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THE NEXUS BETWEEN ECONOMIC RESILIENCE AND CORRUPTION

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Abstract.

This study attempts to explore the possible nexus between corruption and economic resilience, or lack of it. Towards this end, the paper discusses the definition and the effects of corruption, emphasising the theoretical link between economic resilience and corruption, and, ultimately, economic growth and development. Empirical evidence on the link between economic resilience and corruption, presented in the paper, indicate that they are negatively related, leading to the conclusion that countries that wish to improve their economic governance should develop appropriate policies and institutions to fight corruption.

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Introduction

Briguglio *et al.*, (2009) assert that countries highly exposed to economic shock, particularly small states, could withstand their economic vulnerability by building into their economic systems, policies that garner economic resilience. Indeed, resilience is seen as the obverse of vulnerability and, as the debate on economic vulnerability has evolved, scholars and global governance institutions, including the United Nations Conference on Trade and Development (UNCTAD, 2006), have agreed that strategies for building resilience include:

- · improving the competitiveness of the economy;
- · building a sound macroeconomic environment;
- · improving governance and knowledge systems at the national and global levels;
- · diversifying the economy to reduce excessive reliance on a narrow range of exports[1]; and,
- strengthening transportation and communications infrastructure.

Increasingly, economic resilience is being associated with a country's pursuit of an agenda based on good governance and institutional development. According to the literature on good governance (World Bank, 1989; 1997), corruption is seen as a by-product of poor governance and, as such, it has the ability to undermine, or even erode, the pursuit of sound economic policies. Moreover, some economists allege that corruption is not only an ethical issue but, its pervasive presence in a country could have a deleterious effect on that country's level of economic growth and development.

This study attempts to explore the possible nexus between corruption and economic resilience. The remainder of the paper is organised as follows. In Section 2, the effects of corruption are discussed. Section 3 presents the theoretical link between economic resilience, corruption, and, ultimately, economic growth and development. Section 4 presents some empirical results of the relationship between corruption and resilience. Some conclusions are presented in Section 5.

The Effects of Corruption

Corruption is popularly defined as the use of public office for private gain (Gray and Kaufmann, 1998) and, includes activities such as embezzlement, bribery, self-dealing, insider trading, and special interest legislation. According to Rose-Ackerman (1999: 75) corruption is the "abuse of power for private economic gain". However, private gain need not be pecuniary but, might include loyalty, power, or valuable information.

Munroe (2002: 272-273) has sought to broaden the conceptual framework from the abuse of public power to the "use of position whether formal office or otherwise for illicit benefit to secure advantage whether personally or for ones connections (political, family, business etc)." This includes civil society, non-governmental organizations and private

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1This, however, is not an easy task since there are major constraints with regard to diversification in SIDS. Principally because such diversification could lead to excessive fragmentation and loss of efficiency.

transnational corporations. From this broad definition, therefore, corruption ranges from a government's official submission to threats, and to appointing party activists to fill government posts.

This definition also accords with the definition proffered by Transparency International which states that corruption is the "misuse of entrusted power for private gain". Similarly, the Asian Development Bank (1998) argues that corruption "involves behaviour on the part of officials in the public and private sectors in which they improperly and unlawfully enrich themselves and/ or those close to them, or induce others to do so by misusing the positions in which they have been placed."

Whilst acknowledging that corruption exists in both the public and private sectors, (perhaps, as a result of the absence of demarcation between the sectors) most scholastic engagement on the issue has focused on public sector corruption, while the notion of ethics and corporate governance has emerged to address malfeasance on the part of corporate executives. For the researcher corruption is a demand and supply issue hence, the need to address "bribe-givers" with the equal force of the law that, we accord to "bribe-takers." The impact of corruption on societies and on the international community, on a whole, is mostly felt in the area of economic growth and development. The general consensus is that for developing countries to have a "fighting chance" to alleviate poverty reduce their dependence on aid and, finally, to be able to sustain themselves, they need to adopt principles of good governance (World Bank, 2001). [2]

It is sometimes argued that corruption had useful aspects such as assisting in capital formation, fostering entrepreneurial abilities and, allowing business interest to penetrate bureaucracy (Theobald, 1990). From recent studies, however, the overwhelming evidence suggests that the impact of the various forms of corruption is largely negative and, is a major obstacle to economic development (World Bank, 2001). Similarly, there is evidence that while corruption is a feature of all societies to varying degrees, countries with high levels of corruption usually experience poor economic performance and, the continual presence of corruption has a particularly devastating impact on the development progress, and good governance structures of developing countries (World Bank, 2001).

It is therefore, becoming clear that corruption can have a direct and indirect adverse effect on a country's level of development. Theobald (1990) outlines some of the ways in which corruption hinders the development of a country. According to the author, corruption reduces domestic investment and discourages foreign direct investment; and, it raises the costs of doing business.

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[2]
However, according to Arthur Lewis (1973) the harmful effects of corruption on economic growth can be gravely exaggerated. From a businessman's point of view, for example, "corruption is just a payment for service. Provided that the required bribes are reasonably small, having regard to the profit involved in the transaction to which they relate and, provided also that they can be foreseen when entering into contracts, they are just a form of costs like any other and they are passed on to the consumer in prices" (Lewis 1973: 409).

As such, it stifles entrepreneurship and, it can also affect the competitiveness of some firms. Similarly, corruption reduces administrative performance, capacity and efficiency, results in the misuse of scarce national resources, shifts government spending away from vital services such as, education, health and, infrastructure projects, towards less efficient activities. It undermines revenue collection capacity and contributes to fiscal weakness and macroeconomic difficulties. It also leads to an increase in informal or underground economic activities. Corruption also hinders political development and weakens good governance, which may contribute to serious political decay and undermine stability, democracy, and national integration.

Many international development agencies have placed a premium on the search for effective solutions to eradicate or minimise corruption. In its 1997 White Paper on "Eliminating World Poverty", the UK Department for International Development (DFID), proposed measures to build sound and accountable governments in cooperation with its partners, in a bid to help poor people to enjoy all known rights to the full.

The consequences of corruption as seen by DFID (1997) include the following:
- "The immediate impact on the poor people of higher prices and fewer employment opportunities due to the distortions that corruption can cause, while corrupt officials may demand payment for public services which are supposed to be free.
- The diversion of scarce budgetary resources away from poverty elimination into unproductive expenditure or into the repayment of debts accumulated because of corrupt activities, as well as the loss of tax and customs revenues.
- The indirect economic impact that constrains economic growth by increasing the uncertainty and unpredictability of costs to prospective investors.
- The indirect political impact that reduces poor people's representation as elites cling to power in order to exploit opportunities for corruption" (Cm 3789: 30).

Corruption is also thought to reduce the effectiveness of Overseas Development Assistance and this is especially important for SIDS, which tend to be highly dependent on aid from developed nations, especially former colonising powers (Boone, 1996; Svensson, 2000; Gong and Zou, 2001). Whilst aid donors are aware that aid flows have a greater impact upon those countries that have good institutions (Kaufmann *et al.,* 2006), aid continues to flow to those countries where corruption is rampant. Indeed, it has been argued that aid may increase the incidence of corruption (Alesina and Weder, 2002). This has been attributed to the fact that many governments have not been duly punished for their dishonesty and, donors are not necessarily influenced by a country's level of corruption when making lending decisions. Instead, some of these financial decisions are based more on the strategic location of certain states, as well as the presence and availability of natural resources, than on the country's level of corruption.

Corruption and Economic Resilience

Corruption can undermine a country's level of economic resilience by thwarting national efforts aimed at institution building for the purpose of good governance. While states may engage in additive institutional design to combat corruption these efforts are

neutralised by the effects of corruption. Citizens and international donors are distrustful of states with low good governance indices and scores, business interests are less likely to invest where the "rules of the game" can be ignored and outcomes cannot be predicted. In order to build resilience, SIDS has to implement policies that mitigate this pervasive vulnerability. This can be done through the adoption of prudent governance practices and, the implementation of a stringent economic management regime.

There are two main schools of thought on the nexus between corruption and economic development. On the one hand, the efficiency enhancing school, associated with authors such as Lewis (1963), Huntington (1968) and Nye (1967), contend that corruption may "grease the wheel" of business and commerce and, facilitate economic growth and investment. Corruption can, therefore, increase efficiency in an economy; the cost of which is factored into a firm's costs of production, just like any other cost of production. On the other hand, contemporary development theorists posit that corruption inhibits private investment and growth, distorts public investment, subverts the merit principle, and rewards those who do not play by the rules. Thus, contributing to the deterioration of sustainable livelihoods in a country, especially among the poor (Waller *et al.,* 2006: i). This school of thought proposes that corruption reduces efficiency.

The efficiency reducing argument was advanced by McMullan (1961), Krueger (1974), Myrdal (1968), Shleifer and Vishny (1994), Tanzi and Davoodi (1997), amongst others. This argument can be synthesised as follows:
- Corruption tends to increase the size of public investment at the expense
of private investment;
- Corruption skews the composition of public expenditure away from the maintenance of current operations towards expenditure on new equipment;
- Corruption skews the composition of public expenditure away from human capital (health and education) towards other public projects from which rents can be extracted with relative ease;
- Corruption may reduce tax revenues because it compromises a government's ability to collect taxes and tariffs, though the net effect depends on how the nominal tax and other regulatory burdens are chosen by corruption prone officials.

Based on research by Fishman cited by Wei (2001), perceptions of corruption also have an impact on the financial system and currency crises. Wei and Seivers (1999), using data from the Global Competitiveness Report, identify an association between weak regulatory institutions and corruption, and vulnerability. They further contend that more corrupt countries have volatile stock returns, a higher level of insider trading and, smaller capital markets. The confidence, or lack thereof, in public statistics is also an indication that the public sector is viewed as corrupt.

According to Mauro (1995) there is very little empirical evidence of the "wheel greasing phenomenon proposed by the efficiency enhancing school. In addition, Ades and Di Tella (1997) conclude that corruption does not have a negative impact on the growth rates of countries, who are significantly encumbered with bureaucratic red tape.

In an effort to explain the failure of some countries to achieve economic growth and development, Finnie *et al.,* (2006), explore the triad of corruption, individualism, and economic development. From their research they conclude that countries with high levels of individualism also have low levels of corruption and high levels of growth. While their paper extols the virtues of neo-liberal creed—free trade, moderate government, individualism, and property rights—it is useful in exploring some of the cultural factors that impact on economic development and the links between corruption, economic resilience and, ultimately, economic growth and development. They argue, *inter alia,* that the level of corruption is inversely related to levels of wealth, democracy, freedom, and ownership that exist in a country. In addition, according to Briguglio *et al.,* (2009) governance is a key indicator of economic resilience.

The aforementioned literature roughly reflects the dominant position taken by both the academic and the wider epistemic communities on corruption and its impact on economic resilience.

Empirical evidence

In this section, we empirically investigate the connection between the resilience index developed by Briguglio *et al.,* (2009) and corruption. To measure corruption we utilize the Corruption Perception Index (CPI)[3] which measures the perceptions of the degree of corruption as seen by business people and country analysts, and ranges between 10 (highly clean) and 0 (highly corrupt).

We use both scatter graphs and simple regression analysis to try to determine the existence of any associations that could exist between the CPI and economic resilience.

The Resilience Index

The index produced by Briguglio *et al.,* (2009) was based on the hypothesis that the variables that enable a country to build its economic resilience are the following:
- Economic factors: measured by macroeconomic stability and market efficiency;
- Socio-political factors: measured by good political governance and social development.

*Macro-economic stability.*According to Briguglio *et al.,* (2009) macroeconomic stability is conducive to economic resilience as it relates to the interaction between an economy's aggregate demand and aggregate supply. If aggregate expenditure in an economy moves in equilibrium with aggregate supply, the economy would be characterised by internal balance, as manifested in a sustainable fiscal position, low price inflation and an unemployment rate close to the natural rate, as well as by external balance, as reflected by the level of government debt. These can be considered to be variables which are highly influenced by economic policy. Briguglio *et al.,* (2009) propose that the

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macroeconomic stability component of resilience can be measured by three variables, namely (i) the fiscal deficit-to-GDP ratio; (ii) the sum of the unemployment and inflation rates; and (iii) the debt-to-GDP ratio. Briguglio *et al.*, argued that these variables are related to the room for manoeuvre that the government would have in counteracting shocks. For example, if an economy already has high levels of debt and unemployment it is likely that adverse shocks would impose significant costs on it. If, on the other hand, the economy has low levels of debt and unemployment, then it can withstand adverse shocks to these variables without excessive welfare costs. In this sense, therefore, debt and inflation are associated with resilience [4]

Market efficiency. Briguglio *et al.*, further argued that if markets adjust rapidly to achieve equilibrium following an external shock, the risk of being negatively affected by such a shock will be lower than if market disequilibria persist. Indeed, with very slow or non-existent market adjustment, resources will not be efficiently allocated in the economy, resulting in welfare costs, manifested, for instance, in unemployed resources and waste or shortages in the goods markets. These considerations have important implications for shock-absorbing resilience. Following a search for suitable indicators, Briguglio *et al.*, decided to use a component of the Economic Freedom of the World Index entitled 'regulation of credit, labour and business' which is aimed at measuring the extent to which markets operate freely, competitively and efficiently across countries. The index is designed to identify the effect of regulatory restraints and bureaucratic procedures on competition and the operation of markets. Bureaucratic control of business activities tends to inhibit market efficiency as it limits competition and the operation of markets. This occurs, for example, when such activities retard entry into business or when prices are determined by dictat thereby discouraging private sector involvement. These actions impede the adjustment market to absorb shocks. Similar considerations apply in the case of the labour market. Here interference relates to unduly high unemployment benefits (which could undermine the incentive to accept employment), excessive restrictions in dismissal regulations, minimum wage impositions, centralised wage setting and conscription. All these could preclude work effort, thereby limiting the ability of a country to recover from adverse shocks.

Socio-political factors. Briguglio *et al.*, argue that good political governance is essential for an economic system to function properly and hence to be resilient. Good governance is associated with issues such as rule of law and property rights. Without mechanisms of this kind in place, it may be relatively easy for adverse shocks to result in economic and social chaos and unrest.

Hence the effects of vulnerability to external shocks would be exacerbated. There are various indicators of political governance, including that produced by the World Bank. Briguglio *et al.*, also argued that social development indicates the extent to which

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[4] Briguglio *et al.*, recognised that certain countries may have external debt not because of a weak policy framework but because of highly developed international financial activity. This is a weakness in the use of this indicator. However, the inclusion of other variables related to market efficiency and governance, to an extent, "corrected" this weakness, as these variables either exacerbate the effect of external debt in the presence of a weak policy framework or counteract it otherwise.

relations within a society are properly developed, enabling an effective functioning of the economic apparatus without the hindrance of civil unrest. Social development can also indicate the extent to which effective social dialogue takes place in an economy which, in turn, would enable collaborative approaches towards the undertaking of corrective measures in the face of adverse shocks. Briguglio et al. propose that the social development component of economic resilience can be measured by education and health indicators utilised to construct the UNDP Human Development Index (HDI).

The Corruption Perception Index

The Corruption Perception Index (CPI) 2010 is an aggregate indicator that brings together data from sources that cover 2009 and 2010. The 2010 CPI is calculated using data from 13 sources by 10 independent institutions. All sources measure the overall extent of corruption (frequency and/or size of bribes) in the public and political sectors, and all sources provide a ranking of countries, i.e. include an assessment of multiple countries.

Figure 1
The Relationship between the CPI and the Economic Resilience Index

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Source: Data is available in the Appendix
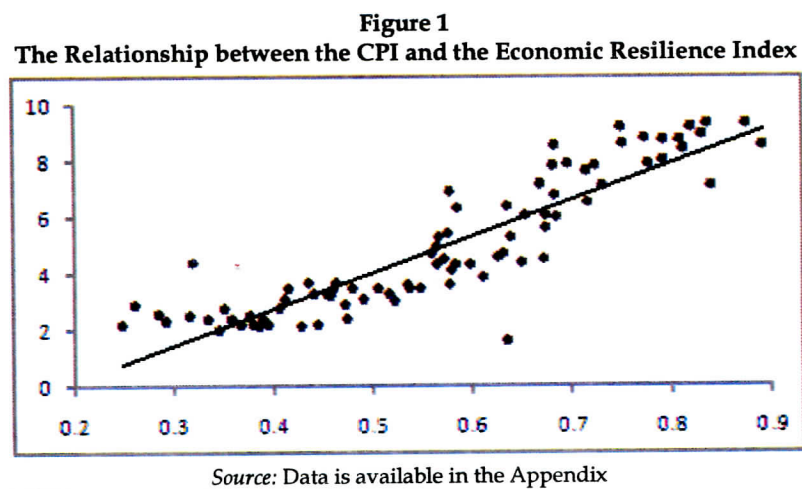
Evaluation of the extent of corruption in countries/territories is done by two groups: country experts, both residents and non-residents, and business leaders.

The first step to calculate the CPI is to standardise the data provided by the individual sources (that is, translate them into a common scale). The authors use what is called a matching percentiles technique that takes the ranks of countries reported by each individual source. This method is useful for combining sources that have different distributions. All reported scores to remain within the bounds of between 0 and 10.

The second step consists of performing what is called a beta-transformation on the standardised scores. This increases the standard deviation among all countries included in the CPI and makes it possible to differentiate more precisely countries that appear to have similar scores.

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The relation between the ERI and the CPI

Figure 1 shows that, as hypothesised above, there is a clear positive relationship between the Economic Resilience Index and the Corruption Perception Index. The correlation between the two variables is high (R2=0.8) as can be seen from the scatter diagram shown as Figure 1.

Conclusions

This paper attempted to investigate the possible links between corruption and economic resilience. We based our investigations on two main bodies of literature: firstly, the theoretical perspectives of the efficiency reducing and the efficiency enhancing schools of thought; both of whom, are interested in the significance of corruption on a country's level of economic resilience and, in turn, its economic growth and development path. Secondly, we discussed the individualists and structuralists perspectives on corruption such as, definitions, relevance and, the purported influence of corruption on the economic system of a modern society.

We carried out an empirical investigation, by correlation of economic resilience, developed by Briguglio *et al.,* (2009) with the Corruption Perception Index, developed by Transparency International. The implications of the results are that countries that are resilient tend to be less corrupt. Briguglio *et al.,* (2009) have also shown that the resilience index is also correlated with GDP per capita, and this suggests that GDP per capita is also correlated with the CPI. This does not settle the question as to whether Economic resilience and GDP per capita lead to a reduction of corruption or vice versa, that is whether lack of corruption leads to resilience. However, going by the arguments presented above, lack of corruption would seem to be the cause and not the result of economic resilience.

The major conclusion of this paper is that corruption negatively influences economic resilience. An extension of this argument is that institutions must be put in place to enable governments and stakeholders to take proactive action to reduce the incidence of corruption, as argued by Osei (2007) in the case of Jamaica.

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Appendix

Country	Resilience Index	Corruption Perception Index	Country	Resilience Index	Corruption Perception Index
Albania	0.453	3.3	Malaysia	0.649	4.4
Argentina	0.472	2.9	Malta	0.674	5.6
Australia	0.808	8.7	Mauritius	0.575	5.4
Austria	0.777	7.9	Kuwait	0.672	4.5
Bangladesh	0.334	2.4	Latvia	0.598	4.3
Barbados	0.724	7.8	Lithuania	0.564	5.0
Belgium	0.729	7.1	Luxembourg	0.682	8.5
Bolivia	0.405	2.8	Madagascar	0.285	2.6
Brazil	0.436	3.7	Malaysia	0.649	4.4
Cameroon	0.368	2.2	Malta	0.674	5.6
Canada	0.829	8.9	Mauritius	0.575	5.4
Chile	0.667	7.2	Mexico	0.490	3.1
China	0.480	3.5	Morocco	0.460	3.4
Colombia	0.416	3.5	Nepal	0.380	2.2
Costa Rica	0.639	5.3	Netherlands	0.772	8.8
Cote d'Ivoire	0.246	2.2	New Zealand	0.874	9.3
Croatia	0.579	4.1	Nicaragua	0.316	2.5
Cyprus	0.585	6.3	Nigeria	0.358	2.4
Czech Republic	0.626	4.6	Norway	0.750	8.6
Denmark	0.836	9.3	Pakistan	0.291	2.3
Dominican Rep.	0.521	3.0	Panama	0.577	3.6
Egypt, Arab Rep.	0.412	3.1	Papua New	0.386	2.1

El Salvador	0.534	3.6	Paraguay	0.395	2.2
Estonia	0.716	6.5	Peru	0.506	3.5
Finland	0.819	9.2	Philippines	0.474	2.4
France	0.681	6.8	Poland	0.567	5.3
Germany	0.695	7.9	Portugal	0.684	6.0
Greece	0.536	3.5	Romania	0.463	3.7
Honduras	0.389	2.4	Russian	0.427	2.1
Hong Kong,	0.811	8.4	Senegal	0.260	2.9
Hungary	0.630	4.7	Singapore	0.874	9.3
Iceland	0.890	8.5	Slovak	0.564	4.3
India	0.440	3.3	Slovenia	0.634	6.4
Indonesia	0.350	2.8	South Africa	0.571	4.5
Iran, Islamic Rep.	0.445	2.2	Spain	0.673	6.1
Ireland	0.790	8.0	Sri Lanka	0.458	3.2
Israel	0.652	6.1	Sweden	0.749	9.2
Italy	0.610	3.9	Switzerland	0.791	8.7
Jamaica	0.517	3.3	Thailand	0.547	3.5
Japan	0.681	7.8	Trinidad	0.635	1.6
Jordan	0.558	4.7	Tunisia	0.582	4.3
Kenya	0.385	2.1	Turkey	0.320	4.4
Kuwait	0.672	4.5	Uganda	0.377	2.5
Latvia	0.598	4.3	UK	0.714	7.6
Lithuania	0.564	5.0	USA	0.839	7.1
Luxembourg	0.682	8.5	Uruguay	0.577	6.9
Madagascar	0.285	2.6	Venezuela, RB	0.345	2.0

Source: The Resilience Index is sourced from Briuglio *et al.,* (2009) and the Corruption Perception Index is sourced from Transparency International (2010)