FIGHTING GRAFT MAY HARM GROWTH: New evidence that corruption can have both positive and negative economic effects, depending on institutional quality

Corruption can actually improve growth in countries with weak institutions, according to an analysis of 128 countries by Réda Marakbi and Camélia Turcu, to be presented at the annual congress of the European Economic Association in Geneva in August 2016.

They note that there are two contrasting views on the economic impact of corruption: either that it 'greases the wheels' of an inefficient business environment; or that it 'sands the wheels' by reducing investment, governance and institutional quality. Thus, corruption might improve efficiency by allowing people to overcome institutional failures, but when institutions are strong, corruption would be harmful for growth.

The new study measures both effects by analysing data on 128 countries over the period 1984-2012. It demonstrates that the quality of the institutional environment changes the impact of corruption on growth. While in many cases corruption slowed growth, the authors argue that the data show that fighting corruption can sometimes also be harmful for growth in countries with low levels of institutional quality.

They conclude that strong institutions are the best defence against graft in two ways: 'Improving institutional quality will have a direct positive impact on growth, but can also have an indirect positive impact on growth by reducing corruption.'

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In recent years, corruption has been a big focus of public debate in both developed and developing countries. According to Transparency International (2009), about a third of international assistance is taken every year by corrupt officials in developing countries. In developed countries, corruption cases have also been put forward as underlined by Van den Heuvel (2005) when analysing the Netherlands case or by the European Commission (2014) for the EU28 situation in general. But no consensus has been reached yet within the academic community on the economic consequences of corruption.

In particular, at theoretical level, the impact of corruption on economic growth is extensively addressed, along two main conflicting views. According to a first view, which is the oldest historically, corruption ‘greases the wheels’ of business enabling economic growth and development.

It can be efficiency enhancing by allowing firms and individuals to get round the rules of an ineffective administrative and legal system that slows down investment and therefore growth (Leff 1964; Nye 1967; Hutington 1968; Méon and Weil 2010). Furthermore, corruption provides incentives to bureaucrats to work harder. This increases labour productivity and overall economic activity.

A second view considers that corruption ‘sands the wheels’ of economic growth. This widely accepted view is supported by plenty of factual evidence (World Bank, 2013). In this respect, the theoretical and empirical literature argues that corruption is negatively related to growth through its adverse effects on private investment, public expenditure and human capital, as well as governance and institutional quality.
The authors of the new study explain their work: within this framework, we propose a novel reassessment of the impact of corruption on economic growth through the lens of institutional quality. Our contribution to the literature is four-fold.

First, in contrast with most existing studies on the topic, we do not consider that corruption can have only a positive or only a negative impact on economic growth. Hence, we aim at reconciling the ‘greasing the wheels’ and the ‘sanding the wheels’ views by highlighting that both effects could co-exist.

Second, we explain this by the fact that the relationship between growth and corruption could be non-linear. Specifically, we go beyond existing studies which estimate the corruption growth nexus as we highlight the existence of non-linearities in the link between corruption and economic growth, using a Panel Smooth Transition Regression model. This allows us to determine endogenously the eventual non-linearities and the thresholds in the relation between growth and corruption, and to show the co-existence of the greasing the wheels and sanding the wheels hypotheses.

Third, we show that this differentiated/non-linear impact of corruption on growth depends on the level of institutional quality of the analysed countries, captured using an extensive set of six institutional variables.

Fourth, in contrast with most existing studies that extensively use cross-section data, we employ panel data, we account for the time-varying nature of the relation between growth and corruption and we also use a richer data set including both developed and developing countries.

Specifically, our empirical study covers 128 countries over the period 1984-2012, and shows how the quality of the institutional environment modulates the impact of corruption on growth. In the case of institutional shortcomings, corruption can improve efficiency by allowing individuals to overcome the institutional failures. In contrast, when institutions are strong, corruption can be harmful for growth.

In the light of the above considerations, we can advance that countries should strive to improve the quality of their institutions. Improving institutional quality will have a direct positive impact on growth but can also have an indirect positive impact on growth by reducing corruption.

But fighting corruption can sometimes be harmful for growth: in countries with low levels of institutional quality, beyond a certain threshold, the sensitivity of growth to corruption is rather low. Therefore, the growth that could be obtained in these countries, although co-existing with corruption, could be, further on, used to improve the quality of institutions above a certain threshold, and this will furthermore, limit corruption.

Hence, the issue of an optimal action of governments, in several steps, should be investigated further on.

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