PRIVATE SECTOR APPROACHES TO FIGHTING CORRUPTION

Ruslan Stefanov

Coordinator of the Economic Program, Center for the Study of Democracy (CSD)
Sofia, Bulgaria

Presentation outline

The focus of my current presentation is on the private sector approaches to fighting corruption. We'll go through the following chapters in the presentation. The first is the connection or the relationship between corruption in the private sector and corruption in the public sector and how they reinforce or stall each other. Second, we’re going to ask why the private sector is so important in fighting corruption, as it's usually the public sector that is tasked with countering corruption. Then we’re going to go through briefly the international conventions to fight corruption and the formal instruments the international community has put in place to fight corruption. And then we're going to review the private sector approaches to fighting corruption and how these have evolved in Eastern Europe and what the results have been; that is, corporate governance, corporate social responsibility, and, of course, codes of conduct, rules of disclosure, conflicts of interest, and other instruments for fighting corruption in the private sector.

The overall idea of the presentation is that the private sector and the public sector governance are important and reinforce each other in turns. That is, the private sector is important for ensuring that stakeholders are interested in improving good governance in the public sector, and, at the same time, public sector governance is important to enforce equal rules to all private sector participants.

Corruption in the public and private sectors

Corruption in the public and the private sector mutually reinforce each other, or it's the chicken and egg question, especially in Eastern Europe, where in the beginning of the 1990s there was no or very tiny private sector. Governance in the private and the public sector is mutually interlinked, which means that whenever there is corruption in the public sector, it transforms into corruption in the newly emerged private sector. And then, the newly emerged private sector, if it has emerged under rules that are not transparent, under rules that enhance entrepreneurs who did not seek added value but redistribution, leads to ineffective public sector.

So, in every country around the world, governance in the private and the public sector is mutually reinforcing, because the private sector, through the mechanisms in democracy, influences how the public sector is governed. And then, the public sector through the mechanisms of the rule of law and through the mechanisms of competition shapes the way private institutions operate and the way private institutions react to the outside environment.

In the long run, it has been proven that democracy and markets reinforce each other. Of course there are different prerequisites for this to happen and this is the subject of many other presentations in this Development Institute's courses. But what is important to remember is that governance is not only a public sector trait or a public sector problem. It is also a private sector problem, and the quality of governance in the private sector has long been connected to the quality of governance in the public sector.

Why is the private sector important in limiting corruption?

Why is the private sector important to limiting corruption? Why do we have to look into the private sector when corruption, especially in the developing world, is inherently connected with the public sector? And why is it important to know how institutions in the public sector should work right?

Well, for starters, not only in the Western society, but also in countries in transition in Eastern Europe, already 70 or 80 percent of the economy is controlled by the private sector, which means that if there is no good governance in the private sector, we can't expect the good governance spillovers in the public sector. Of course in many developing countries the public sector is much bigger than the private sector, and it is normal that especially in the transition economies in the beginning we expect and we look forward to the public sector or to the top tier of the government to have good governance. Because at the end of the day, it is public policies where we start to look into governance and how it reflects on the private sector.

Now of course, we have to take into account that it's always two-sided. It always takes two sides for a bribe to work. It's usually the public sector and private sector, but it's also fairly frequent in the developing world to have private sector-to-private sector corruption. For instance, when big international institutions discover that their employees are being bribed by smaller suppliers, and this also creates a problem for the private sector.

Increasing importance of private sector in development

We have to take into account that the private sector is playing a more and more important role in development, because in the age of globalization, private companies, especially multinationals, are more and more important and have much more bargaining power or leverage vis-à-vis developing countries' governments or transition countries' governments when it comes to development. And of course, in developed countries when we've seen in the past a shift of market power from the states to the private sector, the expectations of the society towards the private sector have also gone up.

So what we could say is that corporate governance reinforces the effects of good governance in national government. In the age of globalization, corporate governance, or the spread of corporate governance culture, is important for reinforcing – or ruining – good governance in different countries and national economies.

What if the private sector is corrupt?

If the private sector is corrupt, what are the consequences? Well, much like in the public sector, if the private sector is corrupt, we can list a number of negative effects on the economy. First, we have squandering of economic, environmental, human, and financial resources, which leads to lower economic growth. Corruption is a tax, and it's a tax that doesn't return public value, which means that whatever is taxed through corruption is lost to society or is a pure deadweight loss, which means that it's a squandering of resources. It's not enough to say, okay, this is a private company and its resources have been squandered because of corruption or because it has not been managed properly. But as the private sector grows in importance, the societal expectations of the private sector also grow. Sometimes big companies control – and especially in transitional or developing economies – 10, 20, or 30 percent of gross national product. We expect more from them. We expect them [the private sector] to meet the same standards that we expect from the public sector in terms of governance.

Negative effects of corruption

[Corruption] leads to lower competitiveness. Companies that base their competitiveness on corruption, companies that receive public procurement through corruption or receive their orders through corruption cannot operate and compete on fair grounds. And of course, there are probably much more important long-term negative effects that we've seen in Eastern Europe, where corruption has led to inverted choice. This negative investor selection means that governments have chosen investors that have been more willing to pay higher prices or higher bribes but not the ones that are most capable of delivering. In the end of the day this has led voters to conclude that this is what democracy means. Democracy comes in, privatization comes in, and these are the corrupt guys who got all the different assets. It means that this shapes a negative view of capitalism in society, which is a long-term problem for many countries in Eastern Europe. So there are long-term consequences in corruption in the private and in the public sectors.

Economic fallout of corruption

And of course, the consequences of corruption are much worse in economic fallouts. Eastern Europe has been lucky and it has been growing for the past 10 years, but as we've seen in the cases of the Asian crisis or the Russian crisis of 1998, bad economic choices, or bad corporate and public governance, lead to much deeper economic crises in terms of downturns. The resilience of the naturally competitive companies is not there, because there are bogus contracts that are based on corruption and not based on mutual benefits. And that's why this leads us to conclude that private sector corruption has similar negative impacts like public sector corruption, especially as the scale of private sector expands and as multinationals or bigger companies have much higher weight in national economies, which means that societies are placing more and more expectations on the private sector as well as the public sector.

Ensuring a good, open business environment

What can governments do if you have a corrupt environment in the private sector and you have a corrupt environment in the public sector? You have to ensure good, open business environment, meaning that you have to ensure that businesses have an open access to government. And it's not that one business speaking to that one government minister, but it's that platform, or association of businesses, saying that you have to transform this culture of one-to-one talk, this culture of solving problems in a one-to-one environment: one businessman speaking to one minister. You have to replace it with platforms for interaction, platforms of exchange of ideas where an association of businesses speaks [to] the whole government. If we look at the experience of successful open governments in the Western world, we'll see that the more open platforms, formal and informal, that a government has to share its ideas with businesses the better; the more clarity and predictability in governments' decisions to the private sector the better. And of course, it’s the same in return. The more clarity in the government as to what hurts businesses, as to what is important to businesses, the better it is for government decision-making.

There are many more other instruments that are very practical, like ensuring the rule of law, like whistle-blowing protection, like ensuring that there are institutions in place that guarantee fair competition; ensuring that privatization is done to the highest bidder and done publicly; ensuring corporate governance and a good legislative base for business associations; good legislative base for corporate governance; good legislative base for protecting small investors.

Enforcing international conventions on corruption

Of course, as the world has globalized, the importance of international conventions against bribery has gained force. For instance, the very important Foreign Corrupt Practices Act, which the United States has enacted since 1977, has been probably the most important international tool to fighting corruption. And we have to note that the U.S. has been much stricter in enforcing this law than its allies in the European Union, for example, though this is probably going to change as we've seen recent scandals of Siemens and Volkswagen. We are probably going see more and more pressure from the governments on the private sector to correct the ways they do business as multinationals become more and more important in the developing world as their FDI increases.

There is also the OECD Anti-Bribery Convention, also the United Nations Convention against Corruption [UNCAC]. But again, if these conventions are to bring tangible results on the ground in transitioning economies and in developing economies, they have to be implemented. And we've seen a lot of soul-searching, especially among European governments, as to enforcing these rules in big multinationals. At the same time, we have to bear in mind that multinationals have a very high, very strong leverage power against smaller and weaker governments.

Higher social expectations from the private sector

So what we've seen in the past 10 or 15 years is that as power shifted more and more towards the private sector, societies have come to expect much more from the private sector. In the flattening world, much more scrutiny and expectations have been put on the private companies. We've seen zillions of organizations already working to scrutinize the private sector as well as the public sector, and we've seen societies expecting businesses to move from corporate governance into corporate social responsibility, which is not only managing the relationship between management and ownership, such as the corporate governance, but also between the corporations and the society, which is corporate social responsibility. And there is sustainable production, which means that companies are requested to produce in a sustainable manner so that next generations could also use the resources that we have available today.

Principles of good corporate governance

Of course, the principles of good governance apply to the private sector as much as they apply to the public sector. These are transparency, accountability, fairness, and responsibility. And these principles act together. So we can't expect a government that is not accountable to apply principle of transparency or a private sector that is not accountable to apply principle of transparency. And these are converted into different instruments that the private sector has to develop. There is much more emphasis on ownership and who the owner is. There's been much concentrated management control in emerging markets in Eastern Europe, where well-connected insiders have gained control because of privatization. They have much more concentrated management control than is the case in developed societies. It means that in Eastern Europe, there is much more need for good corporate governance in the private sector, much more need for taking care of minority shareholders' rights. And of course, there is no corporate governance culture.

Businesses in Eastern Europe

Most of the corporations in Eastern Europe have emerged not in a natural, step-by-step way, but rather as a result of privatization deals. It means that most of the time much of the corporate governance control has been on paper and not in actual implementation, which makes corporate governance or good corporate citizenship a much harder institution to build in Eastern Europe, or in the newly emerging markets, than it has been in Western Europe. Because you need five or 10 years to do what other countries have done for 50 years, which of course, takes a lot of external scrutiny. The coming together of Eastern Europe and emerging market in the global world has helped bring these instruments quicker into the emerging markets than in the developed world.

Instruments for fighting corruption in the private sector

There are different instruments to fight corruption in the private sector, starting from strong business associations that bring about codes of conducts, disclosure rules, and [mitigate] conflicts of interest through their members. And it's important to know that all these instruments require not only public scrutiny: we can't expect that the government will do everything in the private sector. In the Eastern Europe in the past 20 years, there has been much more focus on the public sector governance than on the private sector governance. For example, there is a lack of indigenous business associations that protect the interests of their own constituents, but also take care that the constituents abide by the rule of law, and by strict codes of conduct.

Improving good corporate governance risk areas

And of course, private companies, especially multinationals, have grown in importance: the way they do procurement, the way they do sales and marketing, the way they do product control, the way they protect trade secrets, the way they do hiring. The spread of multinationals in the world and the spread of multinational companies in emerging markets has come to play a very important role in shaping the governance environment in those emerging markets, because sometimes procurement by a big multinational is bigger than the biggest procurement by the whole government. It means that the way a multinational does business is paramount to the way that the corporate culture of the host country will emerge. And in this case, Eastern Europe has been lucky because it got a lot of companies from Western Europe that are established and that abide by corporate culture standards that are much higher than those of the host countries in Eastern Europe.

Conclusions

To make a recap, the private sector governance is as important as the public sector governance in fighting corruption, especially in a world that has become very much dependent on private capital flows, and multinationals have come to play a much more important role. But we have to remember that in the long run, democracy and markets can only go hand in hand in good governance and equilibrium, meaning that as the markets develop and grow, there are good, democratic institutions that support those market mechanisms, not only in the public sector but also in the private sector.

Center for International Private Enterprise
1211 Connecticut Ave NW • Suite 700 • Washington, DC 20036 • USA
ph: (202) 721-9200 • www.cipe.org • e-mail: education@cipe.org