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THE CORRUPTION AND TRANSACTION COST IN THE FINANCIAL SECTOR IN SRI LANKA. (WITH SPECIAL REFERENCE TO COLOMBO SUB URBAN AREA)

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Abstract

Corruption and bribes are dishonest behavior by those in positions of powers in government and private financial institutes. Corruption is also partly responsible for emerging unstable economies and it is mostly evidenced as one of the modern evils in many countries including Sri Lanka. A significant number of economists argue that corruption has a negative impact upon the banking system, and it's cost of borrowing. The study focuses mainly on the link between corruption and transaction cost in financial institutions in Sri Lanka. Under specific objectives, this study focused on the institutional reasons for corruption in financial institutions and their impact on the increase in the transaction cost of the customers of financial institutions i.e, banks and microfinance institutions in Sri Lanka. The study was mainly based on the primary and secondary data sources. The primary data were gathered through structured questionnaire and interviewing method. The data were mainly analyzed by using quantitative and qualitative techniques. Firstly, the data were analyzed by using data tabulation and charts. The Kendal-tau-b tests, chi square tests and cross tabulation were used to find the relationship between variables associated with corruption factor. The non-parametric test (Mann Whitney test) was used measure the relationship between two ordinal variables. People of Sri Lanka have an assurance about banks and its transactions. They believe that corruptions are taking place in the financial institutions and banks in small scale, but the corruption happens in providing large scale loans to customers and thus increase cost of transaction. As measures of minimizing the bad activity the law enforcement should be strengthened first within judicial and institutional systems. Law enforcement should be implemented for those who found guilty in such transactions. The segregation work duties of the institutes need to be assigned to officers without conflicting authority levels. Collective decisions and approvals in financial transactions at committee levels are recommended.

Key words: banking sector, corruption, cost, transaction

1. Introduction

As the World Bank says the corruption is the main detrimental activity to the ongoing economic and social development mainstream. Corruption is a serious problem in the society that affects all facets of it. Corruption is not just about bribery and it extends to misuse exercises of discretionary power in the public sector. In the academic literature, corruption is often defined as the misuse of public office for private gains (Shleifer and Vishny, 1993; Klitgaard, 1991;

Transparency International, 1995). In the banking sector financial corruption relates to the dishonest practices of bank managers and/or bank officials.

The time and money spent in the financial transactions is the transaction costs. The information transparency in the emerging economies is low, considered further, the property right is weakly defined and protected in emerging economies. As the phase of exchange is complex the transaction cost is high. So, such an environment provides room to bureaucrats and officers and their arbitrary power may create delays and barriers in granting license, permits, financial aids and loans for more bribes (Rose-Ackerman, 1997).

The financial systems include of banks and non-banks institutions, such as pension funds and insurance companies and the reasons for weakness of financial structures in some emerging countries are numerous. The countries with new dimension for development need good financial systems to maintain economic sustainability while some countries have not been successful in setting up their financial systems, nor in attracting foreign direct investments (Rivera Batiz, 2001). Corruption is also partly responsible for this situation and it is mostly evidenced as one of the modern evils in many countries including Sri Lanka. A significant number of economists argue that corruption has a negative impact upon the banking system, and it's cost of borrowing. The corruption decreases the financial credibility of the institutions and markets. Scandals and unethical behavior in financial institutions erode confidence in such firms. This could lead to decline of the financial institutions themselves. (Dornbush and Reynoso, 1989; Sauner and Sommariva, 1993; Szego, 1993).There are various reasons for corruption in emerging countries including Sri Lanka , may be the low salaries earned by civil servants, the availability of economic rents from which bribes may be extracted, and the under-development of legal systems (Rose Ackerman, 1978, 1999; Shleifer and Vishny, 1998).

An important area of the research considers the corruption on transaction cost influenced by financial institutions. Therefore, this article focuses mainly on the link between corruption and transaction cost in financial institutions in Sri Lanka. Under specific objectives, this study focused on the institutional reasons for corruption in financial institutions and their impact on the increase in the transaction cost of the customers of financial institutions i.e, banks and microfinance institutions in Sri Lanka.

2. Literature Review

2.1. Theoretical Background

The state of corruption in a country is a process of its historical, religious, political and cultural roots, and that corruption disturbs to the level of economic growth, legal and governing system in the country. The Treisman study (2000) examines the relation between corruption indices and a country's historical, cultural, economic, and political characteristics. He finds that countries with lower corruption tend to be largely "Protestant".

La Porta et al. (1999) find that under developed countries, countries of majority Catholic and Muslim populations with socialist laws (in contrast to common laws), seem to be having inferior measures of government performance, including higher corruption. Rose-Ackerman (2001) shows that the corruption in a country decrease after longer exposure to a democratic structure. Morris also described corruption as a behavior of a public official in which public interest is not considered (1991).The World Bank is also of that view "the abuse of public office for private gain" (World Bank, 1997: 8).

The lack of transparency and poor financial education in transactions enables providers of financial services to exploit their customers. Papa demos (2008) and Blinder et al. (2008) debate the potential harm that weighs on individuals with poor financial education and lack of transparency or lack the ability to understand and interpret financial information provided. Myrdal (1974) points out that the corrupt officials may use their arbitrary power to create delays and barriers in order to collect more bribes. Rose-Ackerman (1997) too points out that the corruption direct uncertainties into the economic environment that can effecton private firms including financial institutions.

2.2. Empirical Survey

Corruption could have devastating impacts on financial institutions and financial markets. For example, the collapse in banking system in Japan in the 1990s due to the existence of corruption (Kane, 1993). Kane noted the bureaucratic incentives make regulators reluctant to acknowledge the extent of exposure to risk. The Japanese financial crisis was caused mainly by banking fraud, bribery, extortion, and high interest rate lending (Mac Farlane 2001). The financial crisis in Asia in 1997 is another example as a result of corruption (Khemani and Meyerman, 1998).

The progress of the financial institutions depends upon the efficiency. The efficiency can drop asa consequence of four reasons: drop in specialization, barriers to competition, incapacity to protect the lender and the indirect costs. As for the first reason, the corruption reduces the quality of the judicial institutions which raises the business uncertainty, consequently the transaction costs lift, which makes the economic agents to abstain from all but only necessary market exchanges. In turn, the level of specialization drops, leading to a lesser efficiency. The second reason is a rise in competition barriers. Corruption affects competition in two ways. The first way is that the institutional fragility makes the transaction costs higher. In corruption free countries, the economic agents, because of low transaction costs, have the ability to change partners very often. Contrary to this, in corruption ridden economies, the rational agents should be incited to form partnerships, in order to protect themselves from high transaction costs. As a consequence, these partnerships are difficult to join for the outsiders, and difficult to quit for the insiders. This results in the fact that the membership in these partnerships is often rewarded in a cut in a certain monopoly, but paid by longstanding loyalty to the alliance, and a prime paid to every transaction committed with a partner. From the outsider point of view, the fact that it is difficult to join a partnership, leads to the fact that the outsider enterprises, especially the foreign ones, have high institutionalized entry barriers to the market. It should not be forgotten that even to form a partnership it takes year of investing in seeking a right partner, which also constitutes a considerable economic loss of resources, otherwise usable in productive activities.

As for the third reason, it is not possible to keep the credit system, because the law and economic system is incapable of protecting a lender. In this kind of system, these are the borrowers who

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are protected, because they are not forced to return the resources they have borrowed, because the judicial system is unstable. This incites the creditors to raise the cost of the credit, which in turn raises the business risk, makes business ventures more expensive, raises the costs of investments, raises the cost of transaction, raises the general price level, and lessens the efficiency.

There are three indirect costs that affect the efficiency. The first are the costs of the corruptive transaction. As corruption is normally illegal, the partners in this activity are not protected by the court of justice. They have to protect their interests themselves. they have to find a partner for their activity and to negotiate with him. As normally there is no ‘’beaten track’’ in finding a partner, nor in negotiation, this activity provokes a considerable loss in resources. Second type of indirect costs is the opportunity costs, the costs spent at rent seeking, that could have been used in productive activities. Third type of indirect costs, according to Begović (2007, p. 303), are the costs of property rights protection. In a country with a frail judiciary system, the economic agents are forced to protect their property themselves, which augments their costs.

At the microeconomic level, corruption is accompanied by low institutional quality, inefficient institutions in terms of performance and stability, and higher costs of doing business (Asiedu, 2003; Méndez and Sepulveda, 2006; and Diaby and Sylwester, 2015). Consequently, the level of corruption has the potential to undermine bank profitability and stability. More recently, Park (2012) evaluates the influence of corruption on the soundness of the banking sector using an international dataset. The results show that corruption can be associated with a higher proportion of bad loans in the banking sector. In addition, corruption increases the allocation of bank funds from normal to bad projects which leads to increase the cost of borrowing as well as transaction cost of customers and ultimately undermining bank soundness.

The corruption affecting a bank’s performance could arise for several reasons: firms may bribe politicians (e.g., to secure loans by bypassing the loan review processes), banks may bribe politicians5 (e.g., to gain regulatory forbearance), and so on (see Munshi (1999) for examples of corruption that affect bank performance.) Presumably, one possible result will be the misallocation of loan able funds from normal projects to bad projects, which typically ends up with an increase of non-performing loans. As a result, increasing the amount of bad loans may lead to the reduction in the productivity of private investment finally, it may lead to higher transaction cost for both bankers and customers and lower economic growth. Although it is highly likely that a country with highly corrupt public sector usually has a highly corrupt banking sector, corruption does not necessarily lead to bad loans in the banking sector. For example, a borrower who has a good project may bribe a loan officer to save time by bypassing the usual loan review process. In this case, the probability of success may increase due to the timely implementation of the project (see Mauro (1995) for a similar “speed money” argument). Even when a borrower with a bad project receives funds via corruption, nobody knows if the funded project will fail or succeed in the end, though the probability of success will be relatively low.

According to the scale of Corruption Perceptions Index (CPI), the Sri Lanka ranks hold the 89th position out of 180 countries. According to Park (2012), corruption measured by the Corruption Perceptions Index has little to do with the corruption of the banking sector because it is related to the behavioral aspects of corruption. For example, they may ask questions like “Have you experienced any bribery during bank transactions?” but they may not ask questions like “Have you seen any bad loans during bank transactions?”

Lalountas et al. (2011) point out that in countries with a high degree of risk aversion in the banking sector there could be benefits in terms of increased bank lending from an increase of corruption and in the short term corruption can potentially increase bank profitability. However, the observation, that corruption can positively influence bank lending, does not necessarily mean that corruption will bring welfare gains. For instance, if an expansion of banking activity is accompanied by an increase in low productivity nonperforming loans it increases risk and ultimately raises the cost of borrowing for a bank and its customers.

3. Methodology

3.1. Sample

The fifty numbers of respondents from Colombo sub urban area was drawn as the sample. The sample was consisted with clients of both private, public banks and microfinance institutions and officers in financial institutions. The respondents represent the different levels of education, occupation and employment sector. The sample was drawn based on the snow bolling method.

3.2. Data Collection

The study was mainly based on the primary and secondary data sources. The primary data were gathered through structured questionnaire and interviewing method. The perceptions of customers of bank towards and corruptions and its transaction cost were mainly gathered through structured questionnaire. Apart from that, the issues and corruptions that customers faced in obtaining lending facilities were gathered by interviewing the customers. The secondary data were mainly gathered from books, journals, conference papers and newspaper articles.

3.3. The data analysis techniques

The data were mainly analyzed by using quantitative and qualitative techniques. Firstly, the data were analyzed by using data tabulation and charts. The Kendal-tau-b tests, chi square tests and cross tabulation were used to find the relationship between variables associated with corruption factor. The non-parametric test (Mann Whitney test) was used measure the relationship between two ordinal variables. Kendall’s tau-b is also used to measure the relationship between two ordinal variables. In this study, the first Kendall’s tau-b test was conducted to evaluate the relationship between the adequacy of micro and the satisfaction of micro finance services provided by MFIs. The Chi-Square test of Independence is used to determine if there is a significant relationship between two nominal (categorical) variables. The frequency of one nominal variable is compared with different values of the second nominal variable. If the sig value is (this is presented in the column labelled Asymp. Sig. 2-sided) is less than 0.05, the null hypothesis will be rejected. If the null hypothesis is accepted there would be no relationship between two nominal variables.

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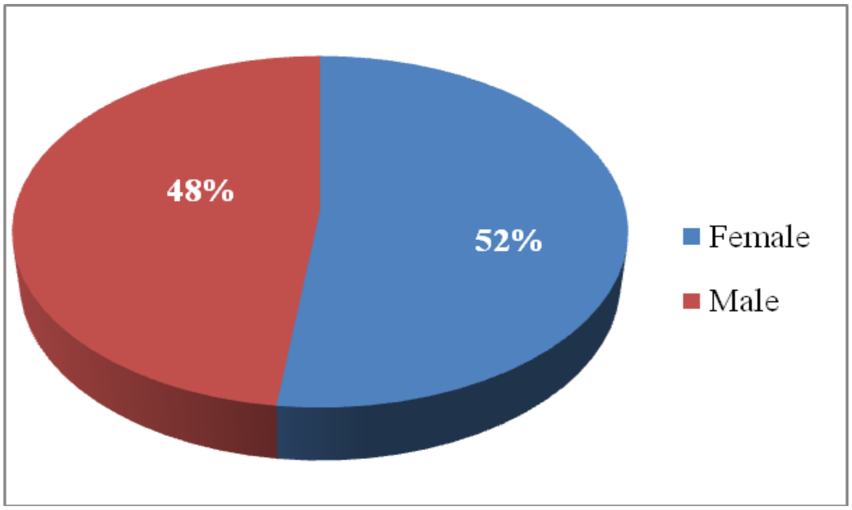
4. Results and Discussion

4.1. Descriptive Analysis

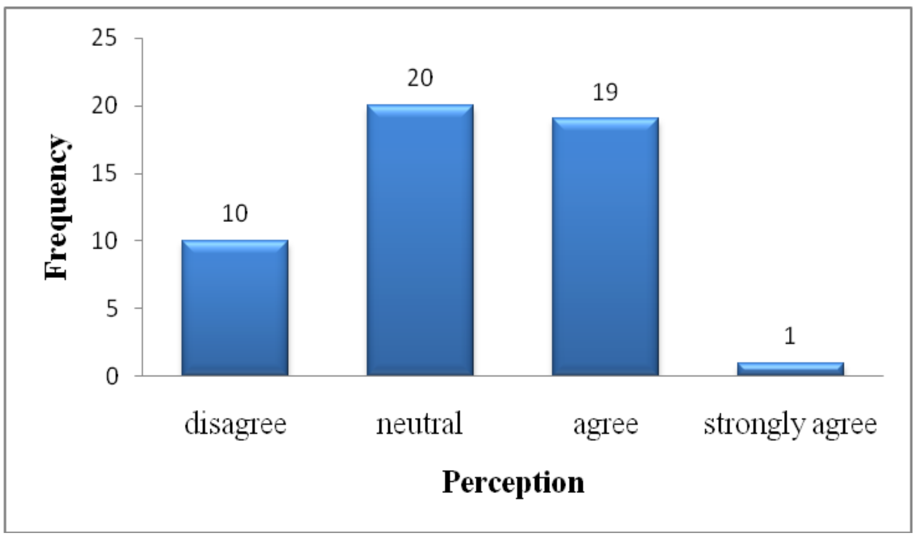
Figure 01: Gender Composition



Source: Survey Conducted in Colombo in 2018

According to the empirical findings, the gender can be identified as an important factor which affect for the perception towards corruption and giving bribes. The sample of the study was drawn from the Colombo sub urban area and out of the total sample 52 percent represent female and 48 percent represent male.

Figure 02: Perception of customers towards giving money/gifts to bank officers



Source: Survey Conducted in Colombo in 2018

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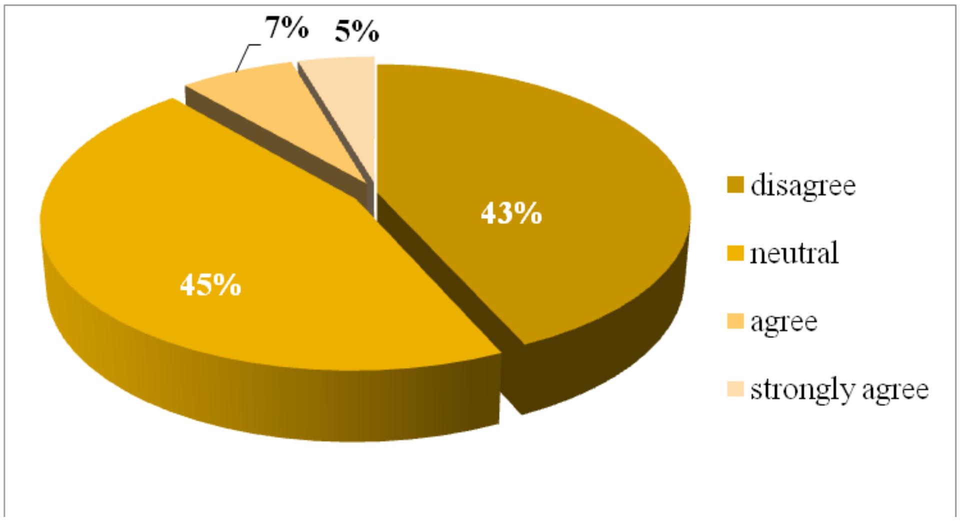
According to the statistics 20 percent and 40 percent out of the sample commented as disagreed and neutral about the giving money/gifts to bank officers respectively. Thus, it implies with the current situation in Sri Lanka, it is not acceptable and justifiable that the clients of the banks give money or gifts to bank officers.

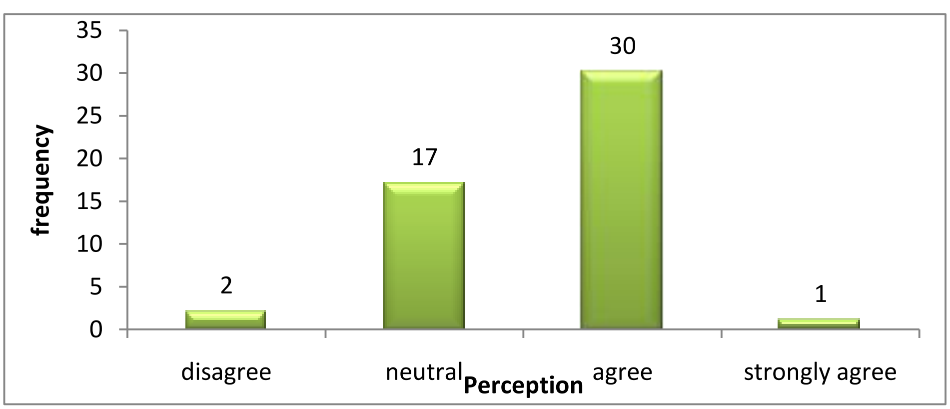
Figure 03: Perception of customers towards receiving money/gifts by bank officers



Source: Survey Conducted in Colombo in 2018

According to the statistics majority commented as disagreed (43 percent) and 43 percent commented as neutral towards perception of customers towards receiving money/gifts by bank officers. Thus, it implies with the current situation in Sri Lanka, it is not acceptable and justifiable that the bank officers received money or gifts from their clients.

Figure 04: Perception of customers about the assurance of the bank



Source: Survey Conducted in Colombo in 2018

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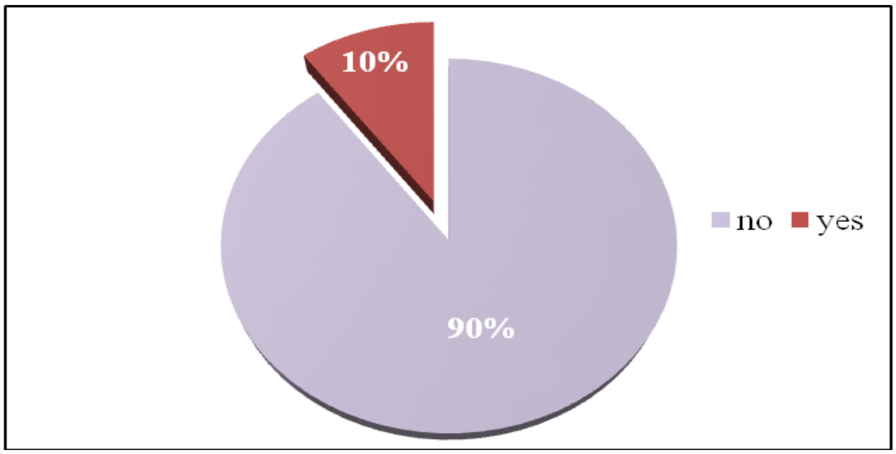
Almost 82 percent agreed that they have assurance about the bank they visit whereas 34 percent stated that they are neutral about the assurance about the bank they visit. Since they are much assured and have trustworthiness about the procedure, ethics and practices of the bank and its officers, the clients expect that officers do not demand any money or gifts in direct or indirect way

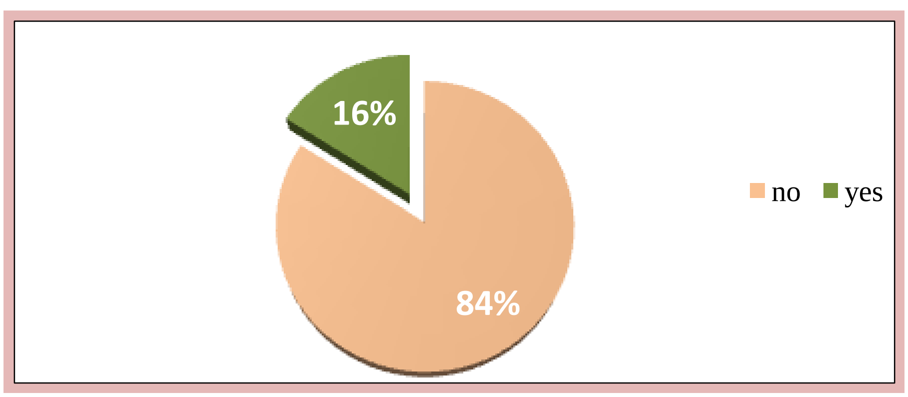
Figure 05: Perception of customers towards asking bribes in direct way by bank officers



Source: Survey Conducted in Colombo in 2018

90 percent of clients out of the sample stated that bank officers do not directly ask the money or gifts as bribes for passing their loans and other financial aids while 10 percent stated that they ask bribes directly.

Figure 06: Perception of customers towards asking bribes in indirect way by bank officers

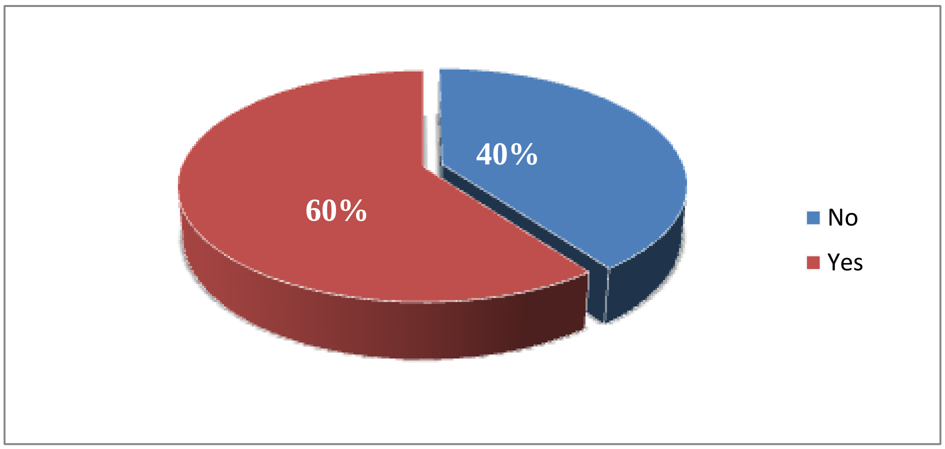


Source: Survey Conducted in Colombo in 20

84 percent of clients out of the sample stated that bank officers do not indirectly ask the money or gifts as bribes while 16 percent stated that they ask bribes indirectly. Thus, it is possible to state that majority believe that bank officers do not take bribes in terms of money or any other

forms of gifts either direct or indirect way. Instead, clients think that they should give some gift for the bank officers who supported them to get the financial loan or aid just to show their gratitude. The customers take it as ethical consideration rather than giving bribes. According to the statistics in figure 07, 60 percent stated that they give gifts to officers to show their gratitude. But, even giving gifts to show gratitude will affect to increase the transaction cost in the banking sector.

Figure 07: Perception of customers towards giving bribes to show their gratitude



Source: Survey Conducted in Colombo in 2018

4.2. Quantitative Analysis

Table 01: Relationship between sector of employment and giving money/gifts to bank officers

	CR_14
Mann-Whitney U	274.000
Wilcoxon W	652.000
Z	-.735
Asymp. Sig. (2-tailed)	.462

a. Grouping Variable: Sector of the employment of the respondent

Source: Survey Conducted in Colombo in 2018

According to the test statistics of the Mann-Whitney Test, the sig value is 0.462 which is higher than 0.05 and the null hypothesis s accepted. Therefore, sector of the employment does not affect for the perceptions towards giving money or gifts to the bank officers.

Table 02: Relationship between occupation and giving money/gifts to bank officers

	CR_14
Chi-Square	7.757
df	6
Asymp. Sig.	.256

Source: Survey Conducted in Colombo in 2018

The test statistics of Kruskal-Wallis Test reveals that there is no any significance difference between occupation and perceptions towards giving money or gifts to the bank officers. Moreover, the respondents who are engaged in academic field do not tend to give money to bank officers to get their job done. According to the test statistics of Kendall's tau_b in table 03, the sig value is .000reveals that there is high relationship between the perception of customers towards giving money/gifts to bank officers and perception of customers towards receiving money/gifts by bank officers. This implies that the people who justify the offerings of bribes will tend give bribes for officers.

Table 03: Correlation between Perception of customers towards giving money/gifts to bank officers and receiving money/gifts by bank officers

			CR_14	CR_15
Kendall's tau_b	CR_14	Correlation Coefficient	1.000	.793**
		Sig. (2-tailed)	.	.000
		N	50	50
	CR_15	Correlation Coefficient	.793**	1.000
		Sig. (2-tailed)	.000	.
		N	50	50

Source: Survey Conducted in Colombo in 2018

Table 04: The relationship between Gender of the respondent and taking advantage of personal relationships to influence those who are responsible for transaction

Chi-Square Tests

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	1.424[a]	3	.700
Likelihood Ratio	1.815	3	.612
Linear-by-Linear Association	.091	1	.763
N of Valid Cases	50		

Source: Survey Conducted in Colombo in 2018

According to the statistics in table 04, the Pearson Chi-Square value is 0.7, which s higher than 0.05. Therefore, the null hypothesis is accepted. It means the factor gender does not influence for taking advantage of personal relationships to influence those who are responsible for transaction.

4.3. Qualitative Analysis –Case wise analysis

The cost of transaction and lending corruptions are taking place in the financial sector constantly. Those are common factors today when the customers want to obtain loans for housing, educations and projects etc. In the sample test done 80% of the customers mostly educated are reluctant to offer bribes to bank officers and feel guilty of the same. It is generally accepted that there are a cost of transaction and formality requirements in applying loans from banks and also100% prerequisite requirements could not be fulfilled by customers. Insufficient incomes and collaterals are the main problems. In such circumstance’s customers compel to find many ways get through to loans by offering gifts to officers as a gratitude not a bribe. The tendency in receiving bribes in private banks is less than that of public bank because of the gap in salaries and other facilities. High income customers want to offer gifts get their personal loans passed considering time saving factor. In this instance transaction cost increases little bit, but when it comes to bigger loans like for projects depending on the size of the loan amount high rank bank officers may request indirectly through a third party some percentage of the loan thus increasing the transaction cost to the customer in addition to legal and bank charges provided enough collateral. If the project target is achieved the profitability margin drops and if not achieved the customer would bear an additional cost because of the bribe offered. This could happen other way round to the bank as a loss in a failed project loan because the risk factor and the value of the security are not granted for by the relevant officers because of the interest to the bribe offered. The bank can be another customer of a big lending institution with network of deposits customers. Finally, the ultimate cost arising from financial transactions and irregularities is passed to customers. In the Colombo share market there were various forms of manipulating share prices of non- performing companies by an organized group to attract customers and earn some money from the transactions between dealers. Actually there were additional cost to the final investors.

In the recent past many stories of the above nature in the financial sectors were heard and published in the local news papers the consequences of the bad transactions. The Golden Key fraud is the biggest scam in Sri Lanka in 2007s. The fraud amounts to 15 to 20 billion Rupees of the depositors who invested at higher rate (30%) for higher return for their money. There were financial irregularities, mismanagement and misappropriation of funds. The directors of the said financial institute had reinvested the money mostly in their private businesses entities and the interests were paid from the collection money of the new customers. Seylan Merchant Bank had fallen into an abyss of financial mismanagement, corruption and unethical practices. When customers requested their withdrawals were restricted and Rupees 2.4 billion from depositors was not invested in profitable ventures. (Sunday Times 11.1.2009) (Sunday Times 15.03.2009).Edirisinghe Trust Investment Finance Ltd had gone bankruptcy and the depositors were not paid their total money (Sunday Times 01.04.2018). Sri Lanka’s Co-operative Society

Banks face credit and deposit risks. The news highlighted the importance of urgent intervention by authorities to arrest the plague of corruptions (Sunday Times 7.8.2016).

5. Conclusions

People of Sri Lanka have an assurance about banks and its transactions. They believe that corruptions are taking place in the financial institutions and banks in small scale, but the corruption happens in providing large scale loans to customers. Those who are giving and accepting bribes justify the activity for their benefits not even considering the rising cost and risk and according to the study the gender has no different views about giving bribes. There is a tendency to giving bribes from the high-income people. People give bribes to get the service done faster and show gratitude. Hence it is observed that the transaction cost is rising.

6. Policy Implementations

Corruption and bribes are dishonest behavior by those in positions of powers in government and private financial institutes. As measures of minimizing the bad activity the law enforcement should be strengthened first within judicial and institutional systems. Law enforcement should be implemented for those who found guilty in such transactions. The segregation work duties of the institutes need to be assigned to officers without conflicting authority levels. Collective decisions and approvals in financial transactions at committee levels are recommended. Unnecessary parts of rigid rules and formalities should be removed for customers to avoid giving bribes. Awareness programs need to be launched to educate the officers and customers the risk factor involved in less transparent transactions.Therearevariation in salaries, incentives and other benefits in public financial sector when compared to private sector. The issue should be addressed to sort out the difference. The environment should be created for customer to feel assured when visiting the financial institute.

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