CORRUPTION: COSTS and MITIGATING STRATEGIES

PARLIAMENTARY WORKSHOP
Global Context

- Corruption has been identified as one of the most important problems facing the world today.

- Rising income inequality feeds perception of “rigged” national and global systems.

- Corruption fuels such perceptions and causes moral outrage.
  - Street protests (e.g., Arab Spring, Ukraine, Honduras, Guatemala)
Macro-Economic Impact

- Public Sector Corruption — abuse of public office for private gain

- Afflicts economies at all stages of development

- Cost of bribery alone – $1.5 to $2 trillion annually (about 2 percent of global GDP)

- Clearly corruption has a macro-economic impact

- Cross-country studies show that economic and social costs of corruption undermine ability to deliver inclusive and sustainable growth
Objectives

- The economic and social cost of corruption – Overview

- How to reduce corruption?
  - Simple analytical framework – Bridging policies and channels
  - Role of IMF
The Economic and Social Costs of Corruption
Cost of Corruption: Channels

Uncertainty, transaction cost↑

Inadequate property rights protection

Provision of public goods and services↓

Trust, revenue base ↓

Grand corruption ↔ Petty corruption

Lower investment/growth, entrenched inequality, social conflict
“Corruption Kills” (Aftermath of Fire in Bucharest’s Nightclub in 2015)
Corruption, Trust, and Revenue Base

Source: World Values Survey
An effective strategy requires a holistic approach
But measures must be sequenced, notably ensuring the institutional framework is adequate.

It is a long term process (need to manage expectations)
There is a role for short-term measures with more immediate impact.

Preventive measures are no less important than enforcement
Transparency is a typical example
Corruption: Simple Analytical Framework

Extent of corruption = Number of opportunities for corruption × Probability of a corruption act
How to Reduce Opportunities for Corruption?

- Structural reform:
  - # docs, procedures, cost to open business, trade, construct, register property;
  - Reducing number of controlling services, licenses;
  - Simplification of tax system, custom tariffs
  - Privatization

- Sometimes – pure “red tape”

- Often – hard choice between reducing corruption and correction of market failures
  - E.g. Georgia in 2000s: fire and food safety departments closed down

- Another hard choice: rules vs. discretion
Outsourcing government services:
- E.g. quality control in less corrupted countries (f.e. medicine licensing)
- Procurement, customs management

Information technology:
- Automated procedures: e.g. paying taxes, applying for licenses, detecting traffic rules violations..
- Digitized, centralized records: one-stop shops for services
- Software-based choice for audits: at customs, tax administration, bank supervision,
- Software-based assignment of judges to court cases
- E-government procurement
- Automated assignment for social transfers

How to Reduce Opportunities for Corruption?
Opportunity vs. Probability: Sequencing of Anti-Corruption Policies

- Important not to add burden by fighting corruption
  - Possible if bribery is an escape from excessive “red tape”
- Often reducing opportunities is of higher priority than reducing probability
- Bribery, extortion exist even if rules are OK
  - Important to crackdown on them too
Corruption: Simple Analytical Framework

Extent of corruption = Number of opportunities for corruption × Probability of a corruption act
Corruption: Simple Analytical Framework

Corruption opportunity yields tradeoff:

Honest option: Wage

VS.

Dishonest option: Wage + bribe, but chance of being caught

Main components: public sector wages, chance of being caught (and punished),… also non-monetary cost of dishonest action
“Efficiency” Public Sector Wages

- Wage↑ → chance of corrupted act ↓
  - Only if punishment and probability of detection are not zero!

- Effect of efficiency wages is likely stronger is the presence of risk-aversion or aversion to illegal activity
  - Marginal benefit of illegal income diminishes

- Effect is also stronger if wage increases are merit-based and transparent

- Not sufficient but likely necessary measure…
  - Part of many successful anti-corruption strategies: Georgia, Singapore
Punishment and Intangible Cost of Corruption

- **Punishment (fine, loss of job, etc)** ↑ → chance of corrupted act ↓
  - Again, effect depends on probability of detection

- **Cost of illegal act (reputation, social capital, etc.)** ↑ → chance of corrupted act ↓
  - Bureaucrats may self-select themselves into public positions based on status or monetary rewards
  - The cost may also depend on trust, on what others are doing, on culture
  - As a result, same anti-corruption policies (wage, fines) may lead to low or high corruption in different countries
  - Also, big one-time crackdown may have a long-lasting effect
“Islands of Excellence”: New Police in Ukraine
Punishment and Intangible Cost of Corruption

- Making harder to launder proceeds of corruption = effective benefit from corruption is lower

- Political institutions: harder to “rig” political representation = effective cost of corruption is higher
  - E.g. political competition, restricted contributions/lobbying/gerrymandering, etc.

- Enforcement must also target the private sector
  - Both tangible and intangible costs matter
Intangible cost of breaking rules: Traffic memes in Latin America
Chance of Getting Caught: Official Institutions

- Probability of detection (audit, etc) $\uparrow \rightarrow$ chance of corrupted act $\downarrow$

- … but subject to caveats:
  - Audits can be corrupt too, used for victimization and extortion, i.e. exacerbate situation with corruption
  - Anti-Corruption Bureaus can be rendered ineffective because of institutional flaws or constraints
    - E.g. “starving” of ACB in Indonesia by delaying wage payments

- Yet, even though effective legal framework for ACBs may not be sufficient, it is a necessary component

- Critical role of leadership
Chance of Getting Caught: Transparency and Monitoring

- Transparency, access to information
  - Data dissemination rules and standards, property registers, income declarations, procurement process
  - Governance process: public council hearings, stenographic records of gov’t meetings, etc

- Information technology:
  - Detecting tax non-compliance, leakages in social spending, illegal financial transactions
  - Global exchange of information
  - … but mind cybersecurity and cyberfraud

- Encouraging grassroot monitoring
  - Closeness of government to people (decentralization): increased political competition, yardstick competition
  - Free press (incl. social networks), human capital, digitalization: supply of and demand for information about gov’t abuses
  - Supply of bribes: whistleblowing encouraged.
Encouraging whistleblowing: “He Would Not Be Silent”
Mitigating Corruption: Role of IMF
Transparency

► General initiatives
  ► Development of international standards on fiscal and financial transparency
  ► Transparency in extractive industries – these are important because of their relative share in many economies
  ► Supporting international standards on transparent corporate ownership

► Targeted initiatives
  ► Targeted interventions in corruption sensitive sectors (wealth declarations; audits fraudulent transactions)
Enhancing the Rule of Law (Punishment)

- Set up of new specialized institutions
- An effective anti-money laundering framework to minimize the laundering of proceeds of corruption
- Enforcement targeting the private sector
Reducing number of opportunities for corruption

**De-regulation**

Excessive regulation is an important source of corruption

De-regulation and simplification is a cornerstone of anti-corruption strategy

Structural reform, de-regulation are always in Fund’s focus
Building Institutions
The key issue is implementation, for which institutions are critical.

Building blocks for effective institutions:

**A clear legal framework is required**
For example: an independent central bank (mandate, oversight, operational and financial autonomy, appointment criteria, dismissal rules, legal protection of staff)

**With adequate technical expertise**
Institutions cannot be effective without requisite technical competence
Conclusions

► Corruption hinders inclusive and sustainable growth

► How to mitigate corruption?
  ✔ Reduce number of opportunities: structural reform, de-regulation, technology
  ✔ Reduce probability of corrupt act: public sector wages, punishment (both monetary and non-monetary cost of corruption), higher chances of being caught (esp. transparency)

► IMF is active in many directions:
  ✔ Transparency, enhancing the rule of law (punishment), structural reform and de-regulation, building institutions
Thank You!