

Meeting Summary

Corruption: A Constraint on Growth and a Threat to Security?

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Presenters:

Michael Alexeev, Professor of Economics, Indiana University

Robert Legvold, Professor Emeritus of Political Science, Columbia University

Chair: **Andrew Kuchins**, Senior Fellow and Director, Russia and Eurasia Program, CSIS

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This was the fourth of six meetings in the series, “Economic Change in Russia and its Implications for U.S. Policy,” a CSIS project sponsored by the Carnegie Corporation of New York.

Corruption is one of the main continuities in Russian politics from the Tsarist, Soviet and post-Soviet periods. Through the present day, it remains one of the most persistent problems plaguing Russian governance and economic development. Alexeev and Legvold’s presentations focused on the impact of corruption on the two main themes of the seminar series: Russian economic growth and US policy.

Alexeev began his presentation by discussing the definition of corruption. He prefers to define the term as the use of public office for private gain, although he acknowledges that this is a problematic concept since it is unclear what the terms themselves mean. There are several measures of corruption used to understand distinctions between different countries. He focused on the World Bank and Political Risk Services’ (PRS) data, both of which focus on the perceptions of businessmen and other stakeholders in the economic policy-making process.

Alexeev prefaced his presentation of the empirical evidence on the impact of corruption by discussing the theoretical propositions behind the relationship between corruption and growth. First, corruption, by affecting the efficiency of utilization of existing resources, can limit the availability of resources needed for growth, such as investment and human capital. Second, corruption might negatively impact the factors that directly affect

growth. However, it is very difficult to disentangle cause and effect in the relationship between corruption and growth.

Paradoxically, corruption could produce some benefits. First, it alleviates the effects of excessive regulations and red tape in the bureaucracy, thus promoting greater efficiency, and potentially more growth. Second, it can direct government services to those economic agents who value them most or speed up delivery of services to those who value rapid delivery most. (Government bureaucracies usually operate on a first-come-first-serve basis, which might not be the most efficient method of allocating services.) Third, corruption supplements the income of officials, thus reducing the need to increase taxes, which tend to distort economic relationships. More generally, when negotiations among parties entail no transaction costs, corruption can produce socially efficient outcomes. However, as Alexeev notes, there are usually high transaction costs associated with corruption. In particular, some of the parties that are affected by corruption often have only an indirect input into the outcomes of these “negotiations.” For example, when a construction firm bribes an official to obtain a contract to build a lower quality road at a higher price than its competitor, neither the competitor nor the population at large are part of the bargain.

The benefits of corruption are far outweighed by its attendant costs. First, as a function of attempts to increase rents from bribes, excessive regulations tend to result from high levels of corruption. Second, governmental processes are slowed by attempts to extort money to speed up these processes. Third, although bribes could reduce the need for tax revenue, they are usually even more economically distortive than taxes. Fourth, corruption benefits well-organized groups, and not society as a whole. Fifth, a corrupt regulatory environment tends to lead to bigger and less effective government; for example, potentially corrupt officials need to be monitored by other officials. Sixth, the secrecy associated with

corruption distorts the choice of economic activities. Corruption in the customs service is an apt example. Customs officials might find it much easier to conceal corrupt behavior during importation of a particular good rather than another. As a result, the former good is imported and not the latter, distorting the structure of imports and consumption. Seventh, corruption cripples economic processes that require greater government intervention. Eighth, tax revenue collection is ineffective when tax administrators are corrupt. Finally, corruption hurts competition. When corrupt officials regulate markets, they prefer dealing with a few large enterprises instead of many small ones. In addition, if bribes serve as an entry fee into a regulated market, they also decrease competition by increasing market entry costs.

Despite these costs and the theoretical justifications for the negative effect of corruption on growth mentioned above, direct quantitative evidence of this relationship is mixed. One early cross-country study estimated that an increase of one standard deviation in corruption resulted in a 0.8 percentage point drop in annual growth rate of GDP. However, this estimate showed a rather weak statistical significance. Some other studies obtained inconclusive results of a linear relationship between corruption and growth. Alexeev's own work shows that corruption control affects growth positively, and that there is no difference between democratic and non-democratic countries on this score.

Despite the weakness of data linking corruption directly to growth, there is strong quantitative evidence that corruption affects the factors that are responsible for growth, especially investment. Studies show that increases in the corruption index lower public and private investment (including FDI), spending on education, and the quality of public expenditure, while increasing infant mortality, dropout rates in primary schools, and inefficient military spending.

In the case of Russia, the World Bank has always listed it as highly corrupt, but not at the far bottom of its rankings. While the number of countries ranked by the World Bank has been increasing over the years from about 150 to over 200, Russia has usually occupied the 30th to 40th place from the bottom. Further, there is scant evidence that corruption has become more widespread; Russian business does not see corruption as a significantly more severe problem than its counterparts in Eastern Europe. The reason for this perception might be that corruption has become more centralized in recent years. Centralization here amounts to corrupt officials better coordinating their bribe demands and providing assurances that multiple bribe payments for the same services are not necessary. According to Alexeev, the more centralized corruption is, the less detrimental effect it has on economic efficiency and growth; it becomes more like taxes. Decentralized corruption is much less efficient.

Legvold's presentation focused on the implications of corruption in Russia and the CIS on international security. One of his main arguments is that we need to think about corruption in a qualitatively different way and we need new rankings of corruption to reflect this. Most current measures focus on the perceptions of stakeholders, which are not the most reliable yardstick. We need new measures about the impact of corruption on economic development, not growth *per se*. For example, if corruption becomes an impediment on liberalization, then there might be less reform.

Another of Legvold's major arguments is that corruption in the former-Soviet states is a major concern for US national security. Among other issues, the scale of corruption in the region has a major impact on war and peace, including regional conflicts; nonproliferation issues and the spread of WMD; transnational crime; the flow of

“contaminants,” such as drugs, trafficked humans and illegal arms; and national economies, by handicapping them through illicit trade and money laundering.

Legvold differentiates between three categories of states and their corruption profiles. First, there are criminal states. These are states where “the core activity of the state is criminal ---that is, where the state depends overwhelmingly on the returns from illicit trade to finance itself, and, therefore, not only protects, but, in fact, conducts the bulk of the business.” None of the twelve non-Baltic post-Soviet states fall into this category, but several of the unrecognized *de facto* mini-states, such as South Ossetia and Transnistria, do. Russia, Ukraine and the other states of the region are criminalized states. In these countries, “the state’s core activity may not be corrupt, but the *process* by which the state acts is.” Finally, some states, such as Italy, are characterized by public corruption, whereby some public agencies and officials are corrupt but most core institutions remain “uncontaminated.”

There are many examples that demonstrate the profoundly disturbing implications of corruption for international security. Perhaps most illustrative is the case of Oleg Khintsasgov, a smuggler arrested by Georgian security agents in January 2006, who had passed through the Russian-Georgian border with 100 grams of weapon-grade uranium in his jacket. In another example, between 1995 and 2005 as many as 850,000 women may have been trafficked out of Russia, while the number for Ukraine, a country with around a third the population of Russia, the number is 500,000 for the years 1991-1998.

Corruption in the post-Soviet region is thus a large, multi-faceted problem that is not epiphenomenal or secondary, but central to the economic and political dynamics in these states. The many aspects of corruption thus must be treated with an integrative strategy, instead of the current piecemeal approach that treats the various manifestations of

corruption in isolation. A wide range of instruments, tactics and institutions must be brought to bear on the problem in a coordinated manner.

Progress towards eliminating this problem must begin on a national level. Russian President Dmitri Medvedev has made fighting corruption a major theme of his presidency and has introduced a package of legislation into the parliament to address the problem. Measures include forcing public officials to report assets and income. However, the legislation will only punish those who commit corruption, rather than addressing the causes of corruption. To do that, Medvedev must go after the clans at the top of the Russian political system, and it is unclear that he has the political clout to do so. The case of Georgia, where improvements in the post-Shevardnadze period have occurred as a result of an elaborate anti-corruption regime set to European standards, demonstrates that progress on these issues is possible.

According to Legvold, the US has an important role to play in this equation: corruption “should be front and center in US policy – indeed, national security policy – toward Russia and in the region.” Although multiple international treaties, organizations and regimes exist to counteract corruption, the problem remains intractable since governments often do not take the issue seriously. The US must create a comprehensive strategy to attack the problem and must coordinate the efforts of internal agencies. The issue must be addressed at the highest levels for real progress to be achieved.

The discussion centered around two major issues. First, one of the participants questioned Legvold’s conception of corruption, pointing out that many of the phenomena discussed in his presentation could instead be thought of as crime. Even though there are many links between corruption and crime, there is no necessary linkage. The question then arises of the difference between fighting international crime and fighting corruption. For

example, drug trafficking might be a purely criminal matter, involving little or no corrupt practices on behalf of government agencies or officials. Another participant questioned Alexeev's assertion that it is easier for enterprises to operate under conditions of centralized corruption. Using the example of Gunvor, the Swiss-based trader with links to the leadership that has come to dominate Russia's oil exports, the participant pointed out how difficult it has become for foreign majors to operate in Russia under such conditions.