Corruption and Development

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What are the principal causes and costs of corruption? This article examines these questions and suggests specific ways to enhance anticorruption efforts in developing and transition economies.

CERTAIN CLAIMS about corruption in developing countries are often heard: bribery and corruption can have positive effects; corruption is endemic everywhere; the costs of addressing corruption are prohibitively high; and the few resources that exist should be spent on enforcement measures, such as high-profile government watchdog agencies. But, in fact, there is increasing evidence that the economic costs of corruption are enormous; levels of corruption vary widely among developing countries; controlling corruption is feasible; and strategies to address corruption need to pay more attention to its root causes—and thus to the roles of incentives, prevention, and specific economic and institutional reforms.

The past few years have seen growing public recognition and discussion of the problem of corruption, including in addresses to the World Bank-IMF Annual Meetings by World Bank President James Wolfensohn and IMF Managing Director Michel Camdessus, lengthy discussions in the 1996 and 1997 editions of the *World Development Report*, internal task forces on corruption in the World Bank and the IMF (which have submitted reports to their respective Executive Boards and to the joint Development Committee), the increasing influence of the nongovernmental organization (NGO) Transparency International, the Organization for Economic Cooperation and Development's (OECD) recent landmark resolution to criminalize bribery abroad, and a rapidly growing body of theoretical and empirical literature on corruption and its economic impact. Equally telling is the willingness of many public officials in emerging economies to discuss openly the challenges of corruption in their countries. In a recent survey of more than 150 high-ranking public officials and key members of civil society from more than 60 developing countries, the respondents ranked public sector corruption as the most severe impediment to development and growth in their countries.

Corruption's many faces

A general definition of corruption is the use of public office for private gain. This includes bribery and extortion, which necessarily involve at least two parties, and other types of malfeasance that a public official can carry out alone, including fraud and embezzlement. Appropriation of public assets for private use and embezzlement of public funds by politicians and high-level officials (associated with "grand" corruption in various countries, some of which are beset by kleptocracies) have such clear and direct adverse impacts on a country's economic development that their costs do not warrant sophisticated discussion. The analysis of bribery of public officials by private parties—and, in particular, its impact on private sector development—is, however, more complex. In unbundling bribery, it is useful to consider what private parties can "purchase" from a politician or bureaucrat:

- *Government contracts:* Bribes can influence the choice of private parties to supply public goods and services and the exact terms of those supply contracts. It can also affect the terms of recontracting during project implementation.
- *Government benefits:* Bribes can influence the allocation of monetary benefits (tax evasion, subsidies, pensions, or unemployment insurance) or in-kind benefits (access to privileged schools, medical care, housing and real estate, or ownership stakes in enterprises being privatized).

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• *Public revenues:* Bribes can be used to reduce the amount of taxes or other fees collected by government from private parties.

• *Time savings and regulatory avoidance:* Bribes can speed up the government's granting of permission to carry out legal activities.

• *Influencing outcomes of the legal and regulatory process:* Bribes can alter outcomes of the legal and regulatory process, by inducing the government either to fail to stop illegal activities (such as drug dealing or pollution) or to unduly favor one party over another in court cases or other legal proceedings.

The incidence of corruption varies enormously among different societies, ranging from rare to widespread to systemic. If it is rare, it may be relatively easy to detect, punish, and isolate. Once it becomes systemic, however, the likelihood of detection and punishment decreases, and incentives are created for corruption to increase further. This pattern of an initially rising, but then falling, cost of engaging in corrupt acts can lead to multiple equilibriums: one holding in a society relatively free of corruption, the other holding in a society where corruption is endemic. Moving from the latter toward the former is likely to be harder than controlling corruption when it has become prevalent but not yet systemic. Where there is systemic corruption, the institutions, rules, and norms of behavior have already been adapted to a corrupt modus operandi, with bureaucrats and other agents often following the predatory examples of, or even taking instructions from, their principals in the political arena.

Economic costs of corruption

The body of theoretical and empirical research that objectively addresses the economic impact of corruption has grown significantly in recent years. It leads, in general, to the following conclusions:

• 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 transaction costs and uncertainty in an economy.

• Bribery usually 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 (outside the formal sector), 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 unfair. It imposes a regressive tax that falls particularly heavily on trade and service activities undertaken by small enterprises.

• Corruption undermines the state's legitimacy.

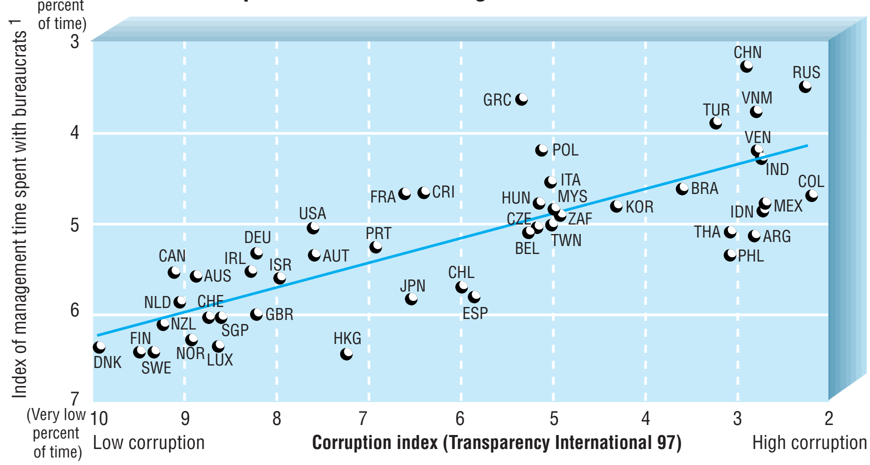
Some observers have argued that bribery can have positive effects, under certain circumstances, by giving firms and individuals a means of avoiding burdensome regulations and ineffective legal systems. But this argument ignores the enormous discretion that many politicians and bureaucrats have (particularly in corrupt societies) over the creation and interpretation of counterproductive regulations. Instead of corruption being the "grease" that lubricates the "squeaky wheels" of a rigid administration, it fuels the growth of excessive and discretionary regulations. The argument that bribery can enhance efficiency by cutting down on the time needed to process permits is also questionable. The possibility of bribery may be what causes the process to slow down in the first place.

Available empirical evidence refutes the grease and "speed money" arguments by showing a positive relationship between the extent of bribery and the amount of time that enterprise managers spend with public officials. Responses from more than 3,000 firms in 59 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 (Chart 1). And the evidence also suggests that the cost of capital for firms tends to be higher where bribery is more prevalent. Further, there is no empirical evidence that "East Asia is different," as some people argued during its years of high growth: the same relationship between bribery and additional management time spent with officials applies there as elsewhere.

In any society, there should also be a core of laws and regulations that serve productive social objectives, such as building codes, environmental controls, and prudential banking sector regulations. The grease argument is particularly troublesome in this context, since bribes can override such

Chart 1

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



ARG = Argentina	CHN = China	FRA = France	ISR = Israel	NOR = Norway	THA = Thailand
AUS = Australia	COL = Colombia	GBR = United Kingdom	ITA = Italy	NZL = New Zealand	TUR = Turkey
AUT = Austria	CRI = Costa Rica	GRC = Greece	JPN = Japan	PHL = Philippines	TWN = Taiwan Province of China
BEL = Belgium	CZE = Czech Republic	HKG = Hong Kong S.A.R.	KOR = Korea	POL = Poland	USA = United States
BRA = Brazil	DEU = Germany	HUN = Hungary	LUX = Luxembourg	PRT = Portugal	VEN = Venezuela
CAN = Canada	DNK = Denmark	IDN = Indonesia	MEX = Mexico	RUS = Russia	VNM = Vietnam
CHE = Switzerland	ESP = Spain	IND = India	MYS = Malaysia	SGP = Singapore	ZAF = Zambia
CHL = Chile	FIN = Finland	IRL = Ireland	NLD = Netherlands	SWE = Sweden	

Source: Daniel Kaufmann and Shan-Jin Wei, 1998, "Does 'Grease Money' Speed Up the Wheels of Commerce?" paper presented at the annual meeting of the American Economic Association, Chicago, January.

Note: The use of the Global Competitiveness Survey and Transparency International indices in no way constitutes official World Bank endorsement of their precise country ratings.

[1] Global Competitiveness Survey, 1997.

regulations and cause serious social harm, such as illegal logging of tropical rain forests or failure to observe building codes designed to ensure public safety. Bribers can also purchase monopoly rights to markets—as, for example, in the energy sectors in some formerly communist countries, where unprecedented amounts of grease payments buttress gigantic monopolistic structures. Finally, the obscure insider lending practices and improper financial schemes inherent in poorly supervised financial systems have contributed to macroeconomic crises in Albania, Bulgaria, and—very recently—in some countries in East Asia.

Corruption's complex causes

Corruption is widespread in developing and transition countries, not because their people are different from people elsewhere but because conditions are ripe for it. The motivation to earn income is extremely strong, exacerbated by poverty and by low and declining civil service salaries. Furthermore, risks of all kinds (such as illness, accidents, and unemployment) are high in developing countries, and people generally lack the many risk-spreading mechanisms (including insurance and a well-developed labor market) available in wealthier countries.

Not only is motivation strong, but opportunities to engage in corruption are numerous. Monopoly rents can be very large in highly regulated economies, and, as noted previously, corruption breeds demand for more regulation. Further, in transition economies, economic rents are particularly large because of the amount of formerly state-owned property that is essentially up for grabs. The discretion of many public officials is also broad in developing and transition countries, and this systemic weakness is exacerbated by poorly defined, ever-changing, and poorly disseminated rules and regulations.

Accountability is typically weak. Political competition and civil liberties are often restricted. Laws and principles of ethics 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 critical; 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 government job has only a limited deterrent effect 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.

Creating political will

Understanding what makes powerful politicians do what they do, and which interests they represent, is of paramount importance in addressing the corruption problem. Finding pockets of political support is crucial; even in countries where corruption is endemic, there are likely to be some reform-minded decision makers whose constituencies will support reform to further the country's broader interests. And particular 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 constituencies of civil society to support anticorruption efforts.

Constructive pressure and assistance from abroad is certainly not decisive, but it can help. International organizations and donor groups can help to focus countries' attention on corruption and support reformists in government and civil society more generally. Furthermore, the post–cold war move to a more integrated world economy has opened many countries up to greater international scrutiny. Countries compete for both foreign direct investment (FDI) and international portfolio investment; and foreign investors value stability, predictability, and honesty in government. Evidence is emerging that corruption imposes a significant "tax" on FDI in all regions of the world, including East Asia.

Tackling corruption

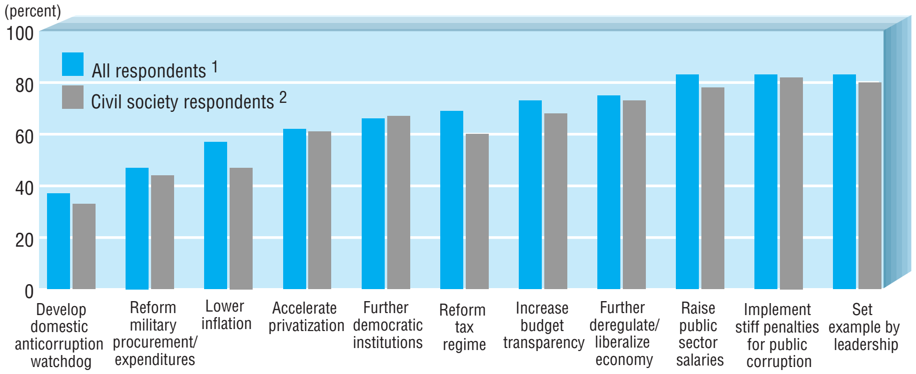
Even if they acknowledge many of the costs of corruption, skeptics question whether fighting it is worth the bother. The "fatalist" camp often points out the dearth of successes in anticorruption drives and remarks that it took more than a century for England to bring corruption under control. But Hong Kong SAR 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 some progress toward controlling corruption.

What are the most common features of these successes? Anticorruption watchdog bodies, such as the Independent Commission Against Corruption in Hong Kong 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 implementation of a public information campaign against corruption. Botswana is an example of a country with sound economic and public sector management policies that, once instituted, led to honest governance early on; its success has not been principally derived from the more recent advent of its anticorruption department.

> ***"Corruption and lack of economic and public sector reform go hand in hand, with causality running in both directions."***

Surveys of public officials and members of civil society in emerging economies may provide a useful perspective here as well: most respondents did not think highly of anticorruption watchdog bodies, rating their effectuality the lowest on a list of possible anticorruption measures (Chart 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,

Chart 2
What to do about corruption: Shares of respondents rating various domestic solutions



Source: Daniel Kaufmann, 1997, "Corruption: The Facts," *Foreign Policy*, No. 107 (Summer), pp. 114–31.
[1] Civil society respondents plus public officials.
[2] Private entrepreneurs, NGO staff members, and parliamentarians.

soundly rejecting the notion that such reforms fuel corruption.

In fact, survey respondents support the notion that corruption and lack of economic and public sector reform go hand in hand, with causality running in both directions. They 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. Respondents also brought up the challenges posed by international responsibility for part of the corruption experienced by many countries. While emphasizing first and foremost the domestic causes of corruption, many also indicated that bribery by foreign firms played a significant role. They thought that OECD member states should enforce antibribery legislation abroad and that international institutions should make curbing corruption a priority when providing assistance to their member countries.

In sum, corruption is a symptom of fundamental economic, political, and institutional causes. Addressing corruption effectively means tackling these underlying causes. The major emphasis must be put on prevention—that is, on reforming economic policies, institutions, and incentives. Efforts to improve enforcement of anticorruption legislation using the police, ethics offices, or special watchdog agencies within government will not bear fruit otherwise.

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 focus on internal competition and incentives in the public sector, and strengthening internal and external checks and balances. As a complement to these broader reforms, the careful and transparent implementation of enforcement measures, such as prosecuting some prominent corrupt figures, can also have an impact.

A comprehensive list of all possible anticorruption measures might include many not mentioned above. Emphasis should be placed on selecting the key measures to be implemented, in line with a country's implementation capabilities, during the first and subsequent stages of an anticorruption campaign. The entrenched nature of systemic corruption requires boldness in implementation—incrementalism is unlikely to work. Since windows of opportunity to take action against corruption have recently opened up in many countries, reformers will want to move quickly beyond the general first principles usually listed in the literature on corruption and instead demand practical, country-specific advice. After careful country assessments are prepared, specific policy and institutional advice will need to be provided. 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 opportunities for corruption.

Finally—and perhaps of fundamental importance for the next stage of both research on, and action against, corruption—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 within a country have brought about government reforms not only there but also in other localities. The existence of a free press is of paramount importance. Both the introduction and the continuance of restrictive libel laws protecting politicians and public officials must be opposed to safeguard citizens' freedoms of expression and information. Indeed, however difficult and imperfect gathering data and disseminating information about corruption are, and will continue to be, 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. F&D

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