

Leniency policies and illegal transactions

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Abstract

We study the consequences of leniency—reduced legal sanctions for wrongdoers who spontaneously self-report to law enforcers—on sequential, bilateral, illegal transactions, such as corruption, manager–auditor collusion, or drug deals. It is known that leniency helps deterring illegal relationships sustained by repeated interaction. Here we find that—when not properly designed—leniency may simultaneously provide an effective governance mechanism for occasional sequential illegal transactions that would not be feasible in its absence.

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1. Introduction

The economic and social costs of organized illegal transactions are enormous. Financial frauds, earning management schemes, firm/auditor and investment bank/analyst collusion have recently undermined the smooth operation of financial markets in more than one country.¹ The direct and indirect costs of drugs, arms, toxic waste, and people trafficking are obvious and huge.

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¹ Leading the US government to introduce the Sarbanes–Oxley Act which, among other things, reinforces protection of whistle-blowers.

Terrorism can also be seen as a form of organized crime. And even economists' traditional benevolence towards corruption, once seen as a way to overcome excessive regulation, has been heavily questioned by recent studies showing that corruption may reduce investment, financial development, and growth.²

Since illegal transactions involve at least two parties and require trust among them—their potential opportunism cannot be limited by court-enforced contracts—one way law enforcement agencies traditionally fight them is undermining trust by shaping incentives to play one party against the other(s): ensuring that they find themselves in a situation as close as possible to a Prisoner's Dilemma.³ Law enforcers do this by awarding leniency—typically a reduction or cancellation of legal sanctions accompanied by protection from retaliation and related benefits—to wrongdoers that self-report helping to convict “the rest of the gang”. Formal or informal exchanges of leniency against information are common in most world countries, and have been extensively and successfully used to fight Mafia, drug dealing and terrorism.

It is by now well known that on multi-agent criminal relationships sustained by repeated interaction leniency for self-reporting wrongdoers can have a particularly strong deterrence effect: Spagnolo (2000, 2004) showed that leniency for undetected wrongdoers that spontaneously self-report could in principle costlessly deter all forms of organized crime enforced by reputational considerations, making the investigation activity redundant. To have such pervasive effects, however, leniency should not only reduce sanctions, it should also reward wrongdoers that spontaneously report and turn in their partners. Instead, in reality leniency is often “moderate”: it only reduces or at most cancels legal sanctions against a self-reporting party (obvious examples are the US and EU Leniency Programs for cartels). The main reason why such policies often do not offer rewards to applicants appears ethical and political, as many people consider immoral to reward someone who acted illegally, and fear the lack of trust of an “informants' society”, although rewards to whistleblowers are and have been successfully used in many situations.⁴

Moderate leniency may still produce significant benefits as it reduces law enforcement cost for individual crimes (Kaplow and Shavell, 1994), and may have deterrence effects on long term illegal relationships as it may facilitate prosecution (Motta and Polo, 2003), and increase both the incentives to defect and report and the “strategic risk” of entering an illegal arrangement (Spagnolo, 2004). However, as it turns out, moderate leniency may also have puzzling side effects on occasional illegal transactions, which add a potential cost besides their just mentioned benefits.

² Bardhan (1997) offers an overview of the early literature; hundreds of economic papers have been published since then. The pioneering analysis of Mauro (1995) estimates that a one standard deviation improvement in a country corruption index is associated with an increase in the investment rate by about 3% of GDP. Recent work on transition economies places corruption at the heart of their poor post-privatization performance (see e.g. Boycko et al., 1995; Jones et al., 2000; Black et al., 2000).

³ From a theoretical point of view, the Prisoner's Dilemma game itself is perhaps the best known model of leniency in law enforcement: the sanctions for a prisoner that unilaterally confesses his crime are reduced to induce him to confess and prove guilty his former partner(s).

⁴ See Spagnolo (2006) for a discussion of historical and present examples. Rewards to whistle-blowers may entail potential costs not analyzed in the present setting, including reduced trust in organizations and society, false reports aimed at capturing rewards, and courts increasing standards of proof. Aubert et al. (2004) and Buccirosi et al. (2005) analyze several potential costs of rewarding whistleblowers, but argue that the benefits stemming from the deterrence effects of appropriately designed rewards are likely to outweigh all these potential costs.

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