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The Rationale of Transparent Public Finances — Impacts on Economic Growth

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Empirical stylized facts

The research on the prevalence of corruption, on its causes and consequences, is in full swing. Thanks to the data that has been collected and provided by "Transparency International," the topic is part of many research efforts worldwide, and a handful of results are available today. Let me present to you the most relevant empirical regularities in this domain.

Finding 1: More corruption is related to smaller per capital income (Mauro 1995).

In other words, corruption is more usual in poor countries than in rich countries. [More bullet points will follow on this list. Let me just quickly make a digression and show you this result in more detail.]

This chart shows the statistical relationship between the percentage of people who report having paid bribes in the last year, and the income per capita in the respective country. Note that the vertical axis is logarithmic, so what we see here is not a linear, but more or less a hyperbolic relationship. This means that very poor countries typically have very high levels of corruption, but countries somewhere in the middle in terms of per capita income already have rather low levels of corruption.

The following slide makes the connection between wealth and corruption maybe even more obvious. [Slide with graph by Transparency International] What we see here is the distribution of the corruption perception index (CPI) as published by Transparency International. The map looks almost like a map of poverty. The correlation is not perfect, there are exceptions (Chile, Italy, ...), but the connection is still very clear.

William Easterly, the famous former Worldbank economist, has put it concisely when he said:

"The rich have markets,
the poor have bureaucrats."

Actually, maybe it is not the bureaucrats *per se*; maybe it's the fact that they tend to collect bribes that makes them harmful, so one might also say:

"The rich pay prices,
the poor pay bribes."

Let me show you some more results that have been found in this empirical literature on corruption. Each of the following results has been published in one or several scientific articles, and if you are interested in the sources, the references are available.

Finding 2: More corruption is related to less equal distribution of income (Gupta et al, 2002).

It has been found that an increase in corruption acts like a degressive tax, thereby redistributing wealth from the bottom to the top.

Finding 3: More corruption is related to weaker public finances, in the form of higher debt and lower per capita tax revenues (Tanzi and Davoodi, 2000; Tanzi, 2002).

It has to be expected that tax revenue is weaker since corruption is correlated with low income. But this effect is still there even after controlling for income. The reason is simply corruption of tax inspectors. If they can be bribed, tax revenues that go to the legal state decline, although the tax burden of the citizens may only decline a little, since the bribe really is just part of the tax deal.

Finding 4: Corruption reduces private investments of all forms. It reduces financial and physical investments (Mauro, 1995; Brunetti et al, 1998, Wei, 2000), as well as the formation of human capital, in the form of education or health care (Mauro, 1998; Gupta *et al*, 2002; Tanzi, 2002).

This is probably the most severe effect from an economic development point of view. Corrupt governments seem to spend less on education and health care. Private individuals seem to reduce their investments as well, just like foreigners. Corruption is not a good business climate because deals that rely on it are much more difficult to enforce, should one side decide to renege on a deal. This heightened uncertainty is no good news for business.

Finding 5: More corruption is related not only to lower average income and higher poverty, but also to lower trend growth rate (Mauro, 1995 and others).

There is a distinction between the level of income per capita on the one side, and its growth rate on the other. The negative relation of corruption with the growth rate has been found by several authors, but is less pronounced. Moreover, there is an important exception to this finding.

The big exception: East Asia

In a recent article, Michael Rock and Heidi Bonnett (2004) find that the negative correlation between corruption and investment and between corruption and growth is conditional on region and size of the respective economies. In particular, the effect of corruption in the larger East Asian economies — China, Indonesia, Korea, Thailand, and Japan — seems to be reversed. The smaller, industrialized or newly industrialized East Asian Economies — Singapore, Hong Kong, and Malaysia — have developed with very small amounts of corruption, but this is not true for the large countries just mentioned.

It is of course not possible from such a small sample of countries to pinpoint the exact reason for these different experiences, but the authors are able to tell a convincing story that seems to make sense. They argue that the question whether corruption is detrimental to growth depends on the domestic organization of corruption. If corruption is performed individually, by many independent bureaucrats, the result is effectively to impose an extremely high tax rate on citizens, which is bad for development and growth. The authors cite many African countries as well as India and the Philippines as examples. If, on the other hand, there is a strong central state that exerts control over the whole corruption network, the outcome then depends on the time horizon of the top executive.

If the top executive has a short horizon and the power to monopolize the corruption network, the effect is disastrous. The authors identify some Latin American and some African economies with this situation. They call it hyper-presidentialism, in which a strong president faces only limited constraints and checks, and where business-politicians turned presidents simply loot the nation as long as they can.

If, on the other hand, the government has a longer perspective, it will behave like a patrimonial monopolist and organize good deals for the economy as a whole in exchange for kickbacks. The authors argue that

this is a way in which corruption might actually be beneficial for development, and they cite the large East Asian countries as examples of this strategy.

Which way does the causation go? — Endogenous institutions

So, with the exception of some major East Asian countries, corruption is associated with smaller income per capita, slower growth, and weak investment. It seems reasonable to assume that there is a causal link that goes from corruption to weak development. Some econometrics tests have indeed verified that this is the case (e.g. Gupta *et al*, 2002).

New theoretical research, however, points towards the possibility of reverse causation as well (Bruegger, 2005). Corruption may not also be one of the causes of low growth, it may also be due to low growth.

The idea is the following: if people expect low growth in the future, the property rights they have today is not worth very much. Why invest in factories or education if prospects are bad? In fact, factories and a good education are not worth very much in such a circumstance.

So if property rights are not very valuable, people will also not try very hard to defend and protect them. They are much more likely to accept weak or even extortionist institutions. If, however, property rights are valuable because growth prospects are good, then the people who hold these properties will fight for good institutions, for "institutions of private property" as Acemoglu et al (2001) have called it.

Conclusion

Weak institutions facilitate corruption, and corruption is bad for growth, which makes property rights less valuable. For this reason, people will accept weaker institutions, which then again facilitates corruption. This makes corruption a self-enforcing process and a vicious circle. The

bright side of this is that combating corruption can induce a virtuous circle, that makes it more and more easy to improve the functioning of the public and private system.

What do you need to fight corruption? You need the political will to do it. The political will to do it will emerge as soon as a sufficient share of the electorate is interested in good institutions. As long as this is not the case, successful political parties will only pay lip service to this aim, because there is no political capital in this topic.

A significant share of the population will be interested in good institutions only if there is a sufficiently broad middle class. I was told yesterday and the day before that this is currently not the case in this country.

What is the middle class? My personal definition is this: it is people who have some property to lose (and who are therefore interested in property rights), but who still have to work for a living.

Serbia's economy will grow — I think there is little doubt about that; Serbia is on a catching up path. The question is how this additional wealth will be distributed. If everything goes to a few tycoon families, Serbia will become a new aristocratic society, with a large working class and a small aristocracy who owns everything — very middle age. I think, or I hope, that this will not happen.

I think it is more likely that the wealth will ultimately spread, and a middle class will actually emerge. When this happens, the high days of corruption will be gone.

Now, if it is indeed true that Serbia has no middle class to speak of today, then realistically, I am afraid, we are talking not about years, but about decades for this process to complete.

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