Addressing Corruption Openly

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Traditionally, public officials have been somewhat nervous about discussing corruption openly. Over the past several years, however, I have been struck by the extent to which world leaders are now willing to talk candidly about this problem. It is not just that the economic costs have become self-evident. It is also because there is an increasing demand for change.

In a recent global survey, corruption was regarded as the "topic most frequently discussed by the public," ahead of poverty and unemployment (survey cited by Klitgaard 2015, p. 15). Given that both poverty and unemployment can be symptoms of chronic corruption, my view is that the priority given to this problem by the public is entirely justified.

In this essay, I would like to share the IMF's perspective on the economic impact of corruption and our experience in helping countries design and implement strategies to address it.

I recognize that there are many possible definitions of corruption, both broad and narrow. For the purposes of this essay, which is focused on the public sector, corruption includes any abuse of public office—whether it arises from financial incentives or political interference.

I would like to make three main points.

First, while the direct economic costs of corruption are well known, the indirect costs may be even more substantial and debilitating, leading to low growth and greater income inequality. Corruption also has a broader corrosive impact on society. It undermines trust in government and erodes the ethical standards of private citizens.

Second, although corruption is an extraordinarily complex phenomenon, I do not accept the proposition—or the myth—that it is primarily a "cultural" problem that will always take generations to address. There are examples of countries that have managed to make significant progress in addressing it in a relatively short time.

Third, experience demonstrates that a holistic, multi-faceted approach is needed—one that establishes appropriate incentives and the rule of law, promotes transparency, and introduces economic reforms that reduce opportunities for illicit behavior. Perhaps the most important ingredient for a successful anti-corruption approach is the development of strong institutions, centered on a professional civil service that is sufficiently independent from both private influence and political interference.

The Economic and Social Costs

Corruption afflicts countries at all stages of development. Indeed, some developing countries score better on corruption indices than many advanced countries. While there are no recent studies that quantify the overall global scale of corruption, a sense of how big a problem it is can be gauged from an estimate of the amount paid in bribes every year. A recently updated estimate points to $1.5 trillion to $2 trillion (or around 2% of global gross domestic product) in bribes paid annually in both developing and developed countries.[1] Given that bribes are just a subset of all of the possible forms of corruption, the overall cost of corruption—in terms both of tangible losses and of lost opportunities—is a very high amount.

The direct economic costs of corruption are easily recognized by the general public. Two very clear examples are bribes given in order to evade taxes or to bypass public tender procurement. The first example results in a direct loss of public revenues; the second may result in both higher public expenditure and lower-quality public investment.

Corruption has a pernicious effect on the economy. Pervasive corruption makes it harder to conduct sound fiscal policy. For example, in data covering a range of countries, we find that low tax compliance is positively associated with corruption. By delegitimizing the tax system and its administration, corruption increases tax evasion: if the granting of a tax exemption is perceived to be the product of a bribe, it is not surprising that the public are far less willing to comply with the tax laws.[2]

Corruption also undermines certain types of public expenditure to the detriment of economic performance. For example, it is associated with lower outlays on education and skewed public investment, driven by the capacity to generate "commissions" rather than by economic justification (Mauro 1998).[3] The distortion in public investment spending is particularly harmful given the importance of promoting efficient public investment as a means of reducing infrastructure gaps and promoting growth.

The indirect economic costs of corruption may be even more consequential.[4] Clearly, causation is difficult to establish and, in quantitative analysis, a significant effect of corruption on growth has not been found (Svensson 2005).

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Nevertheless, in comparative studies of national data, corruption is associated with a number of key indicators. Countries with low per capita income tend to have higher corruption, and countries with higher corruption tend to have lower growth. Studies have identified different ways in which corruption could affect growth.

First, corruption tends to impede both foreign and domestic investment. The higher costs associated with corruption are a form of tax on investment that, in turn, translates into less investment in business research and development and product innovation. Moreover, by creating uncertainty as to how the regulatory framework will be applied, it increases the "country risk" associated with a particular investment project.[5] More generally, corruption generates an unfavorable business climate in which the creation of new enterprises is stifled, reducing the economy's dynamism.[6]

Second, corruption undercuts savings. The illegal use of public funds to acquire assets abroad shrinks the economy's pool of savings that could otherwise be used for investment.

Finally, corruption can perpetuate inefficiency. Because an over-regulated economy provides opportunities for regulators to demand bribes, corruption creates a strong incentive to delay economic liberalization and innovation.

The impact of corruption on social outcomes is also consequential. Social spending on education and health is typically lower in corrupt systems. This, in turn, leads to higher child and infant mortality rates, lower birth-weights, less access to education, and higher school dropout rates (Gupta, Davoodi, and Tiongson 2002).

These outcomes disproportionately affect the poor, since they rely more heavily on government services, which become costlier due to corruption. Moreover, corruption reduces the

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income-earning potential of the poor as they are less well-positioned to take advantage of it. For all these reasons, corruption exacerbates income inequality and poverty (Gupta, Davoodi, and Alonso-Terme 2002).

Corruption also breeds public distrust in government. It undermines the state's capacity to raise revenue and to perform its functions as a supplier of public goods and services, a regulator of markets, and an agent for society's redistributive goals. Where powerful business elites collude to control public institutions, corruption results in state capture and "the privatization of public policy."

The fallouts are all too clear: higher inequality in political influence, deterioration of public values, and ultimately a diminution in the overall quality of life. These non-economic costs create a vicious cycle of underperformance in the public sector that is harmful to the economy in the long term. The moral fabric of society is also put at risk. It is not just that bribery becomes part of one's everyday life. In a society where success is more likely to depend on who you know rather than on personal merit, the incentives for young people to pursue higher education are undermined.

Strategies for Addressing Corruption

Given the potential impact of corruption on macroeconomic stability and sustainable economic growth, the IMF has been actively engaged in helping our members design and implement anti-corruption strategies. In 1997, the Fund adopted a policy on governance that provides guidance on the nature of its involvement in circumstances where issues of governance, including corruption, are judged to have a significant macroeconomic impact.

Since that time, we have gained considerable experience in helping members design and implement anti-corruption strategies. This is particularly important in the context of economic crises, where effective anti-corruption measures are critical to restore confidence. In some cases, the problem has been so severe that the Fund had no choice but to withhold support until a credible reform strategy was in place.

Clearly, any anti-corruption strategy must be tailored to the circumstances of the particular country. Yet we have found that success requires the existence of a number of mutually supporting features, which are briefly summarized here.

Creating the Right Incentives

As has been noted by one expert in this area, "Corruption is an economic crime, not a crime of passion. Givers and takers of bribes respond to incentives and punishments" (Klitgaard 2015, p. 37). A number of instruments—broadly characterized as disciplinary in nature (sticks)—can enhance individual accountability. Other instruments provide positive reinforcement (carrots). The Fund's experience is that an effective anti-corruption approach needs both positive and deterrent measures.

Strengthening the rule of law is critical to increasing individual accountability. The Fund has taken an active role—including through its conditionality—to strengthen legal frameworks that are designed to increase such accountability. For example, Ukraine's current Fund-supported programme provides for the enhancement of legislation in a number of areas, including, in particular, the law on corruption.

However, unless legislation is effectively enforced, it will not be credible in deterring corruption. Without effective law enforcement institutions—the police and other investigatory services, the public prosecutor's office, and, ultimately, the courts—even the most robust legal framework will be ineffective. So, the greatest challenge arises when corruption has permeated society to the point that these institutions themselves have become compromised. In these cases, it may be necessary to create specialized "bridging" institutions in the hope that they can more effectively fight corruption, including in the traditional law enforcement institutions, while broader institutional reform is implemented. These "bridging" institutions include independent anti-corruption commissions and specialized

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anti-corruption courts, such as those currently being established in Ukraine and the earlier ones in Indonesia (IMF 2015b; IMF 2004).

In this context, the Fund has found that the establishment of Anti-Money Laundering Frameworks is central to the fight against corruption. Requiring banks to report on suspicious transactions provides a very effective means of deterring criminal activities. The fact that these laws generally require even closer scrutiny of transactions conducted by "politically exposed persons" makes them particularly relevant to an anti-corruption strategy.

Beyond the enforcement measures discussed above, an effective anti-corruption policy must also rely on transparency. Transparency shines a spotlight on government decisions and transactions, enabling citizens to monitor the actions of their governments which, in turn, deters corrupt behavior. Publicizing instances of corruption and the efforts taken to address them also serves as a disincentive to engage in corrupt activities and shores up public trust in government. For these reasons, the Fund has been actively engaged in promoting greater transparency in the overall economic and regulatory environment.

We have developed standards and codes of best practices in areas such as data dissemination, fiscal transparency, and monetary and financial policies (IMF 1997).[7] Promoting transparency in the extractive industries is another area that the Fund has actively pursued in its technical assistance work. Under the aegis of the Extractive Industry Transparency Initiative (EITI), a template is now available for reporting and monitoring government revenues from natural resources.

Transparency can only go so far. It needs accountability for it to become a powerful deterrent against corruption. It is critical that public officials and institutions be assigned with specific mandates and tasks upon which they are expected to deliver. Moreover, oversight mechanisms are needed to ensure that officials and institutions are delivering as expected. This is why the Fund has actively supported its members in strengthening those institutions that exercise oversight powers in the management of public funds and in enhancing the financial accountability of state-owned enterprises. It has also provided technical assistance to help members monitor the use of public resources and consolidate extra-budgetary funds into the budget.

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Even well-meaning public officials will be tempted by corruption if they cannot earn a living wage. Research shows a correlation between increases in wages and improvements in a country's ranking on the Corruption Perceptions Index (CPI) (Van Rijckeghem and Weder 2002). This is why Fund-supported programmes have sometimes included increases in public salaries as part of an anti-corruption approach (IMF 2006). That said, there are two critical considerations. First, the remuneration of the public sector needs to be transparent and meritocratic; otherwise, it will be perceived as merely an instrument of political patronage. Second, studies show that an increase in remuneration will have little effect unless accompanied by clear signals that public officials will lose their jobs if they are caught engaging in corrupt acts.

Economic Liberalization and Effective Regulation

As I have indicated, one of the costs of corruption is that regulators seeking bribes through approval processes have an incentive to delay the type of economic liberalization that fosters sustainable growth. Wherever discretion is granted to an official regarding the approval of an economic activity, there is a risk that this discretion will be abused. Appropriately designed liberalization can therefore be a powerful anti-corruption instrument.

As part of its core mandate, the Fund has been actively engaged in encouraging liberalization of trade, price, and financial systems. We have also advocated free and fair market-entry regulations, as well as good statistics and transparency. Importantly, where liberalization involves privatization, it is critical that safeguards—such as adequate and transparent procedures—are in place so that the sale of assets is not compromised by corruption.

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Of course, experience demonstrates that regulation in a market economy is essential for both sustained growth and financial stability. The challenge, however, is to design regulatory frameworks that balance the benefits of regulation while minimizing opportunities for abuse of discretion.[8] For this reason, in its core areas of expertise, the Fund has promoted the adoption of rules, procedures, and criteria that are as targeted, clear, simple, and transparent as possible. These areas include public expenditure management, tax policy and administration, banking and foreign exchange systems, and data management (IMF 1997).

The Role of the Private Sector

When people complain about corruption, they sometimes forget—perhaps conveniently—that for every bribe taken by a public official, one is given by a member of the private sector. Clearly, then, addressing the behavior of the private sector needs to be a key component of any effective anti-corruption strategy. How can this be done?

In some cases, this means using enforcement measures. For example, in those countries where bribery is a common way of facilitating foreign investment, it is critical that the country of the foreign investor enforces laws that prohibit foreign corrupt practices. The Organisation for Economic Co-operation and Development's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions can be invoked in this effort (OECD 1997).

However, experience also shows that the private sector can become effective partners in combating corruption. It is sometimes said that business might benefit from corruption by virtue of the fact that it can "grease the wheels" of a rigid and inefficient bureaucracy. I disagree with that proposition. Based on my own experience, investors actually seek out countries that can give them the assurance that, once an investment is made, they will not be blackmailed into providing bribes. Because corruption creates an enormous amount of unpredictability for businesses, anti-corruption strategies can be designed to solicit their support.

I find Indonesia's experience of implementing that partnership particularly illuminating. At a recent seminar hosted by the IMF on the topic, Sri Mulyani Indrawati, Indonesia's former Minister of Finance (and currently Chief of Operations at the World Bank), described how she successfully partnered with businesses to provide a streamlined customs approval process in exchange for their commitment not to offer any bribes to officials—"new rules of the game."[9]

The "new rules of the game" concept has underpinned several technical assistance activities by the Fund and the World Bank. In reforming tax agencies in Bolivia, Bulgaria, Indonesia, Myanmar, Peru, Poland, and Senegal, Large or Medium Taxpayers' Offices were established to deal with a select group of taxpayers under streamlined conditions.

Beyond the business community, civil society also has a role to play. Through the use of social media, civil society can become a powerful force in combating corruption. In addition to being a very effective means of monitoring government activities, social media can also greatly enhance the credibility of an anti-corruption campaign by linking new institutions that have a specific mandate in this area.[10]

Building Values and Institutions

When dealing with corruption, a robust framework of incentives and a well-calibrated economic liberalization cannot be substitutes for strong values and effective institutions. Of course, developing values at a personal and institutional level may seem beyond the control of any government. It is clearly not something that can be legislated. Yet unless public officials take pride in their work—and their independence from both political and private influence—all other efforts will fail.

Building values among public officials requires sustained public education. Formal training can help but, ultimately, values are most effectively instilled through the education framework, societal pressure, and—as I will discuss further below—the example of leaders. The key objective is to develop a cadre of public officials who are—and are perceived to be—independent from both private influence and political interference. This is the single most important feature of a strong institution. Indeed, it has been noted that one way to assess the strength of an institution is to assess the extent to which key employees are replaced at the time of elections.

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There are other factors that lend support to effective operation, some of which—such as rules that establish transparency and clear accountability—have already been mentioned. An area in which the Fund has been particularly active is the establishment of legislative and institutional frameworks that strengthen the independence, integrity, and governance of central banks, including through the Fund's "safeguards assessments." A recent example has been work in Tunisia in support of the Central Bank, which strengthened its independence, internal control mechanisms, and powers. Of course, enhancing the overall technical competence of officials who work in these institutions is also critical. For this reason, the Fund has invested considerable resources in capacity-building in a broad range of areas, from public finance management to the strengthening of the financial intelligence units, that are responsible for applying anti-money laundering laws.

Political Will

Developing professional institutions that do not become excessively politicized is critical. Yet the irony is that in circumstances where institutions have been completely compromised by corruption, active and sustained political will is essential. Powerful vested interests can only be effectively challenged when a country's top leadership sends a clear signal that they are committed to do so. In some cases, this may require wholesale dismissals within an agency that has a reputation for corrupt practices. Prosecuting the powerful "big fish," which is necessary in order to send a clear signal of commitment and change, can only be achieved if a country's leaders visibly support the process. Moreover, political leaders play a unique role in setting an example of professional integrity. Lee Kuan Yew is a leader who was very effective in both signaling a zero-tolerance policy towards corruption and building competent institutions at a time when corruption was pervasive in Singapore.

Avoiding Pitfalls

Although active and sustained political leadership is critical to the success of any anti-corruption campaign, it is important that reforms in this area are not hijacked to implement a political agenda. One way of assessing whether anti-corruption efforts are credible is to note whether enforcement is limited to the prosecution of political rivals, or instead also extends to the government's political supporters.

In addition, care should be taken to ensure that an anti-corruption campaign does not create such fear that public officials are reluctant to perform their duties. For example, in circumstances where state-owned banks have extended a loan to a company that has become insolvent, it is often in the interest of the bank, the debtor, and the economy more generally to restructure the loan (which might include principal write-downs) in a manner that enables the company to return to viability.

Yet the Fund's experience has been that, in some countries, the managers of state-owned banks are simply afraid to engage in such negotiations. They fear that, if they agree to any debt write-down, they will be prosecuted under the country's corruption law for having wasted state assets—even though a restructuring might actually enhance the value of the bank's claim relative to the alternative, the liquidation of the company.

Finally, although regulatory reform can promote simplicity and automaticity, there are certain functions, such as bank supervision, where discretion will always be essential. For these reasons, regulatory reform cannot be a substitute for the development of effective institutions.

Concluding Observations

As the head of an intergovernmental organization, I recognize that there may be considerable sensitivity about the IMF shining a spotlight on corruption. At the same time, the alternative—turning a blind eye to the problem—is not a viable option. As is recognized under its existing policies, it is not tenable for the IMF to assess a member's economic prospects exclusively through the lens of monetary, fiscal, or financial sector policies, when the problem of corruption is endemic and has a major impact on economic performance. In such cases, the Fund will continue to engage constructively with its members in designing and implementing anti-corruption strategies, drawing upon its cross-country experience, while partnering with other international organizations that have proven expertise in this area.

ENDNOTES

1 This 2015 estimate is an extrapolation by Daniel Kaufmann based on his work in *Myths and Realities of Governance and Corruption* (2005).

2 In addition, non-compliance with tax obligations distorts competition. See IMF. 2015a. *Current Challenges in Revenue Mobilization*. Washington, D.C.: IMF.

3 See also, for example, Tanzi, V. and Davoodi, H. 2002. "Corruption, Public Investment, and Growth." In G. T. Abed and S. Gupta, eds., *Governance, Corruption & Economic Performance*. Washington DC: IMF, pp. 280–299. Military spending is, in addition, prone to corruption, because of secrecy and a lack of transparency (see Gupta, S., de Mello, L. and Sharan, R. 2002. "Corruption and Military Spending." In G. T. Abed and S. Gupta, eds., *Governance, Corruption & Economic Performance*. Washington, D.C.: IMF, pp. 300–332).

4 While the analysis of the association between corruption and growth remains controversial, a meta-analysis of 52 cross-country studies found that a one-unit increase in the perceived corruption index is associated with a nearly 1 percentage-point decrease in the growth rate of per capita GDP (see Ugur, M. and Dasgupta, N. 2011. *Evidence on the Economic Growth Impacts of Corruption in Low-Income Countries and Beyond: A Systematic Review*. London: EPPI-Centre, Social Research Unit, Institute of Education, University of London).

5 Over the past decade, risk-rating agencies have realized that their previous models, driven by economic variables alone, were unsatisfactory and have incorporated governance and corruption factors, such as the Worldwide Governance Indicators.

6 There are cases where corruption has caused some donors to interrupt foreign aid flows.

7 For example, the Fiscal Transparency Evaluation conducted by the Fund in Mozambique (the first in Sub-Saharan Africa) identified a need for greater transparency in public procurement and state-owned enterprises (see IMF. 2015c. Republic of Mozambique – Fiscal Transparency Evaluation). In Tunisia, the Fund has supported the development of a more transparent budget law that would strengthen budget preparation and execution procedures and introduce performance-based budgeting.

8 Many countries are taking the positive step of automating public services, which not only allows for simplification and efficiency, but also eliminates the potential for abuse of discretion.

9 2015 IMF Annual Meetings Flagship Seminar – Individual Integrity in Public Sector Governance, Lima, Peru.

10 A good example is the "I paid a bribe" website in India (www.ipaidabribe. com). For other examples in Bhutan, Pakistan, and Kenya, see Strom, S. 2012. Websites shine light on petty bribery worldwide. New York Times. 6 March 2012. Available from: http://www.nytimes.com/2012/03/07/ business/web-sites-shine-light-on-petty-bribery-worldwide.html?_r=0).

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