

EconoFact Chats: Costs of Corruption

Luigi Zingales, University of Chicago Booth School of Business

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Michael Klein

I'm Michael Klein, executive editor of EconoFact, a non-partisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein

Professor Luigi Zingales begins his 2012 book, *A Capitalism for the People*, by recounting his first visit to America to attend graduate school at MIT. He contrasts the opportunities he would have in America, where his skills and hard work could help him advance, to what he left behind in his native Italy, where professional success often depended on nepotism and patronage rather than natural ability and performance. But tellingly, Luigi also expresses the anxiety he felt at that time, since if he failed, he would have no one to blame but himself. Well, Luigi did not fail. He is a professor at the Booth School of Business at the University of Chicago. He has published influential research on a range of topics, especially in the areas of finance, corporate governance, and political economy. In 2015, he became the director of the University of Chicago's Stigler Center. Luigi, I'm very pleased to welcome you to EconoFact Chats.

Luigi Zingales

Oh, the pleasure is mine.

Michael Klein

I recently read *A Capitalism for the People* for the first time, and I found it compelling and convincing. You have a number of instances in the book where you compare the economic system in the United States favorably with that of the Italy you left in your early 20s. But you also have a clear-eyed view of America. And note the deep flaws due to the way in which narrow political interests affect economic outcomes, what some people call crony capitalism. And what you say are policies that are pro-business rather than pro-market. What do you mean by pro-business versus pro-market? And what are some examples of this?

Luigi Zingales

I think that pro-business means that this is good for the business people, the people who own business, but not necessarily for the market overall. So if you have, for example, a tariff that protects some local producer, this is great for the incumbent that produced that good because he's protected and they're going to make more money. But it's terrible for the market overall because it would increase the cost for consumers and also generates less incentive to innovate. So at the end of the day, it's bad long-term—almost for everybody—except the big winner of the benefit from the tariff.

Michael Klein

So economists talk about this term rent-seeking. Can you explain what it means and how it relates to what you just described?

Luigi Zingales

Oh, it's very important. Exactly. I need to give a big shout-out to Gordon Tullock, who was a graduate from the University of Chicago and a very good economist, but he didn't receive the reward that he deserved because, I never met him, but I was told that he was of bad character and so antagonized everybody. But he actually invented the idea of rent-seeking, but did not invent the name. But the idea is very simple, is that if there is an easy way to obtain a rent through some political shenanigans, for example, introducing taxes that protect a particular good, then in a market where a lot of people can try to do this, they're going to dissipate most of this rent by trying to capture this rent. So the rent-seeking is the activity, for example, lobbying Congress to obtain those tariffs. And that activity is rent-seeking. And one of the ideas that belongs to Gordon Tullock is that unless there are restrictions to entry in the business of rent-seeking, the amount of rent-seeking would be at least as big as the total rent that are generated. So any monopoly that we observe is not only bad for the technical reason that we economists say. We economists have the fact that monopolies tend to underproduce, and this is a cost. But the biggest cost is that there are a lot of rents that dissipated in stupid activities that don't add to the welfare of humankind.

Michael Klein

In fact, work by people like Ray Fisman shows that in the United States, lobbying offers a very big return. If you lobby, you can get laws passed that will really help you much more than the cost of the lobbying itself, right?

Luigi Zingales

I think that it's probably safe to say that it's true in most countries. I think that, but the United States has become much worse in recent periods. So I think you're absolutely right.

Michael Klein

So you alluded to why rent-seeking is economically inefficient, because people are working to influence economic outcomes through politics, rather than by selling a better product. Overall, Luigi, how damaging is this for an economy?

Luigi Zingales

I think it's very damaging, because what is good about a capitalist economy is that people, in order to try to make money, are actually adding to the welfare of everybody else. So if I try to make money by innovating, I end up benefiting everybody. If I try to make money by simply subtracting some rent from somebody else, I am not adding anything. In fact, I'm subtracting, because I spend valuable resources into this activity. So think about all the brilliant lawyers who spend all the time trying to influence the political activities in one way or another is a complete waste of talent of the worst type.

Michael Klein

In fact, this idea goes back to at least Adam Smith, right?

Luigi Zingales

The idea that lobbying can be detrimental, yes, goes back to Adam Smith. I don't think he formalized in the way that Gordon Tullock did, but yes, the intuition was there.

Michael Klein

And this is the essence of what you mean by being pro-business versus pro-market, that you help influence laws and regulations such that particular businesses are advanced rather than overall market competition, right?

Luigi Zingales

Absolutely.

Michael Klein

So today, you've already alluded to one type of rent-seeking, the imposition of tariffs. And I'm sure that we're going to see lobbying for carve-outs that exempt certain companies from paying these taxes on imports. So is this, in your mind, a prime example of politics rather than market competition, picking winners?

Luigi Zingales

I think it's one example. But I think that if we go down economic policy in the last few years, I think that each one of them is a fantastic example. In the sense, whether you like or not the ultimate purpose of the Green New Deal, the Green New Deal was made of subsidy given to everybody, including the oil companies. So much so that, I don't know if you know this, but there's not much discussion by the Trump administration to abolish the Biden Green New Deal because it was so generous to everybody. And generous with what? With, at the end, the taxpayers' money. I think that the regulation of banks that goes under the name of Dodd-Frank, I think that there was a need for regulation. But this regulation was crafted by the large banks to the interest of the large banks. And surprise, surprise, what you saw after the regulation is there was no new entry in banking, and the big banks became even bigger. And you can go up to private prisons. You know that there is evidence suggesting that private prisons are very effective in lengthening sentences so that there are more prisoners. So I think that that's the worst form of lobbying is that you even end up keeping people more in jail just because the private sector wants to make more money.

Michael Klein

So this suggests that beyond the straight economic damage, there are also corrosive social effects if rewards reflect who you know, or even who you pay off, rather than what you know. What are the broader consequences of this type of non-market determination of outcomes, what we typically call corruption?

Luigi Zingales

I think the ultimate aspect is the lack of faith in the system and, to some extent, the rejection of the system. I always make this example. My son resents this example and has a different interpretation. But when my son and daughter were small, they were playing Monopoly together. And inevitably, it was ending in my daughter crying and I had to intervene. And I was trying to figure out what was happening. And at the time, my daughter could not perfectly read because she was a bit younger and my son could. And my understanding, as I said, my son disputes this, but my understanding was that my son was selectively enforcing the rules. So he knew what the rules were. And he remembered the one that was in his favor, but not the one that was in my daughter's favors. And my daughter, not knowing the rules, but not being fooled, understood that

there was something that was amiss. And she did what she could do at that age, which was to cry. And I think I always see this image as a wonderful image of the political system, because I think a lot of people, ordinary people, cannot pinpoint the detail of what is wrong. But they're not stupid. They see that the system is rigged. And what they do is they cry, they scream, they protest. And I think unless we can somehow channel this protest into something positive, it can be very disruptive.

Michael Klein

So maybe we won't tell your children about this podcast. And what you're speaking of gets to the role of trust. Your daughter didn't trust your son. And more broadly, trust can be eroded or destroyed even, I suppose, when people see the system as corrupt. How important is trust for an economy?

Luigi Zingales

Oh, I think it's enormous. I have to say, when I came into this country—at this point, it's 36 years ago—one of the things that shocked me the most was the trust that people had for the system. I remember that I experienced the first hurricane warning in Boston. And the mayor said, you have to go home and tape windows and don't get out until I say so. And my reaction as an Italian is, number one, if the mayor tells you to go inside, you stay outside because there is a reason why he's sort of trying to trick you. And number two, if he tells you to tape the windows it's because his brother is selling tape and he's trying to make money out of it. And when I saw that everybody was actually taking very seriously what the mayor said, I said, wow, this is really what it means, a government for the people, not only of the people and by the people, but also for the people. And when people have this sense, they trust their institution. I have to say that in the subsequent 36 years, things have gotten much, much worse in this country. And I like to say that the United States is becoming more and more like Italy, except for the good food and wine. And I think that this is problematic.

Michael Klein

In the book, you distinguish between what you call personal trust and general trust. Can you explain the difference between these two?

Luigi Zingales

Oh, absolutely. In Italy, there are a lot of people who are very close friends and they trust each other deeply. And that's what we call the personal trust. The general trust is a trust toward other people in general and more broadly toward institutions. So it is the trust you have toward the mayor of Boston telling you, you have to do that. Or in more recent time, one authority telling you, you had to get vaccinated or you have to lock down during COVID or stuff like that. I think that this is really, can you trust the institution? And of course, Italians are not fools. Most of them don't trust the institution because the institution are not trustworthy. I always make the reference and it's a very sad story, but you remember that in 2000...I think it was 2012, there was a big ship that went under in the Mediterranean Sea. It was a Costa Concordia. And the captain was an Italian. And as the ship was taking water on board, the captain told the passengers, everything is fine, go to your cabins. And the Americans in the ship went to their cabins and die. And the Italians went to the deck and jumped out. So I think that if the institutions are not trustworthy, it's very dangerous to trust them. But it's very important to be in an equilibrium in which you can

trust the institution. Now, as I said, they need to deserve your trust.

Michael Klein

So along with trust, there are also informal societal norms. All contingencies can't be legislated. And the good working of an economy depends upon these norms as much as, or even perhaps more than, formal regulations. You give an example in the book of students signing up for courses at your school and how what they did was not against the rules, but it was perceived as against the societal norms. Can you recount that experience and maybe say a few words about more broadly how that affects an economy?

Luigi Zingales

Sure. So the story is that at Chicago Booth, we assign classes through a bidding process in which students have a certain number of points and they allocate those points to the professors they like the most. And I think it's a clever way to make sure that you don't always have your favorite professor because your favorite professor is in short supply. However, in the old days—now this problem can be fixed—there was a trick that you could play to bid early on. If you are a second year student, you could bid before the first year students showed up for classes you knew the first year student would like a lot and then swap them and gain points in a way that was basically defeating the system. And I remember that when this was revealed, some of my colleagues said, I'm not so sure we should punish them. We should reward them because they were smart and they found the hole. And certainly they were smart and found the hole. But I think that from a societal point of view, it's a little bit dangerous when you don't put some limitation. And I think that this is very important when it comes, for example, to run large corporations. You can get away with a lot running a large corporation. And the question you have to ask yourself, do you want to do it or do you have some morality that limits how much you're going to push something? And I think that that's a very important point.

Michael Klein

So you said that the rules changed at Booth to prevent that activity. What does this say about the need to expand rules when norms break down or when the norms are insufficient?

Luigi Zingales

I think that this is, again, where my Italian experience is very helpful. Because in Italy, there were so many norms because you expected everybody to try to cheat at every corner. And then the norms become, first of all, overwhelming. Second, paralyzing. And third, so oppressive that you feel even justified to try to cheat because there is no sense of accountability and ownership in the norms. So this is where I say, to the extent this is possible – and sometimes it's not possible when things are too specific or there is too much money at play – but I think it's important to raise children, students, understanding that they should respect some norms that are good for society overall. And, but also, don't reward cheating. So I decided I'm going to teach in the spring and I decided that I'm going to let my students use ChatGPT as much as they want. And one of the reasons is because they're going to do it anyway. And if I start to put norms to restrict it, what I'm doing is I'm going to penalize the honest because the dishonest are going to do it anyway. And so the honest are going to be penalized. And plus, I think that ChatGPT is the future or general AI is the future. And so I think that students need to learn with the new tools; not to prepare for the past war.

Michael Klein

Luigi, do you think we're in a time now in the United States when the norms are breaking down? And if so, would changing the rules help? But of course, that raises a question, who would change the rules?

Luigi Zingales

I think that we are in an escalation of violation of norms on both sides of the political spectrum and everybody kind of point fingers, but they both do it massively. And I think that the result is, to me, devastating. And so how to go back in this situation? This is really the most difficult question to which, unfortunately, I don't have an answer, but I don't think anybody has an easy answer. I like to tell a lot of people a story that actually I learned from a podcast from NPR of a pasta factory in Italy that was able to change the social norm of the place where everybody was basically not showing up for work and pretended to be sick. But it takes a lot of effort and a little bit of luck to succeed. And even in for-profit organizations where there is a clear leadership and where there are clear incentives, etc., when it comes to the political arena, it's very, very hard to go back. That's the reason why it's so important not to deteriorate them, because it's much easier to scare some birds away than to bring them back.

Michael Klein

Or it's much easier to break things than to put them back together again.

Luigi Zingales

Definitely.

Michael Klein

In the first half of your book, *A Capitalism for the People*, you identify the problems. And then in the second half, you propose some solutions. To start talking about this, we have to consider whether there's a tension between fairness and equity. What is that tension?

Luigi Zingales

I think that there is definitely a tension, because if you want to create incentives, for example, to innovate, but also to work hard, etc., you have to pay people differently. And I think that that will create a sense of unfairness, especially when people cannot see what you're doing so visibly. I think that my impression is people are not very resentful when big football or basketball players are paid a fortune, because they see the value of those players. They're much more resentful when they see a CEO of a bank making a bazillion, because they don't know whether he really deserves and created that or not. So I think that that's one very important fundamental tension.

Michael Klein

Another tension that you identify in the book is this idea of a winner-take-all economy. And you say that that adversely affects people's perception of the fairness of the system. And through this, it contributes to an erosion of trust and a greater willingness to break the rules. What does winner-take-all economy mean? And how did it emerge?

Luigi Zingales

So, in general, if, let's say, the old days, a slightly better typewriter than you are, I make a little bit more money than you do, but nothing to write home about, right? That's the typical structure of the economy that we grew up experiencing, and that dominated most of the world, I think, in the 20th century. However, even in the 20th century, there were some sectors where this was not the case, because when it comes to, for example, singing, or even play soccer, people want to listen to the best player, not just the second one, or at least they are willing to pay a large premium to look to the first and not to the second. And this is at a time where technology made it possible for the first to satisfy very easily the demand of both. So, with the development of the digital technology, everybody can listen to Beyoncé all over the world, and everybody can see Messi all over the world. I grew up when Pelé was playing, but I grew up in Italy, I couldn't see Pelé playing. Today, everybody could see Messi from China to Thailand, to Europe, to the United States. And so, in this situation, the winner tends to be disproportionately rewarded. And this is not a problem per se, but it brings with it a very negative side effect, is that if I, for whatever reason, think that I don't stand a lot of chances to win, I might give up pretty soon. So, even if I learn pretty quickly that you're going to be a better typewriter than I am, there's no reason for me not to learn to type, because, yeah, I will make a little bit less than you, but I still will make a decent living and it's worthwhile for me to invest. On the other hand, if I pretty quickly realize I cannot be such a good tennis player, or such a good singer as you are, I'm not going to make less. I'm going to make basically zero. And so, why to make any effort? So, I give up from the beginning. And if you sort of add the fact that probably the people who started at an advantage are the people who are children of people who are, like, rich to begin with, or better connected, etc., that creates a sense of resentment, because, basically, you start to have a little oligarchy that transfers the benefits from parents to children, and the people, everybody else is left out.

Michael Klein

And I imagine it's an even worse situation for social cohesion if it's not Roger Federer, who's, you know, one of the greatest tennis players of all time, but somebody who is in a winner-take-all position because of political connections, rather than technological change or their own inherent talent.

Luigi Zingales

Oh, absolutely. I think that it becomes very difficult to justify the inequality, and there is a desire of resentment, of the subvert. And I think that this is what we are experiencing in the United States in the last 10 years. I think that one of the things I got absolutely right in that book, even if I basically got zero credit, is I wrote that book in 2012. Actually, in 2011, it came out in 2012, when Mitt Romney was running for president and almost won the presidency. Now, it's hard to imagine today, right? But at the time, it was there. And at that time, I wrote a chapter called 'Populism is Inevitable. The Only Question is which Form it will Take.' And eventually, I was vindicated, but I think that at the time, people kind of laugh at me.

Michael Klein

So you, in that book, did propose some solutions. What would you propose today? Because as you're alluding to, the world is very different a dozen years on from when the book was published.

Luigi Zingales

I think that some of the proposals I have are still intact. Some might need to change. And there is an entire sort of aspect I don't touch at all, which is the political side that I think needs to be addressed. Because there is a sense of an entire set of the population that feels left behind. It's people living in the Midwest, not in the two coasts. And feeling they're not part of the winning oligarchy. And as a result, being willing to take a lot of risk because they have nothing to lose. I think that that's a very important aspect that we've been ignoring for a long time. But so one thing that I did not discuss, for example, in that book, but I think now is very important, is think about how to change the taxation, and the use of land. Even in this respect, the United States has become much more like Italy. When I left Italy, houses were very expensive, especially vis-a-vis the average salary that people had. And the reason was that, of course, Italy is beautiful, but part of it was simply the fact that you couldn't build anything. And so if you have a growing population and a fixed supply, prices will go up. And a lot of the benefit of innovation will be appropriated by the landowner. Because if you create a new factory and you need to attract the workers, you need to pay the workers to be next to the factory. And if the houses are super expensive, you need to attract them by paying them a lot. And so at the end of the day, it's a form of rent extraction that benefits a lot the homeowner. And I think that this is creating many of the distortions I've seen in Italy. For example, children that don't leave the house of their parents because it's too expensive to live on their own. Children that wait to get married and start a family because it's too expensive. And very little migration to go where the opportunities are. And I think that the solution is to make it easier to build. And my favorite line would be to say that you can deduct your local taxes only if in that town there is a very permissive policy in terms of building. If not, you eat your taxes, your local taxes. So that would create a strong incentive at the local level to have a system that is much more open to innovation. I think that that, to me, is an important step.

Michael Klein

Well, that issue certainly resonates in the United States now. And more broadly, the kinds of things that we've been discussing over this last half hour or so are things that are really relevant for the performance of the U.S. economy and people's views of the economy. But typically, economists look at more narrow questions. So I applaud you for looking at this broad issue and bringing an economic lens to these problems, which really are going to be things that we are going to have to address moving forward. So, Luigi, thank you very much for joining me today on EconoFact Chats. I very much enjoyed our conversation.

Luigi Zingales

Likewise. Thank you for having me.

Michael Klein

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