

## Jenni Pääkkönen: Corruption as a drag on growth and development in transition

There is mounting literature on how institutions affect growth. Two lines of this literature are particularly interesting to transition and emerging economies, namely democracy and corruption. In this paper we focus on corruption.

There is compelling evidence for the idea that countries which have low levels of corruption tend to have higher output, while countries with high levels of corruption tend to have a low level of output. The idea that corruption is detrimental to growth is not new to economics. There are at least two channels via which corruption may hurt economic development; 1) it reduces the incentive to invest, since the more a firm invests the more it has to pay bribes and 2) corruption may delay the distribution of licenses and permits, slowing down the adoption of new technologies. From a wider point of view, corruption has a detrimental effect on politics, since it hinders democracy and the rule of law; on society, since it undermines people's trust in the political system and institutions; and on the environment, as it allows the bending of environmental regulations.

### Manifestations of corruption

Transparency International, an organisation that tackles corruption, defines it as the "misuse of entrusted power for private gain" and further, corruption is also "where a bribe is paid... for something that the bribe receiver is required to do by law" or "a bribe paid to obtain services the bribe receiver is prohibited from providing". Thereby the government agents have many ways to obtain illicit payments from their clients. Transparency international has surveyed the extent of corruption from 1995, when it launched its Corruption Perception Index (CPI). The year 2008 figures were released in September.

In its survey, Transparency International looks at public sector corruption basing on expert views and opinion surveys. Today 180 countries are included in the survey and the index is scaled from zero to ten, the former being highly corrupted. Countries are also ranked according to their CPI score, from the least corrupted countries down. According to the survey, OECD countries are generally the least corrupted. The transition economies, on the other hand, score poorly in this study as only Slovenia (26) and Estonia (27) rank among the best fifth of the countries sur-

veyed, and in general the transition economies are located at the lower end of the list. Notably the more democratic countries are at the top, while authoritarian countries remain at the bottom.

Due to its intrinsic nature, corruption is hard to measure as respondents tend to hide it when surveyed. Yet there are other ways to uncover its presence. For example, economists have tried to price the political connections of corporations. It is not only campaign contributions, but political connections that might be reflected in the value of a firm: If connections buy tax breaks, give advance in bidding for government contracts or help achieving licenses, then they should boost firm's profits and be reflected in the firm's stock market value. One recent study measured the value of political connections by simply following the political careers of business men as well as the business careers of politicians, and found that in Russia, some 87 per cent of the Moscow stock exchange's value is in companies with close Kremlin connections – compared with that of 40 per cent in London Stock Exchange.<sup>i</sup>

Another interesting paper<sup>ii</sup> studied diplomats stationed in New York, NY from 146 countries. The study evaluated their parking violations, since diplomatic immunity allows the diplomats to get out of parking violations, unpunished. The diplomats were expected to follow their domestic cultural norms, while being in the same legal setting. The study finds a strong persistence in corruption norms as diplomats from high corruption countries commit more violations than diplomats from low corruption countries.

In underdeveloped economies, corrupted regimes have a tendency to promote an underground economy, since entrepreneurs find it easier to operate outside the law to avoid permits and to evade taxes. In addition, regimes characterised by rent-seeking provide futile soil to extra-legal activities such as drug dealing, smuggling and human trafficking since the entrepreneurs can resort to bribery or even collude with the police. Even though hidden activities are by nature hard to measure, estimates suggest that these activities are hardly minuscule. According to one study,<sup>iii</sup> the size of the shadow economy in Russia would be almost as high as 50 per cent of the official economy. In comparison, the OECD average is 16 per cent. China strikes as a sort of anomaly, since its estimated size of the shadow economy is

some 15 per cent - the smallest among the transition economies (see Figure). If even part of the hidden activity were conducted legally, the impact on total GDP, to say nothing of government tax revenue, would be remarkable. A recent paper from the World Bank confirms this view by suggesting that decreasing corruption and bribery related to foreign trade would lead to a 16 per cent increase in the real GDP in Russia and to a 6 per cent increase in the real GDP in China.<sup>iv</sup> Figure depicts the relationship between corruption (x-axis) and the size of the shadow economy (y-axis) in transition economies. It appears that higher corruption i.e. a value closer to zero, is related to the larger size of the shadow economy.

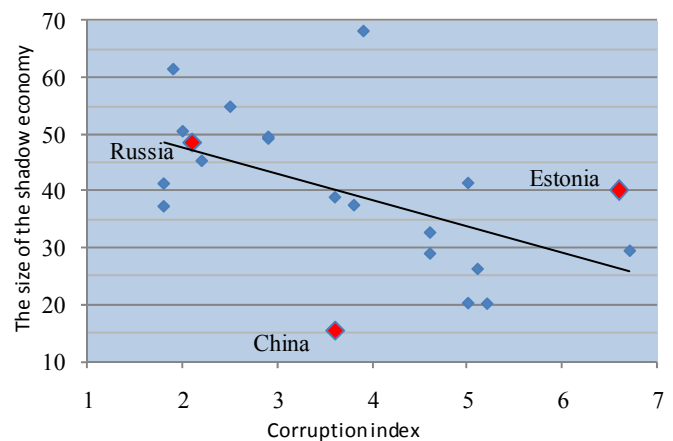
### Cures of corruption

Economic analysis also offers some insights on how to fight corruption. Firstly, as the study on diplomats' parking behaviour suggests, in order to curb corruption we need to be able to change the cultural norm regarding anti-corruption, in their homeland. The cure for corruption also calls for change at institutional level, i.e., governments should be more transparent while, at the same token, law enforcement should be enhanced. Assisted by freer press, the bad publicity of being caught should discourage bribetaking. Some argue that a wage increase for public employees might help, since it should alleviate the incentive to take bribes where the pay is not sufficient to make a living. The opponents of wage increases argue that this medicine is not only expensive but also inefficient, since bribes change hands even when the public employees are well paid.

For an international firm operating in such an environment, the presence of corruption and tax evasion pose a challenge. First, the business environment is likely to be if not hostile towards foreign firms at least demanding; as it is true that most corrupted countries also often perform the worst in the World Bank's Doing Business survey that measures the business climate of a country. Second, international firms are more prone to be harassed by predatory government agents or crooks. In top of that, if the government agents and crooks collude, the firms

cannot expect the local police to protect them from the crooks. Lastly, if tax evasion is widespread among domestic firms, foreign firms end up contributing more than their fair share to the government's tax revenue. Thereby, it would be in the interest of firms doing business in transition economies, if the local governments took decisive action to root out corruption, tax evasion and organised crime in these economies. Responsible governments have no reason to shy away from this reform, since the impact on domestic GDP and the tax revenue are expected to be on the positive side.

### Relationship between corruption (CPI value) and the size of the shadow economy (as % of GDP)



<sup>i</sup> Faccio, M. (2006): "Politically Connected Firms", *American Economic Review*, March 2006.

<sup>ii</sup> Fishman, R. and Miguel, E. (2006): "Cultures of Corruption: Evidence from Diplomatic Parking Tickets", *NBER Working Paper 12312*, June 2006.

<sup>iii</sup> Schneider, F. (2005): "Shadow Economies of 145 countries all over the world: What do we really know?", *CREMA Working Paper Series 2005-13*.

<sup>iv</sup> Abe, K. and Wilson, J.S. (2008): "Governance, Corruption and Trade in the Asia Pacific Region", *World Bank Policy Research Working Paper 4731*, September 2008.

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