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Economic Crime, Corruption and the Destabilization of Developing Countries

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I. INTRODUCTION

The economic reforms in India were introduced as a response to an economic crisis which was manifested by a precariously low level of foreign exchange reserves. Abatement of corruption was arguably not an overt rationale justifying the paradigm change. Interestingly, however, in the aftermath of the reforms, reduction of rent seeking activities (and corruption in general), as a consequence of the end of the *licence raj*, received substantial attention from the media and social scientists alike. The new paradigm, involving fewer permits and licenses, was hailed by all (vocal) sections of the economy.

This reaction is hardly surprising. Since independence in 1947, policies and programmes of the central and state governments were shaped such that the core sectors including infrastructure were reserved for the public sector, and the pillars of the economy were controlled by the central government. The people were fed on slogans of "socialism" which was manifested through administered prices of essential commodities, poverty alleviation programmes and the system of subsidies. The bureaucracy, which thrives within any economy that is governed with the use of controls (as opposed to incentives), shackled the system and vested interests and pressure groups burgeoned within the economy. The most evident consequence of this controlled regime was corruption which, in turn, led to distortions in economic decisions, thereby compromising the efficiency of the economy. Rent seeking became the order of the day.

Clearly, rent seeking is perceived as distortionary in the sense that it leads to loss of efficiency in the economy. In particular, economists have argued that if rent seeking is deemed profitable then people will allocate resources in a way that will enable them to be in a position to partake in rent seeking (Krueger, 1974). The resultant allocation of resources can be inefficient in the Pareto sense. We must note here that the inefficiency arises not only out of the misallocation of resources, including human capital, but also because of the fact that if expected rents are high then people are willing to wait (i.e., refuse other job opportunities) till they get to the desired position.

However, while a discussion about Pareto efficiency might seem to be somewhat abstract, there are more practical reasons to ensure that corruption is minimized. For example, it is argued by MNCs that despite reforms red tapism in the Indian bureaucracy is pervasive and that the resultant delay involved for sanctioning of projects is substantial. The MNCs presumably have to incur significant expenditure to submit project proposals, and the problem is exacerbated by high time costs. This assertion underscores a wariness on their part in so far as investment in India is concerned. In an attempt to quantify relative corruption, on a scale of zero (absolutely corrupt) to ten (very little corruption), Mauro (1995) concluded that there is a significant and negative correlation between corruption and the state of economic development of a country.[1] He accorded high point to developed countries on the aforementioned scale: a perfect 10 each for the United States, Canada, Australia and France, and 8.75 for Japan. Developing countries, on the other hand, received much lower points on the scale, with India (with 5.25) emerging marginally superior to Bangladesh (with 4), Ghana (with 3.66) and Egypt (with 3.25).

The implications of this, in so far as India is concerned, are grave. There is general consensus about the fact that corruption lowers private investment and hence reduces growth rates, and that is a sobering thought given that the government desires foreign direct investment to the tune of USD 10 billion annually. The magnitude of the problem becomes clearer when we take into account the fact that at least one potential investing country, the United States, has stringent laws which aim at dissuading entrepreneurs to use unfair means to obtain contracts or tenders. Under the Foreign Corrupt Practices Act, the United States government can penalize any company partaking in corrupt practices to secure contracts in foreign countries upto USD 5 million in fines. The relevant employees of the company can be imprisoned for upto 5 years.

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[1] In other words, there is a very high and *positive* correlation between the points accorded to a country on the Mauro scale, and its state of development.

II. CORRUPTION IN POST-LIBERALIZATION INDIA

The Indian liberalization process remains an exercise in contradictions. The professed policy of the Government of India, is to carry forward the economic reforms to their logical conclusion. However, *de facto*, clearances have to be obtained from the Government of India (Foreign Investment Promotion Board), before a multinational corporation can invest into any industry/sector. There are delays in the decision making process and, as exemplified by the so-called telecom scam, there is little transparency in the process involving approval of project and/or finalization of global tenders. Considerable expenditure has to be incurred by the multinational corporations and their Indian partners to submit project proposals or global tenders, and this cost is further enhanced by delays in the decision making process. It is widely believed that the delays are deliberate ploys on the part of the powers that be to coerce the companies into a rent seeking arrangement before the relevant projects are cleared or tenders approved. In the era of competition, India has *competitive corruption.*

What forms do corruption take? The episodes involving several banks and the so-called Harshad Mehta scam, as well as the switching of shares at the Bombay Stock Exchange are, by now, common knowledge.[2] There are, however, other forms of corruption which do not catch the fancy of the masses as easily, namely, over invoicing of projects. Industrial firms advertise ambitious projects and woo the investors by generating expectations of high returns. At the same time, the project cost is inflated significantly through over invoicing of resources like land and capital goods, as well as services like managerial skills and external consultancy. The resultant surplus of the exhibited cost over the actual cost can then be siphoned away by the promoters concerned, and can yield significant *profits* even after accounting for their investment into the project as directed by the guidelines of the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI). In one such case, the initial (estimated) project cost of Rs. 8 million (USD 230,000) was inflated into Rs. 180 million (USD 5.15 million) and foreign exchange to the tune of USD 2.57 million was siphoned out of the country through over invoicing of imports.[3]

[2] Although the term *common knowledge* has been used here in the literary sense of the words, the Indian paradigm permits its use as defined in the game theory literature!

[3] The example cited here, as well as those cited elsewhere in the paper have been taken from the following sources: (1) Janaki Raman Committee Report, Reserve Bank of India, 1992, (2) Report on the Functioning of the Banking System, 1992, (3) case histories from the Directorate of Revenue Intelligence, (4) Economic Times, and (5) report of the Bank of England on the collapse of Barings.

Other, equally innovative, schemes are also in effect. For example, on the basis of the guidelines given by the RBI, scheduled banks extend credit to exporters upto 60 to 80 per cent of the contractual value against a firm export order. It leaves the door open for a bent exporting to enter into "contracts" with its cronies based abroad, and obtain insurance cover from the Export Credit and Guarantee Corporation (ECGC). Such companies often enter into sub-contracts with supporting manufacturers to show that they are serious about executing the contract. Suppose that the "contract" is valued at USD 125,000. The exporting firm can then obtain credit upto USD 100,000 from his bankers, by way of a cheque. The interest rate associated with this form of bank credit is nominal: 13.5 per cent for 90 days, 15.5 per cent for between 90 and 180 days, and 18.5 per cent for more than 180 days.

The firm can, in turn, discount the cheque with a money changer and receive USD 99,000 in cash. Instead of utilizing the money for procuring the goods ostensibly required for the export "contract," the firm can enter the market for short term loans (repayable within 140 days at 30 per cent interest per annum) as a lender. Before the payment of the loan becomes due, the firm can export goods valued/invoiced at (say) USD 150,000 and ship the same either on collection or delivery against documents basis. It also extends credit to the overseas buyers ranging from 30 to 90 days, as per RBI norms. The firm is then in a position to obtain USD 135,000 from its bank, after discounting of the export invoice under the Bill Discounting Scheme. It can thus pay back its loan worth USD 100,000, and reenter the short term credit market as a lender. In other words, the arbitrage opportunities, apart from the opportunities from over and under invoicing (in violation of the Foreign Exchange Regulation Act), provide more incentive for corruption and misuse of export schemes than for export and foreign exchange earning.

While perverse incentive mechanisms provide encouragement in favour of corruption and rent seeking, perhaps a bigger contribution to these problems is made by the lack of accountability which, in turn, arises out of the lack of adequate monitoring on the part of the authorities. Nowhere is this hypothesis more valid than in the case of the capital market. With the increasing autonomy of the RBI and the SEBI, and with the formulation of regulations which aim at reducing the information asymmetry between the firms and the investors, and at increasing the transparency of the trading system, the activities of the firms, the investors and the intermediaries are increasingly becoming rule bound.

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Accountability, indeed, is perhaps the single most important curative process for the malaise that is corruption.

III. Incentives, Information, and Corruption

Interestingly, whether or not corruption is good in a system that is otherwise sluggish has been a bone of contention among economists. Some have argued that corruption and rent seeking, which we can henceforth call bribery for the sake of simplicity, can be of help to investors if bribes can ensure them whatever good or service they want to possess (Leff, 1970). Economists have also shown that in the presence of bribery, delivery of services is not delayed in the long run so as to extract a higher bribe (Lui, 1985). On the contrary, after bribery is permitted, those that accept the bribe have an incentive to speed up the system. The intuition offered for the result is that if the queue moves sluggishly even after bribes are "permitted," people will not have an incentive to be in the queue.

But the problem lies with the fact that corruption coexists with uncertainty. The honest entrepreneurs face the uncertainty that their projects might not be approved by corrupt officials. At the same time, when officials are able to enter the market for corruption freely, and when each official or department sets its own bribes without harmonizing its actions with others, there is a positive probability that the action taken by a corrupt official or department will not be complemented by other officials and departments (Shleifer and Vishny, 1991). Hence, dishonest entrepreneurs too face uncertainty. It is a stylized result in Economics that investment is suboptimal in the presence of uncertainty (Dixit and Pindyck, 1994).

Typically, economists argue that the solution to the problem of corruption lies in changing the incentive structure of the organization, namely, the government. This is attained by changing the payoff structure in a way which makes honesty either a dominant strategy or at least the best response of the potentially corrupt officials to the action adopted by those overseeing their jobs. Methodologically, this typically involves the use of principal-agent models the outcome of which are the optimum contracts that the principal (i.e., the monitoring agency) can offer while satisfying the so-called participation and individual rationality constraints. In brief, this implies that in equilibrium the agent (i.e., the potentially corrupt individual) will enjoy a level of welfare which is higher than his welfare with all other possible contracts, and is also higher than his reservation level of welfare.

The problem lies in the fact that effecting an alteration of the payoff structure of the corrupt government officials is not easy. Even if we rule out formation of coalition by officials and the executive, we have to take into consideration the fact that if an official remains honest then the benefits accruing to the society as a result of his actions are largely external to him, and hence he has little incentive to be honest. This problem is aggravated by the weak link between an official's performance and his pecuniary and non-pecuniary perks. At the same time, the career paths of government officials are typically independent of their reputation. Together, these make it extremely difficult for some principal to offer contracts to these officials that are consistent with honest behaviour. In other words, unless an official is pathologically honest or unless there is strict monitoring together with stiff penalties, honesty might not be the best strategy for an official.

One can also argue that a government official is endowed with superior information about various policies and regulations (Tirole, 1994). Bribe, in that case, is a price for that information which interest groups are willing to pay. One way, therefore, to ensure that the officials are not tempted to serve the interest of these groups is to reduce the stake that the groups have in the regulatory decision. In the extreme case, the regulatory decision may itself become moot. The Indian policy regime aimed at delicensing several economic activities is an example of such a policy. Alternatively, policies can aim at reducing the discretionary element of regulations and make it rule bound. Note that the latter policy is in serious conflict with the interests of the officials. For example, in a slightly different context, it has been argued that one reason as to why many LDCs import state of the art technology as opposed to appropriate technology is that it is easier for officials to ascribe values to new technology and hence make resource allocations that are inconsistent with the true value of the technology (Shleifer and Vishny, 1991).

The immediate policy implication of such an analysis is that the expected negative payoffs of corrupt officials, in the event they get caught, have to be increased. This can be done by increasing the frequency or intensity of monitoring and/or the penalties handed out if the official is adjudged guilty of corruption. Since monitoring is typically expensive, the classical policy prescription is to impose the maximum level of penalties possible (Becker, 1981). Later research, however, has shown that if monitoring is expensive, it is optimal for enforcement agencies to have low level of monitoring for relatively smaller acts of corruption (Mookherjee and Png, 1994). In fact, these research endeavours have proposed that a threshold be created below which no enforcement is effected. This *de facto* legalization of minor offences, together with stiff penalties for higher offences, has been deemed an optimum strategy for monitoring agencies. The latter policy is stylized. The implicit logic of the "legalization" policy is that stiff penalties for any minor offence will provide the incentive to all corrupt individuals in the neighbourhood to move to higher offences (which have higher expected payoffs).

The importance of monitoring in abatement of corruption cannot be overemphasized. It has been argued in the literature that if offences are under-reported and if investigation is costly, both of which conditions are satisfied in the Indian context, then efficient enforcement of laws includes monitoring as well (Mookherjee and Png, 1992). Indeed, monitoring, coupled with graduated fines, can provide sufficient disincentive to those involved in petty corruption. Hence, costly investigation can be reserved for higher forms of corruption. In India, on the other hand, the emphasis has traditionally been on prolonged and costly investigation of the activities of firms and individuals against whom there is *prima facie* evidence of corruption, and a virtual absence of monitoring (and accountability) on a day-to-day basis.

IV. THE NEW FACE OF CORRUPTION

While corruption among government officials is a widely debated topic, of late the issue of corruption and monitoring has assumed importance even in the context of the private sector. The issue was brought to the fore by the FERA violation charges levied against ITC Limited. If true, it is quite to safe assume that it is not the only example of corporate corruption, and the methods involved are numerous: over invoicing projects, rigging share prices, packing credit, money laundering through banks, switching of shares, and private placement of shares to name a few.

The importance of monitoring is further enhanced by the fact that in cases of corporate corruption, there is often no incentive for "insiders" to abate corruption. This issue has been debated significantly in the wake of the ITC scandal, with reference to the "inaction" of the financial institutions which sat on the board of the company. If managers are simply inefficient, and the inefficiency adversely affects the profitability of a company, then the (core) shareholders are expected to act so as to replace the incumbent management. Indeed, this is often used as the rationale for privatization. However, if managers are corrupt, and if the corruption is sustainable in the long run in the absence of monitoring-investigation then the effect of the corruption on the company's profitabilty can be positive, and hence there will be no conflict of interest between the owners and the managers. Hence, in the presence of sustainable corruption, it can be perfectly rational for a profit or value maximizing investor to turn a blind eye to managerial corruption. Monitoring and investigation renders corruption potentially unsustainable and hence alters this "win-win" paradigm for the investors and managers.

In so far as the private sector is concerned, monitoring and investigation can deter corruption not only with the threat of penalties but perhaps also with that of potential takeover. As highlighted by the ITC case, credible charges of corruption arising out of monitoring-investigation can lead to fall in the market price of the equity as the future of the company becomes uncertain. If the fundamentals of the company are sound, and managerial corruption is perceived as the sole reason for the fall in equity value, then the equity may be considered a bargain in the market, having a positive *alpha*. There is, therefore, an increased possibility of takeover by a rival firm or investor. While this form of market discipline usually plays a role in discouraging managerial inefficiency, it is perhaps safe to hypothesize that it can also potentially deter managerial corruption. However, the monitoring-investigation regime will then have to be supplemented by favourable takeover laws, a proposed legislation which evoked a heated debate in the recent past.

V. Conclusion

At the end of the day, one has to grapple with a profound question. The discussion has highlighted the importance of monitoring, and various caveats concerning the same. However, while the legislative arm of the government can decide on appropriate changes in institutional and penalty structures, and the judiciary can decide whether or not to convict someone, it falls upon the executive to monitor corruption with the help of its agencies. However, today the executive stands somewhat discredited in the wake of multiple scandals both at the state and the federal levels. The problems facing the country at large are twofold. First, the replacement of a "corrupt" executive is a costly and cumbersome process. Second, since election results indicate not only disenchantment with a particular government but also changes in the tastes and ideologies of the masses, it is difficult to overcome the agency problems faced by the members of the executive (Tirole, 1994). Who, therefore, will monitor the monitor?

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