

Corruption Buffets the Macroeconomy

By Syed Abul Basher

*As infinite as man may undergo
Shall in the general censure take corruption
From that particular fault: the dram of eale
Doth all the noble substance of a doubt
To his own scandal.
(Scene IV. The platform. Hamlet).*

The study of corruption so far has remained a particular interest of microeconomics. This is, however, not intentional. The kind of settings in which corruption usually evolves is essentially a microeconomic phenomenon. For example, corruption typically takes place when a government (the 'principal') delegates its official (the 'agent') to collect tax income, or to allocate import license, or act as a provider of state goods. Numerous researches show that relatively agent possesses superior information about the 'state of the nature' to the principal and thereby undermines the value of state revenue and halts economic growth. Moreover, this asymmetry in information between the principal and the agent can lead to further externality by diverting investment into unproductive sector(s). For example, when bureaucratic corruption is prevalent, everyone invests to become a bureaucrat causing the best talents into rent seeking, leaving less talent in entrepreneurship. When these distortions become persistent, they can put a permanent dent in a country's economy and destabilizes its macroeconomic scenario. The aim of this article is to analyze the potential negative consequences of corruption on the macroeconomy of a country. One thing should be clarified at the outset. That, the purpose of this article is not to offer any particular solution that may be useful in fighting with corruption, but to discuss the damaging aspects of corruption on country's macroeconomy while the ultimate goal being to provide the policymakers an impetus so that they can devise appropriate actions to eliminate corruption from the economy.

Corruption discourages entrepreneurship. Entrepreneurship is the crux of today's market economy. M. Taslim in his 1994 BIDS study has attributed entrepreneurship to as following, "it is the entrepreneurs who bear the responsibilities of seeking out profitable opportunities, organize productive units to efficiently produce for profits, establish a niche for themselves in the market, expand their domain by fiercely competing against one another, constantly endeavor to innovate in order to achieve an advantage over rivals thereby reducing per unit cost of production, and directly add to the wealth of the nation in addition to enriching themselves". In a recent book by Munir Quddus and Salim Rashid (2000) on entrepreneurship and economic development the authors argued that it is the remarkable entrepreneurship which helped the apparel-export industry in Bangladesh to become the only multi-billion-dollar manufacturing and export industry in the country.

However, all these hope and success of entrepreneurship may evaporate if corruption is epidemic in a country. This is because corruption lowers the average skill level of active entrepreneurship. Since corruption affects the population differently, it raises the ability level needed to make entrepreneurship profitable for those with less political protection. In contrast, corruption lowers the ability level needed to make entrepreneurship profitable for those who are politically well connected. Besides, corruption may also dampen small-scale business as this group has a comparative disadvantageous position in need to pay extra fees (the 'cost of doing business'). As a result, less and less find entrepreneurship profitable leading to an increase in

labor supply which is greater than the labor demand for official business causing wage to fall and triggering unemployment.

Corruption hampers smooth functioning of banking sector. As more and more promise of side payments become vivid it refrains the lawmakers to undergo reforms or improve the regularities in this sector. Fictitious loan, captive deposits, diversion in interest rates are common fraudulent financial practices in today's banking sector in Bangladesh. Besides, loan default is another most ill famed attribute of our banking sector. All these demonstrate existence of corruption in the banking sector. A recent estimate shows that the total amount of default loan sanctioned by various public sector, private sector and foreign banks along with four specialized institutions stood at around 24,000 core Taka (Daily Star, 17 Oct. 2000)! This is indeed an astound amount. Just imagine how many technical institutes could have been built to equip our students with modern technology, or at least one public library in every village would have been built to present talents to the economy.

Corruption causes the capital to fly. More than \$10 billion in capital leaves Africa every year which is more than comes in as foreign aid. Alam et al (1995) study document that between 1973 to 1992, for each year US\$ 176 million fled out of Bangladesh, the worst years being 1986, 1987, and 1990, when around US\$3 billion fled the country. This is because as the authors contend excessive corruption results in political instability that raises anxiety among investors and thus may cause the funds to move to country where it is secured. In addition, corruption may undermine a country's ability to attract foreign capital. Between 1986 and 1995, FDI inflows to Bangladesh increased from \$2m to only \$125m, whereas it was \$150m for Vietnam and \$400m for Angola in 1995. This particular source of capital is important for a country like Bangladesh which is in a great need of developing technical know-how.

Corruption may also reduce the export competitiveness of a country. Munir Quddus in his recent study (2000) demonstrated how corruption and rent seeking can severely damage a market or even leads to its demise. He cites the example of corruption in textile sector in Bangladesh and elucidates how severity in corruption may change the business ethics, which in turn may lead to lack in corporate commitment and fraudulent entrepreneurship. As textile sector alone contributes around 70% of our total export earning, persistence of such malpractice will surely diminishes the competitiveness of this principal revenue generating export sector.

Perhaps the more pronounced effect of corruption is the discretion the policymakers exert over composition of government expenditure. Corruption tends to increases the size of public investment at the expense of private investment (famous 'crowding out' effect). This is because many items in public expenditure (say, import of a particular technology) lend civil bureaucrats to manipulate the funds by seeking bribes. Moreover, as most of the public investments are favored with industrial loan, an additional incentive arises when one is in a position to misappropriate these funds. This unnecessary increase of public spending along with reduction in government revenue may well contribute to fiscal deficits, which essentially can lead to higher inflationary pressures. Certainly, this is one of the worst cases of corruption Bangladesh hasn't yet experienced, but if the present trend of corruption continues, the day is, however, not too far.

A number of studies have documented the negative significant association between corruption and the ratio of investment to GDP. As corruption increases the risks associated with making investments, e.g., by lowering the security of property rights, theory predicts that corruption will have a clear negative impact on the ratio of investment to GDP. Paulo Mauro (1995) in his study shows that if Bangladesh were to improve the integrity of its bureaucracy to the level of that of Uruguay, its investment rate would increase by almost five per cent of GDP, and its yearly GDP growth rate would rise by over half a percentage point. Two Harvard economists estimated the opportunity cost of corruption to GDP growth for Bangladesh over a period of 25 years. In their estimate, Shang Wei and Richard Zeckhauser (1999) find that if Bangladesh were able to reduce its corruption to Singapore's level (a six point reduction out of a scale of 10), its average annual per capita GDP growth rate over 1960-1985 would have been

higher by 1.8 percentage points. This translates to a more than 50% boost in 1985 per capita GDP.

Take another hypothetical example. Let us assume the potential GDP growth of a country is 6%, and corruption costs it a 3% reduction in its GDP growth. Now, since the population growth of many developing countries is about 2%p.a., what these estimates imply is that in the presence of corruption the *per capita income* will only grow by 1%. However, if the country in question has an annual GDP growth of 5%, which is Bangladesh averaging at present, signifies zero percent growth in per capita income!

Hundreds of reports and books have been written over the years and many more are in the press, all these manuscripts have been written with a single agenda in mind, *corruption is harmful to growth*. However, relatively little progress has been achieved so far in combating corruption in Bangladesh. Nobody knows where it will lead us if corruption continues to grow unboundedly. Very soon Bangladesh will become a unique textbook example of bizarre corruption or it will eat up the pride of micro-finance Bangladesh has gained over the years if the growth of corruption cannot be restrained. Given the weird nature of administrative and political environment exist in Bangladesh it is less clear that who bears the responsibility to wipeout this social evil. It is fashionable to recommend that Bangladesh should seriously learn lessons from East Asian success. While whether Bangladesh should imitate East Asian is a matter of great debate, but one thing is very much clear that the problem lies in our own psyche. Unless and until we refrain ourselves from this 'illegal money' no matter how much funds international organizations extend us to reform or how many more reports are written to recommend mitigants corruption will remain with us. The technical responsibilities are on the shoulder of our policymakers to come up with an optimal mix of *incentive* and *penalty* scheme, which will help us to achieve a corruption free society.

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