

# *Corruption, Governmental Activities and Policy Instruments—Brief Review of the Main Issues*

*(Keynote Address)*

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*Vito Tanzi*

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## **I. INTRODUCTION**

In recent years a lot of attention has been paid to the problem of corruption. The newspapers of countries where there is a free press have been reporting, almost daily, stories related to this topic. More importantly, in some countries, governments have fallen, whole political classes have been replaced and prominent politicians have lost their positions or, in some case, have gone to jail. It was not always so. If we go back a decade, we find much less frequent mentions of corruption. Then, most observers, including economists, were generally ignoring this phenomenon.

In spite of the recent attention, corruption is not a new phenomenon and references to it can be found as far back as thousands of years. It is, thus, difficult to understand why, all at once, everyone seems to be interested in the topic.

Corruption has been and can be defined in many different ways each lacking in some respect. However, like an elephant, even though it may be difficult to describe, it is generally not difficult to recognize. In most, though not in all, cases different observers would agree on whether a particular behaviour or action reflects corruption. Perhaps the simplest definition is that it is the abuse of public power for private benefit. From this definition it should not be concluded, however, that corruption cannot exist in private sector activities. Especially in large private enterprises where the managers may not be the same as the owners, this phenomenon can also exist. In this definition, a public official who uses his position to derive benefits for himself or for his family and friends, or even for his political party or tribe, is engaging in an act of corruption.

It is a controversial issue whether cultural factors play a role in the existence and prevalence of corruption. The soon-to-be-published 1997 *World Development Report* by the World Bank, which deals with the

economic role of the state, affirms categorically that cultural factors do not play a role in corruption. I disagree with that conclusion because, as I have argued in some of my writing, there are particular characteristics of some cultures which, while meritorious and even noble in themselves, may create a more fertile ground for corruption. This is, for example, the case with close interpersonal relationships which are much more prevalent in some cultures than in others. Such relationships create a warm and friendly environment which makes living in these societies more pleasant but, at the same time, it creates a contiguity which exposes public sector employees to pressures to bend rules to help friends and family members. In certain circumstances such pressures may be hard to resist.

Regardless of cultural factors, however, human behaviour universally responds to positive and negative incentives. Thus, when incentives exist that increase the returns to acts of corruption, some individuals will become corrupt, regardless of culture. By the same token, when effective controls are in place, and when acts of corruption are severely punished, corruption will tend to decrease, regardless of culture. This implies that more attention should be paid to the incentive structure that exists within public sector institutions, including the level of wages. There are now examples of countries that were relatively corrupt in the past but where corruption has been much reduced through determined action on the part of the government.

## **II. INSTRUMENTS AND EFFECTS OF CORRUPTION**

Corruption affects and distorts what should be arms' length, or objective and unbiased, relationships between government officials and private sector individuals. Because of corruption, some individuals succeed in getting favourable treatment by public officials in their economic activities. Such a treatment can either reduce the costs for the economic activities in which these individuals are engaged or create new opportunities for them not available to others. Through the payment of a bribe or through some other favour, an individual can influence the decision of a government official or can have the official bend a rule in his favour. At times, of course, the initiatives may start with the official who may offer a special treatment in exchange for a payment. In all these cases, corruption will change the competitive equilibrium that exists in the market.

Corruption may also occur when a government official demands the payment of a bribe to make decisions that the officials should make in any

case. For example, it was recently reported that in New York City some elevator inspectors required bribes from the owners of buildings to validate that the elevators were in good working order. Apparently, without the bribe they would simply refuse to give such a seal of approval even when there was nothing wrong with the elevators. It is also conceivable that under particular circumstances, government officials may create or invent additional rules and regulations explicitly with the objective of providing themselves with more instruments for extracting payments from individuals. In some cases, there is no written or publicly available version of these rules. The asymmetry of information in such cases makes it impossible for the private individuals to ascertain whether, in fact, the regulation claimed by the public officials is a legitimate one.

Recent attention toward corruption has been promoted by the globalization of economic activities and of information. With increasing frequency globalization is placing individuals from countries less tolerant of, or less used to, corruption into contact with those from countries where corruption is a more common phenomenon. This is, for example, the case with foreign investment or with public projects where foreign companies compete for the projects. The fact that some industrial countries make the payment of bribes to foreigners business expenses deductible for tax purposes while others (the United States) do not, has intensified international interest in corruption related to foreign countries and has led to calls to standardize the tax treatment of bribes. Recent attention has also been promoted by the growing trend in the world toward more open societies with increasingly free and active presses. Thus, behaviour that was not reported in the past, or did not attract attention, is now closely scrutinized. Recent attention to corruption has also been stimulated by the growing concern for economic efficiency and competitiveness on the part of policymakers because corruption reduces the ability of countries to compete internationally.

Corruption is made possible by the monopoly power that the existence of government rules and regulations confers on some government officials. In some countries most economic activities need the authorization or the approval of some public sector official. Often several officials with different jurisdictions must authorize an activity.

The instruments that make corruption possible are many. Important but by no means exhaustive examples are the following:

- (a) regulations or licenses needed to engage in particular activities, such as driving a car, opening a shop, importing, running a business, and so on;
- (b) land zoning and other similar official decisions, which, at the discretion of some public official, may determine whether, for example, a piece of land can be used only for agriculture or for high rise buildings, thus sharply affecting the market value of that land;
- (c) access to the provision of goods and services supplied by the government at below market prices, such as fertilizers, electricity, telephones, foreign exchange, credit, places in good schools;
- (d) control over decisions regarding procurement contracts;
- (e) control over decisions regarding public investment contracts;
- (f) control over the provision of tax incentives to particular investors;
- (g) control over hiring and promotions within the public service; and so on.

In all of these cases, some government official has an element of discretion in making a decision which may have important economic consequences for some individuals. In some cases several officials have such a discretion over a single decision.

The literature on corruption has centred on a basic and, perhaps, debatable assumption, namely that the more involved is the government in economic activity and decisions, the greater is the potential scope for corruption. This assumption is particularly realistic when the government role is not played just through spending and taxing but is carried out through the use of regulations, authorizations, and other quasi-fiscal activities. In particular, the less transparent and clear are the laws and the regulations, and the greater is the discretion of government officials in interpreting and applying them, the greater is the potential for corruption. Thus, *clarity* and *discretion* are key factors. In some countries regulations are not even published so that private individuals are not able to challenge the public officials who claim a given regulation in support of particular actions.

Economists generally believe that too rigid rules may lead to inefficient economic systems, thus reducing growth. Because of this consideration, a few economists have argued that corruption may actually increase the efficiency of economies by rendering the rule more flexible. Countries of Southeast Asia are mentioned as examples because the economies of these countries have grown at very fast rates in spite of the existence of significant corruption in some of them. These economists have argued that corruption can be the oil that makes the economic mechanism operate more smoothly.

In theory at least, corruption could increase efficiency when the rules are in fact too rigid and stifling and when the bribes to be paid are predictable rather than random. In such circumstances, the economic agents who want to start new activities and get around the rigid rules know whom to contact to get the desired decision; they know the size of the bribe to be paid; and they have confidence that the public official who has been bribed has the power and the incentive to comply with the terms of the implicit agreement. In other words, he will not renege on the promise and no other official will appear who will put obstacles on the activities of those who pay the bribe. In this case, corruption is less damaging to economic efficiency and growth as compared to corruption that is random and uncontrolled as it seems to be in Russia today. Some economists have viewed the former type of corruption as a kind of neutral tax which increases the cost of economic activity, but does not distort much the allocation of resources. It just removes, for a fee, an obstacle to the presumed good allocation of resources.

While there may be some truth in the above argument, its practical importance is often exaggerated. It assumes that economic activity is damaged by the existing and unchanging rules so that the bypassing of these rules, through the payment of bribes, removes an obstacle to growth but does not do any other damage. The problem is that corruption is often like a cancer, it starts in one specific area, perhaps the area where the rigid rule is, and soon it begins to spread to other areas. Eventually, most activities may become affected. Then it stops being a proportional tax and begins to be more like a distortionary tax levied with uneven and random rates. When this happens, corruption is no longer just oil for the mechanism but it distorts decisions in ways that at times can be very damaging to the economy. For example, it may encourage expenditure in unproductive investments, because of the bribes or "commissions" that some public officials can get from those who undertake the projects. Furthermore,

corruption may itself encourage the creation of opaque rules and regulations, thus increasing the range of possibilities for which public officials can get bribes. When regulations are creating the possibilities of increasing incomes for some government officials, more regulations may be created or more government officials may join the corrupt ones in using existing regulations to get a piece of the action.

Corruption reduces in many ways the ability of the government to pursue its basic functions. It distorts the allocative, distributional, and stabilization roles of the government. The effect of corruption on the allocative role is somewhat obvious. In the public finance literature, that role is justified in terms of the need for the government to correct for market failures or imperfections. However, corruption itself creates market imperfections by the differential treatment that individuals receive when some of them have been able to bribe a public official while others have not. For example, in some countries corruption has led to the creation of monopolies when those who benefited from it were given exclusive rights to engage in some activities.

The distributional role is distorted because those who benefit from corruption, either as corruptors or as corrupted, are often better placed and better connected than those who do not. The very poor do not have the means to bribe somebody and are too uneducated to be in the strategic government positions where public officials have the power to elicit bribes. Furthermore, they are more likely to be abused by public officials.

The stabilization role is negatively affected because corruption tends to decrease government revenue and to increase government spending, thus contributing to the enlargement of the fiscal deficit.

The reduction in revenue occurs when corruption contaminates the tax and customs administrations, so that some of the payments made by taxpayers end up in the pockets of tax inspectors or customs officials. In some countries major revenue from customs duties has been lost when customs officials assisted in smuggling activities or when they diverted the collected customs duties toward their pockets. Revenue is also reduced when proceeds from the sale of state-owned natural resources, such as oil, are diverted away from the government treasury.

Corruption increases government spending when, because of bribes, useless spending (such as unproductive investments) is promoted or when

individuals receive payments from the government to which they are not entitled. This is the case of ghost workers, phoney disabled workers, and abusive recipients of government subsidies. In some countries major government spending went to pay rebates on fake exports.

Recent, empirical literature has pointed to a negative correlation between corruption and growth, while some of the more speculative literature of earlier years had hypothesized a positive connection between corruption and growth. The reason why some economists now believe that corruption retards growth is because of its negative impact on some of the economic variables that promote growth. For example, recent empirical work by Paulo Mauro of the IMF, done using cross-sectional data, has shown that corruption decreases total investment and expenditure in education. Because these variables are important contributors to economic growth, corruption can be assumed to decrease a country's rate of growth. In fact, Mauro has estimated the probable reduction in the growth rate that can be attributed to the impact of corruption on these variables.

However, corruption may affect economic efficiency in other indirect ways. For example, unproductive public investment may replace more productive investment even when the total is not affected; incompetent officials may move up to positions where their poor decisions are damaging to economic activity; promotions within the civil service may not be based on merits thus leading to the discouragement of good people; public projects may be completed in a sloppy way; and so on. There have been stories of countries where projects such as the building of new roads have been so shabbily done that the road had to be redone in a few years. There have even been reports of countries where expenditure for operation and maintenance was intentionally reduced so that the infrastructure would deteriorate at a faster rate to the point where it would require major new investment, thus providing opportunities to get "commissions" from those who would undertake the project.

### **III. THE MEASUREMENT OF CORRUPTION**

In recent years, various estimates of corruption have become available. Because there is no way of measuring corruption directly and quantitatively, the estimates available are based on surveys whereby some relevant individuals are asked to rate the extent to which economic decisions within a particular country are contaminated by corruption. Examples of these indexes are available from *International Country Risk Guide, Business*

*International, Transparency International, World Competitiveness Report, and Political and Economic Risk Consultancy*. All these indexes tend to be highly correlated among themselves which may mean that they contain some element of truth. However they should be used with a great deal of caution because they are based disproportionately on the opinions of certain classes of individuals who may base their opinions on what happens in some sections of the economy such as foreign investment.

Perhaps, the best known index is the one that has been made available by *Transparency International*, a non-profit organization, with headquarters in Berlin, created by a former World Bank employee. *Transparency International* rates 54 countries with an index that ranges from 0 to 10. Zero means totally corrupt; ten means that there is no corruption. The index is "an attempt to assess the level at which corruption is perceived by people working for multinational firms and institutions as impacting on commercial and social life". As the description implies, it is not a fully presentative index. The *Transparency International* index is highly correlated with per capita income and with indexes of "economic freedom". Thus, as countries become richer, they generally become more free, especially economically speaking, and less corrupt. In other words, the government becomes less intrusive in the daily economic activities of the citizens even though the level of taxation and spending is higher in rich countries. Interestingly enough, some of the least corrupt countries (those of Northern Europe) are also among those with the highest share of taxes or public spending in GDP. The World Bank has been working on a more comprehensive index of corruption. However, because of sensitivities, it is unlikely that this index will become publicly available.

#### **IV. STEPS TO REDUCE CORRUPTION**

Governments should not be fatalistic about corruption. With a well focused and determined effort, corruption can be reduced, although attempting to bring it to zero may not be an optimal policy. At some point, the social benefit from reducing corruption further may not justify the pecuniary or social cost of doing so. For example, it may require excessively high public sector wages or major legal or organizational changes. The optimal theoretical level would be reached where the marginal social cost of reducing it further would be equal to the marginal social benefit from the reduction. This level is likely to be higher than zero. In many countries corruption is well above the "optimal" level so that there is ample justification to try to reduce it.

The war against corruption must be fought on at least four fronts: (a) commitment by the country leadership; (b) reduction of the demand for corruption by the private sector; (c) reduction of the supply of corruption by the public sector officials; and, finally, (d) increasing controls and penalties for acts of corruption.

*Commitment by the leadership:* The war against corruption must start with an explicit commitment by the leadership of the country (president, prime minister) that it wants a clean government and is willing to pay the price to achieve it. To be believable, this commitment must be accompanied by visible action. Leaders should not only declare that they are against corruption, but they should be seen as not tolerating any form of corruption, whether it involves family members, political associates, or other members of government. They must be particularly vigilant and strict especially *vis-a-vis* those closest to them who use their positions or their special relationship with the leaders to extract rents from the private sector.

In some countries, political leaders have not been considered personally corrupt or, at least, no acts of corruption have been traced to them, but they have, at times, tolerated, (or, at least, have closed their eyes to) questionable practices by family members, political allies, and members of their government. These sins of omission are as important in creating perceptions as sins of commission. The fight against corruption requires that neither of these sins be committed. A country where the political leadership is now showing a strong determination to follow this rule is Malaysia, where a powerful political figure was recently asked to leave the government when evidence became available that he was engaged in acts of corruption. On the other hand, in some countries when high level political figures (such as ministers) were accused of corruption, they were just moved to other high level government jobs. In a particular country, a minister who was widely believed to be corrupt was put in charge of a commission to fight corruption.

*Reducing the demand for corruption:* Corruption exists mainly because government officials find themselves in positions from which, through their decisions, they can influence significantly the activities of some individuals. As a consequence, particular individuals, such as investors, businessmen, importers, taxpayers or even plain citizens, can benefit from a decision that is favourable to them. In countries where governmental intervention in the economy is carried out mainly through broad, general and indirect policy tools such as monetary policy, fiscal policy, and exchange rate policy there

is much less scope for corruption. Unfortunately, in many countries government intervention in the economy transcends the use of general policy tools, and is carried out through regulations, authorizations, tax incentives, and other tools that require direct contacts between specific individuals and public officials and require decisions by public officials which are tailored for specific individuals or enterprises. Such intervention creates a strong demand for acts of corruption.

An important reason why corruption seems to be more prevalent in developing and transition economies, than in industrial countries, is that in the former the role of the state is carried out substantially through the use of rules and regulations and less through spending and taxing. As countries become richer and acquire the ability to raise the level of taxation, and as markets develop more fully, the role of the state comes to be played more through taxing and spending and less through regulations. However, when in a country individuals are required to obtain permits or authorizations (and often from several or even many different offices) to import, obtain foreign exchange, borrow, export, invest, benefit from tax incentives, open a shop, start a new activity, and so on, it is inevitable that somewhere along the line a bribe will be offered (or asked) to get the desired decision. The bribe may provide a license denied to others; or it may provide a license more speedily; or it may reduce the cost of complying with existing regulations (as for example those related to health standards), or it may provide a tax incentive or subsidized credit and foreign exchange.

Thus, the fight against corruption must start with the pruning of the regulatory framework, at both the national and local level, to eliminate redundant or unnecessary regulations. This exercise may also reveal that some needed regulations are not in place. The fight must continue with an attempt to make the regulations that are retained clear and more transparent to reduce the possibility of conflicting interpretations. Also, if possible, strict time limits should be set by which a given request must be accepted or rejected in order to reduce the chance that public officials may invite bribes by simply sitting on requests. The deregulation of economic activities which is characterizing the economic policy of many countries should in time lead to a reduction in the demand for acts of corruption.

*Reducing the supply of corruption:* The widespread involvement of the government in the economy, especially when carried out with non-neutral and non-general instruments, creates conditions which lead some individuals to want to bribe public officials. In other words, it increases the demand size

of the corruption equation. However, as the saying goes, it takes two to tango. An act of corruption is much like tango because it involves two sides—one that offers a bribe and one that accepts it. It is conceivable that two countries could have the same instruments for governmental intervention, and thus the same demand for acts of corruption, but one might end up with much more corruption than the other. The reason might be that the willingness of the public officials to accept bribes could be very different. In this case, one reason for the difference might be the relative level of public sector wages and the status of a civil service job.

Recent empirical work carried out within the IMF has supported what one could believe intuitively, namely that there is a correlation between the level of wages in the public sector and the level of corruption. Countries that have low corruption tend to be those where the status of a civil service job is high and these jobs are relatively well paid. In this case, there is less pressure on the public employees to accept bribes (to make ends meet) and there is a higher cost to them associated with losing their government job. In some countries, however, public employees are paid so little that they are pushed, or even expected, to get additional income, either by having second jobs or by compromising their integrity. In these countries, the low levels of wages are often also accompanied by little differentiation in salaries across the ranks which creates additional pressures for some employees and especially for those with more discretion on decisions.

Although the level of wages is far from being the only factor that determines the supply of acts of corruption, it is a very important one so that a country that sets the objective of reducing corruption must be willing to revise the salary structure for its public sector employees. Countries that over the years have made significant progress against corruption, such as Singapore and Hong Kong, compensate well their public sector employees. In Singapore, for example, ministers are among the best paid in the world. This indicates that the fight against corruption is not a costless one.

*Increasing controls and penalties:* So far we have discussed three lines of action in the war against corruption, namely the commitment by the leadership, reducing the demand for corrupt acts, and reducing the incentives on public officials to accept bribes. The fourth line of action must be related to the establishment of better controls and heavier penalties. The controls would be aimed at increasing the chance that a corrupt act will be discovered and punished. The heavier penalties would make it more costly

for those who engage in corruption to continue to do so. There is now an extensive literature that started with work by Gary Becker that supports this approach, with respect to crime in general.

Countries could create the equivalent of a Criminal Investigation Bureau (as in Singapore and Hong Kong) that should be a high profile and politically independent unit staffed with well paid and highly motivated personnel charged with investigating reports of corruption. This bureau should go after corrupt officials and also after those who attempt to bribe the officials and should have the power to recommend adequate penalties (including dismissal) for those who are caught in acts of corruption. It is clear that the effectiveness of such a bureau will depend on its political independence, its integrity, its resources, and the extent to which the results of its investigation bring effective punishment on those who are caught. In this context, the role for the judiciary is important. A criminal investigation bureau cannot be effective if its actions are not followed by other institutions who have the responsibility to punish those who are found to have committed acts of corruption.

## **V. CONCLUDING REMARKS**

In this discussion, we have considered various issues related to the fascinating and serious problem of corruption. We have discussed factors that create an environment where corruption becomes common, and we have outlined major steps to reduce corruption. It should be realized, however, that to some extent corruption is a reflection of society. Non-democratic societies, without a free press and an independent judiciary, are less likely to be relatively free of corruption. At the same time, we have evidence of democratic societies where corruption is still a major problem. But all societies can do a lot to scale down the problem. The costs of not doing so are becoming progressively higher in a globalizing world. But the fight against corruption must be carried out on many fronts. There are no magic solutions for this problem.