U4 Expert Answer

Summaries of Literature on Costs of Corruption

Anti-Corruption Resource Centre
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Query:

"I would initially like to know more on literature that examines the human costs of corruption (personal suffering), the development costs (GDP growth, resources misallocated, etc) and the costs to business (increased risk, lost contracts, etc)."

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Content:

- Part 1: Introduction
- Part 2: Literature survey and summaries

Part 1: Introduction

This draft U4 Expert Answer mostly unearths literature on business and development costs of corruption, but also includes literature on human costs of corruption.

Part 2: Literature Survey and Summaries

The economic costs of corruption vary according to the scale and frequency of corrupt transactions and on which part of the economy and population are most affected by it.

In principle, corruption acts as an unofficial tax on consumers and producers and those least able to pay, the poor, suffer the most from its regressive impact. The macroeconomic costs are hard to assess because it is difficult to measure how much corruption there is and because it is hard to establish a robust causal link between levels of corruption and levels of economic performance.

But many economists agree that there are significant correlations between high levels of corruption and a range of negative economic consequences including:
- Creating inefficiencies in the operation of markets.
- Distorting the composition of public expenditure by focusing spending on activities likely to yield large bribes, for example, major public construction works and defence contracts.
- Reducing the level of direct foreign investment by adding costs and creating uncertainty.

Petty corruption imposes disproportionate costs on the poor but its wider economic costs are limited. Large scale or grand corruption can destroy the economy and impoverish entire populations.

In developing and transition countries there seems to be significant correlation between high levels of corruption and lower levels of investment and growth. High levels of corruption are not incompatible with high levels of economic growth, as some of the East Asian 'Tiger' economies demonstrate. But current economic thinking suggests that if those states had been able to reduce their levels of corruption, they would have experienced even higher rates of economic growth.

In a large robust, dynamic economy, the economic costs of low levels of corruption are minimal. In a fragile, unbalanced, stagnant economy, the economic costs of high levels of corruption are insupportable.

Below we list a range of studies on costs of corruption, some of which are taken from the World Bank website: http://rru.worldbank.org/PapersLinks/Measuring-the-Cost-of-Corruption/

Transparency International Corruption Perception Index, Global Corruption Barometer and Bribe Payers Index

The annual Transparency International (TI) Corruption Perceptions Index (CPI), first released in 1995, is the best known of TI's tools. It has been widely credited for putting TI and the issue of corruption on the international policy agenda. The CPI ranks more than 150 countries in terms of perceived levels of corruption, as determined by expert assessments and opinion surveys. Aside from the CPI, TI also publishes The Global Corruption Barometer, a survey that assesses general public attitudes towards and experience of corruption in dozens of countries around the world and the TI Bribe Payers Surveys, which evaluates the supply side of corruption - the propensity of firms from industrialised countries to bribe abroad.

The Persistence of Corruption: Evidence from the 1992 Presidential Impeachment in Brazil

Author: Rita Ramalho

Source: The World Bank

Corruption imposes substantial economic costs, yet there is little evidence of the success of anti-corruption campaigns. This study focuses on the 1992 impeachment of president Collor in Brazil to evaluate its impact on politically connected companies both in the short- and long-term. Using an event study methodology, it establishes the short-run effect: family-connected firms on average lose 2 to 9 percentage points of their value on dates when information damaging to the impeached president is released. However, this decline is reversed entirely within one year. It concludes that the impeachment had limited success in reducing corruption in Brazil.

The Challenge of Poor Governance and Corruption

Author: Susan Rose-Ackerman

Source: Copenhagen Consensus Challenge Paper, 2004

This paper proposes some approaches to address corruption and poor governance. The author discusses five categories of policy options: voice and accountability, procurement, revenue raising, regulation of business, and international efforts to limit high-level corruption in international business. Some reforms, if well designed and implemented, would have large benefits and very low costs. Unfortunately, they also have serious distributive effects, and those who gain from the status quo are frequently powerful economic and political actors capable of blocking reforms.

Eight Questions About Corruption

Author: Jakob Svensson

Source: Journal of Economic Perspectives 19 (3): pp. 19-42, Summer 2005

This paper discusses eight frequently asked questions about public corruption: 1) What is corruption? 2) Which countries are the most corrupt? 3) What are the most common characteristics of countries with high corruption? 4) What is the magnitude of corruption? 5) Do higher wages for bureaucrats reduce corruption? 6) Can competition reduce corruption? 7) Why have there been so few (recent) successful attempts to fight corruption? 8) Does corruption adversely affect growth?

Corruption in Indonesia

Author: J. Vernon Henderson and Ari Kuncoro

Source: Working Paper No. 10674. National Bureau of Economic Research (NBER), Cambridge, August 2006.

According to this paper, firms in Indonesia reported spending on average 8% of their total costs on bribes and over 10% of management time in "smoothing business operations" with local officials. However, the authors also find that corruption varies significantly across localities. What causes this difference? The authors argue that corruption is closely related to the local fiscal situation as determined by central government policy. Localities receiving relatively few transfers from the central government rely more on bribes and enact more red tape to facilitate bribe activities.

Estimating the Value of Political Connections

Author: Raymond Fisman

Source: American Economic Review 91 (4): pp. 1095-1102, September 2001

In a creative approach to measuring corruption, this paper assesses the value of political connections in Indonesia during the 1990s, under President Suharto. The author hypothesized that on days when Suharto's health was brought into question — for example, by reports that he would be travelling to Germany for a "health checkup" — firms with close ties to him would see their stock prices drop. The study's findings suggest that political connections accounted for a quarter of the value of well-connected Indonesian firms during the Suharto era.

Assessing the Effects of Corruption and Crime on Firm Performance: Evidence from Latin America

Author: Alejandro Gaviria

Source: Fedesarrollo, Bogota, 2002

This paper uses a survey of private firms to assess the effects of corruption on the economic prospects of firms. The paper studies whether corruption and crime affect sales, investment and employment growth at the firm level, and whether bribes and illegal payments by firms reduce bureaucratic interference. The paper finds that corruption and crime substantially reduce sales growth, and that the reported levels of corruption and bureaucratic interferences are positively correlated at the firm level. Overall, the results of the paper suggest that corruption and crime substantially reduce firm competitiveness and that corruption is unlikely to have any positive effects.

Who Must Pay Bribes and How Much? Evidence from a Cross-Sector of Firms

Author: Jakob Svensson

Source: The Quarterly Journal of Economics, February 2003

This paper uses a unique data set on corruption containing quantitative information on bribe payments of Ugandan firms. The data display two striking features: not all firms report that they need to pay bribes, and there is considerable variation in reported graft across firms facing similar institutions/policies. Combining the quantitative data on corruption with detailed financial information from the surveyed firms, the paper shows that firms' "ability to pay" and firms' "refusal power" can explain a large part of the variation in bribes across graft-reporting firms. These results suggest that public officials act as price (bribe) discriminators, and that prices of public services are partly determined in order to extract bribes.

How to Subvert Democracy: Montesinos in Peru

Author: John McMillan and Pablo Zoido

Source: Journal of Economic Perspectives 18 (3): pp. 69-92 Fall 2004

This paper analyzes which mechanism - a constitution, opposition party, regular elections, presidential term limit, judiciary safeguards or a free press - is the most critical in guaranteeing a democratic system. It looks at covert authoritarianism – the negotiation and enforcement of secret deals – as a means to quantify the importance of checks and balances in a democracy. Examining the case of Alberto Fujimori's presidency in Peru, during which an organized corruption scheme was implemented, the authors conclude that although the secret police chief, Vlademiro Montesino, bribed politicians and judges alike, TV stations were the main recipient of side payments. This indicates that the strongest check on government power was the news media.

Monitoring Corruption: Evidence from a Field Experiment in Indonesia

Author: Benjamin A. Olken

Source: Harvard University and NBER, October 2005

This paper measures missing expenditures in over 600 village road projects in Indonesia. The author finds that announcing an increased probability of a government audit, from a baseline of 4 percent to 100 percent, reduced missing expenditures by about 8 percentage points, more than enough to make these audits cost-effective. In contrast, increasing grass-roots participation in the monitoring process only reduced missing wages, with no effect on missing materials expenditures. Since materials account for three-quarters of total expenditures, increasing grass-roots participation had little impact overall. Overall, the results suggest that traditional top-down monitoring can play an important role in reducing corruption, even in a highly corrupt environment.

Who Owns the Media?

Author: Simeon Djankov et al.

Source: World Bank and Harvard University

After examining the patterns of media ownership in 97 countries around the world, the authors find that almost universally the largest media firms are owned by the government or by private families. Government ownership is also found to be more pervasive in broadcasting than in the printed media. The paper then examines two theories of government ownership of the media: the public interest (Pigouvian) theory according to which government ownership cures market failures, and the public choice theory according to which government ownership undermines political and economic freedom. The data support the public choice theory.

Does Corruption Produce Unsafe Drivers?

Author: Marianne Bertrand et al.

Source: International Finance Corporation, Washington, D.C., February 2006

This paper follows 822 applicants through the process of obtaining a driver's license in New Delhi, India. To understand how the bureaucracy responds to individual and social needs, participants were randomly assigned to three groups. Several findings about corruption emerge. First, the bureaucracy is responsive to individual needs. Those who want their license faster, get it 40% faster and at a 20% higher rate. Second, the bureaucracy is insensitive to social needs. Learning to drive safely is not how individuals obtain licenses more quickly. Third, bureaucrats create red tape by arbitrarily failing drivers, independent of their actual driving skills. These findings reject the view that corruption is used primarily to circumvent socially unimportant parts of regulation.

The Costs of Corruption for the Poor: The Energy Sector

Author: Laszlo Lovei and Alastair McKechnie
Source: Public Policy for the Private Sector 207. World Bank, Washington, D.C., April 2000
In recent years the fight against corruption has assumed a key place in development policy, as a way of strengthening economic growth and helping civil society and democracy to function. Corruption not only stifles growth. It also perpetuates or deepens inequality, as the few amass power and wealth at the expense of the many. The energy sector lends itself to corrupt practices. This is a result both of its traditional institutional arrangements--dominated by state monopolies controlling oil, gas, or electricity--and of the sheer amount of cash it can generate. Corruption in energy takes many forms, from petty corruption in meter reading and billing to grand corruption in the allocation of lucrative monopolies. These practices differ in scale but contribute to the same results, weak operational and financial performance and, for the poor in particular, declining service quality or reduced chances of ever accessing network services. The answer to corruption is continuing reform, to reduce the incentive and potential to capture monopoly rents and to increase the transparency of public and private transactions, regulatory structures, and decision making processes.

The Role of Wages and Auditing During a Crackdown on Corruption in the City of Buenos Aires

Author: Rafael Di Tella and Ernesto Schargrodsky
Source: Harvard Business School and UTDT, March 2002
This paper examines the prices paid for basic inputs during a crackdown on corruption in the public hospitals of the city of Buenos Aires, Argentina during 1996-97. The authors find a well-defined, negative effect on the measures used to capture corruption. Prices paid by hospitals for basic, homogeneous inputs fell by 15% during the first nine months of the crackdown. Relative to the pre-crackdown period, higher wages play no role in inducing lower input prices when audit intensity can be expected to be maximal (during the first phase of the crackdown), but have a negative and well-defined effect when audit intensity takes intermediate levels (the last phase of the crackdown).

Ownership, Competition and Corruption: Bribe Takers versus Bribe Payers

Author: George Clarke and Lixin Xu
Source: Policy Research Working Paper 2783. The World Bank, Washington, D.C., February 2002.
Over the past few years, many studies have looked at the macroeconomic, cultural, and institutional determinants of corruption. This study complements these cross-country studies by focusing on microeconomic factors that affect bribes paid in a single sector of the economy. The authors look at how characteristics of the firms paying bribes and of the utilities taking bribes affect the equilibrium level of corruption in the sector. On the side of bribe payers, enterprises that are more profitable, that have greater overdue payment to

utilities, and de novo private firms pay higher bribes. On the side of bribe takers, bribes paid to utilities are higher in countries with greater constraints on utility capacity, lower levels of competition in the utility sector, and where utilities are state-owned. Bribes in the utility sector are also correlated with many of the macroeconomic and political factors that previous studies have found to affect the overall level of corruption.

Sick of Local Government Corruption? Vote Islamic
Author: J. Vernon Henderson and Ari Kuncoro
Source: Working Paper No. 12110. National Bureau of Economic Research (NBER), Cambridge, March 2006
A significant portion of corruption in Indonesia occurs at the local level, where local government officials collect bribes to supplement their salaries. In 2001 alone, bribes paid to local officials averaged 6% of total costs for manufacturing firms. Having this in mind, this paper examines whether democratization with decentralization reduces or increases corruption at the local level. The authors find that corruption did decline with administrative decentralization in the country. However, districts which voted in greater proportions to Islamic party representatives experienced much greater reductions in corruption, indicating that specific politics also matter.

Redesigning the State to Fight Corruption: Transparency, Competition, and Privatization
Author: Susan Rose-Ackerman
Source: Public Policy for the Private Sector 75. World Bank, Washington, D.C., April 1996
Susan Rose-Ackerman argues that anti-corruption reforms should aim at reducing the benefits under the control of officials, increasing the costs of bribery, and limiting the bargaining power of officials. More competition, privatization of government activities, and introduction of greater transparency go in that direction. (PDF, 178KB)

The Firms Speak: What the World Business Environment Survey Tells Us about Constraints on Private Sector Development
Author: Geeta Batra, Daniel Kaufmann, Andrew Stone
Source: World Bank, Washington, D.C. 2003.
If private enterprises are a critical path out of poverty through employment or ownership, then establishing conditions for their growth must be a key component of a poverty-reduction strategy. The World Bank's World Business Environment Survey (WBES) offers important insights as to what is needed to improve the business environment, based on what businesses themselves say about the conditions they need to grow and the impediments they face. Based on the WBES, this paper provides tentative answers to a series of questions that might help solving the poverty riddle, such as: What do active managers view as their main obstacles to operation and growth of their firms? What conditions are associated with a higher level of enterprise growth? Why do firms so frequently opt to function unofficially? What makes reforms so difficult, especially in countries with influential private firms? Is corruption less harmful to business operation when it is predictable?

The Regulation of Entry
Author: Simeon Djankov et al.
Source: World Bank and Harvard University, June 2001
The authors present new data on the regulation of entry of start-up firms in 85 countries, covering the number of procedures, official time, and official cost that a start-up must bear before it can operate legally. The official costs of entry are extremely high in most countries.

Countries with heavier regulation of entry have higher corruption and larger unofficial economies, but not better quality of public or private goods. Countries with more democratic and limited governments have lighter regulation of entry. The evidence is inconsistent with public interest theories of regulation, but supports the public choice view that entry regulation benefits politicians and bureaucrats and increases corruption.

Public Integrity Index
Source: Global Integrity
The Public Integrity Index is the centre piece of the Global Integrity Report, providing a quantitative scorecard of governance practices in each country. The Index assesses the institutions and practices that citizens can use to hold their governments accountable to the public interest. The Index does not measure corruption itself, but rather the opposite of corruption: the extent of citizens' ability to ensure their government is open and accountable.
http://www.globalintegrity.org/

World Bank Enterprise Corruption Survey
Source: World Bank
The Enterprise Survey site contains data on the investment climate in 58 countries, based on surveys of almost 32,000 firms. In some countries, doing business may require making unofficial payments to clear red tape, or gifts to tax inspectors and officials involved in issuing government contracts. This site shows how countries and regions score on these indicators.
http://info.worldbank.org/governance/beeps/

PREM Anti-Corruption Website
Source: World Bank
This anti-corruption site of the World Bank's Poverty Reduction and Economic Management (PREM) unit discusses the importance of a competitive private sector and offers an extensive anti-corruption literature survey.
http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/ORGANIZATION/EXTPREMNET/0,,contentMDK:20795848~pagePK:64159605~piPK:64157667~theSitePK:489961,00.html

Tanzi,V.; Davoodi,D. (1998) Roads to Nowhere: How Corruption in Public Investment Hurts Growth; in *Economic Issues* No 12, March 1998
In this paper, Tanzi and Davoodi analyse the economic impact of corruption in procurement. Contrary to the economics profession's 'golden rule', which states that increased public capital spending leads to economic growth, corruption in procurement seems to reduce the capital spending's productivity and as a consequence lower the growth rate of the country. Tanzi and Davoodi run a series of regressions to determine the relationship between levels of corruption and aspects of public spending and revenue collection. They find that corrupt procurement practices do indeed have the potential to reduce growth by (1) reducing the productivity of public investment, by (2) increasing public investment that is not adequately supported by non-wage expenditure on operation and maintenance, by (3) reducing the quality of the existing infrastructure and by (4) decreasing the government revenue needed to finance productive spending.

This document is based on a paper by Tanzi and Davoodi, which was published under the title "Corruption, Public Investment, and Growth" as IMF working paper 97/139. It forms part of a series which aims to make available to a broad readership some of the economic research produced in the IMF and is, as such, easy to read yet highly informative. Even

though it does not propose solutions, it provides a compelling overview of the harm corruption in procurement causes in the country in which it takes place.
http://www.imf.org/external/pubs/ft/issues12/issue12.pdf

Rose-Ackerman, S. (1996) *The Political Economy of Corruption – Causes and Consequences*; World Bank Note
In this short note, Rose-Ackerman examines corrupt opportunities and their political, economic and distributive implications. Stating that corruption can have a seriously distortionary and debilitating effect on the national economy, she nevertheless stresses that corruption is but a symptom of malfunctioning, not its underlying cause.
http://rru.worldbank.org/Documents/PublicPolicyJournal/074ackerm.pdf

Kaufmann, D.; Wei, S-J (1999) *Does 'Grease Money' Speed Up the Wheels of Commerce?* , Working Paper, WBI
In this paper, Kaufmann and Wei invalidate the theory that bribery reduces effective red tape. Using data from three firm-level surveys, they find that red tape is not exogenous but dependent on both the firms' ability to pay and the discretionary powers of rent-seeking bureaucrats, thus showing that corruption may well enhance red tape, not circumvent it.
http://www.worldbank.org/wbi/governance/pubs/greasemoney.htm

Mauro, P. (1997) Why worry about corruption? *IMF Economic Issues*, No 6
This paper has two goals. First, it lists a number of possible causes and consequences of corruption, derived from a review of empirical studies that use cross-country regressions to determine the strength of the links between corruption and its causes and consequences. Although data limitations subject empirical work to many uncertainties, these studies provide tentative evidence that corruption may seriously inhibit economic performance. Second, the paper presents recent evidence on the extent to which corruption affects investment and economic growth and on how it influences governments in choosing what to spend their money on. It finds that corruption discourages investment, limits economic growth, and alters the composition of government spending, often to the detriment of future economic growth.
http://www.imf.org/external/pubs/ft/issues6/index.htm

The World Bank (2000) Anticorruption in Transition, a Contribution to the Policy Debate, Chapter 2. in *The Economic and Social Consequences of Corruption in Transition Countries*
This chapter reviews the empirical evidence on the economic and social costs of corruption in the context of the Central and East European transition economies. Discussing the consequences of corruption in areas such as growth and investment, fiscal stability, public service provision and government credibility, the authors stress that although these may be prevalent to differing degrees depending on the respective state, they cannot be treated in isolation from one another: corruption, state capture and distrust are mutually reinforcing.
http://lnweb18.worldbank.org/eca/eca.nsf/Attachments/Anticorruption2/$File/chapter2.pdf

Shang-Jin Wei (1997) *Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle?,* Harvard University and National Bureau of Economic Research
This paper reviews the overwhelming statistical evidence that countries with high corruption levels have poorer economic performance. Ultimately, the success of any anti-corruption campaign depends on the reform of domestic institutions in corrupt countries.
http://www.worldbank.org/wbi/governance/pdf/wei.pdf