Corruption, good governance and the economic development of Vietnam

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Abstract
High levels of corruption and poor governance are widely believed to be constraints to economic growth in developing countries. This paper examines cross-country evidence on the relationship between corruption, GDP per capita and growth rates, with special reference to Vietnam. The paper presents evidence in support of the argument that in actual fact, causality runs from higher income to lower corruption, rather than the other way around. In light of this argument, the paper suggests that Vietnam’s successful, pro-poor economic performance is most likely to be sustained through a continuation of a domestically-driven reform and policy agenda, and that fears of a slowdown in growth due to perceived weak governance are in fact misplaced.

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1. **Defining corruption**

Corruption is a notoriously difficult concept to define. This is not to say that people lack understanding of the issue, it is something on which almost everybody has an opinion. The problem is more to do with whether people see corruption as being a deviation from ethical norms or from legal norms. Both of these approaches see corruption as being process oriented, that is corruption somehow alters the “normal” processes of society. Definitions can also be outcome oriented, that is a corrupt act is one which harms the public interest, or the abuse of public office for private gain. This however leaves some scope for interpretation as to exactly what is the public interest and how it may or may not deviate from private interests. For such reasons, most economists tend to stick to an objective and process based definition of corruption along the “deviations from legal norms” approach.

The principle weakness in understanding corruption, however, is the tendency in the literature to focus purely on economic corruption and to ignore the interrelated effects of political corruption. Economic corruption is that where an exchange takes place that yields economic benefits for both parties, such as the selling of licences by officials to firms. This is based on the assumption that the state is more powerful that its clients, and therefore able to extract resources from them. Political corruption is where an exchange takes place between the state and a relatively powerful client or client group. Such exchanges are often involuntary, but the state is forced to make such off-budget transactions to maintain power and stability.

2. **What are the likely theoretical relationships between corruption and economic development?**

There is some confusion in the literature regarding the possible damaging and/or beneficial effects of corruption. One of the earliest contributions came from Left (1964) who argued that corruption might actually have positive effects in developing countries suffering from restrictive private monopolies and state intervention. Bribes would allow entrepreneurs to overcome cumbersome regulations and the illicit payments would act as a piece rate for bureaucrats. This is essentially the argument that bribery “oils the wheels” of slow-moving bureaucracy. However another early contributor, Myrdal (1968) challenged this value–enhancing interpretation and highlighted cases where corrupt officials may actually create administrative hurdles
with the specific intention of collecting bribes from those needing to circumvent the restrictive bureaucracy (Gray and Kaufmann (1998) also make this point). Khan (1996) introduced the idea of “benchmarks” and this does much to clarify confusion on the issue. He suggested that whether corrupt acts are value enhancing or reducing depends on which benchmark is considered. Essentially bribes alter the allocation of rights for a given economic agent. A movement from one allocation to another may be efficiency enhancing compared to the previous allocation, but the overall outcome may still be less efficient than the original allocation of rights. (i.e. A second-best solution may be better than a third-best solution, but it is still less good than the first-best solution.) Economists often merely look at the existence of corruption in developing countries and compare it to a benchmark of well-defined property rights of the type seen in developed economies. Such a benchmark may well be unattainable for many developing countries, in which case a simple “corruption is a bad thing” analysis would be misguided. Acts of corruption could be the means of reallocating inefficiently distributed rights in a more efficient manner, to those with the highest marginal benefits from using the rights. Authors such as Krueger (1974), Posner (1975) and Bhagwati (1982) all argue that rent-seeking costs (bribes) are losses in efficiency because they are “directly unproductive” and do not enter anyone’s utility function, but such costs may have value if they move society from a less efficient position to a more efficient one and if the optimal position is unattainable.

Schleifer and Vishny (1993) remains the most famous analysis of the costs of corruption. They make the very useful distinction between corruption with theft and corruption without theft. Corruption with theft is where bureaucrats provide goods or services at a price below marginal cost without compensation to official funds. Corruption without theft is where bureaucrats do compensate official funds, and so ration supply (much like a monopolist) so that they can receive a net payment above the marginal cost of providing the good or service. Schleifer and Vishny then discuss three cases of corruption without theft: where there is a monopoly supplier of rights which maximises the overall collection of bribes; where there are competing agencies supplying complementary rights, and so individual bribes are highest but the overall volume of bribes is lower than in the monopolist’s case; and where there are competing agencies each supplying all rights, and so both the overall and level of each bribe is lowest. Therefore the policy conclusion of Schleifer and Vishny is that the
competitive outcome should be openly encouraged with competition among agencies in the provision of rights, provided that bureaucrats cannot steal. Examples of such cases of political competition are extremely rare in both developed and developing countries so this doesn’t seem to be a particularly helpful recommendation, but their argument is useful in analysing the effect of state fragmentation on corruption. It does make sense that a highly fragmented state would be more damaging to development, and Schleifer and Vishny use Russia as a good example of how investment does not take place when there are so many agencies that have to be bribed and no coordination between them. However, even Schleifer and Vishny are puzzled by South Korea’s level of innovation and economic success (p.615) when it is clearly not in the competitive position, more likely an example of the monopoly supply of rights.

3. Vietnamese economic development and corruption
Since economic reforms began in Vietnam in 1986 under Doi Moi, the country has been highly successful in terms of both economic development and poverty reduction. Real GDP growth rates are among the highest in the world: averaging 6.1 percent between 1990 and 2002, and reaching 7.5 percent in 2004 (ADB 2005). The transition to a market economy has occurred comparatively smoothly and with relatively strong growth and economic stability throughout most of the 1990s. Household survey data from the Vietnam Livings Standards Surveys shows that as recently as 1993, some 58 percent of the population lived in poverty, compared with 37 percent in 1998 and 29 percent in 2002. The earlier gains in terms of poverty reduction were for the most part due to the distribution of land use rights to rural households and economic reform that altered the incentive structures for household based farming. More recently, the driver behind poverty reduction has been increased job creation in the private sector and the increased integration of agriculture into the market economy.

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1 ‘Economic renewal’ – Vietnam’s policy of economic reforms and transition which began in 1986. Note that that while Vietnam is certainly an economy in transition and has implemented a large number of market-oriented reforms, the State still retains a commitment to developing a Marxist-Leninist state, (Van Arkadie and Mallon 2003).

2 Based on the national poverty line – the cost of purchasing 2,100 calories per head per day plus an allowance for non-food costs.

However, even with a decade of impressive economic growth and poverty reduction, Vietnam remains a low-income country with an annual per capita GNP of just USD 485 (UNDP 2004). Human development indicators are relatively high, given per capita income, but market institutions remain underdeveloped. Until the mid 1980s, the State actively discouraged private business activity and the public sector still dominates the economy of Vietnam, contributing some 50 percent of total output.

Van Arkadie and Mallon (2003) argue that while advocates of the ‘Washington Consensus’ are quite ready to claim that the Vietnamese experience validates their paradigm, in actual fact “…Vietnam’s quite remarkable development progress is not so readily subsumed within the more orthodox versions of that framework”. They also note that following doi moi, Vietnam essentially implemented an “IMF style” fiscal and monetary reform package, but without the customary IMF financial facility to cushion the effects. Transparency International’s 2004 ratings for corruption perceptions put Vietnam 102nd out of 146 countries, ranked equally with Eritrea, Papua New Guinea, Uganda and Zambia - hardly the countries that Vietnam is normally compared to when it comes to economic performance or pro-poor development. Vietnam ranks well behind India (90th), China (71st), Thailand (64th) and Malaysia (39th), although somewhat better than Indonesia (133rd). Dollar (2002) states that “Vietnam has been one of the fastest growing economies in the world in the 1990s, and yet by many conventional measures it has poor economic policies”. In the international aid environment after Assessing Aid (World Bank 1998), donors operating in Vietnam face something of a difficulty in that Vietnam does not have a particularly “good policy environment” according to the Bank’s CIPA (Country Policy and Institutional Assessment) rating, yet Vietnam consistently manages to deliver good results in terms of poverty reduction.

The success of Vietnam’s transition from planning to markets caught many commentators off guard, especially given that the country’s home-grown reform agenda has not conformed to that expected by international donors and institutions. In recent years, there has been a growing chorus of disapproval suggesting that weak governance and a high incidence of corruption in Vietnam is poised to undermine

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4 Figure is for per capita GNP in current USD, the equivalent figure in PPP (Purchasing Power Parity) terms in 2003 was USD 2,300 (UNDP 2004).
growth and development. Dollar (2002) argues that “…a comparison of governance indicators… …reveals serious institutional weaknesses in Vietnam that need to be addressed if a high growth rate is to be sustained”. Fritzen (2003) notes that “If ‘governance matters’ (Kaufmann et al 1999)… …and various indices of corruption are to be believed, Vietnam should be a country where the outcomes of anti-corruption policies should matter nearly the most.”. The most recent edition of the Vietnam Development Report is titled “Governance” and the whole report is essentially a thesis on the need to improve the machinery of government in Vietnam. The report does, however, acknowledge that “Vietnam does not appear to be an outlier in terms of corruption, once its development level is taken into account”.

4. **Exploring the good governance agenda**

There is a large amount of literature attempting to illustrate how damaging corruption (and weak governance) is for economic growth and development. Mauro (1995), Knack and Keefer (1995), World Bank (1997), Kaufmann, Kraay and Zoido-Lobaton (1999), Treisman (2000), and Kaufmann and Kraay (2003) all use cross-country regression analysis to advance the good governance argument for economic growth and development. Most of the work reaches the same broad conclusions as Mauro (1995), who plotted a regression with corruption on the horizontal axis, and the rate of growth on the vertical axis. Looking at the graph there is a straight line positive relationship between higher growth and better governance. However, looking more closely at the data, it becomes clearer that actually there are three distinct clusters of countries. Firstly there is a group of already developed economies with good governance experiencing moderate growth, and secondly there is a group of developing countries with poor governance experiencing low growth (and therefore not converging). Hence a simplistic regression would suggest that good governance is good for growth. Such a conclusion would be erroneous, as it ignores the small statistical group of outliers that have poor governance (or at best marginally better governance than the slow growers), but high growth and are converging with the developed countries. This group would include such countries as Korea, Taiwan and Malaysia. Indeed, Treisman (2000) highlights how the three “most corrupt” countries in the Business International data used for his analysis of the early 1980s—Zaire, Thailand, and Indonesia—had average growth of 5.1 percent during the 1980s, significantly above the worldwide average of 3.1 percent. This suggests that better
governance is almost certainly not the “missing ingredient” for launching the takeoff into sustained growth among those countries which are experiencing dismal growth. In fact historical evidence suggests that corruption was also widely present in the current developed economies during the early stages of their development. In this regard, Chang (2002) is most notable in advising caution against insisting on standards of global excellence with respect to institutions in developing countries. Several of the cross-country regressions plotted by the various authors referenced above showed a strong relationship between the level of income and governance or corruption.

5. Empirical analysis

There are various proximate means of measuring corruption. This analysis relies on the Transparency International Corruption Perceptions Index - a poll of polls, reflecting the perceptions of business people and country analysts on problems with harassment, corruption and inefficient regulation. A simple plot of GDP per capita against corruption perceptions reveals little. Vietnam is, unsurprisingly, clustered in the group of countries with low income and high corruption in the bottom left corner of the diagram. Richer and less corrupt countries are clustered in the top right corner.

Figure 1: Plot of GDP per capita vs. corruption perceptions, 135 countries, 2003

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5 Scores on the Transparency International corruption perceptions index ranges from 10 (no corruption) to 0 (absolute corruption), and are based on the aggregate of a number of indices.
Plotting the log of GDP per capita against corruption perceptions, as in Figure 2, is more helpful in illustrating the dynamic process of interaction between income levels and corruption. At first glance, the diagram does appear to lend support to the argument that there is a strong linkage between the reduction of corruption and higher incomes. A straight line plot fits the data well with an $R^2$ of 0.706, implying the straight line relationship “explains” just over 70 percent of the variations in the raw data. However, closer inspection of the shape of the data suggests that a straight line fit might not be best. At the bottom left of the diagram, there are a number of countries above the trend line, in the centre countries are generally located below the trend line, while at the top right of the diagram, there are a number of countries above the trend line. Hence, a quadratic function is actually a much better fit for the data and provides a higher $R^2$ of 0.8198.

**Figure 2: Plot of log GDP per capita vs. corruption perceptions, 135 countries, 2003**

Source: Author’s calculations based on World Development Indicators 2004 and Transparency International 2004

This functional fit implies that the relationship between corruption and income (and development) is actually a dynamic one. It suggests that for developing countries starting from the bottom left corner (and wishing to move towards the top right
corner); an increase in income is likely to come before a reduction in corruption. This would indicate that the causality runs from higher incomes to lower corruption, rather than the other way around.

Figure 3 is most revealing of the complexity surrounding corruption issues and shows a plot of country GDP growth rates against corruption perceptions. This diagram also suggests that the relationship is more complex than advocates of the conventional “good governance” agenda would suggest. Richer countries with low corruption and lower growth rates are clustered around the top centre of the diagram. However, in this plot the diversity of economic performance of the high corruption, low income countries can be seen. Essentially the high corruption, low income countries can be separated into two groups: those which are not converging with the low corruption, high income countries (located on the bottom left corner of the diagram); and those which are converging with the low corruption, high income countries (located on the bottom right corner of the diagram). Vietnam is well within the latter group and converging rapidly, albeit from a low base. Interestingly there are no countries at all in the top right corner of the diagram (i.e. low corruption and high growth), implying that the suggested causality between low corruption and growth does not appear to be strong.

**Figure 3: Plot of GDP growth rates vs. corruption perceptions, 135 countries, 2003**
The main conclusion that can be drawn from this brief analysis is that in actual fact the relationship is probably not that good governance enables higher incomes, but that higher incomes enable better governance. Khan (2002) also argues that the gradual reduction in corruption in the successful developers may have been the result rather than the precondition of successful development.

A weakness of the cross-country regression approach is that the data for governance and corruption (including the Transparency International data used in this analysis) is nearly always based on qualitative surveys of perceptions of corruption. Empirical studies do present a stronger case that corruption perceptions affect investment, and therefore investment affects growth. However, perceptions of corruption are almost certainly counter-cyclical, and it is more likely the case that in an economy mired in recession, corruption will be blamed as a contributory factor and investment will dry up anyway as business opportunities appear less favourable. In an economy growing swiftly where investment is high and investors are optimistic, then corruption is more likely to be less of an issue, even if it is just as prevalent. In addition, the empirical evidence again fails to explain why some very corrupt economies in East Asia such as Vietnam, Indonesia and Thailand, have experienced very high levels of investment.

6. How corruption does and does not distort incentive structures

A key point that has not yet been sufficiently emphasised in the literature is the extent to which corruption does or does not affect the time horizons and perceptions of economic agents in both the public and private sectors in developing countries. Schleifer and Vishny touch upon the issue of corruption in the Philippines under Marcos being similar to revenue-maximising taxation (p.611), but fails to show what could be the main issue - that when corruption approximates taxation, it is unlikely to have any serious detrimental effects on growth. Most developing country governments simply cannot collect a sufficiently high proportion of GDP to internalise all the transactions that take place officially in a developed country. Hence if corruption broadly approximates a tax system, albeit outside of official channels,
then the effect will probably not be damaging.\(^6\) With consistency, long-term horizons are not affected. It does not matter to the businessman or investor whether a tax or bribe is illegal or not, what matters is if the rules are applied with regularity so businessmen can invest without fear of expropriation and forecast the costs of a transaction or investment project. Obviously this is a second-best solution though. Authors such as Bardhan (1997) have suggested that bribery is more costly than taxation because it is ex-ante, but in the absence of a first-best solution, efficiency may be maximised through tax-like corruption given the constraint that the first-best solution of no corruption is unattainable.

For this type of “taxation corruption” that does not discourage long-term investment, the incidence of corruption with theft needs to be minimised. This means that the time horizons of bureaucrats and government are of major significance also. It is not a coincidence that virtually all of the successful late developers that have managed to converge at least partially with the developed nations were characterised by strong transformative states. The same can be said of Vietnam. It seems that only with long-term time horizons of government will bureaucrats be content with the extraction of value-enhancing bribes that do not damage investment. With short-term time horizons, bureaucrats are more likely to be in fear of losing their positions and hence more likely to partake in extracting value-destroying bribes and corruption with theft. Hence the social discount rate of bureaucrats is the defining factor.

Schleifer and Vishny seemed perplexed that Korea had grown as strongly as it has done, the real question given this time horizons of government analysis is not “Why are ‘bad governance’ countries like Vietnam, China and Korea growing so fast?”, but “Why is India now growing so fast when it is democratic (and government is necessarily short-term in outlook)?”. A strong transformative state, which has long-term time horizons, a low social discount rate, and is a powerful patron relative to its clients, is much more able to ensure that value-destroying corruption is minimised.

\(^6\) For example in Vietnam there is an unwritten but widely acknowledged “10 percent” rule when bidding for government contracts. It is general practice that a successful bidder will return 10 percent of the contract price to the bureaucrats that awarded the contact. 10 percent is considered to be doing business, 15 percent is considered to be unacceptable corruption!
So what does corruption affect? Well, for a small country it undoubtedly affects the level of Foreign Direct Investment (FDI). Foreign firms simply cannot afford not to be in India or China, regardless of corruption. But for smaller countries such as Vietnam, “too much” perceived corruption may be the factor that tips the balance and encourages firms to invest elsewhere. Certainly, the level of corruption is at least a partial cause of Vietnam’s recent poor performance in attracting foreign investment since the FDI boom in the late 1990s. Only if FDI affects growth significantly will causation therefore run from the incidence of corruption to growth. However, there is little evidence to suggest that FDI is a major growth determinant, certainly if has played a key role in the development of some countries such as Malaysia, but it played virtually no role at all in other successful late developers such as Korea or Taiwan. If anything, FDI should be seen as an “investment accelerator”, rather than a “growth driver”.

7. To what extent can corruption be controlled through institutional reform?

The conventional wisdom on good governance and corruption holds that countries that have higher corruption have a higher “policy distortion index”; a lower opportunity cost of being caught; a less meritocratic bureaucracy; and a lower level of predictability in the judicial system, (World Bank 1997). These are all true but the idea that correcting market distortions and paying civil servants more will lead to a fall in corruption and an increase in growth is somewhat naïve. It ignores the importance of the nature of corruption, rather than just its existence as well as the importance of power relationships, time horizons and the ability of the state to transform society as outlined above.

Schleifer and Vishny’s argument that decentralisation and competition among government agencies will reduce corruption also seems weak given that it ignores much of the above, and will do nothing to encourage consistent taxation style economic corruption, and is likely to actually weaken the state with respect to its clients. This is not to mention the fact that there is no empirical evidence at all of successful late developers with highly fragmented states.
Arguments that a more empowered civil society, or the existence of democracy will help to curtail corruption are weak for similar reasons (this is not to say that neither civil society empowerment or democracy are not desirable for their own sake). Treisman (2000) admits that fighting corruption in many countries has proved very difficult. He suggests that the distant past appears as important as, or possibly even more important than, current policy. He admits that democratization has to be radical and long-lived to decrease corruption much and that, even though corruption may hinder growth, countries can grow their way out of corruption.

Authors such as Klitgaard (1988) have also noted that in any case, getting rid of corruption is costly. There may be is an optimal (minimum) level of corruption within a given society, below which the marginal social costs of removing corruption are greater than the actual net costs of the corruption.

8. Conclusions – can Vietnam grow its way out of corruption?
Recent research such as Rodrik (2002) has begun to highlight the importance of country specific solutions, which may not accord with the best practice models or involve wholesale reform, but which target the key local constraints given the local social and political context of development. The experience of the present successful late-developers such as China, Vietnam and India points to a much more incremental, country specific approach to building the state. In light of the failure of so many “good governance” projects and initiatives, donors are beginning to accept that the “achieve good governance – then growth will come” approach is perhaps not the best means of actually promoting growth. DFID’s Chief Governance Advisor writes:

“Many economic reform programmes identify weak governance as the key constraint, and then ask what to do about it. But if getting good government is itself a long-term endeavour, and integrally linked to economic and social change, a more useful question may be how to get growth in spite of weak governance.” (Unsworth 2003).

Just because there is little that policy makers can actually do to reduce corruption, of course does not mean that it is something that can totally be ignored. The negative effects of corruption, particularly the corrosive effect it can have on institutions and
public perceptions are real enough. As society becomes more capitalist, that is the capitalist sector grows to become the dominant sector of the economy, then it is natural that the interests of society at large and capitalism will become closely aligned. Therefore as economies develop, the sort of economic corruption that could exist when the capitalist sector was small is no longer tolerated, and the sort of political corruption that could exist in a pre-capitalist economy is no longer required to anything like the same sort of extent. In time, and though the process of the expansion of the state’s fiscal take, it becomes possible for transfers to be internalised into on-budget taxation and spending. In this sense, Treisman and Unsworth are correct in suggesting that economies can grow their way out of corruption.

With respect to Vietnam, where the economy certainly is growing, and where corruption certainly is prevalent; it is timely to remember the motto of the ruling Communist Party of Vietnam – “Đoàn kết về dân – By the people, for the people”. Given the disastrous consequences of previous foreign attempts to influence Vietnam, and given the successful domestically-managed transition from planning to markets achieved thus far, it is worth giving the country the benefit of the doubt when it comes to “growing its way out of corruption” and achieving a uniquely Vietnamese solution to policy questions surrounding corruption, good governance and economic development.
Bibliography


