

INDIA OUGHT TO DISTINGUISH 'GOOD CORRUPTION' FROM BAD

Relevant for: Ethics | Topic: Challenges of corruption

Economic growth under a stiff regulatory structure is usually accompanied by corruption

A few days ago, former Prime Minister Manmohan Singh wrote of the “palpable climate of fear in our society today” as one of the reasons for India’s economic slowdown. This fear is partially caused by a crackdown on corruption, which is choking new projects, investments and bureaucratic decisions. The slowdown is partially a result of the government using harsh methods to eliminate corruption, black money and tax evasion. This may sound strange. How can attempts to end corruption slow the economy down? Shouldn’t it be the other way around? Shouldn’t a clean and corruption-free society foster economic growth?

Economists have quite a bit to say on the issue. Corruption, defined as “the use of public office for private gain”, is usually said to hamper efficiency and economic growth. However, economists have also made the case that in certain institutional settings, corruption often helps economic efficiency and growth, and one must be careful to distinguish between “good corruption” and “bad corruption”. In countries that have burdensome and pervasive regulation, “good corruption”—or rather, the type that increases efficiency—might actually help improve economic growth.

India has a nightmarish regulatory system, inherited from the British Raj and subsequently from its socialist Licence-Permit-Raj era. Despite some deregulation in the 1990s, India remains overregulated. Over-regulation combined with a weak state fosters corruption. Cumbersome rules that make market entry difficult or impose costs on legitimate economic activity, if well-enforced, tend to hamper growth because they create high barriers for new projects, investments and entrepreneurial ventures, and this hurts economic activity.

In this kind of institutional setting, economic activity facilitated by corruption could be the next best alternative. One of the initial models developed around this idea was by Nathaniel Leff in his 1964 paper *Economic Development Through Bureaucratic Corruption*. He argued that, “If the government has erred in its decision, the course made possible by corruption may well be the better one.” Others, like Francis Lui, developed queuing models, where “speed money” helps move files along myriad administrative departments and helps get ahead in slow moving queues. Samuel Huntington is even more forgiving in his book *Political Order In Changing Societies*, where he argues that, “In terms of economic growth, the only thing worse than a society with a rigid, over-centralized, dishonest bureaucracy is one with a rigid, over-centralized, honest bureaucracy”.

As an economist, Manmohan Singh likely knows the difference between “good” and bad corruption. The Indian economy, especially its small and informal business sectors, has been high on corruption because India’s regulatory structure is a disaster. Virtually everything is controlled, and anything could be deemed illegal. Most businesses in India are informal because the cost of formality is too high. And informality often brings with it corruption. Coming down hard on this kind of corruption, especially in the informal sector, hampers economic growth. The argument is not that corruption is objectively and unconditionally good. Rather, it is that achieving high economic growth under the current regulatory structure will likely be accompanied by a large degree of informality and corruption.

The Manmohan Singh government may have gone to an extreme, as it seemed to turn a blind eye to corruption in India. India witnessed rapid growth under Singh's leadership, but also had several corruption scandals. His silence on these scandals could be interpreted as support for corruption and nepotism at high levels. And while Prime Minister Singh, who was in office from 2004 to 2014, should have been more circumspect about political shenanigans around him, economist Singh may possibly have had the correct intuition.

Unfortunately, the Narendra Modi government seems to have gone to the other extreme, essentially going to war against corruption and the informal economy, killing a lot of economic activity in the process. Demonetization and the current tax harshness are examples of this kind of faulty economic thinking because much corruption in India is occasioned by the regulatory framework. The government needs to recognize that India's informality and accompanying corruption will end only when it is easy and profitable to do business formally. The corruption scandals under the United Progressive Alliance related to telecom spectrum allocations, mining licences, etc., disgusted citizens and led to distrust of the ruling class. These cannot and should not be condoned. But these must be differentiated from the good, or at the very least, "necessary" corruption across India's informal economy.

To fix this, India needs sensible economic thinking. India needs a second incarnation of the 1991 reforms, a wholesale revision of its regulations, especially in the factor markets of land, labour and capital. The current government's assault on corruption, if accompanied by liberalization and deregulation, could help the Indian economy grow faster and also deliver a functional and clean society. Deregulation will eliminate the need for "good corruption". And then, state capacity can be reserved for the "bad corruption" that's attempting to capture India's top institutions and privileges. Without reforms, an assault on corruption will likely slow the economy down even further.

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