Rewarding Whistleblowers to Fight Corruption?

Whistleblower reward programs, or “bounty regimes”, provide financial incentives to witnesses that report information on infringements, helping law enforcement agencies to detect/convict culprits. These programs have been successfully used in the US against procurement fraud and tax evasion for quite some time, and were extended to fight financial fraud after the recent crisis. In Europe there is currently a debate on their possible introduction, but authorities appear much less enthusiastic than their US counterparts. In this brief, we discuss recent research on two commonly voiced concerns on whistleblower rewards – the risk of increasing false accusations, and that of crowding out other motivations to blow the whistle – and the adaptations these programs may need to fight more general forms of corruption. Research suggests that the mentioned concerns can be handled by an appropriate design and management of the programs, as apparently done in the US, and that these programs can indeed be a cost effective instrument to fight corruption, but only in countries with a sufficient quality of the judicial system and administrative capacity. They may instead be problematic for weak institutions environments.
Corruption and fraud seem to remain highly widespread in almost all countries. For example, a recent survey of over 6,000 organizations across 115 countries shows that one in three organizations, both worldwide and in the US, experienced fraud in the past 24 months, prevalently in the form of asset misappropriation, cybercrime, corruption, and procurement and accounting fraud (Global Crime Survey, 2016).

Whistleblower (protection and) reward programs are a possibly effective tool to combat fraud and corruption, at least in the light of the US successful experience, where for a long time whistleblowers reporting large federal fraud have been entitled to up to 30% of recovered funds and sanctions under the False Claims Act. The US Internal Revenue Service (IRS) also allows whistleblower rewards in the tax area, and the Dodd-Frank Act introduced them for financial and securities fraud, apparently also with success (c.f. Call et al., 2017, and Wilde, 2017).

In Europe and the rest of the world, instead, rewards are absent and whistleblowers are still poorly protected from retaliation from employers. Some countries have taken encouraging legal steps to at least improve protection, and a discussion is ongoing at the G20 level on how to further improve the situation (G20 report, 2011).

Although many praise whistleblowers, there has been a large range of objections raised against introducing rewards (and even against improving whistleblower protection); mostly by corporate lawyers and lobbyists, but also by regulatory and law enforcement agencies (see Nyreröd and Spagnolo, 2017, for an overview).

In the rest of this brief, we focus on two often voiced concerns, the risks of eliciting false/fraudulent reporting and of crowding out of non-financial motivation, on which recent research has shed light that should be taken into account in the current policy debate. We then discuss some problems linked to the use of whistleblower rewards programs in a more general corruption context.

Fraudulent reports

One concern commonly raised in the discussion of whistleblower rewards is that they may create incentives to fraudulently report false or fabricated information in the hope of receiving a reward. Although clearly an important concern to take into account, we only know of very few anecdotal cases of malicious or false reporting, and fraudulent reporting does not appear to have been a major problem in the US (see again Nyreröd and Spagnolo, 2017 for an overview of the empirical evidence).

A recent paper by Buccirossi, Immordino and Spagnolo (2017) analyzes this concern within a formal economic model and shows that it is not a ground (or an excuse) for not introducing appropriately designed and managed protection and reward programs in countries with sufficiently effective court systems. In these countries, stronger sanctions against lying to the court can (and should) be introduced to balance the incentives for manipulation that may be generated by large bounties. Most legal systems already have defamation and perjury laws, which means that a whistleblower is already committing a crime by fraudulently reporting false information, that can easily be strengthened where necessary without giving up whistleblower rewards. According to this study, the balancing of incentives is what allows the US to effectively use large financial incentives for whistleblowers, besides a very strong protection from retaliation, with little problems in terms of fraudulent reports.

However, the study also shows that this is only possible if the precision (effectiveness, independence) of the court system is sufficiently high. Where court systems are imprecise, the interaction between courts’ mistakes in the legal case based on the information reported by the whistleblower and in the following case for perjury/defamation against the whistleblower if the first case is dismissed, incentives for fraudulent reports, and courts’ adaptation of the standard of proof to account for these incentives,
make it impossible to appropriately balance the two incentives. Therefore, whistleblower reward programs should not be introduced in environments where the law enforcement system is ineffective, independently from why it is so (bureaucratic slack, incompetence, political interference, corruption, etc.).

Crowding-out non-financial motivation

Another concern is that whistleblower rewards may have a “crowding out” effect on intrinsic motivation. The problem is that “the commodification of whistleblowing via the provision of bounties may render would-be whistleblowers less likely to come forward by reducing the moral valance of the wrongdoing” (Engstrom, 2016:11). Recent experimental evidence suggests that this concern is overstated. In particular, Schmolke and Utikal (2016) investigate the effects of whistleblower rewards in an environment where one subject may increase his payoff at the cost of harming the group, and find rewards to be highly effective in increasing the number of crimes reported. Data from that experiment suggests a little role for crowding out of non-monetary motivation, if any. Another recent study by Butler, Serra and Spagnolo (2017) investigates if and how monetary incentives, expectations of social approval or disapproval, and the salience of the harm caused by the reported illegal activity interact and affect the decision to blow the whistle. Experimental results show that financial rewards significantly increase the likelihood of whistleblowing and do not substantially crowd out non-monetary motivations activated by expectations of social judgment. The study also finds that public scrutiny and social judgment decrease (increase) whistleblowing when the public is less (more) aware (aware) of the negative externalities generated by the reported crime. All in all, most the recent studies we are aware of suggest that crowding-out of non-financial concerns is not a first-order problem for whistleblower reward schemes as long as there is a clear perception of the public harm linked to the illegal behavior reported by the whistleblower.

Whistleblower rewards and corruption

Although whistleblowing can occur in any sector, firm, or government, an area of particular interest is corruption. Corruption in public procurement is estimated to cost the EU 5.3 billion Euros annually. Hence, corruption deterrence through increased whistleblowing could save the EU significant resources annually (EC Report, 2017).

Contrary to fraud, corruption always takes at least two parties, a bribe taker, typically a government official or politician, and a bribe giver, which may be a firm or an individual. The fact that at least one additional party is involved than in the standard case of fraud, should make whistleblower rewards programs even more powerful since they may deter corruption by increasing the fear that a (potential or real) partner in crime may blow the whistle, even when no third party witness observes the illegal act (Spagnolo, 2004).

When the reported wrongdoer is an individual, as is often the case with corruption, there may be an issue in the use of rewards for whistleblowers linked to the funding of the rewards (c.f Nyreröd & Spagnolo, 2017b for an overview).

In the current US schemes, rewards for whistleblowers are ‘self-financing’, as they constitute a fraction of the funds recovered thanks to the whistleblower or/and of the fines paid by the culprits. An individual and a government official involved in a corrupt deal may, however, not be wealthy enough for the fines and the recovered funds to amount to a sufficiently strong incentive to blow the whistle, given the loss of future gains from the corrupt relationships and the various forms of retaliation whistleblowing may lead to. This problem is of course also relevant for fraud when an individual with few or well-hidden assets is the culprit,
rather than a corporation, but it seems particularly relevant for corruption.

Whistleblower reward programs are also malleable to the concerns at hand. If the priority is to combat higher-level corruption, then setting a monetary threshold for when a claim is to be considered is appropriate to limit administrative costs for the program. Indeed, a concern with utilizing whistleblower rewards programs for combating lower-level corruption is that the administrative burden required looking through the whistleblower claims and the costs of limiting abuses may outweigh the benefits gained in detection and deterrence. This concern is also valid for small fraud and tax evasion, which is why all the US programs have a minimum size for cases eligible to whistleblower rewards, but the problem is likely to be more relevant to the case of ‘petty’ corruption. These programs are more suited for ‘large cases’ in which the amount of funds recovered is large enough to pay for rewards and administrative costs, making these programs self-financing even without calculating the benefits for the deterrence/prevention of future infringements. However, when focusing on large corruption cases, other issues become relevant.

An issue particularly important for the case of ‘grand’ corruption is how independent the judicial system is from political pressure, and how able it is to protect whistleblowers against politically mandated retaliation. If corrupt politicians can importantly influence courts, the police or other relevant administrative agencies, then protection can hardly be guaranteed and inducing witnesses to blow the whistle through financial incentives may put their life at risk, although sufficiently large rewards can partly compensate for this risk and help escaping part of the retaliation.

Conclusion

On the whole, whistleblower rewards, in general and in the corruption context specifically, remain a promising tool to detect and deter crime. Careful design and implementation are necessary, because as for any powerful tool, these programs can be well used to do great thing, but also misused to do great damage. As the US experience has shown, along with sufficiently independent and precise courts and an effective administration of law enforcement, well designed and administered whistleblower reward programs hold the promise of greatly improving fraud and corruption detection and of being self-financing through recovered funds and fines.

Of course, even in a very good institutional environment, a poor design and/or implementation can lead to poor performance and do more harm than good (c.f. the case of leniency policies in China discussed in Perrotta et al., 2017). Moreover, in poor institutional environments, where the court system is not sufficiently precise and independent and other law enforcement institutions are not effective, even well-designed and implemented whistleblower reward schemes may bring more problems than benefits. Whistleblower rewards, as any other high-powered incentives, need good governance to ensure that the potentially very high benefits they can generate will be realized. Third parties like international courts and organizations could potentially provide for some low institution environments, the independent safe harbor necessary to protect whistleblowers and a check on court effectiveness for the award of financial incentives.
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References


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