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The impact of liberalization on bureaucratic corruption

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ABSTRACT

Liberalization increases the number of goods available for consumption within a country. Since bureaucrats value variety, this raises the marginal utility of accepting a bribe. This "benefit effect" is counteracted by an increasing "cost effect" from corruption deterrence activities that arise due to greater international pressure to curb corruption. The interaction of these two effects can lead to a non-monotonic relation between liberalization and corruption. Moreover, pre-commitment to deterrence activities is shown to be more effective in controlling corruption. Empirical evidence supports the existence of a non-monotonic relation between economic openness and corruption among developing countries.

1. Introduction

In an increasingly integrating world, the nexus between globalization and corruption is an important issue, especially for policy purposes.[3] The extant literature on corruption has generally found a negative relation between corruption on one hand and trade, investment and growth on the other (see Rose-Ackerman, 1975, 1978; Mauro, 1995; and the survey by Bardhan, 1997).[4] The explanation offered is as follows: by introducing greater foreign competition, trade liberalization reduces monopolistic rents enjoyed by firms and decreases their ability to pay a bribe, thereby reducing bureaucratic

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3 Corruption – the misuse of public office for private gains (Bardhan, 1997) – can be "administrative" (misuse by law enforcers) or "grand" (misuse by lawmakers). This paper deals with the former type of corruption only.

4 There is less unanimity on the effect of corruption on static efficiency. While Shleifer and Vishny (1993), Mauro (1998) and Ahlin and Bose (2007) find corruption to be distortionary, Leff (1964) has argued that in a second best world with pre-existing policy induced distortions, corruption may actually improve efficiency. The ability of the lowest cost firm to pay the highest bribe can ensure an efficient outcome in a bargain between a corrupt official and prospective firms, where the former tries to sell a permit to the latter. This argument, of course, presupposes that the lowest cost firm is able to meet the objectives of the permit-program as well as the other firms. On the institutional economics of corruption, see Lambsdorff (2007).

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corruption.[5] One exception to this general finding is Ades and Di Tella (1999), who show that if corruptible officials are paid an efficiency wage to induce honest behaviour, the effect of increasing competition on corruption is ambiguous. By reducing profits of oligopolistic firms, competition reduces the efficiency wage as it becomes less attractive to induce honesty, but, at the same time, any level of wage deters more corruption as the gains to corrupt officials fall with competition. As a result of these two contradictory effects, equilibrium corruption can either rise *or* fall with competition.

The empirical evidence on how openness affects corruption across countries has been mixed. In contrast to the ambiguous nature of their theoretical predictions, Ades and Di Tella's (1999) empirical results showed that foreign competition (as proxied by import to GDP ratio and other variables) negatively affects corruption. Similarly, Wei (2000a,b) and Gatti (2004) found an inverse relation between openness and corruption. Treisman (2000), however, reported a "surprisingly small" negative relation between corruption and openness to trade (measured by import to GDP ratio).[6]

The ambiguity evident in the literature, notably in Ades and Di Tella (1999) and Treisman (2000), seems to suggest that the relation between openness and corruption is more complex and may even be non-monotonic in many countries due to the interplay of opposing factors that are inherent in globalization.[7] A positive relation between openness and corruption is borne out by the initial experience of the transitional economies of Eastern Europe and erstwhile USSR, "where essential steps to privatize the economy and rewrite the rules of commerce after the demise of socialism were often accompanied by widespread corruption" (Transparency International, 2005, p. 271). However, there is recent (1999–2002) evidence to support the view that "the prevalence and costs of some types of corruption are becoming more moderate in many countries in the region" (Transparency International, 2005).

The purpose of the present paper is threefold. First, we explore a different (from those explored in the existing literature) channel through which economic openness can induce corruption among public officials. Second, we provide a possible explanation as to why the relation between economic openness and corruption may be non-monotonic in some countries. Lastly, we provide empirical evidence which indicates the existence of such a relationship in some countries. In this sense, our empirical analysis moves away from the existing literature which is preoccupied with estimating the linear relationship between openness and corruption.

The different channel, referred to above, is as follows: liberalization typically increases imports, and imports introduce new goods and services to consumers of liberalized economies.[8] This effect is likely to be stronger in developing countries, which lack the ability to produce many goods and depend on imports to make them available. Availability of more products increases the marginal utility of consumers' income, given that they have a taste for variety. In particular, this will also increase the corruptible officials' marginal utility of bribe income and increase their incentive to be corrupt. Thus liberalization, by increasing the allure of consumerism, strengthens the propensity of officials to be corrupt (at least initially) in our model.[9]

But there is a second, and countervailing, effect that results from greater openness. A commonly observed attribute of globalization is that it engenders additional pressures on developing countries to reduce corruption and improve governance. For one, greater openness makes domestic corruption more "internationally visible." Second, international bodies have a greater ability and incentive to engage and pressure more open countries to crack down on corruption.[10] For instance, according to Williams and Beare (1999, p. 142), "both the IMF and World Bank have recently introduced reforms to their lending practices making the provision of funds conditional upon the successful implementation of a variety of macroeconomic and anti-corruption reforms." Similar international anti-corruption initiatives have been launched by the United Nations (*UN Convention against Corruption*, 2005), African Union (*Convention on Preventing and Combating Corruption*, 2003), and the Organization of American States (*Inter-American Convention against Corruption*, 1996).

[5] The causality between openness and *grand* corruption can run in the other direction as well. Corrupt lawmakers are more likely to create regulations involving licenses, permits, quotas, and tariffs so as to facilitate their rent-seeking activities. Such policies can be inimical to trade and business opportunities.

[6] In contrast, Williams and Beare (1999, p. 116) have noted "a conviction that corruption has increased to epidemic levels, and that globalization has provided much of the impetus and opportunity for this growth."

[7] The possibility of a non-monotonic relationship between economic growth and corruption has been suggested by Bardhan (1997). While reporting a negative relationship in general for most countries, Bardhan (p. 1329) observed that, "in some countries with the process of modernization and growth corruption may have got worse for some time before getting better." This, according to him, can arise due to counteracting forces generated by the growth process. On one hand, an expansion of the economy provides public officials with "more opportunities for making money from their decisions" (Bardhan, 1997). On the other hand, a prospering economy can afford to pay its civil servants better (thus reducing their motivation to be corrupt), and may be more likely to install institutions that check corruption. Bardhan (1997), however, does not formally model these forces or their interaction.

[8] This is in the spirit of international trade models with product differentiation (such as Krugman, 1980; Lawrence and Spiller, 1983) and Romer, 1994. Klenow and Rodriguez-Clare (1997) estimate that a 1% lower tariff was accompanied by a 0.5% increase in import variety for Costa Rica during 1986–1992. Also, see Mitra (2005).

[9] In India, there is widespread perception that the post-liberalization consumerism, spurred on by influx of imports, has increased not only official greed and corruption, but also other illicit and extortionary money making ventures (such as dowry demands). This is reflected in the remarks of the head of the Central Vigilance Commission in a talk delivered at BASF Mumbai in 2002 (see http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN019875.pdf): "This brings us to another important social root for corruption that is probably getting more accentuated in recent times. This is the spreading cult of consumerism. . . Consumerism and desire for an ostentatious lifestyle tempt many to make money by hook or crook. Corruption is the result."

[10] See, for examples, the following media articles: "Africa tackles graft, with billions in aid in play" (*The New York Times*, July 6, 2005), and "EU takes China to task over product safety" (*The Globe and Mail*, July 23, 2007). International aid agencies and NGOs are often active in pressuring governments of developing countries to crack down on corruption. For example, USAID has developed a wide range of anti-corruption programs. *Transparency International* and *U4* provide resources and training in regulating corruption, and also provide information that exposes corrupt deals, thereby raising domestic and international awareness and pressure for cleaner governance in these countries.