Comrade's Dilemma

Corruption and Growth in Transition Economies

Scott Kennedy

Corruption's impact on growth depends on the surrounding environment. Corruption has often hobbled entrepreneurship. In certain environments, however, corruption has ameliorated less-than-ideal circumstances.

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Does corruption help developing countries grow? Or is it one of the gravest threats to economic development that can beset a fledgling state? The answers to these questions are important not only to the ordinary third-world state looking to pull itself up by its bootstraps, but also for the communist and post-communist countries that are currently engaged in sweeping transitions to market economies. If media reports are accurate, corruption is rampant and rising in all the transition economies. Not only is the number of individual cases growing, but corrupt officials apparently are increasingly in cahoots with organized crime operations. China and Russia appear to be two of the more egregious cases. Yet despite their common disrepute, the growth patterns of Russia and China could not be more divergent. In the eighteen years of its reforms, China's gross domestic product has grown at an annual rate of more than 9 percent. In contrast, Russia's gross domestic product shrank almost 13 percent annually between 1990 and 1995. How could countries with similarly widespread corruption have such starkly different transition experiences otherwise?

Given the difficulties of collecting reliable data on inherently illicit activities, one might be tempted to give up on the enterprise. Judging from the limited academic work on corruption, this is the most common choice. Nevertheless, the available evidence suggests that corruption is as much a symptom of economic change as it is a cause. The same policies, natural endowments, and political institutions that aid or hinder economic growth also affect corruption. Whether corruption assists or hinders growth depends on at least four factors: the extent to which existing economic policies promote efficiency, the way corruption is organized, how the gains from corruption are used, and how corruption affects support for market reforms generally. Corruption fosters growth when existing economic policies promote inefficiency, when corruption itself is organized like a free market, when the gains from corruption are reinvested in productive ventures, and when corruption enhances support for reform policies.

What Is Corruption?

Not only is corruption difficult to measure accurately, but it is difficult to define. Walter Lippman identified the spirit of corruption when he called it "traffic in privileges."[1] Corruption has been defined as a violation of the law, societal norms, or the public trust, and—the definition that may best stand the test of time—"behavior which deviates from the formal duties of a public role because of private-regarding (personal, close family, private clique) pecuniary or status gains or violates rules against the exercise of certain types of private-regarding influence."[2] This would include both malfeasance and misfeasance,[3] as well as illicit "market transactions" between an official and someone else (bribery) or an act that does not involve an exchange (misappropriation).

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Despite this seeming clarity, defining corruption is still rather slippery. If official norms and rules are unjust, formally corrupt behavior may be perceived as righteous. Furthermore, since norms vary among countries and evolve over time, the actual corrupt behavior is subject to wide interpretation. The same act may be seen as corrupt if performed by an official but legitimate if performed by a private citizen—for example, appointing a son as minister of construction versus naming a daughter manager of the family firm's construction subsidiary. Countries with large public sectors are likely to have a wider spectrum of behavior defined as corrupt. Under democratic regimes, influence peddling before a law's adoption, such as lobbying and campaign contributions, is accepted and common behavior.[4] However, in authoritarian and fledgling democratic states, where access to policy decisions is severely limited, avenues of interest articulation are available primarily after a law or policy is implemented. Business is often left with little alternative but to commit illegalities within the normal process of exerting influence.[5] Joseph Nye's reference to deviance is usually reasonable; however, rampant corruption is often justified with the refrain "But everyone else is doing it!"[6]

The dilemma over defining corruption is magnified in times of fundamental political and economic change. The countries currently undergoing market transitions are in the midst of unparalleled societal transformations that formally encourage a new set of norms. What was corrupt under a planned economy (for example, simple market transactions) is now strongly encouraged.[7] In communist countries, the bureaucratic and political responsibilities of party members have also come under scrutiny. Once sacrosanct Communist party privileges are now attacked as corrupt. The line between official and private behavior has become blurred almost beyond recognition, making it harder to distinguish the corrupt from the noble.

Sources and Manifestations of Corruption

Corruption has been blamed on traditional culture (for example, giving gifts to officials on a holiday) or values associated with capitalism. Chinese call this "bourgeois liberalization,"[8] and one Vietnamese commentator referred to the phenomenon as the "harmful neo-colonialist garbage of the U.S. imperialists."[9] To the contrary, culture's impact seems limited, for it alone could not explain the vast differences in the level of corruption in countries sharing similar traditional cultures (for example, Singapore and China) or similar levels of corruption in countries with contrasting cultures.

Structural political and economic factors seem more important. First, states routinely intervene in the economy through macroeconomic policy, fiscal levers, and regulations, although to different degrees. Noted scholar Susan Rose-Ackerman has argued, "Corruption incentives are the nearly inevitable consequence of *all* government attempts to control market forces."[10] Greater intervention creates conditions that are more ripe for corruption. Second, intervention necessarily favors one set of actors over another. The losers often resort to corruption to advance their interests. Conversely, the privileged may use corruption to maintain their status. Third, bureaucrats and politicians who do not believe they are adequately compensated may see corruption as an alternative source of income. And fourth, where the government has little enforcement capability, officials are less likely to be worried about being caught; the lower the risk, the higher the probability that corruption will occur.

Communist states faced all four of these structural problems. They had a privileged elite that monopolized access to resources.[11] Moreover, their planned economies were extremely inefficient and rigid, creating implicit inflation and unemployment.[12] Low official inflation masked the high cost of searching or queuing for goods. Similarly, although there was full employment, factories were overstaffed and their output was seldom of value. These inefficiencies encouraged the growth of a second economy, a black market that fulfilled popular needs not met by legitimate channels. In his book *Crime and Punishment in Soviet Officialdom: Combating Corruption in the Political Elite, 1965–1990*, William Clark concludes that the USSR's "informal, illicit system became more important than the soft, formal system."[13] In fact, it appears that "the clandestine smuggling networks saved the state's industrial machine from choking on red tape."[14] In the late 1980s, Gorbachev allowed the formation of cooperatives, essentially legitimizing existing practice. By 1989 there were 193,000 cooperatives, employing 4.9 million people and producing 10 percent of the country's entire retail trade.[15] The same pattern replicated itself in the other centrally planned states. Whether they called it *blat*, *veze*, or *guanxi*, Russians, Yugoslavs, and Chinese relied on connections to get what they could not obtain legally. A survey of China's media found that the most commonly reported form of corruption in the late 1970s to early 1980s was of cadres who found housing for their friends or relatives (16.1 percent). Other forms of corruption included "illegal feasting" (15.1 percent), embezzlement (9.2 percent), bribery (8.2 percent), and misappropriation (7.6 percent).[16]

The piecemeal reforms of the transition era have produced a new brand of corruption. Even the relatively rapid pace of change in Eastern Europe, the former Soviet Union, and Mongolia still leaves many parts of the reform agenda unfinished. Shock therapy was just the first step in a long process that also must include the structural adjustment of enterprises, the financial sector, the fiscal system, and labor markets. Partial reforms leave in place a wide array of obsolete regulations and establish new, often conflicting ones, creating fissures that officials can exploit. Partial reforms also signal the ruling elite that their privileges are under attack, while still providing them a chance to manipulate change in their favor.

The second source of transition-era corruption is the decentralization of authority from the central government (and its ministries) to regional and local governments. (Admittedly, China's economy was already decentralized in many ways before the reforms.) Handing over authority to local leaders has a clear economic logic, but it also creates new opportunities for those officials to pad their incomes with illicit deals.

Weak legal infrastructure is a third source of corruption. The lack of laws regarding contracts and property, conflicting laws that are still on the books, and inadequate enforcement mechanisms have made property rights less secure and open to exploitation.

Finally, corruption also results from the declining strength of many transition regimes. Democratization has necessarily meant greater constraints on states' powers, particularly executive authority. New police forces, procuracies, and judiciaries had to be reconstituted. In the interim, corrupt officials and criminals exploited this window of opportunity to assert their control. Even relatively stronger, authoritarian transition states have not been immune to more independent-minded bureaucrats, local officials, farmers, entrepreneurs, and professionals.

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Partial reform, decentralization, insufficient property rights, and the weakened state have combined to create opportunities for corrupt officials and organized crime to flourish, often in unison. Begun in 1985, China's drawn-out price liberalization created a dual price structure in which officials could buy goods at the low state prices and resell them at higher market rates. Russian local officials in charge of privatizing state and party assets often would sell properties at reduced prices to acquaintances, pocketing kickbacks rather than auctioning them to the highest bidder as required by law. With private firms still young and vulnerable, criminals and corrupt officials from Vientiane and Ulaanbaatar to St. Petersburg and Budapest have joined forces to charge new entrepreneurs dearly for protection and investment. Pyramid schemes tacitly or directly supported by officialdom have proliferated. Companies such as Russia's MMM, China's Great Wall Development, and Romania's Caritas bilked investors of hundreds of millions of dollars before their schemes were uncovered.[17] Officials and criminals have used their access to Russian raw materials to engage in seemingly unprecedented levels of smuggling between the former republics and the West. Without mining a gram, Estonia became one of the world's largest exporters of non-ferrous metals.[18]

Corruption and Growth: A Conditional Theory

Yet despite this clearer sense of corruption's meaning and its chief sources and myriad manifestations, it is still diffi-

Table 1

How Corruption Can Hurt or Aid Growth

Hurts growth	Aids growth
directs investment to unproductive ventures	improves allocative efficiency of investment more effectively than formal state policies
promotes consumption or capital flight, thus reducing investment	leads to capital accumulation, which is then invested in productive ventures
impedes the flow of market information across the economy	improves the flow of information to the populace by avoiding secretive bureaucracy
decreases the government's capacity to implement coherent policies	provides a "piece rate" tax to the official, which leads to better work performance
occupies the valuable time of state officials	saves officials time by cutting through red tape with the use of "speed money"
discourages entrepreneurship by demanding protection payments and charging high interest for loans	encourages entrepreneurship by protecting property rights and giving access to otherwise unavailable capital

cult to address the question of corruption's relationship to economic growth. A 1995 comparative empirical study that found a moderate negative correlation between corruption and economic growth has several key weaknesses.[19] The corruption indices are based on the subjective judgments of foreign business analysts, not on reported corruption, and are likely influenced by each country's economic performance. Moreover, the study assumes that political institutions remain constant, an unrealistic assumption for transition economies. Since the data are from the early 1980s, they include no transition economies.

Comparing data from a recent survey of perceptions of corruption in fifty-four countries (including five transition economies) with their average gross national product growth rates for 1990 to 1995 yields an even fuzzier picture. The resultant regression, with an R^2 of .01, reveals no discernible pattern.[20] In fact, a review of the literature and the experiences of transition economies suggests that corruption's effect could be either positive or negative, as Table 1 indicates. Most broadly, the relative impact of corruption depends on the analyst's frame of reference. Those who think corruption hurts growth compare corruption to a well-working free market. In contrast, those who see corruption's benefits compare it to a poorly functioning market or no market at all—that is, a pre-transition economy. As economist Jim Leitzel put it, "A corrupt market is preferable to no market."[21] Corruption's effect on growth in transition economies is based on four conditions, summarized in Table 2.

Efficiency. Corruption is one way entrepreneurs can bypass cumbersome roadblocks. Similarly, if formal markets are rigid or monopolized by a small group, then a black market could be more efficient and promote growth. Citizens who made antiquated products for official markets could be more productive in a black market that is more responsive to demand. If current policies promote import substitution (and ration import licenses), bribing an official to get an import license for a good for which your country lacks competitive advantage (and would otherwise produce at a higher cost) should be beneficial to the national economy.

Organization. The organization of corruption is important in determining its effect on growth. Monopolies drive up prices in illegal as well as legal markets. If corruption is organized like a free market, government officials can essentially auction their "services." The most efficient producer is able to make the highest bid for the bribe, resulting in an efficient outcome.[22] Since there are multiple suppliers of similar goods who regularly deal with multiple purchasers, such "free market corruption" should lead to stable, fair prices. In contrast, in an "exclusionary black market," those allowed to make bids are limited either by political or personal criteria, potentially excluding the most efficient producer.[23] Consequently, the bribe goes to a more costly producer and growth is stymied.

If corruption is organized like a monpoly, however, two other alternatives are possible: The official could be a "unitary monopolist"—directly controlling all the relevant products (the only toll booth on a highway) or organizing the actions of lower-level monopolists. Although the purchaser has to pay rent because of the monopolist's power, the rent should be relatively stable over time. Al-

Table 2

Conditions That Affect Corruption's Impact

Condition	Promotes growth	Hinders growth
market efficiency	formal markets are inefficient	formal markets are efficient
corruption organization	free black market; unitary monopolist	exclusionary black market; independent monopolist
how gains are used	reinvested	consumed, capital flight
reform prospects	broadens support for reforms	weakens support for reforms

ternatively, the official could be an "independent monopolist"—controlling one item while the purchaser needs several (one of many toll booths on the highway). In this instance, the independent monopolists would each charge a high rent. Since they do not coordinate their prices, they end up charging a higher fee than the unitary monopolist, and fewer people use the road. This form of corruption would hurt growth.[24] In many ways the old communist planned economies were similar to both the free black market and the unitary monopolist models. The question is whether the structures have now changed to more closely resemble the exclusionary black markets and the independent monopolist.

Use of Gains. If the gains from corruption are reinvested in a productive venture, then corruption could very well support economic growth, especially if the original holder of the money would not have invested it wisely. If, on the other hand, the corruption is followed by consumption or the gains are sent abroad, corruption would hurt growth.

Reform Prospects. If corruption broadens support for market reforms, then it should promote growth in the long run, even if the specific act of corruption detracts from short-term growth. This political trump card is obviously hard to calculate but is no less important than the other factors. Economist Barry Naughton suggests that corruption can be used to buy the support of a ruling elite that is giving up its monopoly: "If economic reform is successful, the gains to the economy would be large enough to buy out the existing ruling stratum and still make the remainder of the population substantially better off."[25] A Chinese economics professor, apparently bowing to political realities, tells his students, "Corruption is the price that China has to pay for the changes from a centrally planned economy to a market system—it is the grease that can lubricate the political machine in a changing society."[26] But if the students and the rest of society are not persuaded and tolerance for corruption wanes, then the increased exposure of a corrupt elite may have the opposite effect of forcing the postponement of key reform policies or perhaps derailing reforms altogether.[27]

Corruption and Growth: The Consequences

Given the general parameters of the relationship between growth and corruption, what can we say about the effects of corruption in the transition era? A key goal for each transition economy is the development of a vibrant non-state economy, either through privatizing existing state assets or encouraging new start-ups. Examining this area will highlight the utility of viewing corruption contextually.

Privatization. It is almost gospel among economists that privatizing state enterprises is absolutely crucial for fostering growth. Only owners with firm property rights who face hard budget constraints in a competitive market are willing to make the required investments to improve their firms' efficiency and creditworthiness, according to the conventional wisdom.[28] By mid-1995, the private-sector share of gross domestic product was more than 50 percent in nine of twenty-five transition economies in Eastern Europe and the former Soviet Union, much of which came from privatizing state assets. States that have privatized a major share of their large-scale enterprises include the Czech Republic, Estonia, Hungary, Slovakia, Kyrgyzstan, Russia, and Uzbekistan. Land privatization has progressed rapidly in Albania, Armenia, Bulgaria, the Czech Republic, Hungary, Moldova, Poland, Romania, and Slovakia.[29]

Privatization schemes have differed according to the groups of people allowed to participate (restricted to firm management and employees versus open to the public or foreigners) and the method of purchase (vouchers, stocks, or cash). Regardless, all have been extremely susceptible to corruption, in large part due to the wide latitude often given to privatization committees and government ministries.

In some cases, officials have bypassed public auctions and sold off enterprises at cut-rate prices to other officials, organized crime groups, or individual citizens in exchange for bribes. Hungary's interior minister, Gabor Kuncze, admitted in an interview that in some of the more than 100 cases of illegal privatization, "assets were not sold to a prospective cash buyer, but rather were sold later for less and in exchange for compensation notes."[30] Just as common have been cases in which privatization was illegally restricted to managers and employees who wanted to protect their positions. Poland's "liquidation" scheme and Russia's voucher plan both favored insiders, particularly labor.[31] Finally, officials have engaged in "spontaneous" or "nomenklatura" privatization (known as "sign-flipping" and "pocket-swapping" in China)—misappropriating funds from ministries or state enterprises to set up their own firms.[32] An alarmed Jeffrey Sachs recently wrote of spontaneous privatization: "It is clear now that [mining] should have remained state property until such a time as it would become possible to set up honest, effective, and controllable management of mining enterprises."[33]

In Poland insider deals at least moved privatization along more quickly than the often-inefficient formal markets.

The foregoing obviously provides some ammunition for the argument that corruption has hampered growth by distorting privatization. Voucher programs and tenders that were supposed to act as free markets were bypassed by officials who operated what amounted to exclusionary black markets. In Russia entrepreneurs either turned state monopolies into private monopolies or exported raw materials at below world-market prices, leaving shortages at home and proceeds overseas.[34]

Corruption related to privatization has also weakened mass support for further reforms. In Mongolia, the government has privatized nearly 1,000 large state-owned enterprises and thousands of smaller firms since 1991. Sixty percent of the economy is now in private hands. However, popular resentment of privatization—as represented in a mid-1996 strike carried out by employees of a privatized department store—stems from accusations that the government has handed over large portions of state assets in return for bribes.[35] In short, it is quite possible to see how the corruption that has accompanied privatization has slowed the reform process and in so doing slowed economic growth.

Yet in many instances corruption has facilitated privatization and growth. In Poland, while public auctions appeared more efficient, the country's minuscule capital markets and limited private savings combined with the difficulty in evaluating assets and the sheer number of firms to be privatized to slow down open auctions.[36] Insider deals at least moved privatization along more quickly than the often-inefficient formal markets. Illicit sales to outsiders cut through red tape and put firms in the hands of owners who were potentially more willing to take risks. Workers are often the least likely to be willing to undertake the necessary reforms to make the enterprise profitable.[37] Corrupt purchases have been one way to give outsiders access to other firms and thus at times have resembled free black markets. The public outcry over illicit deals has to be balanced against the willingness, however guarded, of entrenched bureaucrats to go along with the reform program; even as they distort current moves, they are most likely becoming more vulnerable to competition from other domestic and foreign firms. Even corrupt new managers have started to behave "in a more market-like manner" as they face harder budget constraints and free prices.[38]

New Entrepreneurship. Encouraging new entrepreneurs is another strategy to raise the proportion of non-state participants in transition economies. New businessmen who face hard budget constraints and market prices have been the largest source of economic growth in these countries.[39] This group includes not only those who start formal private ventures but also those who, because legal guarantees for private firms have not been firmly established, have sought refuge under the more ideologically safe titles of collectives or cooperatives. Russians interested in striking out on their own before the 1992 privatization sought refuge, often unsuccessfully, under the aegis of cooperatives.[40] China's collective firms are formally not in private hands, but a substantial portion of those who "wear a red hat" behave almost identically to their private brethren.[41] In China by 1995, state-owned enterprises employed 68 percent of workers in industry but only produced 34 percent of total industrial output.[42] In largely agricultural Vietnam, the non-state sector in 1994 accounted for 70 percent of output and 92 percent of employment.[43] Even as surprising as these numbers appear, it is widely agreed that official statistics in the transition economies fail to capture a large percentage of inherently private legal business activities.[44]

The road to greater entrepreneurship, however, has not been smooth. With property rights still ill defined and police understaffed, entrepreneurs have had to bribe corrupt officials and dole out protection money to get business licenses, raw materials, and credit, or to stay open. A 1994 Russian government report estimated that 70 to 80 percent of private enterprises and commercial banks in major Russian cities have had to pay 10 to 20 percent of their income to organized crime.[45] To register, obtain licenses, or get loans, Chinese private entrepreneurs often have had to bribe officials with entertainment, presents, or cash.[46] In China's rural areas, officials who have lost their dominant role have used their remaining authority to charge farmers "movie-watching fees," "education taxes," and "social stability tithes."[47]

Just as with formal privatization, the potential detrimental consequences for economic growth are apparent. Bribes and protection payoffs appear to raise the cost of doing business, which may keep potential players on the sidelines.[48] Although they point to the possible positive economic aspects of corruption, economists Leitzel, Gaddy, and Alexeev admit, "Many would-be Russian entrepreneurs are discouraged by the prospect of having to run a gauntlet of demands for bribes and protection money."[49] An Eastern European considering opening a factory in Moscow said: "Just to get space we need, I would have to pay fantastic bribes. . . . And then once business opened, we would surely be hit up by the mafia, who would want 30 percent of our turnover or more." Those that do start a business must factor these costs into their prices, which leads to inflation. Such charges reportedly accounted for a quarter of Russia's inflation in 1993.[50] This suggests that corruption is distorting what would otherwise be efficient market behavior. Independent monopolists who run protection rackets often do not reinvest the rents they obtain from their "clients." Finally, the difficulties facing entrepreneurs have left many skeptical about the market's promise of greater prosperity. To some, the security of yesterday appears more inviting than the chaos of today.

Corruption is distorting what would otherwise be efficient market be[illegible] Independent monopolists w[illegible] protection rackets often [illegible] the rents they obtain [illegible]

Yet there is reason to believe that corruption could aid growth. The legal structures in all the transition economies are far from complete or streamlined. Bribes are one way to bypass the red tape blocking the licenses or loans necessary to engage in economically beneficial practices.[51] Protection money, however unseemly, has in some instances stabilized contracts and restored some semblance of order where little existed.[52] It also appears that some organized crime groups have consolidated their protection rackets, thus resembling the less costly unitary monopolist described above.[53] Moreover, the products of new entrepreneurs have been better suited to the market than those produced by dilapidated state-owned enterprises. As with privatization, allowing corrupt officials to profit from the reforms has dampened their opposition to reform and bodes well for long-term growth.

Conclusion

The relationship between corruption and economic growth is not straightforward, but, rather, depends on a multitude of factors. It is worth re-emphasizing that corruption is the byproduct of other factors that have a larger, more direct impact on growth. To understand the contrast between Russia and China's growth patterns, for instance, the focus should be placed on better candidates for independent variables, including the whole range of transition policies, each country's factor endowments, and their political situations. These factors largely shape the conditions, such as market efficiency and reform support, that determine whether corruption appears to aid or inhibit growth. Corruption has often hobbled entrepreneurship. In certain environments, however, corruption has ameliorated less-than-ideal circumstances.

This is not by any means to condone or welcome corruption. Rather it suggests that the aim of reducing corruption should not be to facilitate economic growth. Instead corruption should be denounced for its damage to social harmony, economic justice, and political legitimacy. Focusing on the relationship between economic growth and corruption may blind those who think about or have to confront this problem from seeing that valuing growth for its own sake may make such new prosperity hollow for much of the populace in the transition economies.

In this article the term "transition" has been taken for granted, as if the countries under examination face identical situations and are necessarily headed for similar outcomes. In fact, the term may be even more slippery than corruption. The transition process is much more open ended than usually thought, leaving one commentator to suggest substituting the term "metamorphosis."[54] This recognition of choices and tradeoffs creates a dilemma for those living in transition economies. Economic growth should not be equated with development or progress. Corruption's potential benefits necessarily entail costs that may not show up in growth statistics.

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For Further Reading

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