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The Impact of FEMA on U.S. Corruption: Implications for Policy

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THE IMPACT OF FEMA ON U.S. CORRUPTION:

IMPLICATIONS FOR POLICY

PETER T. LEESON AND RUSSELL S. SOBEL

EXECUTIVE SUMMARY

With the Hurricane Katrina debacle raising questions about public corruption's impact on disaster relief, corruption has once again become an important issue in American politics. This comment, however, analyzes not corruption's impact on disaster relief, but rather the impact that disaster relief has on corruption.

Disaster relief floods money and resources into the affected area, which provides public officials the incentive and opportunity to gain wealth through corrupt practices. Our analysis shows that states that receive more disaster relief also have more instances of public corruption.

Corruption not only hinders the effective management of disaster relief, but it also has long-term consequences for economic prosperity. More corruption is associated with lower growth and investment, and states that receive disaster relief often suffer from these effects.

When determining the best course of action, policy makers must remember that increased corruption is an unintended consequence of disaster relief. Increased oversight is unlikely to solve the problem of corruption because of the circumstances surrounding natural disaster. The time sensitive nature of the disaster relief means that protocol will take a backseat when disasters actually strike.

Policies that assume the federal government plays the primary role in disaster response are the most susceptible to corruption. Total elimination of public corruption generated by disaster relief will not be possible so long as FEMA relief exists. Any plan to reform disaster relief that intends to minimize corruption should recognize the role of local actors, presumably charities and business, and create space for them to react in time of crisis. Policy makers should recognize the consequences of disaster relief when dealing with urgent crises in order to make sure that they do not hinder the long-term prosperity of a community.

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The Impact of FEMA on U.S. Corruption:
Implications for Policy

INTRODUCTION

A key insight of economics is the unintended, often undesirable, consequences of government activity. Although the idea that government policy may create harmful secondary effects is well-known, too often when policy makers craft policies designed to promote the public welfare they seem to ignore these effects. This Policy Comment demonstrates the harmful, secondary effects of government natural disaster relief.

Between 1990 and 2002, more than 10,000 public officials in the United States were convicted of crimes related to corruption. The majority of these convictions occurred in states also hit more severely by natural disasters. For instance, Mississippi, Florida, and South Dakota averaged 7.5 corruption-related convictions per 100,000 residents during these twelve years. In contrast, the national average was only four corruption-related convictions per 100,000 citizens. During the same period, Mississippi, Florida, and South Dakota averaged nearly 19 natural disasters each. The average state, however, suffered less than 12 natural disasters during this time. The most disaster-prone states are also the most corrupt.

Bad weather, per se, could not be responsible for this relationship. Hurricanes or earthquakes by themselves cannot make the states they strike more corrupt, but government-provided relief that follows these disasters can. Natural disasters trigger resource windfalls in affected states in the form of Federal Emergency Management Agency (FEMA) natural disaster relief. These windfalls create incentives for political actors to appropriate the newly-available resources. One of the chief ways they do this is through corruption, the abuse of their public authority for private gain.

Corruption creates problems. Chief among them is that corruption harms economic performance in several ways. Each of its harmful effects interrupts the process of wealth creation and may reduce economic progress.[1] Continuing progress requires economic policy that minimizes public corruption. However, the only disaster relief policy consistent with this objective involves eliminating, or at least seriously reducing, the size of FEMA-provided disaster relief. Policy makers face a tradeoff. They may have less corruption but less FEMA relief or more FEMA relief but more corruption; they cannot have the best of both.

[1] We are concerned only with the effect of disaster relief on public sector corruption. We are not making any claim with regard to the size of that effect. We are simply saying that this effect exists and could be a threat to economic growth in the United States.

This Policy Comment explains how FEMA-provided disaster relief causes corruption in America. The fundamental, policy-relevant ideas in this comment are three-fold:

- Government-provided disaster relief generates unintended, undesirable consequences, manifested in the form of new incentives and opportunities for public corruption. Disaster-relief policy that does not bear this in mind will not only be ineffective, but will also likely exacerbate public corruption.

- To eliminate the harmful effects of public corruption, government must remove itself from the disaster-relief process; increased oversight of relief will not do. There are two reasons for this. First, increased relief oversight necessarily channels resources and efforts away from relief itself to montoring corruption. In doing so, it compromises the primary goal of disaster relief: assisting disaster victims. Second, the nature of public sector corruption makes corruption-oversight measures "time inconsistent." When the opportunity for profitable corruption arises in the wake of natural disaster, political agents are likely to break the stricter oversight policies devised today. Policy aimed at retarding the harmful effects of public corruption following natural disasters should focus on eradicating the root of its cause: FEMA-provided disaster relief.

- Disaster relief policies intended to minimize corruption should recognize that the potential for corruption increases when there is a distance between the dollars allocated and the dollars spent. Any plan for reforming disaster relief should recognize the role of local actors, presumably charities and businesses, and create space for them to react in time of crisis. Policies that assume the federal government plays the primary role in disaster response are the most susceptible to corruption.

We have organized this Policy Comment as follows. First, we discuss how public sector corruption adversely affects economic performance. We then explain how FEMA-provided disaster relief increases public corruption. Next, we empirically consider the magnitude of FEMA's effect on corruption in the United States. In the last section of this comment, we provide the policy implications of our analysis.

A. The Economic Impact of Public Sector Corruption

Public sector corruption occurs when political officials abuse their public authority for private gain. There are three ways that political officials may do this. First, political officials may steal public funds directly through embezzlement. Second, political officials may transfer government funds indirectly to private parties for their (i.e., political officials') own gain. Bribes and kickbacks are good examples of this. A political agent in charge

of contracting out a government service may, for instance, offer the contract to the party willing to offer him the largest side payment instead of the best provider. Finally, public officials may manipulate the legal rules they are charged with enforcing, for their personal benefit. A regulatory inspector, for example, may solicit or accept bribes from private individuals subject to regulatory inspection in return for his approval.

In 1995, International Monetary Fund (IMF) economist, Paolo Mauro, published the first study that investigated the relationship between corruption and economic growth.[2] Mauro found that countries with more public sector corruption grow more slowly than those with less public sector corruption. Several reasons account for this finding:

1. Corruption directs public sector resources to unproductive ends that benefit political actors, but yield no benefit for society. For example, corrupt public officials may steal funds earmarked for critical infrastructure projects, such as roads, that would improve individuals' abilities to interact for mutual benefit. While corrupt political actors gain through this, society loses. Similarly, corruption directs private sector resources to satisfying corrupt political figures instead of wealth-enhancing activities. This diversion of resources, while profitable to corrupt politicians, constitutes a loss from the perspective of society. Resources that could have been employed for the production of goods or services are instead used to appease corrupt political actors. For instance, if prospective producers must bribe bureaucrats in order to start businesses, the resources they spend this way cannot be used to produce goods that would contribute to society's wealth.

2. Corruption thwarts the regular workings of the competitive process that tend to channel resources to their most highly valued uses. For example, in the absence of corruption, government agents select vendors because they are the most efficient suppliers and thus able to place the lowest bid. In the presence of corruption, however, this process does not work. Public agents instead choose vendors on grounds unrelated to their efficiency—because they agree to provide political support to the public agent charged with vendor selection for instance, or because they have the highest willingness to pay bribes. As a result, resources are channeled according to political criteria instead of economic criteria that tend to direct resources to the most capable producers.

[2] Paulo Mauro, "Corruption and Growth," *Quarterly Journal of Economics*, 110(3) (1995): 681-712.

3. Corruption lowers the payoff of wealth-producing activities and raises the payoff of seeking government resources or even becoming a corrupt political agent oneself. For example, if a producer must pay bribes to corrupt political agents to produce, he may find production less profitable than becoming a political agent, thereby drawing time and talent away from activities that contribute to social wealth.

These are the most direct ways that public sector corruption harms the process of wealth creation and economic growth. However, there are also less tangible, indirect harms that corruption imposes on the economy. For example, highly corrupt governments foster a general disregard for the rule of law, which society requires for economic growth. Significant corruption in one area, such as bribes demanded by bureaucrats from citizens to obtain permits or licenses to set up businesses, may spread to other areas of citizens' lives where they begin to see corruption as a reasonable way to achieve their ends.

An individual who has been forced to pay bribes to open his business and is later accused of committing a crime, for instance, may not wait this time for the relevant political actor, in this case the judge, to solicit his graft. He may offer it up himself and in doing so tempt the judge to accept his payment, even though in the absence of his offer the judge would have behaved honestly. In this way, corruption may spread and undermine other important elements of the politico-economic order, which in the long run destroys society's capacity to create wealth. "Institution-destroying" effects of public sector corruption such as these are difficult to quantify and thus less frequently discussed, but they are very real all the same.

B. How FEMA Causes Corruption

B.1 The "Windfall Curse"

Among the less developed countries of the world, a peculiar phenomenon exists. An abundance of natural resources leads not to wealth and prosperity, but to poverty. Economists call this counter-intuitive phenomenon the "natural resource curse," which the following logic explains at least partly. Rich and valuable natural resources, such as large oil deposits in the Middle East, create a windfall of resources to their owners. In most developing countries, like Nigeria, these owners are governments. The ability to exploit the resource cheaply creates cash inflows that fall on its owner with little effort. This windfall fuels corruption in two ways:

1. First, when the owner is the government, the presence of the resource increases the power of the government over the economic lives of its citizens. Since the bulk of the profits citizens can make in this economy stems from exploiting the natural resource, citizens need to be in the government's good graces. This situation creates new opportunities for govern-

ment officials in charge of access to the resource to solicit bribes or other forms of graft from citizens seeking to benefit from the resource-created windfalls.

2. Second, the resource's presence increases the value of being its political owner or a public gatekeeper to its access. This creates a flurry of activity by political actors to improve their status vis-à-vis the resource. One of the forms that this activity may take is corruption. For instance, political actors may engage in criminal behaviors at the behest of their superiors in an effort to gain increased authority over the valuable resource.

Research that examines the effect of foreign aid on corruption in developing countries corroborates the positive relationship between resource windfalls and government corruption. Recent work suggests that there is a "foreign aid curse" analogous to the "natural resource curse" discussed above.[3] Like rich natural resources, foreign aid disbursements to governments in developing countries also create resource windfalls. These windfalls generate similar incentives and thus similar behaviors to those described above in the case of natural resources, including increased public sector corruption.

B.2 FEMA-Relief Windfalls

Government-provided natural disaster relief creates resource windfalls in much the same way that natural resources and foreign aid do. Under the current system of disaster relief, a disaster striking a state in the United States triggers the flow of federal relief from FEMA in the form of cash and supplies to the affected area. Federal relief constitutes a resource windfall for the recipient state. Financial resources and physical goods are channeled to the state through no effort of its own. Following our logic from the natural resource and foreign aid curses above, it is not difficult to anticipate the likely effect of natural disaster relief windfalls: they increase public sector corruption.

FEMA-relief creates three new avenues of public corruption following a natural disaster:

1. The first is new opportunities for direct expropriation of earmarked funds or physical resources. The influx of funds and resources suddenly in the control of state and local officials often proves too great a temptation to withstand. For example, an employee of Florida's Department of Health and Rehabilitative Services attempted to embezzle $48,000 in FEMA relief following a 1998 hurri-

[3] Simeon Djankov, Jose Montalvo, and Marta Reynal-Querol, "The Curse of Aid" (mimeo, 2005).

cane.[4] Accusations of a similar nature have surfaced surrounding relief efforts following hurricanes Katrina and Rita.[5]

2. Second, natural disaster relief increases the ability of public officials to transfer government funds to private individuals for their own gain. These opportunities arise because of the structure of government relief efforts. For instance, for an individual to receive aid, a public official must assess the damage that the individual suffered and determine the amount of aid to be awarded. In this capacity, public officials enjoy new opportunities to facilitate individuals' fraudulent claims in return for bribes. This form of corruption can be very lucrative. In Louisiana, for example, Wayne P. Lawless, a Louisiana Department of Labor clerk, recently pleaded guilty to exchanging fraudulent disaster unemployment benefits for bribes.[6]

3. The third new avenue of public corruption created by FEMA-relief windfalls is cronyism. In the aftermath of a disaster, public funds finance large rebuilding projects. These projects present political officials with new opportunities to reward friends and supporters with lucrative contracts. This is what happened, for example, to the FEMA relief that went to rebuild bus shelters in Guam after it was hit in 1997 by Super Typhoon Paka. The Governor of Guam's Chief of Staff corruptly awarded the rebuilding contract to the Governor's primary business rival in return for the rival's support of the Governor in the 1998 gubernatorial campaign.[7] Similarly, in Mississippi, reconstruction contractor Mitchell Kendrix and Army Corp of Engineers representative Paul Nelson pleaded guilty to a scheme in which Kendrix falsely approved loads of hurricane debris from Nelson in return for bribes. [8]

B.3 Compounding Corruption

Several factors unique to the circumstances in which FEMA disperses relief compound the corruption problem that government-provided natural disaster relief creates:

1. First, owing to their largely uncontrollable and unpredictable natures, natural disasters breed chaos and confusion where they

[4] "FEMA Worker Held for Trial in 1998 Scheme to Steal $48,000," *Insurance Journal,* May 27, 2005.
[5] See for instance "In Louisiana, Graft Inquiries Are Increasing," *New York Times*, March 18, 2006 and "FEMA Officials Arrested in New Orleans on Federal Public Bribery Charges," *US Fed News*, January 27, 2006.
[6] Department of Justice, *Press Release*, July 17, 2006.
[7] Department of Homeland Security, *Semiannual Report to the Congress, April 1, 2004-December 30, 2004.*
[8] Eric Lipton,"'Breathtaking' Waste and Fraud in Hurricane Aid," *New York Times,* June 27, 2006.

strike. The resulting mayhem facilitates new opportunities for relief-related corruption. In an environment of confusion, it is more difficult to monitor where relief resources are going and how they are being used. Since the likelihood that corruption will be detected drops considerably, this lowers the political actor's cost of engaging in abusive activities.

2. Adding to this problem is the issue of disaster relief prioritization. In the midst of a devastating natural disaster, evacuating victims, tending the injured, and finding provisions and shelter for refugees is, quite justifiably, considered more important than keeping an eye on unscrupulous political actors to ensure that they do not behave corruptly. The time-sensitive nature of many disaster-related relief activities demands that relief be a priority and corruption monitoring/punishment take a back seat. With attentions focused on relief activities instead of corruption, public officials are less likely to be caught engaging in corrupt activities. This leads them to undertake more corruption.

   In the disaster's aftermath this situation is not much different. Until wreckage is removed, families are reunited, and reconstruction is underway, turning government's attention to public sector corruption seems inappropriate and unlikely. Typically, attention only turns to public abuses that occurred in the midst of the disaster's chaos after the chaos has calmed down. Like above, these features of natural disasters make it easier to get away with abuses and so facilitate public sector corruption.

3. Third, the nature of the task FEMA faces during response, relief, and recovery efforts makes it difficult in many cases to assess the relief-related activities undertaken or overseen by political officials. Hauling debris, for example, is not an exact science. Neither is determining the level of damage to individuals' property. Relief and recovery-related activities such as these create ample latitude for corrupt public officials to engage in criminal behavior, such as accepting government finances for clean up without undertaking actual work.

4. Fourth, because natural disasters are irregular, so too is the flow of natural disaster relief. As a result, there tend be fewer and less effective checks on relief-related spending than other forms of government spending. There is less oversight and fewer well-defined mechanisms for detecting public abuse of disaster relief funds than there is, for instance, for the federal disbursement of educational monies to states. This has the effect of lowering the cost of engaging in disaster relief-related corruption, providing addi-

tional incentive for corrupt political actors to do so.

5. Lastly, the distance between government disaster relief disbursement, which is at the federal level, and disaster relief receipt, which is at the state or local level, contributes to heightened corruption created by disaster-relief windfalls. It is more difficult for the federal government to monitor resources used at the state and local level than it would be for state and local government authorities. The large separation between the principle—the federal government—and the agent—state and local recipents—reduces the cost of unscrupulous state and local public officials corruptly appropriating and distributing relief resources. This, of course, leads to greater corruption.

Each of the factors considered above are particular to natural disaster-generated relief windfalls under current American disaster relief policy. They tend to exacerbate the corruption-enhancing effect of FEMA relief, making its initial impact even worse. Thus, when it comes to corruption, FEMA-provided disaster relief is doubly damaging. On the one hand, the windfalls it generates increase corruption in the form of activities such as bribes, kickbacks, etc. On the other hand, the unavoidable appearance of these windfalls in the midst of a natural disaster (the impetus for their disbursement in the first place) compounds this increase since windfalls appear at the worst possible time, when monitoring, detection, and punishing mechanisms for corruption are at their weakest.

C. Empirical Evidence for the Impact of FEMA Relief on Corruption

In a recent study, the authors examine the relationship between FEMA relief spending and public sector corruption in the United States.[9] This study measures corruption with the average number of corruption-related crime convictions per capita by state between 1990 and 1999. It estimates the impact of FEMA relief on state-level corruption by taking average FEMA relief received by each state per capita over this period and also controlling for a number of other variables that previous research identifies as important determinants of public corruption. For instance, more racially fragmented states tend to be more corrupt, as do poorer states, states with

[9] Peter T. Leeson and Russell S. Sobel, "Weathering Corruption" (working paper, Mercatus Center at George Mason University, Arlington, VA, 2006).

laxer laws punishing public corruption, less educated states, more populous states, and states with greater income inequality.

Regional location may also be correlated with corruption. If, for instance, historical factors contribute to the level of corruption across states and these factors are clustered geographically, controlling for states' regional status will adjust for this. Other forms of government spending, both at the state and federal level, may also contribute to the level of corruption in states. To account for this, the authors' study also adjusts for non-FEMA related state spending and non-FEMA related federal spending in each state.

Finally, it is important to account for the direction of causation. For instance, while the "windfall curse" reasoning discussed above suggests that greater FEMA spending should increase corruption, it is also likely that states that are more corrupt have political actors who are more adept at corruptly attracting disaster relief resources in the first place. Political officials in a highly corrupt state, for example, may manipulate the appearance of the damage incurred following a natural disaster in order to attract more federal funds to corruptly appropriate. In order to correctly measure the impact of FEMA relief on corruption, however, an empirical examination must make sure that it isolates only the arrow of causation going from FEMA relief to public corruption, excluding the arrow of causation that runs the opposite direction.

Questions like this that deal with the issue of causality can be difficult to overcome in empirical analyses. Fortunately, we were able to address this issue by using a third variable,[10] private insurance property claims from natural disasters.

Our results confirm the "windfall curse" logic discussed above and hinted at by the anecdotal evidence pointed to earlier in this section. FEMA-provided disaster relief increases American corruption. Each additional one dollar per capita in average annual FEMA relief increases corruption nearly 2.5 percent in the average state. Abolishing FEMA relief would reduce public sector corruption by more than 20 percent in the average state. The results of this study explain the seemingly bizarre relationship between bad weather and public sector corruption noted in this paper's introduction. Natural disasters create resource windfalls in the states they strike by triggering federally-provided natural disaster relief. Disaster relief windfalls in turn increase corruption. States that are more frequently and

[10] We can isolate the causal arrow of interest by examining the connection between something we know cannot be manipulated by corrupt political actors and FEMA relief and then using the part of FEMA relief explained by this variable to investigate the impact of FEMA relief on corruption.

severely hit by natural disasters, such as Louisiana and Mississippi, attract more FEMA relief than other states, making them more corrupt than these other states as well.

D. Implications for Policy

If policy makers want to reduce the extent of public corruption in the United States, then the most effective way to do so would be to reduce FEMA relief. Every reduction in one dollar per capita in average annual FEMA relief will reduce the average state's level of public corruption by about 2.5 percent. If the federal government did not provide FEMA relief to states following natural disasters, the average state's level of corruption would fall by about 22 percent.

Importantly, tinkering with federally-provided disaster relief, for instance by increasing government oversight of FEMA relief following natural disasters, is unlikely to be effective and may in fact interfere with the overriding objective of government disaster relief: assisting victims of natural disaster. There are three reasons for this:

1. As discussed above, the time-sensitive nature of natural disaster recovery, relief, and reconstruction puts a priority on assisting those in need instead of monitoring and bringing to justice unscrupulous political actors who use disaster-wrought havoc to corruptly appropriate relief-related resources or abuse in other ways their positions of public authority for private gain. However, strengthening government oversight of public sector corruption following a natural disaster and devoting greater energy to this cause would necessarily come at the expense of the relief process's ultimate end of saving lives and restoring those that have been damaged. Each dollar or unit of time used to monitor public sector corruption is a dollar or unit of time that cannot be devoted to, for instance, evacuating disaster victims. Thus, although increased oversight of FEMA relief may raise the cost of corruption and thus reduce corruption somewhat, it would come at a cost most policy makers and other individuals, quite reasonably, would not be willing to pay.

2. More stringent mechanisms for monitoring and disciplining public sector corruption in the case of natural disaster are unlikely to be effective. Such mechanisms suffer from what economists call a "time-inconsistency problem." Although political actors may under normal circumstances desire to reduce public sector corruption, when a natural disaster hits and a myriad of new, highly profitable avenues of corruption related to relief activities emerge, they are unlikely to use the mechanisms they created before the disaster for monitoring relief-related corruption. The creation of

new, profitable avenues of corruption following the disbursement of FEMA relief makes using these mechanisms more costly to them. Political actors' desires in non-disaster times are inconsistent with their desires after a disaster has actually hit. By applying the more stringent corruption-monitoring mechanisms they devised before the disaster, political agents forego more income in the form of increased opportunities for corruption. It is therefore less likely that they will actually make use of them.

3. There is also another problem of putting into practice more stringent corruption-detection mechanisms. If corrupt political actors devise these mechanisms, they will design mechanisms that do not effectively improve upon existing ones, so as not to upset their abilities to corruptly appropriate and transfer relief resources. Thus, if state-level officials are in charge of devising the new mechanisms, corrupt states—the states that need these mechanisms most—are unlikely to introduce more stringent corruption-detection mechanisms or punishments.

4. Disaster relief policies intended to minimize corruption should recognize that the potential for corruption increases when there is a distance between the dollars allocated and the dollars spent. Any plan for reforming disaster relief should recognize the role of local actors, presumably charities and businesses, and create space for them to react in time of crisis. Policies that assume that the federal government plays the primary role in disaster response are the most susceptible to corruption.

5. The longer FEMA is involved in a post-disaster context, the more opportunities there will be for corruption. In order to minimize the opportunity for corruption, FEMA should exit as soon as possible following a disaster. FEMA was not designed to operate months or years after a disaster, and policy reforms should recognize this.

At the very least, policy makers must be aware of the unintended, undesirable consequences of government-provided natural disaster relief. Although, for the reasons recounted above, it is unlikely that marginal changes in the process or oversight of FEMA relief would appreciably reduce the effect of FEMA relief on public corruption, it is critical that any disaster relief policy keep in mind the corruption-enhancing impact of providing natural disaster relief through government.

CONCLUSION

In this Policy Comment we explain the role of government-provided disaster relief in increasing public sector corruption in the United States. We first explain why and how corruption harms the wealth-creation process and may reduce economic

progress. We then discuss how resource windfalls, for instance from natural resources and foreign aid, alter the incentives of political actors and set in motion forces allowing them to engage in additional, unproductive corrupt activities. Next, we address how FEMA natural disaster relief creates similar resource windfalls that engender the same kind of public actor incentive shift and increased engagement in corruption.

This concatenation of factors explains the seemingly strange connection between U.S. states with bad weather and high levels of corruption. States located in places prone to more frequent and severe natural disasters receive more FEMA relief. When a natural disaster strikes, federal relief to the affected areas creates a resource windfall in the state hit by the disaster. This resource windfall leads to increased corruption, causing states that receive more FEMA relief to be more corrupt than others.

The results of a study we conducted estimates that each additional one dollar per capita in average annual FEMA relief increases public sector corruption nearly 2.5 percent in the average state. The average state's level of corruption would fall by over 20 percent if policy makers totally abandoned FEMA relief.

Policy makers must bear in mind that government disaster relief generates unintended, undesirable consequences. In the case of natural disaster relief, these manifest in the form of increased corruption. Policy proposals that would only tinker with the existing system by strengthening oversight of FEMA relief and monitoring of relief-related activities more closely are unlikely to work and may jeopardize disaster relief's ultimate goal: assisting disaster victims.

Stronger relief oversight and disaster-related corruption monitoring devotes precious time and resources to a subsidiary concern when disaster victims urgently need recovery and relief. Furthermore, such changes are time-inconsistent; political actors have little incentive to implement these mechanisms following a natural disaster. Finally, so long as the windfall exists, corrupt political actors have an incentive to stay one step ahead of the new rules. The best way to reduce the corruption-creating impact of FEMA relief is to reduce this relief's size. Total elimination of public corruption generated by disaster relief will not be possible so long as FEMA relief exists.

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