

# 1C Corruption, economic development, and governance: Private sector perspectives from developing countries

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*Widespread and persistent corruption remains one of the leading problems for business, Governments and citizens worldwide. Increasingly, efforts to combat corruption are no longer just a prerogative of NGOs and civil society organizations: Businesses are also mounting sustained efforts to address both the supply and the demand sides of corruption. The increasing costs of corruption for business in countries worldwide are driving the private sector involvement in anti-corruption initiatives. For example, CIPE's partner INDEM has estimated that businesses in Russia pay over US\$300 billion in bribes each year. A recent survey of the Iraqi business community, conducted by CIPE and Zogby International, revealed that corruption adds more than 40 per cent to the costs of doing business for 38 per cent of companies.*

The addition of an anti-corruption principle to the United Nations Global Compact illustrates the increasing importance of the private sector in the global fight against corruption. “Companies are waking up to the need to fight corruption,” said Transparency International Chairman Peter Eigen, when the addition of the new principle was an-

nounced in June 2004. The event signified that sustainability, business leadership and good governance are becoming the defining elements of the private sector's internal safeguards against corruption. The United Nations Convention against Corruption, which stresses the need to reform public institutions and lays out a framework for private-public cooperation, is another tool in fighting corruption.

These two United Nations initiatives demonstrate that if challenges of corruption are to be met with resolve, there has to be a sustained multi-dimensional effort. Although it is important to develop legal codes to combat bribery, it must be recognized that it is just as important to address the enabling environment issues. In that sense, efforts to establish the rule of law, strengthen the protection of private property rights and improve the quality of regulations become crucial in anti-corruption reform. New institutional economics provides us with a set of tools that can help Governments, the business community and society address the root sources of corruption. This paper highlights several approaches.

In many cases, measures to fight corruption can be created as part of the institutional development of

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countries—establishing the incentive structures that reward honesty and transparency and punish bribery and abuse of public office. Despite the continued pervasiveness of corruption, decades of reforms and the success of countries in combating corruption cannot be ignored. As corruption remains on the top of the list of issues of concern for business both internationally and locally, the emphasis should be put on continuing second-generation reforms in countries where anti-corruption efforts have succeeded and applying the lessons learned in countries where anti-corruption efforts have failed to strengthen institutions that make corruption unsustainable.

Business principles also play an integral role in anti-corruption initiatives. While this article focuses on business-Government relations in addressing corruption, the importance of internal company controls against bribery can't be underestimated. One example of such a control mechanism is the Business Principles for Countering Bribery (BPCB) developed by Transparency International (TI). Equally important are procurement reforms and other transparency measures to combat corruption. Probidad, a programme implemented by CIPE's partner, the Colombian Confederation of Chambers of Commerce (Confecámaras), is illustrative in this sense: it brings together private companies and local municipalities to create a more transparent process of awarding public works contracts.

In some countries where—due to the closed nature of their political and economic environments—corruption remains institutionalized and off-limits to public scrutiny, initiatives of the private sector and civil society, as well as international pressure and increased competitiveness in the search for foreign capital, play a key role in reducing opportunities for corruption and paving the way to economic growth. In such environments, where the political will for anti-corruption initiatives is lacking, introducing measures that put forth the institutional solutions to corruption on both sides of the equation should be a priority for the business community.

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cess. The stakes for the private sector are high: if businesses choose to remain on the sidelines and continue to participate in corruption, they will not be able to gain access to foreign and domestic investments. Moreover, a lack of competitiveness associated with corruption can leave businesses unable to survive in a highly demanding global economy. Experience shows that business participation in anti-bribery initiatives—effective and consistent advocacy efforts on the part of associations and chambers of commerce—can lower corruption levels and allow more efficient markets and Governments to arise. Increasingly, both local and international business communities refuse to accept the uncertainty that comes with extortion, bribery and lack of fairness.

Combating corruption should be thought of as more than simply weeding out crooked Government officials. Such an approach has been implemented in many countries and has proven to be unsuccessful in reducing the extent of corruption. Corruption is a symptom of underlying problems, not the problem itself. Therefore, the trends that sustain it should be addressed. These problems include opaque regulations, weak enforcement mechanisms, barriers to business, inefficient Government agencies, absence of a public dialogue on corruption, excessive discretionary powers in the hands of public officials, and a lack of checks and balances. Simply, corruption is an institutional problem, and the institutions that allow for sustainability of corruption should be reformed.

As acts of weeding out single corrupt officials are coming to be viewed as publicity stunts and an institutional approach to combating corruption is gaining momentum, the next decade of anti-corruption reforms in developing countries will place an amplified emphasis on more effective law enforcement and a strong judiciary. Anti-corruption reforms should move beyond advocacy and policymaking, as proper and fair implementation of laws and regulations requires increased attention. It is a reality in too many countries that policy intentions differ from policy outcomes, and the seemingly effective measures to reduce corruption fail. This policy gap should be addressed if corruption is to be reduced.

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### Approaches that work

CIPE partners have implemented dozens of successful anti-corruption initiatives in many countries around the world. Although they work in different political, economic and social environments, their successes share the same basic principles and approaches largely based on private sector advocacy to reform inefficient institutions that breed corruption. The process involves the private sector taking a leadership role and building awareness of the need for reform, identifying the root causes of corruption, developing solutions, and working with policymakers, business partners and other civil society groups to put an end to bribery, extortion and facilitation payments.

In the early stages of anti-corruption initiatives, it is important to break the taboo about discussing corruption. While discussion of corruption is increasing in many developing countries and media coverage of it is more pervasive, there are countries where the topic is still off-limits due to its political sensitivity and social acceptance. It is also important to dispel the myths that sustain corruption, such as the myth that corruption is inseparable from traditions and culture in certain countries.

Here lies one of the problems with combating corruption—corruption itself becomes widely accepted and perceived as a normal part of daily life. In such cases, sentiments such as “it has always been done this way,” “nothing can be done about it,” or “it is too sensitive an issue to address because everyone is doing it” are common. Many small entrepreneurs are used to it and have developed mechanisms to keep corruption manageable on a daily basis. It is important, therefore, to demonstrate to the public, the business community and the Government that corruption is not permanent and inevitable—that it can and should be dealt with.

Many countries face a lack of political will to combat corruption. Often, grandiose statements by high-level public officials about the importance of anti-corruption measures do not translate into commitment on the local level to tackle the institutional problems that sustain corruption. This is not surprising, since local officials are often major beneficiaries

of corruption, and in a broken system they have few incentives to eliminate this source of personal gain. This lack of political will discourages the private sector and regular citizens, as it seems impossible to implement anti-corruption initiatives in environments where political leaders block such initiatives and weak democratic institutions do not allow citizens to hold their leaders accountable for their actions. Yet an absence of political will does not mean that political will cannot be created.

There are several ways in which political will to combat corruption can be fostered, and the private sector and NGOs play a key role in this process. Globalization has emerged as one of the solutions. As international trade becomes more widespread and the process of globalization affects businesses of all sizes, corruption makes business uncompetitive and corrupt countries end up on investor “blacklists.” This means that Governments face the prospect of an uncompetitive economy, which translates into political instability through lower Government revenues and an inability to provide social services to the population. From this perspective, it is becoming harder for politicians to ignore corruption.

On the other side, the problem of political will can be approached from the grassroots level, where private sector representative organizations such as chambers of commerce and business associations can not only approach the Government about reform, but also engage the Government in a dialogue with the business community. Increasingly, corruption is one of the top issues in the electoral process, as Government officials cannot ignore constituents’ interest in eradicating bribery and extortion. Private sector can find public officials who are committed to eradicating corruption and use them as focal points to change attitudes within Government agencies.

Revealing that corruption is a serious threat to economic development is not nearly enough. The next step is to identify the root sources of corruption and demonstrate how corruption occurs through a basic audit of countries’ institutional and administrative resources. The pattern leading up to corruption is similar in many countries—it is often a combination of obscure and opaque

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laws and regulations, complex tax codes, overregulation of economic activities, overstaffing of Government agencies and lack of technological innovation within them, absence of an independent audit, weak corporate environment, shortage of accountability mechanisms, and lack of transparency in policy making and in relationships between Government and business.

After the root sources of corruption are identified, the next step is mobilizing key anti-corruption constituencies and building anti-corruption coalitions. This is one of the keys to the development of successful anti-corruption strategies, because lack of communication and cooperation among members of the private sector can weaken their ability to successfully develop and implement anti-corruption initiatives, as well as advocate for reform. An important part of this stage is promoting a healthy dialogue between the private sector and Government to ensure that policies designed to curb corruption address the real needs of the business community. The private sector and independent think tanks play a crucial role in this process by providing information to Government officials in a timely manner. Mobilizing constituencies and building coalitions leads to a successful development of action plans with specific anti-corruption policies. Yet, in many countries, most problems occur when it's time to implement and enforce those policies. Anti-corruption policies will often stagnate on paper while corruption persists on a daily basis. Effective oversight of implementation and evaluation of programs is crucial.

### Some examples

Many measures of corruption and governance are not specific—they uncover correlations between the rule of law and corruption levels but fail to indicate what exactly needs to be done to reduce corruption. Similarly, studies showing that civil servants are corrupt are a useful starting point but they often fail to indicate the reasons for this corruption.

Not all countries are the same—raising the question of whether a “one size fits all” approach is viable. Although corruption varies in scope and definition in different

countries, in its essence it requires the same cure—reforming institutions to make them more efficient. The challenge is identifying which institutions are key to the problem and prioritizing the reform process among them. For example, while some countries may require a complete regulatory overhaul, others may have the right rules in place but lack sufficient enforcement of those regulations.

Specific measures to curb corruption should address both the private and the public sectors—the demand and the supply sides—equally. The private sector does not always recognize that it is in fact a source of corruption—after all, in many cases bribes and kickbacks have to be offered before they are accepted. Although it is true that the private sector is often a victim of corrupt Government officials who use their power to extort bribes, especially from smaller entrepreneurs, the private sector often facilitates corruption—such as when businessmen try to gain preferential Government treatment or win over their competitors. Measures that address the supply side of corruption aim at limiting the ability of the private sector to willingly engage in corruption. Efforts on the demand side of corruption, on the other hand, aim at limiting the ability of public sector employees to extort bribes and use their power of public office for personal benefit. In the end, measures on both sides aim at correcting the institutional problems, i.e. taking away the incentives and opportunities to be corrupt. It is important to look beyond simply weeding out corrupt individuals and focus on reforming systems that reward corrupt behaviour.

### Institute sound corporate governance systems

Although corruption is bad for business, individual companies that engage in corruption receive a short-term advantage. It is important to set up a system that makes it hard for companies to engage in corruption, even if it seems desirable.

Corporate governance is perhaps the single most effective tool to limit the ability of private sector companies to participate in corruption. Good corporate governance establishes a system where companies are unable to provide bribes covertly and are easily held accountable for wrongdoing. Corporate governance ensures that man-

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agers act in the interest of a company, board members exercise good judgement, investors receive timely and relevant information and decision-making is not done behind closed doors. By making companies transparent and by holding decision makers accountable for their actions, corporate governance makes it hard for companies to provide bribes or other company resources to Government officials in exchange for services.

### **Implement codes of conduct for intermediaries**

As multinational companies (MNCs) are increasingly dependent on intermediaries to open up markets and enable them to function, those same intermediaries increasingly abuse this dependency. Such abuse is especially easy in local settings where companies require assistance with such important daily issues as taxes, customs, shipping, contract administration and payment collection. But the integrity of MNCs is threatened when their agents are themselves dishonest and corrupt; therefore corporations are faced with the need to monitor agents' performance and ensure their integrity. Since such monitoring can get expensive, the solution may be a system of incentives to discourage corruption from entering the system via local markets. The short-term benefit of corruption is in this way offset by the possibility that corrupt agents will be excluded altogether.

Such is the idea behind Transparent Agents and Contracting Entities (TRACE), an international non-profit association that conducts corruption reviews of its members and posts ratings thereof, and runs compliance training and anti-corruption workshops; its members are commercial intermediaries such as sales agents, distributors and suppliers. TRACE recognized the willingness of companies to be corruption-free at every level of their supply chain and set up a system that enables it to combat corruption by creating an honest international business environment, where the privilege of doing business is reserved for companies that do not engage in corruption. TRACE maintains a database of “clean” companies and provides its members with a background check on honest agents throughout the world.

### **Streamline legal and regulatory codes**

As the primary source of corruption is inefficient regulations, efforts to simplify legal and regulatory environments should form the core of anti-corruption initiatives. The purpose of such efforts is to take away opportunities for corruption, such as when public officials use selective judgement in applying laws or businesses try to bribe public officials to avoid unnecessary and costly regulatory hurdles.

### *Case example: Ecuador*

The efforts of the National Association of Entrepreneurs (ANDE), a voluntary private business association in Ecuador, illustrate this approach to reducing corruption. To address widespread corruption and the need for legal reform in Ecuador, ANDE identified and proposed the elimination of duplicative and conflicting commercial laws. Importantly, ANDE's focus was not to blame past corruption on any one particular group, as is often done, but rather to initiate reforms that would change the direction of business and institute clean practices.

To identify the roots of corruption, ANDE reviewed the country's commercial laws, particularly those concerning production, foreign trade, the establishment of official prices in the private sector and technology transfers. ANDE's studies showed that since the founding of Republic of Ecuador more than 150 years ago, some 92,250 legal norms have been created, of which 52,774 were in force in 1997. The sheer number of overlapping, unclear and contradictory laws had created an environment of legal chaos and had left the application and enforcement of laws to the discretion of bureaucrats. ANDE obtained the support of chambers of commerce, industry, agricultural entities, labour unions, ministries and NGOs and presented its legal reform proposals to the Government, which implemented 25 per cent of all proposed legislative changes in the first year alone.

The experience of ANDE and other think tanks and associations suggests that they play a key role in legal simplification. Governments are often compelled to make decisions and execute “top-down” reforms once problems get out of hand. Yet input from the private sector is key to the

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formulation of legal and regulatory reform. The private sector knows first-hand the inconsistencies that hamper business growth and present opportunities for corruption for both business and Government officials. Such a grassroots approach to reform is more effective in reducing opportunities for corruption than a top-down method.

### Lower barriers to starting and operating a formal business

Business registration procedures present a field of opportunities for corruption.

#### *Case example: Peru*

One of CIPE's first partners to research the negative effect of burdensome business registration procedures was Peru's Institute for Liberty and Democracy (ILD). In the early 1980s, Hernando de Soto, the head of ILD, decided to set up a small business and attempted to get it licensed. With the help of five university students who spent several hours a day winding their way through Peruvian bureaucracy, he discovered that to obtain a legal license to operate took 289 days and cost 31 times the average monthly minimum wage. Since then, a similar approach has been undertaken in many countries, and the result has always been the same: burdensome business registration facilitates corruption in two ways—directly, by forcing entrepreneurs to bribe Government officials to simplify the registration process, and indirectly, by forcing entrepreneurs into the informal sector, survival in which most often involves bribes.

As the issue of business registration procedures and their effect on corruption levels is explored, the problem evolves into one of transaction costs—constraints on business beyond business registration, such as labour laws and enforcement of contracts. Simply put, when the costs of complying with official regulations exceed the benefits, companies will seek a more “efficient” resolution of the problem, thus institutionalizing corruption.

### Streamline business inspection procedures

One of the complications of the informal sector that also applies to the formal economy is that businesses are subject to frequent Government inspections. In many countries, the authority of the inspectors is so strong that they have the ability to shut down companies for a short period of time if they so much as suspect non-compliance with any one of many regulations, no matter how inconsequential. This forces business to give bribes, as being shut down even for a few days, especially for small entrepreneurs, can force companies out of business. Limiting the number of inspections and inspection agencies is also an important step in reducing corruption.

#### *Case example: Russia*

In Russia, for example, where inspections have become increasingly widespread in their scope and authority in recent years, anti-corruption efforts have yielded a regulation prohibiting Government inspectors from shutting down businesses for non-compliance with regulations; exceptions are made rarely.

### Reform procurement policies

Corrupt procurement processes are a cost to business and society as firms with insider contacts remain in business and the most efficient firms almost always are pushed to the sidelines. To combat corruption, especially at the top echelons, it is important to establish sound procurement codes that require open bidding and tenders. At the core of such codes are efforts to eliminate the discretionary power of Government officials in conducting bidding procedures, open up the bidding process and make it public, and fully disclose procedures and requirements.

#### *Case example: Brazil*

In the mid-1990s, the Liberal Institute of Rio de Janeiro (ILRJ) led a project titled “Reducing Transaction Costs in Brazil.” Through studies by its economists, ILRJ documented that the cumbersome bureaucracy and lack of transparency created high costs for business and lowered

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benefits for consumers. To address the problem, ILRJ proposed several reforms, seven of which were adopted by policymakers. The policies included: better dissemination of bidding rules, reduction of the discretionary power of bureaucrats, better definitions of decision-making authority, more competition among contract bidders, broader criteria for evaluating proposals and waiving bidding requirements only in urgent cases. As a result of the ILRJ project, significant legislative changes in Brazil were passed to reduce transaction costs. Perhaps the most important was the passage of a law to reduce the ability of bidders to collude and fix prices in the public contracting process. On the local level, similar efforts can be very effective in reducing corruption and paving the way for fair and transparent market transactions.

### *Case example: Colombia*

The Colombian Confederation of Chambers of Commerce (Confecámaras) in the late 1990s recognized that on paper Colombia had a sophisticated set of norms and instruments for detecting, controlling and punishing corrupt practices. However, these mechanisms were often not applied, partly because of fear of political backlash from entrenched, corrupt politicians. Confecámaras therefore attempted to put forth measures that would ensure application of anti-corruption initiatives on the supply-side of the equation—the private sector.

Confecámaras worked with local businesses to establish clear rules and codes of conduct in procurement processes and to demonstrate the benefits of compliance. With input from local business leaders, Confecámaras developed local ethical codes of conduct, to which over 1,000 businessmen voluntarily signed in the first year alone. To ensure transparency in public procurement, Confecámaras also proposed the development of integrity pacts. In the first year, a total of 12 integrity pacts were signed between local businesses and Governments, and the total value of the contracts that were signed under integrity pact requirements with the Manizales city mayor amounted to US\$1,039,200.

### Conclusion

Corruption is often viewed a social issue because definitions of corruption vary and what is perceived to be corruption in some countries could be a socially acceptable behaviour in others. Corruption is also frequently legitimized as a means of avoiding inefficient regulations and was even perceived as a contributor to economic growth in some countries, such as in Asia in the 1990s. But in reality, corruption creates inefficient and uncompetitive economic systems, imposes additional costs on business and threatens democratic institutions.

Corruption is not only a moral issue, it is also an economic one. Combating corruption, therefore, requires looking at the costs that it imposes on business, governments and society and instituting good governance mechanisms within both the public and the private sectors. Such mechanisms take away the opportunities for corruption and hold corrupt public officials and companies accountable for their actions.

As corruption is a problem of the private and public sectors, both sectors should implement anti-corruption measures. Simply blaming corruption on the other party, as is often done, does not solve the problem. Also, anti-corruption measures should not be focused on weeding out single corrupt individuals. Such measures merely deal with the symptoms of a larger problem. Instead, anti-corruption initiatives should address the root sources of corruption – inefficient institutions. Building a system of strong, balanced institutions reduces corruption by creating a set of reliable incentive structures, where compliance is not costly and corrupt behaviour is monitored and punished.

Initiatives to combat corruption should come from the private sector, as well as from Governments and civil society groups. Recognizing its role, the business community continues to mount successful efforts not only to reform external institutional structures, but also to build internal mechanisms to make corruption unsustainable within the private sector. The challenge in the coming years is to ensure that it is not only a handful of private sector organizations that actively participate in combating corruption. To reduce corruption, a widespread commitment by the private sector, regardless of size, industry and location is essential.