Chapter 2: The Economic and Social Consequences of Corruption in Transition Countries

In recent years, many studies have presented powerful empirical evidence on the economic and social costs of corruption. They have shown how corruption hinders investment (both domestic and foreign), reduces growth, restricts trade, distorts the size and composition of government expenditure, weakens the financial system, and strengthens the underground economy. Most importantly, a strong connection has been demonstrated between corruption and increasing levels of poverty and income inequality. The experience of the transition countries strongly supports these findings. Yet unbundling corruption in transition reveals the extent to which these costs vary as a result of different patterns of corruption.

The costs of state capture and administrative corruption are mutually reinforcing and are themselves influenced by a range of other factors. The fiscal distortions caused by corruption, for example, erode the quality of government services, with particularly serious consequences for the poor. The negative effects of corruption on investment and growth similarly exacerbate poverty and erode the tax base, further undermining the quality of public services. Though this chapter will examine the consequences of corruption in a range of independent areas—growth and investment, poverty and inequality, fiscal stability, public service provision, and government credibility—the mutually reinforcing nature of these costs and the complex lines of causation should always be kept in mind.

Investment and Growth

It is well established that investment is significantly affected by the level of uncertainty in the business environment. By increasing uncertainty, corruption raises the effective cost of investment for the firm and

Typology Charts

For the purposes of analysis in the following chapters, the countries have been divided into four groups on the basis of thresholds of administrative corruption and state capture as in Figure 1.4. This produces a two-by-two matrix that groups countries on the basis of similarities in both the level and pattern of corruption. However, it is important to recognize that the composition of the groups is based on the determination of the dividing lines, which is done here for analytical purposes only. As several countries lay close to the thresholds, their inclusion into either group is subject to a greater margin of error. For a graphical depiction of the matrix along with the margins of error, see Annex 1.

Charts such as the one below will be used throughout this report. These charts show the averages of the relevant variable for the countries in each group of the two-by-two matrix. The charts illustrate associations between the relevant variable, administrative corruption and state capture, rather than causation. These associations do not take into account the potential explanatory significance of other variables that might influence the associations.
consequently reduces investment levels. In transition countries having high levels of both administrative corruption and state capture, gross domestic investment averages more than 20 percent less than in countries in the medium/medium category of our typology.

The negative effects of corruption are particularly clear from the firm-level performance data. The average annual sales growth over the past three years was 17 percent for firms reporting moderate levels of administrative corruption, declining to 10 percent for firms reporting higher levels. The differential for investment growth is equally stark: 17 percent versus 9 percent, respectively. The differences hold regardless of firm size, origins, and line of business. It is difficult to establish the direction of causality in this relationship. Weak firms might be more inclined to rely on administrative corruption as a survival mechanism. Alternatively, administrative corruption could directly weaken firm performance, raising questions as to whether such bribery yields any selective benefits for the firm.

The effects of state capture on firm performance show a marked contrast. Where state capture is reported to be prevalent, firms that pay bribes to influence the content of laws, decrees, and regulations show significant increases in sales growth. In such environments, firms engaging in capture grew by over 30 percent in the past three years, compared to a growth rate of only 8 percent among other firms. Yet in countries where state capture is limited, engaging in capture does not appear to bring any specific gains to the firm in terms of sales growth. Though capture would appear to create an uneven playing field in certain contexts concentrating gains to powerful firms, high levels of state capture are nevertheless associated with lower firm growth rates overall—sales growth in low-capture countries averages 21 percent, compared to only 11 percent in high capture countries. The gains to capture for particular firms appear to be associated with negative consequences for less influential firms. Again, the issue of the direction of causality could be raised—capture could directly improve firm performance or stronger firms could be more likely to engage in capture.

Though a small group of firms appears to receive gains from capture in certain contexts, the social costs of capture are substantial. State capture represents a transfer of wealth among politicians, firms, and the state via distortions in the underlying competitive and institutional framework. Figure 2.1 shows that countries with high levels of state capture and administrative corruption had the largest output decline in the period 1989-98. Though the direction of causation is ambiguous, a strong case can be made that corruption contributed to the output decline, given its effects on investment and growth, the weakening of tax revenues, the misappropriation of credits and subsidies, and the erosion of public sector services.

Figure 2.1. Corruption and Output Decline

![Figure 2.1. Corruption and Output Decline](data:image/png;base64,iVBORw0KGgoAAAANSUhEUgAA...)
Poverty

For so many individuals and families, the most immediate and visible consequence of the transition has been a decline in their living standards. Even among the more advanced reformers, poverty levels have expanded over the past decade at an alarming rate, as demonstrated in the Prague 2000 report *Making the Transition Work for Everyone*. The expansion of poverty was initiated by the collapse of GDP, which fell by 50 percent in the CIS countries and 15 percent in CEE. Yet even with recovery, poverty rates have remained high as incomes of the poor have failed to recover and inadequate social safety nets have left the most vulnerable groups unprotected.

Figure 2.2 demonstrates that poverty is highly correlated with administrative corruption. Surely, poverty can contribute to corruption as poor countries have fewer resources to implement and maintain the monitoring and oversight necessary to contain the problem. Yet corruption also exacerbates poverty. As demonstrated above, corruption is empirically associated with lower economic growth rates, weakening the main factor that can pull people out of poverty. Moreover, corruption has a direct impact on the living conditions of the poor.

**Corruption and service delivery:** When corruption misdirects the assignment of unemployment or disability benefits, delays eligibility for pensions, weakens the provision of basic public services, it is usually the poor who suffer most. Such corruption undermines the social safety net and may deter the poor from seeking basic entitlements and other public services.

**Bribery at the household level:** The extent to which households engage in bribery is strongly correlated with both administrative corruption and state capture as demonstrated by a UNICRI cross-country survey of more than 25,000 households in 20 transition countries. For example, in a country like Georgia, with high levels of both state capture and administrative corruption, nearly 30 percent of households said they paid a bribe in the previous year, in marked contrast to Slovenia where only 1.5 percent of households reported bribe payments. Though corruption at the household level affects people at all income levels, the poor again appear to be most seriously affected. Detailed household surveys show that the poor are the least likely to know how to get proper treatment when an official abuses his position. In Latvia, for example, only 31 percent of households in the poorest third of the population knew how to seek recourse to deal with corrupt service provision, compared to 42 percent among the richest third of the population.

**Effect on small and micro enterprises:** Within the economy, corruption is a highly regressive tax as the BEEPS data demonstrate. Small enterprises across the region pay, on average, more than twice as much of their annual revenue in bribes as do large firms. Such firms are particularly hard hit by administrative corruption. Microentrepreneurs appear to be prime
targets for corruption. Household surveys in several transition countries demonstrate that bribery at the household level is most strongly associated with participation in a microenterprise. In Georgia, for example, poor households that earn unofficial income were four times more likely to pay bribes than households without unofficial income. Corruption clearly hinders the ability of the poor to help themselves out of poverty.

**Inequality**

As examined in the Prague 2000 report *Making the Transition Work for Everyone*, inequality within the transition countries has increased at an alarming pace. In some countries of the region inequality has now reached levels on par with the most unequal Latin American countries. Though numerous factors contribute to the growth in inequality, corruption should also be seen as a contributing factor. As the data on firm performance demonstrated, state capture concentrates substantial gains to a narrow group of firms in a position to encode their advantages in the basic legislative, legal, and regulatory frameworks that govern the economy. By capturing the state, the “early winners” of transition gained fabulous wealth taking advantage of arbitrage opportunities associated with partial reforms and laying claim to state assets at highly undervalued prices. Privatization, in particular, became a key focus for state capture in some transition countries as some firms and political structures used illegitimate forms of influence to concentrate productive assets in their hands. In contrast, the poor gained little, if at all, from the redistribution of what were once “social” assets. While the interaction between corruption and income inequality is certainly complex, the ultimate result has been clear: income inequality has expanded most in countries with high levels of corruption and capture, as demonstrated in Figure 2.3.

**Fiscal Implications**

While increasing private revenues to public officials, corruption tends to have a negative impact on public revenues. This impact operates through a number of channels. First, as the surveys demonstrate, a substantial share of administrative corruption is directed towards tax and customs officials, presumably resulting in lower tax and customs payments by firms. In the BEEPS survey, one in nine firms said they frequently make unofficial payments to tax inspectors or customs officials, while half of the firms did so at least occasionally. Such corruption represents a substantial indirect private transfer in many countries from the budget to public officials.

Second, as is clear in Figure 2.4, corruption is closely associated with the unofficial economy, the
size of which can have profound fiscal implications in many transition countries.\textsuperscript{19} When firms produce for the unofficial economy, they underreport economic activity or avoid the state entirely. This creates competitive advantages that can drive honest competitors from the market, thereby generating further corruption and fiscal shrinkage.\textsuperscript{20} The reduction of tax revenues reduces the funds available for public services, providing firms with fewer incentives to operate officially. Once underground, such firms pay bribes to avoid detection and punishment. The fiscal implications in some countries have been staggering. In Ukraine, the government recently offered an amnesty for an estimated US$20 billion in “gray capital” kept offshore.\textsuperscript{21}

Third, corruption in procurement, assignment of subsidies, and outright theft leads to an exaggerated flow of funds out of the public coffers. Corruption in procurement, for example, leads to waste of public resources for often inferior quality products and services, and ultimately may deter honest vendors from doing business with the state. In a survey in Georgia, the need to make unofficial payments was the most cited reason that firms said they do not participate in state tenders.\textsuperscript{22}

The fiscal weaknesses exacerbated by administrative corruption and state capture contribute to weak macroeconomic performance. As Figure 2.5 shows, transition countries with the lowest levels of administrative corruption and state capture have the most effective institutions for macroeconomic governance.\textsuperscript{23} Though macroeconomic instability certainly creates a fertile ground for corruption, the fiscal implications described above suggest that corruption contributes to the macroeconomic instability as well.

\textbf{Credibility of the State}

As later chapters of the report will demonstrate, combating corruption requires strong and credible political leadership. Yet this is precisely the aspect of the political system that is most seriously undermined by administrative corruption and state capture.\textsuperscript{24} The BEEPS data confirm that approval ratings for the key institutions of government drop sharply with increasing levels of state capture and administrative corruption: only 38 percent of firms in countries in the high-high category of the typology expressed satisfaction with the political leadership, compared to 56 percent in the other transition countries. Firms in the high-high category also expressed the least confidence in the capacity of the legal system to uphold their property and contract rights: 58 percent of firms in these countries complained of insecure property and contract rights, compared to 35 percent of firms in the medium-medium category. Corruption erodes trust in the institutions of state, which in turn weakens the state’s capacity to fight corruption. A 1999 household survey in the Slovak Republic confirms the point: respondents who believed that corruption was widespread were more than twice as likely to doubt the credibility of the government’s anticorruption campaign than those who perceived corruption to be more limited.\textsuperscript{25}
A dangerous byproduct of this erosion of trust is increasing crime. Problems with both organized crime and street crime are highly correlated with state capture and administrative corruption. As Figure 2.6 suggests, more than twice as many firms in countries in the high-high category identify organized crime as an obstacle to their business than in the medium-medium group of countries.

Ultimately, corruption, capture and distrust feed on each other, deepening and entrenching the problems. If and when political leaders committed to fighting corruption arrive on the scene, in many countries they face a cynical population that has strong doubts about the credibility of the state. Where states have been captured, reformers must overcome a deep chasm of distrust before an anticorruption program can take hold. Yet by failing to address the problem of corruption, they are confronted by a vicious circle of lower investment and growth, higher poverty and inequality, greater fiscal imbalances, and weaker delivery of basic public services.


2 Corruption is also a notorious deterrent of foreign direct investment. However, since foreign investment is often motivated by abundance of natural resources, which is in turn associated with high levels of corruption, the statistical relationship between foreign direct investment, capture, and corruption in transition countries is ambiguous.

3 Gross domestic investment in 1997 was 27 percent of GDP in countries with medium levels of administrative corruption and state capture, compared to 21 percent in countries with high levels. The difference is significant at the 5 percent level in a pair-wise t-test.

4 In the BEEPS survey firms were asked how often they make unofficial payments to influence the content of laws, decrees, or regulations. Responses to this question were used to identify “captor” firms, whose individual performance can then be measured. Only a small share of firms (generally less than 5 per cent of the sample in each country) reported engaging in capture. There is, however, a correlation between the number of firms that report engaging in state capture and the number of firms that report experiencing a significant impact on their business from state capture. See Hellman, Jones, and Kaufmann (2000a).

5 This remains true even after accounting for other factors, such as firm size, sector, ownership, and origin, that influence firm performance.
Though it would be difficult to assert the direction of causality with certainty, there are indications that the gains to firms come as a result of capture. First, bribing to influence rules and laws is more likely to be a voluntary transaction between the firm and state officials and, hence, unlikely to be a form of direct extortion by state officials. Thus, presumably, firms would not engage in it unless it brought clear advantages. Second, the gains to capture are strongly influenced by the nature of the broader environment in which capture takes place. Capture is associated with specific gains to captor firms only where some threshold of capture has been reached in the country. This strengthens the view that capture actually generates such gains.

See Annex 1.

This section draws on Anderson and others (1999). See also Gupta, Davoodi, and Alonso-Terme (1998), Dethier (1999a, 1999b).

Recent empirical studies on corruption’s disproportionate impact on the poor include Knack and Anderson (1999) and Gupta, Davoodi, and Alonso-Terme (1998). See also Narayan and others (2000) for the impact of corruption on the poor in the words of the poor themselves.


EBRD (1999) finds that for a given level of privatization the quality of governance in countries with relatively low levels of capture is substantially higher than in countries with higher levels of state capture.

See Annex 1.

However, administrative corruption payments in the areas of tax and customs administration are often paid to reduce the discretionary power of bureaucrats to levy taxes and customs rather than to reduce standardized tax and customs levels.

In virtually every country where detailed surveys have been undertaken, the customs service is identified as an organization in which bribes are frequently paid. Examples include Albania (Kaufmann, Pasha, Preci, Ryterman, and Zoido-Lobaton (1998)), Georgia (Anderson, Azfar, Kaufmann, Lee, Mukherjee, and Ryterman (1999), Tajikistan (Mirzoev (1999)), Ukraine (survey by “Intellectual Business Foundation,” cited in Holovaty (2000)). Even in more developed transition countries, customs is noted by enterprises as one of the organizations at which bribery is common: Latvia (Anderson (1998)), and the Slovak Republic (Anderson (2000)).

See Annex 1.


This vicious circle has been explored by Johnson, Kaufmann, and Shleifer (1997) and by Johnson, Kaufmann, and Zoido-Lobaton (1998a and b). “The unofficial economy accounts for a larger share of GDP when there is higher bureaucratic inefficiency and discretion, and also when firms experience a higher tax and regulatory burden and more bribery and corruption.”


Macroeconomic governance is an index measuring the extent to which policy instability, exchange rate instability, and inflation are an obstacle to business. See EBRD (1999) “Transition Report 1999: Chapter 6 - Governance in Transition” and Annex 1 for details.

The findings described here are consistent with recent empirical work showing that levels of trust are higher in countries with lower levels of bribery. Zak and Knack (1998).

Anderson (2000).