

## CORRUPTION: CAUSES, CONSEQUENCES AND CURES

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*The paper stresses the need to keep the issue of corruption squarely in view in the development agenda. It discusses the causes and consequences of corruption, especially in the context of a least developed country with considerable regulation and central direction. Lack of transparency, accountability and consistency, as well as institutional weaknesses such as in the legislative and judicial systems, provide fertile ground for growth of rent seeking activities in such a country. In addition to the rise of an underground economy and the high social costs associated with corruption, its adverse consequences on income distribution, consumption patterns, investment, the government budget and on economic reforms are highlighted in the paper. The paper also touches upon the supply side of bribery and its international dimensions and presents some thoughts on how to address the corruption issue and to try and bring it under control.*

There is a growing worldwide concern over corruption at the present time. Several factors are responsible for this.

First, a consensus has now been reached that corruption is universal. It exists in all countries, both developed and developing, in the public and private sectors, as well as in non-profit and charitable organizations.

Second, allegations and charges of corruption now play a more central role in politics than at any other time. Governments have fallen, careers of world renowned public figures ruined, and reputations of well-respected organizations and business firms badly tarnished on account of it. The international mass media feeds on it and scandals and improper conduct, especially of those in high places, are looked upon as extremely newsworthy, and to be investigated with zeal and vigour. The rising trend in the use of corruption as a tool to discredit political opponents, the media's preoccupation with it as a highly marketable commodity, and the general public's fascination with seeing prominent personalities in embarrassing situations have brought

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scandalous and corrupt behaviour, a common human frailty, into the limelight of international attention.

Third – and the main issue taken up in this paper – is that corruption can be a major obstacle in the process of economic development and in modernizing a country. Many now feel that it should receive priority attention in a country's development agenda.

This greater recognition that corruption can have a serious adverse impact on development has been a cause for concern among developing countries. In a recent survey of 150 high level officials from 60 third world countries, the respondents ranked public sector corruption as the most severe obstacle confronting their development process (Gray and Kaufmann 1998). Countries in the Asia and Pacific region are also very worried about this problem and they are in substantial agreement that corruption is a major constraint that is hindering their economic, political and social development, and hence view it as a problem requiring urgent attention at the highest level.

Increasing public interest and concern over corruption have resulted in a large amount of scholarly research on the subject. Admittedly, there are still wide gaps in the current state of information and knowledge on the matter and much more remains to be done. Nevertheless, theoretical and empirical research that has been conducted thus far has yielded fresh insights into the problem. We now have a clearer understanding of the underlying causes of corruption, its consequences, and ideas and approaches on possible measures to combat it. At the same time, a better perspective has been obtained on the reasons why corruption persists in so many countries, and why it is difficult to deal with, although people throughout the world view it with disfavour.

This paper presents some ideas and issues that have emerged from the current discussion and ongoing debate on the corruption question in the region and around the world. It considers the causes, consequences and international dimensions of corruption, which seem to have generated a lot of public attention in many countries. Thoughts and suggestions on possible remedial measures have also been included as it would not be a fruitful exercise to only discuss issues and problems, without coming forward with some solutions as well. The aim of the paper is to create greater awareness of the subject and to highlight the desirability to keep it in view in thinking about development issues, especially in the context of a least developed country.

## I. DEFINITION AND CONCEPTS

### *Definition*

In this paper, corruption is defined as the use of public office for private gain, or in other words, use of official position, rank or status by an office bearer for his own personal benefit. Following from this definition, examples of corrupt behaviour would include: (a) bribery, (b) extortion, (c) fraud, (d) embezzlement, (e) nepotism, (f) cronyism, (g) appropriation of public assets and property for private use, and (h) influence peddling.

In this list of corrupt behaviour, activities such as fraud and embezzlement can be undertaken by an official alone and without involvement of a second party. While others such as bribery, extortion and influence peddling involve two parties – the giver and taker in a corrupt deal.

The two party type of corruption can arise under a variety of circumstances. Often mentioned are concerned with the following:

- (i) Government contracts: bribes can influence who gets the contract, the terms of the contract, as well as terms of subcontracts when the project is implemented.
- (ii) Government benefits: bribes can influence the allocation of monetary benefits such as credit subsidies and favoured prices and exchange rates where price controls and multiple exchange rates exist. Bribes can also be important in obtaining licenses and permits to engage in lucrative economic activities such as importing certain goods in high demand and in short supply. Moreover, bribes can be employed to acquire in-kind benefits such as access to privileged schools, subsidized medical care, subsidized housing and real estate, and attractive ownership stakes in enterprises that are being privatized.
- (iii) Government revenue: bribes can be used to reduce the amount of taxes, fees, dues, custom duties, and electricity and other public utility charges collected from business firms and private individuals.
- (iv) Time savings and regulatory avoidance: bribes can speed up the granting of permission, licenses and permits to carry out activities that are perfectly legal. This is the so-called “grease money” to turn the wheels of bureaucracy more smoothly, speedily and hopefully in the right direction. It is also not difficult to think of a really awful situation where rules and regulations, and the way they are applied, are so complex and burdensome that the only way left to get things done is to pay money to avoid them.

- (v) Influencing outcomes of legal and regulatory processes: bribes can be used to provide incentives to regulatory authorities to refrain from taking action, and to look the other way, when private parties engage in activities that are in violation of existing laws, rules and regulations such as those relating to controlling pollution, preventing health hazards, or promoting public safety as in the case of building codes and traffic regulations. Similarly, bribes can be given to favour one party over another in court cases or in other legal and regulatory proceedings.

### *Economic rent*

The concept of economic rent (or monopoly profit) occupies a central place in the literature on the subject of corruption. Economic rent arises when a person has something unique or special in his possession. This something special can be a luxury condominium in a posh neighbourhood, a plot of land in the central business district of the city, a natural resource like an oil well, or even some pleasing personal traits such as beauty and charm. A person who owns such a special asset can charge a more than normal price for its use and earn economic rent or monopoly profit. To illustrate, suppose there is a young lady who has breathtakingly good looks, a charming personality, and exceptional acting, singing and dancing skills. Due to these special personal assets, she becomes a superstar and a heartthrob of teenagers all over the country and thus commands a princely sum for her appearances. But what exactly is her economic rent? To determine this, it is necessary to know the next best thing she can do to earn a living if she is not a superstar. Suppose she has a law degree so the next best occupation she can take up is to become a lawyer. Then the difference between her income as a superstar and the earnings she can obtain from her next best occupation (as a lawyer), is her economic rent for having an unusually pretty face, charm, and superb singing, dancing and acting talents – a winning combination which no other young lady in the country can match.

A similar line of reasoning can be applied to a minor bureaucrat working in the business license issuing office of a government ministry. Suppose this bureaucrat has the responsibility of typing, stamping the official seal, getting the appropriate signatures and delivering the authorization letter that grants permission to business enterprises to engage in a certain line of economic activity. Business executives are anxious to have the letter typed expeditiously and correctly, and have it properly stamped, signed, sealed and delivered and are willing to pay a price for this special service. Hence the bureaucrat who has a monopoly of typing, stamping and processing the letter can use his official position to acquire economic rent from his clients. A useful approach to find out the amount of his economic rent is to think of what he can earn if he is fired from the licensing office. If the next best thing he can do when

he loses his government job is to become a taxi driver then the difference between his earnings at his new job and his intake as a public official is his economic rent.

In the light of the discussion above, the economic profession often refers to bribery, fraud, graft, and other shady deals involving misuse of public office as “rent seeking activities.”

### *Rules, regulations and their transparency and consistency*

The conduct of economic and business affairs, like engaging in a sporting event such as a football match, requires observance of certain “rules of the game” for activities to proceed in an orderly fashion. Rules and regulations are required to maintain a sense of fair play; to prevent disastrous conflicts; keep greed, predatory and other unsavoury human instincts in check; minimize socially undesirable consequences; and generally to ensure that players and referees abide by certain accepted standards of moral conduct and good behaviour. Naturally, for rules to be properly observed, they must be transparent, that is, must be set out clearly and made known in advance to all concerned, so that they can be understood and obeyed by participants in the game. The game cannot proceed in an orderly way if players are uncertain about what constitutes a foul for which they will be penalized, or the referee is not sure when to blow the whistle. Aside from being clear, rules must also be applied in an impartial manner with respect to all players and must be consistent and not be subject to frequent and arbitrary changes. Obviously, the game will become unplayable and players will pack up and leave, if rules keep changing as the game proceeds and the referee keeps blowing his whistle whenever he feels like it.

### *Discretionary powers*

Discretionary powers represent another key concept in discussing corruption. They arise because it is not possible to devise rules and regulations that are watertight and foolproof and will take care of all contingencies that can crop up in trying to control or direct an economic activity. Hence, some flexibility and discretionary powers will have to be given to administrators in interpreting and implementing rules. Even in a football match, the referee is granted discretionary powers and has considerable freedom to exercise his good judgment in reaching decisions such as in awarding a penalty kick or showing a yellow or a red card to an offending player. These decisions could prove decisive in determining the final outcome of the game.

To elaborate on the above point a little further, consider a case involving customs administration. A general rule, let us assume, has been established to levy a duty of 50 per cent on all consumer electronic goods entering the country. In order to implement this rule, customs officials must also be provided with some guidance on how to value such goods for customs purposes. One foolproof way to take care of this problem is to prepare a book that lists the prices of all consumer electronic goods

that could possibly be imported into the country. But there are literally thousands of consumer electronic goods and each item comes in a large variety of brands, makes, models, characteristics, technical specifications and prices. With rapid technological advance in this industry, many older models are being discontinued due to obsolescence, while new models and entirely new products are coming on the market every day. In this dynamic context and intense competition that characterizes the market for these products, price changes occur frequently. Prices of some computer products, for example, are known to have nose-dived to unheard of low levels within a short period of a few months. Hence, to prepare a book that takes account of all these contingencies, and that provides a comprehensive, accurate, and up-to-date list of prices of consumer electronic goods would be a formidable task. The book would run into several thousand pages and there is a good chance that it would be out of date once it comes out in print. The costs in terms of time, effort and money to prepare such a book could exceed the customs revenue that may be realized from the imported goods.

In addition to the customs valuation issue, there is the tricky question of deciding the customs category to which a particular imported good belongs. For example, an audio cassette player can be regarded as a "luxury consumer electronic product" when it is used for listening to popular songs in the living room of a well-to-do family. But the same cassette player can be looked upon as an "educational tool" when used by a student in the language lab of a foreign language institute. Likewise, it can also be considered as a "device to propagate religion and to uplift the spiritual well-being and moral standards of the people" when used to broadcast the teachings of a revered monk at a religious gathering. In short, regardless of how ingenious we are in designing rules and regulations, there must always be some room for personal judgment and freedom to exercise a measure of discretion on the part of officials administering and implementing the rules; or else if everything has to be done "by the book", general paralysis will set in and the whole administrative machinery will come to a grinding halt.

### ***Accountability***

Finally, a few remarks about accountability are necessary as it occupies an important place in considering the corruption question. Accountability has to do with the fact that for proper observance of rules and regulations, those administering the rules must be held responsible and accountable for their actions. For example, it is normal practice in most countries to request assistance from parents to help finance desirable projects in their children's school. Usually such projects are well publicized, and their objectives, benefits, work plan and estimated costs are explained in detail to parents. Periodic progress reports are provided when the project is under implementation. And then when it is completed, a final report is prepared highlighting how the project's objectives have been achieved and where full disclosure is also

made and properly audited accounts are presented with respect to total contributions received and costs incurred. Under these circumstances, school authorities can be held accountable for their actions. When something appears questionable, improper, or inaccurate in the information and accounts presented, the authorities can be called upon to provide an explanation to clarify the matter and to take corrective action and make amends, as necessary. Those in charge are obliged to respond to such queries so that doubts are cleared, and remedial or disciplinary actions are taken to the satisfaction of all concerned.

On the other hand, a family can be asked to make a large financial contribution as a condition for enrolment of a child in the kindergarten. Parents are told the contribution is for upgrading facilities in the school and to improve the welfare of students, teachers, and administrative and general services staff. But if no receipt is issued for the payment made and no financial statements or information are provided on how the money is utilized, then there is no accountability.

## II. CAUSES, INCIDENCE AND FORMS

### *Corruption equation*

Drawing upon the concepts described above, a corruption equation can be set out as follows (Klitgaard 1998):

$$C = R + D - A$$

In the above equation, C stands for corruption, R for economic rent, D for discretionary powers, and A for accountability. The equation states that the more opportunities for economic rent (R) exist in a country, the larger will be the corruption. Similarly, the greater the discretionary powers (D) granted to administrators, the greater will be the corruption. However, the more administrators are held accountable (A) for their actions, the less will be the corruption, and hence a minus sign in front of A.<sup>1</sup>

Stated differently, the equation tells us that a fertile ground for growth of a thoroughly corrupt system will emerge in a country if it satisfies the following three conditions:

- (i) It has a large number of laws, rules, regulations, and administrative orders to restrict business and economic activities and thereby creates huge opportunities for generating economic rent, and especially if these restrictive measures are complex and opaque and applied in a selective, secretive, inconsistent and non-transparent way;

<sup>1</sup> Mathematically speaking, we can say C varies directly with R and D, and inversely with A.

- (ii) Administrators are granted large discretionary powers with respect to interpreting rules, are given a lot of freedom to decide on how rules are to be applied, to whom and in what manner they are to be applied, are vested with powers to amend, alter, and rescind the rules, and even to supplement the rules by invoking new restrictive administrative measures and procedures; and
- (iii) There are no effective mechanisms and institutional arrangements in the country to hold administrators accountable for their actions.

### *Levels*

Although corruption can occur at a variety of levels, attention has usually been directed at only two – namely, the high and the low – and these are believed to reinforce each other.

High level corruption refers to misconduct at the top and by leading politicians. Since these people are generally well-off and have a lot of privileges associated with their high office, their corrupt behaviour is not attributable to low pay and out of necessity to meet the living expenses of their families. Instead, greed is considered a main motivating factor. But there are other compulsions. To remain in office, for example, can also be an overriding motivating force. With election campaigns becoming expensive, corruption related to campaign financing is a big political issue in some countries. The need to dispense favours among political allies, colleagues and subordinates to keep them happy, cooperative and loyal is another factor. Moreover, in some societies there are traditions and customs whereby elected officials are expected to make substantive contributions to the welfare of the people in constituencies that elect them. For instance, in some countries a politician is required by tradition to present an expensive gift at a wedding involving a supporter in his electoral district. When such a community has a large number of wedding receptions, birthday parties, anniversaries, celebrations, rituals, festivals, and fund raising ceremonies for all sorts of worthy causes, the financial burden of these festivities can fall heavily on elected officials. And the higher up you are in the pecking order, the larger is the contribution you are expected to make by custom and long held traditions of the land. Hence, there are economic, political, social and cultural imperatives that motivate higher level bureaucrats to engage in rent seeking activities.

At the other end, low level corruption – such as the underhand payment that has to be made to a clerk to expedite the issue of a driving license – has its own set of problems. In this case the general perception is that civil servants with insufficient salaries to meet the living expenses of their families are driven by necessity to engage in corrupt practices. Raising their pay, it is argued, will mean less need to depend on illegal activities to earn a living while they have more to lose if they get caught. This sounds reasonable and there are cases where countries that pay their civil servants



well, tend to have less public sector corruption than in those where pay scales are low. But there is no hard evidence to suggest that low level public employees are less greedy than their superiors. The line between “need driven” and “greed driven” corruption is hard to draw and it is difficult to determine where one ends and the other begins. Thus, there are those who believe that increasing pay without other complementary measures is not likely to have a significant impact on reducing corruption. On the contrary, the cost to the government budget of paying employees more, may be much larger than the benefit that may result from reduced corruption. Moreover, when no serious efforts are made to control inflationary pressures in a country, shopkeepers will take an increase in civil servant salaries as a sign for them to raise prices. Higher pay leading to higher prices and higher costs of living mean there is no increase in the “real” wage of government employees and no improvement in their welfare. But raising civil servants’ pay, by causing a general increase in prices, will lead to a deterioration of economic conditions for everybody. This illustrates the point that there is a need to control inflation, restore macroeconomic stability, address the underlying causes for destabilizing speculative behaviour, and to build confidence in the economy for the success of any reform measure.

Aside from encouraging corruption, low pay has other detrimental effects on the attitudes and performance of public employees. It contributes to reducing incentives, low morale, increased inefficiency, moonlighting and absenteeism and loss of self respect and dignity. As a result, some of these employees become nasty, rude and indifferent in their dealings with the general public. They can be exasperating and create a lot of nuisance value to ordinary citizens. Under these circumstances, it is also hard to recruit and retain good workers as they will seek employment or leave to take up more challenging and higher paying jobs in the private sector or abroad. Hence, rather than considering the matter only from the corruption point of view, a more wide-ranging civil service reform programme, including adjusting salaries to cover the living expenses of an average family when inflationary expectations have been brought under control, would need to be given careful and serious attention where such conditions prevail in a country.

### ***Incidence***

Incidence of corruption varies among societies, and it can be rare, widespread or systemic. When it is rare, it is relatively easy to detect, isolate and punish and to prevent the disease from becoming widespread. When corruption becomes widespread, it is more difficult to control and to deal with. But the worst scenario is when it becomes systemic. When systemic corruption takes hold of a country, the institutions, rules and peoples’ behaviour and attitudes become adapted to the corrupt way of doing things, and corruption becomes a way of life. Systemic corruption is very difficult to overcome and it can have a devastating effect on the economy.

### ***Well-organized and chaotic***

Another useful distinction that is often made is between well-organized and chaotic corruption (Mauro 1998). Under a well-organized system of corruption, business executives have a good idea of whom they have to bribe and how much to offer them, and they feel reasonably sure of obtaining the favour for which the payment is made. This takes a lot of hassle and uncertainty out of corruption which is a big plus factor. Moreover, under a well-organized system, bribe-receivers take a longer run view of the situation and think of cuts they can get from profitable deals and a continual stream of income that can be realized when entrepreneurs and business firms they have been associated with become prosperous and well-established with the passage of time. They, therefore, have an interest not to unduly harm the goose that may be laying golden eggs in the future.

In sharp contrast, under chaotic corruption, there is a lot of confusion and no one is exactly sure how much to pay and to whom payment is to be made. So in this confused state of affairs, business people end up paying bribes to a lot of officials without assurance that they will not be asked to pay additional bribes to more officials further down the line. With unclear delineation of authority and responsibility, the outcome of the bribe, and whether the sought after favour will be delivered, is also uncertain. Moreover, there is little coordination among numerous bribe-takers with regard to bribe levels, and one corrupt official has no idea what the other corrupt official is charging. Consequently, there is a tendency to overcharge and demands may be made that are felt excessive and unreasonable by the business community. When that happens, the goose will become disoriented and dispirited, and may not bother to make the required effort to lay eggs.

## **III. SUPPLY SIDE AND INTERNATIONAL DIMENSIONS**

### ***Supply side question***

Up to now, our discussion of corruption has dwelt on officials misusing their public office for their own private benefit. This considers the problem from the receiving end, or demand side of the transaction. It does not present a balanced view of the matter. Looking at the problem only from the demand side gives an impression as if those on the supply side, the ones who give bribes, are innocent victims who are forced by corrupt officials to make payoffs to go about their own legitimate business. In reality this is usually not the case. Since both parties (giver and taker) in a bribery deal can gain from the transaction, they often conspire to defraud the public. In fact, a bribery deal can easily be initiated from the supply side, and big local business firms, and large multinational corporations from industrialized countries in particular, can make proposals which officials in poor countries will find hard to resist.

To give an illustrative example, suppose the health ministry of a small developing country has received a grant of a million dollars from a donor agency as emergency food aid for the country's children who are badly undernourished due to dislocations resulting from a recent flare-up of ethnic violence. A European foodstuff supplying company conspires with the health minister of this country to supply milk powder whose date for safe use has expired and which therefore can be purchased at a cheap price. The food supplier makes a handsome profit from the deal and transfers an agreed sum from the proceeds into the foreign bank account of the minister. The supplier and the minister benefit. The children suffer because consumption of the tainted milk powder not only has little nutritious value but it also upsets their stomachs and adds to their misery.

Hence, there is growing realization in the industrialized world that to help poor countries fight corruption, it is not sufficient to view the matter only from the demand side and to be advising them to launch campaigns against corrupt officials and systems in their countries. For a more realistic and balanced approach to the problem, industrialized countries must also direct attention to the supply side, to bribe givers, who often turn out to be business firms with headquarters in their own backyard.

### *International dimensions*

But why should advanced countries be concerned about corruption in poor countries? One good reason is that with the ending of the cold war, there is less need for major donors to be distributing aid based on political considerations. As a result, other considerations such as whether aid is properly used and whether it is benefiting the people for whom it is intended (such as the poor) are gaining prominence. A perception among donors is that the effectiveness of aid has been much reduced due to corruption. Aid giving countries, as well as the IMF and World Bank, are therefore devoting increased attention to this matter in dispensing aid.

Aside from aid effectiveness, greater integration of world financial markets and advanced technology have made it possible to transfer millions of dollars from one country to another by a mere click of a computer mouse button. Consequently, corruption has gone international and high-tech. Like terrorism, the drug menace, AIDS, and environmental degradation, it is one of those problems that has no respect for national boundaries. As such, the need for an international response to it has become evident (Klitgaard 1998).

### *Initiatives to counter global corruption*

The increased acceptance of the international dimensions of the corruption issue has prompted industrialized countries to take some initiatives to address the problem, and especially to make life tougher for bribe giving business firms in their

own countries. These initiatives fall into four broad categories and are briefly described below (Vogl 1998).

First, activities carried out by the press and public prosecutors in the leading industrial countries to investigate and expose bribery have created greater public awareness of the problem and have led to the adoption of remedial measures. Domestic scandals are the main target of these investigations but they easily spill over into misdeeds done overseas. A good example is the experience of the United States in the 1970s. The Watergate affair and the international corporate scandals exposed by the country's Securities and Exchange Commission and the Senate's Subcommittee on Multinational Corporations provided the stimulus for the passage of its Foreign Corrupt Practices Act in 1978. The Act makes the payment of foreign bribes by United States firms a crime.

Second, the above example set by the United States has now received wider acceptance in the developed world. In December 1997, the 29 member governments of the Organization for Economic Cooperation and Development (OECD) signed the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. It called upon these governments to enact legislation to criminalize foreign bribery. In addition to these official initiatives, there have been some moves from the private sector as well. Recently, the International Chamber of Commerce adopted new antibribery standards. It will also be useful to mention that many multinational corporations have been paying bribes around the globe for decades and changing corporate habits, like in any large bureaucracy, is not easy. But it is encouraging to note that executives of the world's largest multinational companies are becoming increasingly sensitive to the corruption question and they have been giving support to the initiatives for reforms taken in this sphere. Moreover, of no less significance are the activities of the Transparency International, an NGO acting as a watchdog on international corruption. It started operations in the early 1990s and now has 70 national chapters around the world. It is expected to play a useful role in monitoring implementation of the OECD anti-bribery convention when it comes into force.

Third, there is a need to counter international money laundering, which is regarded as a handmaiden of global corruption. Bribery is so much more appealing, profitable and safe if an official in a poor country can rely upon the expertise and good offices of the world's top multinational corporation to help him take the necessary evasive action and deposit his share of the loot in a discreet foreign bank account. The devious ways in which money is laundered worldwide make most leading international banks unwitting, though not entirely innocent, participants in the game. The magnitude of this business is large. In a speech given in February 1998, Mr Michel Camdessus, IMF's Managing Director, said: "estimates of the present scale of money laundering transactions are almost beyond imagination – 2 to 5 per cent of global GNP" (Vogl op. cit). The World Bank estimates world GNP to be

\$29,926 billion in 1997 (World Bank 1998). Two to five per cent of this comes roughly to around \$600 billion to \$1,500 billion. Since the total GNP of low income countries in the same year is estimated at \$722 billion<sup>2</sup>, the share going to officials from poor countries is likely to form only a tiny percentage of the huge sums involved in global money laundering transactions. As in the case of world trade, investment and finance, the developed countries are probably each others' best customers in the international money laundering business. Consequently, new and innovative regulatory initiatives have been taken in many of these countries to strengthen detection of money laundering and to improve supervision of financial institutions to limit the scope of this activity. But time and again, corruption has been able to stay one step ahead of the best regulatory measure that can be devised to control it, and the fight is turning out to be an uphill battle.

Finally, direct measures in trade and public procurement are also seen as necessary to combat global corruption. The World Trade Organization (WTO) is sensitive to this issue as corruption is unfair, does not provide a "level playing field" for participants in the game, and causes distortions in the world trading system. The WTO, under pressure from leading industrial nations, is expected to take up the matter in a big way when the OECD antibribery convention comes into force and governments have formally adopted policies penalizing business firms paying bribes in other countries.

#### IV. ECONOMIC CONSEQUENCES

##### *Grand corruption*

When one considers the economic consequences of corruption, the adverse impact of grand corruption comes readily to mind. Corruption on a grand scale associated with some dictators and their cronies can involve embezzlement of huge sums of public funds, and the mismanagement, wastage, inequity, and social decay that come along with it, can be disastrous for an economy. There are familiar tales of fortunes in gold, gems and jewelry stashed away in secret hiding places by corrupt officials and hundreds of millions of dollars spent in acquiring real estate abroad and in depositing into their foreign bank accounts. The devastating impact of misconduct on such a massive scale, especially for poor countries that are facing perennial and severe foreign exchange shortages, is obvious and requires no further comment. But corruption does not have to be on a grand scale to inflict serious damage. There are other adverse effects that can be just as damaging for a poor country. These deserve a closer look and are taken up below.

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<sup>2</sup> The World Bank designates a country with a per capita income of \$785 or less in 1997, as a "low income country".

### ***Rise of the underground economy***

Underground economic activities exist in all countries. They are of two types. First, there are those that are illegal such as engaging in the drug trade or the smuggling business. The second consists of those activities that are legal but are not officially recorded to evade taxes or for some other reason. Corruption gives rise to both these types of activities and contributes directly to the rise of the underground economy.

Although underground economic activities exist in all countries, they become pervasive where corruption is widespread. When a large portion of an economy goes underground, official macroeconomic data which mostly cover only the formal sector, become unreliable to assess economic performance or to provide a basis for policy making and analysis. Official foreign trade statistics, for example, no longer reflect a country's true volume, or value, of exports and imports because of large illegal and unrecorded movements of goods and services across the border in a thriving smuggling business. Similarly, the official exchange rate becomes symbolic and generally meaningless when foreign exchange dealings are mostly transacted in the parallel market and at the unofficial exchange rate which bears no relation to the official rate. The inflation rate, based on the consumer price index (CPI), also becomes suspect as the consumer basket of goods and services which is used to calculate CPI, may not adequately cover items that consumers have to purchase in the unofficial market at exorbitant prices. Likewise, the official interest rate – a continuing source of dismay, frustration and headache for the formal banking community – may not reflect the true cost of capital and may diverge considerably from the more realistic interest rate at which a large volume of financial transactions takes place in the informal credit market.<sup>3</sup> Similar problems arise with respect to other key macroeconomic indicators. Under these circumstances, proper economic accounting and macroeconomic management become difficult. In the absence of reliable data, transparent policies, and proper macroeconomic management, there is not much hope for economic development, modernization, or emergence of a well functioning market economy.

### ***Income distribution***

Under a corrupt system, the privileged and the well-connected enjoy economic rent. Economic rent, by definition, represents abnormal or monopoly profits and can bestow large benefits. As such, there is a tendency for wealth to be concentrated in the hands of a tiny minority of the population. Income distribution, therefore, becomes

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<sup>3</sup> This is not to deny the fact that interest rates in any informal credit market tend to be high, due to the unorganized nature of the market, lack of adequate information, lack of collateral, high transaction costs associated with servicing a large number of small loans, high risk premiums, and other market imperfections.

highly uneven. In addition, the burden of corruption falls more heavily on the poor as they cannot afford to pay the required bribes to send their children to a decent school, to obtain proper health care, or to have adequate access to government provided services such as domestic water supply, electricity, sanitation and community waste disposal facilities. An undesirable situation can arise as in some countries where through illegal connections to the water mains, the water sprinkler system in a golf course operates most of the day to keep the grass green on the fairways, while villagers living across the street do not have sufficient water for their daily household needs. At night, through payment of bribes, the driving range of the golf course is ablaze with floodlights, while children in the nearby village have to do their homework by candlelight in support of the government's energy conservation effort.

### ***Consumption pattern***

Closely associated with an unequal income distribution and concentration of wealth in the hands of a few, there emerges a distorted consumption pattern aimed at meeting the lifestyle of the new and extremely rich urban elite. This involves import of a large variety of luxury goods from abroad – flashy cars, lavish home furnishings, state-of-the-art consumer durables and electronic products, fashion clothing, exotic perfumes, expensive foodstuffs, fine wines and spirits, and fancy goods of all kinds that can be found in supermarkets and department stores of any prosperous Asian city in the heyday of the region's economic boom. Most of these goods are, of course, beyond the reach of ordinary citizens in the cities and in the countryside. Conspicuous consumption with expensive cars cruising along dirt roads, and conspicuous construction with luxury apartment buildings rising amidst poverty and squalor, bring home the point that affluence is not widely shared in these countries.

### ***Impact on investment***

Corruption's adverse impact on private investment, both domestic and foreign, is considered to be particularly harmful for a developing economy. Bribes may have to be given before any investment takes place and upon entering into negotiations for the establishment of an enterprise. More payments usually follow in the process of setting up the business. Procurement of leases for land and buildings; permission to engage in activities such as production, transport, storage, marketing, distribution, import and export; obtaining connections for water, gas, electricity, and telephone; having access to telex, fax and e-mail facilities and so on; can involve payment of substantial bribes at various stages and may require the services of agents with specialized expertise on how to get around complex rules and procedures to acquire these things. Unfortunately, these agents and middlemen, instead of being part of the solution can often become a part of the problem. Their services do not come cheaply

and they add to the cost and complexity of doing business under a corrupt regime. Then, when the enterprise is finally established and up and running, corrupt officials may demand cuts from the firm's earnings. Moreover, in order to establish and maintain good public relations, and for continued viability of the enterprise as a business concern, entrepreneurs may have to contribute to all sorts of charities and worthy causes that are unrelated to their line of work.

Bribe payments constitute a form of tax on enterprises. But they represent a pernicious type of tax as bribery deals have to be struck in a surreptitious way and bribe-givers cannot always be certain that bribe-takers will live up to their part of the bargain. It is also a regressive form of tax. Its burden falls more heavily on small businesses in trade and service sectors as these small entrepreneurs normally do not enjoy political patronage. Hence, corruption not only raises the initial costs of investment but by substantially increasing risks and uncertainty for a venture, can significantly reduce the incentive to invest.

For a poor country, talented local business people, managers, entrepreneurs, and industrialists represent a scarce and valuable resource. Their talents should not be wasted in rent seeking activities. They should be doing productive work. For them to invest and engage in productive work will require not only political stability but economic stability as well as a measure of predictability and honesty on the part of the government.<sup>4</sup> Surveys have also revealed that business people have to spend a lot of management time in discussions, negotiations and waiting for appointments with bureaucrats and public officials in corrupt regimes than in countries where there is less corruption (Gray and Kaufmann *op. cit.*)

As for foreign direct investment (FDI), the benefits it can bring to a developing country are well known. FDI helps augment the much needed capital resources in a poor country. What is more important, it can also bring technology, knowhow and managerial and marketing skills that improve a country's international competitiveness, help develop valuable market outlets abroad, and strengthen foreign contacts and broaden the outlook of its business community. Moreover, foreign investment can increase employment opportunities, assist in improving labour skills, and can produce useful goods and services for the domestic market. It can also be crucial in building modern infrastructural facilities, establishing reliable energy generating and distributing systems, setting up high technology communication networks, providing efficient transport links with the rest of the world and in developing capital markets and business and financial services which are essential for a country to become a modern, developed nation. In short, FDI can play an important role in assisting a country to modernize and to more fully develop its productive potential.

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<sup>4</sup> Economic stability involves two things. First, there must be internal stability by keeping the domestic inflation rate low and the budget deficit at a prudent level. Second, there must be external stability by keeping the exchange rate relatively stable and maintaining balance in the balance of payments.



The above advantages of FDI will be forthcoming to a country only if it provides a conducive climate for foreign investment. FDI will not come in a big way where policies are unclear and inconsistent, relevant and reliable economic information and data to plan and make sound business decisions are hard to come by, and the courses of action and measures the government is likely to pursue on the major issues facing the economy are difficult to fathom and to predict. Long term investment decisions cannot be taken under such conditions. Both the quantity as well as quality of foreign capital inflows into the country will therefore be adversely affected. The type of investment that foreigners would be willing to undertake in this uncertain economic climate would mostly consist of activities to exploit the country's natural resources or to engage in quick yielding ventures that have little beneficial spread effects and backward and forward linkages with the domestic economy. Investments in setting up facilities to assemble, package and label imported parts and components for export represent a good example. These activities bring little in the way of local value added, or in imparting skills and technology to help a poor country in its industrialization effort.

At a more fundamental level, corruption makes it difficult for a low income country to establish and maintain domestic and internationally acceptable "rules of the game" which are necessary for orderly and proper conduct of investment and business activities. This deficiency is believed to be an important reason why the least developed countries in the world are poor. It is also believed to be a reason why some of them will remain that way (Klitgaard op. cit).

### ***Effect on the government budget***

Corruption can have undesirable consequences on both the revenue and expenditure sides of the government budget. The consequences on the revenue side are more familiar. Paying bribes to reduce taxes, fees, dues, custom duties and public utility charges such as for water and electricity, are common in many countries. Bribes are also used to make illegal water, electricity, gas and telephone connections to have access to these facilities without paying for the services obtained. All these result in serious losses of revenue for the government. Fraud, embezzlement and misappropriation of public funds add to the losses.

The consequences on the expenditure side are more insidious. Corruption adversely affects the composition of government expenditure. This is because large benefits can be realized from corrupt deals on expenditure items that are expensive, whose costs are not readily apparent, and which are considered to serve some high national priority concern so that they have to be undertaken in a discreet and secretive way. Purchase of jet fighter aircraft, for example, ideally meets these requirements. This item is costly, it is not something that one can buy in a supermarket and find out its price, and it is required to safeguard national security – a high national objective

which no one wants to compromise or to appear unpatriotic by questioning its usefulness. Moreover, acquisition of fighter jets is politically sensitive and hence the deal has to be handled with considerable discretion. Large and expensive projects whose costs are hard to determine but with huge potential for kickbacks and economic rent are also good candidates for corrupt deals and hence for inclusion in the national budget. On the other hand, not much money can be made by spending on teachers' salaries, in buying school textbooks, or on projects on rural preventive health care or training programmes to meet a shortage of a vital labour skill in industry. Corrupt regimes therefore tend to devote a large share of their national budget expenditures on acquiring sophisticated military hardware and on large projects, and less on education and health, and on other priority needs that would contribute towards overcoming critical bottlenecks in the economy and help ease hardships that most ordinary people face in their daily lives.

### *Social costs*

In any society, there are laws and regulations to serve social objectives and to protect the public interest, such as building codes, environmental controls, traffic laws and prudential banking regulations. Violating these laws for economic gain through corrupt means can cause serious social harm. There are many instances of this throughout the Asia and Pacific region.

For example, there have been numerous cases where soil erosion, resulting from illegal logging, has led to whole villages being washed down hill sides in flash floods or buried in mud slides, taking a heavy toll in lives. Violating building codes through the connivance of corrupt officials and building contractors has resulted in collapse of apartment buildings, department stores and hotels in some countries. Failure to observe proper fire prevention and safety regulations has caused supermarkets, hotels and discos, filled with shoppers and customers to go up in flames. Overloaded ferries and passenger ships have sunk in seas and rivers all over the region. Paying bribes to operate un-roadworthy and poorly maintained public vehicles have led to accidents on the highways and buses plunging down ravines and gorges due to mechanical failure are common in many countries.

There has also been growing concern over corruption in large infrastructure projects such as dams and bridges. A huge project, estimated to cost over \$7 billion is a source of particular worry (*Asiaweek*, 9 April 1999). Shoddy workmanship, use of substandard materials and disregard for proper design and engineering specifications, due mainly to corruption, have caused bridges to collapse and dams to burst, resulting in heavy loss of life and property.

Obscure insider trading practices and financial scams that can result from poorly supervised financial systems also have serious economic and social consequences. People have lost their life savings and fortunes in financial scams.

This has led to massive street demonstrations and civil unrest in several east European countries. Lack of transparency, shady deals and corrupt practices have also been a contributing factor to the financial and macroeconomic crisis that has swept across East and South-East Asia.

### ***Price controls, subsidized goods and black markets***

It is a common practice in many developing countries to institute price controls and to provide essential goods and services at subsidized prices to consumers. The official price for a key food item, such as rice, is fixed by paying a low administratively set price to farmers, while gasoline, electricity and charges for public transport and other essential items are provided at low subsidized prices. These mostly benefit city dwellers as they are the main consumers of these subsidized goods and services. The urban bias in the provision of subsidized food and other necessities stems from the political reality that city dwellers, especially the large masses at the lower end of the income scale, are more politically conscious, better organized and are easier to be instigated into civil unrest than the rural poor. It is usually discontent in the cities that ignites social and political upheavals in a country.

Fixing prices at artificially low levels lead to demand exceeding supply for the subsidized goods so that the all too familiar shortages, rationing, corruption and black markets result. Several undesirable consequences follow.

First, there is a loss of potential government revenue. For example, when those that have access to subsidized gasoline, such as government officials and car owners, sell it on the black market at several times the official price, they make large profits. These profits could be expropriated as revenue by the government, if there is no subsidy, no price distortion, and gasoline is valued at its true opportunity cost, that is, charged by the government at its market clearing price.

Second, setting low farm prices on rice and other agricultural products, to provide cheap food for city dwellers, means farmers are subsidizing the people in the cities. Likewise, low prices set on gasoline and energy contribute to deficits in the government budget. When these deficits are met out of the general budget, is tantamount to the rest of the country, and especially the rural sector, subsidizing the consumption of these goods and services by the urban sector.

Third, fixing low prices on rice and agricultural products, in the wake of sharp increases in the prices of other domestically produced and imported goods (such as fertilizers), turns the terms of trade against farmers. This adversely affects their incentive to produce and hence agricultural output.

Fourth, low prices set on energy result in huge losses for the government enterprises engaged in this area. Consequently, they do not have the resources to invest in new facilities, to buy spare parts or to properly maintain existing machinery and equipment that are falling into disrepair. Some machines and transmission lines

that are still in use may have outlived their useful economic life. The outcome is frequent breakdowns, unreliable and poor service, and general inability to meet requirements in terms both of generating capacity and in the quality of energy produced.

Finally, under-pricing energy has other detrimental effects. Cheap energy leads to its uneconomic and wasteful use. Moreover, when energy prices are kept at a level much below cost for decades, there is little incentive for its users to adopt energy efficient technologies and methods of production. So they are not sufficiently prepared for the large price adjustment that inevitably comes when low prices are no longer sustainable due to an internal or an external shock. The result is disruption in production, more corruption as bribery will be resorted to in order to avoid payment of the higher charges, and increased inflationary pressures as higher energy costs will be passed on to consumers by raising prices.

Thus, price controls, subsidies and the corruption and black markets they generate, can lead to undesirable social and economic consequences. This also illustrates the point that dismantling controls, getting rid of subsidies, preventing price distortions, and “getting prices right” in general, form a key element in economic reforms and for the establishment of a properly functioning market economy.

### ***Impact on economic reforms***

Unfortunately, corruption places severe constraints on a country’s capacity to undertake economic reforms. This is because reforms require greater transparency, accountability, free and fair competition, deregulation, and reliance on market forces and private initiative, as well as limiting discretionary powers, special privileges, and price distortions – all of which will reduce opportunities for economic rent on which corruption thrives. The rich and the powerful, the main gainers of a corrupt system, will therefore oppose reforms.

## **V. REMEDIAL MEASURES**

### ***Corruption and poor countries***

Although corruption exists in all countries it is more widespread in low income countries. This is not because people in poor countries are more corruptible than their counterparts in rich countries. It is simply because conditions in poor countries are more conducive for the growth of corruption. Bribery and graft are crimes of calculation and not of passion. Hence, when benefits are large, chances of getting caught are small, and penalties when caught are light, then many people will succumb.

Low income countries usually have highly regulated economies that give rise to large monopoly rents. Accountability in these countries is generally weak. Political competition and civil liberties are often restricted. Laws and principles of ethics in government are poorly developed and legal institutions charged with enforcing them

are ill-prepared to address this complex task. Watchdog organizations that provide information on which detection and enforcement for anti-bribery action is based, such as investigators, accountants, the press, and other civil society organizations, are not well developed and are sometimes suppressed. On the other hand, the discretionary powers of administrators are large, with poorly defined, ever-changing and poorly disseminated rules and regulations making the situation worse. Given these formidable constraints, what can be done to redress the situation?

### *Pessimistic view*

Those with a pessimistic outlook will say “nothing much” and the matter is not worth the bother. Since the top leaders, key politicians and those in power, in collusion with leading international firms and prominent local business people are involved, and are reaping huge benefits from the system, chances of bringing about change appear remote. The pessimists point out that even in a country like Britain, it has taken over a hundred years to bring corruption under control (Gray and Kaufmann op. cit.). They also note the lack of substantive progress in anti-corruption drives that are underway in many Asian countries. One country, for example, has launched a major campaign for nearly a decade, but results achieved have fallen far short of expectations. The top leaders in this country have come out strongly against corruption in their public statements on many occasions, considering it a matter of the highest national priority and concern. It is also reported that 35,084 cases of official graft and embezzlement were investigated in the country in 1998, out of which action was taken in 26,834 cases (Asiaweek, 9 April 1999). In addition, several prominent figures from the party, government, and the business community were arrested and persecuted. But the problem remains far from being resolved, and the country’s leaders would be the first to admit this. Thus, the Prime Minister has designated fighting corruption as one of the four overriding national objectives in the country’s development agenda for the coming years.

While campaigns against corruption have not met with much success, there have been worrisome developments on this front that make the situation appear more hopeless. In many countries, corruption has now reached new heights where rules and regulations are increasingly looked upon by public officials as a means to augment their low salaries. New rules are invoked and existing rules changed solely to generate income for themselves. Bribery and extortion have become institutionalized and take forms such as open requests for contributions and forced sale to the general public of unwanted and unnecessary articles at high markup prices as a means to raise revenue.

A basic difficulty with systemic corruption is that when the majority of people operate under such a system, individuals have no incentive to try to change it or to refrain from taking part in it even if everyone would be better off if there were no corruption. So people become resigned and try to make the best of a bad situation

and to get on with their lives. Why bother changing something that can't be changed? Why bang your head against a wall? Why entertain a buffalo with harp music? Nothing lasts forever anyway, and so on, are the type of attitudes that prevail in such a society.

### ***Optimistic view***

But not everybody agrees that endemic corruption is in the nature of things and the unenviable lot of low income countries. These more optimistic people point out that there are developing countries in the world, such as Botswana and Chile that, at present, have less bribery than many industrialized countries. They note that developing economies like Hong Kong, China and Singapore have been able to transform themselves from being very corrupt to relatively clean within a reasonably short period of time. They also point to serious efforts at market reforms and development of democratic institutions that are taking place in many developing countries which everybody knows would reduce opportunities for economic rent and, thus, benefits to be derived from corruption. They are encouraged by many top leaders in the Asia and Pacific region that openly discuss corruption in their countries, freely admit that it is imposing a severe strain on the social and moral fabric of their communities, that it is destroying their institutions, and hence recognize it as a critical problem that must be urgently addressed. Finally, the optimists also point out that campaigns against poverty, hunger, disease and injustice have been going on for decades and the fact that they have yet to yield satisfactory results in many parts of the world, does not mean that such efforts should cease. The fight against corruption, they say, should be viewed in the same light. No one claims it can be eliminated. But they believe it can and should be checked and brought under control so that the bad effects are minimized.

### ***Remedial measures***

Some ideas and suggestions that have been put forward by the members of the optimistic camp to fight corruption are as follows:

- (i) **Leadership:** For proper house cleaning and repairs, it is a good idea to begin by fixing the roof. Hence, many authors, including Professor Syed Hussein Alatas of Malaysia, a noted authority on corruption, are of the view that the leadership in a country has a key role to play in combating corruption (Alatas 1999). It is an Asian tradition to hold leaders and those in authority in high regard and esteem. Hence the top leadership must set a good example with respect to honesty, integrity and capacity for hard work. Since fighting corruption will involve taking difficult decisions, the leadership must also display

firmness, political will and commitment to carry out the required reforms. But honest and dedicated leaders are a necessary, but not a sufficient, condition to counter corruption. Several other conditions need to be satisfied.

- (ii) **Credibility:** Credibility is one of them. For success, the offenders both on the demand and supply side of a corrupt deal must be convinced that the government is serious about fighting corruption. One suggestion towards this end is to “fry some big fish”, that is to publicly try and punish some well-known corrupt people in the country. Some highly publicized trials and convictions of important officials and businessmen on charges of corruption have taken place in several Asian countries. However, since allegations of corruption are often used to discredit political opponents, the suggestion is further made that the fish that is fried should preferably be from your own pond.
- (iii) **Involving people:** A publicity campaign to create greater awareness on the adverse effects of corruption and a clear and unequivocal official pronouncement on the desirability to bring it under control would be helpful. Ordinary citizens have a lot of first hand experience with corruption, they are a good source of information and their help and cooperation should be solicited for the successful launch of an anti-corruption drive. Once people are convinced that a sincere and genuine effort to combat corruption is underway, they will respond and extend their full cooperation in resolving the problem. Just a little opening up and providing opportunities for them to express their views on the matter will bring forth an outpouring of information, ideas and suggestions that will be beyond anyone’s imagination.
- (iv) **Responsible press:** A responsible press to gather, analyse, organize, present and disseminate information is considered vital to create greater public awareness and to provide the momentum for undertaking reforms to overcome corruption. Secretiveness has been a key factor that has enabled public officials and politicians to get away with corruption. A responsible and an investigative press has played an important role in many countries, both developed and developing, in exposing misconduct as well as in serving as a watchdog to limit corruption and preventing it from getting out of hand. The press has not always acted in a responsible manner, and like everything else in this world, it is not perfect. Nevertheless, its power to limit misconduct and improper behaviour should not be underestimated.
- (v) **Oversight bodies:** Views on the effectiveness of anti-corruption oversight or watchdog bodies are mixed. There are instances where

they have proved useful. For example, the Independent Commission Against Corruption in Hong Kong, China, and similar institutions in Botswana, Chile, Malaysia and Singapore are regarded as having done a good job. However, in surveys and interviews of public officials and members of civil society organizations, most respondents do not have a high opinion of them. The prevailing view is that for such bodies to be effective, they have to be created in a political atmosphere where leaders are honest, civil servants are insulated from political interference, and better incentives are provided to discourage corruption. Otherwise, the oversight bodies will be rendered useless or worse, misused for political gain (Gray and Kaufmann *op. cit.*). An unwelcome situation can then arise and the country may have to appoint a watchdog to watch over the watchdog body.

- (vi) Improving institutions: This is a very large area and only brief mention can be made of the relevant issues. It involves such things as improving the legal framework; smoother, less time-consuming and less burdensome ways to conduct business in the functioning of law courts and in the administration of justice; promoting efficiency of the police force; strengthening the auditor general's office; and appointment of a responsible inspector general empowered to investigate and prosecute corruption.

## VI. CONCLUSION

A useful conclusion that has emerged from the current discussion and ongoing debate on the corruption issue is that corruption is a symptom of deep-seated and fundamental economic, political and institutional weaknesses and shortcomings in a country. To be effective, measures against corruption must therefore address these underlying causes and not the symptoms. Emphasis must thus be placed on preventing corruption by tackling the root causes that give rise to it through undertaking economic, political and institutional reforms. Anti-corruption enforcement measures such as oversight bodies, a strengthened police force and more efficient law courts will not be effective in the absence of a serious effort to address the fundamental causes.

Another observation that may be useful to bear in mind is that corruption is most prevalent where there are other forms of institutional weaknesses, such as political instability, bureaucratic red tape, and weak legislative and judicial systems. The important point is that corruption and such institutional weaknesses are linked together and that they feed upon each other. For example, red tape makes corruption possible and corrupt officials may increase the extent of red tape so that they can get more bribes. So, getting rid of corruption helps a country to overcome other institutional weaknesses, just as reducing other institutional weaknesses helps to curb corruption.



The main conclusion to be drawn is that undertaking reforms (both economic and political) by reducing institutional weaknesses offers the best hope to overcome corruption. Corruption will not disappear because of reforms. But reforms will bring it under control and minimize its adverse consequences so that the country can proceed with its efforts to become a modern, developed nation with a good chance of attaining that goal.

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