

Chapter 11 Lecture: Development Policymaking and the Roles of Market, State, and Civil Society

ECON 211 - 70: Economic Development

Chapter 11 Lecture: Development Policymaking and the Roles of Market, State, and Civil Society

+ Economics of Corruption

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System of Economic Management

Mixed economy

- Private sector: profit maximizing business firms
- Public sector: employment maximizing government agencies

Economic systems

- Capitalism: large private sector, but small public sector
- Socialism: large public sector, but small private sector

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Capitalist Market Economies vs. Socialist Planned Economies

- The extreme distinction between market and planned economies is often used
- The concept of “march to markets” can refer to both the transition from socialism in centrally planned countries and the increasing liberalization in LDCs
- The difference in efficiency between a market and planned system depends largely on how each deals with 1) information and 2) incentives

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Economic Role of the State

- Protect private property and legal rights
- Produce public goods
- Improve market competition
- Improve income distribution
- Preserve the human environment
- Manage the economy

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Role of Incentives

- It is argued that the profit motive is the most reliable way to increase output, cut costs, innovate, and meet unmet wants
- In socialist economies, public-mindedness was an insufficient incentive, so promotions and raises were offered to managers who met the goals of government planning; although these might have helped managers achieve quantitative goals, they did not encourage them to cut costs, innovate, and meet unmet needs

The Case of Vietnam and China

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Resurgent of Market Orientation

- Failure of planning
- IMF and World Bank policy requirements for foreign aid and direct foreign investment
- Joint ventures of domestic and foreign enterprises

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Requirements for Market Orientation

- Social mobility
- Individualism and materialism
- Deferring gratification to create private saving
- Rationality and efficiency
- Honesty of government
- Competition of business
- Availability and freedom of information

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Requirements for Market Orientation

- Trust
- Law and order
- Security of private property rights
- Balancing between competition and cooperation
- Division of responsibility and diffusion of power
- Social safety net
- Social mobility

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Need for Government Intervention

- **Income redistribution through progressive taxation and transfer payments**
- **Excess market imperfection on behalf of domestic and foreign business**
- **Substantial negative externalities (pollution and decay)**
- **Investment in social and human capital**
- **Structural transformation**

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Non-Government Organizations

- **Comparative advantages of NGOs in**
 - **Innovative design and implementation**
 - **Program flexibility**
 - **Specialized technical knowledge**
 - **Provision of targeted local public goods**
 - **Common-property resource management design and implementation**
 - **Trust and Credibility**
 - **Representation and advocacy**

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Limitations: “voluntary failure” – NGOs may be...

- **Insignificant, owing to small scale and reach.**
- **Lacking necessary local knowledge to develop and implement an appropriate mix of programs to address relevant problems**
- **Selective and exclusionary, elitist, and or ineffective**
- **Lacking adequate incentives to ensure effectiveness**
- **Captured by goals of funders rather than intended beneficiaries; may change priorities one year to the next**
- **Giving too little attention to means, preventing needed scale...**
- **Or, find that means—such as fundraising—can become ends in themselves**
- **Lacking immediate feedback (as private firms get in markets, or elected governments receive at the polls); this can let the weaknesses go on for some time before being corrected**

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Two Ways to Transform

- 1. Shock therapy – this transition is rapid and was used by Poland and some other countries**
- 2. Gradual transition – this was used by China and some other countries**

Is there a “correct” way?

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"It doesn't matter whether the cat is black or white, as long as it catches mice."

Deng Xiaoping
(Former Chinese Prime Minister)

Cross the river by feeling the stones.

摸着石头过河。
Mōzhe shítou guòhé



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Rent Seeking

- ▶ When sectors of society create quasi-rents through special interest lobbying, law suits, and other activities that seek to establish special advantages through licensing, legal awards, monopolies, etc.
- ▶ Resources spent on rent-seeking are generally viewed as unproductive, since they typically transfer wealth, rather than creating it.

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The Economics of Corruption



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Definition of Corruption

- ▶ "The abuse of public power for private benefit"
 - ✓ Or for the benefit of party, family, tribe etc
 - ✓ Corruption not equal to bribes
 - ✓ Bribes not equal gifts
- ▶ Corruption may be
 - ✓ Political ("grand") or bureaucratic ("petty")
 - ✓ Centralized or decentralized
 - ✓ Predictable or arbitrary
 - ✓ Etc etc

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Measuring Corruption

- **The impact of corruption - what we know**
- **Hampers service delivery - keeps the poor, poor**
- **Entrenches corrupt elite networks - makes the rich, richer**
- **Slows economic development - unemployment**
- **Destabilizes democracy and democratic institutions**
- **Undermines Constitutional rights and freedoms**
- **Contributes to high-levels of crime and violence**
- **Corruption involving the well connected in business and politics (political corruption) has the greatest impact**

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Corruption and Development

- **"The Sanders":** Corruption is a major obstacle to development and a cause of under-development and absence of growth.
- **"The greasers":** Corruption fosters development by allowing agents to overcome government failure.
- **Sanding the wheels**
 - ✓ Corruption prevents economic and legal systems from functioning properly.
 - ✓ Corruption leads to misallocation of talent
 - ✓ Corruption reduces the incentive to accumulate "capital"
- **Greasing the wheels**
 - Corruption lubricates economic systems by allowing agents to circumvent cumbersome and time consuming regulations.
 - Corruption is like a competitive auction: those who want a service the most get it and the result is an efficient allocation of resources.

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Factors Causing Corruption

- **Licenses, permits and authorization**
 - ✓ Give monopoly power to officials
 - ✓ Single office for authorizations
 - ✓ Frequent contact, waiting time
- **Taxation - invites corruption if there is ...**
 - ✓ Discretion
 - ✓ Lack of transparency
 - ✓ Weak control or no sanctions against offenders
 - ✓ Low wages

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Factors Causing Corruption

- **Government spending and investment**
 - ✓ Procurement spending (many controls...)
 - ✓ Wage payments
 - ✓ Extra-budgetary accounts with lack of transparency and control
- **Government supplies goods below market prices**
 - ✓ Public housing, foreign exchange, water, credit, education
 - ✓ Rationing, queuing
- **Party finance**

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Indirect Causes of Corruption

- Quality of the bureaucracy
 - ✓ Hiring and promotion based on merit
 - ✓ Absence of patronage and nepotism
- Incentive structures
 - ✓ Salary levels and corruption – what is the link?
 - ✓ Penalty
 - ✓ The risk of getting caught
 - Free press
 - Ethics commissions
 - ✓ Quality of leadership

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The Corruption Equation

- C (corruption) = M (monopoly) + O (Opacity) + D (discretion) – A (accountability)
- Fighting corruption, thus, requires eliminating monopoly, reducing discretion and promoting transparency and the rule of law while increasing accountability standards and practices. (Robert Klitgaard)
- Opacity - Loss of clarity in something that is normally clear or transparent.

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Measuring Governance and Corruption

- The very nature of corruption (secrecy, illegality, national variations) prevents precise information on cross-country comparisons of extent and frequency
- Survey-based measures of corruption by experts and firms: Most techniques attempt to capture the degree of corruption in a country through the perception of investors, creditors, and local economic agents. The measure of corruption thus is highly subjective.
- Corruption is most often incorporated in political risk factors and its weighting differs according to each rating institution.
- We often rely on anecdotes and *perceptions* of corruption (and I have lots of anecdotes)

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Measuring Governance and Corruption

- Transparency International: Corruption Perception Index and Bribe Payers Index
<http://www.transparency.org/>
- Heritage Foundation: Index of Economic Freedom
<http://www.heritage.org/research/features/index>
- You can find others

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Economic Effects of Corruption

- **Positive effects (in theory):**
 - ✓ Greasing the wheels arguments – speeding up things
 - ✓ Bribes promotes efficiency through bidding
 - ✓ Political glue. Politicians get necessary funds.
 - ✓ Substitute for taxes
- **BUT REMEMBER: rigidities and controls are endogenous. Officials may manipulate systems and rules to maximize their rents**
- **Speed money is an incentive to delay things**

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Negative Effects

- People are diverted from production to rent seeking
- It distorts public investment, its size, composition and quality
- Higher public deficits
- More inequality and poverty
- It distorts markets, incentives and regulations
- Obstacles for small firms (esp. many local government controls)
- Arbitrary tax with high welfare costs
- Protection of property rights and rule of law undermined
- The legitimacy of the market economy and democracy undermined. Problem in many transition economies...

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Fight Against Corruption

- **No single cause of corruption, so we need a broad approach**
- **Donors: How do they tackle corruption?**
- **Anti-corruption is part of state reform**
 - ✓ Civil service reform, salaries
 - ✓ Discretionary regulations
 - ✓ Eliminate tax incentives
 - ✓ Transparency
 - ✓ Leadership commitment
 - ✓ Reduce demand and Reduce supply

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Combating Corruption: A Policy Toolkit

Adapted from Center for International Private Enterprise



Supply-side Recommendations

- ✓ Independent media equipped with tools of analysis
- ✓ The role of think tanks, business associations and other NGOs
- ✓ OECD Anti-Bribery Convention
- ✓ Internationally accepted accounting standards
- ✓ Good standards of corporate governance
- ✓ Continue strengthening general OECD guidelines

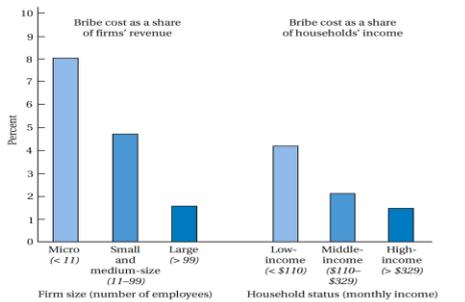
Demand-side Recommendations

- ✓ Establish sound procurement codes
- ✓ Require independent audits
- ✓ Legal reform and simplification
- ✓ Inventory of legal barriers and duplicative regulations
- ✓ Reduce the “shadow” economy
- ✓ Simplify tax codes
- ✓ Salaries of the civil servants have to be competitive with private sector ones
- ✓ Transparency in the financial/banking sector

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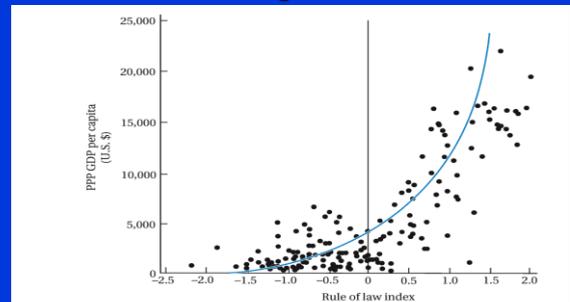
Corruption as a Regressive Tax: The Case of Ecuador



Source: World Bank, *World Development Report, 2000-2001* (New York: Oxford University Press, 2000), p. 102, fig. 6.2. Reprinted with permission.

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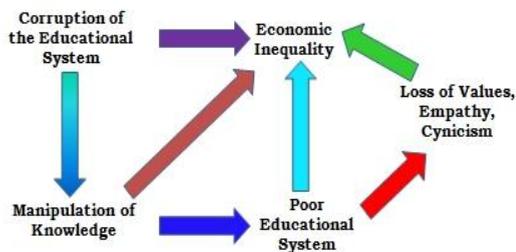
The Association between Rule of Law and Per Capita Income



Source: World Bank, *World Development Report, 2000-2001* (New York: Oxford University Press, 2000), p. 103, fig. 6.3. Reprinted with permission.

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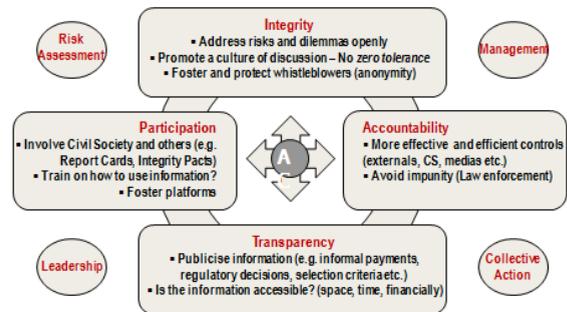
Corruption in Higher Education



Source: McCormac (2012) adaptation from Wilson (2009). Used with permission.

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The Pillars of Anticorruption



Source: Boehm, F. (2011). Used with permission.

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