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13 Corruption in Russian regions

Elena Chirkova and Donald Bowser¹

Researchers are paying increasing attention to variations in perceived levels of corruption within countries. Marked variations characterise cross-country comparisons. To explore whether such variations also define large federal states – and to dispel the myth of Russia as monolithic – TI Russia carried out a public opinion survey entitled the Corruption Index for Russian Regions.²

Funded by the Open Society Institute (Soros Foundation), the survey was designed to create a multidimensional picture of corruption in Russia. It sought to capture the relative amounts of bribery, the characteristics of corrupt practices and the degree of public confidence in government institutions, both in the Russian Federation as a whole and across its regions. In July and August 2002, 5,666 individuals and 1,838 entrepreneurs (representing small and medium businesses) were surveyed in 40 out of Russia's 89 regions. The survey involved two questionnaires, which targeted private citizens and businessmen. Questions related to both perceptions and personal experiences of corruption. Results were aggregated to develop composite corruption indices.

The survey addressed different forms of corruption, including both private sector corruption and petty corruption between citizens and public officials. Within the area of private sector corruption, the survey assessed both administrative corruption (involving corruption between businesses and authorities) and state capture (involving the impact of businesses on policy-making). Questions on trust assessed the degree of public trust in different levels of government (federal, regional and local) and in different institutions (executive, judiciary, legislature and law enforcement agencies).

The principal output of the project was a 'map of corruption' reflecting the different perceived levels of corruption across Russia's regions (see Figure 13.1). Several main tendencies become apparent from the mapping of survey results.

The findings suggest that the southern part of Russia is seen as more corrupt than the north. Corruption is perceived as a serious problem in the agricultural, pro-communist regions known as the southern belt – stretching from the Rostov *oblast* to the Volga region.³ In contrast, northern regions such as Arkhangelsk, Karelia and Yaroslavl *oblast* tend to be seen as less corrupt. This distinction may reflect the developmental and cultural differences between the more modern, Europeanised regions of northern Russia and the more traditional regions of southern Russia; the stronger family and clan structures that flourish in the Caucasus may facilitate corruption.

The findings also point to other geographical distinctions. Respondents perceive the eastern part of Russia – such as Khabarovsk *krai* and Primorski *krai* – as more corrupt

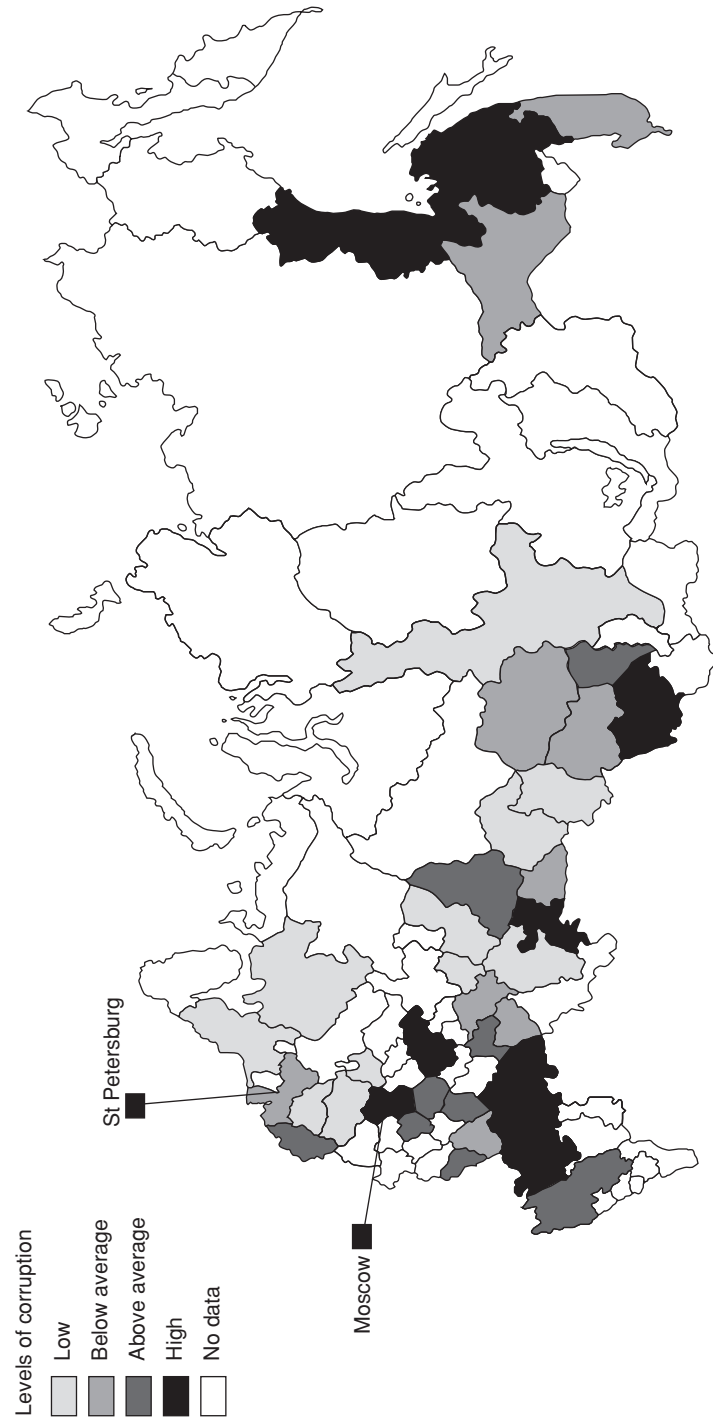


Figure 13.1: Perceived levels of corruption across Russia's regions

than the west. However, the western area known as the capital region – St Petersburg, Moscow city and Moscow *oblast* – was assessed as one of the most corrupt regions. Thirdly, counter to popular expectations, the degree of corruption in areas that are rich in natural resources – such as Tyumen *oblast* and Bashkortostan – was viewed as below average.

In order to be able to monitor changes in the scope and structure of corruption, similar surveys are planned on an annual basis. It is hoped that in future the survey will encompass all of Russia's 89 regions.

Notes

1. Elena Chirkova is programme coordinator for corruption research at TI Russia. Donald Bowser is programme development coordinator at TI Russia and director of IMPACT, a private consultancy firm.
2. The project may be downloaded from www.transparency.org.ru/proj_index.asp
3. *Oblast* and *krai* are the administrative districts of the Russian Federation.

14 Measuring the transparency of political party financing in Bulgaria

*TI Bulgaria*¹

During 2002–03 Transparency International Bulgaria carried out a project to promote integrity in political party financing, with the support of the Westminster Foundation for Democracy. The project included developing guidelines for greater transparency, as well as suggesting mechanisms for civil society monitoring. As part of the project, an independent expert evaluation was made of the level of transparency and accountability of party financing, which involved designing a new index for transparency in party financing, with two components:

- The *qualitative* component was a survey of personal assessments among four target groups: local and national leaders of political parties, representatives of the business sector, NGO activists and journalists. The survey was carried out from October–December 2002 in the cities of Sofia, Burgas, Varna, Veliko Turnovo and Kurdzhali. In total, around 180 people were interviewed. The survey asked a series of questions, including whether party financing is sufficiently transparent, whether control measures are effective, whether there are sufficient legal mechanisms for limiting illegal financing, and whether legislation needs amending.
- The *quantitative* component was an empirical assessment based on the regular reports submitted by political parties to the National Audit Office (NAO). Every year all parties are required to submit their annual reports to the NAO. Within one month of all elections, they are required to report their campaign incomes and expenses. Within six months of receiving the parties' annual reports, the NAO has to announce publicly whether the reports are in compliance with legislation. (If a party is found not to be in compliance, it is deprived of its annual state subsidy for the relevant year.)

The survey results showed agreement between the four different groups on several issues. Many respondents felt that the mechanisms limiting illegal financing are not applied effectively – they noted a persistent problem concerning the financial control of political parties and the implementation of sanctions. A large majority of those interviewed believed that the public does not have enough information on the principles of financing and control of political parties (see Table 14.1). Among all groups the

dominant opinion was that Bulgaria's party financing law needs amending – 64 per cent of all respondents thought so, and only 9 per cent disagreed.

Table 14.1: Do you agree that political party financing in Bulgaria is sufficiently transparent?

	Political parties	Business sector	NGOs	Journalists	Average
Definitely yes (%)	3.0	0	0	0	0.7
Yes, but there are a lot of improvements to be made (%)	21.2	9.1	5.6	11.1	11.6
Do not know (%)	15.2	3.0	11.1	2.8	8.0
Rather not (%)	24.2	27.3	25.0	30.6	26.8
Definitely not (%)	36.4	60.6	58.3	55.5	52.9

On the basis of both the qualitative and quantitative components of the evaluation, a new index was developed: the Index for Transparency of Political Party Financing. The qualitative component was based on the survey results and represents the perceptions of the level of transparency of political party financing. On a range from 0 (highly corrupt) to 10 (highly clean), the political parties themselves gave the highest rating (2.25) and business representatives the lowest (0.71). NGO representatives gave a score of 1.30 and journalists 1.76. The combined perceptions score was 1.52. The quantitative component was based on the NAO's review of parties' financial reports and was calculated as the proportion of parties that had submitted their financial reports on time. The score was 3.36.² Giving equal weight to the qualitative and quantitative components, this first use of the index indicated a low level of transparency in political party financing in Bulgaria: an aggregate score of just 2.44 out of 10.

A strength of the survey is that it can be used regularly for measuring the dynamics of transparency in party and campaign financing. All groups of respondents in the first survey agreed that the index should be tested during elections. Local elections in Bulgaria are scheduled for October 2003, and on the eve of the local elections TI Bulgaria is planning to assess transparency in campaign financing of both political parties and independent candidates.

The survey could be applied in any country with minimal legal provisions and guidelines on reporting contributions and expenses, though it would be necessary to adapt the methodology to the particular regulations in a given country. It would be particularly interesting to use the index to compare the transparency of election campaign financing with the transparency of political financing between elections.

Notes

1. For further information contact Katia Hristova-Valtcheva, programme director at TI Bulgaria: katia@transparency-bg.org
2. According to the NAO, only 90 out of 268 parties (33.6 per cent) had submitted reports of their revenues and expenses by 15 March 2002.

15 Benchmarking corruption in South Asia: insights from a household survey

*Gopakumar K. Thampi*¹

South Asia accounts for 30–40 per cent of the world's poor and more than 40 per cent of its 1.4 billion people live in poverty. Corruption is rampant in public services across the region and impinges directly on everyday life. Across South Asia, the state has a monopoly on the delivery of critical public services such as potable water, health, education and power. Given the overarching role of the state, there is no real 'exit' option whereby the majority of the population could move to another provider.

In such an environment, 'voice' mechanisms, such as citizen feedback surveys, are particularly important. Surveys highlight an interesting array of useful information for service providers and at the same time empower other stakeholders to demand more accountability from the state.

Transparency International (TI), which has a strong presence in South Asia through its national chapters, designed a project in 2001 to assess the levels and forms of corruption in the five large countries of the region. What made the initiative unique was that a common questionnaire was used to capture perceptions and experiences across the region, making it possible to compare emerging trends. The focus of the survey was on a set of public services of particular importance to the poor: healthcare, education, power, land administration, taxation, police and the judiciary.

The surveys were conducted in Bangladesh, India, Nepal, Pakistan and Sri Lanka between November 2001 and May 2002 and focused on urban and rural households in each country, ranging from 2,278 households in Sri Lanka to 5,157 in India. Three thousand households were surveyed in Pakistan, 3,030 in Bangladesh and 3,060 in Nepal.

The survey results reveal the grip of petty corruption on the everyday lives of citizens in South Asia. Access to public services was found to be an important issue for a large proportion of the population in all five countries, especially in Bangladesh, Pakistan and Sri Lanka. The finding implies that the poor in these countries face the danger of exclusion from access to public services due to the high artificial barriers, economic and otherwise.

Petty corruption was found to be endemic in all key public sectors in the five countries, with citizens reporting moderate to high levels of corruption in their regular interaction with public services. Lack of accountability and monopoly of power were quoted as major factors contributing to corruption in public services. Extortion was

the most prevalent form of corruption, with middle and lower-level functionaries identified as the key facilitators of corruption in all sectors studied.

The survey revealed that bribes impose a heavy financial burden on South Asian households, because of both the high frequency of demands and the large sums paid. More than half of the users of public hospitals in Bangladesh, for example, reported that they had paid a bribe to access a service, with bribes averaging 1,847 takas (US \$33). In Pakistan, 92 per cent of households with experience of public education reported having to pay bribes: the average amount paid was 4,811 rupees (US \$86). These sums are substantial given that per capita gross national income in Bangladesh and Pakistan is US \$360 and US \$410 per annum, respectively.

When asked about perceptions of specific sectors, respondents identified the police as the most corrupt sector in four out of five countries. In Nepal, the police were perceived to be the third most corrupt after land administration and customs. Asked about their experiences, actual users of services in all countries (see Table 15.1) indicated that the police and judiciary were the two most corrupt sectors, followed by justice, land administration and the tax department.

Table 15.1: Percentage of respondents reporting bribery in their interaction with different public services

	Education	Health	Power	Land admin.	Tax	Police	Judiciary
Bangladesh	40	58	32	73	19	84	75
India	34	15	30	47	15	100	100
Nepal	25	18	12	17	25	48	42
Pakistan	92	96	96	100	99	100	96
Sri Lanka	61	92	Sample too small	98	Sample too small	100	100

The survey revealed the pervasive nature of corruption in critical public services across South Asia, with large numbers of the population victims of extortion. The survey strongly supports the case for empowering regulatory bodies, such as the office of the ombudsman, to oversee the activities of public agencies, which are the sole providers of many basic necessities across the region.

For more information about the survey, including the full report, see www.transparency.org/pressreleases_archive/2002/2002.12.17.south_asia_survey.html

Note

1. Gopakumar K. Thampi is chief of programmes of the Public Affairs Foundation, India, and former executive director for Asia at Transparency International. Contact: gopa66@yahoo.com

16 Governance Matters III: new indicators for 1996–2002 and methodological challenges

Daniel Kaufmann and Aart Kraay¹

In our latest effort to measure the quality of governance worldwide, we constructed governance indicators for 199 countries and territories for four time periods: 1996, 1998, 2000 and 2002. The indicators are based on several hundred variables measuring perceptions of governance, drawn from 25 data sources constructed by 18 organisations. We constructed six aggregate indicators from the variables: voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and control of corruption.

An attractive feature of the aggregation method is that it provides measures of the precision of the indicators. While the addition of data has improved precision relative to past years, the margins of error remain large, as illustrated in Figure 16.1 by our rule of law indicator for 2002. For each country we show a vertical bar summarising the range of statistically likely values, with the mid-point representing our best estimate. These ranges are large relative to the units in which governance is measured.

The substantial margins of error imply that cross-country comparisons should be made with caution. This is particularly the case for changes over time, which in the vast majority of cases are small relative to the margins of error. Nevertheless, in those cases where changes over time are large (for example, the recent deterioration of rule of law in Zimbabwe, or the worsening political instability in Argentina), we generally find that there is broad consensus among our many sources as to the direction of change.

The margins of error reflect the observation that individual sources provide a noisy signal of the unobserved 'true' level of governance. It is important that aggregate indicators combine the imperfect sources as efficiently as possible, and accurately represent the extent of remaining measurement error. As we discuss in our latest paper,² we use a methodology that optimally weights each individual source according to its precision or reliability, which results in substantial reductions in overall margins of error relative to unweighted average scores. We also show that the methodology used to create margins of error matters – for example, we argue that the bootstrapping procedure used by TI to construct margins of error for the Corruption Perceptions Index may overstate the index's precision, especially for countries with relatively few data sources.

As well as describing our methodology, our latest paper addresses a number of frequently heard criticisms of subjective governance indicators:

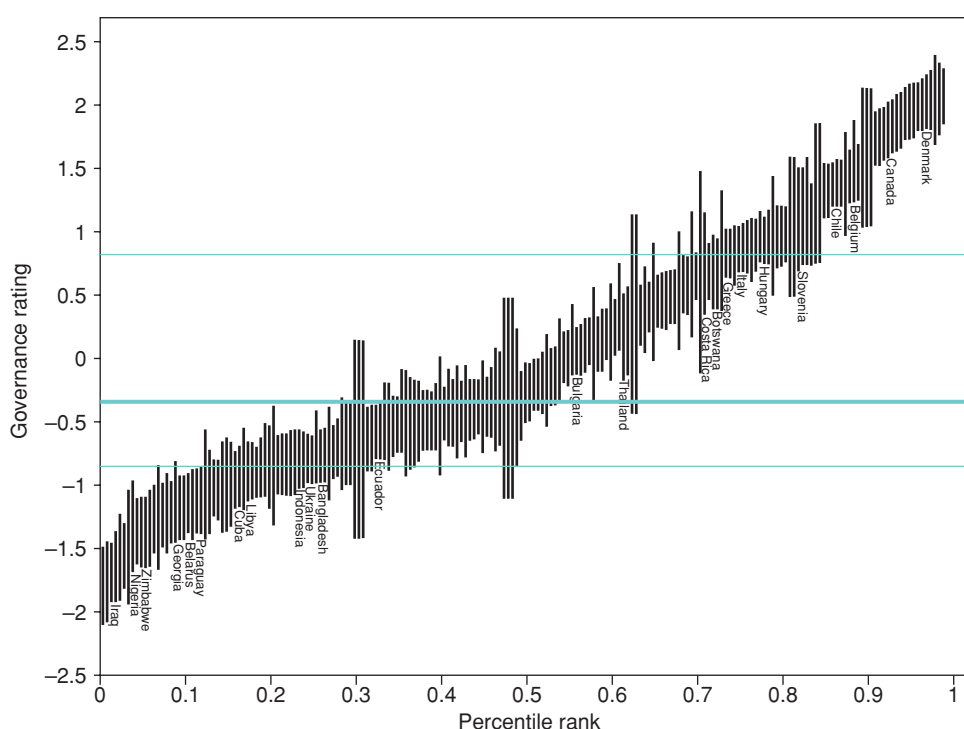


Figure 16.1: Estimates of rule of law, 2002^a

^a The figure shows estimates for all countries of the rule of law in 2002 (on the vertical axis), with each country's percentile rank on the horizontal axis. Vertical bars show the statistically likely range of values for each country, with the midpoint corresponding to the best single estimate. Selected countries are labelled. The ranking of countries along the horizontal axis is subject to significant margins of error and in no way reflects the official view of the World Bank, its executive directors or the countries they represent.

1. Is subjective data useful for measuring governance, or should it be dismissed as 'only capturing opinions'?

For many dimensions of governance, subjective data is the only data that is even potentially informative – especially for corruption, which is almost impossible to measure directly given its illegal and clandestine nature. Nevertheless, recent research has made an effort to document corruption 'objectively', for example by comparing differences in prices paid for similar objects in public procurement.³ However, given the immense data problems associated with such an exercise, it is unlikely that cross-country comparable measures based on this idea will be a viable alternative in the near future.

In contrast, we currently have a wealth of perceptions-based data on corruption from diverse sources, among which there is broad agreement regarding cross-country differences. Furthermore, subjective data contains significant 'signal' content, and

perceptions do matter in terms of the behaviour of economic agents. Finally, there have been significant improvements in questionnaire design, so that so-called subjective variables increasingly rely on 'experiential' questions, which are often quantified in a cardinal sense (for instance, measuring percentage of revenues paid as bribes).

2. Since the margins of error are large, shouldn't we rely on 'objective' indicators that do not have these measurement problems?

Objective measures of governance also have measurement error, and hence should also have associated margins of error. Consider, for example, using the share of trade tax revenue in total revenues to capture the inability of a government to broaden its tax base. This measure will be a 'noisy' indicator of overall government effectiveness for at least two reasons: the tax revenue itself may contain a variety of errors, and the extent of the tax base is only one dimension of government effectiveness. Our calculations suggest that measurement error in many objective sources is at least as important as the measurement error in subjective governance indicators.

3. Do the perceptions of think tanks and commercial risk rating agencies reflect the ideological biases of these institutions?

In order to isolate the effects of potential ideological biases in governance ratings produced by these types of organisations, we compared their ratings with the responses of firms and/or individuals in cross-country surveys to see whether they gave systematically higher or lower scores to countries with left-wing or right-wing governments. (The survey data should not reflect any ideological biases since the respondents form a very large sample of individuals.) We did not generally find evidence of ideological bias. In the one case where we did, the effects tended to be small on average – with a difference in ratings for countries with left- and right-wing governments of only about 10 percentile points.

4. Since the indicators only capture countries' relative positions, is it possible that some countries' scores worsen simply because the others are getting better?

The limited information that we have on absolute trends over time in governance, if anything, suggests a small worsening worldwide. We reviewed the global averages of the individual sources that are available in a consistent format since 1996. While most of the changes in these global averages are small, most of the statistically significant ones point to deteriorations. Whether this reflects a true worsening of institutional quality, or reflects other factors at play, is an open question. However, there is no evidence of a worldwide improvement in governance, and thus downward trends in individual countries cannot be justified with the argument that the world at large is getting better.

5. Are these governance indicators sufficiently informative to be used as a basis for aid allocation or other policy decisions?

This question has become relevant with the US government's recent proposal to rely in part on our governance indicators to allocate funds from the new Millennium Challenge Account (MCA) (see 'Governance, corruption and the Millennium Challenge Account', Chapter 7, page 135).⁴ In order to be eligible, low-income countries need to score well on a number of governance indicators, including several of ours. Most prominently, countries need to be in the top half of low-income countries on our control of corruption indicator. A mechanistic rule such as this one risks misclassifying countries, given the substantial margins of error in the governance indicators.

The risk of misclassification is illustrated in Figure 16.2, which shows our control of corruption indicator for countries potentially eligible for the MCA. The vertical lines indicate the margin of error for each country, with the mid-point the best single estimate. While for countries well below and well above the median the risk of misclassification is low, there is a non-trivial risk that many countries near the median will be misclassified. For the latter group of countries, the probability that the corruption score is above the median is between 25 and 75 per cent. The large margins of error point to the importance of complementing cross-country indicators such as ours with more nuanced and in-depth information from country governance diagnostics.

More generally, we recognise that there are limitations to what can be achieved with this kind of cross-country, highly aggregated data. This type of data cannot substitute for in-depth, country-specific governance diagnostics as a basis for policy advice. Thus a significant complementary effort has taken place to develop country-based governance diagnostic methodologies, based on in-depth surveys of enterprises, users of public services and public officials.⁵ Such diagnostics unbundle governance performance by type of governance and institution, permitting the use of the significant variations within a country to learn about the priorities for action for a country.

Notes

1. Daniel Kaufmann is the director for global governance and regional learning at the World Bank Institute, United States. Contact: dkaufmann@worldbank.org. Aart Kraay is a senior economist in the development research group at the World Bank. Contact: akraay@worldbank.org. The opinions expressed here are the authors' and do not necessarily reflect the official views of the World Bank, its executive directors or the countries they represent.
2. For the full paper, see www.worldbank.org/wbi/governance/pubs/govmatters3.html. The data and a graphical interface are available at www.worldbank.org/wbi/governance/govdata2002
3. See for example R. DiTella and E. Schargrodsky, 'The Role of Wages and Auditing During a Crackdown on Corruption in the City of Buenos Aires', *Journal of Law and Economics*, April 2003; Transparency International, *Global Corruption Report 2003*.
4. See www.worldbank.org/wbi/governance/pubs/mca.html
5. See www.worldbank.org/wbi/governance/capacitybuild/index.html

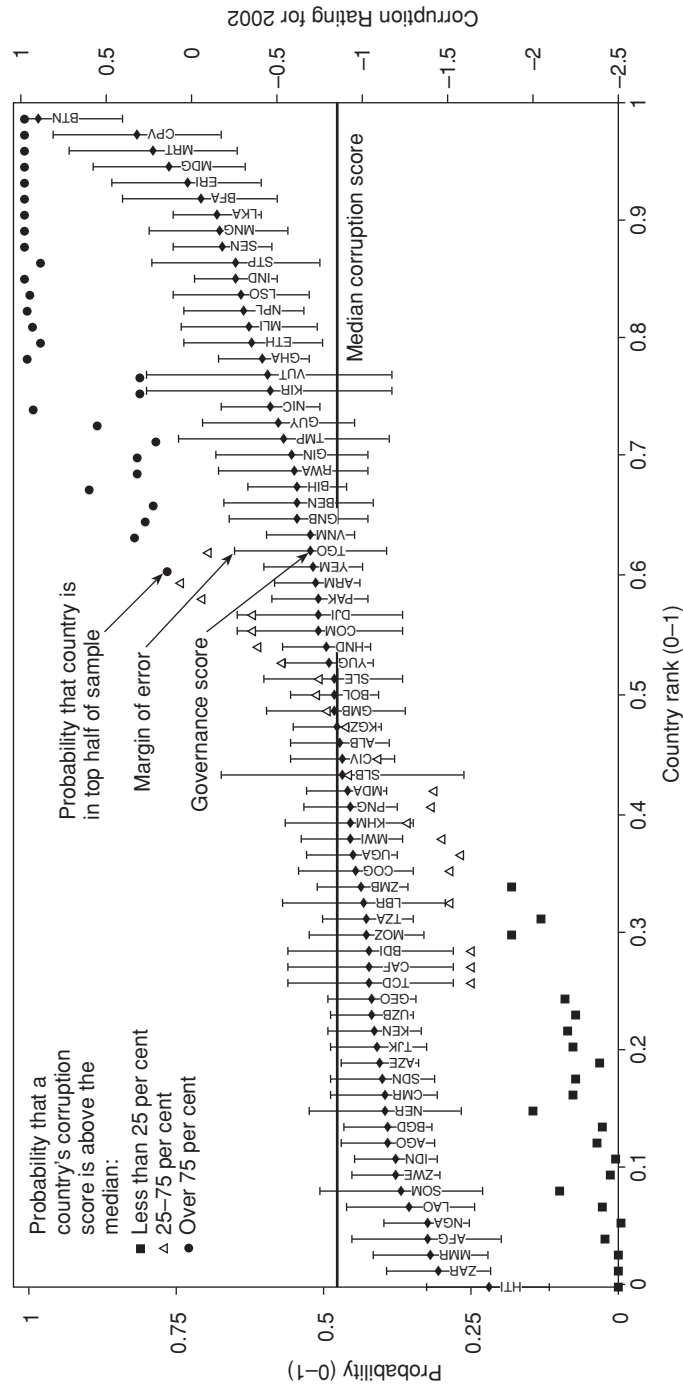


Figure 16.2: Margins of error in the control of corruption indicator, 2002^a

^a The figure shows estimates of the control of corruption in 2002 (right-hand vertical axis) for all 74 countries potentially eligible for the first round of the MCA, with each country's percentile rank on the horizontal axis. The vertical line for each country indicates the 90 per cent confidence interval, with the mid-point showing the best single estimate. The ranking of countries along the horizontal axis is subject to significant margins of error, and the ordering in no way reflects the official view of the World Bank, its executive directors, or the countries they represent.

17 The University of Pittsburgh Latin American Public Opinion Project's corruption victimisation scale

*Mitchell A. Seligson*¹

TI's Corruption Perceptions Index is the most widely used measure of corruption available today, providing a picture of corruption perceptions aggregated at the national level. If researchers want to know the characteristics of people most likely to have been victims of corruption, however, or to know in which nations the experience (rather than perception) of corruption is greater, then a measure of corruption experience at the individual level can help. The University of Pittsburgh Latin American Public Opinion Project developed a series of questions that it included in national samples in several Latin American countries to provide such information.

The questions were inspired by crime-victimisation surveys, the mainstay of sociological investigation into crime. They built on work by the United Nations Centre for International Crime Prevention – launched in 1989, the International Crime Victims Survey now includes more than 70 countries and in 1996, for the first time, it included a question on bribe victimisation.² But a broader series of questions is preferable, since anti-corruption projects need much more detailed information about the nature and level of corruption than any single question can provide.

In 1996 the University of Pittsburgh Latin American Public Opinion Project therefore began applying a broader approach, as did the World Bank in 1998. These efforts, which may also ask about perceptions of corruption, focus on citizens' actual experience (victimisation) with public sector corruption. At Pittsburgh the aim has been to measure both corruption and its impact.³ A module of questions on corruption experience was included in public opinion surveys of democratic values and behaviour applied to a random (probability) sample of the nation being studied.⁴

Respondents were asked a series of questions recording their experience with corruption over the year immediately prior to the survey. The forms of corruption measured were selected on the basis of focus groups and are the ones found to be most commonly experienced in Latin America. The questions varied between the questionnaires, but included items such as: observing a bribe being paid to a public official, being asked to pay a bribe to a police officer, paying bribes to a public utility to avoid paying the full bill, or being asked to pay a bribe in the school system. Respondents were also asked questions on their trust in the system of government, so that the impact of corruption victimisation on trust can be measured (controlling for other factors, such as the respondent's income, education, gender, region and party affiliation).

The data allow particular forms of corruption to be highlighted. For example, Figure 17.1 shows the proportion of respondents (men and women shown separately) who reported that a public employee solicited a bribe from them during the preceding year. The proportion ranges from less than 10 per cent in El Salvador and Honduras to well above 20 per cent in Bolivia. While corruption-victimisation rates vary substantially from country to country in Latin America, in all the countries studied it is substantially higher than in advanced industrial countries. According to the UN data, in advanced industrial countries the corruption-victimisation rate is less than 1 per cent in any given year. The figure also shows that men are more likely to be the victims of corruption than women in Latin America.

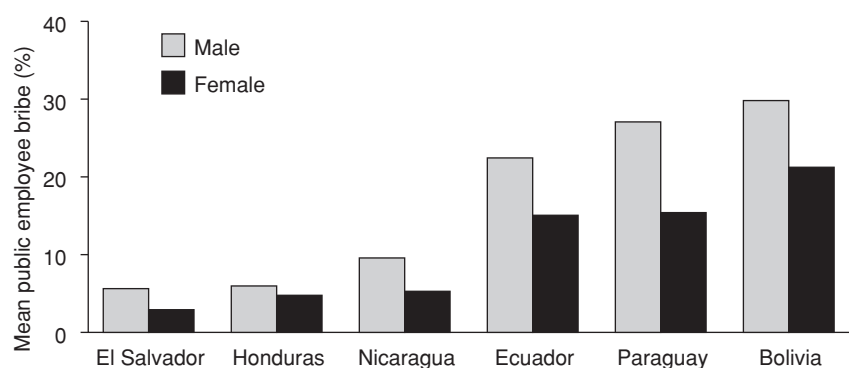


Figure 17.1: Corruption victimisation by gender: six countries.
Public employee solicited bribe

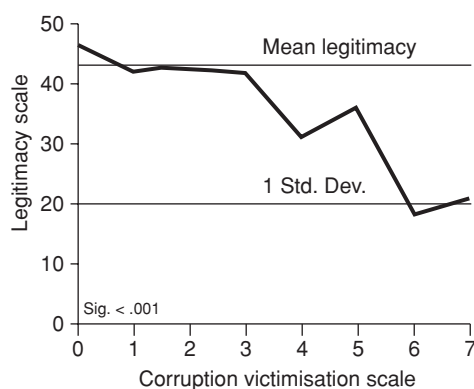


Figure 17.2: The impact of corruption victimisation on legitimacy in Nicaragua

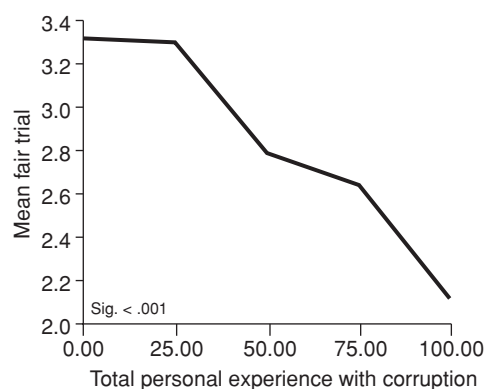


Figure 17.3: Belief in ability to get a fair trial in Nicaragua and total personal experience with corruption

An overall corruption-victimisation scale was also developed from the various questions,⁵ allowing us to examine the link between corruption and other variables, such as political legitimacy. In the case of Nicaragua, a country that has been struggling with problems of political stability, the overall legitimacy scale declines steadily as corruption victimisation increases, as shown in Figure 17.2, falling from above the national mean for those who had not been victimised by corruption (0 on the horizontal axis) to one standard deviation below the national mean for those who had frequently been the victims of corruption (6 or 7 on the horizontal axis). One especially relevant item from the legitimacy scale – the belief that people can get a fair trial – clearly demonstrates that corruption does erode confidence in the system. As Figure 17.3 shows, again for Nicaragua, the greater the personal experience with corruption, the less likely individuals were to believe they could get a fair trial.⁶ Similar results were found for other Latin American countries.

Notes

1. Mitchell A. Seligson holds the Daniel H. Wallace Chair of Political Science and is also a Professor in the Graduate School of Public and International Affairs, both at the University of Pittsburgh, United States. Contact: seligson@pitt.edu
2. See *Global Corruption Report 2001*.
3. The World Bank surveys do not include questions on the impact of corruption victimisation.
4. The surveys reported on in this project are all national probability samples carried out at various times from 1998 to 2002 in Bolivia, Ecuador, El Salvador, Honduras, Nicaragua and Paraguay. The samples each have between 2,500 and 3,000 respondents, except for Paraguay, which included only 1,463. The first survey, conducted in Nicaragua, was developed with Casals and Associates. The author would like to thank Sergio Dias Briquets of Casals and Andrew Stein, now of the US Department of State, for assistance in that early work. Orlando Pérez of Central Michigan University has assisted in more recent studies in Ecuador and Honduras.
5. When formed as a scale, the items were found to be reliable (Cronbach Alphas of around 0.75, depending on the country).
6. We can be confident that the direction of causality runs from corruption victimisation to reduced legitimacy because corrupt officials could not be selecting their victims based on the former's foreknowledge of the latter's belief in the legitimacy of the political system.

18 How corruption affects economic development

*Johann Graf Lambsdorff*¹

That corruption adversely affects economic development has become a commonplace assertion in academia and public discussion. Identifying the precise reasons for this impact is not straightforward, however. Two recent papers shed light on the reasons by suggesting that corruption may either deter investments or render them less productive.² The appropriate remedy depends on which impact is of greater concern in a given country.

Our recent research has revealed that an increase in corruption by one point on a scale from 10 (highly clean) to 0 (highly corrupt) lowers productivity by 4 per cent of GDP and decreases net annual capital inflows by 0.5 per cent of GDP. An improvement with regard to corruption by 6 points of the Transparency International Corruption Perceptions Index – for example, Tanzania improving to the level of the United Kingdom – increases GDP by more than 20 per cent and increases net annual capital inflows by 3 per cent of GDP.

Investments are often sunk and cannot be redeployed if investors are disillusioned about the institutional environment of a country. Railroads cannot be moved, pipelines cannot be relocated and real estate cannot possibly be used in a different region. Politicians and bureaucrats may misuse their position once investments are sunk. They can delay necessary permits and hold up investors until offered a bribe. Governments with a reputation for corruption find it difficult to commit to effective policies and to convince investors of their achievements. As a result of such failures, capital inflows deteriorate with levels of corruption, as shown in Figure 18.1 for a cross-section of countries. This finding is robust to statistical tests related to the inclusion of further explanatory variables, sample selection, measurement error and endogeneity.

The absence of corruption can be assessed through four governance indicators: law and order, bureaucratic quality, government stability and civil liberties. The Political Risk Service's International Country Risk Guide provides data on the first three variables; Gastil/Freedom House provides a measurement of the last variable.

Our analysis has shown that the crucial means by which corruption adversely affects capital inflows is through an absence of *law and order*. A good performance with respect to law and order is assigned to countries that have sound and accepted political institutions, a strong court system and provisions for an orderly succession of power. Corruption can undermine a tradition of law and order, for example when judicial decisions and laws are for sale. It is particularly the failure of a country's integrity system

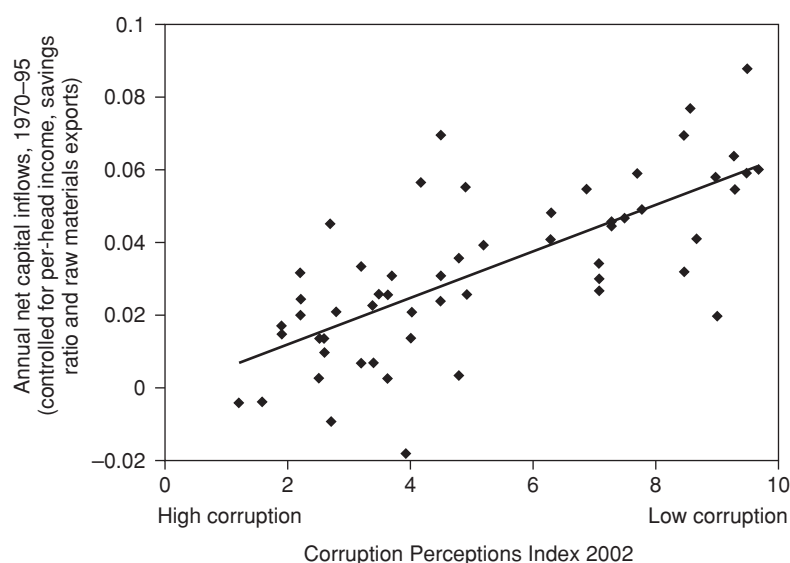


Figure 18.1: Corruption and capital inflows

and the resulting insecurity of property rights which alienates investors. We found the other governance indicators to be less significant in the calculus of investors.

Corruption can also be shown to lower capital productivity, as shown in Figure 18.2.³ The relationship with productivity can be traced to a variety of channels. A country's tradition of law and order is insignificant in this context, but other governance indicators come into play.

One mechanism through which corruption reduces productivity is the undermining of *government stability*. Politicians' search for corrupt income is commonly in contrast to their declared programmes, reducing their popular support and threatening their ability to stay in office. When office holders devote themselves to obtaining illegal, additional payoffs, the allocation of capital goods will not be optimal, because they prefer projects that promise large side-payments and low risks of detection to those that benefit the public at large. Reduced productivity is the result.

A second mechanism is the link between corruption and restricted *civil liberties* because such restrictions tend to distort markets, inducing the search for illegal ways to circumvent them. Distorting markets can be lucrative when corrupt politicians have the power to manage the resulting bottlenecks. Such bottlenecks, however, 'sand the wheels' of business and lower productivity.

But the crucial reason why corruption has an adverse impact on productivity is related to accompanying low levels of *bureaucratic quality*. Corruption may imply that public servants are appointed on the basis of nepotism or bribes, without regard to efficiency and capacity concerns. In addition, the effort level of public servants may suffer from adverse incentives because creating artificial bottlenecks can increase the

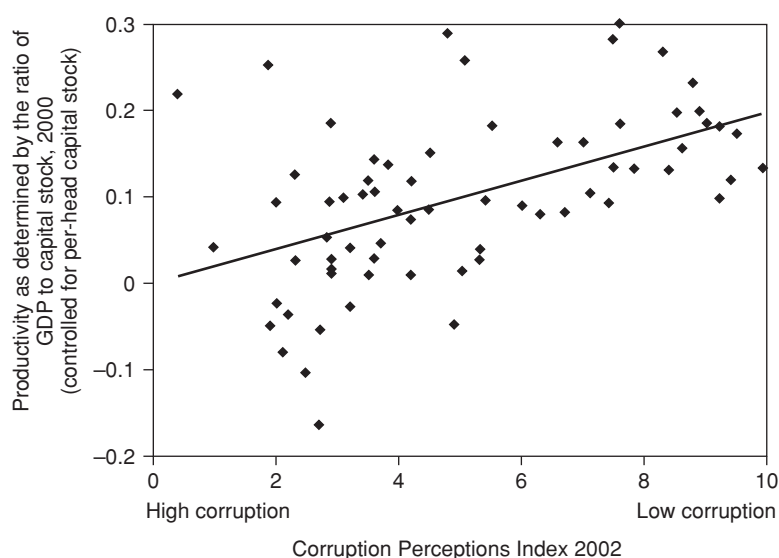


Figure 18.2: Corruption and productivity

need to pay 'speed money'. Attempts to increase productivity must address corruption through public sector reform aimed at improving integrity in the bureaucracy.

Anti-corruption reform strategies should be fine-tuned, depending on whether countries are primarily concerned with increasing productivity or attracting foreign capital. Public sector reform aimed at increasing bureaucratic quality, improving government stability and expanding civil liberties should be given priority if countries are to increase productivity. Legal reform should be addressed primarily with the aim of improving law and order and the security of property rights if countries want to attract foreign capital.

Notes

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2. Johann Graf Lambsdorff, 'How Corruption Affects Persistent Capital Flows', *Economics of Governance*, vol. 4, no. 3 (2003); Johann Graf Lambsdorff, 'How Corruption Affects Productivity', *Kyklos*, vol. 56, no. 4 (2003).
3. This finding, again, is robust to statistical tests related to the inclusion of further explanatory variables, sample selection, measurement error and endogeneity. Contrary to the argument that corruption has had less of an impact on economic development in Asian countries, these countries performed no better than others in our regressions.

19 Corruption and foreign direct investment

Mohsin Habib and Leon Zurawicki¹

Corruption is widely recognised as a factor in investment decisions though, at first glance, it does not appear to be an absolute deterrent to foreign direct investment (FDI). China, Brazil, Thailand, Mexico and Argentina have all received substantial FDI inflows, notwithstanding perceived high corruption levels, as measured by the Corruption Perceptions Index (CPI). Our research carried out over the last few years helps to reveal a more complex relationship between corruption and FDI.²

The findings of our research support the following generalisations:

1. Foreign investors are more sensitive to corruption than their local counterparts.
2. Individual countries involved in FDI respond differently to host country corruption.
3. Corruption is one of the dimensions of the psychological distance separating the home and the host countries. For that reason, FDI is affected by the differences in corruption between the home and the host countries.

Corruption is often expected to exert negative influences on both FDI and local investment. In fact, because of their more extensive experience in the domestic market, local investors are better positioned to manage the local transaction costs than their foreign counterparts. Moreover, unlike foreign investors, most local investors do not have the option to invest abroad and must become more creative to make the best under difficult circumstances. Accordingly, this research verifies statistically that corruption affects the rate of FDI more than it does domestic investment.

Table 19.1 shows that corruption, as measured by the CPI, negatively affects FDI. Holding everything else constant, countries with a higher corruption level receive relatively less FDI. The table also indicates that corruption has a significant negative effect on local investment. When compared, the magnitude of the CPI coefficient for FDI is double that for local investment. Corruption appears to be twice as important for foreign investors as for local ones.

The effect of host country corruption on incoming FDI was further analysed by controlling for variables such as cultural similarity, the openness of the economy (trade/GDP) and economic ties. These variables are expected to promote FDI and weaken the effects of corruption. The results show that corruption remains a significant negative factor but that the magnitude of its impact is less. The findings suggest that, for example, a decrease of corruption from the level of Pakistan to the level of Morocco or Jamaica (roughly one point on the CPI) will result in an estimated 19 per cent increase in FDI for Pakistan. That shift corresponds to about US \$130 million of foreign investment.

Table 19.1: Corruption reduces attractiveness of FDI^a

		Log FDI	Log local investment
CPI	Correlation	0.40	0.30
	Regression coefficients	0.51	0.24
Absolute difference in CPI	Regression coefficient	-0.10	

^a The CPI coefficients are based on regressions of log FDI (or log local investment) on corruption (CPI), log population, GDP growth, log GDP/capita, unemployment, trade/GDP, cultural distance, log distance, economic ties, political risk and price index. The 'absolute difference in CPI' coefficient is based on a PROBIT analysis of log FDI on similar variables. All reported results are statistically significant. The FDI data are for 89 countries for the period 1996–98.

A separate study focused on the similarity in the levels of corruption between the home and host countries. FDI becomes a challenge for companies that are unwilling to or incapable of working in a country that is more corrupt than their own. In such cases, corruption can result in a decision to avoid FDI. In contrast, exposure to corruption at home can prepare individual companies for work in corrupt environments abroad. This advantage is lost, or turns into a disadvantage, when expertise in corruption becomes redundant in 'clean' markets. The difference in the exposure to corruption between the host and home countries is thus expected to affect foreign investors.

This analysis used data on aggregate bilateral FDI flows. The absolute difference in corruption levels between the host and the home countries was calculated with CPI data. The results of the analysis, shown in the bottom part of the table, indicate that the absolute difference in CPI variables has a significant negative effect on the share of FDI flow.

Finally, separate analyses were carried out of each investing country and its bilateral FDI flows. In Figure 19.1, the vertical axis highlights the differences in response to host country corruption for 17 investing OECD countries. As the scores on the vertical axis show, the magnitude of the CPI regression coefficients, which reflect the impact of host country corruption on FDI inflow, varied considerably. The horizontal axis shows the corruption levels of the investing countries. As expected, the figure shows that the two factors are correlated: investing countries that are more exposed to corruption in their home markets are relatively less sensitive to corruption in foreign markets.

In conclusion, the negative effect of corruption on FDI suggests that firms do not support corruption. The difference in corruption levels between the home and host countries also has a negative impact on FDI. Foreign investors may shun corruption because they believe it is morally wrong or because it is costly and difficult to manage. Public officials must realise that the macro-environment and the institutional framework play a critical role in FDI decisions, and that corruption is one relevant factor in this respect.

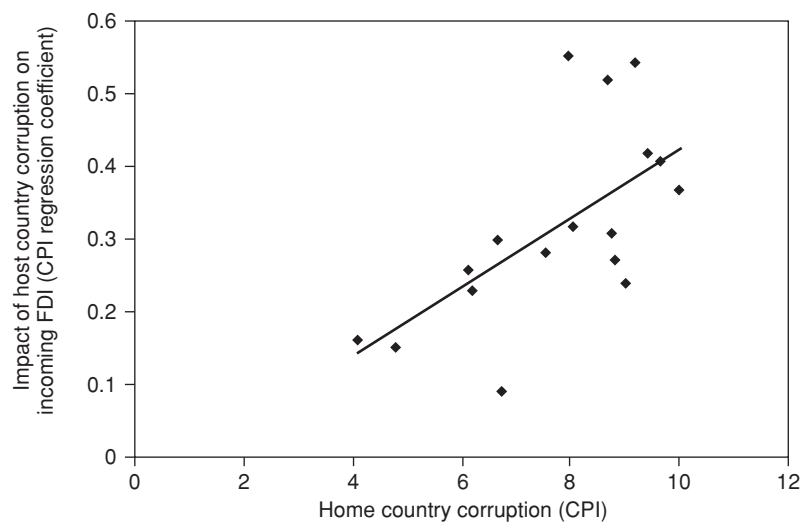


Figure 19.1: Home country corruption and responses to host country corruption^a

^a The CPI coefficients are based on regressions of log FDI on host country corruption (CPI), log population, trade/GDP, log distance, economic ties and political risk for 17 home countries. The home country CPIs are for Australia, Austria, Denmark, Finland, France, Germany, Italy, Japan, Korea, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK and USA. The correlation between the two variables is 0.62.

Notes

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2. See Mohsin Habib and Leon Zurawicki, 'Corruption and Foreign Direct Investment', *Journal of International Business Studies*, 2002, vol. 33, no. 2; 'Country-Level Investments and the Effect of Corruption: Some Empirical Evidence', *International Business Review*, 2001, vol. 10, no. 6; 'Foreign Direct Investment and Corruption: Conceptual and Methodological Issues', *Journal of Transnational Management Development*, 2001, vol. 6, no. 4; and 'National Differences in Investors' Responses to Corruption: An International Comparison', *International Business and Economics Research Journal*, 2002, vol. 2, no. 1.