



Fiscal Affairs Department

# Corruption: Costs and Mitigation Strategies

Presented by

**Bernardin AKITOBY**

Assistant Director

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# Motivation

- ▶ Corruption has been identified as one of the “most important problems facing the world today”
- ▶ To a varying degree, it afflicts economies at all stages of development
- ▶ This SDN looks at Fund country experience; it does not, however, draw implications for Fund policy

# Outline

- ▶ Definitions and Manifestations
- ▶ The economic and social costs of corruption based on a comprehensive review of existing and new literature
- ▶ Strategies for addressing corruption based on IMF experience
- ▶ Conclusions

# Definitions and Manifestations

## “Abuse of public office for private gain”

Limited to public sector corruption (not private sector corruption)

Corruption can:

- ▶ Involve non-financial gain (e.g., conflicts of interest arising from family interests)
- ▶ Pervert the law making process (state capture/privatization of public policy)
- ▶ If corruption becomes systemic (i.e. the norm), in the extreme it can affect all state functions and lead to a breakdown

# The Economic and Social Costs of Corruption

# Corruption

## State Functions

**Fiscal**

**Market  
Regulation**

**Monetary  
Policy**

**Financial  
Sector  
Oversight**

**Public Order  
&  
Enforcement**

### Macro-Financial Stability

- Banking crises
- External sector imbalances
- Inflation
- Fiscal unsustainability
- Financial inclusion

### Public & Private Physical Capital

- Inefficient public investment
- Costly investment and production
- Distorted composition of projects
- Uncertainty
- Distorted asset prices

### Human Capital

- Insufficient spending on education/health
- Poverty and inequality
- Disincentives for skill acquisition

### TFP

- Insufficient investment (R&D)
- Inefficiency
- Distorted capital allocation
- Skills mismatch

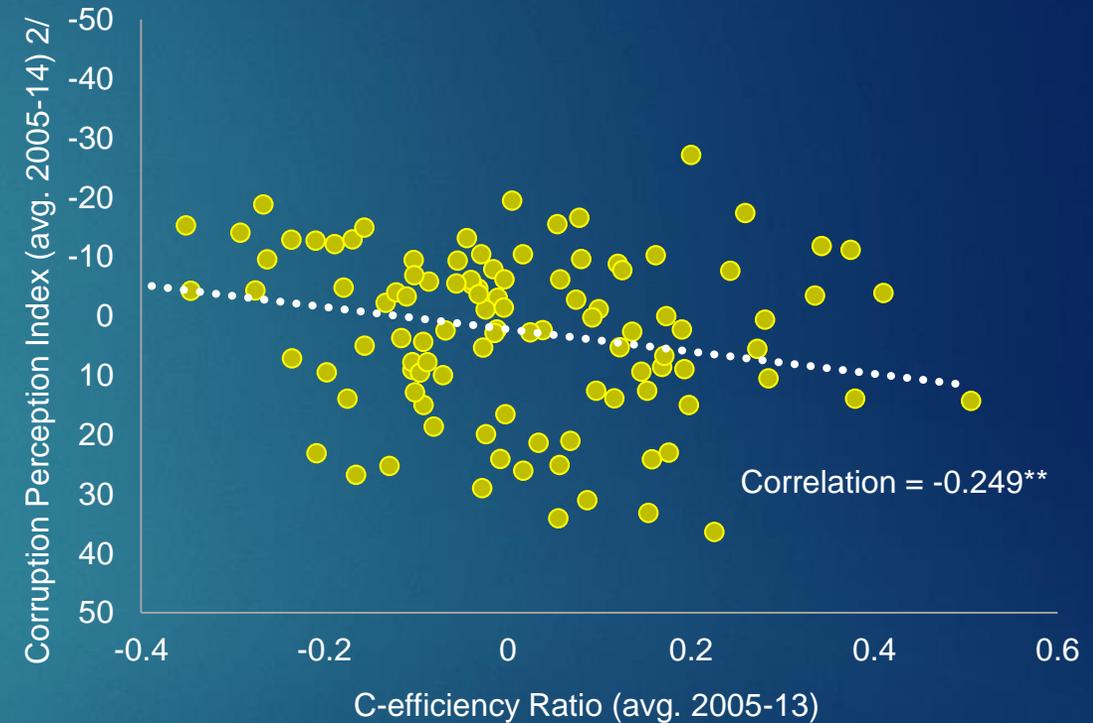
### Political Instability and Conflict

Potential Inclusive Growth

# Corruption weakens the state's capacity to raise revenue

- ▶ Harms the culture of compliance, increasing tax evasion (see figure)
- ▶ Creates disincentives to pay taxes when tax exemptions are viewed as arbitrary
- ▶ As a result, lower revenue limits the ability of the state to provide public services with consequences for growth

Corruption and VAT C-Efficiency 1/



1/ Variables presented are deviations from values predicted by income level.  
2/ Larger numbers indicate lower perceived levels of public sector corruption.  
Asterisks from the correlation equation imply significance at 5%.

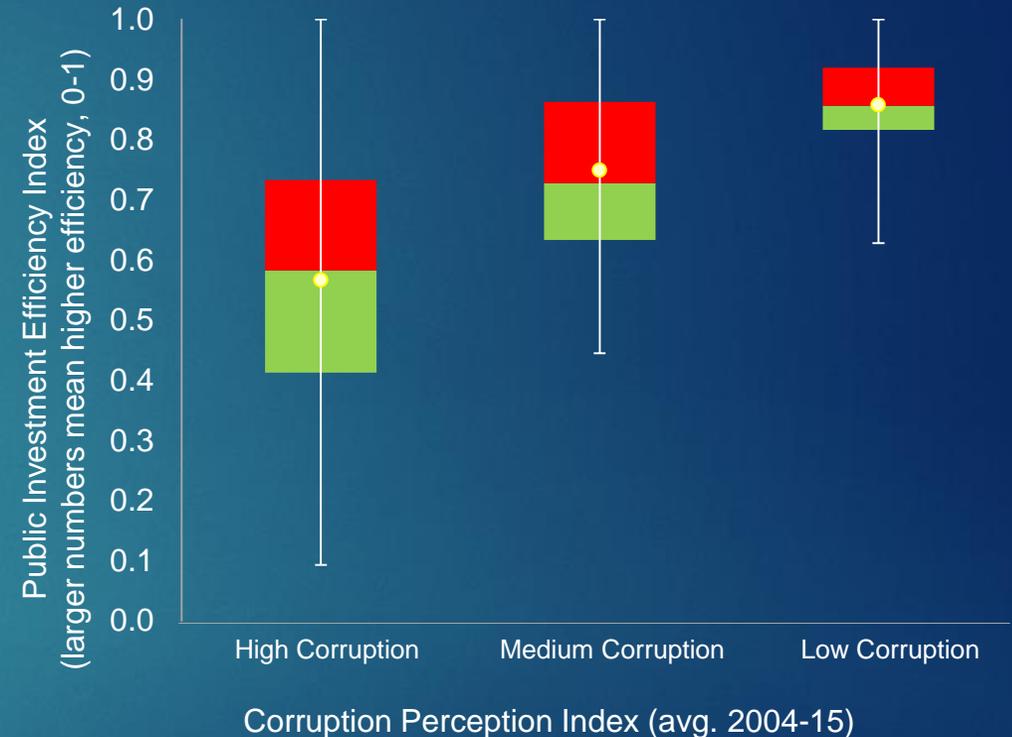
# It undermines quantity and quality of public spending through...

- ▶ Inflated public procurement costs
- ▶ Siphoning of funds through off-budget transactions
- ▶ Weak payroll controls and
- ▶ Weaknesses in computerized PFM systems

## Distorts budget allocations

- ▶ Lower public investment and other priority spending
- ▶ Lower efficiency of public investment (see figure)

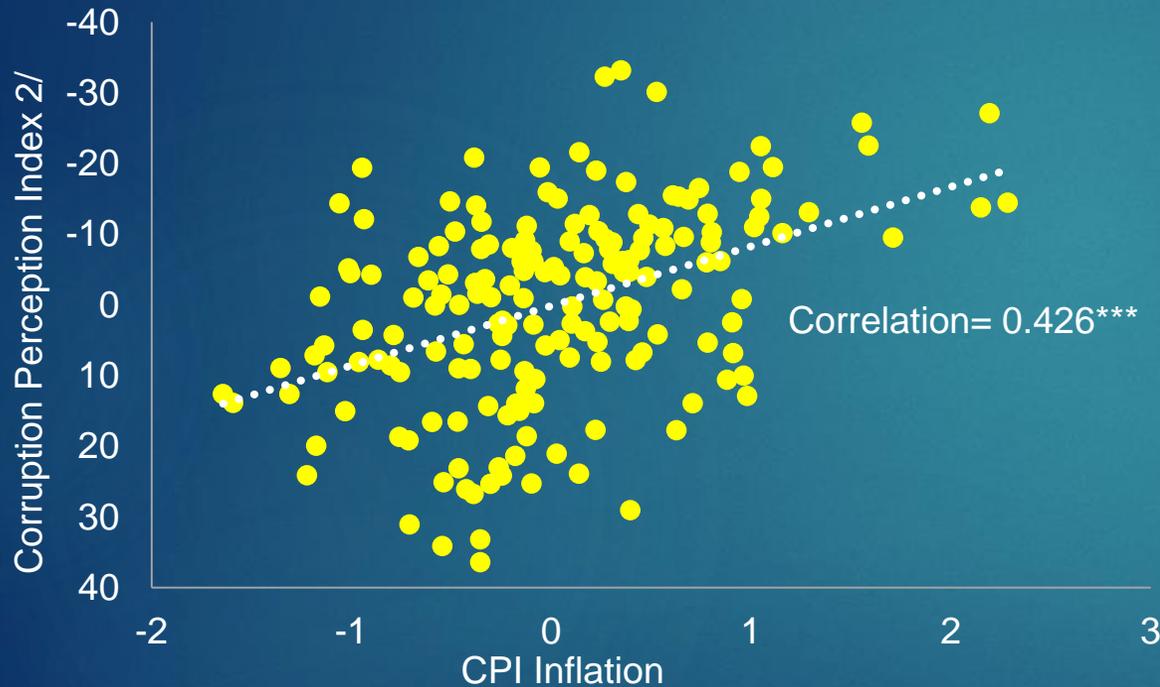
Public Investment Efficiency and Corruption Perception Index



Note: The samples are grouped into high, medium and low corruption in equal numbers based on the Corruption Perception Index. The lines show the range of efficiency for each group. The green and red boxes are the second and third quartile (from the bottom) of the samples, thus the boxes cover 50 percent of the countries.

# ... and can hinder sound monetary policy

**CPI Inflation and Corruption Perception  
Index 1/  
(Average for 1995-2014)**



1/ Variables presented are deviations from values predicted by income level.

2/ Larger numbers indicate lower perceived levels of public sector corruption.

Asterisks from the correlation equation imply significance at 1%.

**Because of lower public revenues,  
countries tend to rely more on seigniorage  
finance**

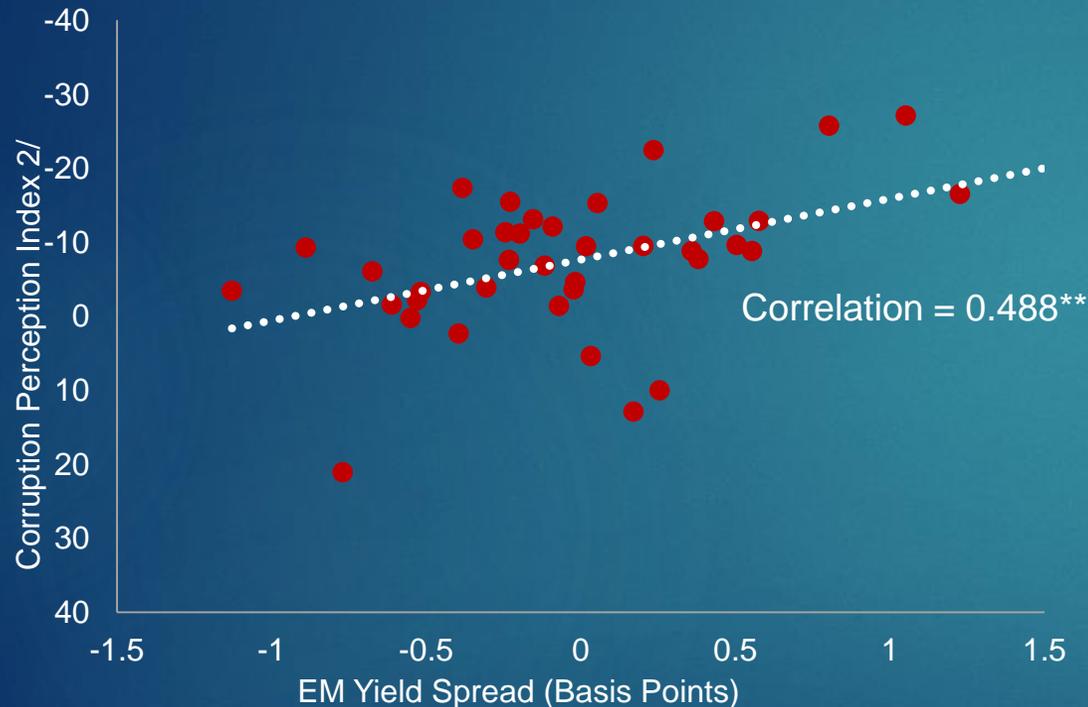
- ▶ Fiscal dominance
- ▶ Inflation bias as shown in the figure

**Corruption further weakens financial  
oversight and stability**

- ▶ Poor lending and regulatory practices
- ▶ Weak banking supervision

# Corruption hampers market access...

Emerging Market Sovereign Spreads and  
Corruption Perception Index 1/  
(Average for 1995-2014)

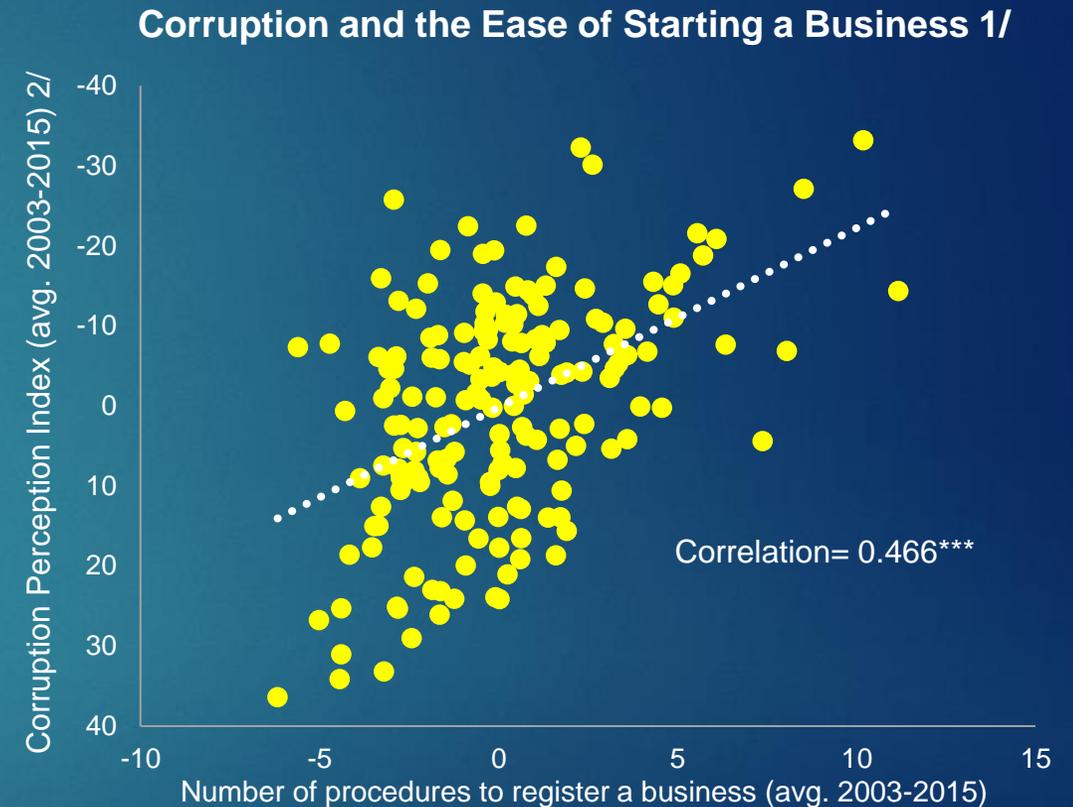


Even market participants appear to factor in corruption into their lending decisions

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# ... and negatively impacts the private sector by:

- ▶ Raising uncertainty
- ▶ Acting as a barrier to entry (see figure)
- ▶ Distorting resource allocation from productive to rent-seeking activities



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# Corruption is linked to poor social and environmental outcomes

Limits build-up of human capital

- ▶ Through reduced allocations for social programs
- ▶ Compounded by leakages
- ▶ With potential consequences for equality and poverty

**Studies show that child mortality rates are about one-third higher in countries with high corruption. Infant mortality rates and percent of low-birthweight babies are almost twice as high.**

More pollution due to

- ▶ Weaker, poorly enforced environmental regulations
- ▶ Over extraction of natural resources

# Political instability and conflict

- ▶ In the extreme, systemic corruption can lead to political instability and conflict
- ▶ It has been argued that natural resource abundance can accentuate the situation



# Strategies for Addressing Corruption

Transparency, Rule of Law, Economic  
Reform and Regulation, Building  
Institutions

# Costs and Strategies

## Fund experience

- 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.

# Challenges in Measuring Corruption

- The clandestine and hidden nature of corruption.
- There is a heavy reliance on perceptions.
  - There is a margin of error inherent in subjective perceptions, which is amplified when used for complex statistical constructions.
- Differences in the types of transactions captured under the definition of corruption are a complicating factor.

# Fund Experience: four main areas

1. Transparency: providing public with access to information
2. Rule of Law: having a credible threat of prosecution
3. Economic Reform: eliminating excessive regulation
4. Building institutions: all depends on effective institutions

# Transparency

- ▶ General

- ▶ Transparency is a pre-requisite for the proper functioning of the market

- ▶ It can also be targeted on corruption

- ▶ 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

# Enhancing the Rule of Law

- ▶ There must be a credible threat of prosecution
- ▶ Sometimes new specialized institutions must be set up where existing ones are themselves corrupt
- ▶ An effective anti-money laundering framework must be in place to minimize the laundering of proceeds of corruption
- ▶ Enforcement must also target the private sector

# Economic Reform

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## Eliminating Excessive Regulation

Excessive regulation is an important source of corruption (Anne Krueger: “rent seeking”)

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Elimination of excessive regulation and simplification are a cornerstone of anti-corruption strategy (i.e., Ukraine Caribbean, MENA countries).

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However, it is important to have an adequate institutional framework in place first when transitioning from state controlled monopolistic markets. (i.e., emerging economies in Eastern Europe)

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# Building Institutions

The key issue is implementation, for which institutions are critical.

Four 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

## **And the right incentive package for non-corrupt behavior**

For example: securing wage adequacy in combination with effective dismissal procedures

## **With a critical role of leadership**

For example: both setting a personal example and ensuring decisive action

# Conclusion

- ▶ Public sector corruption substantially impairs key channels influencing inclusive growth.
- ▶ Fighting corruption calls for a long term and holistic strategy, albeit appropriately sequenced based on country-specific circumstances.
- ▶ A crisis can be a catalyst for change; but a crisis setting generally does not permit for full resolution. Determined leadership over time is a key underlying factor.