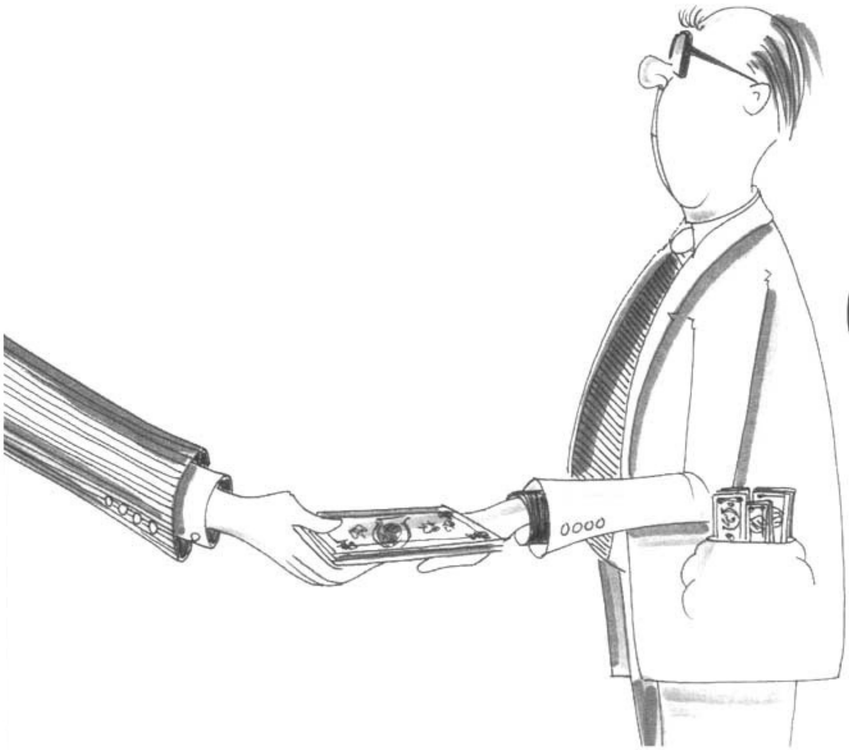

Corruption, Governmental Activities, and Markets

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CORRUPTION distorts the role of government and is costly to society. Governments can minimize the opportunities for individuals to engage in corruption by reducing the role of the state in the economy.

Corruption comes in many shapes and forms. It is very difficult to define and, at times, even more difficult to identify. Here we shall simply define it as the intentional noncompliance with the principle of "arm's-length relationship," which states that personal or family relationships ought not to play a role in economic decisions by private economic agents or government officials. This principle is essential for the efficient functioning of markets.

The term corruption comes from the Latin verb *rumpere*, to break, implying that something is broken. This something might be a moral or social code of conduct or, more often, an administrative rule. For the latter to be broken, it must be precise and transparent. Another element is that the official who breaks the rule derives some recognizable benefit for himself, his family, his friends, his tribe or party, or some other relevant group. Additionally, the benefit derived must be seen as a direct quid pro quo for the specific act of "corruption." This simple description reveals several potential difficulties.

First, there must be evidence that a particular rule has been broken. This requires that all the rules be precisely stated, leaving no doubt about their meaning and no discretion to public officials. But what about cases where rules are not precise or where bureaucrats are specifically given some discretion? For example, legislation in many countries has left the granting of tax incentives or import licenses to the discretion of officials. It is up to them to decide whether an investment or import is "essential" or "necessary" to the country. These officials are often the sole interpreters of what those terms mean. Thus, in a way, they are in a position of monopoly, since they can grant or deny these permits and the permits cannot be obtained from other sources.

But are rigid rules the answer? Over the years, there has been a lot of controversy among economists on whether economic policy should be guided by precise rules or whether it should have an element of discretion. Evidently, the greater the element of discretion, the greater the possibility that it might be used to someone's (rather than the public's) advantage. Thus, the simplest course to prevent corruption might be to create precise and rigid rules. But, of course, some rules may be created just to give some government officials the power to benefit from their application. Often, it is precisely the excess of rules that creates a fertile ground for corruption. Furthermore, if rules are too rigid, they can create obstacles to the smooth functioning of the economy or a particular organization.

Second, when social relations tend to be close and personal, it may be difficult to establish a direct link between an act that could be assumed to reflect corruption and a particular payment for it (see box). An employee who uses his official position to favor acquaintances—say to help them get a valuable license, a government contract, or a government job—may be compensated with an immediate or explicit payment (clearly a bribe). Alternatively, he may be compensated, at a much later time, with a generous gift to his daughter when she gets married, or with a

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good job offer for his son when he completes his studies. In other words, there may not be any direct, explicit, and immediate compensation for the favor. The payment may be delayed in time and, when made, it may appear completely unconnected with the favor received. In many cases, the "corrupted" and the "corruptor" may never even have discussed the payment. It would simply be understood that a favor granted today creates a presumption or even an obligation for a reciprocal favor tomorrow. In other words, it contributes to the growth of the giver's "social capital." In some societies, a "shadow market" for favors develops with demand and supply and with implicit prices. This market often does not use money but trades in what could be considered the equivalent of IOUs. Implicit prices for favors—and, possibly, even for future favors—are established. In this market, it becomes very difficult to separate genuine favors from those that are close to being bribes, and it is thus difficult to clearly identify bribes and punish those who receive or pay them.

This takes us to the third and final difficulty. In societies where family or other kinds of relationships are very strong, and especially where existing moral or social codes require that one help family and friends, the expectation that the public employee will routinely apply arm's-length principles in his relations with friends and relatives is unrealistic. In these societies, the type of ideal bureaucracy advocated by Max Weber will prove very difficult to install. In the Weberian ideal, bureaucrats would work within a set of principles in which there is no place for personal relations or cronyism and, above all, there would be no confusion of public with private interests. Life in the real world, however, is likely to be very different. Centuries-old and widely accepted social norms will often prove more powerful as guides to behavior than new and often imported rules based on arm's-length, impersonal, and universal principles. When this reality is ignored, disappointment is likely to follow. This explains why some reforms imposed in developing countries, promoted by foreign advisors and which may implicitly require or assume arm's-length relationships, often do not survive the test of time.

In these societies, the cost of the corrective role of the government in the market is likely to rise. Economic relationships within the private sector will also be affected, thus rendering more difficult the establishment of a well-functioning market economy. To argue that the personal relationships that come to be established between public sector employees and individuals who deal with them reflect a "corrupt" society may be correct in a legalistic sense, but it misses the point that these relationships simply reflect different social and moral norms.

Economic consequences

The instruments that make corruption possible are many. Important examples include: (a) administration of government regulations (such as the issuance of licenses and permits, and zoning and other sorts of regulations that may have great economic value); (b) fines for alleged or actual violations of legal norms; (c) control over government procurement contracts; (d) control over public investment contracts that can favor some areas or contractors over others; (e) tax incentives, subsidized credits, and multiple foreign exchange rates; (f) controls over hiring and promotions; (g) controls over the assignment of entitlements and other benefits (disability pensions, scholarships, subsidies); (h) controls over access to underpriced public services (such as electricity, telephone, and water); and (i) tax administration decisions (auditing, determination of presumptive income, etc.).

These examples are far from exhaustive. The greater the use of these instruments by a country, the greater the potential for corruption. Control over these instruments can give government employees great power, which—given the right social environment, the right incentive systems, and weak and uncertain penalties—may allow them to extract large financial advantages (rents) for themselves or for their families and friends.

Corruption: in the eye of the beholder?

On January 25, 1992, the *Economist* reviewed a paper by Prakash Reddy, an Indian social anthropologist who, reversing the common pattern of Western scholars going to study developing countries' social behavior, obtained a research grant to study a village in Denmark. He spent a few months in this village and registered his impressions of the relations among its inhabitants. Professor Reddy was amazed to observe that the villagers hardly knew one another. They rarely exchanged visits and had few other social contacts. They had little information on what other villagers, including their neighbors, were doing and apparently little interest in finding out. According to Professor Reddy, even relationships between parents and children were not very close. When the children reached adulthood, they moved out, and after that, they visited their parents only occasionally.

Professor Reddy contrasted this behavior with that prevailing in a typical Indian village of comparable size. In the latter, daily house visits would be common. Everyone would be interested and involved in the business of the others. Family contacts would be very frequent and the members of the extended families would support one another in many ways. Relations with neighbors would also be close.

This story has implications for the concept of arm's-length and, in turn, for the role of corruption. Arm's-length relationships in economic exchanges would be much more likely to prevail in the Danish village than in the Indian village. In the latter, the concept of arm's-length relationships would seem strange and alien. It would even seem immoral. The idea that, economically speaking, one should treat relatives and friends in the same way as strangers would appear bizarre. Relatives and friends would simply expect preferential treatment whether they were dealing with individuals in the private or public sector.

If a government were established in each of the two villages, with each having a bureaucracy charged with carrying out its functions through the instruments described earlier, it would be far easier for the Danish bureaucrats to approximate in their behavior the Weberian ideal than for the Indian bureaucrats. In the Indian village, the attempt to create an impersonal bureaucracy that would operate according to principles in which there is no place for personalism, cronyism, etc., would conflict with the accepted social norm that family and friends come first. In this society, the government employee, just like any other individual, would be expected to help relatives and friends with special treatment or favors even if, occasionally, this behavior might require bending, or even breaking, administrative rules and departing from universal principles. The person who refused to provide this help would be seen as breaking the prevailing moral code and would be ostracized.

The Indian and Danish villages represent polar or extreme cases of how individuals may interact within a community. Whether Professor Reddy's description of them is accurate or not, they provide convenient polar cases. Most societies probably fall somewhere between these two extremes, with Northern European and Anglo-Saxon countries closer to the Danish village model, and many other countries closer to the Indian village model. The Anglo-Saxon concept of privacy is probably just a manifestation of arm's-length relationships. Many developing countries would probably be closer to the model represented by the Indian village. Sadly, the very features that make a country a less cold and indifferent place are the same ones that increase the difficulty of enforcing arm's-length rules that are so essential for modern, efficient markets and governments.

When civil servants appropriate, for their own use, the instruments that the government has at its disposal to influence the economy and to correct the shortcomings of the private market, they reduce the power of the state and its ability to play its intended, and presumably corrective, role. Assuming that government policies had been, or would have been, guided by the traditional criteria that justify governmental action, corruption distorts the end result in the following ways.

It distorts the allocative role of government:

• By favoring taxpayers who, because of the special treatment they receive from tax inspectors, are able to reduce their tax liabilities. The loser will be the market, which will function less efficiently.

• Through the arbitrary application of rules and regulations. This may be particularly important in the allocation of subsidized credits and import, zoning, and other permits. If, for example, these instruments had been developed to assist genuine "infant industries" but ended up assisting others, the corrective role of the government would be distorted, and, once again, the functioning of the market would be damaged.

• Through the allocation of public works or procurement contracts to enterprises that win competitive bids not because they can do the job at the lowest cost but because of their connections and the bribes they pay.

• Through the arbitrary hiring and promotion of individuals who would not have been selected or promoted on the basis of fair and objective criteria. The selection of these individuals will damage the economy not only because of the poor decisions and the number of mistakes they make but also because of the resulting labor-market distortions—discouraging more able but less well-connected individuals from pursuing particular careers.

• Some individuals will try to get jobs not in the areas in which they might use their particular ability for productive use but in areas that provide scope for taking advantage of their special positions. Such behavior, termed "rent seeking," will be stimulated by corruption.

Corruption distorts the redistributive role of the government in myriad ways. If the well connected get the best jobs, the most profitable government contracts, the subsidized credit, foreign exchange at overvalued rates, and so forth, government activity is less likely to further the goals of improving the distribution of income and making the economic system more equitable.

Finally, in all its ramifications, corruption is likely to have negative implications for the stabilization role of the government, if that role requires, as is often the case, a reduction of the fiscal deficit. This will occur because corruption will most likely raise the cost of running the government while it reduces government revenue. The allocation of disability pensions to people who are not disabled, the granting of government contracts to people who pay bribes to obtain them and thus raise their costs, and other corrupt practices that distort spending decisions increase the total cost of providing government services. By the same token, government revenue falls when potential tax payments are diverted or are never collected. In some developing countries, the effective tax burden—that is, the ratio of all tax-related payments made by taxpayers to national income—may be significantly higher than the official tax burden because some payments end up in the pockets of tax inspectors.

Overall, corruption has a corrosive effect. The belief that everyone does it is likely to lead to a situation where many people, if not everyone, will do it. As with tax evasion, imitation will prove to be a powerful force.

Policy implications

Several factors determine the extent to which corruption plays a significant role in a country: (a) the role of the state and the range of instruments it uses in fulfilling that role; (b) social characteristics of the society (for example, the extent to which arm's-length relationships prevail in social and economic relations); (c) the nature of the political system; and (d) the penalty system for acts of corruption that are uncovered.

Especially in societies where arm's-length relationships are unlikely to be enforceable (because of the close and continuous contacts among closely knit groups of citizens who tend to personalize most relations), the larger the role of the state, the greater the probability that its instruments will be used by public officials and civil servants to favor particular groups in addition to themselves. When this happens, the cost of government rises while the ability of government to correct the shortcomings of the market falls. In other words, the effective control that the government has over the economy is reduced. In this situation, the best policy for decreasing corruption will be to reduce opportunities to engage in it by scaling down the government's role in the economy. Both the demand for, and the supply of, corruptive practices can be contained by a sharp reduction of that role in all its aspects, such as spending and taxing activities and, especially, issuing and enforcing economic regulations.

When corruption in the Weberian sense characterizes modern states, it can be reduced by increasing penalties on those who engage in it; by increasing the transparency of the rules, regulations, and laws; and by strengthening controls on civil servants. However, in more traditional societies, this option, while still worth pursuing, is not likely, by itself, to give very positive and, especially, permanent results. History is full of examples of campaigns against corruption (and against tax evasion) that started with great fanfare but did not accomplish much over the long run. By the same token, one should not officially sanction corruption by, for example, reducing the wages of civil servants on the assumption that they are getting payments under the table. Unrealistically low wages always invite corruption and, at times, lead society to condone acts of corruption. This is why repression of public sector wages, if carried too far, is never a good policy.

Because social intimacy creates the environment that promotes corruption, a policy that has been effective in some cases (for example, tax administration) in reducing corruption is that of forced and periodic geographical mobility for civil servants, to remove them from the region where they have their closest social or family relations and prevent the formation of new relations. Some forms of social relations take time to develop, so that, for a while, after a government official has moved to a new region or taken up a new function, such relations will not play a large role in the contacts between bureaucrats and the citizens who depend on them. Thus, periodic mobility, especially in a large country, could effectively reduce bureaucratic corruption.

Conclusion

Economists have developed elaborate and elegant theories about the workings of markets and the role of the public sector in those markets. A normative role has been assigned to the government to correct market failures. In recent years, public choice economists have stressed that, in addition to market failure, political failure could result when political actions or the actions of civil servants are influenced by objectives other than the need to correct market failures and to promote the public interest.

The more that real-life bureaucracies diverge from the Weberian ideal—the more they are permeated by corruption—the less control the government will have over its policy instruments and the less able it will be to correct the imperfections of the market. In other words, the less legitimate and justified will be the corrective role of the government. A scaling down of that role is likely to reduce the scope of corruption. F&D

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