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## Corruption and Development, Revisited

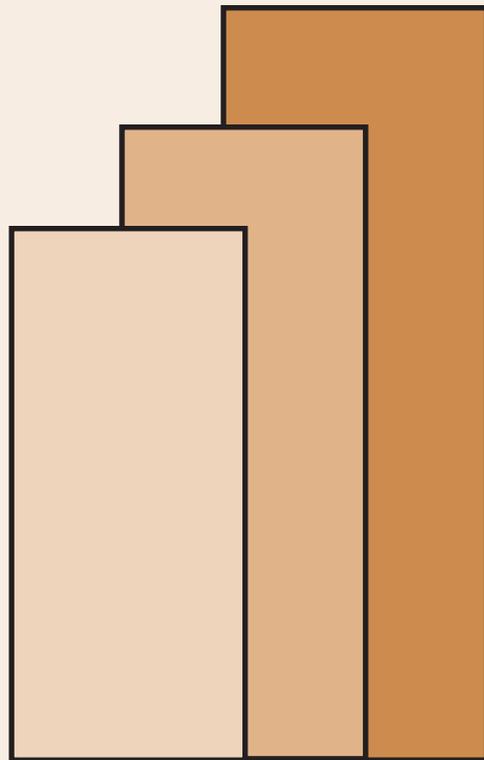
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## Corruption and Development, Revisited<sup>1</sup>

Jenny D. Balboa and Shinji Takenaka

### Abstract

Graft and corruption is considered to be one of the biggest threat to development. Several studies had shown the tremendous impact of corruption in the economy. For a number of developing countries, a huge portion of government resources are lost and wasted due to corrupt activities, further plunging the country to poverty and underdevelopment. Various efforts to combat this social ill have been explored. However, the problem continues to persist. This short paper revisits the issue and aims to contribute to the growing literature of understanding corruption in developing economies and creating the necessary policy response. It answers the following questions: What are the different forms of corruption? What drives corruption? What has been done to address the issue? The Philippine case is also briefly discussed.

*Key words: political economy, corruption, development*

*JEL: 019, 05, F5*

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<sup>1</sup> This paper takes off from the article written by Balboa, J and E. Medalla entitled, Anti-Corruption and Good Governance: The Case of the Philippines, which was presented at the APEC Study Center Conference in Vietnam in 2005 and in Thailand in 2009.

## Corruption and Development, Revisited

Jenny D. Balboa and Shinji Takenaka<sup>2</sup>

### Introduction

Corruption has been identified as one of the most debilitating problems in the developing world. However, while the impact of corruption is borne by the constituents of a corrupt state, in an increasingly interdependent world, the cost is easily spread to other countries, especially with the more prominent role played by multilaterals and bilateral partners that provide foreign assistance to developing economies. It has been observed that some foreign-aid programs have a low-level selectivity against highly corrupt governments (Alesina and Weder, 2002). Thus, indirectly, the cost of bribery, kickback, and extortion in developing nations is also borne not just by beneficiary states, but also by donors. As transaction costs increase and project costs balloon in beneficiary states, development assistance provided to vulnerable states are misallocated and incomes redistributed from target beneficiaries to other recipients, thereby decreasing the efficiency and effectiveness of donors and wasting the taxes of people from donor states<sup>3</sup>. Henceforth, research on anti-corruption measures should receive continuous attention for achieving economic development and social justice in the context of growing economic interdependence.

This short paper is organized as follows: The next section of this paper will briefly discuss the definition of corruption, pointing out the common cases in both developing and developed countries. The third part will introduce the recent findings on its impact on macroeconomy. The fourth section discusses the anatomy of corruption, and the fifth section discusses the case of the Philippines. The paper ends with a brief concluding remarks and a discussion on commonly identified features of a state vulnerable to corruption.

### Definition

Corruption is commonly defined as the misuse or the abuse of public office for private gain (Asian Development Bank, 1998). It can come in various forms and a wide array of illicit behaviour, such as bribery, extortion, fraud, nepotism, pilferage, theft, embezzlement, falsification of records, kickbacks, influence peddling, and campaign contributions (Klitgaard, 1991). While corruption is commonly attributed to the public sector, it also exists in other

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<sup>3</sup> There is a dearth of studies which focus on proper utilization of development aid to recipient economies, and how much of these aid actually yields desired results. (Easterly and Pfitze, 2008)

aspects of governance, such as political parties, private business sector, and NGO (USAID, 2005).

Another classification suggested by Easterly (2001) sorts corruption into two types: spontaneous and institutionalized (or systemic). Spontaneous corruption, as its name implies, is done in secrecy and spontaneously and not grand scale. This could transpire in societies observing strong ethics and morals in public service. Institutionalized corruption, on the other hand, is found in societies where corrupt behaviours are perennially extensive or pervasive. In these societies, corruption could be even a way of life, a goal, and an outlook towards public office.

Certain types of corruption can function without money. It may involve gift-giving or influence-peddling. It can also come in the form of future benefits rather than present profits. With this type of corruption, the boundary between corrupt and non-corrupt behaviour becomes quite thin. Take for instance the act of giving a gift to a public official as a token of appreciation for services done. While considered illegal in some countries, this may be tolerated in some societies or cultures. In this context, definition of corruption may be culturally bound.

A survey conducted by Transparency International revealed that corruption in the public sector takes the same form in both developed and developing countries. It showed that areas of government activities most vulnerable to corruption include public procurement, rezoning of land, revenue collection, appointment of government official and local governance<sup>4</sup>. It has also found the remarkable similarity in their methodologies as follows: cronyism involving family members, relatives and other personal connections, donations to political campaigns, kickbacks on government contracts (and subcontracting consultancies), and similar forms of fraud. Research on corruption in developing states are thus likely to benefit the governance in developed countries as well.

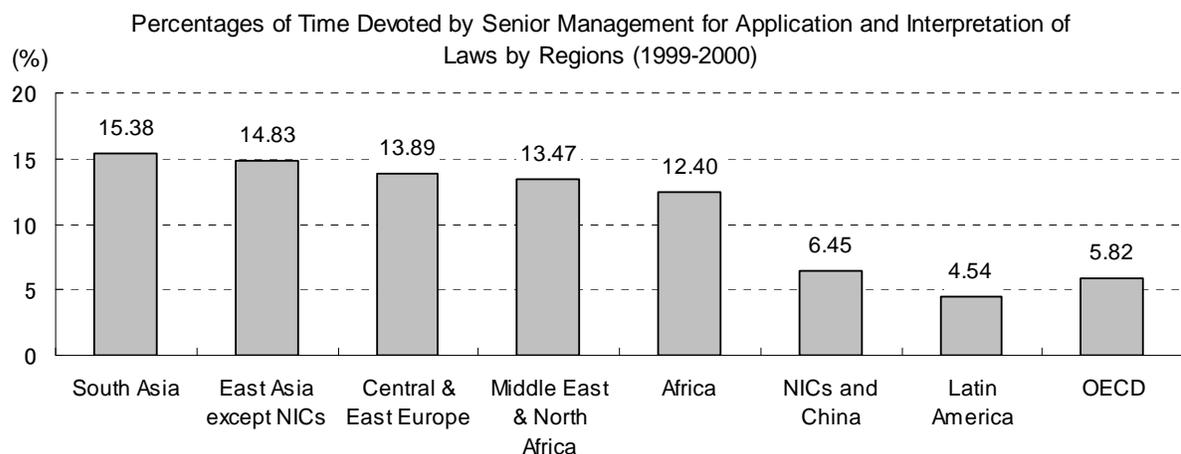
### **Macroeconomic impacts**

Corruption in the government retards economic development by distorting the allocation of resources. In a corrupt system, public choices are in favor of the wealthy, powerful minority, but against spending on social safety nets (UNDP, 2000). Decreased provision of social services and inflated infrastructure projects can maximize bribery receipts and minimize the chance of their detection. Several studies validated how corruption can further worsen the condition of the poor and the disadvantaged. Mauro (1998) found that a corrupt government is more likely to decrease education spending and spend less on human resource development. Moreover, the tax revenue in Ecuador has increased substantially after offering a large-scale buyout to low-performance officials and introducing a computer-based taxation (Inter-American Development Bank, 2002).

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<sup>4</sup> Transparency International I Source Book 2000, Anatomy of Corruption (Ch.2)

Private sector growth, particularly small and medium enterprises, is also affected by corruption, taking the form of rigid regulations that increases tax burdens and transaction costs for new entrants. In a study conducted by Batra, Kaufmann and Stone (2004), the developing economies in Asia was shown to be more vulnerable compared to other countries in other regions (see figure below). This can have an impact on the number of entrants to promising new business and ventures. The ramifications of such obstacles should be further examined particularly how it impacts in promoting new business and creating employment.



Source: Batra et al. (2003)

The cost of corruption could be enormous--- to a loss of as much as half a percentage point in terms of gross domestic product (GDP) per year, and 5 percent in terms of aggregate investment<sup>5</sup>. This is believed to be still a conservative estimate, since it does not factor in other unobservable factors, and the reverse causality from (rapid) growth to corruption (Svensson, 2005; Balboa and Medalla, 2005).

There exists, on the one hand, a consensus over the negative effect of corruption on foreign direct investments (FDI). According to the estimation by Kaufman (1998), investing in a relatively corrupt country, as compared with an uncorrupted counterpart, is equivalent to bearing additional 20-percent private tax. The empirical analysis by Wei (2000) also revealed that worsening a country's corruption level from Singaporean to Mexican equally affects as much as raising the tax rate by 18 to 50 percentage points on inward foreign direct investment.

<sup>5</sup> In other words, a country mired in corruption is estimated to achieve a lower aggregate investment by as much as five percent, compared to a country with a relatively corruption-free government, and to lose about half a percentage point of gross domestic product per year.

## Decomposition of corrupt behavior

Typical features of a system prone to corruption are characterized as follows (UNDP, 2004): (1) concentration of powers in the executive and weak or non-existent checks and balances, (2) poor transparency surrounding executive decision (accountability) combined with restricted access to information, (3) elaborate regulatory system for discretionary decision making, (4) weak systems of oversight and enforcement, (5) soft social control systems/high tolerance for corrupt activities.

In other words, corruption is considered an outcome of monopoly of power, combined with discretion and absence of accountability. Modifying the original version in Klitgaard (1991?), UNDP (2008) suggested the following formula:

$$C \text{ (corruption)} = M \text{ (monopoly)} + D \text{ (discretion)} - A \text{ (accountability)} - I \text{ (integrity)} - T \text{ (transparency)}.$$

One can then assess the potential (and room) for corruption in certain government projects or activities by evaluating to what extent these factors are present. The formula summarizes the theoretical and empirical insights on corruption as a result of various failures in governance<sup>6</sup>.

More simply, the dominant economic theory on corruption could be summarized into:

$$\text{Corruption} = \text{Greed} + \text{Discretion}$$

Countries with high level of corruption are observed to have: 1) High Policy Distortion Index; 2) Non-meritocratic bureaucracy; and 3) Weak judicial system. (Khan, 2009)

Certain policies and interventions could actually create the breeding ground for corruption. Khan (2009) cited market restricting policies, as well as policies that feed patron-client relationship, as damaging interventions.

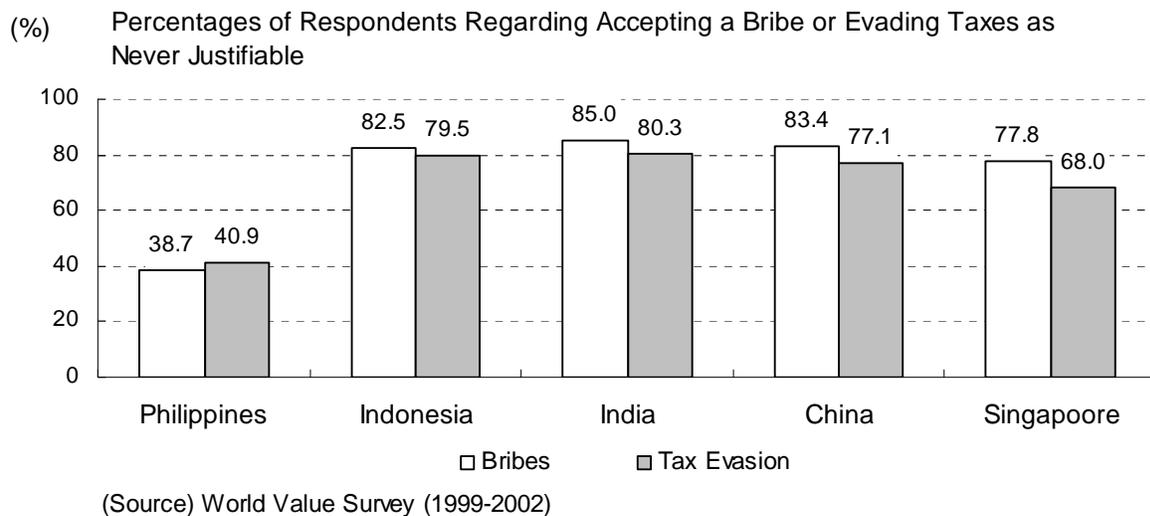
While both low growth and high growth countries are vulnerable, it is the type and amount of corrupt activities that determine the extent of damage corruption can create in the economy. In this context, it is important to distinguish between political corruption and predatory corruption. Political corruption can be addressed by fine-tuning fiscal programmes and implementing stricter checks and balance. Predatory corruption, on the other hand, is a structural issue that could only be addressed by much more aggressive interventions.

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<sup>6</sup> Anti-corruption, UNDP February 2004

## Some insights on Corruption Perception: The Case of the Philippines

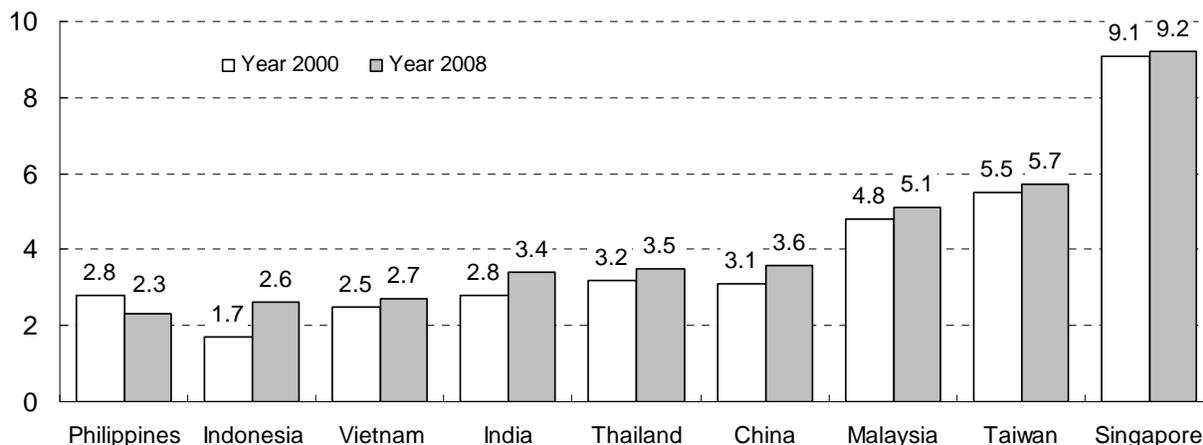
According to the World Value Survey conducted around year 2000, fewer people in the Philippines believed that receiving bribes or evading taxes is a crime, as compared to Indonesia, India, China and Singapore where people strongly believed that it is a serious offense.



Another interesting finding is the correlation between the attitudes toward bribes and tax evasion. This is consistent with an earlier study which pointed out the correlation between perceived corruption and tax evasion in the late 1990s (Uslaner, 2003).

Consistent with the findings from above data, surveys of Transparency International (2000, 2008) showed a deteriorating score for the Philippines, in stark contrast with other emerging economies in Asia which seemed to be gaining improvement in people's awareness about corruption.

Corruption Perceptions Index of ASEAN and Other Major Economies in Asia



(Source) Transparency International

(Note) The index is composed of the results from more than 10 independent surveys. A lower score signifies more serious status of corruption.

Several studies had been devoted to understand the Philippines' apparently downhill fight against corruption. Analysts attribute this to historical colonial legacies, aggravated by the corrupt Marcos years that created the crony capitalist system in the Philippines and the continuing presence of patronage politics and weak institutions that lack enough safeguards against abuse.

Corruption is nurtured by politicians who coddle supporters and followers, who in turn pressure them to engage in corrupt activities to spread the benefits of a corrupt regime. It thus creates a cycle to preserve and distribute benefits within small sectors of the populace (Co, 2005). The principal-agent theory of Jensen and Meckling (1976) also provide an alternative story. The agents (in this case, the politicians and bureaucrats) can abuse the advantages offered by such discretionary power in the wake of the incoherent interest of the principal (in this case, the electorate or the public at large)<sup>7</sup>.

Some others attribute the issue to the social divisions (e.g. ethnolinguistic dimensions, religion and urban-rural distinctions), and economic divisions (the huge gap between the rich and the poor). The data of *World Development Indicator* showed that the percentage of population living on less than two US dollars a day has been increasing in the Philippines the past decade. In stark contrast, Indonesia and Vietnam, two other lower middle income ASEAN states, showed a decreasing number of poor population living below \$2. Income gap is also wide in the

<sup>7</sup> See also the publications by Transparency International, Bhargava and Bologaita (2004), and Rose-Ackerman (1999, 2004) for further details.

Philippines, posting the highest gini co-efficient among East Asian economies in recent years. These factors could have contributed to the people's seemingly nonchalant attitude on corruption. Nonetheless, the relationship between economic gap and social cohesion to the spread of corruption still has to be established by empirical studies and examined further.

### **Concluding Remarks**

An anti-corruption template has been developed by experts through the years, comprising of the following : downsizing the public sector, bureaucratic reforms, enforcing the accountability of politicians, monitoring by non-governmental organizations (Khan, 2009). More sophisticated measures had been developed the past decade (Rose-Ackerman, 2004), however, given the nature of corruption which thrives on secrecy, and coupled with the use of technology, corruption had become a much more elusive problem. Effective anti-corruption efforts showed that it is important to distinguish among the different types of corrupt practices and prescribing a well-targetted, outcome-oriented strategy. Time-proven practical solutions also work. A randomized experiment of audits, for instance, proved its effectiveness to cut the costs of public investments in Indonesian villages (Olken, 2007). Ferraz and Finan (2008) showed that the public disclosure of audit reports reduced the Brazilian corrupt mayors' likelihood of re-election by 17% of statistical significance. In addition, the preshipment inspections by private companies, substituting customs' service, increased the import duty revenues, including those of some developing countries (Yang, 2008).

International economic agreements such as FTAs (Free Trade Agreements) can also provide opportunities to introduce and lock in reforms to fight corruption through more harmonized customs procedures and business processes. Those changes thus deserve an attention for measuring its possibly favourable impact on curbing corruption.

Still, the challenge is how to sustain the efforts and create much longer term impact. The level of corruption in the Philippines, for instance, failed to show significant improvement despite decades-long struggle to curb corruption through various laws and policies. Deeply entrenched personalistic politics is an obstacle to reform efforts. Another reason is turf war between previous and incumbent politicians. The new administration tends to abandon programs initiated by the previous administration in its bid to make its own mark in good governance efforts in the country, wasting incremental success achieved by the previous government. (Balboa and Medalla, 2009). This shows that the success of anti-corruption efforts largely rest on political will and commitment of stakeholders to uphold reforms.

An understanding of the broad picture of corruption and development, particularly of the social and economic forces in a state, is crucial in crafting the right solutions to this issue. Khan cited

that the Neo-Patrimonial<sup>8</sup> System in developing economies plays a big role in perpetuating corruption. The Neo-Patrimonial system is sustained by commonly seen features in developing countries, particularly ethno-linguistic fractionalization, absence of democracy and accountability and economic inequality. In this system, politically-driven accumulation is the norm, pushing the state to political and economic underdevelopment. Apparently, these are issues that can not be solved by short-cut methods, but only through long-term policy strategy. Meanwhile, productive forces in society have to learn to operate within this system, while keeping a firm long-term goal of creating a system which will value integrity and dignity much more than personal and material gains from political power.

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<sup>8</sup> Neopatrimonialism is a term used for patrons using state resources in order to secure the loyalty of clients in the general population, and is indicative of informal patron-client relationships that can reach from very high up in state structures down to individuals. (<http://en.wikipedia.org/wiki/Neopatrimonialism> accessed on June 22, 2010)

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