Mihály Fazekas[1] and Bence Tóth[2]

Measuring Corrupt Rent Extraction by Tracking the Misuse of Corporate Vehicles

AUGUST 2016, BUDAPEST, HUNGARY

[1] University of Cambridge and Government Transparency Institute, mf436@cam.ac.uk
[2] University of Cambridge, Government Transparency Institute, and University College London

In recent years, the abuse of diverse corporate networks for extracting corrupt rents and channelling them to opaque destinations have come to the forefront of international anticorruption efforts. This was marked by the UK anti-corruption summit's focus on beneficial ownership[3] which built on initiatives against opaque companies by OECD or FATF to name a few. However, results remain to be seen[4]. This is partially due to the difficulty of measuring success on the ground rather than in law books.

In order to adequately measure the corrupt misuse of corporate vehicles we have to focus on the exchanges they conduct with public bodies rather than simply looking at legal loopholes or the mere existence of suspicious companies. Corrupt exchanges involving companies typically require the participation of public and business elites who can manage high value public decisions, and can move large sums among business entities. Public decisions can concern, among others, public contracts, concessions (e.g. mining rights), specific regulations (e.g. protection from competition), or the sale of public property. Such high-level corruption requires the violation of the underlying universalistic or impartial principles of public resource allocation in order to benefit a select few to the detriment of others[5].

MEASUREMENT APPROACH

Any valid and reliable measure of such high-level corruption has two requirements: first, identifying the full universe of potentially corruptible transactions (e.g. mining rights awarded). Second, identifying those companies which are likely designed for corrupt rent extraction rather than genuine economic exchange in line with stated public objectives.[6] There is a wide array of high corruption risk corporate characteristics pertaining to particular domains[7], here we only demonstrate the feasibility and utility of one simple proxy:

Age of company at the time of exchanging with the state.[8]

In markets where experience and skills are prerequisites (e.g. mining for minerals, supplying goods), companies, which are incorporated shortly before the exchange with the government commences, could be created only for corrupt rent extraction, especially when incorporation coincides with political cycles or other red flags. To reconcile the non-linear character of corruption and our continuous measure, a cut-point needs to be applied to mark risky observations. For the sake of simplicity, we take companies younger than 1 year as high risk and all other companies as low risk.[9]

---

[3]   https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/522791/FINAL_-_AC_Summit_Communique_-_May_2016.pdf

[4] http://www.ingentaconnect.com/content/aea/jep/2010/00000024/00000004/art00007

[5] For some of the related scholarship see: http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0491.2008.00391.x/full or https://muse.jhu.edu/article/200112/summary

[6] This implies that our proposed indicator does NOT capture corruption conducted via well-established companies also used for non-corrupt purposes.
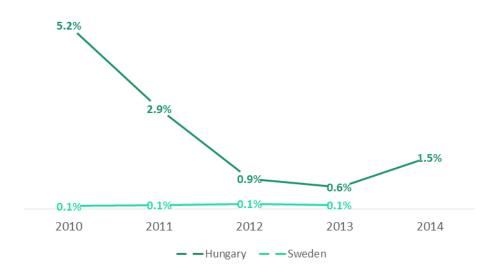
[7]   http://digiwhist.eu/publications/a-comprehensive-review-of-objective-corruption-proxies-in-public-procurement-risky-actors-transactions-and-vehicles-of-rent-extraction/

[8] This is measured as the number of days, months, or years between the company's incorporation and the commencement date of the exchange between the company and the public body.

[9] Cut-points are likely to differ by context. The optimal cut-point can be formally defined using validity tests.

We use the domain of public procurement in Sweden and Hungary in 2009-2014[10] to show a concrete example; however, the logic is generally applicable to other public activities if certain conditions are met.

As expected when comparing a high perceived corruption risk country with a low perceived corruption risk country, the value of contracts awarded to very young, hence high corruption risk, companies is considerably higher in the corrupt country (Figure 1). Note the decline of young companies' market share in Hungary following the government change in 2010.

FIGURE 1. SHARE OF PUBLIC PROCUREMENT SPENDING GOING TO COMPANIES YOUNGER THAN 1 YEAR[11]

Such a simple indicator needs to be tested and potentially combined with further corruption proxies. If young companies are predominantly used for corrupt exchanges rather than genuine economic activities, their transactions should have higher corruption risks too. A simple indication that basic rules of open and fair competition were circumvented is when only 1 bid is submitted in a supposedly competitive public tender (Figure 2).[12]

---

[10] Data collected and (soon) republished in full by DIGIWHIST: http://digiwhist.eu/resources/data/. Note that contract values and company-level financial data are only available for a sub-set of contracts, hence the analysis may suffer from measurement bias.

[11] Due to a too high proportion of missing records, that is potential measurement bias, in 2009 for Hungary and Sweden and in 2014 in Sweden we do not show these values. Nevertheless, they confirm the same overall trends

[12] For more on this corruption proxy see for example: http://prq.sagepub.com/content/69/2/320
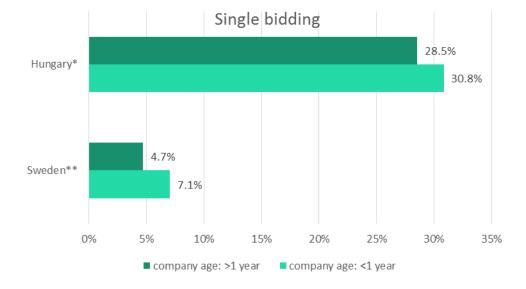
FIGURE 2. SHARE OF SINGLE BIDDER CONTRACT AWARDS BY COMPANY AGE GROUP

Note: *** 1%; ** 5%; * 10% significance using random permutation tests

If companies are corruptly used they have to earn higher profit or channel profits to opaque destinations such as tax havens. In the absence of reliable public information on opaque transactions, we can track company profitability (Figure 3).
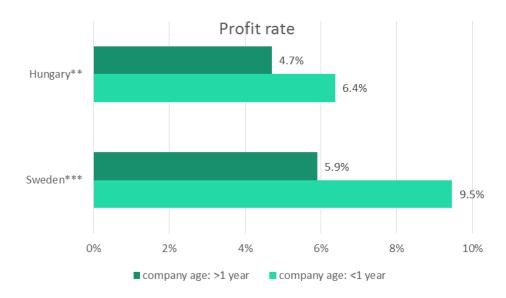
FIGURE 3. AVERAGE PROFIT RATE PER COMPANY AGE GROUP

Note: *** 1%; ** 5%; * 10% significance using random permutation tests

STRENGTHS AND WEAKNESSES

The main strength of this indicator is that it is solely based on objective administrative data and highly sensitive to change. Combined with further indicators underpinning validity it can be used for reliable and valid analysis. It can help track the effectiveness of policy interventions concerning spending oversight mechanisms, court sentences, or company registration requirements.

Its weaknesses lie in the need for extensive and high quality administrative databases and the capacity of corrupt actors to shift the locus of corruption (e.g. buy up established firms). Also, innovative, new companies may leave the same corruption markers: young, profitable, having no competitor. Finally, this indicator presumes that there are well-established companies potentially entering into exchange with the state which may not be the case.[13]

---

[13] https://ideas.repec.org/p/tse/wpaper/27862.html