Corruption, Governance and Economic Development

Mushtaq H. Khan

[in Jomo, K.S. and Ben Fine (eds) 2004. *The New Development Economics*. New Delhi: Tulika Press and London: Zed Press]

Corruption and governance have come to the fore in contemporary discussions of reform in developing countries. Many of the problems to which corruption and governance refer are significant and longstanding. Yet, the way in which mainstream economics has analysed them simply provides support for a programme of market-enhancing reforms. These seek to reduce the role of the state to the delivery of a small range of core services that cannot be delivered by the private sector. The mainstream analysis is not only misleading in failing to identify many of the most important determinants of corruption and of apparent governance failures in developing countries. By offering wrong diagnoses and solutions, these mainstream approaches waste time and resources in programmes that are unlikely to provide reductions in corruption and improvements in governance. Even worse, by promoting reforms that lessen the ability of the state to accelerate development, they may paradoxically reduce the prospects of substantial and lasting improvements in corruption and other desirable features of "good governance" such as democracy.

The first section outlines the definitions of corruption and governance used in the literature. The second section describes the comparative evidence on corruption and governance that has driven the contemporary interest in these issues as determinants of the prospects of developing countries. The third section outlines the mainstream analysis and its limitations. It argues that the neoclassical analysis of corruption and governance and its policy conclusions are based on a model of market-driven development that is inappropriate for analysing a number of critical problems that developing countries face in their transitions to more productive societies. The fourth section provides an alternative approach to corruption and governance, drawing on different segments of the heterodox literature on the role of the state during the social transformations that developing countries are going through. It identifies four different types of corruption with very different causes and implications, and with different policy implications. The neoclassical analysis of corruption is at best relevant for understanding and responding to one of these types of corruption, and this is not the most important type of corruption affecting developing countries. The other types of corruption are associated with processes more critical for explaining the success or failure of developing countries, but here neoclassical policy prescriptions actually hinder the construction of more effective developmental policies that are necessary for sustainable reductions in corruption. These conclusions apply to the neoclassical analysis of good governance as well. That analysis is also based on the assumption that the governance tasks of the state should be limited to providing the basic conditions for a market economy to work. It ignores the political and economic transformations that developing countries are going through and the state capacities necessary for success in this transformation. As with neoclassical anti-corruption policy prescriptions, its good governance policy prescriptions are damaging because they can weaken those state capacities that are vital for the social transformations that developing countries are going through. The fifth and final section summarizes the implications of this analysis for policy in developing countries.

Defining Corruption and Governance

Most economists and social scientists define corruption in a narrow way, and I will follow this definition in addressing the literature and its implications. According to this definition, corruption takes place when public officials (including both bureaucrats and politicians) violate formal rules of conduct in pursuit of their private benefit, whether for wealth in the form of bribes or for political advantage (Nye 1967, World Bank 1997). Corruption is therefore defined as an exchange between a private individual (or group) and a public official (or officials), where the public official breaks formal rules of conduct and provides something to the private individual or group that would not otherwise have been received. The benefit that the public official gains is technically illegal because it violates a formal rule of conduct (for the act to be corrupt). But the benefit the private individual receives in exchange may be either a legal entitlement that they would not otherwise have received or an illegal benefit that confers greater advantage than otherwise. The differences between these cases are important and will be discussed further later.

A number of points are noteworthy about this definition. First, corruption is defined in such a way that its analysis does not involve moral judgements about the act. This is an advantage of the definition, since if corruption is defined as acts that are "wrong", this would result in different acts being identified as corrupt by different people according to their different moral standards. For instance, a public official who gives a job to a nephew in exchange for maintaining his own political influence over his clan may not be considered as corrupt by someone who thought that it was a moral duty to promote one's family. But it would be corrupt according to the definition here as long as formal rules of conduct for public officials in that country ruled out such acts. Even so, there is still the possibility that there may be differences in legal or formal rules of public conduct across countries but, in general, in virtually every country, rules of public conduct do not allow the acceptance of bribes, nepotistic allocations or diversions of public resources for economic or political benefit. This makes it easier to identify corruption according to this definition without engaging in debates about morality. Nevertheless, the problem is that in everyday usage, people do make moral judgements when discussing corruption, and the difference between the everyday sense of corruption and the definition that is commonly used in economic and social analysis needs to be kept in mind.

Secondly, corruption is deliberately defined as a <u>process</u> rather than as an <u>outcome</u>. If corruption were to be defined to include only acts that have damaging <u>outcomes</u> for the public, then this would rule out cases where a process was corrupt but its overall effects were neutral or even positive. Thus, the definition we use is useful in analysing differences in the effects of corruption across countries. But, once again, in common usage, corruption is often used to describe actions by public officials that are against the "public interest", whether or not any rules of conduct are violated; while actions where rules <u>are</u> violated but the "public" does not suffer (or even benefits) are often not described as corrupt. Once again, the difference between everyday conceptions of corruption and its definition in economics and social analysis needs to be kept in mind.

Finally, the definition of corruption that we follow places public officials at the centre of the analysis. According to this definition, corruption does not take place where public officials are not involved and, in this sense, corruption is simply a lens through which to examine the operations of the state. This too is somewhat at odds with common usage where corruption can refer to reprehensible behaviour by anyone, including interactions exclusively between private individuals or agents. According to the social science definition, if a private person steals from another, that is theft, not corruption. However, even in the case of theft, corruption may be implicated because the state is the ultimate protector of property rights, and theft may take place with the connivance or even involvement of public officials. Note that using this definition does not mean accepting that corruption is more important than theft, only that the focus of corruption analysis is on the functioning of the state.

Nonetheless, there are important grey areas that we need to keep in mind. If a small shopkeeper gives a job to a relative without following proper procedures, or charges a fee for providing the job, these acts would very likely be described as nepotism or extortion rather than corruption in common usage, and here common usage conforms to the economist's definition. But, if the chief executive of a large quoted company did the same thing, this would be commonly described as corruption, and would very likely be treated in the literature on corruption as a corrupt act. This is because many authors treat private sector executives in important economic positions as having semi-public roles. But a more consistent position would be to argue that their activities are regulated by the state so that theft, extortion or fraud by executives in important private sector positions often involves either a failure of public governance, or direct corruption and collusion by public officials. It is important to keep in mind that the definition of corruption is not making a statement about the relative importance of the private and public sectors in explaining economic and social problems, but is rather a lens through which to analyse the operation of the state. In this sense, heterodox analysis can contribute to the debate while keeping to a definition of corruption that puts the state at the centre of the analysis.

The definition of governance is also deeply connected to the state. Governance is what states do, but identifying the areas of governance on which to focus is problematic because it requires specific assumptions about what the state is supposed to be doing. Here, the conventional analysis of "good governance" is explicitly based on a neoclassical analysis of the role of the state in economic development. The assumption in neoclassical analysis, in its neo-liberal form, is that all that the state is required to do is to protect stable property rights, achieve low corruption, and restrict itself from expropriation by committing itself to democracy and the protection of majority interests. This, in turn, is based on the assumption that the market is sufficient to ensure rapid development and, as long as the state maintains stable property rights and an environment of low transaction costs and low expropriation risk, the market will work efficiently. This model of the economy and of the role of the state then leads to the conclusion that reducing corruption, improving property right stability, lowering expropriation risk and deepening democracy are preconditions for rapid economic development (Khan 2002a, 2002b).

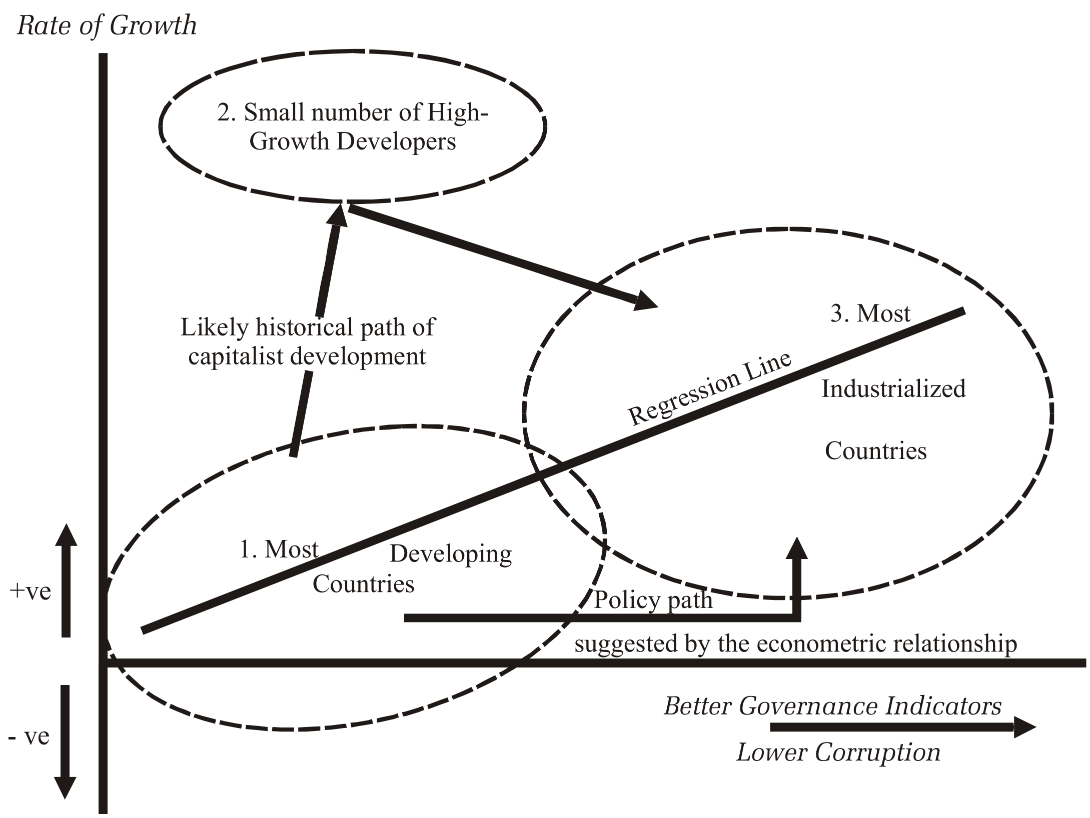
The Comparative Evidence

Each of the variables in mainstream neoclassical analysis of "good governance", such as corruption, the stability of property rights, expropriation risk, and the depth of democracy are regularly "measured" in cross-country surveys that collect subjective judgements of these variables by investors, ordinary citizens or other target groups. These survey-based indices have serious problems that are well known. First, these are subjective indices, and so they are likely to be biased by local economic performance. For instance, investors or ordinary citizens are likely to report greater property right stability or lower risk of expropriation, and perceive lower corruption if the economy is performing well rather than if it is stagnating.

Second, these indices are only available for the last couple of decades, and this makes it difficult to assess causality. The problem in assessing causality is that we expect corruption and governance to improve anyway with greater prosperity. As economies become richer, they spend more on law enforcement, they can afford higher salaries for public officials and, most important, as the capitalist class becomes entrenched and acquires legitimacy, it begins to buy influence through legal processes of lobbying, political contributions and so on, which converts illegal influence-buying in the form of corruption into legal influence-buying of different sorts. As a result, corruption is reduced, even though influence-buying by the rich does not. Therefore, to see if the prior reduction of corruption is a precondition for development, data over longer periods are required to determine the sequence of changes in corruption, governance and economic development. If low corruption and "good governance" were preconditions of growth, only those poor countries that first reduced corruption or improved on these specific governance indicators would achieve high growth subsequently. If, however, corruption was reduced and "good governance" was achieved only after growth was achieved for some time, the sequence observed would be reversed. But these different hypotheses about the relationship between corruption, good governance and economic development cannot be tested with data for very short periods.

Despite weakness in these indices, they are widely used in mainstream analysis and, in particular, to support the policy prescriptions suggesting that focusing on these variables will help to create the preconditions for an efficient market and, therefore, for rapid development. The empirical evidence is quite strong, keeping in mind the shortcomings in these indices. It shows that, in general, countries that have lower corruption and better scores on property right stability, expropriation risk, democracy, and other "good governance" characteristics perform better in terms of growth rates and other economic indicators (for instance, Hall and Jones 1999, Kauffman, Kraay and Zoido-Lobatón 1999, Johnson, Kaufman and Zoido-Lobatón 1998, Clague and others 1997, World Bank 1997, Knack and Keefer 1997, 1995, Barro 1996, Mauro 1995). But the problem is that this correlation does not tell us much about causality. In other words, the correlation does not tell us whether some countries perform better because they first achieved lower corruption and better governance as defined in the good governance analysis, or whether they have lower corruption and better governance because they developed first.

The standard statistical regression does not answer this question, but a closer look at the data shows that the causality suggested in the neoclassical analysis of corruption and governance is seriously flawed (for an extensive discussion see Khan 2002a and 2002b). Figure 1 summarizes the data on corruption and governance observed over the last two decades that underpins most of the statistical results apparently supporting the mainstream position. Most developing countries are in group 1, with relatively low growth and poor governance and corruption indicators. Most advanced countries are in group 3, with moderate growth and much better governance and corruption indicators. Because most countries are clustered in either group 1 or group 3, the statistical regression relationship shows a positive relationship between better governance and lower corruption, on the one hand, and growth and other economic performance indicators, on the other.



Source: Khan 2002a Figure 2

Figure 1. Empirical Relationships Between Corruption, Governance And Economic Performance

The problem for the conventional view is the existence of a small number of high growth developing countries that were actually growing fast enough to begin to converge to the living standards of the advanced countries. These high growth developing countries are located in group 2 in Figure 1. They had the highest growth rates of all countries, since by definition, they were catching up with the advanced countries, but their corruption and governance indicators were not distinguishable from the developing country average. This raises a serious question for the conventional wisdom. Even with the very limited periods over which there is data, it is possible to argue that a move from group 1 to group 3 cannot be achieved by trying to first emulate the governance characteristics of group 3 countries (as neoclassical theory prescribes). This is simply because it is not possible to find any example of a high-growth developing country that had achieved high growth by first acquiring advanced country governance or corruption characteristics. The only feasible route for sustained reductions in corruption, and even for achieving some of the "good governance" characteristics of group 3 countries is likely to involve first emulating the governance characteristics of group 2 countries, which may then allow group 1 countries eventually to catch up with advanced countries in group 3. The relevant governance characteristics of group 2 countries that allowed them to grow rapidly are different from the "good governance" characteristics of property right stability, democracy, low corruption and so on, even though all of the latter may be desirable goals in their own right. What is important is that achieving these desirable goals may require first achieving the social transformations that group 2 countries are successfully achieving because of governance characteristics that neoclassical approaches are not well suited to identifying.

In contrast to neoclassical analysis of corruption and governance, heterodox theories provide a very different diagnosis and identify very different priorities for reform. These theories fit in better with the feasible route to development suggested in Figure 1, of a transition from group 1 to group 3 via group 2. The role of the state in heterodox analyses of this transition is significantly different. The state in successful developing countries is identified as playing a much more important role than simply maintaining property right stability and providing some key services. The state is recognized as a key set of institutions playing a role in the social transformation of pre-capitalist societies into capitalist ones, in assisting the acquisition of technology and in maintaining political stability (Amsden 1989; Aoki, Kim, and Okuno-Fujiwara 1997; Khan and Jomo 2000; Lall and Teubal 1998; Rodrik 1995, 2002; Wade 1990; Woo-Cumings 1999). All of these processes require significant interventions in pre-existing property rights, so that the neoclassical requirements of low corruption and "good governance" are typically not met in any developing country, regardless of their relative economic performance (Khan 2002a, 2002b). At the same time, there is no reason to be sanguine about property right instability or corruption in developing countries. In most developing countries, property right instability and corruption is, indeed, associated with very poor economic performance, and by studying the types of corruption and property right instability that are involved in specific countries, valuable insights can be gained into the processes that are blocking a transition of the country from a group 1 to a group 2 country.

The Mainstream Analysis and its Limitations

The weakness of the neoclassical economic analysis of corruption and governance is that it ignores many of the most significant causes and effects of different types of corruption. In the same way, it ignores some of the most important types of governance failure relevant for developing countries and concentrates on an analysis of governance failure (described as failures of "good governance") that is at best relevant for economies that have already achieved the transition to a developed economy. Misleading use of statistics is then used to find support for these simplistic economic models. In fact, a considerable literature exists on different types of corruption and their causes and effects (significant contributions to the debate are available in Williams 2000; Williams and Theobald 2000; Heidenheimer and Johnston 2002). This complements the equally substantial literature on the role of the state in economic development that shows that the role of the state in successful developers has typically gone well beyond the relatively limited tasks of property right maintenance and service delivery that neoclassical theory suggests.

Here, it will be argued that the mainstream approach to corruption and governance identifies a number of general effects of corruption and some specific governance failures that are potentially damaging in theory, but these effects are not the most important for most developing countries. In contrast, a number of very important damaging effects of corruption as well as many serious types of governance failures are ignored and downplayed. This makes the mainstream analysis both misleading and potentially damaging.

Any corrupt transaction is a type of "exchange" and therefore has two components. First, there is the bribe or the political support that is offered by the private sector individual or firm to the public official and this has a measurable cost in terms of lost investment or higher costs of business. The cost of this part of the transaction includes the cost of the resources used up in unproductive activities like lobbying, bargaining, and other activities that seek to identify and influence the relevant public officials. It also includes the possible social cost implicit in transferring resources (the bribe) from productive users (if the bribe-givers are productive investors) to less productive ones (bureaucrats or politicians). The overall effect of this part of the transaction is therefore very likely to be negative, increasing the costs of doing business and the uncertainty for investors. In general, therefore, the first effect of any corrupt exchange is typically negative since bribe-giving or offering political support usually (though not always) transfers resources (the bribe) from more productive to less productive resource users, and the organization of the transfer or the support can itself be very costly and increase the uncertainty faced by investors.

But giving the bribe or political support to the public official is only one part of the corrupt transaction. In exchange, the public official offers something in return to the individual or firm offering the bribe or the political support in the form of an action or decision affecting resource allocation. For instance, the official can allow the person or firm giving a bribe to get access to some resources, or make a decision that favours that individual or firm and all these decisions also have an economic effect. Thus, corrupt transactions always have a second economic effect, since there is always some public decision affecting resource allocation that would not otherwise have been made. But this effect is not always negative. If the intervention that the public official offers in exchange adds to the productivity of the economy, the effect of this second component of the corrupt transaction is positive, and if it reduces social productivity, this effect is negative. Our judgement of the second effect of corruption depends on an analysis of the types of interventions that are productivity-enhancing or productivity-reducing. This is why any analysis of corruption involves an analysis of the role of the state in economic development. Some interventions by corrupt public officials can clearly have damaging consequences for the economy. Examples would be the creation of monopolies or decisions that allow bribe-givers to corner markets or engage in fraud. In these cases, the second effect of corruption is negative, adding to the first negative effect discussed earlier. But in other cases, the second effect may be positive and this could in some cases outweigh the first effect so that the overall effect of corruption can be positive. Examples would be cases where public officials transfer resources to productive uses or make decisions that raise productivity but charge a bribe for doing so. In these cases, the positive effect of a productivity-enhancing decision may outweigh the negative effect of the cost of organizing the bribe.

For the mainstream neoclassical analysis, corruption is always damaging because the effects of both components of the corrupt transaction are deemed to be negative. The first effect, associated directly with the organization and transfer of the bribe, is always likely to be negative because it increases the cost of doing business. But in the mainstream analysis, the interventions offered to the private sector in exchange (typically in the form of creating private monopolies and transfers) are also judged to be damaging for the overall economy. The two negative effects of corruption then add up to explain why corruption can have serious economic consequences. Mainstream economists recognize that corruption can sometimes allow investors to avoid socially damaging regulations and restrictions, like unnecessary restrictions on imports and exports. But they argue that even in these cases, the best policy would be to remove the unnecessary restrictions directly, rather than hope that corruption would enable the economy to function. The mainstream policy conclusion is therefore to fight corruption with a combination of liberalization (to remove these restrictions and interventions) and direct anti-corruption measures. Policies to attack corruption directly include raising bureaucratic salaries (to reduce the incentive to be corrupt), setting up independent anti-corruption agencies with the power to prosecute and punish, and encouraging civil society organizations to act as watchdogs (World Bank 1997, 2000). These policies also form an important part of what has come to be known as the "good governance" agenda. While this analysis appears to be plausible, it is based on the implicit assumption that there is an underlying competitive market economy that would work ideally in the absence of any state intervention, which only creates opportunities for corruption. This leads to the conclusion that if only these unnecessary interventions and opportunities could be removed, the underlying market would drive faster economic growth and development.

But the historical evidence shows that only relatively advanced capitalist countries have been successful in significantly reducing corruption, and there are virtually no poor developing countries with low corruption. Why is this so? Moreover, contrary to neoclassical theory, observation of developing countries shows that the mix between public and private sectors, the presence or absence of democracy, or the types of economic policies that developing countries adopt have very little effect on the overall extent of corruption. Developing countries that follow policies of low intervention and have active civil society participation in politics tend to have just as much corruption as those that have more interventions or have authoritarian political regimes (Treisman 2000, Khan 2002a). Yet, the economic performance of developing countries can vary dramatically. To make sense of this evidence and to come up with better policy responses, a more refined analysis is necessary.

An Alternative Framework: Four Types of Corruption

Implicitly, the neoclassical analysis of corruption focuses on opportunities for corruption created by state interventions that are not themselves necessary for economic development. Examples would be unnecessary red tape and restrictions on private sector activities that serve no useful purpose except to create opportunities for public officials to extract bribes from private citizens seeking to avoid these restrictions. In these cases, not only is the intervention unnecessary, the corruption imposes additional costs on society.

But not all state activities are of this type and, by making this distinction, some sense can be made of the historical evidence. While bribing and other ways of illegally influencing the state imposes costs on society, the net economic effect of corruption also depends on the type of intervention or subversion of policy that is achieved through the bribe. Many interventions of the state are critical for accelerating development, as heterodox analysis of the state in developing countries has pointed out. In these cases, corruption can have ambiguous effects. If the state can intervene in ways that accelerate development, even if these interventions create opportunities for corruption, as long as the cost of organizing the corruption does not snowball, corruption can coexist with substantial economic dynamism.

On the other hand, if corruption results in useful interventions being subverted, the overall effect of corruption would be unquestionably damaging for the economy. Moreover, in addition to these types of necessary interventions that can potentially be legally regulated, other necessary interventions are more problematic because they cannot be sanctioned and regulated by law. For instance, often in developing countries, there are interventions that cannot be legally sanctioned for political reasons even though they are necessary for maintaining political stability or economic growth. In these cases too, the economic effects associated with the corruption can be ambiguous, because the benefit of the intervention for growth or political stability can sometimes outweigh the costs associated with bribing and influencing. These distinctions between types of corruption are important for understanding both the economic and political effects of corruption and the appropriateness of different anti-corruption strategies.

Based on this discussion, at least four types of corruption can be distinguished. The differences between them depend on whether the underlying interventions are potentially necessary for economic or political reasons, and whether the interventions in question are legally allowed or not. While all corruption involves the violation of some formal rules of conduct, the underlying interventions with which they are associated may themselves be legal or illegal, and they may be harmful or beneficial for economic development. These distinctions are important for identifying the types of policies that may be appropriate for dealing with different types of corruption, and to identify some types of corruption that may not be amenable to any simple policies. This classification is shown in Table 1.

Only the first type of corruption is relevant for the anti-corruption policies that are widely promoted by multilateral agencies following the neoclassical analysis. These corrupt acts are associated with laws that enable interventions that have no potential to assist economic development. Classic examples are tariff protection for industries that have no catching-up potential, or excessive regulation and requirements of permissions that have no purpose except to enable bureaucrats to extract bribes from businessmen. These dysfunctional interventions not only cause direct economic damage, they cause secondary damage through corruption as entrepreneurs attempt to capture monopoly profits or circumvent unnecessary restrictions. They include, in particular, the "petty corruption" involving low level officials extracting small bribes for performing their duties (red-tapism and speed money), for not harassing the innocent by deliberately misinterpreting very complex and unclear regulations (customs officials or police engaging in petty extortion). This is the most visible face of corruption and, in opinion surveys, public irritation with these types of corruption often dominates. Police corruption, for example, often takes top position in popular perceptions, largely because the police in developing countries have the powers to gain from widespread petty corruption when implementing complex and badly defined laws.

Table 1. A Typology of Corruptions Affecting Developing Countries

	The Required Interventions ARE Legally Allowed	The Required Interventions are NOT Legally Allowed
Interventions that **are** required for Economic Development or Political Stability	ii) This type of corruption may be associated with growth or stagnation depending on how seriously necessary interventions (market regulation, promotion of industries, subsidies for political stabilization) are subverted. Anti-corruption policy should seek to improve implementation and reduce corruption, but not to remove the interventions.	iii) All such interventions are likely to involve corruption. These types of corruption may be associated with growth or stagnation depending on the nature and extent of these interventions (political stabilization using off-budget transfers, preferential access to resources for emerging capitalists). Policy should focus on legalizing necessary interventions and reducing damaging interventions.
Interventions that are **not** required for Economic Development or Political Stability	i) These types of corruption are associated with dysfunctional interventions (unnecessary paperwork and permissions, protection of inefficient industries) and always have negative effects. Policy should seek to remove these state "functions" (through liberalization and privatization). This has been the focus of mainstream anti-corruption strategies.	iv) Predatory Extortions. This type of corruption predominates in failed or failing states where armed groups can extort from society regardless of political stability or economic performance (Afghan warlordism, extortion by political mafias). Effective policy to counter this type of corruption has to strengthen the centralized coercive power of the state.

While these types of corruption are very irksome and can affect the greatest number of people, they are not necessarily the <u>most</u> damaging type of corruption from an economic perspective. Nevertheless, these types of petty corruption are damaging, they are regressive in that the victims are very often the poor, and they increase transaction costs and the general perception of lawlessness in developing countries. It is for this type of corruption that the neoclassical analysis of corruption is most appropriate. Here, not only is the public official extracting resources from society, the "services" or decisions that they are providing, or threatening not to provide, usually have further damaging effects on society. Moreover, the ability of the state to define unnecessary laws can encourage the creation of more and more artificial restrictions and more and more red tape to increase opportunities for extraction (Myrdal 1968: 937-51).

For this type of corruption, the liberal prescription of liberalization and privatization would, in theory, be the most appropriate, together with direct anti-corruption measures such as higher salaries for public officials and more effective punishments. But it is doubtful if this is the most important type of corruption in most developing countries. If this is only a part of the corruption problem, and if in addressing this, the policies involved damage the potential of accelerating development through state intervention, then these policies may hinder, rather than help the reduction of corruption in the long-run. A better approach would be to target these types of corruption separately, rather than with general anti-corruption strategies that may at best make sense for particular types of corruption but may make economic performance worse if other types of corruption predominate.

The second type of corruption shown in the table is associated with the implementation of interventions that are potentially necessary for the economy or polity, <u>and</u> which are allowed and regulated by law. These include such things as managing taxes and tariffs to promote catching-up by domestic industry, the regulation of financial markets, the allocation of land and the licensing of land use, and the allocation of credit or the prioritization of infrastructure construction. These are precisely some of the types of interventions that heterodox theories of the state have identified as critical in developing countries going through rapid transitions and catching up with advanced countries. Clearly, corruption in these areas can have a much more significant effect on the economy, both in terms of growth and distribution.

Nevertheless, the simple neoclassical prescription of fighting corruption through liberalization can have problematic consequences as soon as we begin to look at these cases. The difference is that for this category of corruption, the service or decision that the public official is providing or making is <u>potentially</u> beneficial for the economy though, in practice, the decisions may often be damaging because corruption may subvert the type of decision or allocation that is being made. But here, the correct approach cannot be, in general, to remove or even reduce the capacity of the state to engage in these interventions. A more involved analysis is now required that distinguishes between those functions of the state that are never likely to play a useful role, and those that can. The policy response to the two should be very different. For those functions that are never likely to be of any use, the neoclassical policy prescription would still apply. But for a range of state functions that are critical for development, the appropriate policy response must be to <u>strengthen</u> the capacity of the state to intervene, and to reduce the susceptibility of state decisions to subversion by corruption or political processes, rather than to remove the interventionist capacity itself.

If the decisions that are being “sold” are the right ones in terms of accelerating economic development, then all that needs to be done is to reduce or eliminate the corruption, perhaps by paying bureaucrats and politicians more, or by setting up better monitoring and greater sanctions for the corrupt. On the other hand, if corruption is subverting decision-making and resource allocation, so that potentially important state functions are being subverted by corruption, the policy has to be a more aggressive one. It can involve insulating key state agencies from the pressures of particular unproductive groups or encouraging the organization of productive groups and weakening unproductive groups. For instance, it may be potentially very beneficial for society to provide emerging entrepreneurs with tax breaks or other resources to accelerate technology acquisition.

But if their political power allows inefficient capitalists to use corruption and other methods of exerting pressure to capture subsidies without engaging in technology acquisition, a potentially critical economic mechanism is subverted by corruption. In these cases, it is important to have specific policies to improve the implementation of these critical state functions, for instance by weakening the political organization of capitalists. Thus, if inefficient capitalists lose the political power to resist subsidy withdrawal by the state, corruption on its own will not prevent states from withdrawing subsidies from inefficient capitalists because public officials can extract even bigger bribes by allocating subsidies to productive capitalists (Khan 1996).

This is where heterodox approaches can effectively identify a significantly different, and wider, set of governance issues than those in the neoclassical approach. The heterodoxy accepts the importance of state capacities and powers to encourage the emergence of local capitalists, of assisting their technology acquisition, and of vigorously pushing their interests in international trade and investment. If these tasks have not been effectively carried out in the past, the heterodox approach would identify the political and institutional problems that have prevented this, and target these for policy attention in the future.

In contrast, the neoclassical approach to governance observes the failure of most developing country states to prevent the subversion of critical state tasks by corruption, and argues that these interventionist capacities should therefore be removed. This is clearly an extreme and counterproductive "solution" that is not likely to work if the state capacities in question are indispensable for development. Unfortunately, most anti-corruption strategies in developing countries are aimed at removing the capacity of states to intervene in these areas, rather than assisting states to intervene better to accelerate catching up by encouraging technology acquisition, promoting local capitalism and regulating incentives to achieve these goals.

The third type of corruption shown in our table refers to a much more problematic area associated with the implementation of necessary interventions that are not, or cannot be, regulated by law. These include processes of political stabilization through off-budget transfers, and interventions to accelerate and promote emerging capitalism through processes of "primitive accumulation". Primitive accumulation describes non-market processes (both legal and illegal) through which the emergence of a capitalist economy is accelerated in countries going through a transition to capitalism. Primitive accumulation includes in particular the changes in property rights in favour of an emerging capitalism and the asset transfers that are facilitated by state actions that tilt the playing field in favour of emerging capitalists (or particular factions of emerging capitalists). Some of these state actions can be legal, in the form of changes in relative prices, taxes, land licensing and so on, but others cannot be legalized because the underlying processes are too politically unpopular, unjust or unfair for it to be possible to codify and regulate them. In extreme, primitive accumulation can take the form of outright theft or occupation of public or common assets by factions or individuals, often exploiting political connections to facilitate this process.

Not surprisingly, when states are engaged in primitive accumulation, corruption is endemic. Conversely, the absence of primitive accumulation to anything like the same extent in countries that are already significantly capitalist is part of the explanation for systemically lower levels of corruption. But as noted earlier, lower corruption does not mean that influence-buying is lesser in advanced capitalist countries. The process of primitive accumulation has not been sufficiently analysed, even in heterodox analysis. The outcome of primitive accumulation does not necessarily have to be a dynamic capitalism. Much of the resources that are transferred to potential "emerging capitalists" may be wasted because the appropriators may fail in the end to become capitalists and instead prove to be unproductive consumers of stolen assets. This is part of the explanation for the very high degree of variation in the outcomes of primitive accumulation ranging from the rapid emergence of dynamic capitalism in countries like China after the eighties to the waste and collapse within many economies in Asia, Africa and Latin America as a result of failed processes of primitive accumulation.

While processes of primitive accumulation do not always lead to the emergence of viable capitalist economies, it is difficult to envisage how the transition from pre-capitalist to capitalist economies can be organized without primitive accumulation. By definition, developing countries have large segments of their economies that are unviable in terms of the technologies and prices set by the world market. As a result, developing countries are typically forced to go through rapid economic and social transformations simply because pre-existing economic formations are often rapidly collapsing. In the fortunate cases, new and more dynamic social formations have rapidly emerged but it is scarcely credible that such transformations could be organized while observing all the legal requirements characteristic of, and now demanded by, the developed countries. In other countries, social transformations have been much slower, even though the collapse of pre-existing formations was just as rapid. In the least fortunate cases, there is growing social chaos and conflict, and viable alternatives have failed to emerge. But in all developing countries, pre-existing property rights and class structures have been rapidly eroded or changed by powerful processes that cannot be easily stopped or reversed. These processes are not just market processes where more productive producers buy out less productive ones. They also include significant non-market processes simply because more productive producers and efficient markets do not already exist, and resources are captured by political entrepreneurs of different types who may or may not become dynamic capitalists over time.

The important observation from this perspective is that corruption is unlikely to be controllable in a context of rapid non-market changes in property rights where political power is being used to change rights, grab resources and rewrite the rules of the game. These processes are in turn likely to predominate in contexts of transition and primitive accumulation. The important point is that economic and social transformation and primitive accumulation are not processes that are simply the product of any "intention" on the part of public officials who want to profit from the opportunities they create for corruption. Rather, transitions in developing countries are typically driven by the growing non-viability of pre-capitalist rights and production processes and the internal political conflicts and struggles that this generates. If the ensuing transition takes society in the direction of a viable capitalist economy that can produce a significant economic surplus, this can eventually pay for the protection of the new structure of rights. Once this happens, both primitive accumulation and corruption can be significantly reduced. But before this happens, the existing structure of rights is <u>not</u> viable in the typical developing country. Surplus generation is low, and the state is unlikely to have the resources to protect property rights and ensure that voluntary and legal market transfers predominate. Moreover, in such a context, powerful groups and factions in society are likely to be engaged in a struggle to restructure ownership and the organization of production or simply capture resources using their political power as a tool. In this context, the corruption associated with primitive accumulation is a systemic process, and not one that can be limited or by-passed by policies such as limiting the role of the state, increasing public awareness or paying bureaucrats more. A focus on these policies assumes that corruption is largely due to the <u>intentions</u> of public officials and that if their incentives and opportunities can be changed, corruption can be reduced.

Thus, during this period, regardless of the incentives facing public officials, a significant part of the activities involved in protecting and transferring assets in developing countries are likely to be non-market, illegal and unjust. Anti-corruption policies that assume that states can be made to stabilize essentially unviable property rights and establish a rule of law in this context are not likely to work. If states tried to do this, given that the existing structure of rights is not productive enough to pay for such a scheme, the likelihood would be that such policies would be rapidly abandoned. Indeed this is precisely what we observe in developing countries that have adopted, for a time, a serious commitment to across-the-board anti-corruption strategies. This explains why the "political will" to combat corruption appears to be systematically lacking across the entire swathe of developing countries.

Another type of intervention that falls within the category of necessary interventions that cannot be legalized is intervention aiming to achieve political stabilization in the absence of significant fiscal resources. In advanced capitalist countries, political stabilization is typically organized using fiscal transfers through the budget. This process is legal, and the rent-seeking (or influence-buying) that it generates is, therefore, also legal, typically in the form of lobbying, political contributions and other legal or semi-legal means to influence the allocation of subsidies and transfers. Once again, note that influence-buying and rent-seeking can be widespread in advanced countries. It is only that most of it is legal.

In contrast, in developing countries, the fiscal space for political redistribution is limited for a number of reasons. The modern sector of the economy that can be taxed to redistribute to others is small. At the same time, the political conflicts faced are often more serious than those in an advanced country. In many cases, the taxes collected are insufficient even for paying the salaries of bureaucrats. Capital expenditures in the development budget often depend on aid and other foreign capital inflows. Thus, the fiscal reality in most developing countries (apart from a few resource rich ones) leaves little scope for significant redistributions through the budget. But the political survival of the regime requires that powerful groups have to be accommodated.

These powerful groups are typically not the poorest. Their political accommodation often requires off-budget "redistribution" through patron-client networks to achieve political stabilization (Khan 2000b). The corrupt exchange here involves politicians (the public officials in question) transferring resources to powerful clients and receiving, in exchange, their political support. In some cases, clients can provide more than simple political support, by acting as thugs and musclemen for patrons. It is impossible to regulate these off-budget transfers legally for two inter-related reasons. First, by definition, these transfers go to buy off the most dangerous or troublesome sections of society and cannot be given to everybody. This inherent inequity based on the potential power to disrupt cannot be legally recognized. Secondly, given the absence of fiscal resources, financing these "transfers" involves patrons in public office engaging in acts of corruption to raise resources for their political survival, even in the extreme cases when there is no individual greed. Of course, if political survival requires corruption, this attracts a particular type of individual to public office, and few political leaders in developing countries can refrain from individual enrichment. It is, therefore, not surprising that political stabilization through patron-client networks in developing countries is inherently clandestine and is often closely linked to the processes of primitive accumulation described earlier.

None of the processes raised - the primitive accumulation that follows from collapsing pre-capitalist production structures and the political stabilization that has to take place clandestinely because of fiscal constraints – is significantly affected by the presence or absence of democracy, civil society pressures, or the integrity of individual public officials. Nor is there any government function that can be removed to reduce this type of corruption. If corruption were largely due to the greed of public officials, or the absence of public awareness, political mobilization would indeed succeed in reducing the problem.

But if the problem is that <u>any</u> ruling group is unable to stabilize property rights that are not viable, and has to engage in political corruption to survive, then political mobilization, democratization and demands for integrity, will do little to reduce this type of corruption. In fact, developing countries that have attempted to root out corruption through public mobilization have uniformly failed to make a lasting dent on the problem. In most cases, this has done little to reduce the problem in the long term, though there have sometimes been short-term reductions in corruption because of public pressure.

Lasting reductions in corruption in developing countries going through a capitalist transformation generally only take place once a viable capitalist economy has been established, defined as one where the modern or capitalist sector is generating enough surpluses to finance the effective protection of its property rights by the state. At the same time, the growing surplus generated by a viable capitalist sector allows the tax share in the economy to be significantly increased, allowing political stability to be maintained through transparent and legal transfers to broadly defined social groups. As soon as political corruption is no longer structurally necessary for the political survival of a regime, pressure from powerful interest groups that are hurt by corruption can begin to make rapid progress in reducing the extent of corruption. Of course, having the resources to avoid political corruption is not <u>sufficient</u> for corruption to come down. It is easy to find examples of very rich countries that continue to suffer from corruption. Popular pressure is also necessary. Nevertheless, pressure alone is not sufficient to reduce corruption if existing property rights are not feasible and if political power cannot be maintained using fiscal strategies of redistribution.

Thus, for this type of corruption (box iii in our diagram), it would be futile to target the corruption directly since its removal would paradoxically be detrimental to the stability of the state and would, therefore, not be sustainable. Here, feasible policy has the more limited task of damage-limitation in the short-run and of ensuring rapid progress to a position where it would be possible to legalize some of these interventions, while other interventions would no longer be necessary. This too is an area where discussions of feasible anti-corruption strategies are most deficient. To some extent, while these types of corruption are very undesirable because they are associated with unfair and inequitable processes, they are unlikely to be tackled using the conventional mechanisms of liberalization, democratization and criticisms coming from civil society. The long-term answer must be to achieve a viable economy, increase tax collection and gradually shift to maintaining political stability through fiscal transfers and property right stability through enforcement mechanisms financed by taxation. The viability of these strategies depends on the success of the state in promoting economic development, rather than its immediate success in implementing "good governance" reforms. This is particularly important because there is little evidence, as we have argued, to show that stable property rights and "good governance" can be meaningfully achieved before the conditions for rapid growth have been set in place.

Finally, the worst type of corruption is the fourth type shown in our box, where the social order has broken down completely and corruption is associated with illegal interventions that have no economic or political rationale for any group apart from the predatory "officials" involved. This type of corruption is based solely on the coercive power of small groups to extort from the majority. This type of corruption may appear to occupy a grey area since if the state fragments sufficiently, individual warlords lose any state-like quality and become more like private individuals stealing from other private individuals. The distinction is largely semantic in this case, because warlords in such a society are the state, and if they deliver "security" only to those who are willing to pay for it, this is clearly a type of corruption rather than simply being an example of theft. While there are aspects of such extortions in every society, it only takes on significant proportions in failed or failing states, which are characterized by the failure of higher levels of the state to discipline lower levels. If the state is not in a process of collapse, some degree of extortion can always take place at lower levels of the state, but higher levels have no interest in allowing this extortion to continue when they discover it, because it is unlikely to aid their own accumulation and stabilization strategies. This is because if the state can actually enforce discipline, then even if higher level bureaucrats and politicians are interested in personal enrichment, they will do better by promoting development rather than through predation (Khan 1996). This is why predation and extortion are usually endemic in fragmented and weak states and, paradoxically, much less in evidence in strong and centrally coordinated ones. The latter are more likely to engage in what we have described as type ii corruption, associated with the management of developmental interventions, and these are likely to be more rewarding for politicians and bureaucrats in these societies than attempts at predation. If a significant amount of extortion takes place without higher levels of the state reacting, this is usually evidence of a much more serious underlying problem that can be described as actual or impending state collapse. The policy response in these cases has to be very different from the others, simply because, here, the priority must be to construct the political and institutional conditions to re-establish the state as an institution with a monopoly of legitimate violence. Far from liberalization, democratization and civil society pressure, the priority in these cases has to be a much more fundamental political one of constructing the political basis for creating the state's monopoly of legitimate violence and establishing the institutions to exercise the centralization of violence capacity in society.

Implications for Policy

By breaking down corruption into a number of different problems in this way, it is possible to explain why the prior reduction of corruption has never been a precondition for rapid capitalist development. Some types of corruption are simply not going to be significantly reduced in societies going through social transformations, even in societies where such transformations eventually turn out to be successful. At the same time, this is not to deny that corruption is a problem. Very few developing countries have graduated to become dynamic capitalist economies. In the poorly performing economies, corruption is damaging because it subverts critical state functions, or is associated with failing processes of primitive accumulation or political stabilization. In extreme cases, corruption can be associated with state collapse and descent into warlordism.

However, our analysis suggests that in each case, the policy response has to be based on a proper analysis of the types of corruption that dominate and target the strengthening of state capacities that are most important for creating governance capacities required for achieving rapid transformation and high growth rates. Here, heterodox analysis of governance capacities in high growth developing economies can play an important role in identifying critical transformational state capacities that may be subverted by specific types of corruption that dominate in particular countries. If the necessary state capacities for accelerating transformation can be achieved, a low growth economy can transform into a high-growth one. Paradoxically, corruption may persist and coexist with growth if the state is able to provide the necessary interventions and regulations, even if it extracts resources through corruption, both for political stabilization and for the personal enrichment of individuals within the bureaucratic and political structures.

Yet, even if corruption can co-exist with rapid growth, this should not be interpreted to mean that corruption in these countries is functional. This is not the case because even if some interventions were useful, it would be even better if these could be organized with less corruption. Recall that all corrupt transactions have two components and the first component, that is bribe-giving and all forms of rent-seeking, is usually a cost. If necessary state interventions could be organized without this cost, or with lower cost, economic output would be even higher. Heterodox analysis is not arguing that corruption is functional, but only that if the attempt to remove corruption results in the removal of useful interventions, the outcome may be even more serious economic damage. If corruption simply allowed investors to work their way around unnecessary legal restrictions, it is even less convincing to argue that corruption was functional. Accordingly, some earlier mainstream analyses that suggested that corruption could be functional -- if it allowed businessmen to sidestep restrictive regulations (for instance, Leff 1964) -- were misleading because they ignored the fact that such unnecessary regulations could themselves be removed as part of an anti-corruption policy. The outcome would then be even better.

While corruption does not therefore play any functional role in driving economic development, heterodox analysis points out the danger of making anti-corruption strategies a precondition for economic development, and an adjunct of liberalization and privatization strategies. This analysis suggests that attempts to fight all types of corruption in developing countries through these mechanisms will not only fail to reduce corruption, they may seriously damage long-term efforts to enhance the capacity of developing country states to carry out the interventions that, in the end, are essential for accelerating development and creating viable economies. The analysis of corruption helps us to understand that the state capacities required during processes of social transformation are far removed from the market-enabling capacities that neoclassical analysis focuses on. The key governance capacities of the developmental state are related to its political and institutional capacity to carry out the necessary developmental interventions that enable a dynamic capitalism to rapidly emerge. But for this to be possible, the state's political and institutional conditions must allow political stabilization and primitive accumulation in the direction of a viable capitalism. In some developing countries, the most important task may be the even more basic one of consolidating a state and imposing control over fragmented predation. Thus, the political and institutional priorities for different countries cannot be generalized into a blueprint of reforms. These priorities are bound to depend on pre-existing political, social and institutional configurations.

If a developmental state can be constructed in a developing country, some types of corruption can co-exist for a while with high rates of accumulation and growth. But even a developmental state in a developing country will be located in a context of rapid social transformation. It is therefore unlikely, by definition, to be able to enforce stable property rights and low expropriation risk for all social groups (though dynamic capitalists are likely to face low expropriation risk in high-growth economies). This is why it is not surprising that high-growth early developers do not fit into the expectation of good governance theories in having stable property rights, high levels of democracy, low levels of corruption, and so on.

While neoclassical analysis is wrong to identify corruption and "good governance" as necessary preconditions for growth, it would be wrong to deny that the reduction of corruption and the achievement of democracy are, in particular, important aspirations for many people in developing countries. Heterodox analysis is important for pointing out that the achievement of these aspirations requires a successful social transformation of these societies and, therefore the achievement of a very different set of transformation capacities for the state from the ones identified by neoclassical analysis. An analysis of the types of corruption that predominate in particular developing countries can provide a useful lens for examining the accumulation processes and the political constraints that different countries face. This, in turn, can help to identify the most important areas where policy should concentrate to strengthen the capacities required for successful transformations. Thus, the analysis of corruption and of different types of governance capacities remains important in helping to identify appropriate policies for accelerating growth in particular countries, even if there may be no immediate, general strategies to reduce corruption significantly across the board in most cases. Lasting reductions in corruption and expropriation risk, improvements in the stability of property rights and the deepening of democracy are all likely to depend on whether policy can be used to ensure that growth and development can be accelerated and sustained over time. None of these goals is likely to be promoted, and their eventual achievement may even be damaged, by the uncritical adoption of mainstream anti-corruption and good governance policies.

References

Amsden, Alice (1989). *Asia's Next Giant: South Korea and Late Industrialization*. Oxford University Press, Oxford.

Aoki, Masahiko, Hyung-Ki Kim, and Masahiro Okuno-Fujiwara [eds] (1997). *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis*. Clarendon Press, Oxford.

Barro, Robert (1996). "Democracy and Growth". *Journal of Economic Growth* 1 (1): 1-27.

Clague, Christopher, Philip Keefer, Stephen Knack, and Mancur Olson (1997). "Democracy, Autocracy and the Institutions Supportive of Economic Growth". In Christopher Clague [ed.]. *Institutions and Economic Development: Growth and Governance in Less-Developed and Post-Socialist Countries*. Johns Hopkins University Press, Baltimore.

Hall, Robert, and Charles Jones (1999). "Why Do Some Countries Produce So Much More Output Per Worker Than Others?". *Quarterly Journal of Economics* 114: 83-116.

Heidenheimer, Arnold J., and Michael Johnston [eds] (2002). *Political Corruption: Concepts and Contexts*. Third edition. Transaction Publishers, New Brunswick.

Johnson, Simon, Daniel Kaufmann, and Pablo Zoido-Lobatón (1998). "Regulatory Discretion and the Unofficial Economy". *American Economic Review* 88 (2): 387-392.

Kauffman, Daniel, Aart Kraay, and Pablo Zoido-Lobatón (1999). "Governance Matters". World Bank Policy Working Paper No. 2196, World Bank, Washington DC.

Khan, Mushtaq H. (1996). "A Typology of Corrupt Transactions in Developing Countries". In Barbara Harriss-White, and Gordon White [eds]. "Liberalization and the New Corruption". *IDS Bulletin* 27 (2): 12-21.

Khan, Mushtaq H. (2000a). "Rents, Efficiency and Growth". In Mushtaq H. Khan, and Jomo K.S. [eds]. *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge University Press, Cambridge.

Khan, Mushtaq H. (2000b). "Rent-seeking as Process". In Mushtaq H. Khan, and Jomo K.S. [eds]. *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge University Press, Cambridge.

Khan, Mushtaq H. (2002a). "State Failure in Developing Countries and Strategies of Institutional Reform". In Bertil Tungodden, Nick Stern, and Ivar Kolstad [eds]. *Towards Pro-Poor Policies: Aid, Institutions and Globalization: Proceedings of the World Bank's Annual Bank Conference on Development Economics*. Oxford University Press, New York for World Bank 2004.

Khan, Mushtaq H. (2002b). "Corruption and Governance in Early Capitalism: World Bank Strategies and their Limitations". In Jonathan Pincus, and Jeffrey Winters [eds]. *Reinventing the World Bank*. Cornell University Press, Ithaca.

Khan, Mushtaq H., and Jomo K. S. [eds] (2000). *Rents, Rent-Seeking, and Economic Development: Theory and Evidence in Asia*. Cambridge University Press, Cambridge.

Knack, Stephen, and Philip Keefer (1995). "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures". *Economics and Politics* 7 (3): 207-227.

Knack, Stephen, and Philip Keefer (1997). "Why Don't Poor Countries Catch Up? A Cross-National Test of an Institutional Explanation". *Economic Inquiry* 35: 590-602.

Krueger, Anne (1974). "The Political Economy of the Rent-Seeking Society". *American Economic Review* 64 (3): 291-303.

Lall, Sanjaya, and Morris Teubal (1998). "'Market-Stimulating' Technology Policies in Developing Countries: A Framework with Examples from East Asia". *World Development* 26 (8): 1369–85.

Mauro, Paolo (1995). “Corruption and Growth”. *Quarterly Journal of Economics* 110 (3): 681-712.

Myrdal, Gunnar (1968). *Asian Drama: An Inquiry into the Poverty of Nations. Vol. II*. Twentieth Century, New York.

Nye, Joseph S. (1967). “Corruption and Political Development: A Cost-Benefit Analysis”. *American Political Science Review* 61 (2): 417-27.

Rodrik, Dani (1995). “Getting Interventions Right: How South Korea and Taiwan Grew Rich”. *Economic Policy* 20: 55-107.

Rodrik, Dani (2002). *Institutions, Integration, and Geography: In Search of the Deep Determinants of Economic Growth*. Princeton University Press, Princeton NJ.

Treisman, Daniel (2000). “The Causes of Corruption: A Cross National Study”. *Journal of Public Economics* 76: 399-457.

Wade, Robert (1990). *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*. Princeton University Press, Princeton, NJ.

Williams, Robert [ed.] (2000). *Explaining Corruption*. Edward Elgar, Cheltenham.

Williams, Robert, and Robin Theobald [eds] (2000). *Corruption in the Developing World*. Edward Elgar, Cheltenham.

Woo-Cumings, Meredith [ed.] (1999). *The Developmental State*. Cornell University Press, Ithaca.

World Bank (1997). *World Development Report 1997: The State in a Changing World*. World Bank, Washington DC.

World Bank (2000). *Helping Countries to Combat Corruption. Progress at the World Bank Since 1997*. World Bank, Washington DC.