to double rent to prostitutes, supplied by the brothel manager. While this contract design should have provided the officer with extra income, in fact, it set him even more at the mercy of the brothel owner. In case the dwellings were not fully occupied, which indeed happened, the officer would even risk making losses.<sup>7</sup>

The relationship did not start intendedly as a corrupt relationship from the point of view of the police officer. After his arrest, the official regretted his relationship with the woman, declaring that she was nothing more than an ice-cold prostitute who used him. Therefore, the start of the corrupt relationship is worth a focus. The officer valued the non-material benefits of the relationship in the beginning with a remarkable degree of *naiveté*. To him, passing on the information of which he had become aware, thanks to his position, seems to have been more or less a favor done to a good acquaintance. But the corrupt aspect of the

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<sup>7</sup> Frankfurter Neue Presse, 09.08.2000, "Polizist ließ sich vom Rotlicht-Milieu bestechen".

relationship gained more importance, the longer the relationship endured. In exchange, the favors that he was willing to provide became substantial in their value to the brothel owner and a serious offence against the officer's duties.

Police officers can be in a strong bargaining position. Since they are in charge of controlling the red-light district, they have ample possibilities to demand a bribe. Given the frequent contact to those they control transaction costs can be lowered considerably. For example, Borner and Schwyzer (1999) argue that policemen can lower the transaction costs of corrupt agreements with criminals by regularly controlling the activities of such people. The idea would be that opportunism among the criminal could be avoided by threatening increased supervision or even harassment. While the police officer should be in a strong position, the story suggests the opposite. The reason is that after an initial bribe payment, the public servant loses his bargaining power and places himself at the mercy of the private one. In our case, this occurred when the officer had contact to prostitutes without paying for their services and culminated when the officer rented three dwellings under his name, which were to be double rented to prostitutes. This type of contract may have helped the parties camouflage a bribe as a mark-up for taking caretaker services. But renting of the flats put the officer in a vulnerable position, open to be exploited by the brothel manager. In this case, the brothel manager could have easily downplayed him by holding back the prostitutes and put him in financial distress. Even the brothel manager's flight to Spain shows that the private parties of corruption are in a clearly advantageous position vis-à-vis their public servant partners. Public servants tend to be rooted firmly in their own society. They are normally recruited through a painstaking procedure from among those who make an initial investment of receiving a special training for their positions. Furthermore, the risks they run in their given positions are multiple. First of all, they run the risk of losing their job for good. Once these people lose their tediously attained positions, then they have no chance to reclaim these within their own country. Further, they cannot just simply move to another country and assume a similar position there. Considering the actors in our case, it is not in the feasibility set of our police officer to move to Spain and continue holding a similar position there, whereas there is nothing to prevent the brothel manager to start a new business along the same lines in Spain. The case shows some hints of an unsuccessful vertical integration as well. The very fact of the police officer's double renting houses to prostitutes is an attempt of becoming a brothel operator himself. As he would be operating a brothel in his own field of duty, the case would have been one of vertical integration had it been sustainable. The brothel owner would simply make the officer his partner, giving him repeated incentive to provide the joint firm with inside information on raids and controls as well as avoidance of harassment by the police.

#### 4.3. The Philippine *Jueteng*

Another case study comes from the Philippines and is described in detail by Coronel (2000: 26-36). *Jueteng* was an illegal lottery, a variation of an old Chinese numbers game. Illegal as it was, the game was popular all throughout the country thanks to various layers of protection. Officials and law enforcers from the village level to the national protected the activities of the *jueteng* operators. Bet collectors (*cobrades*) reported to headmen (*cabos*), who were, in turn, supervised by a *jueteng* operator. It was the operator's task to ensure that influential officials protect the game. Of course, protection always comes at a price. Rolio Golez, the head of the House Committee on Public Order and Safety suggests that according to their estimates in 1995, every year some 2.5 billion Pesos (almost 100 Mio. US \$) of *jueteng* money was going to bribes in return for toleration of the game.

Enjoying such protection, the game was hardly ever kept secret. The *jueteng* operators were well known both by the folk in their area and by government officials. In October 2000, Ilocos Sur Governor Luis 'Chavit' Singson charged President Joseph Estrada with having received more than P540 million (US\$10.8 million) from the illegal gambling payoffs

between November 1998 and October 2000. In the Philippines, daily politics and the *jueteng* network were so much intertwined that it is hard to draw a line between the two. It was not uncommon for a *jueteng* operator to be a member of a political clan, or even further, to hold an official position. Singson, himself, is no exception to the rule. He and his brother Jose 'Bonito' Singson appeared frequently in police reports as *jueteng* operators. Even before Singson blew the whistles for Estrada, the indications that *jueteng* money played some role in campaigns for the top administrative offices were evident. Vice-President Gloria Macapagal-Arroyo allegedly received contributions to her campaign from a certain *jueteng* operator, named Bong Pineda.

According to the story of Singson, Estrada invited him, Bong Pineda and a close friend of his Charlie 'Atong' Ang, to his residence in August 1998. There he appointed Pineda with the duty of collecting *jueteng* payoffs and handing them in to Ang. However, Singson was asked to take over the collection of *jueteng* payoffs two months later, apparently as a result of a problem between Estrada and Ang. Singson kept a ledger of the collections from 22 provinces and estimated the daily *jueteng* money collection at P50 million. Of this amount, 3% was the kickback to the President. Singson confessed that he collected the money and delivered it to Estrada either at his home or at Malacanang Palace. Accordingly, Singson's task consisted of collecting the money from local *jueteng* operators to make sure that the President was taking his cut from the collections of all regions.

It is noteworthy to point out that Singson's estimate of *jueteng* collections, i.e. P50 million per day or P18 billion per year, is in accordance with Golez's estimate of the *inteli hensiya* (bribe) payments to the police, i.e. P2.5 billion to P6 billion, that is, between 14% to 30% of the total. Indeed, there were enough payoffs to keep everyone silent and to keep pockets full in the world of *jueteng*. A report from 1995 by the Philippine Centre for Investigative Journalism (PCIJ) and Institute for Popular Democracy showed how the gains from *jueteng* were distributed. In order to come up with a countrywide estimate of the pattern, they sampled a single town called Pangasinan. The report estimates that roughly a third of the money went to protection. Another third went to operational costs in the form of 10% for winnings, 10% for *cabos* and *cobrades* and 10% for maintaining the operation. The remaining third went to the *jueteng* operators, who also used part of the returns in patronage relationships to keep a solid base for their operations.

Up to this point, everything seemed to be in perfect harmony. So what went wrong to lead to the denunciation of the whole arrangement? Apparently, Estrada wanted a higher cut from the *jueteng* network. The means to achieve this end was to legalize *jueteng* under the name Bingo-2 Ball via the Philippine Amusement and Gaming Corporation (Pagcor). It was Atong Ang, who was to supervise the operation of replacing the illegal *jueteng* game with the new legal alternative. Ang set out by appointing some of the existing *jueteng* operators as Bingo-2 Ball franchisees. However, he awarded an impressively high 27% share of the total collections to a private firm, headed by himself. According to Singson, he was merely fronting Estrada in the firm and that the whole scheme was not one of legalizing the business but of grabbing a higher share from gambling. Interesting to note is that Ang proceeded without the permission of the Congress to legalize the game. The backing of the President furnished him with the due flexibility to do so. He embezzled the largest share to his firm. By legalizing the game, what was formerly given to the police as protection money (*inteli hensiya*) would now belong to him. In the meantime, the police were reported to be negotiating with Pagcor to have a legal cut from these proceedings to make up for the *inteli hensiya* money that they lost from legalizing the game.

The events then took a turn that rid Chavit Singson of the potential gambling profits from his region. The Bingo 2-Ball franchise was given to Bonito Singson, Chavit's brother, but at the same time his rival as a *jueteng* operator. Chavit Singson was carelessly pushed out

of the game. He stroke back, exposing the hidden deals of the President. The ledgers seized by the police in Ilocos Sur showed the going rates in the province as follows: P1 million per month for the regional police director, P500,000 for the provincial police chief, P150,000 for the local congressman, and P7,500 to P30,000 for the municipal police chief. Furthermore, the media was also involved in the ledgers. Some 18 journalists were listed in the ledgers for Ilocos Sur. On the national scale, the media also figured in disbursements made from the *jueteng* money to Jimmy Polcarpio, the chief of Presidential Legislative Liaison Office. According to Singson, Polcarpio kept a series of influential media figures on a payroll to ensure favorable coverage for Estrada. Singson admitted that he made the whole story public since Estrada gave a gambling concession to someone else.<sup>8</sup>

The case lends itself to a fruitful analysis of relational contracting of a corrupt deal and its aftermath. We know too little about the specifics of the first corrupt deal between Ang and Estrada. Nevertheless, it is open to speculation that it must have been inadequately negotiated to a certain extent. The fact that within as little as two months Singson replaced Ang suggests such a conclusion. On the other hand, the future promises of a profitable relationship between Ang and Estrada seems to have prevented Ang from whistleblowing at the first place.

The *jueteng* case demonstrates how an existing perfectly legal relationship, that of a local governor and a president, could be used as a means to seal a corrupt deal. This requires some explanation. Singson already depended on the benevolence of the president, as he was a public servant in the first place. This would put a check on the potential opportunism from his part. The political positions they held enabled them to strike a corrupt deal behind close doors. Therefore, they saved on transaction costs of seeking a partner and minimized the risk of raising some eyebrows through advertising for their corrupt intents. The deal enabled Estrada to claim his cut from the national collection of gambling proceeds in return for tolerance, or protection, of the illegal game. The end result is a striking case of centralized corruption. A static analysis up to this specific point in time would lead one to argue that the relationship was fairly stable, as Singson would not have an incentive to resort to opportunism unless something was drastically changed in the pattern of the deal. It was Estrada's strive for further acquisition that brought the stable relationship to an end.

On the other hand, the relations between Estrada and Ang are also worthy of attention. Had the measures to keep Singson's mouth shut been taken, the relation between these two could have been a simple example of a relational contracting among corrupt partners. Although the initial arrangement failed and Singson took over Ang's position at the first place, the secret information that the parties had about one another discouraged denunciation. Corrupt seeds in this case were not so hard to plant as corruption came as a by-product of these entrenched political relationships. The events took an unexpected turn as Singson was pushed aside instead of being retained as an insider that could have been handy in future corrupt prospects. As such deals are sealed between a closed group, it was surely a mistake for the corrupt parties to exclude an insider without providing him an incentive to remain silent. Not providing for sufficient means to maintain Singson's loyalty, Estrada ran the risk of denunciation.

Such cases of highly organized and centralized corrupt practices are rare because the inevitable publicity commonly calls for counteractive measures. As shown, their organization was only possible because hierarchical government organizations, political parties and clans were highly intertwined with *jueteng*. These legal relationships provided for sufficient mechanisms to sanction opportunism and to guarantee loyalty. Corrupt relationships could then be parasitically linked to these legal relations. While the corrupt relationships broke up, it will remain an issue whether the Philippine government organizations, political parties and clans will manage to contain this effective base for corruption in the future.

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<sup>8</sup> See Coronel (2000: 26-36), and Economist, 19.10.2000, "The Philippines turns on its president".



## 5. Conclusion and policy recommendations

This study argued that corrupt deals require particularly high transaction costs because 1) the deals necessitate secrecy, 2) court ordering, i.e. legal enforcement mechanisms, is not available and 3) corrupt partners live at the mercy of one another after contract fulfillment. A variety of institutional mechanisms can be employed to seal and enforce corrupt agreements. This study argued that linking corrupt relationships to legal ones is a common measure to economize on transaction costs. Corrupt relationships per se are not necessarily secure in and of themselves. What makes them more secure, i.a. less vulnerable to opportunism, is their embeddedness in a legal relationship. Corrupt contracts are therefore primarily relational contracts. In this context, one can no longer talk about a corrupt relationship, but about a relationship, which has legal aspects as well as corrupt ones. Presence of existing legal ties, either in a political context or in a context of friendship, between the parties may create ripe opportunities to secure a corrupt deal. The case studies presented also support the hypothesis that sealing corrupt deals in an ongoing context of a legal relationship saves a considerable amount of transaction costs and reduces the related risks. However, the double nature of such relationships blurs the line between what is to be considered corrupt and what is to be considered *clean*.

After so much has been said about the corrupt deals, now it is time to refer back to our introductory study from Bielefeld. In the light of the theoretical survey and the case studies we have offered in this paper, the story of Günter R. should sound much less shocking to the ears of a social scientist working on the analysis of corrupt deals. While the *grand public* is somehow deeply and naïvely shocked by such a scandal, we have supported the hypothesis that there is rarely ever a purely corrupt relationship in life; instead corrupt deals are sealed in a framework of existing legal relationships, due to transaction cost considerations. Corrupt partners often need a legal base on which, at a later stage, to build their corrupt side-dealings. The same ambivalence might also arise with people's motivations. There might not be such a thing as a purely corrupt intention. It is not (only) due to psychological reasons why a person's motivations are commonly more complicated and more divert. Even those who are charged with the most unscrupulous and corrupt self-seeking must pursue some further genuine goals and interests: They must find partners and friends to establish trusted relationships; they must find jobs and contracts where they are expected to honestly deliver what was promised. In sum, legal and illegal actions are not substitutes, where one is chosen and the other is omitted. Very often they are complements. Legal relationships then provide the basis for sealing and enforcing corrupt agreements.

This approach suggests various avenues for future research. First, while there is consensus about the negative welfare effects of corruption, it is plausible that some forms of corruption are more disruptive than others. One issue could relate to the legal base that is used for the enforcement. For example, where corruption is linked to otherwise fertile business relations it may be less harmful than where it is embedded in less productive political connections.

Reform commonly focuses on how to avoid corrupt opportunities by limiting bureaucratic discretion and increasing public servants' accountability. This study suggests one further important pillar of an anti-corruption strategy. It was argued that a public servant's office not only provides the opportunity for exacting a corrupt pay-off, it may also supply mechanisms to enforce a corrupt deal and to economize on transaction costs. Reform strategies should therefore focus on how to aggravate the enforcement of corrupt deals and how to impede that a public office is used for lowering the respective transaction costs.

Alongside with the official duties, all other legally undertaken relationships of a public servant must equally form a part of a reform strategy. In cases where a conflict of interest arises, supervision and regulation is required. Based on our approach, such conflicts of interest

arise particularly where such relationships, for example long-term business relationships, can serve as a basis for the enforcement of corrupt deals. Regulation must in this case limit misusing a public office for the enforcement of corrupt deals. Friendship belongs to the private sphere of a public servant and should not overshadow his duties. This is not only true because a public servant might otherwise be tempted to favoritism, but also because friendship allows to camouflage a bribe as a gift, obfuscate the quid pro quo, allow reciprocity even years after a favor has been given and thus helps to enforce a corrupt agreement. New institutional economics can provide us with a variety of suggestions for reform. As this study highlights, investigating the potential of legal relationships to allow for corrupt spin-offs is an indispensable element of a successful reform strategy.

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