Cambridge University Press
978-1-107-15267-0 — Corruption and Development in Indian Economy
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Issues in Corruption

Theoretical and Empirical

The rent seeking behaviour of individuals tends to gain momentum in a society with stringent regulations. In a free economy it is usually feared that the individual's choice to decide what is good or bad for himself may involve substantial conflicts of interest and thus there is the need for interventions and regulations. But ironically regulations empower a selected few who then in turn earn a rent using their position and power to render benefit or impose punishment by distorting facts or mitigate penalty by suppressing part of the unlawful activities. Of course in a society without regulation individuals may harm each other to serve their own interests leading to pure chaos and therefore there could be a genuine need for economic policy. So determining an optimal mix of freeness and regulation is perhaps the biggest challenge that a society faces in order to keep itself at a safe distance from chaos and at the same time not allowing regulations to corrupt its members.

Why people take recourse to unfair means is an age old question, bothering thinkers to find an easy solution with an effective strategy to curb this tendency. The simplest answer perhaps lies in the fact that some, if not many, have a tendency to experience gains more than proportionate to their efforts or endowments they have. And in order to materialize this they often stoop down to take recourse to corrupt means of bribing. Religion takes the route of fear to caution while spiritualism reminds the transitory satisfaction that material wealth can offer and the negativity that the mind develops by cultivating the desire to receive disproportionate gains. All this, however, does not have an effect on those who do not believe in preaching. Hence, there is the need for a body to punish the greedy, be it through law or any other entity.

A more hazardous situation appears when one individual does not believe in corruption but another believes and the latter stands on his way until the former compromises. Of course the former can take a strong stand and get prepared for any dire consequence that may come in his way rather than succumbing to the pressure applied by the corrupt. But there can be situations which involve substantial emotion, respect and compulsion: the best example one can think of is paying extra money to get the bed in the hospital for his/her dear one because without this extra bribe money the person-in-charge will not allow access to the hospital bed. This might have provoked some to say that paying bribe is not as criminal as demanding one. The same defense is extended to one who pays dowry during his daughter's marriage because most of the prospective grooms declined to entertain the proposal not accompanied by any offer of lucrative gains.

There are situations in which one can afford to remain firm and there are situations when one is hard-pressed to pursue corruption. The moralists would of course suggest to remain firm whatsoever dire consequences may come one's way, though an ordinary human being may find it difficult to practise that at least in a couple of instances, if not all. So, one way to handle this is to enforce utmost transparency and strict policy of retribution for one who claims bribe though there can still be slips of significant magnitude with the entry of a third entity into the scene, who is expected to monitor and identify the guilty. As the number of players increase, the probability of breaking the law rises. In other words, it is impossible to rule out corruption in absolute sense in any human society unless each of its members believes in utmost honesty strictly. Further it has to be followed in our own interest because individual abilities to score over others differ substantially across individuals. One may cheat another but a third individual may cheat the gainer between the two. So, in order to avoid the risk of being cheated, one has to give up the tendency of cheating others. But this argument still can be discounted as there are risk lovers even in the sphere of corruption and they may take gains and losses incurred through unfair means with a sportive spirit. So does this mean that corruption is impossible to be removed?

If corruption is inevitable perhaps it will be interesting to look at its positive side purely from economic point of view, leaving aside the ethical issues. Views exist to show how corruption can actually enhance economic wealth which in turn can be utilized for welfare and redistributive measures (Ghosh, 2011).[1] These are attempts to legitimize black money, particularly those accumulated in foreign banks, so that the unaccounted wealth can freely move into the domestic territories and can be utilized to finance major development projects or pursue pure growth strategies, which in turn can generate enough surplus necessary for welfare initiatives. This sort of an argument is acceptable to many because the black money, which otherwise remained idle without contributing to growth and welfare, is able to break the low equilibrium trap.

1 Ghosh, Sugata, (2011), ET Bureau, 9 May.

But can we term all investments to be growth and welfare inducing, or can we be sure that every legitimization and inflow of black money will encourage productive investment? As Kumar (1999) points out, the need to incorporate the black economy is not simply an empirical matter but a theoretical necessity as the circular flow of incomes changes with the black economy.[2] There are instances of money squandering/laundering in land market and other speculative activities, leading to distortions in the housing market and skyrocketing of prices of various goods and creating huge demand for gold and its unnecessary hoarding. It could be like an excess supply of money injected into the economy disproportionate to the goods and services available domestically and/or from imports. Similarly, investment in new projects related to the manufacturing sector may create environmental damages which cannot be repaired even with significant interference. The rise in the cost of living as a result of speculative activities of those who have the black money can create more damages to the have-nots than how much they can be compensated by the surpluses of the productive utilization of the black money. And unless we have an economy-wide model to give the details of the overall gains and losses of black money generation and its utilization, any argument favouring its legitimization can never be adequate.

The other pertinent question is in which sector does corruption have greater adverse impact on the economy? Naturally not all sectors can create equal quantum of either beneficial or adverse effects from the entry of the black money. Certain sectors have greater inter-linkages with the rest and, hence, the cascading effects can be enormous. Similarly growth in certain sectors is more inequality-aggravating and a steady rise in inequality prompted by corruption can lead to social segregation. Usually growing segregation would mean persistence of poverty which in turn tends to reduce growth. The so-called demographic dividends and the potential gains in terms of growth would remain far from realization if a large percentage of the working age population remains engaged in petty activities without being able to enhance their capabilities.

Though there is literature in defense of corruption, i.e., 'grease the wheel', the benefits rendered to the bribing party materialize at the cost of the other competitors/firms. Hence, corruption cannot lead to an outcome which is Pareto optimal. It rather results in loss of output and productivity in the long run at the aggregate level notwithstanding individual gains. Of course if the individual

2 In 1990–91, as Kumar (2002) pointed out, 35 per cent of the national economy fell into the domain of black economy.

gainers happen to be the giant firms, the overall industry may show positive growth. However, if an aggregate picture is drawn relating to the potential loss of public revenue and its utilization towards infrastructure and human capital formation, the magnitude of loss, particularly in meeting the pro-poor growth objectives, is substantial. With growing inequality there can be a change in value system of the society. The philanthropic attitude can diminish and the role of civil society may become superfluous. The lack of genuine concerns may not only reduce the mobilization of resources that can contribute to pro-poor growth but also encourage corruption and leakages in handling the public funds, which are threats to future growth. For example, though in the rural areas of India employment guarantee programmes have been initiated, there are severe leakages. On the positive side, these programmes raised the rural wage rate and provided consumption support to several households below the poverty line. But, since these programmes were carried out in a haphazard manner and involved a great deal of leakages, they did not help in asset creation either at the household or community level.

The tax policy at times can be such that it may encourage both inequality and corruption. For example, real estate taxes, inheritance taxes and taxes on capital gains from the sale of a principal or secondary residence or asset need to be revisited in the Indian context. Besides, the large corporate sector has to be motivated to participate in welfare programmes by providing certain incentives in terms of tax exemptions. Raising the tax burden primarily on the salaried middle class tends to encourage tax avoidance. Many activities falling into the domain of wholesale and retail trade and transport, storage and communication need to be brought under the scrutiny as the extent of tax evasion in these activities is high. The small and medium entrepreneurs in the manufacturing sector, if taxed heavily, will be discouraged to pursue their business as it may affect their investment drastically. But many units both in goods and services sectors deliberately keep their business small by splitting into different components in order to avoid the regulations applicable to the formal sector. The use of unique identification card, if made effective, can possibly lead to better scrutiny and help consolidate the activities of a particular household for tax purposes. Also, several households are engaged in unorganized money market and other activities relating to finance and they are able to suppress the gains by holding accounts in the names of the dependents. Such cases need to be identified in order to increase the public revenue.

As mentioned above, the overall policy towards a particular sector can be responsible for rising inequality and corruption. For example, in India the agriculture sector is exempted from tax. But there are a number of large farmers who in turn spend surplus income on money laundering and speculative activities in the land market.

In the name of innovation the firms are actually spending the research and development (R&D) funds on a variety of superfluous activities and not on technology innovation which can raise total factor productivity growth (TFPG). In fact, not too many incentives exist for encouraging innovation except in pharmaceutical industry (Mani, 2009). There again the public sector gets much of the incentives though the private sector units are actually involved in innovative ventures.

Though labour market reforms have not been carried out in India on a significant scale, several indirect routes have been followed to allow the firms to introduce labour market flexibility without providing labour with any safety net. This seems to have aggravated wage inequality. Not much support was extended to the unorganized sector enterprises: the small scale industry policy of the government did not actually focus on the micro enterprises the bulk of which are located in the unorganized or informal manufacturing sector. It referred mainly to the modern small scale industry which is located in the organized or formal sector. Within the manufacturing division there is a large unorganized or informal sector with enterprises of small size, low capital-labour ratio and unprotected labour market. Within the informal manufacturing sector the household or own account enterprises are the most unviable ones which have not received any major support. The credit assistance programmes etc. which exist scantily often bear significant leakages. Except the formation of cooperatives the marketing assistance is mostly negligible. The intermediaries tend to reduce further the meagre incomes of the workers, often forcing them to accept pay lower than the minimum wage recommended by the government.

Particularly in regions, which lack opportunities for progress, the educated unemployed youth tend to participate in unproductive activities, leading to insurgency and social unrest. Such situations exacerbate growth and encourage corruption in various forms, leading to extreme form of violence.

Usually it is thought that as corruption increases and bribing opportunities emerge significantly, cheating gets easier and regulation compliance diminishes (Bardhan, 2006; Acemoglu and Verdier, 2000). However, Mendez (2011) refutes this view and argues that corruption can actually raise regulation compliance though it does not happen always. We can be optimistic about economic policy, which may be effective in reducing corruption.

These are only a few aspects in the long list of issues concerning corruption. We now turn to some of the approaches followed in the literature to address corruption.

Various approaches

The issue of corruption has been analysed in the principal-agent framework (Mishra, 2005). Let us say, the authority is the principal and the inspector is the agent who then can be influenced by a third party (a dishonest labour contractor or a polluting firm), which offers a monetary benefit to the agent in exchange of a favour and that benefit remains only with the agent without being passed on to the principal. It can also be seen as principal-supervisor-agent relationship, i.e., principal is the authority and agent is the labour contractor or the polluting firm.

From a macro perspective corruption is associated with market and institutions and the divide between economic and political sphere (Mishra, 2005). The lack of economic development and the inadequacy to understand and execute the responsibility and power in the public sphere (leading to creation of market based on profit considerations) can result in corruption (Myrdal, 1968). As Mishra (2005) lucidly describes, given the possibility of divergence in the objective of the principal and the agent, optimal policy under incomplete information can lead to large magnitude of rents accruing to the agent since there can be collusion between the agent and the supervisor (Tirole, 1996). So how the rent emerging from such collusions can be minimized, or how the possibility of collusion can be reduced are some of the important considerations for the principal. One need not view collusion as the only means of revenue loss to the principal. Extortion is equally important – by paying a bribe to the supervisor the tax burden can be reduced and at the same time an honest taxpayer may like to evade taxes if he is subject to extortion by the inspector (Mishra, 2005). Though views exist in favour of corruption on the ground that it reduces bureaucratic delays and improves efficiency in the commercial sphere (Huntington, 1968), such views have also been criticized suggesting that bribe payment can encourage further rigidity and red tape (Myrdal, 1968). So what seems to be a solution to improving efficiency actually turns out to be the cause of further inefficiency by providing legitimacy to it.

Acemoglu and Verdier (2000) viewed that corruption can be seen as a cost of government intervention – rise in market failure, rise in government intervention and rise in the cost of government intervention are positively correlated. Hence, developing countries end up having greater government presence and corruption both. By allowing some degree of corruption both the government presence and the costs associated with it can be reduced. Another argument suggests that low wages of the government employees can encourage bribe seeking behaviour, but at the same time high wages can raise the bargaining power and the level of bribe payment if the probability of detection of bribe payment is low (Besley and McLaren, 1993 as summarized by Mishra, 2005). Basu, Bhattacharya and Mishra (2005) envisage possibilities of introducing many layers of supervision and the practice of rewarding for honest reporting which, in turn, can then make bribe taking less attractive though collusions among officers across different layers can also take place and need not result in reduced level of corruption.

Usually increased level of competition is thought to reduce bribe payment and corruption. But this may not be the case always. If the bribe amount is very high and is shared by a number of firms competing with each other in the product market, the high cost firms may decide to exit as the cost of operation for them becomes exorbitantly high. On the other hand, if too few firms are left with and their profitability is not adequate to meet the requirements of the inspector, the equilibrium outcomes will be in terms of reduced bribe and reduced number of firms (Ades and di Tella, 1999 as summarized by Mishra, 2005). The theoretical model of Bliss and Di Tella (1997) has shown that corruption affects the number of firms in free-entry equilibrium. The intensity of competition in the economy rises with lower overhead costs relative to profits and with a tendency toward similar cost structures. Increases in competition may not lower corruption. The model explains why a rational corrupt agent may cause the exit of a firm. The welfare effect of corruption was shown complex as the exit caused by corruption does not necessarily reduce social welfare. In a recent attempt, using cross-country data and general measures of corruption, Alexeev and Song (2013) have shown empirically that stronger product market competition is associated mostly with greater corruption of the cost-reducing variety.

How corruption affects economic growth or other important macro variables is a pertinent question and all this requires a sound methodology for measurement of corruption. Corruption Perception Index (CPI) and the World Bank Institute's control of corruption measures are some of the attempts in this direction:

notwithstanding limitations, these indices do suggest ranking of different countries in terms of the extent of corruption. Also, it is important to ask whether corruption is a deviant behaviour in relation to a specific norm, or it is a norm itself if judged in terms of its significant presence in certain societies.

The World Bank Institute has constructed six indices of corruption. Kaufman *et al.* (2006) used the following indices to reflect on governance. In addition to a measure of corruption control, the indices include voice and accountability, political instability and violence, government effectiveness, regulatory burden and the rule of law. Voice and accountability measure political, civil and human rights; political stability and absence of violence measure the likelihood of violent threats to – or changes in – government, including terrorism; government effectiveness measures the competence of the bureaucracy and the quality of public service delivery; regulatory quality measures the incidence of market-unfriendly policies; rule of law measures the quality of contract enforcement, the police and the courts, as well as the likelihood of crime and violence; and control of corruption measures the exercise of public power for private gain, including both petty and grand corruption, or 'state capture'.

The volume on corruption (Rose-Ackerman, 2006), though deals with aspects raised primarily by the economists. Most of the chapters in the volume understands the importance of politics in explaining the roots of corruption. Kunicova (2006) poses if the variations in the democratic framework have any impact on the incidence of corruption. Constitutional structures and voting rules are seen to have links with perception on corruption. In relation to the question whether institution leads to corruption or vice versa, the arguments are presented to indicate it as bi-directional. Mishra (2005) argues that corrupt payments to low-level government officials can reduce the effectiveness of the public programmes. Interestingly, exploring the political set up, economic growth and corruption linkage for more than 100 countries, Drury, Krieckhaus and Lusztig (2006) showed that corruption had no significant effect on economic growth in democracies while non-democracies suffered significant economic harm from corruption. Furthermore, this study concluded that democracy mitigates adverse economic effects of corruption. Given the fact that several economies are rife with corruption, promoting democracy within them may enhance not only their general human rights and welfare but also their opportunity for prosperity. Focusing on a panel data set covering a large number of countries between 1996 and 2003, this relationship is further explored by Rock (2007). A substantial empirical support is found for an inverse relationship between democracy and corruption. The turning point in corruption occurs rather early in the life of new democracies and at rather low per capita incomes.

On the reverse causality, Johnston (2000) analysed that corruption threatens democracy and governance by weakening political institutions and mass participation and by delaying and distorting the economic development needed to sustain democracy. In a study of 83 countries, Johnston (2000) compared Transparency International's CPI with an index of political competitiveness and found that well-institutionalized and decisive political competition was correlated with lower levels of corruption. These results were confirmed, even after controlling for gross domestic product (GDP), and on the basis of time series data as well. Gupta *et al.* (1998) also found that corruption can lead to reduced social spending on health and education. Countries with relatively higher corruption tend to have lower levels of social spending, regardless of the level of development. Corruption lowers tax revenues, increases government operating costs, increases government spending for wages and reduces spending on operations and maintenance, and often biases government toward spending on higher education and tertiary health care.

One unifying theme in the volume (Rose-Ackerman, 2006) is the importance of politics in understanding both the roots of corruption and the success or failure of alternative policy interventions. Lambsdorff (2006) reviewed a broad selection of cross-country research on the causes and consequences of corruption and noted links running from costly regulation to corruption though some of the most honest countries in northern Europe are also seen to have very active regulatory measures.

The role of decentralization is not definite (Bardhan and Mookherjee, 2006): though competitive pressures reduce corruption, payoffs can also be associated with laws that restrict entry and trade. Kunicova (2006) argues that the structure of government affects the integrity of government, but the connections are complex. Very interestingly cultural and social factors are seen to be related to a country's level of corruption – for example, when family ties are important, reported corruption is high. Geography is also said to matter – the rich deposit of natural resources can be a precondition for corruption.

A high level of inequality may induce corruption or it could be an outcome of corruption. Similarly, high levels of poverty can encourage corruption with the increasing need for the provision of public goods. Market failures, the need for subsidy, infrastructure building and state initiative in terms of anti-poverty programmes involve huge scope for corruption. Moreover, if corruption done by some would have a major brunt on those who are already vulnerable, adversity is likely to get aggravated further. In this regard, Gupta, Davoodi and Alonso-Terme (2002) provided empirical evidence to support that high and rising corruption increases income inequality and poverty. Analysis indicated that an increase of one standard deviation in corruption raises the Gini coefficient of income inequality by about 11 points. The findings of this has an important policy implication: anti-corruption measures will most likely reduce income inequality and poverty as well.

A World Bank study (2000) on poverty following the transition to a market economy in Eastern Europe and Central Asia (ECA) produced important findings concerning income distribution and corruption. The study analysed whether there 'is any apparent link, within ECA, between corruption and measures of income inequality'. When Gini coefficients for income per capita (measures of income inequality) were graphed against the Transparency International (TI) Corruption Perceptions Index (CPI), lower levels of corruption were seen to be statistically associated with lower levels of income inequality (simple correlation was +0.72). Similar results were obtained using different measures of corruption. The links between corruption and inequality show that the costs of corruption fall heavily on small firms in particular.

Often there are debates relating to the estimation of corruption, a broad manifestation could be the relative size of the black economy. Some of the studies in the Indian context have tried to estimate the black economy and it has been a strong agenda of the government to come up with an estimate of black economy from time to time. Particularly the last phase of the UPA government is said to be characterized by a high incidence of corruption, which forced the government to initiate large scale projects in various research organizations for estimating the size of the black economy. However, it is important to clarify in the beginning that the term unincorporated economy does not necessarily overlap with black economy. The unincorporated economy may include several unregistered activities conducted in the so called informal sector about which not accurate information is always available. Of course, some of the firms in manufacturing or services may have deliberately chosen to be in the informal sector in order to avoid taxes though their actual turnover might have been substantial to place them in the formal sector. In such situations, unregistered output and black economy would coincide but not in a situation where a petty vendor is operating in the informal sector in search of a livelihood. Since no accurate documentation is available on the value added and created by this individual, the national income