Property In Bribes Revisited in a Cross-Disciplinary Perspective

TAN Yock Lin

lawtanyl@nus.edu.sg

[February 2017]

Property In Bribes Revisited in a Cross-Disciplinary Perspective

TAN Yock Lin

National University of Singapore Faculty of Law

Abstract

Taking its point of departure from the decision in FHR European Ventures LLP v Cedar Capital Partners LLC, this article seeks to bring cross-disciplinary perspectives to bear on the question whether an agent should hold the bribe he has received on constructive trust for his principal. Two methods or models, the economising and the principal agent models, were employed. The results were at least three-fold. First, an effective legal rule responding to the problem of harm caused by corruption must recognise and take account of differences between competitive and non-competitive environments, auditing possibilities, as well as multiple causalities, both individual and institutional. Second, a property rule fails to do that. Third, ignoring such endogenous and exogenous variables, it overestimates or underestimates the harm suffered by victims of corruption.

Introduction

This article seeks to evaluate the persistent debate over property in bribes from the perspectives of theories of economic efficiency as well as socio-political theories of autonomy and accountability.[1] In recent cases, courts have held that the bribee is not only personally accountable to his principal for the value of the bribe. He also holds the bribe and its traceable substitutes on constructive trust for him. Deterrence of immoral and opportunistic behaviour, it will be argued, is an over-simplistic justification for this result if efficiency is a key goal in the implicated activity. Studies on the economics of corruption are far from supporting a wide-scale deterrence-based instrumentalist policy for the sake of efficiency. Applying the Calabresi and Melamed tripartite efficiency model of property rule, liability rule, and inalienable right, this article argues that where the conditions posited by the model for optimal market decision-making exist, deterrence has only an auxiliary role. It is simply not efficient to vest the property in bribes in the principal in all circumstances. Perhaps more importantly, where competitive conditions obtain, it is not efficient to vest the property in bribes in the principal *irrespective of fault on the principal's part*. If the need for principal-vigilance in detecting, avoiding or curbing bribee-proclivity for bribes is relevant, personal accountability will be more efficient.

Insights from studies on the socio-politics of organisations reinforce the above-mentioned conclusions in non-market conditions. From the point of view of institutional integrity and design, a key question is how to deliver maximal autonomy and accountability within a given hierarchy of organisation. Focusing on the impact of autonomy and accountability on organisational integrity, this article goes on to argue that autonomy and accountability can have either positive or negative implications or associations for organisational integrity and sustainability. Accountability may either enhance or diminish the positive effects of autonomy. Over-emphasising accountability could lead to the effects of accountability and autonomy becoming subtractive instead of additive. This

article argues in particular, that over-emphasising accountability, a rule giving the principal property in a bribe undervalues the positive effects of autonomy even in the simplest of hierarchical systems. This conclusion also requires a narrowing of a rule vesting property in a bribe in the principal.

To achieve the above demonstrations, the article is structured as follows. The progression in the case law towards a universal property rule in bribes is outlined very briefly in Section I. The building blocks for the efficiency-based arguments in the article begin in Section II with a sketch of the nature of utility-maximising efficiency. The discussion continues with a description of the Calabresi and Melamed model and arguments for its applicability to the problem of corruption under market conditions. Section III sets out the main arguments from an efficiency perspective for a liability rule. The building blocks for conducting a socio-political analysis of institutional corruption in non-market conditions and the arguments based on them are then set out and developed in Sections IV and V.

Building on the general conclusions reached, this article finally argues in Section VI that the corrupt trustee, and the corrupt agent, receiving a bribe stand on very different grounds. The settlor as the trustee's principal operates in a non-competitive context and is a benevolent principal who has little left to do when he has set up the trust and imposed on the trustee (his quasi-agent) accomplishment of a non-contractible output. The trustee thereafter acquires and is expected to acquire full information on cost and demand conditions without accountability to the settlor. Accountability to the beneficiaries also plays a diminished role since as is well known the trustee is authorised to exert free rein in trust adminstration. The concern accordingly is primarily with his autonomy to perform the trust and a property rule that the trustee holds a bribe on constructive trust is both efficient and appropriate. Brief concluding remarks follow in Section VII.

I. RECENT CASE LAW

Judicial recognition of a property rule in bribes in the case law probably began in a Singapore case in the 1990s. In *Sumitomo Bank Ltd v Thahir Kartika Ratna*,[2] Lai Kew Chai J was persuaded by the logic that a dishonest agent could not be better off than an honest fiduciary. If an honest fiduciary was required to hold secret or unauthorised profits he made on constructive trust for the beneficiaries, much more the dishonest agent ought to hold the bribe he received on constructive trust.[3] When the case was heard on appeal, this reasoning ceased to be influential. In the interim, the Privy Council had decided in a case from New Zealand, namely *A-G of Hong Kong v Reid*,[4] that the former Director of Public Prosecutions held the bribes he had received whilst in office on constructive trust. The ground of liability was that equity looked upon that as done which ought to have been done.[5] The agent owed a duty to account as fiduciary for the bribes to his principal; and by a proleptic operation of equity, he was to be treated as if he had so accounted and transferred the bribes to his principal. Citing the Privy Council decision, the Singapore Court of Appeal in *Thahir Kartika Ratna v PT Pertambangan Minyak dan Gas Bumi Negara (Pertamina)* reached a similar conclusion.[6]

The immediate English reaction to the Privy Council decision was sceptical and unfavourable.[7] Among academics, opposite arguments against the imposition of a constructive trust prevailed strongly for a season. The most important objection of policy[8] was that the new direction charted by the Privy Council (and

---

[2] [1992] 3 SLR(R) 638.

[3] It has been conceptualised that *AG v Reid* and *Pertamina* related to a form of trust which does not exist until the bribes are received by a fiduciary in breach of his duties. See *PP v Ng Teck Lee (Centillion & Environment Recycling Ltd etc) (Ung Yoke Hooi, intervener)* [2011] 4 SLR 906 at [56].

[4] [1994] 1 AC 324.

[5] *A-G of Hong Kong v Reid* [1994] 1 AC 324 at 331-332 *per* Lord Templeman. Lord Templeman purported to rely on Sir P Millett "Bribes and Secret Commissions" [1993] RLR 20.

[6] [1994] 3 SLR(R) 312 at [56].

[7] See eg D Crilley "A Case of Proprietary Overkill" [1994] RLR 57; W Swadling "Property and Unjust Enrichment" in J W Harris (ed) *Property Problems: From Genes to Pension Funds* (Kluwer, 1997) at 130 and follg.

[8] According to those who cast their weight in favour of the orthodoxy of *Lister & Co v Stubbs* (1890) 45 Ch D 1.

the Singapore courts) created a unfair insolvency advantage for the principal and conversely unfair prejudice to creditors of the bribee. The new path moreover ran contrary to doctrinal considerations of property law.[9] Under the influence of these criticisms, the English Court of Appeal in *Sinclair Investments Ltd v Versailles Trade Finance Ltd* 'strove' to keep to doctrinal considerations of property, attempting to draw the line more exactly between property and liability.[10] The result was a dichotomous rule which arguably stretched property distinctions to a vanishing fineness.[11] Apparently, the slender line could not bear the strain.[12] In *FHR European Ventures LLP v Cedar Capital Partners LLC,*[13] the United Kingdom Supreme Court considered that the efforts of the Court of Appeal could not withstand scrutiny and came round to the position established in *A-G of Hong Kong v Reid.* Although the Supreme Court was faced with a fiduciary who had made unauthorised profits, the Court made a conscious decision to settle also the English law on bribes received by an agent. The majority judgments intimated no distinction between receipt by an agent of unauthorised profits and a bribe. The majority listed inconsistency in the case law upholding the personal liability view, the difficulties in the case law distinguishing between misuse of the principal's property and beneficial ownership of the principal's opportunity for gain, the undesirability that egregious breach of fiduciary duty should be subject only to a personal right, the fact that the interests of unsecured creditors of the agent have limited force, the fact that a proprietary right would support tracing into the value of secondary profits, the fact that a proprietary right would harmonise better with judicial development in the Commonwealth, as well as wider policy considerations

---

[9] See J Penner "The difficult doctrinal basis for the fiduciary's proprietary liability to account for bribes" (2012) 18 Trusts & Trustees 1000 who argues that the decision rested on mutually inconsistent doctrinal bases that the bribee as a wrongdoer must be stripped of his gains or that asa fiduciary he is under a pre-existing liability to account for his unauthorised gains.
[10] [2012] Ch 453.
[11] For there to be property in a bribe, the effect of the decision was that either the bribe had to be acquired through misuse of the principal's property (as in *Daraydan Holdings Ltd v Solland International Ltd* [2004] EWHC 622 (Ch), [2005] Ch 119) or by taking advantage of a right or opportunity which was properly that of the beneficiary.
[12] Sir Terence Etherton C 'The Legitimacy of Proprietary Relief' (2014) 2 Birkbeck L Rev 84 was strongly critical of the elusive line based on 'beneficial ownership' of an opportunity. W Swadling 'Constructive Trust and Breach of Fiduciary Duty' (2012) 18 Trust & Trustees 985 at 993 called it the Achilles' heel of the CA decision, though he welcomed and applauded the decision.
[13] [2014] 3 WLR 535.

relating to corruption and bribery. The surprising and almost oracular conclusion was that there being no plainly right answer, and in the absence of any other good reason against it, the simple answer was the property answer.

Judging from the mixed reception to the decision, the property debate is not over.[14] When the Privy Council in *A-G of Hong Kong v Reid* decided for property rights in bribes, detractors were quick to criticise the unfair insolvency advantage the decision seemed to create. Over time, it is fair to say, insolvency advantage arguments have receded in importance.[15] The more serious and on-going criticisms now direct attention to the failure of the Supreme Court to offer a clear justification for the simple (proprietary) solution. Supporters of the decision, on the other hand, seem to have been inspired by the renewed focus on the duty of loyalty as the conceptual underpin or lynchpin of the property in bribes rule. In their view, the obliteration of any distinction between illegal profits and unauthorised profits is underscored by the principle that both forms of profit damage the duty of loyalty and that both invite and demand nothing less than a property solution.

In the present view, it may be doubtful whether the Supreme Court was predicating its decision in *FHR European Ventures LLP v Cedar Capital Partners LLC* upon the duty of loyalty owed by a fiduciary. The Court's reasoning implies that the proprietary right is rather based on the duty to account for the bribes standing apart from the fiduciary relationship. A contractual or equitable duty of account is enough. If so, the proposition that the property in the bribe should vest in the principal for the sake of protecting the right to the fiduciary's loyalty would be too narrow a reading of the judgment. A strong hint of this appears in the Court's recognition that a prominently featured non-fiduciary parallel exists: "The principal is entitled to the benefit of the agent's unauthorised acts in the course of his agency, in just the same way as, at law, an employer is vicariously liable to bear the burden of an employee's unauthorised breaches of duty in the

---

[14] See
[15] There are muted or moderated criticisms that the Supreme Court failed to acknowledge that there are some circumstances where interests of unsecured and secured creditors are important. See

course of his employment."[16] Not to be overlooked is the point that a bribe is considered objectively in terms of whether the briber believes or has reasonable grounds to believe that the bribee is able to favour him in relation to a principal. Any property given that is calculated to obtain favour will have to be accounted for. This also makes it less significant whether the bribe-taking agent owes a duty of loyalty as fiduciary.

To complete this brief survey of the case law, it should perhaps be added that a different deterrence-based policy rationalisation appealed to the Singapore High Court in a recent case. It was there suggested that property in a bribe went to the principal of the agent as a matter of policy, because '[corruption] is such a scourge'.[17] In the United States, on the other hand, a more familiar sentiment would be disgorgement and restitution rather than deterrence. A constructive trust to strip the criminal of the profits of his crime is recognised.[18] To follow through this reasoning, an agent need not be shown to be a fiduciary before he can be held to be a constructive trustee of the bribe he received. The constructive trust arises not on account of any duty he has undertaken toward the principal but by virtue of reversing the unjust enrichment.[19]

This article takes its point of departure from the dichotomous institutional premises, namely, that either there is or there is not property in a bribe, which has remained a firm and constant assumption in the English and Singapore case law and academic literature.[20] There are essentially two central tenets

---

[16] [2014] 3 WLR 535 at [33].

[17] "One jurisdiction may consider bribery such a scourge that it recognises a proprietary claim to the bribe or its traceable proceeds vested in the principal, one result of which is to accord the principal of an insolvent bribe-taker *de facto* priority over the bribe-taker's preferential and unsecured creditors: see *Sumitomo Bank Ltd v Thahir Kartika Ratna* [1992] 3 SLR(R) 638. Another may consider it undesirable as a matter of policy to do so: *Lister & Co v Stubbs* (1890) 45 Ch D 1; *FHR European Ventures LLP v Mankarious* [2013] EWCA Civ 17. All of these choices rest on policy, not principle.": *Beluga Chartering GmbH (in liq) v Beluga Protects (Singapore) (in liq)* [2012] 2 SLR 1025 at [166] *per* Vinodh Coomaraswamy J.

[18] To be sure, some cases rely on the policy that a person should not benefit from his crime while others are content simply to prevent unjust enrichment of a criminal. See Fratcher (ed) *Scott on Trusts* (Little & Brown, 4th edn, 1989) Vol V, pp 436 and follg.

[19] See *Re Pechar (deceased)* [1969] NZLR 574.

[20] This contrasts sharply with Australian case law, where the remedial constructive trust may be imposed on a bribe if considered appropriate in the court's discretion. See *Grimaldi v Chameleon*

underlying the English and Singapore case law's simple proprietary solution to the problem of bribes: (1) The necessity and sufficiency of the duty to account for the bribe (which need not be the fiduciary duty of loyalty); and (2) the rejection of any middle ground dependent on exercise of judicial discretion to impose a constructive trust. The question which will be explored in a cross-disciplinary perspective is whether these tenets are faithful to economic reasoning and social-political theory. If they are not, the so-called wider policy considerations which support the simple proprietary solution ought to be re-examined and the solution qualified according to those results.

II. EFFICIENCY AND THE CALABRESI AND MELAMED MODEL

Two preliminary considerations are helpful in charting the investigations in this paper. Among the different kinds of perspectives that can be brought to bear on the capitulation to a property rule in the treatment of bribes, that of economic efficiency must be helpful where corruption has a market context. The subject of market-based corruption in the law, it will be argued, lends itself to neo-classical economic treatment; and that furnishes sufficient reason to make this the first line of inquiry. The terms of this inquiry are already familiar and uncontroversial if one accepts the neo-classical premises of utility maximisation as an idealised way of understanding market decision-making. Economic efficiency comprises productive efficiency which describes the state where goods and services are produced at the least cost possible. Productive efficiency combines technical efficiency, that is producing any given level of output utilising the fewest resources, and input allocative efficiency. This implies that the marginal rate of technical substitution between inputs matches the input price ratios. There is a second measure of efficiency, namely that for any given cost, the bundle of goods and services produced maximises the aggregate welfare of consumers, commonly called output allocative efficiency. Output allocative efficiency is achieved when total marginal rates of substitution for all consumers equal the

---

Mining NL (No 2) (2012) 200 FCR 296. See also P Finn 'Common Law Divergences' (2013) 37 Melb U L Rev 509.

marginal rate of transformation in the production of goods. Last but not least, pareto efficiency describes the state where the outputs are distributable among differentiated groups. When Pareto efficiency is reached, there is no way to reallocate outputs to make one person better off without hurting someone else. All possible efficiency gains will have been exploited in this happy state.

The second preliminary observation is that in order to identify and diagnose corruption's effect on efficiency, and determine whether a property or liability rule is a more appropriate response to injury caused by corruption, the Calabresi & Melamed model is a viable tool.[21] This model distinguishes incidence of initial entitlement from protection of entitlement. Initial-entitlement incidence depends on considerations of efficiency, distributive and corrective justice considerations (such as wealth distribution and rewards for effort preferences) and 'other justice considerations'. No single consideration is entirely determinative and complexity may be inevitable. Fortunately, this does not impede the important predictive assertion that in practice initial entitlements which lead to optimal market decision-making are more likely to emerge than those which do not.

Besides the importance of optimal market decision-making, another key insight delivered by the Calabresi and Melamed model is the influence of value of the activity in question. The more valuable the activity, the greater the need to foster optimal decision-making. Thus when considering entitlements in relation to accidental activities, the model argues: "(1) that economic efficiency standing alone would dictate that set of entitlements which favors knowledgeable choices between social benefits and the social costs of obtaining them, and between social costs and the social costs of avoiding them; (2) that this implies, in the absence of certainty as to whether a benefit is worth its costs to society, that the cost should be put on the party or activity best located to make such a cost benefit analysis; (3) that in particular contexts like accidents or pollution this suggests putting costs on the party or activity which can most cheaply avoid

---

[21] Calabresi G & Melamed A D 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral' (1972) 85 Harv L Rev 1089.

them; (4) that in the absence of certainty as to who that party or activity is, the costs should be put on the party or activity which can with the lowest transaction costs act in the market to correct an error in entitlements by inducing the party who can avoid social costs most cheaply to do so; (5) that [however] in an area where by hypothesis markets do not work perfectly - there are transaction costs - a decision will often have to be made on whether market transactions or collective fiat is most likely to bring us closer to the Pareto optimal result the "perfect" market would reach."[22]

The third important insight is that protecting the initial entitlement is not a redundant matter. It is one thing to specify initial entitlements but another to specify how to avoid their infringement. An economic society cannot, indeed must not, protect an entitlement by a property rule in all cases. That kind of protection entails that a person's entitlement cannot be taken away except upon his free and subjective consent. He cannot be compelled to surrender his entitlement even though the objective value of his entitlement is less than his own subjective estimation. Conversely, if he can be compelled to yield to the objective value, his entitlement is not protected by a property rule but a liability rule. The model posits that there are significant reasons that the protection of an entitlement must be variable. Protection of initial entitlement is not unipolar. It also depends on considerations of efficiency, of distributional preference and other justice considerations. For example, protection of an activity where optimal decision-making is important by a property rule will be inefficient whenever it is too costly to talk things through. In cases of accidental liability, for example, pre-accident negotiations would be prohibitively expensive even though a transfer of the entitlement would benefit both. Post-accident negotiations on the other hand would be fraught with holding-out by potential victims and free-rider problems in relation to potential actors and victims. In contrast, a liability rule that imposes a collective valuation of the injury will be more efficient. It will avoid prohibitive costs of negotiations as well as holding out and free rider problems, thus facilitating beneficial transfer between actor

[22] Calabresi G & Melamed A D 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral' (1972) 85 Harv L Rev 1089 at 1096-1097.

and victim of the actor's negligence.[23] An important corollary is that considerations of efficiency will often predominate in the choice of protecting an entitlement. The reason is that locating the distributional preference for options of protection will often be difficult and expensive. It will be more economical to let considerations of efficiency predominate in the selection of options, accommodating distributional preferences as modulations of selected protection option.

To apply the Calabresi and Melamed model to our study, it is necessary to describe the conditions under which corruption exists both where the pertinent markets work and do not work and where they do not work, specify the imperfections which impair their workings and heighten the danger of corruption. Minimally, such danger exists only where imperfections in the market or cultural conventions including social or religious beliefs or conditions of competitiveness create potential for inducing an agent who knows that corruption is wrong to act contrary to conscience. This article postulates that irrespective of where initial entitlement to the bribe should lie,[24] the Calabresi and Melamed model as applied to protection of initial entitlement in relation to accidental harm is adaptable to harm caused by corruption in market contexts.[25]

First, accidental liability although arising from a non-market tort typically implicates a valuable activity where optimal decision-making should be fostered. This is doubly true of liability for market-based corruption. Not only is valuable market-based trade and commerce implicated, legal representation by agents is undoubtedly also a valuable activity in cost-benefit terms. In both respects, optimal market decision-making is to be fostered. Against that, corruption is aberrational being contrary to social morals as much as accidents are

---

[23] Calabresi G & Melamed A D 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral' (1972) 85 Harv L Rev 1089 at 1106.

[24] It is noted that initial entitlement in property often depends critically on acquisitional or creative effort and appropriatory intention.

[25] There is of course a difference between potentially beneficial market activities which are carelessly undertaken, that is accidental harm, and market activities such as bribe-giving and taking which are deliberately undertaken for self-gain or benefit in breach of duty. An extreme view is that optimal market decision-making is irrelevant since corruption is a deliberate infliction of immoral harm; and that a criminal or quasi-criminal deterrence model is apposite.

unintended loss-making acts. Efficiency and not moral denunciation is pivotal where the implicated activity is valuable although subject to aberrational occurrences. Deterrence as moral denunciation or some other distributive or justice consideration is pivotal only to the extent that it will increase efficiency by lowering the potential for corruption.[26] Second, even supposing that the harm caused by corruption should be regarded as moral harm more than economic loss, it is the perspective of protection against the harm that should count. Where moral harm has the same or a similar extent or reach as accidental harm, it ceases to be materially different from economic harm. The same or similar economic considerations of reducing harm become pertinent. Importantly, there is no material difference in incidence of harm between accidental harm arising in the conduct of beneficial activity and corruption arising in the conduct of agency in trade and commerce. The potential for carelessness references an actor who launches a potentially harmful but generally beneficial activity but so also is the potential for corruption peculiarly related to a corrupt agent and briber. The careless actor is not necessarily less motivated than the corrupt actor for gain. The desire for gain and the prospects for gain do not necessarily differ between them. Differences in scale and dimension exist of course. The scale of accidents varies according to numerous exogenous variables, paramount among which is the state of technological advances in safety control or harm prevention. The scale of corruption is variable in a different manner. Competitiveness and cultural attitudes are more important variables than the state of technology. But nothing much turns on these differences of degree. The only impact they have is to enlarge or reduce the quantum of loss that the victim of corruption will suffer. On the other side, there are impressive similarities. Where potentially beneficial activities incurs a risk of accidental loss, the protection against accidental loss by objective compensation strikes a better balance between innovation and risk of harm. This is equally true of beneficial agency activity which incurs a risk of deliberate harm. Where the good or service is heterogenous, it would be

---

[26] I argue a more extreme position in A Robertson & HW Tang (eds) *Goals of Private Law* "Deterrence in Private Law" (Hart Publishing, 2009) ch 13 that deterrence in private law is a tax (relevant only in relation to systemic harm) and neither distributive nor corrective in essence or motivation. Here I merely state the position implicit in the Calabresi and Melamed model that deterrence may play an auxiliary role as tipping consideration in affecting the conduct of potential bribees.

prohibitively expensive for a producer to attempt to negotiate with all other producers a transfer or re-allocation of entitlements beneficial to all, thus eliminating the potential for corruption. The costs are still not insignificant where the good or service is homogeneous. Ante-harmful event negotiations are equally expensive. Post-corruption negotiations would similarly be fraught with holding out and free rider problems.

In short, the Calabresi and Melamed economising model is or should be applicable to deliberate harm caused by corruption where optimal market decision-making is imperative and moral distributive considerations are recessive.

III. CORRUPTION AND ECONOMIC EFFICIENCY

After setting the stage for investigation, the first argument of this article is that corruption affects the efficiency of the activity to which it relates in a non-uniform manner. Popular belief posits that corruption is detrimental to economic efficiency in all three manifestations. It impairs productive efficiency, output allocative efficiency, and distributional efficiency. That corruption impairs efficiency appears to be uncontroversial. This may explain why there are many more theoretical studies which examine the different but related question of the relationship between competition, as a corrective or suppressive prescription against corruption, and incidence of corruption. Some of these aim to show that competition and corruption are inversely related and recommend greater competitiveness as a way to combat corruption.[27] Other studies indicate that the effect of competitiveness on corruption is more equivocal. Where corruption is based on informational advantage, the effect of competition depends on substitutability between competing goods or services and low-powered incentives in diminishing the advantage or the rent which may be

---

[27] See Rose-Ackermann S (1975) The economics of corruption" *Journal of Public Economics* Vol 4 pp 187-203.

extracted from the informational advantage.[28] Probably the most counter-intuitive results are that greater competition in a procurement context may lower or raise corruption levels depending on the heterogeneity of good or service being transacted and intensity of competition among agents.[29]

For the purposes of this article, the existence of a non-linear relationship between competition and corruption does not detract from the central argument. This is because all studies agree that competition and corruption are inter-dependent although the relationship is not necessarily an inversely linear relationship because of the influence of multiple causalities, such as non-heterogeneity of good or service and hence complementarities instead of substitutabilities between facilely competing goods or services, institutional settings, social or religious beliefs or dispositions and other cultural sub-dimensions. The simplest argument building on the mixed conclusions of these studies is that if competition affects corruption but does not unequivocally lower corruption, there can be no warrant to impose a property rule on the fruits of corruption as a simple answer and as ex post deterrent. A property rule as ex post deterrence-sanction superficially reduces the gain and therefore the incentive to want a bribe. There are serious doubts about this[30] but assuming the equation to be true, there would still only be warrant to impose a property rule where greater competition has the effect of raising corruption.

Eschewing the simplest argument, this article considers the more basal question of the nature of the effect, at a given level of competition, of corruption on efficiency. The proposition under examination of vesting property in a bribe for the sake of greater efficiency is immediately falsified if it can be shown that bribery does not impair economic efficiency uniformly, in the same proportion, and on the same scale under all circumstances. Important to the argument is the

[28] See Lafont J-J and N'Guessen T (1999) Competition and corruption in an agency relationship *Journal of Development Economics* Vol 60 pp 271- 295.

[29] See Celentani M and Ganuza J-J (2002) Corruption and competition in procurement *European Economic Review* Vol 46 pp 1273-1303.

[30] Arising from studies on criminal liability for corruption. Rose-Ackerman S (1975) The economics of corruption *Journal of Public Economics* Vol 4 pp 187–203 for example, demonstrates that higher punishment does not mean lower corruption. See also Posner RA (1986) *Economic Analysis of Law* 3rd edition, Boston, Little, Brown.

thesis of Burguet and Che that corruption may be another form of competition where contracts are to be awarded in competitive bidding based on quality and price.[31] Suppose a procurement context where there is an efficient and inefficient seller. Suppose further that at the given level of competition, the agent for the buyer has some but not substantial discretion to manipulate the quality but not the price. Then the efficient seller can win the procurement tender despite the existence of corruption. This is because the efficient firm can lower its product price by lowering its quality premium. The outcome is very different if the agent has substantial manipulative power over the price. Whether he has this power because of the level of competition in the market or heterogeneity of the good or service or has been conferred it by the inefficient seller does not matter. Such agent does affect allocative efficiency by his corrupt manipulations. Burguet and Che explain more exactly that substantial manipulative power can soften price competition and point out that this may not coincide with the quantum of bribe.

Output allocative efficiency

From the perspective of output allocative efficiency, these findings have significant implications for applying a property rule to bribes under the Calabresi and Melamed model. Where the buyer's agent has little manipulative power to affect the price, the corrupt agent will ask for and accept a bribe from the inefficient seller that can be extracted from the efficient firm's superior quality of product. The efficient firm however can lower its price to eliminate the quality differential and nullify the agent's corruption. A property rule is not needed and would be inefficient in reinforcing the inefficiency of the inefficient seller. A property rule in favour of the efficient firm would merely reward the efficient firm for inaction in eliminating corruption which it is well able to do so. It would be inefficient in encouraging the efficient firm to be inefficient. A property rule for the buyer as the bribee's principal would transfer the efficient

---

[31] R Burguet and Y-K Che (2004) Competitive procurement and corruption *Rand J of Econs* Vol 35(1) pp 50-68.

seller's quality premium to him, rewarding the buyer who has paid the price for the lower quality with a windfall, and also be inefficient. A property rule would still not be efficient even if the incidence of corruption requires prediction or needs effort to uncover. Superficially the restitutionary effect of a property rule might serve in these circumstances to disincentivise the agent more strongly from corruption. The fact remains that the ability to eliminate it exists. An efficient firm will ex hypothesi lower its price by factoring in the likelihood of corruption. So again, a property rule would merely encourage the efficient firm to be inefficient. A property rule that requires the efficient seller and the buyer to share the quality premium would of course be insensible.

Corruption under these predicates will no doubt prejudice the buyer if the efficient firm in fact makes a misprediction or delays taking action and the buyer gets a lower quality product at a higher price. A property rule in favour of the buyer might in these more exceptional circumstances seem to be efficient in transferring the price differential from the corrupt agent to the buyer for the sake of spurring the efficient firm to avoid misprediction or take more timely action. There is however only an appearance of efficiency. To adopt a property rule in such exceptional circumstances would incur prohibitive costs of investigation. It would not incentivise the efficient firm to act in exceptional cases beyond what it can already do and has done. It would on the other hand encourage the agent to risk extracting a premium from the bribe in the hope of escaping detection by the buyer and seller. A liability rule by contrast is more effective since it denies the efficient firm a uncompromising remedy, forcing it to eliminate corruption when elimination is well within its reach and power. On the other hand, it provides a remedy to the buyer to reverse its prejudice without eliminating buyer-vigilance. At least until detection, the agent is owner of the bribe. It is his to use and any exceptional value or consumer surplus derived from this will accrue to him. This incentivises the seller and buyer alike to act promptly to obtain his remedy under a liability rule.

Where the buyer's agent has substantial manipulative power over the price, a property rule, perhaps paradoxically, proves to be even more inefficient. A key

postulate of the Burguet and Che analysis is that there is no necessary relationship or correlation between the quantum of the bribe and the price differential; particularly the quantum of bribe is no longer limited by the quality premium. The corrupt agent for the buyer can inflate the price beyond the level of the inefficient seller's low quality to above the efficient firm's quality premium. The efficient and vigilant firm cannot nullify or eliminate the corruption by lowering its price to eliminate its quality premium since the agent has substantial manipulative power over the price. Superficially, it seems that a property rule in favour of the efficient firm would now protect the efficient firm against the loss of a sale and its profits therefrom. If however the bribe is no longer limited by the efficient firm's quality premium, a property rule in favour of the efficient seller giving the efficient firm more than its putative profits after deducting its quality premium will have a reward element. A property rule in favour of the buyer on the other hand would arbitrarily award and transfer the loss suffered by the efficient firm to the buyer.

In any event if a property rule is adopted, it would have to be a rule of co-ownership of the bribe. Two further problems will arise if there is to be co-ownership. First, as the bribe is no longer a measure of the quality premium, there will be formidable difficulties in valuing or measuring the efficient seller's hypothetical loss and hence its share of co-ownership. These cannot be avoided by party consent. Pre-bribe negotiations between the efficient firm and the buyer would be prohibitively expensive. Post-bribe negotiations would be fraught with and impeded by holding-out problems. Second, from the inefficient seller's perspective, it makes a gain by obtaining a sale at the expense of the efficient firm. The efficient firm's loss is in truth a systemic loss because there is no market mechanism of transfer of the gain from the inefficient firm to the efficient firm. The efficient firm cannot price out the bribe and the contract goes to the inefficient firm, the seller, at its expense. Under such circumstances, the systemic losses is best protected by criminalising the act of corruption. The problem then is that a property rule in favour of the buyer leads to cumulation of reward and redress. It is unable to shift the systemic loss from inefficient seller to efficient seller or neutralise it, since some of that loss is included in recovery under a

property rule. At the same time, the buyer who obtains the systemic loss does not have to bear the costs of prosecution but can simply take the criminal results as platform for claiming the benefit of the property rule. This cumulates to the criminalised effects, producing further inefficiency.

Productive efficiency

So far as productive efficiency is concerned, the Calabresi and Melamed model directs attention to the impact of transaction costs and avoidance costs. An important variable is the effect of monitoring and accounting costs in curbing corruption. These costs clearly vary significantly. The higher the investment in monitoring activities on the part of the principal, the less likely corruption of its agent will occur or remain undetected. At one end of possible agency relationships where the agent is appointed for his expertise, the only monitoring that is feasible is a one-time appointment monitoring for the purposes of selecting an honest agent for the task at hand. Thereafter, typically because of the information-intensive nature of the task entrusted to the agent or its specificity the principal is seldom in a position to monitor on an on-going basis the exercise of discretions by its agent.

Under these circumstances, a property rule is inefficient because it relieves the buyer of its duty to tailor agent-discretions to its precise needs even at the outset. A property rule can thus have the effect of providing a windfall or an insurance to a buyer who declines to incur costs of selection of an honest agent since or knowing that any losses may be recouped by recovering the bribe or its substitute. Burguet and Che show that scoring rules can be devised to monitor on-going agent activities. The seller or buyer by relying on such rules can to an extent neutralise incidences of corruption. A property rule is indifferent to this. It especially ignores that deeper on-going monitoring as a scoring rule certainly makes economic sense where the agent is part of the principal's hierarchy of autonomous or semi-autonomous decision-makers.

There is a further complication which suggests that a property rule can yield distortionary effects on productive efficiency. A property rule ought not to be adopted if it would lead to substitution of less quantifiable non-pecuniary rent from pecuniary rent. Bribees faced with a property rule have an incentive to ask for non-pecuniary bribes such as promotion of friends or family to positions which they are unqualified or ill-qualified to hold. Such loss of efficiency is not likely to be immediate. To be sure, when it occurs, the unsuitable appointment can be terminated but the principal will have incurred further consequential loss through inefficient and unsatisfactory performance by the procured appointees. The firm can sue to recover provable loss but this will come at greater cost since such recovery will often require tracing backward to the bribe. Both considerations come at a price, suggesting that the substitution of non-pecuniary for pecuniary bribes which is driven purely by avoidance of the property rule will be distortionary in greater or lesser degree.

IV AUTONOMY AND ACCOUNTABILITY IN HIERARCHICAL SYSTEMS

In this section the effect of a property rule on corruption in non-market systems such as institutional systems of corporate employment will be addressed. To appreciate the significance of auditing or monitoring considerations in non-market systems, socio-political perspectives are useful, particularly for their discriminatory dimensions in relation to organisational integrity.[32] Not much justification is needed for this. Socio-political perspectives are acknowledged to be useful for investigating the effect of corruption in institutional (and hierarchical) settings and are therefore employed for the purpose at hand. The arguments which are developed lead to the conclusion that a property rule is inappropriate in proportion to the degree to which it upsets or distorts positive associations between autonomy and accountability in an hierarchical corporate organisation. The arguments will be structured as follows. First, three kinds of

---

[32] I do not refer to organisational theories because they have a different focus and ambition in seeking to explain and prescribe for the way satisficing decisions are made by hierarchically-situated persons.

hierachical system are differentiated in terms of their distinctive matrix of autonomy and accountability. Second, and more cursorily, the presence of multiple causalities affecting the matrix of autonomy and accountability will be examined. Finally, by zeroing in on the simplest of these systems where multiple causalities are absent or least present, the article will seek to obtain valuable insights on how positive associations between autonomy and accountability can be thrown awry or compromised by a property rule.

In differentiating three kinds of hierarchical system, one acknowledges a limitation, namely that the differentiation is more expositional than essential or substantial. This idealised classification is devised merely for the sake of obtaining an understanding of the spectrum of possibilities of mixed arrangements of autonomy and accountability. There is no intention to suggest that these idealised systems actually exist in reality. Ultimately, the key aim is to situate the discussion in the simplest of systems so as to reveal insights useful for the negative purposes of this article, namely that a property rule is too blunt an instrument to cope with the need to balance autonomy and accountability. In an open system, to begin with, a principal competes for an agent in an agency market which reveals the performance merits and demerits (including the bribe propensities) of each agent. The information generated by this market enables the principal to make more exact specifications which his objectives demand and to select the agent who is most suitable for the task according to performance merits as well as the level of corruption risks which the principal will tolerate. In a closed system, such as that which characterises the relationship between a principal and an agent in a pre-existing employment with him, a principal will generate the pertinent information about his employee agent instead of relying on an agency market. A closed system may of course be a catenated system comprising several gradated levels of accountability and autonomy in which the principal is himself an agent accountable to another principal. Finally, it is enough to say that the reality is that no system is perfectly closed or open and all hierarchical systems will have closed and open features in varying extent.

An important point about hierarchical systems can now be made. This is the

necessity of organisational design for its existence and viability. Undoubtedly, a major goal of organisational design is to discern the mix and spheres of accountability and autonomy which will sustain a viable, evolving, dynamic and self-contained organisation. It follows that insights to the damaging effects of corruption on organisational integrity can be obtained from current organisational theories of accountability and autonomy showing how accountability and autonomy affect utility-maximising performance in the face of two constraints, bounded rationality and opportunism.[33] 'Bounded rationality' posits that decision-making is limited inter alia by informational constraints, cognitive limitations, and limitations of time.[34] 'Opportunism' on the other hand posits self-interested behaviour in seizing and taking advantage of opportunities without regard for previously agreed goals. Opportunism in a neutral sense refers to subordinate decision-making not aligned with the principal's interests. To illustrate these points, consider a government bureaucracy as a prime example of a system which is neither perfectly open nor closed, which has features of both open and closed systems but always exhibits them imperfectly.[35] In such systems, bounded rationality and opportunism easily cause misalignment between objectives pursued by elected officials and preferences of utility-maximising citizens.[36]

In seeking to apply an appropriate sub-set of these socio-political theories, one notices that a considerable volume of the literature has been occupied with the

---

[33] Simon H A (1991) Bounded Rationality and Organizational Learning *Organization Science* Vol 2(1) pp 125-134 and Williamson O E (1985) *New Institutional Economics*.

[34] (1979a) *Models of Bounded Rationality: Empirically Grounded Ecnomic Reason* Cambridge MA, MIT Press; (1979b) Rational decision making in business organizations *American Economic Review* Vol 69(4) pp 493-513.

[35] The system is open in the way elected officials respond to utility-maximising citizens who elect them into office. However, citizens as principals are unable to select officials in an efficient competitive market. This end of the mixed system is entirely or significantly political. The same system is closed in the way elected officials demand the delivery of commensurate public services by non-elected public servants to those citizens. This end too is imperfect. The measurement of public services output is inevitably beset by free rider problems and by the fact that the compilation of information on both delivery and consumption of public services is a virtual monopoly of the non-public agents who deliver the public service outputs.

[36] Simon H A (1991) Bounded Rationality and Organizational Learning *Organization Science* Vol 2(1) pp 125-134; Williamson O E (1981) The economics of organization: The transaction cost approach *American Journal of Sociology* Vol 87(3) pp 548-577. The literature with reference to public bureaucracy is huge. But see Niskanen W A (1994) Nonmarket decision making: The peculiar economics of bureaucracy *American Economic Review, Papers and Proceedings of the Eightieth Annual Meeting of the American Economic Association* Vol 58(2) pp 293-305.

mixed bureaucratic system. It will be necessary to isolate generalisations applicable to closed systems. One such generalisation is that there is no necessary tension or opposition between autonomy and opportunism.[37] The reason is the presence of uncertainty so that autonomy is limited by bounded rationality. Bounded rationality implies the need to create differentiated structures and to adapt to uncertainties, for which autonomy and opportunism are essential. Autonomy defines the position and role of each structure while opportunistic behaviour can contribute to overcoming the limitations imposed by bounded rationality. For example, in a political system, political autonomy ultimately resides in the electorate and is exercised by expressions of electorate preferences for public services vented by election-seeking officials. Political controllers or elected officials and non-elected officials alike seek to respond and maximise the economic welfare preferences of their constituents. Their respective autonomies importantly are not a 'freedom from' but a 'freedom for' since the existence of the other is the raison d'etre and a condition for the relationship between them. One does not start inevitably with a tension or clash. A clash which appears could merely be a deviation produced by multiple causes. One cause is that there is an inevitable time lag between expression of preferences and responses to those expressions. The time difference means that the government's autonomy to decide actual allotments of public sector outputs will be of greater practical impact than the autonomy of elected officials to set the goals and boundaries of provisions of public services. So far from opportunism undermining the service contents autonomy, it is helpful in extrapolating, predicting and actualising more exact changes in preferences between the intervals. Opportunism of course can also be employed for self-gain but this is not an inevitable feature of the system.

A second feature which the political system well illustrates is the existence of multi-dimensional causalities. In the mixed bureaucratic system the provision of

---

[37] Admittedly, in the transaction cost economics literature where the focus is on organisational efficiency, opportunism is assumed to be efficiency impairing. See Williamson O E (1999) Private and Public Bureaucracies: A Transaction Cost Economics Perspective *Journal of Law, Economics & Organization* pp 306-342.

public services has spillover effects across several multiple constituencies.[38] For example, the provision of medical services or transportation services in one constituency will also benefit residents in contiguous constituencies. It is not possible to confine public service outputs to the designated constituents altogether or contain them without leakage. Under- or over-production seems inevitable because of spillover effects or other externalities. Again, opportunism can have positive effects in accommodating spillover effects, as where the provisions are as a result unnecessary or unnecessary to the original extent. At the same time opportunistic behaviour for self-gain is present, not inevitably but contingently. Thirdly, in any case constituents typically lack common resources and uniform capacity to set particular targets and goals. Elected officials on their part may also lack the capacity to assist them in goal setting. In this respect too, opportunism has positive effects in filling in the goal-setting gaps and also occasional negative effects in stimulating opportunistic behaviour for personal gain. Fourthly, and consequently, elected officials basically have a monopoly of the information because they control both the supply side and the demand side. One department produces the supply for another department's demand for public services output. This lack of competitive environment can benefit from positive opportunism but will be aggravated by occasional negative opportunism. Fifthly, elected officials and salaried civil servants can actually or potentially disagree on ultimate political objectives. Some maintain that as a result of multiple causalities, including especially actual or potential conflict of objectives, the risks of corrupt opportunistic behaviour rise significantly.[39] A few may advocate that special legal controls based on criminal deterrence are necessary to dampen them.[40]

V. UNDER A PRINCIPAL AGENT MODEL

[38] Government procuring systems are another example.

[39] See R Burguet and Y-K Che (2004) 'Competitive procurement and corruption' *Rand J of Econs* Vol 35(1) pp 50-68 at 51 who argue that adding layers of intermediaries raises risks of corruption.

[40] See also Posner RA (1986) *Economic Analysis of Law* 3rd edition, Boston, Little, Brown. Cf Calvert RL et al (1989) A Theory of Political Control and Agency Control *American Journal of Political Science* Vol 33(3) pp 588-611 who describe the effects of ex post sanctions or controls.

For the purposes of this article, a detailed investigation of multiple causalities and the need for special criminal controls of systemic risks of corruption is not necessary. To avoid digression into criminal controls, and to demonstrate the shortcomings of a property rule, one needs only to zoom in on closed systems where multiple causalities as absent or little present. In doing so, this article takes a different direction from both economic principal agent models which focus on economising exchanges[41] and social exchange models which posit inter-organisational relationships as social exchanges of human agency attributes such as trust and commitment.[42] Economising models are not suitable for a simple reason. A closed system has no objective market for pricing the value of the services performed in relation to the value of the achieved task. There is no objective benchmark.[43] Social exchange models are also unsuitable for our purposes. The closed system in view is one of formal or legal relationship whereby the principal has a right to performance of the agent's duty to act. Social exchange models, however, work best when formal negotiations or agreements are absent or inconspicuous. Principal agent models that tread a middle road between economising and socialising models focus on mechanisms that hinder or impede the autonomy and accountability of both principal and agent. Such unipolar or unidimensional or one-level principal agent theories predicating that the principal is not himself an agent for another, which have been developed in the political science as well as management science literature,[44] serve the purposes of this article well.[45]

---

[41] Williamson OE (1985) *The economic institutions of capitalism* New York: The Free Press.

[42] DiMaggio PJ & Powell WW (1991) Introduction, In Powell WW & DiMaggio PJ (Eds) *The new institutionalism in organizational analysis* Chicago, Ill: University of Chicago Press.

[43] So that there is ultimatum bargaining but the principal is unable to infer the agent's best response from known parameters. Proponents of principal and agent models may be tempted to advocate or recommend organisational designs which will perform according to some measure of efficiency which they may devise. See SL Schooner 'Desiderata: Objectives for a Government Contract Law' (2002) Pub Procurement L Rev 103. Such notion will likely not be defined purely in market terms since ex hypothesi the closed system is not market-driven. The purposes at hand do not require prescriptions of this nature.

[44] These writings built on precursor economic theories of agency such as Ross S (1973) The Economic Theory of Agency: The Principal's Problem *American Economic Review* Vol 63(2) pp 134–139.

[45] See eg Eisenhardt K M (1989) Agency theory: An assessment and Review *Academy of Management Review* Vol 14(1) pp 57-74 who employs the principal agent model to reach conclusions about mitigating opportunism.

The first reason for this is that there is a strong commonalty of purpose in a closed system.[46] The agent identifies, indeed must identify, with the objectives of his principal and is motivated to do so because he is paid for his coincidental efforts and services. These features of closure of course are seldom perfect even in a closed system so that total elimination of distractions, discrepancies, and misaligned perceptions and objectives is not possible. When principal agent models were first developed to explain political decision-making in a mixed system, the above point was attributed primarily to potential conflicting political objectives between principal and agent. The early literature therefore painted the picture of an informationally disadvantaged principal with limited control over his agent's goal deviations.[47] A common recommendation was that the principal should control deviations from his objectives by manipulating an agent's incentives.[48] It should be noted that the stress on conflicting objectives was heavily influenced by the nature of political conflicts between principal and agent as well as considerations of attribution of blame where political policies undertaken by an agent fail.[49] In the closed system of interest in this article, blaming is not critical. Goal conflict is less prominent than pecuniary self-gain through corruption.

The second reason that the models are apposite is often missing or omitted from the literature on principal agent models. While the principal and agent may share a common purpose, there will be no analogous agency if the principal is in complete de jure control of all information about the task. The reason that an employee assigned a discretionary duty can be considered to be like an agent is that the policy of the law demands that information is not property and that certain knowledge acquired on the job cannot be appropriated by the

---

[46] So that there is no asymmetry of preferences and the agent's preferences are similar to the principal's.

[47] See the overview in Miller GJ (2005) The Political Evolution of Principal Agent Models *Annual Review of Political Science* Vol 8 pp 203–225.

[48] Miller GJ (2005) The Political Evolution of Principal Agent Models *Annual Review of Political Science* Vol 8 pp 203–225.

[49] It may be that for this reason ex post sanctions may be more effective than incentive structures. See Calvert RL et al (1989) A Theory of Political Control and Agency Control *American Journal of Political Science* Vol 33(3) pp 588-611.

employer.[50] It is a shortcoming of unidimensional models that they do not address the subtraction by policy of the law of total information acquired and accumulated in a principal agent transaction. The models posit of course informational asymmetry, meaning the existence of differential knowledge sets or contexts as between principal and agent. Indeed, from inception, such models have taken informational asymmetry for granted and striven to achieve greater principal control by reduction of informational asymmetry between principal and agent. However, the informational constraint set by policy of the law suggests that a common assumption of 'backward induction' in many of such models may not be true. That is to say that the principal unable to appropriate information reserved to the agent cannot work backwards fully to identify the best possible negotiable incentive to overcome the agent's preferred response. In contrast, principal agent models which de-emphasise control through incentive negotiations and highlight the associations between autonomy and accountability in terms of impact on fulfilment of the common purpose of principal and agent are more useful.

Under standard principal agent models which take account of how autonomy and accountability affect the common purpose, the nature of an agent's autonomy is either de jure or de facto. An agent has de jure autonomy according to the discretions and powers legally assumed or conferred under the contract or by virtue of voluntary assumption of agency. These legal powers determine the range as well as nature of choices to be made by the agent. The actual powers may exceed (or exceptionally fall short of) these strict legal powers. As a result of admission of the notion of apparent authority, some of these actual powers are treated as legal powers. However that may be, few will dispute that de facto powers are more influential in relation to opportunistic behaviour. It is the perception or exertion of de facto powers that will motivate, if at all, the proffering of a bribe to or the solicitation of a bribe by the agent as well as determine in part or in whole the quantum of it.

---

[50] See *Boardman v Phipps* [1967] 2 AC 46.

Few will also disagree that the autonomy of the principal must first attract closer attention. Its neglect or marginalisation stems from assuming that the only thing the principal has to do is fix the price for the good or service to be dealt with or performed. Such assumption is appropriate where market mechanisms are operative. Under non-market conditions, the assumption is simplistic. To isolate the autonomy of the principal from the autonomy of the agent means going outside the more common area of focus which looks at the region of overlap where the principal transfers his autonomy to his agent who becomes his alter ego. The areas of non-overlap which are exclusive to the principal are more important to begin with. Typically, the appointment, interventionist and terminatory autonomy are distinct aspects of the mutually exclusive autonomy of the principal. These have a huge impact on agency autonomy as a consequence of their effect on the de facto power. This article submits that the existence of de facto power sets the stage for opportunism much more than de jure power. Informational asymmetry may additionally set the stage as well as provide a catalyst for opportunism. Following the literature, the dynamic interplay of opportunism and informational asymmetry in the process leading to goal accomplishment can be expressed in terms of two primary problems. These are adverse selection and moral hazard problems. The former refers to a situation in which the principal makes an unwise or ill-considered selection of its agent[51] while the latter refers to a situation where the agent takes advantage of the principal's ignorance to pursue its own objectives.[52] Moral hazard thus measures the actual misalignment in objectives when the agent seeks to promote his own or other interests than his principal's.[53]

---

[51] The seminal treatment of the problem of adverse selection in the goods and services market as being essentially a problem of uncertainty in quality arising from informational asymmetry between buyer and seller is to be found in Akerlof GA (1970) The Market for "Lemons" *Quarterly Journal of Economics* Vol 84(3) pp 488–500. Applied to the principal agent relationship, the principal's problem is to identify agents of quality but the presence of corrupt agents tends to drive out legitimate business.

[52] Hölmstrom B (1979) Moral Hazard and Observability *The Bell Journal of Economics* Vol 10(1) pp 74–91. See also Ferris (1992) School-based decision making: A principal-agent perspective *Educational Evaluation and Policy Analysis* Vol 14 (4) pp 333-346.

[53] The two types of agency problems vary in degrees of incidence and scale depending on the type of autonomy attached to the relationship between principal and agent. This can be one of three types: non-fiscal, fiscal, and service contents. Non-fiscal autonomy includes the power to manipulate the quality of the service output. Fiscal autonomy includes the power to manipulate the price of the output. This is less relevant in a closed system. There is also service contents

This article argues that the problems of adverse selection and moral hazard in a closed system can be differentiated and localised. The problem of adverse selection operates at the level of principal autonomy while that of moral hazard at the level of agent autonomy. Adverse selection mainly arises whenever the principal fails to designate, and select according to, the criteria and objectives which matter to him. A principal who neglects to invest resources in selecting the right agent worsens the problem of adverse selection by not differentiating between the types of autonomy, such as fiscal or service contents autonomy, if one premises that no agent is perfectly suitable by credentials and capability in all matters to be entrusted to an agent. Such principal is more likely to attract dishonest than honest agents. If nothing else, when there is no clear demarcation, there is confusion about objectives and functions resulting in overly wide de facto power and enhanced occasions for self-gain opportunism. In light of this, if closer alignment of agent objectives with those of the principal is central to the mix of autonomy and accountability that will accomplish the goal, the principal should not be relieved of responsibility for adverse selection. For the sake of illustration, if the principal is yielding the goal-setting autonomy, but does not take the trouble to institute performance-based awards that differentiate between different types of autonomy and that recognise the vital nature of the goal-setting autonomy, he should not be relieved of responsibility for adverse selection. A property solution would impair organisational integrity to the extent that it relieves the principal of the responsibility for adverse selection and in effect shifts it onto the bribee.

The principal's autonomy is only one side of the equation. The part of his autonomy that is yielded to the agent has been referred to above as the area of overlapping autonomies. By this expression is not meant that the principal and agent exercise exactly coincident autonomies. In the first place, there needs to be independent consideration of the agent's autonomy because as has been said there is the informational constraint and there will be a de facto aspect which

---

autonomy. An agent may have service contents autonomy which indirectly affect the quality or the price of the output.

will go beyond what has actually been yielded by the principal. Secondly, the principal would not want to exercise the yielded autonomy or he would not have appointed an agent for the goal to be accomplished. Without being exhaustive, one can note that there will invariably be a question whether this overlapping autonomy should be exercised by the principal designing and adopting monitoring or auditing measures or mechanisms which will chart the progress in goal accomplishment by the agent and reveal misalignments in goal accomplishment. Monitoring or auditing considerations are typically aimed at detecting misalignments on the ground. Their utility is not much in question. Principal agent models are in agreement that any additional imperfect information about the agent's actions or state of nature can be used to improve performance and to suppress dysfunctional behaviour. [54] But there are complicating points. To monitor effectively the principal must anticipate the type and extent of misalignment. These are matters not capable of exact a priori prediction. The greater the scope of agent autonomy the more difficult it will be to monitor actual misalignment accurately. It should also be possible to generalise that monitoring considerations will vary according to whether the agent is a mid-level or high-level or upper-echelon employee in the principal's hierarchy. Such considerations may be more or less rigid if they are the result of some negotiation between principal and agent, which may be more likely when the agent is a high-level employee. A particularly complicating point is that monitoring considerations that check for alignment of objectives need to be dynamic. There is a need to calibrate and fashion feedback control mechanisms that lighten the burden of accountability in proportion to prospects that the goal looks to be accomplished. Expressed more abstractly, the level of mix of autonomy and accountability changes dynamically. Accountability which checks for alignment thus needs to be adjusted to ensure that agent initiative is not frustrated or subverted by inappropriate or inordinate duties of accountability which then negate the benefits of giving the agent autonomy. All this means that the principal has to calibrate the variables pertaining to the benefits and costs of granting agent autonomy in relation to the importance of the goals to be

---

[54] Hölmstrom B (1979) Moral Hazard and Observability *The Bell Journal of Economics* Vol 10(1) pp 74–91.

accomplished as well as the progress made towards goal accomplishment. That total elimination of opportunistic corrupt behaviour is impossible is a premise for this calibration. Complementarity between autonomy and accountability has to be achieved at a given risk level of corruption that the principal has to set or accept. In the light of this, a property rule could 'over-reward' the principal for abdication of his supervisory autonomy where he has struck a different bargain through negotiation with his agent or otherwise accepted a higher risk level of corruption.

The conclusions reached from applying principal agent models of autonomy and accountability are not markedly dissimilar at a general level to those reached by efficiency reasoning in casting doubts on the wisdom of a universal property rule for bribes. The areas of analysis differ. Unlike efficiency models, the principal agent models employed here predicate an institutional system which is closed and in which market economics does not operate fully or effectively. Where both autonomy and accountability can be positively associated with organisational integrity, vesting the property in bribes in the principal risks destroying or impairing the positive effects both at the level of the exclusive and the overlapping autonomies of the principal. In the worst case scenario, over-emphasising accountability could lead to the positive effects of accountability and autonomy becoming subtractive instead of additive. The conclusion that there needs to be an appropriate mix of accountability and autonomy at a given level of tolerable corruption also requires a rejection or at least a narrowing of a rule vesting property in the principal. A liability rule in contrast responds more appropriately to the need to maintain accountability in positive association with autonomy whereas a property rule is liable to distort the balance of autonomy and accountability.

VI BRIBES IN NON-COMPETITIVE TRUSTING CONTEXTS

This paper has examined the problem of liability for corruption from the two important perspectives of efficiency in market scenarios and organisational

integrity in non-market closed systems. In this final section, it will be shown that the conclusions have an important orientation for a trust relationship. They imply that there is an important difference between the corrupt trustee and the corrupt commercial agent. The absence of competition in the case of the corrupt trustee needs to be factored in while the duty of the trustee to manage the non-contractible business of the trust as an ordinary man of business managing his own affairs[55] suggests that there must be some concern with a notion of efficiency. The purpose of the arguments in this section is to show that the property rule finds a proper place under the kind of non-competitive conditions in which the trustee must discharge his duties. The corollary is that its extension to all other fiduciaries irrespective of context is mistaken.

The case of the trustee is an excellent example of a non-competitive context which produces two kinds of economic rent. The first type of rent arises out of legal as well as non-legal restrictions on who can be a trustee. There is additionally information rent derived from the provision of information to the trustee not available to the beneficiary. One may call the trustee a monopolist agent with a fairly non-contractible output, which is determined by a trust instrument that cannot easily be varied or modified. Studies relating particularly to corruption of the trustee as monopolist agent are obscure but there is no shortage of studies on government corruption. Those studies which adopt a transaction cost analysis, broadly new institutional economics, are a useful source in which to locate and develop the arguments in this section.

In particular, reliance will be placed on the results of Aidt's review of the efficiency literature which is a good and still topical starting point.[56] There is no intention to recount completely Aidt's review of the literature since the present aim is merely to show that one of the models reviewed suggests or implies the relevance of the property rule in non-competitive environments.

Aidt begins by identifying four models of corruption where the corrupt agent is a

---

[55] *Speight v Gaunt* (1883) 9 App Cas 1.
[56] Aidt T S (2003) Economic Analysis of Corruption *The Economic Journal* Vol 113 pp 632-652.

monopolist. Under the first model of efficient corruption, a corrupt monopolist-agent in queuing models takes bribes from consumers or users who seek to jump the queue for economic activity, the demand for which exceeds supply. The idea is that scarce resources such as licences and permits go to those willing and able to pay a higher price (inclusive of the bribe offered); ie those who value not waiting for the service, which enhances efficiency in a second best world. This is unlikely to be the case with trustees. There is no evidence that persons seeking to transact with trustees would prefer to deal in trust assets or that they perceive trust assets to be superior to non-trustee assets. Moreover, efficient corruption models appear to premise a malevolent principal who creates shortages in service outputs that the corrupt monopolist helps to clear.

In those premises, queuing models (and for that matter auction models) have little to offer by way of positive insights for the trust and beneficiary relationship. But for reasons of completeness, efficient corruption models proposed by Shleifer and Vishny should not be missed.[57] These do not premise a malevolent principal and may superficially shed some light on the monopolist trustee if we assume that the trust instrument contains all the information there is on the desired output. They advocate a variant model which posits that the government has full information on the cost/demand conditions facing a monopolist agent who provides a non–contractible output. The conclusion they draw is that the agent sells the monopoly output and collects a scarcity rent equal to the monopoly profit. The corrupt monopolist agent in other words provides an efficient clearing function by selling the output to those who most value it and are prepared to pay a bribe for it. One need not follow them on the conclusion which is invalid or highly dubious. Dhami and Al-Nowaihi argue with justification that, under full information, the monopoly profits are public information and so charging the public-agent a transfer/franchise fee equal to the monopoly profit ensures the first best non-distortionary outcome.[58] This

[57] Schleifer A & Vishny R W Corruption (1993) *Quarterly Journal of Economics* Vol 108 pp 599–617. See also Schleifer A & Vishny R W (1994) Politicians and firms *Quarterly Journal of Economics* Vol 109 pp 995–1026.

[58] Dhami S & Al-Nowaihi (2007) Corruption and Provision of Public Output in a Hierarchical Asymmetric Information Relationship *Journal of Public Economic Theory* pp 727-755.

prescription for efficiency is of little relevance for the trust and beneficiary relationship. Obviously, the settlor never has full information on the cost/demand conditions facing the trustee as monopolist agent. Secondly, trustees discharge a gratuitous office and it would be incongruous to contemplate the settlor charging his trustee a fee.

In the same paper, Dhami and Al-Nowaihi go on to consider under certain conditions a monopolist-agent who provides a public good or service under benevolent political supervision. On premises such as these, they argue that there is a difference between honest and dishonest political supervision, that the costs of the monopolist agent exerts a significant influence on corruption, that these costs vary among monopolist agents some of whom are low cost providers and others high cost providers, and that auditing benefits in reducing corruption are minimal where political supervision is dishonest. The agent commits corruption by selling above the official price set by the politician. This may be described as the benevolent model which is the second model reviewed. If Dhami and Al-Nowaihi's conclusions are valid, the economic analysis of corruption significantly depends on whether the principal is benevolent, whether the agent is a low cost or high cost provider, and whether there are auditing mechanisms.

The benevolent model examples what Aidt describes as an agency model with a benevolent principal. This model sheds more light on the trust and beneficiary relationship than the first. Others such as Aidt who discuss or explore this model point out the importance of institutional factors and emphasise more institutional arguments (how well the institutions are designed) and perceptions of rewards of corruption by individual agents more than the considerations identified by Dhami and Al-Nowaihi. Individual agents allocate contracts according to rewards of bribes and have little incentive to take bribes where they are paid a salary uplift which rewards honesty and fidelity or efficiency wages. Aside from efficiency wages, the level of corruption turns on institutional controls and legal remedies. These create multiple-path dependencies. Aidt therefore argues that an optimally designed corruption free system with high incentive contracts is inefficient. It is more efficient to tolerate some corruption

by trading off honesty and reward to be dealt with in terms of existing legal remedies. The benevolent principal model matches some of the conditions in a trust. The settlor easily matches the description of a benevolent principal.

Aidt's third model which involves the malevolent principal has less bearing on the trust. It is enough to point out that the third and first model have a point of convergence in the premises. The agent is corruptible. The difference is that in the third both principal and agent are corruptible. Principals create restrictions and adopt restrictive policies to generate scarcity rents while agents exploit the potential for corruption. Unlike the first model, these shortages are not pre-existing but endemic because motivations are skewed and the consuming public has no way to price the bribe.

Clearly, the third model does not capture the distinctive feature of premium selection of a trustee which marks out the backdrop of trustee corruption. A benevolent principal (or the court in his place) selects a moral person as his trustee and the trustee who accepts does so under the tenet of no reward for his exertions. This flatly contradicts the conditions of the third model that both principal and agent are malevolent. How does the Calabresi and Melamed model fare under the circumstances? The question is a leading one of course. It supposes that even under conditions of quasi-monopoly and non-contractibility an efficiency model is apposite instead of a deterrence or quasi-deterrence model. Applicability of Aidt's second model is important since it means that we are not constrained to reject economic reasoning even under trusting conditions. When initial descriptions of the second model were made earlier, enough was said about the similarities between the agent-benevolent principal model and the trusting relationship. These include the fact that the trusting relationship exhibits a similar combination of non-contractible output and full information on cost/demand conditions. On-going auditing considerations are likely to be perfunctory tokens created by the trustee himself and of an ex post facto nature. Beneficiaries are not in an appointing position and ill equipped to adopt auditing measures while trustees exercise supreme autonomy. Restrictions on trustee autonomy may be imposed obviously. Even so, there is a notable time interval

during which trustee exercise of de facto autonomy will go undetected and any damage done may be irreversible. Not all conditions obtain, to be sure. While multiple-path dependencies also exist in trusting relationships (for instance trustees may be given incentives to encourage loyalty and fidelity), there is a reduction in degrees of causalities in the trusting relationship. The benevolent principal in the second model can modify the contract by raising output as an integral part of the design. This ability to influence the agent's control over non-contractible outputs is missing in the trusting relationship.

Aidt's concluding arguments in respect of second model corruption are therefore generally applicable. The main argument is stated as follows: "Would a benevolent government allow corruption to persist? The answer is a qualified yes. The optimal design of incentives in bureaucracies often leaves room for corruption. The optimal level of corruption trades off the cost of allowing corruption (in terms of misallocation of resources due, for example, to misreporting) and the cost of designing incentives to eliminate it: corruption persists when the cost of eliminating it is too high. Shleifer and Vishny call this the 'helping hand theory of corruption' because of the maintained assumption that the government is benevolent in the double sense that it wants to implement socially beneficial policies and it attempts to optimise the working of its institutions."[59] An important sub-argument is stated as follows: "This illustrates an important point: eliminating corruption by means of a high powered incentive contract is partly expensive because the government cannot screen its agents before they are hired. Thus, it is the lack of an effective screening mechanism that makes it optimal under some circumstances to allow corruption."[60] There are two general economising transaction cost arguments in these conditions. With respect to the trusting relationship, these general arguments lead to the opposite particular conclusions. Under the moral person premises, the trustee is a good person chosen by the principal to act in his stead who would want his beneficiaries to have the property if the settlor would have

---

[59] Aidt T S (2003) Economic Analysis of Corruption *The Economic Journal* Vol 113 pp 632-652 at 638.
[60] Aidt T S (2003) Economic Analysis of Corruption *The Economic Journal* Vol 113 pp 632-652 at 641.

done the same. The cost of designing incentives to eliminate corruption is wasteful under the premises. Second, the cost of eliminating post-appointment corruption is too high. A property rule under the Calabresi and Melamed model in such circumstances is therefore efficient. This is not necessarily going round in a circle saying that in the end we come back to legal deterrence, thus falsifying the validity of an economising model. The general reason that deterrence does not predominate in the second model is precisely because the phenomenon of corruption is complex. There are multiple causalities. The particular reason that deterrence still does not predominate in the trusting relationship is that the trustee is chosen because he is a good person or presumptively so. This results in a reduction of causalities, not their overthrow.

VII CONCLUSIONS

The clash of opinions between those who welcome the broad sweep of *FHR European Ventures LLP v Cedar Capital Partners LLC* and those who remain sceptical of its pragmatic reasoning is more than one of doctrine and insolvency advantages and disadvantages. In bringing cross-disciplinary perspectives to bear on the debate, we appreciated that there were significant limitations. First, the perspectives chosen were limited. No attempt was made to include others. The reason for this lay in the modest ambition of the article. The objective was to question the simple property rule answer, not to prescribe the necessary qualifications for a better one. There are as a result key questions that remain unanswered by this article. Second, while two methods or models, the economising and the principal agent models, were employed, there was no attempt to do this in a completely general way. Nor was there any effort made to relate efficiency theories and autonomy and accountability theories in some way. The selection of efficiency reasoning was almost obvious. The primary reason for including insights from socio-political studies was to accommodate the theory of property as an expression of individual autonomy. So there was a degree of eclecticism and heuristics in the choices made.

Nevertheless, the methods employed as tools to evaluate the property rule were useful. The unequivocal initial insights they delivered were slightly different in each case but complementary in leading to broadly convergent conclusions. Efficiency perspectives were invisible hand arguments whereas socio-political perspectives were design-oriented. The former showed the dispensability of deterrence as a primary policy and the validity of efficiency reasoning. The latter showed how we might design a system which will minimise distortions between autonomy and accountability. Both approaches supported less omnibus and singular conclusions. First, an effective legal rule responding to the problem of harm caused by corruption must recognise and take account of differences between competitive and non-competitive environments, auditing possibilities, as well as multiple causalities, both individual and institutional. Second, a property rule fails to do that. Third, ignoring such endogenous and exogenous variables, it overestimates or underestimates the harm suffered by victims of corruption.