**Corruption, International Donors, and Governance**

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## Introduction

Corruption is a pervasive and universal phenomenon. Recently, allegations of corruption were instrumental in the reorganization of the political system in Italy, the change in governments in Indonesia, Japan, Peru and the Philippines, and the collapse of governmental authority in Zaire. Corruption, at its heart, poses a threat to economic growth for a number of reasons: it reduces private and public sector efficiency when it enables people to assume positions of power through patronage rather than ability; it distorts the financial and economic environment; and, at the limit, corruption introduces instability and anarchy into the political process.

Given the increased attention being paid to issues of corruption, transparency, and democratic governance and their corresponding influence on economic development, our discussion of the relationship between corruption, governance, and international donor assistance is timely.[1] If aid from international donor organizations[2] inadvertently promotes illegal rent-seeking behavior3, then policymakers and international organizations should be cognizant of this perverse effect when considering efforts to promote economic development. If rent-seeking opportunities are created by

1 See, among others, Transparency International (2000) and World Bank (1997, 2000a, 2000b).

2 We use the term "international donor organization" to refer to those international, non-governmental institutions who provide resources and technical assistance to developing and transitional countries with the objective of improving economic and political systems. The International Monetary Fund and the World Bank are among those considered international donor organizations.

3 We define rent-seeking as the expenditure of resources in order to bring about an uncompensated transfer of goods or services from another person or persons to one's self as the result of a "favorable" decision on some public policy.

international aid, then it is necessary to refocus the efforts of these organizations on actions designed to promote transparency, accountability, and good governance. These actions would make struggling countries more attractive to foreign investors, reducing the need (dependency) for resources from international donor organizations. On the other hand, if, on net, international aid strengthens domestic institutions and promotes markets, then it is likely that investment flows will increase and economic development will result from the assistance of international organizations.

The remainder of the chapter is organized as follows. In the second section, we distinguish between private and public forms of corruption. We then turn our attention in the third section to the influence of public corruption on economic development. In the fourth section, we examine the evidence on whether international organizations promote or hinder rent-seeking behavior. The last section summarizes and offers policy advice.

**Private versus Public Corruption**

Much of the current discussion centers on corruption between a private agent and a government official which we call *public corruption*. Corruption between private agents, whether individuals or corporations, or *private corruption*, is less of a concern in the literature.[4] In this section, we briefly review the differences between private and public forms of corruption and discuss why public corruption is a greater concern to economists and policymakers.

4 See, among others, Klitgaard (1988), Scully (1988), Grier and Tullock (1989), Theobald (1990), Barro (1991, 1996, 1999), Przeworski and Limongi (1993), Tanzi and Davoodi (1997), Tanzi (1998), Burki et al. (1999), and Melese (2002).

In its mildest and most benign form, private corruption can reduce transaction costs and assist in building relationships between private agents. “Facilitation payments” (anything from generous commissions to free meals and entertainment) can replace costly contingent contracts with implicit contracts. The offering agent views the reputational benefit as outweighing the explicit cost of the facilitation payment. Both the offering and receiving agents act as if the implicit contract is an explicit agreement because of the reputational penalties for violating the contract. In other words, such payments are rational actions by agents with the intent of improving commerce. Private corruption, in this benign form, has an offsetting benefit that, on net, lowers transaction costs and “greases” the wheels of commerce.

The most egregious forms of private corruption, on the other hand, typically involve a gain by a private agent or agents with no offsetting benefit in terms of reduced transactions costs, enhanced reputations, or informal contracts. Private corruption, in this form, harms private commerce as firms are looted by their controlling shareholders; profits diverted and concealed by management; and debt concealed through the use of sophisticated (and, in many cases, legal) accounting mechanisms.[5] Corporate profits and shareholder value are adversely affected by these forms of corruption. If the problem is sufficiently widespread, investor confidence in equity markets may be shaken and the overall economy may slow or decline as a result.

Examining equity markets in the United States and Europe, we can observe examples of this egregious form of private corruption. Enron, Worldcom, Adelphia

5 See, for example, Johnson, La Porta, Lopez-De-Silanes, and Shleifer (2001) for a discussion of “tunneling” where assets are stripped from a firm by the shareholders or management of a firm.

Communications, and Tyco International are companies that have either collapsed or are on the verge of collapse due to alleged private corruption. However, in each case senior management responded to incentives by reportedly manipulating financial data to reap monetary rewards.

By concealing debt and overstating revenues, managers were able to boost the firm valuation and stock price. As the stock price increased, the value of the managers' stock options increased, and many received additional bonuses for meeting certain stock price targets. It appears that the financial incentives to cheat were reinforced by what many perceived as a lax regulatory environment, and a culture that demanded senior managers regularly increase firm valuation. Some managers responded to these short-term incentives by engaging in actions that damaged the long-term viability of their firms, ultimately impacting equity markets.

If revealed soon enough, such corrupt practices typically involve costs that shareholders should be happy to shed…along with its perpetrators. If revealed too late (or if corruption is endemic) then bankruptcy is the outcome. Because of this automatic, market-based regulation of private corruption, and the fact some is beneficial, governments should generally limit their interference to encouraging transparency and enforcing the rule of law. Here it would seem the shorter the arm of the law the better, since markets eventually impose significant penalties on firms that employ these techniques.[6]

6 One might argue that the current focus on corporate governance in the United States and the relatively poor performance of firms now identified with "governance issues" provides evidence that markets do "self-correct" over time.

While transparent and efficient markets reward good corporate governance (less private corruption) over time, there is no corresponding "self-correction" mechanism in the public sector. Agents in the public sector are typically not subject to market forces (anyone who has stood in line at a public office understands) and thus rules, regulations, and incentives must be developed to encourage transparent and non-corrupt governance. Public corruption undermines the institutions, rules, and regulations that provide the framework within which free markets operate, impeding commerce and inhibiting economic development.

## Public Corruption and Its Influence on Investment and Growth

There are many types of public corruption, including embezzlement of public funds, theft of state property, accepting bribes to shorten processing time, obtain monopoly power, or to secure government contracts. Tanzi (1998) offers a common definition of public corruption: the abuse of public power for private benefit.[7] Bribery, for example, is defined by the OECD as: a specific form of corruption that can be defined as the voluntary giving of something of value to influence performance of official duty.[8] In general, we often think of corruption as a transaction occurring between a private agent and a public official, with little attention paid to the possibility of corruption between public officials within a government, or between an agent of an intergovernmental organization and a government official.

Surprisingly, corruption has only recently entered the forefront of policy discussions in developed and developing countries. The legality of the tax deductibility

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7 Theobald (1990) provides a variety of definitions.

8 Obtained from their website, http://www.oecd.org/puma/ethics/index.htm.

of bribes, for example, has only recently been eliminated from common practice in some major OECD countries, irrespective of whether bribes to public officials are illegal in the "receiving" country.[9] Deductibility aside, weak (or absent) penalties and lax enforcement in bribe-receiving economies create an environment that prevents allocating resources to their highest valued uses. The fear is that bribes and other forms of corrupt behavior skew the decisions of policymakers to the long-run detriment of a country, hence its increased attention in the literature and by international organizations.

Although one might expect a broad consensus to exist concluding that corruption is "bad," some authors have argued that under the proper circumstances, corruption may facilitate growth.[10] Bardhan (1997) reviews a number of possible arguments supporting corruption on grounds of efficiency, similar to arguments that benign forms of private corruption lower transactions costs in the private sector. Graziano (1980) argues that corruption among politicians can serve as the "glue" holding a country together. Corruption enhances political stability which, in turn, promotes economic development. While there may be cases where a moderate level of public corruption enhances economic development, we believe that a consensus has emerged in the literature on the detrimental effects of corruption on investment and growth.[11]

Mauro (1995, 1996), for example, finds that corruption is negatively associated with aggregate investment in developing countries. Brunetti, Kisunko and Weder (1997) suggest that the perceived reliability of the judiciary, government instability, and

9 See OECD website: http://www.oecd.org/daf/nocorruption/faq.htm.

10 See Huntington (1968) and Braguinsky (1996). Kaufmann and Wei (1999) present compelling evidence, however, that firms paying more in bribes are also likely to spend more management time with bureaucrats, and also pay a higher cost of capital.

11 See Shliefer and Vishny (1994), Mauro (1996), and World Bank (2000a, b), among others.

corruption influence cross-country differences in aggregate investment. Employing aggregate investment rates for sixty countries for the period 1974–89, Brunetti and Weder (1997) find that a lack of rule of law, high corruption, and real exchange rate distortions are the most damaging for investment. Pfeffermann, Kisunko, and Sumlinski (1999) note the link between private investment and perceived business obstacles in developing countries. Countries where obstacles (corruption, unpredictability of the judiciary, onerous regulations for starting a business, and tax and labor regulations) are perceived to be less problematic enjoy higher levels of private investment relative to those countries where obstacles are perceived to be more significant.[12]

Corruption can also be thought of as a tax on private investment.[13] A corruption tax is particularly burdensome for investment projects that by their nature involve a long time horizon and a multiplicity of logistic, administrative and legal steps. At each stage of production, multiple corruption taxes may be levied, increasing the cost of capital and reducing project profitability. Moreover, corruption taxes are horizontally and vertically inequitable. Two projects of similar size are unlikely to face the same tax due to the administrative and political factors. Larger projects may be subject to a higher "rate" as more opportunities exist to levy the tax and the revenues are higher relative to smaller projects. An implication is that less corruption might translate into more resources available for private investment. In addition, strengthened public revenues as a result of

12 These findings are echoed in a January 2001 report by PriceWaterhouseCoopers which develop a new barometer of the business environment: an "opacity index." Opacity is defined as "the lack of clear, accurate, formal, easily discernible, and widely accepted practices in the broad arena where business, finance, and government meet." This report estimates the adverse effects of opacity on the cost and availability of capital in thirty-five countries. Not surprisingly, those countries where "opacity" is a problem pay a risk premium when they borrow from abroad or domestically when issuing bonds.

13 See Shleifer and Vishny (1993) and Wei (1997).

less "leakage" due to corruption could translate into increased public investment, improved public services, and reduced taxes. Reducing the corruption tax would, in effect, facilitate economic development.

**International Donor Agencies, Corruption, and Governance**

Having discussed the potential detrimental influence of corruption on investment and economic growth, we now turn our attention to the potential influence of international donor agencies on corruption and governance. In the best case, international donor agencies promote transparency, accountability, and good governance through the provision of financial resources and technical assistance. In the worst case, local agents and international donors rationally respond to perverse incentives and collude in the provision of financial resources that are effectively "siphoned" away by corruption.

Ideally, international donor agencies work with governments to promote economic development through the transfer of resources and knowledge. Development projects are implemented with the objective of developing local infrastructure, human capital, and improving institutions. Policy advisors work with local governments to improve laws and regulations; lower transactions costs; encourage "arms-length" transactions; and provide a sense of rationality to government policies.

Fiscal decentralization, or the devolution or delegation of revenue and expenditure authority to lower levels of government, has come to the forefront of policy prescriptions offered by international donor organizations. Decentralization, if structured properly, is thought to improve economic efficiency, citizen participation in the governance process, and, more importantly from our perspective, lower the returns to rent-seeking thereby reducing corruption (Martinez-Vazquez and McNab, 1997, 2002a, 2002b). There is evidence, at least in Latin America, that decentralization has helped to strengthen democratic governance in countries that have decentralized their public finances.[14] Fiscal decentralization has complemented existing democratic institutions and encouraged citizen participation in local governance. These improvements have come in the form of direct election of mayors and councils, open council meetings, and several other forms of citizens participation. There is also evidence from polls and surveys that decentralized governance gets high approval marks from citizens and that people seem to trust local governments more than central governments.[15]

A particularly successful innovation in citizen participation in fiscal and management decisions at the local level in Latin America has been the creation of social investment funds.[16] The key to success of the social investment funds has been that they require a high degree of local resident involvement. Increased accountability to local residents increases "visibility" and lowers the reputational (and potentially, financial) returns to corruption. We note these successes have motivated the bureaucracy (national and subnational) to work with its citizens to develop and implement solutions, a facet that is missing from many technical assistance and international aid programs.

While there are cases where international donor assistance has promoted economic development and governance in developing and transitional economies, some economists question whether aid has any discernable positive impact on governance.

[14] See Campell et al. (1991), Campbell (1993), de la Cruz (1994) and Lopez Murphy (1995).

[15] See Fiszbein (1995) and World Bank (1995).

[16] The experience with social investment funds is discussed in Glaessner et al. (1994) and Campbell et al. (1991).

Bauer (1984) argues that the competition for rents derived from international aid has led to a politicization of life in aid-receiving countries. Maren (1997) contends that the collapse of Somalia's civil society is, in large part, due to the competition for control of international food aid. Brautigam (2000) notes that while Sweden's aid agency has spent over 15 years to develop Tanzania's auditing capacity, there has been no impact on public sector accountability because the Auditor General's office does not employ private auditing firms to audit public expenditures. Knack (2001) argues that a cross-country analysis supports the hypothesis that higher levels of international aid erode the quality of governance.

Why does international aid fail to improve governance and reduce corruption? Easterly (2002), for example, argues that international donor organizations implicitly form a cartel that reduces the effective supply of development services. Politicians of developed countries provide financial and political support to the donor organizations to further their own foreign policy objectives. For the donor organizations, soliciting and disbursing aid provides a rationale for their existence and employment for their personnel. Politicians in the developing and transitional countries view international aid as a means of garnering and maintaining political support. International donor organizations, in effect, capture local politicians who thus have an incentive to support the agenda of the international organization over the local needs and preferences of their constituents.

Examining this issue in a principal-agent framework, reveals the existence of powerful incentives that shape the behavior of local politicians and international aid organizations. International organizations solicit funds from donor countries and, in turn, disburse these resources to developing and transitional countries. Not disbursing these resources would raise questions about the need for these organizations.

For the international organizations to disburse resources, they must enlist the cooperation of developing country governments. As Easterly (2002) and others note, the provision of resources under the control of these governments is a strong incentive for cooperation. Zimbabwe, for example, is ranked as be one of the most corrupt and authoritarian regimes in Africa by Transparency International, yet it continues to receive assistance from the World Bank. A brief survey of the World Bank's website in September 2002 noted over $650 million in projects that were in the "pipeline," that is, awaiting approval for implementation to complement the development projects currently underway. Good policies, some would argue, are second to the need to disburse resources to developing and transitional countries.

The effectiveness of international assistance and the influence of these organization on governance and corruption in developing countries is still open to debate. While the World Bank and other organizations have emphatically stated that development assistance has promoted economic growth (World Bank 2001, 2002), others have noted that countries with higher aid-to-GDP ratios grow slower over time (Easterly 2002). The relationship between international aid, corruption, and governance is largely unexplored in the literature and should prove to be a rich and contentious line of research. What we can say is that recent empirical examinations of the relationship between international aid and economic growth have consistently found that aid does not promote, and in some cases hinders economic growth.[17] One possible explanation is that aid

17 See Easterly (2001, 2002) for excellent surveys of this emerging literature.

inadvertently promotes rent-seeking and public corruption, which in turns hinders economic growth.

## Conclusion

If we are uncertain as to whether international aid promotes or hinders economic growth, what can we say about the influence of international donor organizations on politicians and bureaucrats in developing and transitional countries? We note the existence of strong financial and reputational incentives for cooperation with the international donor organizations in the disbursement of resources and technical assistance. Emerging democracies may be particularly susceptible to these pressures as resources are typically quite scarce in those countries, and those who align themselves with the donor organizations have control over donor flows. Targeting donor resources to reward political support (and withholding them as punishment when necessary) creates another layer of incentives for cooperation with donor organizations. If corruption is a significant problem, then the direct rewards for cooperation are quite clear, that is, the ability to siphon resources for personal and political gain from projects supported by international organizations.

How can a these incentives be attenuated? One question is whether international assistance is truly necessary. Curiously, those countries that received lower levels of international assistance relative to GDP over time, grew faster than countries with higher levels of assistance (Easterly 2002). Perhaps what is needed instead of direct financial aid which can be siphoned or taxed, is technical assistance and training to improve accountability, transparency, and reduce transaction costs. As we have noted in this chapter, reducing the corruption tax may free up domestic resources, enhancing the provision of public services and infrastructure. Lowering the corruption tax may also enhance foreign direct investment, spurring economic development.

Encouraging transparency and accountability in the public sector lowers returns to corrupt activities, and can renew the public's faith in government. Instead of subsidizing large, expensive, centralized projects, domestic and international organizations might better serve target populations by encouraging good governance, decentralization, and work to reduce particularly burdensome trade barriers in developed countries. Starting with the premise that good governance and decentralization can lead to market-driven growth through international trade and investment, it can eventually be determined to what extent international aid is truly necessary and to what extent it merely meets the needs of donor organizations.

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