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Corruption and development

What are the main causes and costs of corruption? This note examines that question and suggests ways to enhance anticorruption efforts in developing and transition economies.

Corruption's costs

The growing body of theoretical and empirical research on the economic impact of corruption suggests that:

- Bribery is widespread, but there are significant variations across and within regions. For example, survey responses suggest that Botswana and Chile have less bribery than many fully industrialized countries.
- Bribery raises transactions costs and uncertainty in an economy.
- Bribery leads to inefficient economic outcomes. It impedes long-term foreign and domestic investment, misallocates talent to rent-seeking activities, and distorts sectoral priorities and technology choices (by, for example, creating incentives to contract for large defense projects rather than rural health clinics specializing in preventive care). It pushes firms underground, undercuts the state's ability to raise revenues, and leads to ever-higher tax rates being levied on fewer and fewer taxpayers. This, in turn, reduces the state's ability to provide essential public goods, including the rule of law. A vicious circle of increasing corruption and underground economic activity can result.
- Bribery is regressive, falling heavily on trade and service activities undertaken by small enterprises.
- Corruption undermines the state's legitimacy.

It is sometimes argued that bribery can have positive effects under certain circumstances by giving firms and individuals a means of avoiding burdensome regulations and ineffective legal systems. But in corrupt societies many politicians and bureaucrats exercise enormous discretion to help fuel the growth of excessive and discretionary regulations on entrepeneurs.

Empirical evidence refutes the "grease" and "speed money" arguments. Responses from more than 3,000 firms in 58 countries surveyed in the World Economic Forum's Global Competitiveness Survey for 1997 indicate that enterprises reporting a greater incidence of bribery also tend—even after taking firm and country characteristics into account—to spend a greater share of management time with bureaucrats and public officials negotiating licenses, permits, signatures, and taxes (figure 1).

Bribes are equally pernicious when they override regulations needed by society, such as building codes, environmental controls, prudential banking regulations, and restrictions on logging in tropical rain forests. The obscure insider lending practices and improper financial schemes resulting from poorly supervised financial schemes have contributed to macroeconomic crises in Albania, Bulgaria, and several Asian countries. Finally, bribers can also purchase monopoly rights to markets—as, for example, in the energy sectors in some transition economies, where unprecedented amounts

Growing recognition and discussion of corruption have made it possible to address its costs and causes of grease payments buttress gigantic monopolistic structures.

Corruption's causes

Corruption is widespread in developing and transition economies, not because their people are different from people elsewhere but because conditions are ripe for it. First, the motivation to earn income is extremely strong, exacerbated by poverty and by low and declining civil service salaries and the absence of risk-spreading mechanisms (including insurance and a well-developed labor market).

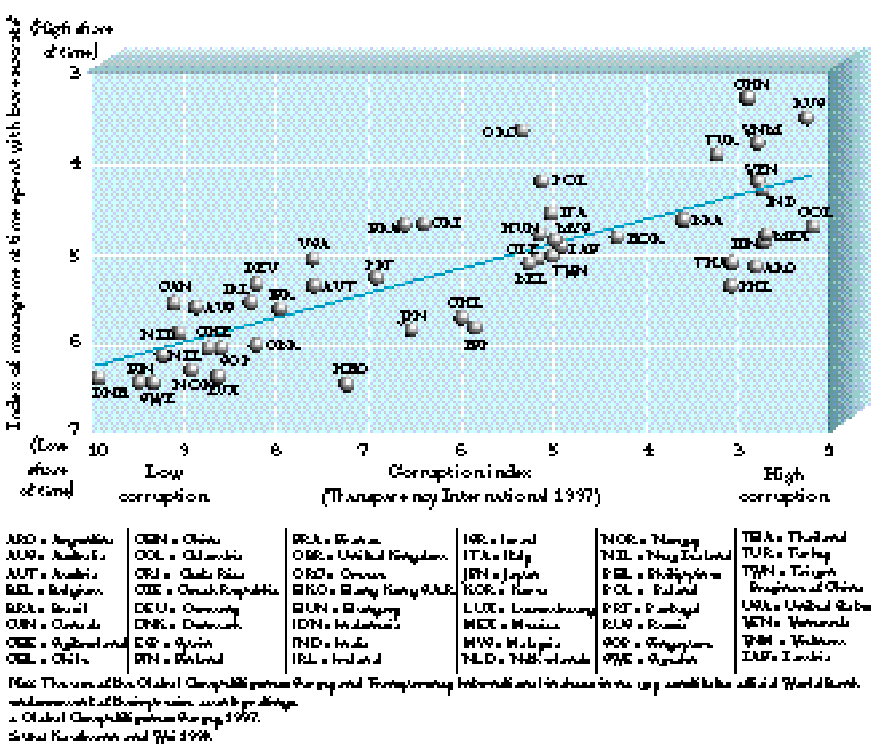
Second, opportunities to engage in corruption are numerous. Monopoly rents can be very large in highly regulated economies—and in transition economies, where property is essentially up for grabs. The discretion of many public officials is broad in developing and transition economies, and this systemic weakness is exacerbated by poorly defined, ever-changing, and poorly disseminated rules and regulations.

The cost of capital for firms tends to be higher where bribery is prevalent—and corruption imposes a significant tax on foreign direct investment in all regions

Third, accountability is typically weak. Political competition and civil liberties are often restricted. Laws in government are poorly developed, if they exist at all, and the legal institutions charged with enforcing them are ill prepared for this complex job. The watchdog institutions that provide information on which detection and enforcement is based—such as investigators, accountants, and the press—are also weak. Yet strong investigative powers are crucial. Because the two parties to a bribe often both benefit, bribery can be extremely difficult to detect. Even if detection is possible, punishments are apt to be mild when corruption is systemic—it is hard to punish one person severely when so many others (often including the "enforcers") are likely to be equally guilty. And the threat of losing one's job is a limited deterrent when official pay is low.

Finally, certain country-specific factors, such as population size and natural resource wealth, also appear to be positively linked with the prevalence of bribery.

Figure 1 Where bribery is perceived to be high, firms' managers spend more time with government bureaucrats



Creating political will

Understanding what makes powerful politicians do what they do, and which interests they represent, is of paramount importance in addressing corruption. Finding pockets of political support is crucial; even in countries where corruption is endemic, there are likely to be some reform-minded decisionmakers whose constituencies will support reform to further the country's broader interests. And windows of opportunity may open up when there is a change in regime or in individual leadership, or when there is a crisis. When such special opportunities are absent, though, the necessary political will may still be generated—albeit more slowly—by efforts to enhance public awareness and mobilize civil society to support anticorruption efforts.

Constructive pressure and assistance from abroad is certainly not decisive, but it can help. International organizations and donors can help to focus attention on corruption and support reformists in government and civil society. Furthermore, in an increasingly integrated global economy countries competing for foreign investment are discovering that foreign investors value stability, predictability, and honesty in government. Evidence is emerging that corruption imposes a significant "tax" on foreign direct investment in all regions of the world, including East Asia.

Tackling corruption

Is fighting corruption worth the bother? Skeptics point out the dearth of successes in anticorruption drives and the fact that it took England more than a century to bring corruption under control. But Hong Kong (China) and Singapore, for example, have shifted reasonably quickly from being very corrupt to being relatively clean. Botswana has been a model of propriety for decades. Chile has performed well for many years, and Poland and Uganda have recently made progress in controlling corruption.

What are the most common features of these successes? Anticorruption watchdog bodies, such as the Independent Commission Against Corruption in Hong Kong (China) and smaller corruption-fighting institutions in Botswana, Chile, Malaysia, and Singapore, are often credited with much of the progress. In contrast, the broader economic and institutional reforms that have taken place simultaneously have not received sufficient credit. The government that came to power in Uganda in 1986 implemented a strategy encompassing economic reforms and deregulation, civil service reform, a strengthened auditor general's office, the appointment of a reputable inspector general empowered to investigate and prosecute corruption, and a public information campaign against corruption. In Botswana sound economic and public sector management policies led to honest governance early on; the country's success in fighting corruption has not been principally derived from the more recent advent of its anticorruption department.

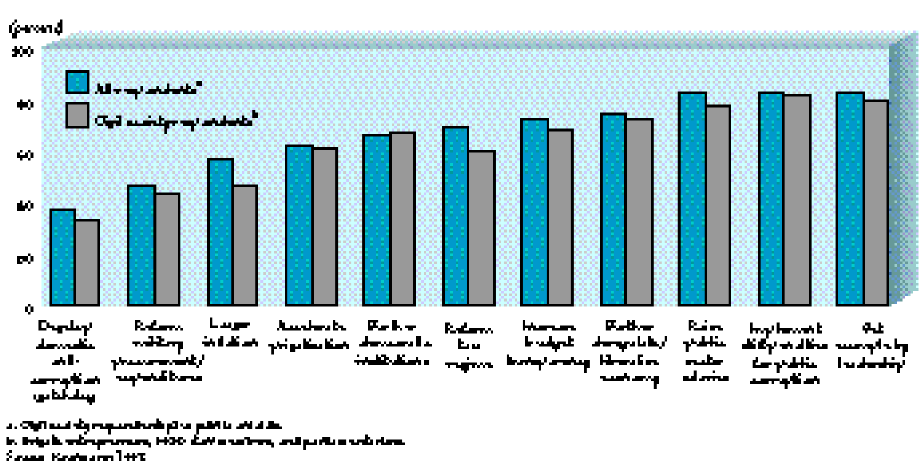
In a recent survey public officials and members of civil society in developing economies rated the effectiveness of anticorruption watchdog bodies the lowest on a list of possible anticorruption measures (figure 2). To be credible, they felt, such watchdog bodies needed to be created in a political environment characterized by honest leadership, insulation of civil servants from political interference, and revamped incentives that discouraged corruption. Otherwise, such bodies could easily be rendered useless or, worse, misused for political gain. The respondents emphasized the importance of economic liberalization and budgetary, tax, and regulatory reforms, soundly rejecting the notion that such reforms fuel corruption.

In fact, survey respondents thought their countries should have made more progress in implementing broad reforms and indicated that corruption and vested financial interests were key reasons for their slow progress. While emphasizing first and foremost the domestic causes of corruption, many respondents also indicated that bribery by foreign firms played a significant role. They thought that OECD members should enforce antibribery legislation abroad and that international institutions should make curbing corruption a priority when providing assistance to their countries.

In sum, addressing corruption effectively requires an emphasis on prevention—that is, reforms of economic policies, institutions, and incentives—if enforcement measures taken by the police, ethics offices, or government watchdogs are to bear fruit.

International organizations and donors can help to focus attention on corruption and support reformers in government and civil society

Figure 2 What should be done about corruption?



The entrenched nature of systemic corruption requires boldness in implementation—incrementalism is unlikely to work

The following are only some of the major economic policy changes that will unambiguously reduce opportunities for corruption: lowering tariffs and other barriers to international trade; unifying market-determined exchange rates and interest rates; eliminating enterprise subsidies; minimizing regulations, licensing requirements, and other barriers to entry for new firms and investors; demonopolizing and privatizing government assets; and transparently enforcing prudential banking regulations and auditing and accounting standards. The reform of government institutions may include civil service reform; improved budgeting, financial management, and tax administration; and strengthened legal and judicial systems. Such reforms should involve changing government structures and procedures, placing greater emphasis on competition and incentives within the public sector, and strengthening internal and external checks and balances. As a complement to these broader reforms, the transparent implementation of enforcement measures, such as prosecuting some prominent corrupt figures, can also have an impact.

Emphasis should be placed on selecting measures that are in line with a country's implementation capabilities during an anticorruption campaign. The entrenched nature of systemic corruption requires boldness in implementation—incrementalism is unlikely to work. Genuine reformers will want to move quickly beyond the general first principles contained in a country assessment to demand practical, country-specific advice. For instance, technocratic lessons are beginning to emerge as to how different privatization methodologies may contain greater or lesser opportunities for corruption, how the strengthening of banking regulations needs to reflect the particular lessons the country has learned about dealing with perverse political influences, and how specific innovations in procurement and bidding methods can reduce corruption.

Finally, practitioners need to search for the information gathering and dissemination methods that can have the quickest and most direct impacts. The Bangalore (India) NGO scorecard method, whereby users rated local service-providing agencies, has already resulted in firings of officials, improved service delivery, and a decreased incidence of bribery. Gathering data and publicizing the vastly different costs of publicly provided school lunches in various localities have brought about government reforms. The existence of a free press is of paramount importance. To safeguard citizens' freedoms of expression and information, libel laws protecting politicians and public officials must not be overly restrictive. Indeed, however difficult and imperfect gathering data and disseminating information about corruption are, the importance of these activities cannot be overstated. Secretiveness has helped elites and politicians keep corrupt practices under wraps in many countries. Careful analysis, presentation, and dissemination of data can be very effective in raising general awareness, creating momentum for reforms, and furthering our limited understanding of what does and does not work in efforts to control corruption.

This note is adapted from an article in the March 1998 Finance and Development *written by Cheryl W. Gray (Interim Director, Public Sector, PREM Network) and Daniel Kaufman (Lead Economist, Development Research Group, Development Economics). For further reading on corruption-related topics, visit the Knowledge Management System website (http://kms).*

PREM network Poverty Reduction and Economic Management

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