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Introduction: The Costs of Corruption

Poverty, poor health, low life expectancy, and an unequal distribution of income and wealth are endemic throughout the world. Many countries have very low or negative growth rates. Even some countries that are well endowed with natural resources have poor growth records and low per capita incomes. Others, especially in the former Soviet bloc, have weak economic records in spite of a well-educated labor force.

Yet a paradox exists. International lending organizations, such as the World Bank, often have difficulty locating acceptable projects. How can this be so when the need is obviously so great? One root of the problem is dysfunctional public and private institutions. Poorly functioning governments mean that outside assistance will not be used effectively. Low-income countries and those with weak growth records are often in difficulty because they are unable to use their human and material resources effectively.[1] They need institutional reform, but such reform is difficult. Constructing dams, highways, and port facilities is technically straightforward. Reforming government and nurturing a strong private sector are more subtle and difficult tasks that cannot be reduced to an engineering blueprint.

The tension between the capacities of developing countries and the requirements of international aid and lending organizations arises from

[1] Phillip Keefer and Stephen Knack (1995) examine the impact of government institutions on investment and growth for 97 countries over the period 1974 to 1989. Their measure of government quality combines indices of corruption, expropriation risk, rule of law, risk of contract repudiation by the government, and the quality of the bureaucracy. The authors show that measures of the quality of government institutions do at least as well as in explaining investment and growth as measures of political freedoms, civil liberties, and the frequency of political violence.

sources as multitudinous as the histories and cultures of the countries involved. To critics, the international organizations do not appreciate local customs and institutions and fail to adapt their programs to fit individual country's special circumstances. Although this is undoubtedly true in some cases, that is not all there is to it. Some countries' institutions are poorly adapted to their own stated development goals.

Other critics question the goals of the international community, arguing that economic growth is a narrow and incomplete measure of well-being. But even accepting that criticism, wide differences remain across and within countries in health, education, economic opportunity, and environmental quality. Whatever seems universally valuable – be it higher per capita income, longer life expectancy, or reduced infant mortality – varies widely around the world and is rising and falling at different rates.

Obviously, subtle differences in culture and basic values exist across the world. But there is one human motivator that is both universal and central to explaining the divergent experiences of different countries. That motivator is self-interest, including an interest in the well-being of one's family and peer group. Critics call it greed. Economists call it utility maximization. Whatever the label, societies differ in the way they channel self-interest. Endemic corruption suggests a pervasive failure to tap self-interest for productive purposes.

We can go a good way toward understanding development failures by understanding how self-interest is managed or mismanaged. The best case is provided by the archetypal competitive market where self-interest is transmuted into productive activities that lead to efficient resource use. The worst case is war – a destructive struggle over wealth that ends up destroying the resource base that motivated the fight in the first place. In between are situations where people use resources both for productive purposes and to gain an advantage in dividing up the benefits of economic activity – called "rent seeking" by economists (Bhagwati 1974; Krueger 1974).

I explore the interaction between productive economic activity and unproductive rent seeking by focusing on the universal phenomenon of corruption in the public sector. In recent studies, high levels of corruption are associated with lower levels of investment and growth. Corruption reduces the effectiveness of industrial policies and encourages business to operate in the unofficial sector in violation of tax and regulatory laws.[2] Foreign direct investment (FDI) is discouraged by

[2] Paolo Mauro (1995, 1998) demonstrates that high levels of corruption are associated with lower levels of investment as a share of Gross Domestic Product

high corruption levels. Asian economies are not an exception – those with high corruption levels would have attracted more FDI if corruption had been lower, and their industrial policies would have been more effective.[3]

Even when corruption and economic growth coexist, payoffs introduce costs and distortions. Corrupt high-level officials support too much unproductive public investment and under-maintain past investments. Corruption reduces total investment and limits FDI, but it encourages excessive public infrastructure investment (Tanzi and Davoodi 1997). In a corrupt regime, economic actors with few scruples, such as those engaged in illegal businesses, have a comparative advantage. A country is poorer overall if corruption levels are high. It may be caught in a corruption trap where corruption breeds more corruption and discourages legitimate business investment.

Cross-country empirical work has confirmed the negative impact of corruption on growth and productivity, but it is of little use in designing anticorruption strategies. The research shows that corruption is harmful but does not identify the precise mechanisms by which corruption affects

(GDP). The corruption indices are highly correlated with other measures of bureaucratic efficiency, such as the level of red tape and the quality of the judiciary. As a consequence, Mauro was unable to measure the marginal effect of any one of these measures. Putting the separate indices together in a measure of bureaucratic efficiency (that ranges from one to ten), "if Bangladesh [with a score of 4.7] were to improve the integrity and efficiency of its bureaucracy to the level of that of Uruguay [score 6.8] . . . its investment rate would rise by almost five percentage points and its yearly GDP growth rate would rise by over half a percentage point" (Mauro 1995: 705). Mauro also demonstrates that highly corrupt countries tend to underinvest in human capital by spending less on education (Mauro 1998). He argues that this occurs because education provides less lucrative corruption opportunities than other types of more capital-intensive public spending.

Alberto Ades and Rafael di Tella (1997a) argue that an aggressive industrial policy may be partly motivated by the corrupt gains the policy makes available. In such cases, the direct positive effect of the policy can be undermined by its role in increasing corruption and, hence, discouraging investment. Their empirical results demonstrate that in the presence of corruption, the positive impact of industrial policy is halved. East Asian economies are not immune from this effect. Simon Johnson, Daniel Kaufmann, and Pablo Zoido-Lobatón (1998: 389–391) find that higher levels of corruption are associated with a larger unofficial economy.

[3] Shang-Jin Wei (1997) shows that corruption acts like a tax on FDI. An increase in the corruption level from relatively clean Singapore to relatively corrupt Mexico is the equivalent of an increase in the tax rate of over 20 percentage points. The statistical result holds for East Asian countries as well as for the others in his sample.

economic performance. In fact, it is not even clear what it means for a country to rank highly on a corruption index. Does it mean that bribes are a large share of the value of contracts and government services? Does it mean that the proportion of deals influenced by bribery is high? Does it mean that bribery has an especially distortionary impact on economic and political life? The surveys give no information that would help one understand their underlying meaning, and in fact, such information does not appear to exist. Further complicating matters, the correlation between corruption and poor economic performance is not absolute. High levels of corruption are more destructive under some conditions than others (Wedeman 1997: 459).

The level of bribes is not the critical variable. One wants to know not just how much was paid, but also what was purchased with the payoff. For that, one needs detailed country-by-country and sector-by-sector analyses. This book is an attempt to set the agenda for such efforts and to draw lessons from the work that already exists. Only if one looks at the fine structure of political and economic systems can one go beyond a showing that corruption is harmful to an understanding of the way it operates in different contexts.[4] Given that knowledge, reform programs can attack corruption where it has the worst effects. I draw on existing work in individual countries to illustrate my arguments concerning the causes and consequences of corruption and to recommend reforms. However, the existing collection of cases is not sufficient. We need more systematic knowledge of just how corruption and self-dealing affect the operation of government programs and private markets.

I analyze the problem of corruption along four dimensions. The first takes the background organization of state and society as given and asks how corrupt incentives arise within public programs. I show that corruption can create inefficiencies and inequities and is, at best, inferior to legally established payment schemes. Reforms can reduce the incentives for bribery and increase the risks of corruption. The goal is not the elimination of corruption but an improvement in the overall efficiency, fairness, and legitimacy of the state. The total elimination of corruption will never be worthwhile, but steps can be taken to limit its reach and reduce the harms it causes.

[4] As an example of the kind of detailed understanding needed for concrete proposals in particular cases, consider Judith Tendler's 1979 report to the World Bank on graft in rural works programs in Bangladesh. The paper is an admirable analysis of the impact of graft on different aspects of a development project and a discussion of the conditions under which local people can be used as monitors of others' honesty.

The second recognizes that corruption has different meanings in different societies. One person's bribe is another person's gift. A political leader or public official who aids friends, family members, and supporters may seem praiseworthy in some societies and corrupt in others. My aim is not to set a universal standard for where to draw the legal line between praiseworthy gifts and illegal and unethical bribes. It will be enough to isolate the factors that should go into the choice. Culture and history are explanations, not excuses. As an economist, I cannot provide an in-depth analysis of the role of culture and history, but I can point out when the legacy of the past no longer fits modern conditions.

The third approach considers how the basic structure of the public and private sectors produces or suppresses corruption. I consider the relationship between corrupt incentives and democratic forms and discuss the relative bargaining power of public and private organizations and individual actors. Reform at this level may well require changes in both constitutional structures and the underlying relationship between the market and the state.

The final section of the book considers the difficult issue of achieving reform. First, I discuss the role of the international community, both aid and lending organizations, and multinational economic and political bodies. For some countries, especially those at low levels of development, the role of multinational businesses is critical. If these firms collaborate in maintaining corrupt regimes, they undermine development goals. I assess recent efforts to enlist business in helping limit corruption in developing countries and in those making a transition from socialism.

Second, proposals for reform lead to the problem of domestic political will. Good ideas are useless unless someone is willing to implement them. The book concludes with lessons drawn from successful and sustainable policies carried out in the past. Although no two countries face the same set of background conditions, modern-day reformers can learn something from the historical record.

This book does not present a blueprint for reform; it does not end with a compilation of "best practices." Instead, it suggests a range of alternatives that reformers must tailor to the conditions in individual countries. There is one fundamental lesson, however. Reform should not be limited to the creation of "integrity systems." Instead, fundamental changes in the way government does business ought to be at the heart of the reform agenda. The primary goal should be to reduce the underlying incentives to pay and receive bribes, not to tighten systems of ex post control.

Enforcement and monitoring are needed, but they will have little long-term impact if the basic conditions that encourage payoffs are not reduced. If these incentives remain, the elimination of one set of "bad apples" will soon lead to the creation of a new group of corrupt officials and private bribe payers.

PART I

Corruption as an Economic Problem

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The Economic Impact of Corruption

All states, whether benevolent or repressive, control the distribution of valuable benefits and the imposition of onerous costs. The distribution of these benefits and costs is generally under the control of public officials who possess discretionary power. Private individuals and firms who want favorable treatment may be willing to pay to obtain it. Payments are corrupt if they are illegally made to public agents with the goal of obtaining a benefit or avoiding a cost. Corruption is a symptom that something has gone wrong in the management of the state. Institutions designed to govern the interrelationships between the citizen and the state are used instead for personal enrichment and the provision of benefits to the corrupt. The price mechanism, so often a source of economic efficiency and a contributor to growth, can, in the form of bribery, undermine the legitimacy and effectiveness of government.

This chapter isolates the most important situations where widespread corruption can determine who obtains the benefits and bears the costs of government action.

- The government may be charged with allocating a scarce benefit to individuals and firms using legal criteria other than willingness to pay. *Bribes clear the market.*
- Officials in the public sector may have little incentive to do their jobs well, given official pay scales and the level of internal monitoring. They may impose delays and other roadblocks. *Bribes act as incentive bonuses.*
- Those engaged in legal pursuits seek to reduce the costs imposed on them by government in the form of taxes, customs duties, regulations. *Bribes lower costs.*
- Illegal businesses frequently purchase corrupt benefits from the

state. In extreme cases illegal businesses and organized crime bosses dominate the police and other parts of the state through corruption and intimidation. *Bribes permit criminal activity.*

These categories are not mutually exclusive. A bribe that acts as an incentive payment, for example, might also allocate a scarce benefit or provide a tax exemption. Nevertheless, each raises enough distinctive issues so that it is worth considering each one separately.

Payments that Equate Supply and Demand

Governments frequently provide goods and services for free or sell them at below market prices. Often dual prices exist – a low state price and a higher free market price. Firms will then pay off officials for access to below-market state supplies. In China, for example, some producer goods were sold at both state-subsidized prices and on the free market. Although the price differences have shrunk in recent years, they were once very large. Chinese researchers reported that in 1989 the market price of coal was 674 percent of the subsidized price. The market prices of seven other producer goods were from 250 percent to 478 percent of the prices fixed by the state. Not surprisingly, payoffs to obtain supplies at state prices were reportedly very common.[1] In Nigeria when oil prices were set artificially low relative to the market price in neighboring Benin, smuggling facilitated by corruption was apparently widespread. The price difference provided benefits both to the smugglers and to the officials who were paid to overlook the illegal trade.[2]

If the supply of credit and the rate of interest are controlled by the state, bribes may be paid for access. Interviews with business people in Eastern Europe and Russia indicate that payoffs are frequently needed to obtain credit (De Melo, Ofer, and Sandler 1995; Webster 1993; Webster and Charap 1993). In Lebanon a similar survey revealed that loans were not available without the payment of bribes (Yabrak and Webster 1995). Personal influence and corruption lead banks into high-risk lending – sometimes to "borrowers" with no intention of repaying the funds. In Kenya, for example, one well-placed observer estimated that a third of banking assets were close to worthless in 1992 as a result of political

[1] Data from the Price Reform Group of the Finance and Trade Institute of China's Academy of Social Science, printed in *Zhongguo Wujia (China Price)*, Beijing, October 1990. For an example, see "China's Paragon of Corruption," *New York Times*, March 6, 1998. On corruption in China, see Gong (1993), Hao and Johnston (1995), and Johnston and Hao (1995).

[2] "Camel Through the Needle's Eye," *Newswatch*, February 3, 1991. Excerpts reprinted in World Bank (1993b, Annex 26).

interference in the financial system (Bigsten and Moene 1996: 191). A similar situation existed at the National Bank of Fiji where political influence was apparently widespread (Findlay 1997: 54). In Korea bank loans continued to be made to well-connected companies after they experienced serious financial difficulties. The companies had made substantial payoffs to powerful politicians, and these same officials pressured the banks to continue making loans. The bankers themselves were also bribed.[3] In Pakistan well-informed researchers calculated that it would cost the government 10 to 15 percent of 1996–1997 gross domestic product to deal with a banking crisis based on nonperforming loans provided to friends of the regime (Burki 1997: 9).

Exchange rates often do not reflect underlying economic fundamentals, thus producing incentives to pay bribes to get scarce foreign exchange at favorable rates. For example, Paraguay's multiple exchange rate system led to corruption before it was reformed (World Bank 1994b). South Africa's twin currency system was a source of payoffs. The financial rand was abolished in March 1995, a policy change that removed one set of corrupt incentives.[4]

The allocation of scarce import and export licenses is a frequent source of payoffs and patronage with bribes linked to the value of the benefits conferred. In the Philippines in the early 1950s both methods operated. Those with political connections could easily obtain licenses so long as they paid a 10 percent commission (Hutchcroft 1998: 73). In Nigeria, the regime in power in the early 1980s resisted free trade reforms favored by the International Monetary Fund (IMF) apparently because the existing system of import licensing was a major source of payoffs and patronage (Herbst and Olukoshi 1994: 465). By the late 1980s the import licensing system had become so discredited that it was abolished. Apparently the Manufacturers Association of Nigeria, whose members had paid bribes without complaint in earlier years, began to see that they would be better off without the system. Furthermore, at the same time that the import licensing system ended, the state introduced other new rent-seeking opportunities (Faruqee 1994: 246; Herbst and Olukoshi 1994: 481–482).

The incentives to make payoffs are clear enough in these cases, but

[3] "Yet Another Shock to South Korea's System," *The Economist*, May 24, 1997; "Hanbo Group Founder Is Jailed for 15 Years," *Financial Times*, June 3, 1997.

[4] *Transparency International Newsletter*, June 1995; "South African Economy in Global Firing Line," *Financial Times*, March 13, 1995; and "Strong Debut for Unified Rand," *Financial Times*, March 14, 1995. According to the March 13 article, however, South Africans still face tough controls on taking funds abroad, a situation that could encourage illegal attempts to circumvent the controls.