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Institutions, corruption, and development and their ramifications for international cooperation

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International cooperation – A tale of success and failure[1]

The last decades have been marked by a unique experiment in international cooperation. Resources have been transferred in unprecedented amounts from richer to poorer countries with the aim of fostering development and alleviating poverty. Over the past 50 years about $1 trillion has been given in foreign aid. The anecdotal evidence suggests that this aid has at times been highly effective and at other times a spectacular failure. Also, over the past 50 years development theory and policy have changed dramatically. The initial post-war period was characterized by a strong belief in the possibility of state-led development, which involved large-scale investments in physical infrastructure, a concerted effort to build up a local industry base, and a deep scepticism of the market, in particular of international trade.

Following the surfacing of problems with import substitution policies, as manifested in the debt crisis, a new consensus (often called the Washington Consensus) emerged which brought about a reversal in the relative roles of state and market. According to this consensus a successful development strategy should rely on opening and liberalizing markets, privatizing, and in general "getting prices right" while maintaining macroeconomic discipline. During the 1990s it was increasingly recognized that functioning markets require a functioning state, and that the poor institutional infrastructure of many developing countries represents an

important obstacle for development. Therefore, the ''Post-Washington Consensus'' or ''Washington Consensus Plus'' adds on a further element, namely ''getting institutions right'', in particular through the control of corruption.

This chapter isolates seven lessons from the experience with development policies, focusing on the ''Washington Consensus Plus'' – that is, on the role of institutions and of corruption in economic development. It draws on a number of recent studies on aid effectiveness, the role of institutions in development, the role of corruption, and the role of donor countries.

The institutional infrastructure is key to successful development

Until about 10 years ago ''governance'', ''institutions'', and ''corruption'' had no place in the international development discourse. There was a general perception that these issues were not central to the explanation of development, or, at any rate, were outside the sphere of the international development community. Today, there is hardly a development strategy paper that does not strongly emphasize the importance of institutions, and hardly a speech by the World Bank president that does not mention corruption.

In the 1970s and 1980s the academic development debate on institutions and development revolved around the form of the political system. The controversy was whether a democratic or an authoritarian political system would be more beneficial for development. Citing the case of Chile, one influential school of thought argued that an authoritarian system could better promote economic development, and produced some empirical evidence that this relationship held more broadly.[2] Other studies showed the contrary, namely that more democracy improved economic growth.[3] More recent empirical studies, however, have established that there is no significant relationship between democracy, authoritarianism, and growth when a large sample of countries is considered. In other words, in terms of economic growth there have been authoritarian failures as well as successes, and the same is true for countries that have regularly held elections.[4]

In the 1990s the debate turned away from the purely political dimension to focus more on the institutional infrastructure of countries. This was in part due to the repeated failure of stabilization and structural adjustment programmes, which meant that attention turned to the underlying ''rules of the game''. There was growing recognition that the institutional infrastructure – the formal and informal rules that govern the

interaction between the private sector and the public sector and the incentive structure within the public sector – is as important, if not even more important, for development as the physical infrastructure. The new consensus was supported by strong empirical evidence that showed the detrimental effects of a dysfunctional institutional infrastructure (poor rule of law, lack of credibility, and corruption) on investment and growth.[5]

Corruption is one of the most important obstacles to development

An important element of the new consensus is that ''corruption is sand in the wheels of the political and bureaucratic machine''. Nevertheless, this metaphor underestimates the negative effects of corruption, because sand may only slow down a machine or bring it to a halt. Corruption, on the other hand, acts to multiply the wheels by creating incentives for public officials to increase bureaucratic loads and the rents they can collect from them. Again, these aspects of corruption were not always recognized by researchers or policy-makers.

For a long time the discussion, both at the policy level and at the academic level, postulated that there may be positive, lubricating effects of corruption. It was suggested that corruption could have a positive effect on economic activity since it may grease the wheels of the government machine. Since this machinery is inefficient, it was argued that corruption payments might lead to more efficient outcomes. For instance, instead of waiting for her turn in the line, the person with the highest time preference may offer the highest bribe and would be helped first. This is a more efficient outcome than queuing. There is, however, a serious flaw in this argument. The problem is that the efficiency of the government machine is not God-given and exogenously determined. The rules and their interpretations are made by the same government agents who are most likely to profit from bribe payments. If they make the rules cumbersome and lacking transparency, this will give them more discretionary powers to create longer queues and collect higher payments from their more impatient clients. If one takes into consideration that rule-making, or at least the level of enforcement, is endogenous to the level of potential corrupt payments, then the lubrication argument no longer holds true and only the negative incentive effects of corruption remain.

After long being a taboo topic, in the 1990s corruption became one of the focal points of the international development debate. One of the reasons for this surge in interest was that the detrimental effects of corruption on economic performance were clearly established in empirical studies. Case-study evidence suggested, long before more systematic data became available, that corruption is harmful for growth. For example, De

Table 8.1: The economic effects of corruption

	Dependent variables		
Independent i variables	Growth per capita	Investment/GDP	Size of informal sector
Constant	0.012	11.32	48.35
	(2.38)	(6.34)	(10.30)
Initial income	−5.14 E−6	−0.0002	−0.0008
	(−4.78)	(−0.62)	(−1.09)
Schooling	0.030	9.52	−15.82
	(1.87)	(1.77)	(−1.38)
Corruption (TI)	−0.004	−1.21	2.39
	−(2.81)	−(2.42)	(2.10)
Number of observations	49	48	26
Adjusted R2	0.31	0.44	0.63

Notes:
1. Growth and investment data from World Penn Tables Mark V, averages 1970–1992 (see http://pwt.econ.upenn.edu).
2. Informal sector data from J. Johnson, D. Kaufmann, and P. Zoido-Lobaton, ''Regulatory Discretion and the Unofficial Economy'', *American Economic Review Papers and Proceedings* 88, No. 2 (1998): 387–392.
3. Initial income and schooling refer to 1972.
4. Corruption data from Transparency International, *Corruption Perceptions Index* (Berlin: Transparency International, 1998).
5. Ordinary least squares are estimates, t-statistics in parentheses.

Soto conducted an experiment to quantify the indirect costs of red tape and corruption for a small entrepreneur in Peru and showed that they were enormous.[6] Klitgaard's *Tropical Gangsters* (1988) is a vivid account of the inefficiencies due to corruption in Equatorial Guinea.[7] Such studies promoted the general acceptance of the notion that corruption has negative effects.

Finally, new empirical research in the last decade has settled this question and has established that corruption is highly detrimental to development.[8] Table 8.1 shows estimates of growth, investment, and the size of the informal sector. The results illustrate that the more corrupt countries have lower investment, lower growth, and larger informal sectors.

Corruption undermines development in a number of ways

There are several ways in which corruption can affect economic performance: by leading to misallocation of resources as well as by lowering the return on the accumulation of capital. The most straightforward effect of

corruption relates to the way in which it functions as a tax on investment. In this case, the public official collects the tax and instead of passing it on to the treasury she keeps the proceeds. There may even be an implicit understanding that such payments are in lieu of higher wages. In fact, Zaire's former President, Mobuto Sese Seko, reportedly publicly encouraged public servants to steal – but only a little. From the point of view of the private sector, such a ''corruption tax'' has the same effects that a fee on transactions would have. It increases costs of doing business and raises the break-even point for investment projects, thereby lowering economic activity. It also creates incentives to avoid the tax by moving into the informal sector and not complying with the rules. It may lead to distortions if the fee varies and not all competitors pay the same fee.

How high is the corruption fee likely to be? This depends among other things on the organization of the rent extraction. A monopolist corruption collector will never set too high a fee because he would destroy his own tax basis. This is the familiar tax Laffer curve: if the tax rate is too high the disincentives to produce outweigh the further gains in revenues and total tax revenues fall.[9] A bureaucracy which acts like a monopolist takes these disincentive effects into account and will set the optimal corruption rate – that is, the rate at which the total income from corruption is maximized. In this view, corruption reduces investment and production up to a certain point, namely the optimal point as far as the government is concerned. But this view is characteristic of the situation of a monopolist government that extracts the maximal amount from the tax base rather than a situation where independent government officials all sell favours in exchange for bribes.

Shleifer and Vishny have provided a theory of the industrial organization of corruption in which they show that the level of corruption depends on the level of competition among government officials.[10] The corruption described above is that of a monopolist, which is most appropriate for understanding corruption in monarchies or old-time communist regimes or in regions dominated by a single mafia. In such a highly organized regime, the bribe income is shared and the relevant officials agree not to demand further bribes. Once the bribe is paid, the firm thus has full property rights over the government good it bought. The other extreme is a system in which the individual government agents do not coordinate their demands at all. This may cause negative externalities among bribe takers because the agencies ignore the effects of their bribe demands on the each other. Thus the individual agency sets a higher bribe demand that results in lower output and a lower aggregate level of bribe income.

There is one important aspect in which bribes differ from taxes. Corruption is illegal and must be kept secret. There can be no clear proce-

dures for corrupt payments, no official tables which indicate how much the bribe is supposed to be in every specific occasion. From the point of view of the private sector, having to pay bribes instead of taxes involves much more uncertainty. The government official can use her discretionary power to set the level of the bribe arbitrarily and keep demanding additional bribes instead of delivering the service. The firm will be hostage to new demands as soon as it has agreed to a first bribe. Whether corruption creates important uncertainties depends in part again on the internal organization of the bureaucracy. The less well organized the bribe-collecting process, the larger the arbitrariness. A theoretical case can be made that the kind of corruption which creates large uncertainties is more damaging than the well-organized corruption which acts more like a transaction cost. In fact this is one of the reasons the corruption in East Asia was claimed to be less harmful than, for instance, that in the former Soviet Union.[11]

Overall foreign aid has been ineffective

Studies on aid effectiveness confirm what other academic studies have found and what practitioners have long suspected.[12] Overall, one cannot demonstrate that foreign aid has helped economic development, nor significantly improved indicators of quality of life. This is not to say that foreign aid has not been effective under certain circumstances, an issue that is discussed further in the next section. Simply, it is not possible to show a positive effect of aid when one looks at the full sample of countries over several decades. Or in other words, there have been as many failures as successes.

Figure 8.1 illustrates that there has been a negative relationship between the amount of aid received and the level of economic growth. Of course, this negative relationship does not say anything about the direction of causality. In other words, the negative relationship could equally be a consequence of the failure of aid to improve growth as it could the consequence of donors' explicit choice to help poor and poorly performing countries more. Studies that take into account this problem of causality have found that aid has not improved growth, even after taking into account donors' allocation decisions.

Foreign aid does work in countries with a good institutional infrastructure and policy framework

When one moves from looking at the broad sample of less developed countries to a more diversified view, one finds that development policies

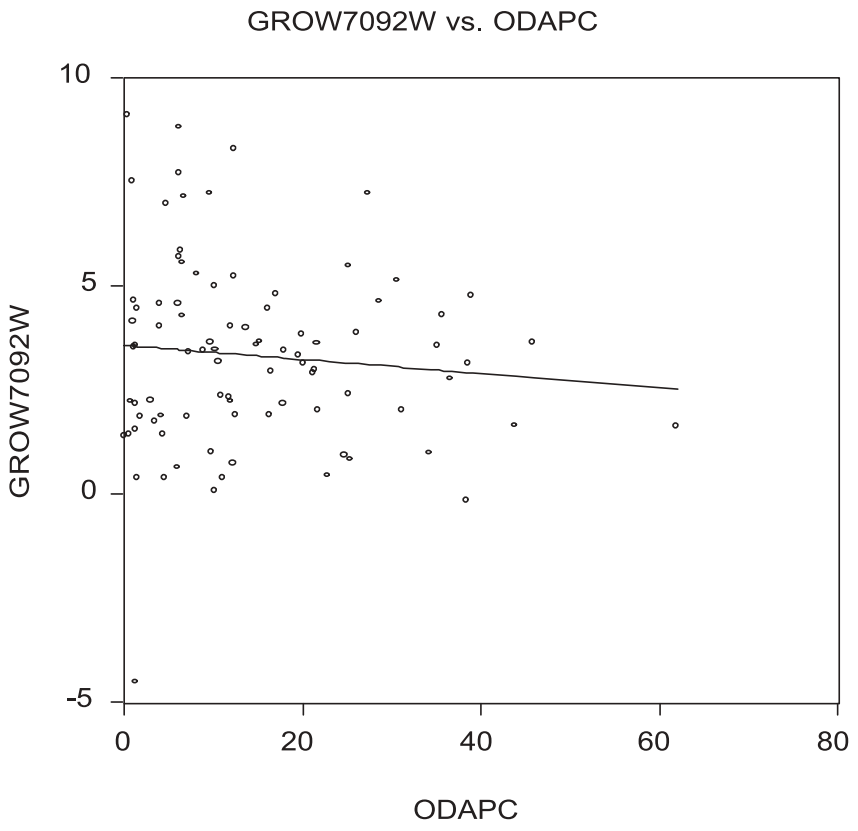

Figure 8.1: Relationship between ODA per capita and economic growth

have worked and foreign aid *has* been highly effective in a subgroup of countries. In countries with sound economic policies and a functioning institutional infrastructure, foreign aid has measurably had positive effects on development. A stable macroeconomic environment, open trade regimes, and protected property rights as well as efficient bureaucracies can deliver education, health, and ultimately higher growth. In countries with this kind of sound management, financial aid has had a significant effect on growth and poverty reduction, improving social indicators over and above what good management itself induced. In such countries a 1 per cent increase in foreign aid translates into a sustained increase in growth of 0.5 per cent of GDP, an increase in private investment of 1.9 per cent of GDP, and a reduction in poverty by 1 per cent.[13]

Table 8.2 shows two estimates which show the effect of aid and ''economic management'' on growth.[14] Economic management is a weighted

Table 8.2: The effects of aid

	Dependent variable	
	Real growth of GDP, four-year averages, 1970–1993	
GDP per capita (initial year)	−0.76	−0.95
	(−1.00)	(1.09)
Financial market development	0.02	0.02
	(1.68)	(1.62)
Government consumption	−4.38	−1.73
	(−0.68)	(−0.25)
Political instability	−0.39	−0.34
	(−1.43)	(−1.19)
Economic management	1.03	0.70
	(7.01)	(3.42)
Aid/GNP	−0.08	−0.37
	(−0.28)	(−0.89)
(Management × aid/GNP)		0.24
	..	(2.38)
Adjusted R2	0.39	0.39
Number of observations	272	268

Note: Two-stage least-squares estimates.
Source: C. Burnside and D. Dollar, ''Aid, Policies and Growth'', World Bank Policy Research Paper No. 1777 (Washington, DC: World Bank, 1997).

sum of the inflation rate, the budget surplus, trade openness, and institutional quality. In other words, it captures both macroeconomic policies and the institutional framework. The first estimate shows that there is no significant relationship between the level of aid and growth. In the second estimate aid/GDP is interacted with the indicator of economic management and there is a significant positive association with growth. Thus, aid has a significant positive effect on growth in an environment where economic policies and the institutional framework are sound.

Fungibility of aid undermines project targeting

One way that donors have tried to ensure the effectiveness of their aid programmes is by carefully selecting projects and monitoring their implementation. Fungibility undermines this strategy. Fungibility essentially means that ''a dollar is a dollar'', and that governments may adjust their own expenditures to take into account the foreign aid inflow. For example, if a donor sponsors a schooling programme, the government may reduce the planned allocations for education and increase some other position – to take an extreme example, say, the government might in-

crease military expenditures. Thus, the effect of this schooling aid should not be measured only in terms of the educational benefit, but should also include the effect on other expenditures that it has ''crowded in''.

Research conducted at the World Bank shows that project aid is in fact often highly fungible. Feyzioglu, Swaroop, and Zhu use the sectoral composition of concessionary loans to 14 countries (from 1971 to 1990).[15] They first show that a dollar increase in foreign aid leads to an increase of 0.95 cents in total government spending – that is, there is no tax relief effect. More importantly, they show that higher concessionary loans to a particular sector do *not* necessarily increase spending in that sector. This is true for education, health, and agriculture. In other words, aid to these sectors has been highly fungible. On the other hand, aid has been less fungible in the energy, transport, and communication sectors. This could be due to the fact that such projects tend to be so large that they would not be realized without foreign assistance.

Of course, fungibility does not say anything about the quality of projects. An education project sponsored and monitored by a foreign donor might be more or less efficient than one carried out by the initiative of the local authorities. The finding of fungibility does imply, however, that it may be futile to try to isolate projects and target specific sectors. In a country where the overall government policy is not favourable to development, targeting will not improve the effectiveness of aid.

Foreign aid has not been allocated to the countries where it is effective

Donor countries and international organizations argue that their aid policies are meant to be selective and favour government reform. The World Bank, for instance, has recently discussed more often and more openly the issue of how to enhance ''good governance'', where the latter means, in particular, low levels of corruption of the bureaucracy and of the officials of the receiving countries.[16] The critics of these programmes argue instead that, contrary to the more or less sincere intentions of the donors, corrupt governments receive just as much aid as less corrupt ones. Furthermore, often financial assistance does not reach the really needy in the developing country, but, instead, is wasted in inefficient public consumption. Many critics make an even stronger argument, namely that not only are corrupt governments not discriminated against in the flow of international assistance, but in fact foreign aid fosters corruption by increasing the size of resources fought over by interest groups and factions.

Unfortunately, in practice aid has mostly *not* been allocated to those countries where it would have been effective. Studies of aid allocation

have show that political considerations loom large in the distribution of aid, and that this is true for almost all major donors.[17] Donors tend to give most to political allies: ex-colonies and countries that support the donor in UN votes receive more aid, democracies receive more, and strategically important countries receive most. What is even more worrying is that counties with high corruption levels have often received more aid than countries with low corruption. Adding this fact to the issues raised in the first two sections of this chapter illustrates why foreign aid has often been rather distortive. By comparison, the allocations of multinational lenders have been less driven by political considerations, as national interests are somewhat neutralized in these organizations. Again, combining this factor with previous lessons implies that development assistance through multilateral channels has been more effective than that from bilateral donors.

Conclusions

The main conclusion that can be drawn from these lessons is quite straightforward. The international community *can* be more effective in fostering development provided that foreign aid helps in the process of institution building, and foreign aid is targeted to those countries that are willing to implement good policies and institutions. In these circumstances, development assistance has been shown to be highly effective.

There seems to be a certain paradox in these conclusions. Lesson one implies that a sound institutional infrastructure is key to development and lesson six says that foreign aid will only work in a country with a sound institutional infrastructure, and that therefore aid should mostly be allocated to such countries. This seems to imply that there are some countries in an ''institutional development trap''. These countries have a poor institutional infrastructure, and as such they would receive no assistance to improve it (since it would be wasted). A possible solution to this conundrum is aid that comes in the form of knowledge and explicit institution building rather than money. In fact this is one of the lessons that the World Bank draws after its comprehensive aid assessment exercise: namely, in countries with sound management put money in, and in countries with poor management disseminate knowledge and information.[18]

Unfortunately bilateral donors have proven to be rather poor at allocating aid to the most effective use, since their decisions are mostly dictated by self-interest. This is unlikely to change dramatically, since it is natural that domestic pressure groups have an influence on all government policies. It follows that multilateral organizations may be in a better

positions to steer the development agenda in the direction described above. Ideally, a multilateral body would channel most aid resources, or at least coordinate most donors' efforts to make sure that aid is allocated to countries where it is effective. This might be a formidable task for the United Nations. But one well worth taking on.

Notes

1. A previous version of this chapter was published under the title of "Foreign Aid, Institutions and Development: Lessons from Four Decades of International Development Cooperation", *Aussenwirtschaft* 55 (2000): 291–303.
2. For instance, S. Huntington and J. Dominguez, "Political Development", in *Handbook of Political Science (3), Marcopolitical Theory* (Reading, MA: Addison-Wesley, 1975).
3. See e.g. G. Scully, "The Institutional Framework and Economic Development", *Journal of Political Economy* 96 (1988): 652–662.
4. For an overview of these empirical studies see A. Brunetti and B. Weder, "Political Sources of Growth: A Critical Note on Measurement", *Public Choice* 82, Nos 1–2 (1995): 125–134.
5. See for instance S. Knack and P. Keefer, "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures", *Economics and Politics* 7 (1995): 207–227; A. Brunetti, G. Kisunko, and B. Weder, "Credibility of Rules and Economic Growth: Evidence from a Worldwide Survey of the Private Sector", *World Bank Economic Review* 12, No. 3 (1998): 353–384.
6. H. De Soto, *The Other Path* (New York: Harper & Row, 1989).
7. R. Klitgaard, *Tropical Gangsters* (Berkeley: University of California Press, 1988).
8. See for instance P. Mauro, "Corruption and Growth", *Quarterly Journal of Economics* 110 (1995): 681–712; A. Shleifer and R. Vishny, "Corruption", *Quarterly Journal of Economics* 108 (1993): 599–617; S. Johnson, D. Kaufmann, and P. Zoido-Lobaton, "Regulatory Discretion and the Unofficial Economy", *American Economic Review Papers and Proceedings* 88, No. 2 (1998): 387–392; P. Bardhan, "Corruption and Development: A Review of Issues", *Journal of Economic Literature* 35 (1997): 1320–1346.
9. The Laffer curve is named after Professor Laffer, an adviser to President Reagan. He suggested that, as taxes rates increased from fairly low levels, tax revenue received by the government would also increase. However, as tax rates rose there would come a point where people would not regard it as worth working so hard. This lack of incentives would lead to a fall in income and therefore a fall in tax revenue.
10. Shleifer and Vishny, note 8 above.
11. In addition to general theories of corruption, it is also important to look at historical and cultural factors when explaining individual cases. For example, in Chapter 3 Karel von Wolferen highlights that in East Asia "informal relations between government and business have been part and parcel of a formula for success" that would not be captured through analysing the situation from a Western perspective.
12. P. Boone, "Politics and the Effectiveness of Foreign Aid", *European Economic Review* 40 (1996): 289–329.
13. See World Bank, *Assessing Aid: What Works, What Doesn't, and Why* (Washington, DC: World Bank and Oxford University Press, 1988): 14.
14. C. Burnside and D. Dollar, "Aid, Policies and Growth", World Bank Policy Research Paper No. 1777 (Washington, DC: World Bank, 1997).

15. T. Feyzioglu, V. Swaroop, and M. Zhu, "A Panel Data Analysis of the Fungibility of Foreign Aid", *World Bank Economic Review* 12, No. 1 (1998): 29–58.
16. See for instance World Bank, "The State in a Changing World", in *World Development Report 1997* (Washington, DC: World Bank and Oxford University Press, 1997).
17. See A. Alesina and D. Dollar, "Who gives Foreign Aid to Whom and Why?", NBER Working Paper No. 6612 (1998); A. Alesina and B. Weder, *Do Corrupt Governments Receive Less Foreign Aid?* (Cambridge, MA: National Bureau of Economic Research, Working Paper No. W7108, May 1999).
18. World Bank, note 13 above: 27.