

UNPREDICTABLE RULES, DISHONEST COMPETITION,
AND CORRUPTION:
COSTS FOR DEVELOPMENT AND GOOD GOVERNANCE

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Asian Development Bank
Organisation for Economic Cooperation and Development
Conference on
Combating Corruption in Asian and Pacific Economies

Session II, Focus Group 1:
Reforming Government Processes and Procedures

29 September 1999

I. PUBLIC-PRIVATE PARTNERSHIPS, GOVERNANCE, AND DEVELOPMENT

Sustainable economic development and good governance depend upon solid, lasting public-private partnerships. In the economic arena, private investment and efficient business management must be complemented by strong public institutions such as a legal system that can defend economic rights while maintaining rules of fair competition, and reliable agencies to collect taxes, administer the customs process, and maintain a sound currency. On the political side, governments need citizen participation for guidance and legitimacy, while citizens depend upon vigorous and honest officials and parliaments to translate political mandates into effective policy and essential public services. Neither public nor private initiative can reach its full potential without the support, guidance, and -- when necessary -- checking influence of the other.

When we look at the most successful societies today -- both the established affluent democracies, and those that have dealt most effectively with the challenges of transition and consolidation over the past decade -- we find densely-integrated networks of public and private activity, interest, and resources. These linkages and partnerships reflect, and help sustain, a synergy between the political and economic arenas that benefits and protects their citizens and businesses in many ways. Often they have developed over many generations, and have become deeply embedded in the economy, politics, and society. But how do we build them anew, particularly in developing countries where they may be needed most? What incentives can draw public and private organizations and interests together? What forces will oppose our efforts?

Public-private partnerships have become especially critical during the past decade, as the liberalization of political and economic systems around the world and the emergence of a global economy have removed old restrictions and

created new challenges. But the development of *beneficial* partnerships is far from inevitable: opening up politics and the economy, while a notable achievement in its own right, does not guarantee that interests in either arena will refrain from exploiting their counterparts in the other, particularly in countries where poverty and repression have been facts of life. Worse yet, illicit and *undesirable* partnerships may be the quickest to form, and once established may be very difficult to uproot. After all, corruption itself is one kind of public-private partnership, albeit one with particularly harmful consequences. Political leaders may divert state resources to build up their own personal followings. Businesses or wealthy individuals may buy public influence, accumulating official "clients" - - *de facto* business partners, in many cases -- within political and bureaucratic institutions. At the very top of society, alliances between business and government figures may be so extensive that the two networks essentially merge. Such alliances may produce impressive growth statistics for a number of years, but over time corruption, a lack of transparency in both public and private dealings, and the growing inflexibility of these elite alliances prevent needed adaptation and can lead to crisis.

It is essential, therefore, both to build open, honest, and beneficial public-private partnerships and to prevent the corrupt variety from taking root. *How* to do that is an exceedingly complex question, one for which the answers will vary in important ways from one society to the next. *Why it must be done* is a good deal more clear, however, and at this level there are many parallels among the countries of the region. Understanding how corruption undermines development and good governance can tell us how undesirable partnerships develop, and helps us form an agenda for reform. Let us first consider the developmental costs of corruption, and then turn to the ways in which public and private forces can cooperate to fight corruption, and the reasons why both have a stake in doing so.

II. THE COSTS OF CORRUPTION

There was a time when considerable debate raged over what some saw as the economic and political benefits of corruption. It is true that all corruption benefits *someone*, or else it would not take place. Major problems of evidence are involved in the study corruption because all who have direct knowledge of it usually share an interest in secrecy. Corruption occurs in many forms and adapts to a range of institutional and social settings, including those of more advanced societies; thus one country's corruption problems can differ considerably from those of its neighbors. Not all corruption is bribery or extortion; some is out-and-out theft and predation. *Political* corruption, such as extended patronage networks feeding upon the public payroll, are important too, and the costs of so-called "petty corruption" involving ordinary citizens and low-level officials can be very serious indeed when assessed over time and in terms of relationships between state and society. And it is worth remembering that consolidating countries face a variety of interlinked political and economic problems of which corruption is but one, and thus that doing away with corruption would not guarantee democracy and plenty for all.

Still, over the past decade imaginative research and evidence have contributed to a new consensus over the harmful effects of corruption upon development and governance. These effects are both systemic, affecting the development of whole societies, and specific to the situations confronting international firms and investors.

Systemic Effects

As Susan Rose-Ackerman points out, the systemic costs of corruption become most clear when we look at whole systems, rather than at individual corrupt transactions in isolation. Corruption protects and rewards inefficiency, and undermines accountability, in both business and government processes,

while short-circuiting honest economic competition. Otherwise uncompetitive firms and entrepreneurs are kept afloat and given unearned advantages, particularly as they deal with government officials, while the returns to wise investment and efficient management decrease. Indeed, on the government side corruption creates *more* inefficiency, delay, and official harassment, as bureaucrats intent upon increasing their incomes (or, simply eking out a living wage) contrive new rules, delays, and requirements in order to extract more payments -- an issue to which I will return below. Human resources and entrepreneurial effort are diverted from productive activities toward rent-seeking; public spending is similarly channeled away from much-needed social services such as education toward "big-ticket" projects like dams, airports, and road construction, where corrupt returns are more plentiful. Corrupt countries are less able to use international aid and loans effectively, and in the future will be more vulnerable to conditionality measures -- adding another element of economic unpredictability. Corruption weakens institutions charged with protecting property rights, enforcing contracts, and maintaining fair economic competition, with harmful effects at all levels the result

In the political realm, serious corruption undermines the legitimacy and credibility of government. Corruption has at times been defended as one way political leaders can build mass followings, but the result is usually very unequal relationships that work to the benefit of patrons. Citizens are kept in a state of dependency that deprives them of real political choices and dissipates their chief political resource -- the unified, independent force of numbers. Institutional checks and balances, and effective oversight of bureaucrats by elected officials, can be rendered meaningless. Indeed, in the most serious cases corrupt alliances between elected and bureaucratic officials can turn government into a shakedown operation and decision making into an auction. In this setting corrupt officials and uncompetitive firms are linked in powerful partnerships,

while that efficient enterprises and honest investors must choose between paying up and getting out. When officials are not accountable to citizens, a major incentive to sound economic policy is removed; indeed, in such a setting officials may protect their personal advantages by keeping potential competitors poor and politically weak. Decision makers who cannot be held accountable are less predictable in their actions; not only does this mean that more corruption is a likely result, but a World Bank analysis also suggests that corruption does the most damage to development where its volume is large and its processes are unpredictable.

Some of the most serious damage of corruption is long-term, and has to do with adaptation in the face of change. An extensively corrupt system is run by, and in the interests of, its political and economic beneficiaries. But it is unlikely to adapt, precisely because entrenched corrupt officials and their clients can pre-empt political and economic competition. Corruption can substitute for adaptation and reform, for a time perhaps, but when change becomes inevitable corrupt systems are less able to bend, and may thus break.

Corruption and the Firm

At the level of the firm it was once argued that most corruption was just an "overhead" cost of doing business in many parts of the world, or even promoted efficiency by cutting through bureaucratic delays and building political support for major investments. Broader effects were positive as well, we were told, as the most efficient operators would be the ones most able to pay the bribes. Where working price systems were absent, corruption served as a functional alternative, informally creating market processes where they had not existed before.

Those arguments, however, frequently rested upon the analysis of hypothetical cases, or of individual corrupt transactions in isolation. A fuller understanding of the origins of corruption, and of the broader settings within which firms operate and economies develop or languish, makes it very difficult to sustain the argument of corruption as an acceptable cost of doing business. Robert Klitgaard's analysis of the factors making for bureaucratic corruption offers insight. In *Controlling Corruption* (1975: p. 75), Klitgaard proposes the following schematic "equation":

Corruption equals monopoly plus discretion, minus accountability.

Klitgaard's equation is not a definition of corruption. It is not meant to explain every corrupt action or account for honest bureaucrats or executives. It fits bureaucratic corruption more closely than it does the political. It does, however, identify conditions that facilitate corruption and -- when such corruption-producing conditions extend across an economy -- make it so damaging to development.

Essentially, Klitgaard's argument is that an official (or a group of them in collusion) with sole control over a significant benefit (a license, a tax deduction, a punishment withheld), who can decide which clients will and will not receive that benefit, and who need answer to no one for his or her actions, is in a position to extract payments for that benefit. Clients must pay up or do without; there are no other sources of benefits, no effective rights to invoke, and no means of recourse. These generalizations hold true not only when officials actively demand payments, but also when firms seek corrupt influence: if these conditions do not hold true, very little corrupt influence will be available to rent. By contrast, where the benefit may be obtained from more than one source (if several tax assessors work in an area and do not collude among themselves), if

discretion is limited by extensive rules and transparent operating procedures, and/or if functionaries are genuinely accountable serious corruption is much less likely to occur. Public-private partnerships have proven especially valuable in this last connection, as we shall see.

Consider the implications of even this simplified view for international and domestic business firms. Corrupt monopolies harm development, rendering real competition irrelevant or impossible and leaving firms open to exploitation by officials -- or by erstwhile "competitors" who have rented the official's monopoly power. Where officials possess discretion and are not held accountable, their actions are unpredictable and unreliable, and their decisions need serve no interests beyond their own. Even a firm that has paid for a decision or a license may find it has purchased nothing: corrupt officials do not always stay bought. Once it has paid, that firm has in effect placed itself outside the protection of the law, and has created evidence of criminality that officials can use against them, perhaps as pressure for further payments. Honest bidding may do little beyond providing valuable proprietary information to bureaucrats and their economic cronies; bribes paid when a bid is tendered may only buy the opportunity to be pressured for further payments later on while unqualified cronies are given the inside track.

The argument that corruption cuts through bureaucratic and other delays, thus creating efficiency, rests upon a fundamental fallacy -- that is, that there is only a finite amount of red tape in the system. Officials who have learned that foot-dragging yields corrupt payments can become very skilled at contriving further delays, inspections, service fees and other administrative harassment, as noted above. Daniel Kaufmann's evidence from formerly communist countries shows that where corrupt payments are largest and most frequent, delays and inspections are *more* common and costly, not less. Similarly, it is doubtful that the

most efficient competitors will be the most able and inclined to pay; more likely the uncompetitive will find corruption a tempting alternative to careful investment and planning, while the efficient will be operating under tighter cost restrictions and lines of accountability. The latter, who can compete anywhere, will have other, more profitable, ways and places to do business; they may thus withdraw from a country, or from a sector of an economy, rather than devote major resources to a risky and unreliable form of influence. Where firms must participate -- as in cases where a corrupt country has a natural resource not available elsewhere -- they are likely to insist on short-term profits and to keep their assets as mobile as possible, as Philip Keefer has shown.

The developmental costs are clear and significant. Monopolies built on state power, and non-accountable bureaucratic discretion, impede both broad-based sustainable growth and open, accountable government. Partnerships of corrupt officials and uncompetitive firms likewise do little for development, and weaken pressures upon officials for improved governance. Mauro has shown that high levels of corruption marginally but consistently reduce countries' aggregate economic growth, over time denying real opportunities to countries and business firms alike. From the standpoint of the firm, the intangible effects of corruption (lack of predictability, inability to plan ahead, unfair and even destructive competition) as well its tangible damage amount to far more than an acceptable overhead cost. Wei likens serious corruption to a tax on foreign direct investment, and estimates that an increase in corruption from the low levels of Singapore to the much higher levels of Mexico is the equivalent of a 21% tax on investment by multinationals. In increasingly competitive global markets, and in the coming environment of increased business transparency and punishments for bribery mandated by the recent OECD convention, such costs will do deep and lasting economic harm *and* drive out the very private parties with a long-term stake in building anti-corruption partnerships. The firms that remain in

high-corruption, low-development countries will also suffer from corruption, *whether they pay up, or not.*

III. TOWARD BETTER PARTNERSHIPS

Beneficial public-private partnerships come in many forms. What they have in common, however, is that they draw upon the common interests of citizens, businesses, elected officials and honest bureaucrats in open, honest, competitive economic and political processes, and in breaking up the monopolies, the unchecked discretion, and the lack of accountability that lie at the heart of corruption.

Some involve law-enforcement, investigation, and penalties. The well-known anti-corruption agencies of Hong Kong and New South Wales not only investigate official activities, but also work with private firms in devising anti-corruption procedures, and in training programs. Both actively solicit citizen reports of corruption; citizens who file such reports can be confident that they will be investigated, and that they themselves will not suffer reprisals. For years, the Hong Kong ICAC also conducted a particularly successful effort to inform the public about corruption and to change public attitudes toward it. The result was that it dispelled the sense that corruption was inevitable, and that nothing could be done about it. Much has changed in Hong Kong since 1997, but the ICAC has made significant progress, over the years, in making anti-corruption activities both a public and a private responsibility. Anti-corruption agencies in Singapore and Botswana, among other places, pursue strategies that are similar in many respects.

Other partnerships -- such as strong and competitive political parties -- link state and society together and foster accountability through open, well-

structured competitive politics. My own analysis of corruption across political party systems suggests that where parties are well-organized and competition is decisive -- as in many Scandinavian countries and the UK, but also in Botswana and Costa Rica -- there is less corruption than we would predict on the basis of economic characteristics. Here, credible commitments to good government help parties win power, and -- more to the point -- corrupt parties and governments can lose because of it. Where parties are splintered along factional lines, or where they collude -- as in Italy, Japan, and Luxembourg -- elections are less decisive, parties can retain shares of power and spoils even though corruption is well-known -- and corruption levels are higher than we would otherwise predict. Vigorous, well-structured political competition gives both officials and private citizens incentives to act against corruption, offers the victims of corrupt pressures opportunities for recourse, and makes it more difficult to sustain corrupt monopolies. In similar ways, open, vigorous, and well-institutionalized economic competition rewards innovation, honest management and accountability in private enterprises while making the monetary costs of corruption less acceptable, both to firms and to investors. Here too, public and private interests converge: credible securities laws enforce business transparency, ideally compelling corrupt firms to reveal their difficulties while offering honest, efficient ones the opportunity to attract private investment more effectively because of their good management and non-corrupt ways of doing business. Public officials, elective and appointed, reap the rewards of sound economic policy and broad-based growth, while private investors are more easily able to pursue their own financial agendas.

Private parties can become partners in corruption prevention in a variety of other ways. In New York City, for example, bidders on public contracts go through a "pre-qualification process" whereby they are able to demonstrate that they are not connected with organized crime or other corrupt interests, and are

therefore eligible to bid on contracts. More generally, Robert Cooter has argued that where civil society is strong private organizations become "law merchants": professional associations can maintain codes of ethics, and trade groups may require members to subscribe to a code of good business practice. Indeed, one of the most neglected areas for anti-corruption activity is *within* business firms and private associations, where administrative sanctions or more informal rewards and punishments can be applied much more quickly, flexibly, and with lower burdens of proof than can the law.

What makes these partnerships work, apart from good will? In fact both public and private parties have strong incentives to resist corruption. On the public side, reducing corruption is a way to win and hold secure and legitimate authority, to compete more effectively for aid and investment, to make sound and effective policy, to encourage broad-based growth, and to take credit for doing so in the long run. Honest officials working in honest agencies enjoy greater public prestige and credibility, and are better able to accomplish the goals that may have drawn them into public service in the first place. Private individuals and firms have an interest in reducing corruption in order to make themselves less vulnerable to exploitation and arbitrary treatment, to achieve more dependable guarantees of rights, to reduce the day-to-day costs of corrupt transactions, and to enjoy the longer-term benefits of sound, credible political and economic institutions. Both public and private groups have an interest in a fair legal and judiciary system, in reliable law enforcement, and in being able to plan for the middle to long term rather than worrying mostly about the next corrupt payoff.

Less well-recognized, but equally crucial, is a shared public-private interest in maintaining well-defined, legitimate boundaries between those two sectors, and orderly paths of access between them. When these boundaries and

linkages are in place, development in each arena can benefit from the vigor and competitiveness of the other, and from the signals and information political and economic actors send each other through their actions. Such boundaries also restrain excesses and protect people and groups in each arena from exploitation by the other. And perhaps the broadest and most essential of all public-private partnerships is the *rule of law* -- that system in which legitimate laws dovetail with social values, and enjoy both broad social support and effective official enforcement. Where that sort of partnership exists, along with the others described here and elsewhere at this conference, corruption can ultimately be controlled.

Getting people to *see* these shared interests is no simple matter. As in Hong Kong, the sense that corruption is inevitable, and that nothing can be done about it, must be dispelled. It will be difficult to persuade people that they actually can plan ahead and can depend upon fair treatment. Credible institutional reforms, visible prosecution of major corrupt figures, and long-term public education must all be part of the anti-corruption strategy. But once perceptions begin to change, the costs of corruption -- which are long-term and often intangible -- will become more apparent. It will become more clear to public and private parties alike that corruption is a risky, unreliable, *and expensive* way to go about their affairs, that it does long-term damage to institutions, to development, and to the social fabric, and that it leads to more insecurity and further costs rather than solving problems. When such perceptions take hold, people in both government and society will be more likely to resist corruption, not just (or even primarily) because of fear of punishment, but because they know there is a better way -- one in which they hold a lasting stake.