

A Note on Corruption by Public Officials: The Black Market for Property Rights*

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Every individual seeks those property rights modifications which he believes will improve his welfare. Since property rights condition behavior, he seeks those modifications which will induce others to make choices conveying on him an increased sense of satisfaction.

Stubblebine¹

Opportunities for gain, whether pecuniary profit or other advantage, accrue to those who can use government. . . . If income distribution and risk allocation is a partial function of law then the law is an object of control for economic or other gain. . . whether the instances be tariff protection, oil subsidies, real estate agents' attempt to ban "for sale" signs on private homes or any other type of property right.

Samuels²

Black Market: Illegal market in which a good is sold for more than its legal ceiling price. The good may or may not be rationed. If it is, experience indicates that the criteria used for rationing are virtually certain to create skullduggery and inequalities.

Spencer³

These quotes summarize the basic components of the following argument. It is not a complex argument. A student in an economics principles course should follow it easily because all that is claimed is that illegal activities by government officials are able to occur for the same reason that many private individuals can commit illegal acts. Illegal activities in the private sector arise because the market mechanism is not allowed to perform its allocative functions. Often when government action creates a shortage by preventing the sale of a good or service at a freely determined market price, there are some individuals in the private sector who are willing to both buy and sell on the black market. This occurs even when production of the commodity is illegal. On the other hand, government action may lead to a surplus. In such cases some individual suppliers are often willing to illegally lower prices or make payments to willing buyers (bribery). This situation is

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typically not referred to as a black market but it certainly is an illegal market (e.g., illegal aliens usually supply their labor services at a price below the legal minimum wage). All such illegal markets are able to exist because statutes or other government regulations prevent a competitive free-market allocation. Illegal actions on the part of government officials are able to exist for the same reason.⁴

Governments govern by creating and assigning property rights and by more or less continually modifying these rights. Some rights modifications made by government prevent the property, or certain uses of the property, from being exchanged in legal private markets. Almost inevitably an illegal market arises since property rights assignments have an important impact on the distribution of income and wealth. Rights in one's possession can have considerable value because of the authority they create to control the use of property. In addition, modification of another's property rights can be beneficial since rights condition behavior. Thus, an individual (or group) will seek new rights whenever use of something becomes desirable, and he will demand modification of existing rights if the modification provides incentives for others to behave in ways that benefit him (given that the benefits offset any costs associated with obtaining the rights modification).

Property rights can be and are modified through exchange in private sector markets. Such exchanges occur any time a commodity is traded. Modifications can occur without total transfer of property however. The control of various uses of property is often divided up and held by different individuals or groups (e.g., the separation of mineral rights from other land use rights). The government can take property rights from private individuals and, in doing so, create a shortage by making private exchanges illegal. Private black markets arise in many such instances, of course. This occurs when the illegal market is difficult to detect and control. For example, rights may be associated with a non-durable, easily transported commodity (e.g., liquor during prohibition and the wartime price control periods, heroin, domestic oil subject to price control, etc.), or with an immediately consumed service (e.g., gambling, prostitution, etc.). These types of goods and services readily lend themselves to a black market situation. Of course, private black markets may arise for many durable, immobile commodities if the market cannot be easily controlled. During World War II when price controls were very extensive, the number of black markets made control of any one very unlikely. Many other examples of private sector black markets could be cited. However, that is not our purpose. Instead, we are interested in situations where public officials are the black marketeers.⁵

Whenever an illegal property rights modification cannot be easily hidden, the modification must be made to appear legal. Therefore, private sector black marketeers cannot provide such a modification. This may be because the property involved is highly visible and a change in use or user can be easily detected. Perhaps the property is durable and immobile (e.g.,

land subject to zoning or other use restrictions), or the property is subject to close scrutiny by government officials or the public for some reason (e.g., highly regulated industries like railroads or banking where almost any change in use or ownership requires regulatory approval). Many examples could be cited. All involve a change in property use which is illegal and therefore cannot take place in a free market.⁶ Furthermore, the change in use is so visible that a private black market will not perform the rights modification.⁷ The needed property rights must be obtained from a government official because it must appear to be legal.⁸

There are many instances where private sector black markets could be prevented or severely limited through *relatively* inexpensive enforcement efforts. In such cases the public officials designated to prevent these black markets are provided with a valuable set of property rights to sell. They can allow specific private sector black marketeers to operate while preventing other potential black marketeers from entering the illegal market. In other words, these officials can sell (and then enforce) the rights to be a monopolist in a private sector black market. Thomas Schelling has suggested, for example, that "organized crime is usually monopolized crime."⁹ Paul Rubin and Annelise Anderson both maintain that one reason these criminal firms possess market power is that they face economies of scale in "buying both police inaction and corruption at other points in the criminal justice system."¹⁰ Demsetz has explained that economies of scale are not a sufficient condition for monopoly pricing, however.¹¹ The ability to exploit a monopoly position, even in an illegal market, appears to result from *selective* entry restrictions established by government. In this instance, all entry is illegal but corrupt public officials sell the right to produce to selected illegal firms. Thus, a black market for property rights controlled by public officials enables a private sector black market to operate.

Government black markets also arise when the desired rights are associated with scarce, publicly owned property for which there are inadequate substitutes available in the private sector. Obviously in such cases the private sector cannot supply the desired rights in either legal or black markets. The rights are allocated through the political process just as regulation allocates restricted rights to various uses of private property.¹² A free-market allocation is not possible but a government black market is. Thus, we find corruption (e.g., the Teapot Dome Scandal).¹³

The above discussion indicates that political corruption can arise when the government is the only possible supplier of some property right which, through government restrictive action, is in short supply. Corruption also occurs when the government purchases goods or services. However, such situations can also be explained as being a black market for property rights.

Susan Rose-Ackerman delineated the possibilities for corruption when government buys from the private sector. She noted that there is no opportunity for corruption when the government is just one of many competitive

buyers in a competitive market.¹⁴ Perfect competition can occur only when rights are privately held.¹⁵ Corruption can occur, however, when government has market power as a buyer. When government is a large and important buyer, a private sector seller may be willing to bribe a public official. Such bribery may occur for one of two reasons.¹⁶

First, suppliers may pay to obtain the *right* to be the exclusive supplier of government needs for the product in question. Willingness to pay a bribe in this case implies that there are others who would supply the good if they could. That is, the price the government is expected to set is higher than a market determined price would be. Furthermore, the revenues to the exclusive supplier must exceed the amount necessary to provide a normal return in a market situation. The bribe is considered a cost of production by the firm, so revenues have to be higher by at least the amount of the bribe.

The second reason a supplier may be willing to bribe a government official arises when the seller is already the only supplier. Rose-Ackerman explained that, in this bilateral monopoly setting, "the efficiency of bribery depends upon the relative bargaining strength of the participants in the absence of payoffs. If the seller believes he can appropriate most of the surplus 'fairly' he is unlikely to engage in corruption."¹⁷ In other words, when the supplier is able to exploit his monopoly position, there is no need for a bribe. Corruption arises when the government has bargaining power strong enough to prevent the supplier from acting as a monopolist. The supplier must, consequently, purchase a rights modification that allows him to set price (or at least have more control over price).

Corruption in a bilateral monopoly situation cannot be explained as arising directly from excess demand or excess supply. However, if the supplier is a monopolist, resources are not optimally allocated by the market. In theory a monopoly may exist because of market failure (natural monopoly).¹⁸ In practice, however, monopoly power arises because of government rights modifications which prevent free entry (through patents, exclusive contracts, licenses, regulatory restrictions on entry, etc.).¹⁹ Thus, corruption in a bilateral monopoly also arises because government action prevents the market from performing an allocative function. The market cannot guide more resources into production of the commodity in question, because free entry into the market is not permitted.

Corruption, once again, is a black market allocative function. Even though the government is on the buying side of the market, public officials still have scarce rights to sell. When more potential producers exist (given expected prices) than are required to provide the desired quantity of a good, government must assign the rights to produce that good. Typically this is an exclusive (monopoly) right since only one firm receives a contract. Even when there is not a potential excess supply, corruption can exist if contract negotiations are characterized by a bilateral monopoly, given that the government is in a relatively strong bargaining position. The supplier may be

willing to purchase a rights modification which allows exploitation of his monopoly position.

In one sense the arguments made here are trivial. It is pointed out that black markets may arise any time the government modifies property rights and, in doing so, prevents the free-market allocation of goods or resources. Obviously activities cannot be illegal until government declares them to be. However, there is more to our argument than this. Corruption by government officials is shown to be a black market situation essentially like any private sector black market. Corruption arises because the free market cannot allocate certain desired property rights. When, for various reasons, an illegal rights allocation must appear legal, the only possible black marketeers are government officials. This occurs when the desired rights are associated with publicly owned property, or when an illegal change in private property use or user is easily detectable. Government officials are also the only potential sellers of the right to supply goods and services to government.

Corruption, like a private black market, arises because government statutes, regulations, or purchases do not allow a free and competitive market allocation. This should not be taken to mean that government interference in the market system is always bad, for externalities exist which may justify collective action.²⁰ However, it does indicate that such government interferences always create opportunities for illegal activity. It has long been recognized that private sector illegal markets often arise following government manipulations of markets. Now we see that even when private sector illegal markets are not possible, public officials still are potential black marketeers. In fact, it is becoming increasingly apparent that corruption in the public sector is extremely widespread.²¹ The primary implication of this presentation is that whenever limitations on private property rights are being considered by elected or appointed public officials (or desired by private sector individuals), it can be expected that private sector crime and/or public sector corruption will result. The added cost of preventing these illegal activities should be considered in the decision-making process. This is all the more reason to harken to the words of Blackstone:

In vain it may be urged, that the good of the individual ought to yield to that of the community; for it would be dangerous to allow any private man, or even any public tribunal, to be judge of this common good, and to decide whether it be expedient or no. Besides the public good is in nothing more essentially interested than in the protection of every individual's private rights, as modelled by the municipal law.²²

NOTES

1. William Craig Stubblebine, "On Property Rights and Institutions," in *The Economics of Legal Relationships*, ed. Henry Manne (St. Paul: West Publishing, 1972), p. 15.

2. Warren Samuels, "Interrelations between Legal and Economic Processes," *Journal of Law and Economics* 14 (October 1971): 444.
3. Milton H. Spencer, *Contemporary Microeconomics* (New York: Worth Publishers, 1977), p. 482.
4. We are examining the reason for the existence of illegal activities. This is only part of the question of why such activities occur. In order to answer this larger question we would have to include a discussion of individual willingness to commit crimes. This part of the question has been analyzed by a list of sociologists, economists, psychiatrists, anthropologists and psychologists that is much too long to cite here.
5. Of course, private sector black markets may exist because of public official corruption. *Individuals may have to purchase the right to operate in (and probably monopolize) the illegal market.* This is often the case when police officers are corrupt, for example. Such corruption is examined below.
6. See for example the discussion of land use and building regulation in John A. Gardiner and Theodore R. Lyman, *Decisions for Sale: Corruption and Reform in Land-Use and Building Regulation* (New York: Praeger, 1978).
7. Actually, private sector black markets may still exist but they would involve corruption of law enforcement officials. Private black marketeers purchase the right to operate from public sector black marketeers.
8. *In many cases, of course, individual public officials do not control property rights. When a rights modification must be performed by a legislature or commission, corruption of an individual official, or several, will improve the buyer's chances of obtaining the desired modifications.*
9. Thomas Schelling, "What Is the Business of Organized Crime?" *American Scholar* 40 (Autumn 1971):643-52.
10. Annelise Anderson, *The Business of Organized Crime* (Stanford, Calif.: Hoover Institution Press, 1979), p. 58. See also Paul Rubin, "The Economic Theory of the Criminal Firm," in *The Economics of Crime and Punishment*, ed. S. Rottenberg (Washington, D.C.: American Enterprise Institute, 1979), pp. 155-56.
11. Harold Demsetz, "Why Regulate Utilities?" *Journal of Law and Economics* 11 (April 1968):55-65.
12. In fact, government allocation of rights to publicly owned property is really just a special case of government modification of rights to private property. See Bruce L. Benson, "Land Use Regulation: A Supply and Demand Analysis of Changing Property Rights," *Journal of Libertarian Studies* 5, no. 4, forthcoming. The government may take specific rights or all use-rights to private property and then assign them to individuals or groups. Typically the rights are assigned to satisfy the wishes of powerful political interest groups. See the following papers by Benson: "Land Use Regulation"; "Observations on the Supply of Regulation in the Context of Stigler's Theory of Economic Regulation," Pennsylvania State University Working Paper (August 1979); "Regulation - The Demand and Supply of Property Rights," *Appalachian Business Review* 8 (Special Issue on Regulation) (1982):22-28; and "The Economic Theory of Regulation as an Explanation of Policies Towards Bank Mergers and Holding Company Acquisitions," *Antitrust Bulletin*, forthcoming. Of course, when black markets arise political power is a less significant determinant of the allocation of rights.
13. Another example is patronage—the sale of an office. Payments need not be monetary, of course, but the ability to provide a relative or supporter with a job which many others want often leads to corruption.
14. Susan Rose-Ackerman, "The Economics of Corruption," *Journal of Public Economics* 4 (February 1975): 188.
15. Rights are attenuated when they differ from a specific "non-attenuated" state. Furubotn defined this non-attenuated state when he wrote: "Non-attenuated implies a state of affairs in which each resource owner possesses the bundle of rights given sanction in an idealized capitalist system" (E. Furubotn, "The Role of Non-Attenuated Rights in Positive Economics: Comment," Texas A&M University Working Paper [1978]).

16. See Rose-Ackerman, "Economics of Corruption," for a more detailed discussion of these two possibilities.
17. Rose-Ackerman, "Economics of Corruption," p. 198.
18. Demsetz argues convincingly that natural monopoly is not a sufficient condition for monopoly pricing, however. See his "Why Regulate Utilities?"
19. For a discussion of monopoly due to government restrictions on free entry, see Demsetz, "Two Systems of Belief About Monopoly," in *Industrial Concentration: The New Learning*, ed. H. Goldschmid, H. Mann, and J. Westen (Boston: Little, Brown and Co., 1974).
20. Government intervention is not warranted just because externalities exist, of course. The social cost of the government action may exceed any social benefit from reduced externality. One of the social costs of government action is the additional cost which can be expected as a result of illegal private or public markets which generally accompany government intervention (e.g., policing costs). Furthermore, even though correction of externalities may be the excuse given for government intervention, the actual reason is probably quite different. Most if not all government action which is touted as being in the public interest is actually designed to benefit small, politically powerful special interests. See for example the following papers by Benson: "Land Use Regulation," "Observations on the Supply of Regulation," "Regulation—the Demand and Supply," and "Economic Theory of Regulation." Also see George Stigler, "The Theory of Economic Regulations," *Bell Journal of Economics and Management Science* 2 (Spring 1971):3–27.
21. See for example Edmund Blair Bolles, *How to Get Rich in Washington* (New York: W. W. Norton & Co., 1952); A. Eisenstadt, H. Hoogenboom, and H. Trefousse, eds., *Before Watergate* (New York: Brooklyn College Press, 1978); Gardiner and Lyman, *Decisions for Sale*; J. Gardiner and D. Olson, eds. *Theft of the City: Readings on Corruption in Urban America* (Bloomington, Ind.: Indiana University Press, 1974); K. Gibbons and D. Rowat, eds., *Political Corruption in Canada: Cases, Causes and Cures* (Toronto: McClelland and Stewart, 1976); A. Heidenheimer, ed., *Political Corruption: Readings in Comparative Analysis* (New York: Holt, Rinehart, and Winston, 1970); and L. Sherman, ed., *Police Corruption: A Sociological Perspective* (Garden City, N.Y.: Anchor Books, 1974). Many more examples could be cited.
22. William Blackstone, *Commentaries on Laws of England* (Chicago: Callaghan and Co., 1899), p. 128.