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The Role of Institutional Quality in the Corruption-Growth Nexus

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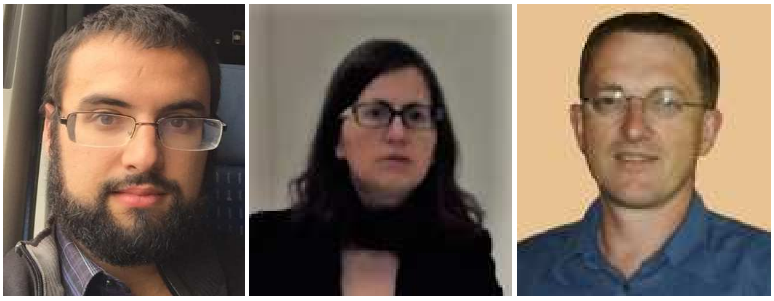

Summary

We analyze the channels through which institutional quality affects the corruption-growth nexus. To this end, we develop an endogenous growth model and empirically test its implications. Our sample consists of a panel of 136 developed and developing countries over the period 1984-2015. We show, both theoretically and empirically, that (i) the corruption-growth relation can be subject to nonlinearities highly influenced by countries' institutional development and (ii) private investment and public spending are two main channels through which institutional quality nonlinearly affects the relation between corruption and economic growth.

Policy Recommendations

Institutional quality modulates the corruption - growth nexus. In particular, improving the quality of institutions seems to affect the functioning of two channels through which corruption acts on growth: private investment and public spending.

Introduction

Corruption is usually defined as the misuse or the abuse of public office for private gain. This phenomenon encompasses different practices, including bribes, cronyism, nepotism, patronage or embezzlement.

About a third of the international assistance is diverted every year by corrupt officials in developing countries.

During the last few years, a number of international organizations have attempted to combat corruption. Nevertheless, corrupt practices are still widespread and remain omnipresent in both developing and developed countries. According to Transparency International (2009), about a third of the international assistance is diverted every year by corrupt officials in developing countries. In developed countries, a report of the European Commission (2014) has underlined similar problems.

The question that arises then is how and through which channels corruption affects economic growth? Is the effect similar in countries characterized by different levels of institutional quality? To address these issues, we propose a theoretical model and an empirical evaluation showing a complex interaction between corruption and growth.

Literature Review

The relation between corruption and growth has been a topical debate and has led mainly to the emergence of two different results.

On the one hand, there is a vast literature concerned with the "sanding the wheels" hypothesis, highlighting the adverse effects of corruption on growth. Overall, in these empirical (e.g. Mauro 1995, Johnson et al 2011) and theoretical (e.g. D'Agostino et al 2016) studies, corruption reduces private investment or its productivity, affects public spending as well as the quality of human capital, and induces political instability. Therefore, the expected outcome is a decrease in economic growth.

On the other hand, several voices have argued that corruption "greases the wheels" of business and economic growth and development. In other words, according to the proponents of this theory, corruption circumvents the institutional shortcomings: if countries cannot develop their institutional environment, corruption becomes a natural loophole allowing the system to achieve growth, at least in a short-medium run perspective. Corruption can be trade enhancing and efficiency generating by allowing economic agents to get around the rules of an ineffective administrative and legal system that slows down trade, investment and therefore growth (Leff 1964, Nye 1967, Huntington 1968). Hence, no clear consensus has emerged and both strands of the literature have been criticized.

Our contribution

The objective of our paper is to address the questions mentioned above by developing a theoretical analysis that describes the mechanisms through which institutional quality might affect the relation between corruption and growth. To this end, we build an endogenous growth model and highlight the existence of two channels causing a nonlinear relation between corruption and growth, depending on the level of institutional quality, namely private investment and public expenditures.

At low levels of institutional quality, corruption positively affects growth while the impact becomes negative at high levels of institutional quality.

Then, we develop an empirical analysis in two steps. First, we introduce interaction terms between corruption and institutional quality and show the existence of a threshold effect between the two variables. At low levels of institutional quality, corruption positively affects growth while the impact becomes negative at high levels of institutional quality.

Second, we go beyond the existing literature by proposing an argument explaining this nonlinearity. In particular, we show that corruption stimulates private investment and then growth in countries with low institutional quality but it undermines public expenditures and consequently growth in high growth economies. Our empirical study confirms our theoretical predictions. Hence, we propose a comprehensive framework to analyze the complex interactions between corruption, institutional quality and economic growth.

Results and Policy Implications

We have shown theoretically that corruption impact the economic growth through the transaction costs related to bureaucracy. On the one hand, when the level of institutional quality is low (hence bureaucracy is very high), investors tempt to circumvent the existing bureaucracy through corruption. On the other hand, when the level of institutional quality is high, the marginal benefit of corruption on growth tends to be low (investors will simply follow the rules of an effective administration and do not pay the cost of corruption). Hence, one of the channels through which corruption acts on growth is private investment, with different outcomes depending on the level of institutional quality.

Moreover, we have highlighted that the effect of corruption on growth is strong if the tax collection mechanism works well (in other words, if countries have good institutions). This is explained by the fact that, in such a situation, as corruption acts like a tax, less funds can be collected at the budget level. Hence fewer public expenditures could be available. However, the impact of corruption on growth might be low if the tax collection mechanism is not functioning, translating a bad institutional quality environment. In this case, the public expenditures financed through the collected taxes would anyway be devoted to unproductive uses (as in Mauro 1995). These results are also empirically tested (through Panel Smooth Transition Regression (PSTR) and GMM models) and are robust to various econometric specifications and sample heterogeneity. We confirm that corruption nonlinearly affects growth through the lens of institutional quality and identify private investment and public spending as the two main channels explaining this relation. We show that the private investment channel is more (less) important than the one of public expenditure in countries having a low (high) level of institutional quality, with respect to the average. Furthermore, private investment is positively affected by corruption in countries where institutional quality is low (as corruption eliminates transaction costs related to a sluggish bureaucracy) and negatively impacted in countries where institutions are effective (translating the fact that in this case investors will no longer need to employ corruption practices).

Conclusion

Our paper shows the existence of a non-linear relationship between corruption and economic growth that depends on the degree of countries' institutional development. Using an endogenous growth model and an original empirical analysis, we also identify the channels through which institutional quality non-linearly affects the corruption-growth nexus.

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