The Effects of Corruption on Economic Development

Mahmoud Moustafa
info@tamimi.com

Effects of Corruption & Importance of Combating Corruption

On the 28th of April 2004 Mr. Daniel Kaufmann (Global Governance Director of the World Bank Institute) – commenting on the costs of corruption- stated that: “a conservative approach to such measurement gives an estimate for annual worldwide bribery of about US 1 trillion dollars.”[1]

Corruption can take many forms that vary in degree from the minor use of influence to institutionalized bribery. Transparency International’s definition of corruption is: “the abuse of entrusted power for private gain”. This can mean not only financial gain but also non-financial advantages.[2]

Definition of Corruption

The definition of corruption and how much money it involves is not a particularly challenging notion to tackle. This paper, rather, brings to the attention of the reader the economic importance of combating corruption. The aim is to show the reader:

1. the role law plays in economic development,
2. the negative effects of income inequality on sustainable economic development and importance of redistribution on grounds of the Marginal Utility theory
3. redistribution as the most effective method of eradicating poverty
4. the negative effects of low approval ratings (unhappiness) on sustainable economic development and
5. the negative effects of corruption on redistribution as well as approval ratings and consequently on sustainable economic development.

The argument simply put is as follows:

1. empirical studies show that countries with a better redistribution of wealth enjoy longer periods of economic development.
2. Redistribution of wealth is justified by the idea that if utility is the building block of economic policy then redistribution of wealth is a favourable on the grounds that it brings upon well being to the greatest possible number of people (since the poor’s benefit is much greater than the rich’s loss out of the redistribution process).
3. Redistribution (based on the idea of Marginal Utility) should only limited by the idea of Efficiency Cost (when it robs production from individual incentive)[3]
4. Countries suffering from corruption cannot implement sound redistributional policies and thus are not expected to take benefit from sustainable economic development despite embarking upon economic growth from time to time for some reason or the other.

The argument, simply put, as well, has it that empirical studies show that countries with higher approval ratings (happiness index) enjoy longer periods of economic development. Countries suffering from corruption have low approval ratings because of the public's frustration of their legitimate expectations, impressions of unfair treatments, expectations of unequal treatment which impose a great risk on individual incentive to produce (Efficiency Cost).

Whereas some would differentiate between bad and good corruption arguing that only corruption[4] which is associated with poor institutions has a negative effect on GDP growth whilst residual corruption (corruption which is uncorrelated with other governance characteristics) is positively related to GDP growth with poor institutions. This line of thought has it that an analysis of financial data is positively correlated with capital accumulation and productivity growth in developing countries and that these empirical findings are consistent with the theory that corruption helps overcome inefficient barriers.

This article argues that all forms of corruption are intrinsically bad (from an economic point of view) justifying the contemporary global practice of combating corruption.

The paper will show how corruption, if left unchallenged, undermines a country's attempts to:

1. fight poverty and inequality (redistribution of wealth)
2. increase approval ratings (happiness index)
3. consequently, engage in sustainable development. The paper attempts to do so by reflecting upon the role of law in economic development as well as shedding some light on current economic development policies and how paramount combating corruption features in them.

It is worth mentioning in this regard that the United Arab Emirates legal market takes benefit from the presence of Al Tamimi & Company's Financial Crime practice, which is the only specialized team of experts in the field of combating corruption in any regional Arab law firm.

Law and economic development

The role of law in development is obscure. Some see law as a transcendental notion of applied justice that has nothing to do with politics, morality and the distribution of wealth. Others see certain types of legal regimes as the environment that fosters and nourishes development. Others recognized the social effects of legalism, its political aspects and distributive function.

In this part we will explore these different roles attributed to law in the field of development.

i. Formalism

The formalists believed deduction of law to be a logical science. There could only be one legally right answer to a certain disputable fact. Law is coherent and has answers to every controversy. Law is detached from politics, morality, religion and society. It thus, according to this theory, has nothing to do with economic development because legalism entails no political decisionism, and exhibits no distributive effects. It is rather the product of impeccable logical deduction from transcendental notions existing supra-society.

The role of the state is to preserve private autonomy, keeping each individual as an absolute lord within his dominion (compartment) of private rights and liberties.

Weberianism

Some saw in the abovementioned legal arrangements the pretext of economic development.[6] Law as a rational science separated from politics, religion, being man-made, universally applied, and disputes decided by general rules, [7] essential for developing science, human activities, and entrepreneurship.

Other societies which have no such legal doctrine could not develop specifically because they don't have such laws.

The difference between this line of thought and the previous is that the "Law as pretext" acknowledges Formal legalism as the inevitable institutional infrastructure for development, whereas Formalists did not.

Two attributes of logically formal rationality legalism are highly praised. First, its relative degree of calculability, second its capacity to develop substantive provisions, principally those relating to freedom of contract necessary to the functioning of the market system. [7]

ii. Realism

The Realists' breakthrough is the critique they presented to the foundations of Formalism. Law derivation is not a science, it is not coherent, and it does not embody answers to all. Cases are decided on its facts not legal doctrine.[8] Adjudication[9] in essence is not deductive logic; it is rather judicial/political decision-making.

They also recognized the distributive function of legalism.[10] Each legal rule renders comparative advantage to the party it favours. In each situation, parties use the available legal norms to twist the counterparty's arms in order to receive as much as possible of the outcome of the bargained deal. [11] Foucault's Power Relations theory entertains a highly praised position in their literature in addition to Hobbes state of nature.

Chronological note on economic development

Development as a field of study became the major concern of the post-Second World War international order. It starts off with two presumed hypotheses:

1. The problematization of poverty,[13] meaning that even if we don't view securing the well-being of individuals as the function of the state, the state from a pragmatic[14] point of view has to address poverty because of its negative social effects.
2. The importance of industrialization and technology.

In this coming section, I will briefly account the line of thought of the Modernization theorists, the Dependency theorists and the Neo-liberal theorists as follows. This should give the reader an idea of the current state of affairs in economic policy and where does our contemporary global practice of combating corruption come from and where it fits.

i. Modernization theorists

They are influenced by the Weberian[15] social theory.

The pillars of their line of thought are: anti-traditionalism (in both its material and psychological sense),[15] and an emphasis on the role of the state and that every man is derived from his own economic self interest.[17]

According to Modernization theorists, the problem with underdevelopment is that underdeveloped societies are traditional whereas developed societies are modern.[17] They are modern in their means of production[18] and their value systems.[19]

For a society to develop it has to shift from a “traditional society” to a more rational/material/modern one. It also has to transform its means of production to industrialization and technology.[20] The role of the state is crucial because it is the state that will impose that shift. They believe that once the state sets the conditions of the shift people will change on their own in pursuit of their economic best interests and hence development inevitably occurs.[21]

They further suggested several approaches to introduce modernity to society. First the “Big Push” theory,[22] where the state will choose certain strategic projects and will use large scale industries in these projects to give momentum to the whole modernization process. Second the “Balanced growth” theory[24], where the state will use technological/industrial means in diverse sectors to create the momentum, coupled with decreasing its exports. Third is the “Unbalanced Growth” theory,[24] where the state creates inbalance within sectors to create forward and backward linkages[25] between industries.

ii. Dependency theorists

They are influenced by Marxian ideology.[26] They have a strong connection with the national/political independence movements in the third world.

The pillar of their line of thought is the exploitation of underdeveloped societies by developed societies and the causal link between being exploited and being underdeveloped.

For them the key is to de-link underdeveloped societies from developed societies and cut the vicious circle of exploitation. Unlike the Modernists, to them underdevelopment is not the attribute of underdeveloped societies (internal), but it is rather imposed by the developed via exploitation (external)[27] and dominance.[28] Dependency is thus the economic antidote of economic imperialism. [29]

A dependent society is one that depends upon other societies for its accumulation of capital (funds, new technology, machinery, equipment of the production of capital goods and enterprise expansion).[30]

Their major contribution to the realm of development theory is their Import Substitution Industrialization (self reliance) policy (ISI).[31] The rationale behind the ISI ideology was to obtain self sufficiency via national industries. [32]

iii. Neo-liberal theorists

They are influenced by Adam Smith’s line of thought. The pillars of their theory are the diminished role of the state, private autonomy, and the emphasis on providing the best set of rules and conditions for market forces to function with the greatest liberty possible. The supporters of this school of thought (Ayn Rand, Alan Greenspan) were influential in our contemporary social order. Rand’s theory of Objectivist epistemology is a manifestation of the abstractions of the Neo-liberal ideologies.

Neo-liberalists call for privatization of all means of production,[33] free trade, free capital flows, free direct foreign investment and free immigration and movement of labour. [34] The role of the state is restricted in providing basic services such as education, infrastructure, health care[35] and providing for best practices for the well functioning of the free market economy. [36] This stems from the idea that state intervention and public spending in the functioning of the economy is non-productive and impairs societal economic growth [c] because the market itself is the most efficient mechanism for allocating its resources.[38]

iv. 2nd generation reforms or the post Washington consensus:

The development field today came as a reaction to the failure of the Neo-liberal theories. Underdeveloped countries that adopted the Neo-liberal strategies remained underdeveloped.

Though Washington Consensus comes from the same economic background (free market economy) as that of the Neo-liberal movement, the concern now is with the necessary social infrastructure for a functioning/developing free market economy.

To seek unrestrained personal interests whilst sharing the very same limited resources with other human beings (who in their turn are also seeking unrestrained personal interests) is deeply conflicted. Some sort of organization/compromise must exist to sustain our existence (collective consciousness) [39]. Both social order as well as political power our products of social necessity. [40]

Understanding that government was organically invented to serve a social need[41] helps us attribute, consequentially, a purpose of governance and a criteria of judging the legitimacy of its exercise; the Greatest Happiness Principle[42].

Legislation seeks to realize the greatest possible happiness (all things considered) of the greatest number of citizens (Rule Utilitarianism-Act Utilitarianism).[43]

Redistribution of wealth (taxation etc.) is only legitimate if and only if such limitation of individual rights is necessary for the welfare of society[44] (by application of the Marginal Utility Principle) and should stop when it starts to become counterproductive (Efficiency Cost). The sole reliance on human endeavours to determine the Greatest Happiness Principle[45] is almost a practical impossibility[46]. That is why we rely on the idea of Marginal Utility. The idea is that the benefit a $ 100 brings to a single unemployed mother is much greater than that it contributes to the well being of a well-to-do business person. Imagine that a person is stranded in the desert and is dying of thirst. The added value of the first drink of water you offer him/her is priceless. But then this “added value” attributed to drinks diminishes the more he/she consumes what you offer. Same concept applies to money, goods and services. The idea of Marginal Utility is conceptualized. When applied in political economy it means that governments will take from the better doing and give to the less fortunate because economic policy is all about utility (added value). And utility is maximized whenever the greatest number of people benefit from it. The challenge is to balance social well-fare policies so as not to discourage productivity by robbing people of any individual incentive to produce (Efficiency Cost).

Contemporary development theories[47] would have it that in order for a given economy to flourish there should be a pre-existing social/legal/human order. For a free market economy to function a certain legislative infrastructure should pre-exist.[48] This theory of Development holds law at the very front of its battles.[49] Law is not just a fostering environment for development;[50] it is the most important tool[51] for redistribution of power and wealth.[52]

Human development is at the core of concerns of the development field today.[53] To have a developing free-market economy, they believe, it is crucial to remove all forms of constraints to human freedoms, both political and civil. [54] They are concerned with Human Rights issues. They call for democracy, independent civil societies [55] independent state institutions,[56] better law enforcement, market-friendly legislations, free trade, free transfer of funds, free transfer of labour, and more direct foreign investments. They preach and stress upon the combat of corruption, international crime and money laundry. They demand for gender equality. They emphasize on informal norms as a source of best practices.[57] They stress on the importance of formalization of all society’s assets.[58]

The players of the development field today are no longer just the governments and metaphysical market forces. In addition to the government and the market forces we have organizations such as the World Bank, the International Monetary Fund, the International Financial Institutions, International and National non-governmental organizations, civil society, in addition to pressure groups and businessmen. [59] Public awareness and pro-activity is also highly praised in today’s development field. [60]

Adopting GDP and/or per-capita income as signs of economic health and no longer trusted. Trusting in the invisible hand of the market and its Trickling Down Theory to achieve social as well as economic stability is no longer considered prudent. Recognizing the drawbacks of consumption economics[61] economists now prefers to target perfect equality, transparency and stability in any given society. To measure this they usually apply, amongst other things, the Gini Coefficient[62] which measures the extent of inequality in income distribution in a given country. By measuring income inequality (not wealth inequality) it distinguishes itself from being a Marxist ideology. Also by excluding non-cash social benefit from the calculation (welfare provision through public services is ignored) it enables governments create a sort of social balance and economic stability by restoring the inequalities in income distribution by providing subsidized goods and services and thus creating a society wherein individuals are equally empowered (no one is suffering poverty) but not all are necessarily equally wealthy.

The Development field witnessed a further step forward by the work of Amartya Sen. [63] His contribution comes as an addition to the 2nd generation reforms in view of the role of human infrastructure. Typically all the previous developmental theorists would evaluate the development of a given society by means of fiscal measures. However, Professor Sen asserts that this is not immune to critique. He illustrates that the actual end of development is not to achieve financial welfare but rather to promote human well-being.

Conclusion

One concludes, according to the above, that law plays a major role in development.

Research shows that a society with less income inequality (better redistribution) almost always enjoys more frequent and longer periods of economic growth (sustainable development). [64]

Research also shows that a society with a higher happiness index (approval ratings) almost always enjoys more frequent and longer periods of economic growth (sustainable development). [65]

It almost goes without saying that corruption is futile to any effective redistribution scheme a government is undertaking. It also goes without saying that corruption frustrates people and leave them disproving of their institutions. Both things mean that a society with corruption can not possibly enjoy leaps and bounds of sustainable economic growth and development.

Corruption is now recognized to be one of the world’s greatest challenges. It is a major hindrance to sustainable development, with a disproportionate impact on poor communities and is corrosive on the very fabric of society.

The impact on the private sector is also considerable, it impedes economic growth, distorts competition and requests serious legal and reputational risks. Corruption is also very costly for business, with the extra financial burden estimated to add 10 % or more to the costs of doing business in many parts of the world.

The rapid development of rules of corporate governance around the world is also prompting companies to focus on anti-corruption measures as part of their mechanisms to protect their reputations and the interests of their shareholders. Their internal controls are increasingly being extended to a range of ethics and integrity issues and a growing number of investment managers are looking to these controls as evidence that the companies undertake good business practice and are well managed.

The international legal fight against corruption has gained momentum in more recent times through the Organization for Economic Cooperation and Development (OECD) 1997 Convention on Combating Bribery of Foreign Public Officials in International Business Transactions[66] and through the entering into force of the first globally agreed instrument; the United Nations Convention Against Corruption (UNCAC) – adopted in Merida, Mexico in December 2003- on the 14th of December 2005.[67] The Arab Convention Against Corruption was signed by both the ministers of interior affairs and ministers of justice of all state members of the Arab League (save for Somalia) on the 21st of December 2010.

On the 24th of June 2004 during the United Nations Global Compact Leaders Summit it was announced that the UN Global Compact henceforth includes a tenth principle against corruption. The Principle reads as follows: “businesses should work against corruption in all its forms, including extortion and bribery.” This was adopted after extensive consultations and all participants yielded overwhelming expressions of support, sending a strong worldwide signal that the private sector shares responsibility for the challenges of eliminating corruption. It also demonstrated a new willingness in the business community to play its part in the fight against corruption.

The UNCAC is the underlying legal instrument for the 10th Principle against corruption.

The adoption of the 10th Principle commits UN Global Compact participants not only to avoid bribery, extortion and other forms of corruption but also to develop policies and concrete programs to address corruption. Companies are challenged to join governments, UN agencies and civil society to realize a more transparent global economy. [68]

Legal practitioners specializing in the field of combating corruption not only work in an ever-developing exciting field but also play an important role in the upkeep of global economy.

Footnotes

1. For further details, please see: "the costs of corruption" under feature stories, press releases – news- on the World Bank website.
2. See further: www.transparency.org
3. Andrew G. Berg and Jonothan D. Ostry, "Equality and efficiency", Finance and Development, IMF, 2011.
4. Maxim Mironov, "Bad corruption, good corruption and growth", Graduate School of Business, University of Chicago, November 14th 2005.
5. David M. Trubek, "Max Weber on law and the rise of Capitalism", p. 722.
6. Id. P. 724.
7. David M. Trubek, "Max Weber on law and the rise of Capitalism", p. 740.
8. Joseph William Singer, "Legal Realism now", p. 469.
9. See further on adjudication: "A critique of adjudication", Duncan Kennedy, Harvard University Press, 1999. And "Hard Cases", Ronald Dworkin, HeinOnline, 88 Harv. L. Rev. 1057 (1974-1975).
10. For further account of such effect see further: "Why the "Haves" come out ahead: Speculations on the limits of legal change", Marc Galanter, Law and Society Review. Vol. 9, No. 1, (1974).
11. David Kenedy, "The stakes of law, or Hale and Foucault", p. 327.
12. Arturo Escobar, "Encountering development: The making and unmaking of the third world", p. 44.
13. William James, "Pragmatism" Dover Publications Inc. 1995 p. 18.
14. Max Weber, "Economy and society: An outline of interpretive sociology", University of California Press, 4th ED. 1978.
15. Myron Weiner, "Modernization: The dynamics of growth", p. 3.
16. Id. P. 11.
17. W. W. Rostow, "The stages of economic growth", P.4.
18. Arturo Escobar, "Encountering development: The making and unmaking of the third world", p. 39, 40.
19. Myron Weiner, "Modernization: The dynamics of growth", p. 5.
20. Arturo Escobar, "Encountering development: The making and unmaking of the third world", p. 39, 40.
21. Myron Weiner, "Modernization: The dynamics of growth", P. 9, 10.
22. James M. Cipher and James L. Diety, "The process of economic development", p. 137.
23. Id. P. 140.
24. Id. P. 143.
25. Id. P. 144.
26. The Material Dialect. The residues of Hegel is apparent in their line of thought.
27. Henrique Cardoso and Enzo Faletto, "Dependency and development in Latin America", p. viii.
28. Id. P. xxii.
29. Id. P. xv.
30. Id. P. xxi.
31. Gilbert Rist, "Self reliance: The communal past as a model for the future", p. 123.
32. Albert Hirschman, "The political economy of Import Substituting Industrialization in Latin America",

p.4.

33. Jardish Bhagwati, “Economic freedom: Prosperity and social progress” (page not included).
34. Id.
35. Kerry Rittich, “Recharacterizing restructuring law distribution and gender in market reform”, p. 29.
36. Id. P. 30.
37. Id. P. 30.
38. Id. P. 115.
39. On the topic of interdependence (mechanical and organic solidarities), please see further: “De la division du travail social” – The division of labor in society, 1893, Emile Durkheim.
40. More on the topic please see: “Droit constitutionnel et institutions politiques” – Constitutional law and political institutions, 1972, Andre Hauriou.
41. More on the topic of public service please see further: “l’etat, les gouvernants et les agents”- The state, governments and agents, 1903, Leon Duguit.
42. More on the theory of the Greatest Happiness Principle please see further: “Utilitarianism”, 1863, John Stuart Mill.
43. Please see on the Utilitarian exercise of political power/legislation: “The principles of morals and legislation”, 1781, Jeremy Bentham.
44. Please see further: “L’etat, le droit objectif et la loi positive” – The state, objective rights and positivist law, Leon Duguit.
45. On the transformation from the Theological to the Metaphysical to the Positivist, please see further: “The course in Positive Philosophy”, 1830-1842, Auguste Comte. See also: “A general view of Positivism”, 1844, Auguste Comte.
46. On the impracticality of identifying the Greatest Happiness choice, please see further: “Darwin’s dangerous idea”, 1995, Daniel Dennett.
47. Post Neo-Liberal also known as the 2nd generation reforms..
48. See further: David Schneiderman, “Constitutional approaches to privatization: An inquiry into the magnitude of Neo-Liberal Constitutionalism”, (2000) 63 Law and Contemporary Problems.
49. Kerry Rittich, “The future of law and development: Second generation reforms and the incorporation of the social”.
50. Max Weber, Economy and Society: An outline of interpretive sociology”, University of California Press, 4th ED. 1978. See also David M. Trubek, “Max Weber on law and the rise of Capitalism”.
51. Joseph William Singer, “Legal Realism now”.
52. David Kenedy, “The stakes of law, or Hale and Foucault”.
53. Kerry Rittich, “The future of law and development: Second generation reforms and the incorporation of the social”, p. 200.
54. Amartya Sen, “Development as freedom”, Oxford University Press, 1999, p.35.
55. Carlos Solinas de Gortari and Roberto Mangabeira Unger, “The market turn without Neoliberalism”, p. 17.
56. Roberto Mangabeira Unger, “The really new Bretton woods”, p. 17.
57. Kerry Rittich, “ The future of law and development: Second generation reforms and the incorporation of the social”, p. 220.
58. Hernando de Soto, “The mystery of capital”, p. 30.
59. Kerry Rittich, “The future of law and development: Second generation reforms and the incorporation of the social”, p. 218.
60. Id. P. 219.
61. See further on this: E. Misham’s “The costs of economic growth”, E.F. Schumacher’s “Small is beautiful”, and Herbert Marcuse’s “One dimensional man”.
62. Corrado Gini, “variabilita e mutabilita”, Jounral of the Royal Statistical Society, Vol. 76, No. 3, February 1913, PP. 326. Variability and Mutability by Corrado Gini.
63. Professor of Economics at Harvard University and Noble Prize for economics award winner.
64. See further: Andrew G. Berg and Jonathan D. Ostry, “Inequality and unsustainable growth: two sides of the same coin?”, IMF staff discussion note, SDN/11/08, April 8 2011 and Martin Ravallion, “A poverty-inequality Trade-off?”, Development Research Group, World Bank, WPS3579, April 2005.

65. See further: Richard Layard, “Happiness: has social science a clue?”, “Lecture 2. Income and happiness: rethinking economic policy”, Lionel Robbins Memorial Lectures 2002/3, delivered on 3, 4, 5 March 2003 at the London School of Economics.
66. See further: www.oecd.org/corruption/oecdantibriberyconvention.htm
67. See further: www.unodc.org/onodc/en/treaties/cac/index.html
68. See further: www.unglobalcompact.org/aboutthegc/thetenprinciples/principle10.html