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The economic consequences of corruption

By Hilton Root

Is corruption inherent in developing country administration? The international development community has long treated the link between corruption and underdevelopment with indifference. Since international development agencies did not make assistance conditional upon integrity, notoriously corrupt governments received development assistance with hardly any reference to the widespread misuse of public funds. How did rampant abuse of public resources avoid disclosure, analysis and response for so long?

Even economists provided scientific support for ignoring corruption by elaborating a number of reasons why corruption does little economic harm during development. Corruption, we are told, lubricates unwieldy administrative machinery that might otherwise grind to a halt. Indifference was also justified on grounds that no evidence existed, that corruption was a quantitatively significant component of GDP. This brand of developmental stoicism drew on Karl Marx's observation that the early stages of capital accumulation thrive on inequality and are inherently unjust. Even Marx's capitalist critics were willing to accept the bitter pill: no corruption, no development.

Stoicism was reinforced by the notion that East Asia's prosperity is proof that dirty practices do not prevent growth. However, the high performers — Singapore, Korea, Taiwan, Hong Kong and Japan —all aggressively tackled bureaucratic corruption before undertaking economic reform as a way to establish the credibility of government in the eyes of their citizens.

Above all, economists and donor organisations believed that corruption is a political problem, and the cure is liberalisation. Trade liberalisation, they conclude, will wipe out the opportunities for big-time graft characterised by collusive arrangements between large firms and government.

The cure has been disappointing. Consider South Asia, India, Pakistan, Bangladesh and Sri Lanka where no national government has been re-elected successively during the 1990s because none has been able to control corruption. Contrary to the claim of apologists that corruption is a Western invention, poor voters in these countries rise in furore against those politicians who practise it. Pakistan's Benazir Bhutto was brought down two times on charges of corruption.

The new Prime Minister, Nawaz Sharif, deposed earlier on charges of corruption, has made corruption a principal target for reform. India's Congress Party was undone on charges of corruption; Prime Minister Rao has already been indicted and many of his top Cabinet members are facing criminal investigations. Sri Lanka's Chandrika Bandaranaike Kumaratunga (People's Alliance Party) made corruption a corner stone of her successful upset during the electoral process of the rule of the United National Party. In Bangladesh the Awami League ousted their rivals, the Bangladesh Nationalist Party, on the grounds that the incumbent had abused public trust while in power. The elections on the Asian subcontinent are unambiguous: corruption scandals erode popular support for government, cost politicians their jobs and produce political crises.

Less obvious are the ways political corruption will inevitably slow productivity growth by making economic liberalism unsustainable. Economists should take note.

One: Corruption erodes the capacity of the government to provide basic public service delivery by shifting the output of government from public to private good. Instead of public good, such as an effective policy matrix, corrupt systems focus on the use of public authority to create private goods for regime supporters. This undermines the credibility of the government and weakens the consensus for long-term support of liberal reforms.

Two: While closing older avenues for kickbacks, liberalisation can open new opportunities like privatisation deals, for corruption.

Three: Corruption distorts the decision making of both the public and private sectors. Officials will work at cross-purposes with the institutions they represent, keep supplies and permits scarce and use opaque regulations to create insecurity in order to maximise their profitable interventions. To prevent manipulation by politicians and to cope with unpredictable government bureaucracies, firms must adapt management structures that maximise secrecy and idiosyncratic forms of ownership.

Business often succeeds at outwitting the regulators but at the expense of transparent practices that would encourage long-term business confidence. And assaults on illegally accumulated wealth subjects business to persistent political uncertainty and denies business public support or a continuous open role in policy making. Weak institutional support for business is overcome by strong personal relationships between business people and politicians. However, deals which depend on the right connections can be overturned when a new government appears. Moreover, the threat of a counter offensive against liberalism, fuelled by populist pressures, biases firms from undertaking long term investment.

Four: In a democracy, corruption is difficult to hide; instead, it is publicly debated, discussed and examined. The ability of an economy to encourage the investment needed to sustain long-term economic growth ultimately depends on the sustainability of political contracts.

This, in turn, introduces uncertainty. If each new government or minister overturns the contracts of its predecessor, an economy will sustain only short-term investments and economic growth will be stifled.

Five: When government changes hands, contracts consummated under one government may be reconsidered. Consequently, property rights are no more secure in democracies of South Asia than in autocracies where the rule of law does not apply and leaders can confiscate the property of citizens at will. Knowing that contracts may not be honoured when the government changes, investors entertain long-term investment reluctantly and often require government subsidies or guarantees of monopoly to offset the risk. Government must stay involved in managing the economy to subsidise the large capital expenditures that can be subject to political risk further crowding out the private sector.

Thus, corruption is a political problem that has far reaching economic consequences; opportunities are lost, innovation is deferred, entrepreneurialism and investment are aborted. When citizens perceive that government cannot credibly commit to the implementation of policy designed to increase economic growth, government loses support, re-election becomes improbable and questions may even arise concerning the durability of the political system. Corruption violates the credibility of the liberalisation process and prevents the establishment of a credible policy, environment, crucial to the success of economic reform.

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