"Corruption in Developing Countries"

A Summary of Remarks by

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Shang-Jin Wei, Advisor at the IMF and Senior Fellow at the Brookings Institution, began his presentation by noting that eliminating corruption in developing countries is becoming increasingly important due to the rise of globalization. He then focussed on two questions of particular interest to both academics and policy makers. First, how can we quantify how corrupt particular countries are? And second, can corruption be good for economic development? Dr. Wei described several indices of corruption that are useful in cross-country comparisons while arguing that the answer to the second question is "no." It is possible, he said, to find examples of places that have done well in spite of corruption, but hard to think of anywhere that has done well because of it!

Much more attention is now being paid to the problem of corruption than was the case in the past. In fact, until recently, only the US had a law (the Foreign Corrupt Practices Act of 1977) prohibiting companies from bribing foreign officials. So, for example, a German multinational could legally pay bribes and even get a tax deduction for these amounts (as long as it got a receipt)! This state of affairs only ended in 1999, when the OECD countries (as well as some non-OECD countries that participated voluntarily) signed a treaty banning bribery.

There are two main reasons for the new focus on corruption. With the end of the cold war, it has become less necessary to tolerate "governance challenged" regimes like those of Marcos and Mobutu. At the same time, increased economic interdependence means that a given level of corruption has become much more costly. It has been estimated that moving from a relatively "clean" government like that of Singapore to one as corrupt as Mexico's would have the same effect on foreign direct investment as an increase in the marginal corporate tax rate of 50%. This means that corrupt countries are also more vulnerable to financial crises because they are forced to rely on short-term offshore loans, which flow out much faster then FDI following a shock. Not surprisingly, portfolio investment is also adversely affected by corruption--a study (by two IMF staff members) of six hundred global and emerging market mutual funds found that fund managers tend to overweight less corrupt countries (relative to the Morgan Stanley Capital International indices).

Measuring the degree of corruption in particular countries is important both for academic studies of economic growth and for the administration of World Bank and IMF loans, Millenium Challenge Accounts, and other programs which seek to tie assistance to good governance. Several indices are now available for this purpose. For example, the Political Risk Services Group (www.prsgroup.com) provides (for a fee) corruption ratings for a number of countries in its International Country Risk Guide. These are based on the expert opinion of its staff. The Global Competitiveness Report, a joint effort of Harvard University and the World Economic Forum (www.weforum.org), rates countries on the basis of surveys of six to seven thousand business executives around the world. Each is asked to think through a sequence of seven transactions involving things like getting an import license or arranging for foreign exchange remittances and to estimate how much these would typically cost in illicit payments. And Transparency International's (www.transparency.org) Corruption Perceptions Index provides a useful (and free) average of the findings of a number of other sources.

All of these indices are somewhat subjective, but this does not detract from their usefulness. It is after all the perceptions of investors that matter for FDI and portfolio investment. Further support for the subjective approach comes from a study of German exporters done during the early 1990's (when it was not illegal to bribe foreign officials), which achieved a more objective measure by asking respondents to report amounts of bribes actually paid to foreign officials. The results were highly correlated with those of perceptions-based surveys.

There are two schools of thought on whether corruption is necessarily bad for economic development. Samuel Huntington have argued that corruption can be beneficial because it allows firms to get around inefficient regulations (barriers to import, entry, etc.) and thus promotes competition in the domestic market. As Huntington argued, "the only thing worse than dishonest and rigid bureaucracy is honest and rigid bureaucracy." Dr. Wei believes that this argument is incorrect because it takes the inefficient regulations as given. In fact, it is more likely that the only reason such inefficiencies are introduced in the first place is to create opportunities for officials to accept bribes. He also finds that the empirical evidence offers "overwhelming" support for the idea of corruption as "sand" rather than as "lubricant." (See, for example, Paulo Mauro's article "Corruption and Growth" in the August, 1995 *Quarterly Journal of Economics*).

So is the new focus on corruption having any practical effect? Dr. Wei cited two cases in which international loans were cut off in response to unacceptably severe governance problems. While much still remains to be done, he feels that cases like these show that the international community is finally beginning to move in the right direction on this important issue.