

Does corruption influence the sustainability of economic growth?

Polajeva, Tanya

Veröffentlichungsversion / Published Version

Zeitschriftenartikel / journal article

Empfohlene Zitierung / Suggested Citation:

Polajeva, T. (2011). Does corruption influence the sustainability of economic growth? *Baltic Region*, 4, 40-48. <https://doi.org/10.5922/2079-8555-2011-4-5>

Nutzungsbedingungen:

Dieser Text wird unter einer CC BY-NC-ND Lizenz (Namensnennung-Nicht-kommerziell-Keine Bearbeitung) zur Verfügung gestellt. Nähere Auskünfte zu den CC-Lizenzen finden Sie hier:

<https://creativecommons.org/licenses/by-nc-nd/4.0/deed.de>

Terms of use:

This document is made available under a CC BY-NC-ND Licence (Attribution-Non Commercial-NoDerivatives). For more information see:

<https://creativecommons.org/licenses/by-nc-nd/4.0>

ECONOMIC ASPECTS OF INTERNATIONAL COOPERATION

UDK 330.35+328.185

DOES CORRUPTION INFLUENCE THE SUSTAINABLE OF ECONOMIC GROWTH?

T. Põlajeva *

Sustainable development is a term that is widely used by politicians nowadays. The definition of the concept of sustainable development is constantly revised. Sustainable development is about promoting an integrated approach. It includes economic, social and environmental objectives. Economic objectives include growth, efficiency and stability.

The main purpose of the article is to analyze the influences of corruption on sustainable economic growth. The impact is decreasing continuously and the main reason behind this is the change in peoples' attitude and saturation to ethically questionable actions. Individuals and organizations can join in sharing resources for creating a sustainable future. There are several factors that influence sustainable development. Among them are: government policies; management and organization; financial and economic factors.

The main question for institutional sustainability may be formulated as the following: can the strengthened institutional structure continue to deliver the results of technical cooperation to the ultimate end-users? Individuals and organizations can join in sharing resources for creating a sustainable future. Anticorruption strategies are related to the reform of state institutions. One advantage of the fundamental economic reform approach is that by linking anticorruption strategies to the reform of economic policies and institutions, the struggle against corruption can be seen as one of the issues in economic policy. Finally, all development assistance should be implemented with the aim of achieving sustainable benefits.

* Tallinn University of Technology
5, Ehitajate Tee, Tallinn,
19086, Estonia.

Received on October 02, 2011.

Key words: corruption, sustainable economic growth, governance

Introduction

People tend to blame governments when economic conditions are bad, and it seems to make sense as governments are in charge and do possess tools for creating a favourable environment with the right incentives for society; the governments are to generate prosperity. So what makes good governments good in the sense of economic achievement, and why governments of many transition economies cannot manage to achieve higher growth rates compared to the developed economies? One major reason is the nature of human beings and the dominance of self-interest over social interest, which leads to corruption and government failure to develop a rapidly growing economy.

Economic growth is apparently the issue that has constant and extensive coverage in research and public literature. Governments change or adjust economic policies, create new institutions and spend billions of tax payers' money on the stimulation of economy in order to achieve a higher growth rate. Why is it so important? All countries want to become richer, more prosperous; they want to improve living standards for their citizens and, at the same time, to ensure their power. The economic growth is a way to achieve prosperity. It becomes clear why governments carefully observe all fluctuations of Gross Domestic Product (GDP), as well as employment rate, foreign direct investment and other indicators. In the long term, it is the growth rate that determines in which countries people will be able to satisfy their needs, and in which countries the living standards will become lower.

Macro-level explanations and corruption

There are numerous definitions of the term 'macroeconomics in scientific literature. Macroeconomics can be defined as "a branch of economics dealing with broad and general aspects of an economy, such as income, investments, etc. of a country as a whole". It is the study of the whole economy with regards to the total amount of "goods and services produced, total income earned the level of employment of productive resources, and the general behavior of prices. Macroeconomics can be used to analyze how to better influence policy goals such as economic growth, price stability, full employment and the attainment of a sustainable balance of payments" [5]. When it comes to corruption, it is important to understand the macroeconomic theory and how the economy behaves.

According to the World Bank, corruption is synonymous to abusing public office for private gain. The level of corruption is defined by the amount of the fee paid for operating a certain business. Economic output can be affected by corruption in two ways. It may decrease due to a lack of skilled employees in all companies with the exception of those that are politically connected. Economic output may be affected by the substitution of people with machinery. Wages decrease due to extra fees that companies are re-

quired to pay in order to continue their profitable business. In today's world, on the macroeconomic level, the terms 'economic freedom', 'globalization', and 'corruption' are getting increasingly intertwined.

The Wall Street Journal and the Heritage Foundation have created a special index, the Index of Economic Freedom (IEF), for measuring the level of economic freedom through the assessment of ten factors (business, trade, fiscal policy, government size, monetary policy, investment, financial policy, property rights, corruption, and labor). On a scale of zero to 100, the index of 100 represents state of absolute freedom. The level of openness and democracy in the political system influences the level of corruption in a given nation. The risk of exposure to corruption can be higher in a more democratic country, thus reducing the level of corruption, sometimes significantly. Additionally, press freedom can act as an important intermediary in revealing corrupt behavior, as well as the economic wealth of the country. A good system of education and a high literacy rate can increase the possibility that any political abusive behavior will be notified [8, p. 7].

In any economy supply creates its own demand and overproduction is impossible. Government policies can be used to fight unemployment and promote demand at a macrolevel; however they can also be used to manipulate the demand. When corruption exists, many employers may be forced to cut down wages to be able to pay bribes, while the prices still remain the same due to production costs. This, in its turn, may lead to a decrease in demand and sales.

Another related phenomenon is an increase in consumers' savings. Excess saving negatively affects the volume of sales and leads to excessive supply. This will create general pessimism and uncertainty of business. When the government has a lot of power in regulating the economy, it is easy to question the fairness of the decision-making process. One specific feature of corruption is that it is relatively invisible, making it difficult to accurately measure the level of corruption in different countries. Transparency International has been able to create an index that makes it possible to compare and assess the situation globally. Conclusions drawn from the studies made by Transparency International and the macroeconomic studies are the following ones: corruption has a negative impact on the economic growth of any country as it reduces investment and consequently lowers the growth rate of industrial output. Additionally, by channeling money to certain economic players, the government reduces expenditures on education and public health services.

Corruption distorts the economical state of a country as it decreases the productivity of public investments and the productivity of a country's infrastructure, reduces tax revenues and prevents the government from reaching a proper level of public expenditures. Finally, corruption reduces foreign direct investment as it acts as an additional tax [8, p. 7—8].

It has been increasingly recognized that corruption has substantial negative effects on economic growth, because different institutions play a role in determining economic performance. When corruption is widespread, it does not make sense for individuals to attempt to fight it, even knowing that eve-

rybody would be better off if corruption were eliminated. Mauro calls this “strategic complementarities”, whereby if one agent does something it becomes more profitable for another agent to do the same thing. Strategic complementarities are a major factor in determining a country’s institutional efficiency and economic performance. Strategic complementarities are consistent with the observation that the degree of institutional efficiency is extremely persistent over time.

Corruption can be said to affect the economy in the following way: if many people steal, the probability of them being caught will be low. This creates a “good” equilibrium characterized by the absence of corruption and high rates of investment and growth. Consequently, a “bad” equilibrium is characterized by constant corruption and low investment and growth. Slow growth and low investment result from the waste of labor hours spent on unproductive transfer of resources, and a low marginal product of capital, because a lower proportion of government expenditure reaches the production processes of which it is an input.

Additionally, it is suggested that corruption and political instability may be two sides of the same coin: there is a link between corruption and politicians’ horizons and implications of this link for economic growth can be drawn. Here, politicians have to decide what kind of private bribe collection system they wish to set up. In doing so, they have to consider the fact that if they hurt the economy, the citizens will not re-elect them, thus being unable to collect bribes in the future” [10, p. 3—5].

High levels of corruption push entrepreneurs ‘underground’ and this is one of the main factors of the increasing role of the shadow economy in all countries. In his research Anderberg tries to answer the question whether labor market rigidities lead to more underground economic activities. He concludes that underground economic activities are more strongly correlated with a commonly used index of unemployment protection than with effective tax rates [2].

It is argued that for capitalism to emerge and function a country needs neither too little, nor too much government [13]. A country can achieve such balance when there is a right distribution of ownership. Too high ownership concentration (such as in the Russian oil and gas industry) is harmful to market development, because large and powerful owners can protect their interests without a fair and objective judicial system. On the other hand, a too dispersed ownership structure (for example, through the voucher privatization schemes) is not conducive to market economy, because it makes coordinating a strong pro-market movement more difficult. It is also mentioned that a country can achieve this balance of economic power more easily when it lacks rich natural resources — oil, gas, diamonds etc., which can automatically create a concentration of economic and political power.

A new political economy approach [4; 12; 9; 14] which has developed rapidly during last fifteen years may be applied for explaining a given economic policy. This approach proceeds from the assumption that an economic policy is formed by maximizing a social welfare function, i. e. it takes into account the fact that an economic policy is determined by a political mecha-

nism and reflects the interests of the most powerful groups in society; and the economic policy process is modeled as a principal-agent problem. “An agent is a policymaker, or a collection of agents responding to specific incentives and constraints. The private sector is considered as a principal who has typically forward looking expectations which induce a different kind of (dynamic) incentive constraints for the agent”. One type of constraints corresponds to a conflict of interest between policymakers and private agents in their economic role; this can be called credibility constraints. Another constraint is a political one — a conflict of interest in their political role. It is shown that larger voting districts (and thus, lower barriers to entry) are associated with less corruption; larger shares of candidates elected from party lists (thus less individual accountability) are associated with more corruption [12].

Governance

There are different characteristics describing government functions. Government exists to perform two main functions:

- establish property rights and set the rules for income and wealth redistribution (based on law and rule)
- provide mechanisms to allocate scarce resources, when market economy fails to do so. Without government interference, companies might start to produce too much of same goods and services [11].

Government also deals with economic problems like antitrust laws and regulations of monopolies, externalities, provision of public goods, the use of common sources, income redistribution, improvement and education of workforce etc. It is clear that all the mentioned functions are important for the wellbeing of society. Government sets preconditions for growth. For economy to work, government has to give people right incentives, government creates the space within households, and firms can operate and make transactions [6]. If government is not able to provide this space for reasons like weak institutions and rule of low or inappropriate economic policies, or political system, the citizens of this country will be less able to create prosperity, or not able to do it at all. There is an opinion that no unique political system is necessary to do the work. Liberal democracy, founded on fundamental principle of the rule of law, is the most suitable for markets to appear. governance aspect here comes in, government has to ensure that companies can do business by free monetary exchange and rule of law is established to respect property laws and social agreement. At this point governance power enables economic growth but does not make it inevitable [11].

In his article on institutions and economic change France Gagliardi [6] draws a conclusion that institutions have a major effect on economic performance, especially the institutions whose main function is protection of property rights and enforcement of the applications of contracts. To prove the conclusion, the author provides an extensive overview of literature on the matter [6]. The basic argument Gagliardi concentrates on is that individuals can capture gains from trade by cooperating; however cooperation without incentives is limited due to the self-interested nature of human beings and coordination costs for collective action. Therefore, institutions have to be in

place to make individuals more willing to take collective action and make everyone in a society better off. Institutions have formal rules like contracts, and political and economic rules, and informal norms such as norms of behavior, codes of conduct and conventions; organizations, for example, universities, government agencies etc., can be considered institutions too.

An empirical study made by Johnson D., Acemoglu [1] confirms the fact that the relation between economic performance and institutions do exist. The researcher took 75 previous colonies of European settlers with diverse set of institutions and made two hypotheses which are of interest: 1) different types of colonization policies created different sets of institutions; 2) colonial state and corresponding institutions remained in place even after independence. By using mortality rate of European settlers during the period, the researcher writes that either the colonization policy was resource exploitive, or it was there for the purpose of creation of new settlements for living. The colony policy for the most part was introduced in Africa, together with scarce protection of property rights and government abuse, while colonized territories like US, Canada and Australia were created for the purpose of living environment creation and is one of the most prosperous countries in the world. Taken as a whole, government must establish the right institutions and make sure they are working efficiently and correctly, as its accountability on economic performance is recognized by academic world.

But there are a lot of empirical studies which show that corruption has its adverse effects not only on static efficiency but also (and above all) on investment and economic growth. According to the Organization for Economic Co-operation and Development (OECD) corruption threatens good governance, sustainable development, democratic process, and fair business practices. Further the organization claims that it worsens public confidence in political institutions and leads to contempt for the rule of law, as well it alters the allocation of resources, increases spending on public sector and erodes competition. Judging by the effects, corruption is a destructive force and has a negative influence on economic growth. It should be kept in mind that the discussion on the importance of institutions for economic development of any country shows that economic growth is hard to achieve in those cases when corruption has a direct influence on the quality of institutions and via versa. Therefore, corruption brings public spending towards the projects that make it easier to collect bribes instead of following priority social programs, which would make the whole society have a better life and benefit poor people, who need the help most.

Sustainable economic growth

Poor governance hampers sustainable economic growth, development of the private sector economic activity, and the reduction of social equity and poverty.

Sustainable development is a term that nowadays is widely used by politicians. The term is in the process of development; therefore, the definition of the term is constantly revised. Sustainable development is about promot-

ing an integrated approach. It includes economic, social and environmental objectives. Economic objectives include economic growth, efficiency and stability. Sustainability is a systemic concept, showing the continuity of economic, social, institutional and environmental aspects of society. Sustainability affects every level of organization, starting from the local neighborhood and to the entire planet. The original term was “sustainable development”; this term was adopted by the Agenda 21 program of the United Nations. There are various attitudes to what aspects of life can be included in the notion “sustainable development”. Despite differences, there are some common principles in most documents or action programmes aimed at achieving sustainable development, sustainability, or sustainable prosperity. They are the following ones:

- dealing cautiously with risk, uncertainty and irreversibility;
- integration of environmental, social and economic goals in policies and activities;
 - ensuring appropriate valuation, appreciation and restoration of nature;
 - conservation of biodiversity and ecological integrity;
 - ensuring inter-generational equity;
 - equal opportunity and community participation/sustainable community;
 - recognizing the global dimension;
 - a commitment to best practice;
 - no net loss of human capital or natural capital;
 - the principle of continuous improvement
 - the need for the good governance [7].

There are three main types of sustainability: institutional, economic and financial, and ecological. The main question for institutional sustainability may be formulated in the following way: can the strengthened institutional structure continue to deliver the results of the technical cooperation to the ultimate end-users? Thinking about the results, as a matter of fact, they may not be sustainable. For example, the planning unit strengthened by the technical cooperation ceases to have access to top-management, or is not provided with adequate resources for the effective performance after the technical cooperation terminated. Institutional sustainability can be also linked to the concept of social sustainability. Speaking about economic and financial sustainability we try to answer the question: can the results of technical cooperation continue to yield economic benefits after the technical cooperation is no longer there? Thus, economic (distinct from financial) sustainability may be at risk, if the end-users continue to depend on heavily-subsidized activities and inputs.

The United Nations declared a Decade of Education for Sustainable Development starting from January 2005. Individuals and organizations can join in sharing resources for creating a sustainable future. All development assistance should be implemented with the aim of achieving sustainable benefits. Ten key factors that influence sustainability development can be mentioned. Among them there are the following: government policies, management and organization, financial and economic factors. Only a strong state is

able to maintain market order, uphold universal rights, and regulate the highly uneven distribution of economic power in transition economies [3, p. 22]. On the other hand, a strong state can easily support and implement an interdisciplinary approach of sustainable development.

Conclusions

Different macroeconomic theories discuss the effect of the government regulations on the wealth of the country; they all have similar ideas on the behavior of output and wages.

Physical capital, human capital/labor and technology/innovation play a dominant role in the economic growth; in order to achieve improvements in these spheres education and investments have to be sufficiently developed. Investments are necessary for capital growth, for investments to get acquired households and firms have to save money instead of consumption/ producing.

Education is crucial for human capital development; it leads to higher productivity and consequently, more industrial output per person. Education also plays a major role in technology and innovations, and similarly, leads to better production. All these have an impact on the output, which is then reflected in GDP. After checking potential GDP, governments can take action through employing fiscal and monetary policies to stimulate, or decrease the economy for reaching the maximum rate for sustainable growth. However, the policies may have a short term effect and may not play a primary role in economic growth. They may be either beneficial for sustainable economic growth, or damaging. The real fundamental impact on economic growth is the creation of incentives for individuals. Incentives are created through institutions; with the right set of institutions (basically, rules) governments can take advantage of individuals as self-interested beings and use this advantage to the benefit of the whole society, its prosperity and development. As institutions are not well established in transition economies, significant part of them still face problems to keep up the higher growth rates than already developed countries. Weak institutions cause corruption and corruption is a major obstacle for economic growth because it benefits only a limited number of people leaving the majority of the population in much worse conditions.

Regardless of the differences in theoretical explanations, all seem to agree upon the effect of corrupt behavior. In general, corruption confuses the measurement of the real economical state of a nation. Any bribery on the national economical level and government efforts in trying to manipulate the supply and demand will have direct effect on the wealth of the individuals in that country. Corruption will deteriorate the wellbeing and wealth of the people, and thus, will have a negative impact on the general wealth and competitiveness of the country.

Corruption distorts the true economical state of any country as it decreases the productivity of public investments and the productivity of a country's infrastructure, reduces tax revenues, and, finally, prevents the government from reaching the necessary level of public expenditures.

References

1. Acemoglu, D. J. 2001, The Colonial Origins of Comparative Development, *The American Economic Review*, Vol. 91 (5), p. 1369—1401.
2. Anderberg, D. 2003, Insiders, Outsiders, and the Underground Economy. ESifo, *Working Paper Center for Economic Studies and Ifo Institute for Economic Research*, no. 1048, University of London.
3. Bruszt, L. 2000, Constituting Markets: The Case of Russia and Check Republic. In: Dobry, M. (eds), *Democratic and Capitalist Transitions in Eastern Europe*, Kluwer Academic Publishers.
4. Drazen, A. 2000, *Political Economy in Macroeconomics*, Princeton, Princeton University Press.
5. Economic expert, available at: <http://www.economicexpert.com/> (accessed 05 September 2011).
6. Gagliardi, F. 2008, Institutions and economic change: A critical survey of the new institutional approaches and empirical evidence, *The Journal of Socio-Economics*, Vol. 37(1), p. 416—430.
7. Hargroves, K., Smith M. (ed). 2005, *The Natural Advantage of Nations: Business Opportunities, Innovation and Governance in the 21st Century*.
8. Lacko, M. 2006, Tax Rates with Corruption: Labour-market Effects, Discussion papers MT-DP — 2006/4, 1—40, Institute of Economics, Hungarian Academy of Sciences Budapest, 2006.
9. Lambsdorff, J. Graf and M. Nell, 2006, Corruption: Where we stand and where to go: The Corruption Monster. In: Kreutner, M. (eds.), *Ehik, Politik und Korruptio*, Vienna, p. 57—70.
10. Mauro, P. 2002, The persistence of corruption and slow economic growth, *IMF Working Paper*, no. 02/213, Washington: International Monetary Fund.
11. Parkin, M. 2008. *Economics*, 8th Edition, Boston, Pearson Addison-Wesley.
12. Persson, T., Tabellini, G. 2000, *Political Economy: Explaining Economic Policy*, Cambridge, MA: MIT Press.
13. Rajan, R. G.; Zingales, L. 2003, The Road to Prosperity: Saving Capitalism from Capitalists, *Transition*, Vol. 14, no. 7—9, p. 1—3.
14. Rosser, J.; Barkley, Jr. and Rosser, M. V. 2007, A critique of the new comparative economics, *Review of Austrian Economics*, in press.

About author

Dr Tanya Polajeva, Associate Professor, Faculty of Economics, Tallinn University of Technology, Estonia.

E-mail: tanja@staff.ttu.ee

