

Corruption: Economic and Fiscal Costs

[2192 words, excl. references]

1. INTRODUCTION

According to Transparency International,¹ corruption is “one of the greatest challenges of the contemporary world”. Mashal (2011) cites six causes of corruption namely; extremely strong motivation to earn income due to poverty, low salaries/wages and ‘high risks of all kinds’ including unemployment and lack of insurance; weak legislative and judicial systems; poorly developed laws and principles of ethics; large population relative to natural resources; political instability & weak political will and many regulations that lead to more opportunities for corruption.

Figure 1 shows that South Africa is ranked as the 64th least corrupt country in the world (0 indicates no corruption), which indicates that although not relatively extremely high, corruption in South Africa necessitates the need for urgent and practical strategies against its effects.

Figure 1: Corruption rankings 2016

RANK	COUNTRY/TERRITORY	SCORE	RANK	COUNTRY/TERRITORY	SCORE	RANK	COUNTRY/TERRITORY	SCORE	RANK	COUNTRY/TERRITORY	SCORE	RANK	COUNTRY/TERRITORY	SCORE
21	Uruguay	71	60	Italy	47	86	Sri Lanka	36	138	Myanmar	28			
1	Denmark	90	61	Sao Tome and Principe	46	87	Gabon	36	139	Nigeria	28	169	Burundi	20
1	New Zealand	90	62	Costa Rica	68	78	China	40	120	Dominican Republic	31	136	Papua New Guinea	28
3	Finland	89	63	Spain	68	79	India	40	101	Ecuador	31	142	Guinea	27
4	Sweden	88	64	Georgia	67	83	Albania	39	101	Paru	36	120	Malawi	31
6	Switzerland	86	65	Latvia	67	83	Bosnia and Herzegovina	39	101	Philippines	36	123	Azerbaijan	30
6	Norway	86	66	Grenada	66	83	Jamaica	39	101	Thailand	36	123	Djibouti	30
7	Singapore	84	67	Cyprus	66	83	Lesotho	39	101	Timor-Leste	36	123	Mozambique	27
8	Netherlands	83	68	Czech Republic	66	87	Mongolia	38	101	Trinidad and Tobago	36	123	Honduras	30
9	Canada	82	69	Greece	44	87	Panama	38	106	Algeria	34	123	Laos	30
10	Germany	81	70	Bahrain	43	87	Zambia	38	106	Côte d'Ivoire	34	123	Mexico	30
10	Luxembourg	81	70	Ghana	43	90	Colombia	37	106	Egypt	34	123	Moldova	30
10	United Kingdom	81	70	Burkina Faso	42	90	Indonesia	37	106	Ethiopia	34	123	Paraguay	30
13	Australia	79	71	Serbia	42	90	Liberia	37	106	Guyana	34	131	Sierra Leone	30
14	Iceland	78	72	Solomon Islands	42	113	Morocco	37	113	Armenia	33	131	Kazakhstan	29
16	Belgium	77	73	Bulgaria	41	90	The FYR of Macedonia	37	113	Bolivia	33	131	Nepal	29
16	Hong Kong	77	74	Kuwait	41	96	Argentina	36	113	Vietnam	33	131	Russia	29
17	Austria	76	75	Tunisia	41	96	Benin	36	116	Mali	32	131	Ukraine	29
18	United States	74	76	Turkey	41	96	El Salvador	36	116	Pakistan	32	136	Guatemala	28
19	Ireland	73	77	Belarus	40	96	Kosovo	36	116	Tanzania	32	136	Kyrgyzstan	28
20	Japan	72	78	Brazil	40	96	Maldives	36	116	Togo	32	136	Lebanon	28
			79	Cuba	47							169	Democratic Republic of Congo	21
			80									169	Uzbekistan	21

Source: Transparency International (2017)

It is noteworthy that, as seen in figure 1, developing countries generally experience high corruption. Concurring with this is the fact that on the bottom of the list most countries are developing countries. On the other hand, developed countries experience relatively less

¹Transparency International is an organisation devoted to fighting bribery around the world. See <https://www.transparency.org/>

corruption; hence, most countries on the top of the list are developed countries. However, no country – even developed – had a ranking rendering it completely free from corruption. In essence, corruption is a widespread problem that poses serious problems for all economies and governments. Against this backdrop, this essay discusses the economic and fiscal costs of corruption. The rest of the essay is structured as follows: Section two gives an overview of the definition and measurement of corruption, Section three discusses the economic and fiscal costs of corruption, and section four concludes.

SECTION 2:

Definition and measurement of corruption

2.1 Definition of corruption

The literature has presented various types of corruption that exist at various levels. Therefore, a major challenge in studying corruption lies in how to define corruption (SAHA, 2009). The definitions of corruption used in an analysis may change the conclusion drawn from the empirical studies or normative policy (Bardhan and Mookherjee, 2005). This paper, therefore, deems an overview of the different types of corruption necessary, and the type of corruption this paper will focus on.

Many studies have broadly identified three types of corruption in a democratic society based on the relationship between the public and government (Rose-Ackerman, 1978; Jain, 2001). Below are short explanations of these types of corruption.

2.1.1 Political corruption

This refers to corrupt acts of political leaders and activities by which they exploit their decision-making power to make national policies serve their own interests (SAHA, 2009).

2.1.2 Bureaucratic corruption

This refers to corrupt acts of bureaucrats (Jain, 2001), where in many cases the public may bribe bureaucrats to receive a service to which they have a right or to quicken a bureaucratic procedure (Kaufman, 1997).

2.1.3 Legislative corruption

This refers to the extent to which voting behaviour of legislators can be influenced (SAHA, 2009). By this type of corruption, legislators can receive bribes from interest groups (e.g. business people and politicians) to enforce legislation that can generate or change the economic rents associated with assets (Rose-Ackerman, 1999).

2.1.4 Corruption in the private sector?

While the conventional view is that corruption is the misuse of public offices only (Jain, 2001), there is no doubt corruption prevalent in the private sector. This type of corruption is called ‘private sector corruption’ (Transparency International, 2017). Like in the case of public officials, it is the misuse of office for private gains. Private sector corruption can manifest in a form of bribery, undue influence, fraud, money laundering and collusion (Transparency International, 2017)

The focus of this essay is political corruption. The reason is that political corruption is “arguably a more serious problem” and controlling it may be necessary for controlling private sector corruption (World Bank, 1997).

2.2 Measurement of Corruption

Measuring or quantifying corruption is also a difficult task because it has various forms (SAHA, 2009). However, more recently, researchers have developed indices that measure corruption based on how experts, whom they survey, perceive corruption in a country (‘perceived corruption’) (SAHA, 2009). The advantage of perception surveys is that of good coverage since it is easier to ask someone’s perception of corruption than to measure corruption directly (Olken and Pande, 2011). The challenge of perception-based measures is that they cannot measure corruption accurately (Olken and Pande, 2011). I believe another possible challenge with these is that the responses of the surveyed experts may not represent or reflect the views of the whole population. Such perception-based indices include Business International Corporation’s ratings, Political Risk Service’s International Country Risk Guide (ICRG), Transparency International’s Annual Corruption Perception Index (CPI), and World Bank’s Control of Corruption Index. In the absence of more reliable measures, this essay makes use of these indices in discussing the costs of corruption.

SECTION 3:

Economic and fiscal costs of corruption

3.1 Economic costs

3.1.1 Investments

Using Business International’s corruption index, Mauro (1995) found that more corrupt countries experienced significantly lower investment rates (Dreher and Herzfeld, 2005). This is because of a negative relationship between corruption and investments (see figure 3 on the appendix). The negative relationship between corruption and investments is attributable to that corruption acts like a tax that discourages Foreign Direct Investments (Camerer, 2009), which is supported by the studies of Wei (1999, 2000a, 2000b) & Smarzynska and Wei (2000). Vast literature focusing on the ratio of gross investment to GDP confirm this result of lower investment rates in more corrupt countries (Dreher and Herzfeld 2005), and if the response variable used is the ratio of private investment to GDP, this result is also confirmed (Campos, Lien and Pradhan, 1999). Camerer (2009) estimates that a corrupt country is likely to achieve aggregate investment levels of almost 5% less than a country that is relatively ‘incorrupt’.

Tuomi (2009) holds that corruption is one of the factors that affect the investment climate in South Africa. This effect is negative; Balamoune-Lutz and Ndikumana (2008) find empirical evidence that corruption has a negative effect on South Africa’s total investment. This may be because foreign investors become sceptical about investing in a country perceived as corrupt. Even local investors tend to ‘park’ (hold back) their big investment projects and operations. For instance, after the Presidential cabinet reshuffle – which the news (Business Live, 2017; Daily Maverick, 2017; BizNews.com, 2017, amongst others) labelled as a product of corruption within the state – big industry players like PIONEER Foods (which produces top brands like Liquifruit, Snowflake flour, White Star maize meal, Ceres fruit juices, Spekko rice, Weet-Bix, and Sasko bread variants) and other big mining companies announced that they were parking their investments, particularly due to political turmoil – which news agencies (including those cited above) also point out to be an outcome of corruption. 58% of executives surveyed by the global accounting organisation Grant Thornton (2016) indicated that they were delaying their business expansions in South Africa. In short, corruption has negative effects on the country’s economic landscape, particularly through the channel of investment.

3.1.2 Poor service delivery

“Corruption fuels poor service delivery” (Corruption Watch, 2014). This is because huge amounts of money that could be used for service delivery are lost to corruption every year (Corruption Watch, 2014). There are a number of examples that prove that corruption leads to poor service delivery, and the lack of textbooks in Limpopo in 2012 is one of them. A report by the Special Investigative Unit (SIU) in 2011 highlighted irregularities and wasteful expenditure within the education sector; the report also found that an R680-million contract was awarded to EduSolutions not because of the ability to provide the service but because of political connections (Moneyweb, 2013). Another example is what is currently happening in our society: roads are built using poor material and people, especially the poor, are usually left without proper roads just months after the roads were built. Since the government provides sufficient money to do such projects, the general view is that people in power buy poor material in order to gain surplus money for private gain. This is a serious economic problem because quality basic infrastructure leads to more economic growth (Blaauw et al., 2017). Poor government delivery also hinders business growth in South Africa (Polity, 2012). 32% of private business owners surveyed by Grant Thornton in 2016 identified poor service delivery relating to utilities (water and electricity) as having the greatest negative impact on their growth (Grant Thornton, 2016). This may be because utilities are key inputs in production and in providing service. All these show the negative effects corruption has on the economy.

3.2 Fiscal costs

3.2.1 Lower revenue collection

In a panel of 68 countries over the period 1980-1995, Tanzi and Davoodi (2002a) find a significant negative impact of corruption on state revenues. Employing a larger sample of countries, Tanzi and Davoodi (2002b) find a similar result, as do Friedman et al. (2000). There are various reasons behind this. First, widespread corruption injures the culture of compliance, thereby increasing tax evasion (IMF, 2016), which erodes state revenue. The negative relationship between corruption and tax revenue suggests this (see figure 2 on the appendix) (IMF, 2015). Second, corruption creates disincentives for taxpayers to pay taxes (IMF, 2016). This happens when tax exemptions appear as a result of a bribe and therefore the public tends to be far less compliant with tax laws, which they perceive as unjust (IMF, 2016). This creates mistrust in the administration, and thus demoralises entrepreneurs from establishing new businesses in the formal sector, thus further eroding state revenue (Dreher and Herzfeld, 2005). Lastly, corruption reduces the impetus for the state to collect taxes (IMF, 2016). This is evidenced in recent IMF research that suggests that in corrupt countries the IMF-supported programs - which generally have a positive effect on revenue performance - become ineffective (Crivelli and Gupta, 2016).

Taxes finance government spending (Okolski and Stratmann, 2010), and empirical evidence suggests that there is a positive relationship between government spending and economic growth (Lin et al., 2010). Hence, a lower government revenue collection may have aggravating effects on the economy as economic growth is linked to many economic variables. For example, theoretically, a lower economic growth may result in low investment, disposable income, demand, and high unemployment. Reduced tax collection would especially be harming to South Africa, where tax revenue contributes about 88% to total

government revenue.² In short, corruption poses a threat to countries' fiscal stance and the economy in general.

3.2.2 Distorts the composition of public spending and cost inflation

Mauro (1996; 1998) finds clear evidence that corruption reduces government spending on education. On the other hand, corrupt governments tend to spend significantly more on the military (Gupta et al., 2001). This suggests that corruption also distorts where government spends money. Corruption may even lead to a provision of a service that is not supposed to be provided (Bardhan, 1997), thus providing further evidence of distortion of public funds. Corruption can take the form of cost inflation – where costs of goods or projects are inflated illegally in order to gain surplus money from purchases or projects. This was seen recently in sub-Saharan Africa, where weak expenditure controls, off-budget transactions, and lack of oversight were root causes of financial integrity failures, particularly illegal cost inflation (IMF, 2016). Inflated public procurement costs have been haunting advanced economies as well (IMF, 2016). A study by Price Water Coopers (2013) noted that corruption hiked the costs of a public project by 13% on average in eight European states. Such cost inflation leads to leakages in public spending programs, especially in military and big public investments, where procurement costs can be easily inflated (Arnone and Iliopoulos, 2007).

The annual financial audits of the Auditor-General of South Africa compare budgeted and actual expenditure of government departments (KPMG, 2016). Three groups of financial misconduct are outlined in the report – fruitless and wasteful expenditure, irregular expenditure and unauthorised expenditure (KPMG, 2016). Although these three groups may capture some corruption-related activities if the financial mismanagement was for criminal purposes rather than maladministration, it is not possible to isolate the values of corrupt activities from these recorded amounts (KPMG, 2016). However, it is clear that if the wasted expenditures from corruption are even a fraction of these amounts, there are significant costs that corruption incurs to the South African economy (KPMG, 2016). Thus, corruption may have distorted (a big portion of) R59.67 Billion of public spending in 2014/2015, which may have been used in key services like health care and education.

South Africa also has a big problem of procurement cost inflation; the country loses about R25-billion each year to corruption in government procurement (Moneyweb, 2013). Hence, there is now an office of the Chief Procurement Officer at the National Treasury to deal with this.

3.2.3 Large fiscal deficits and debt accumulation

The result of thriftless public expenditure and lower state revenue collection can be excessive fiscal deficits and considerable debt accumulation (Ivanyna et al., 2015; Kaufman, 2010). This is because off-budget spending creates budget deficits and government borrows to curb these deficits, hence debt accumulation. A country with high corruption and public debt can find itself in a woeful circle of corruption and fiscal wastefulness, resulting in a debt crisis (Achury et al., 2015). A report in 2012 by Transparency International argues that corruption played a role in the fiscal and debt crisis in the European Union because of a serious lack of public sector accountability and deep-seated problems of malfeasance and inefficiency in some member countries (IMF, 2016).

² Own calculations from the 2017 budget, available at <http://www.treasury.gov.za/documents/national%20budget/2017/review/FullBR.pdf>

In 2015/2016, South Africa's total tax revenue was about 88% of total government revenue, which is the same as the estimate for 2016/2017.³ Since corruption increases government spending and reduces government revenue in South Africa, it can be concluded that corruption has some contribution to the large budget deficit (3.9% in 2016) and government debt (currently 51% of GDP) (Trading Economics, 2017).

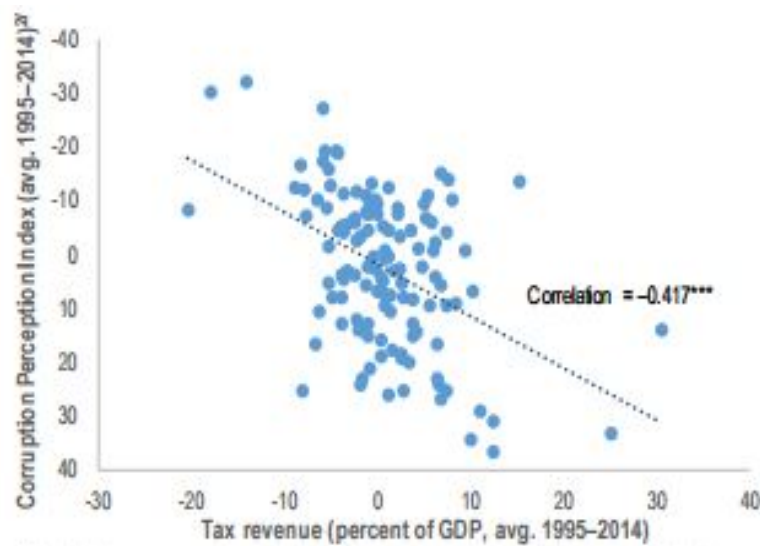
4. CONCLUSION

This essay discussed the economic and fiscal costs of corruption with reference to international and local studies. The economic costs of corruption discussed were low investment and poor service delivery, and fiscal costs were low government revenue, distortion of the composition of public spending and cost inflation, and large fiscal deficits and debt accumulation. This essay's discussion was based on political corruption.

Corruption is a chronic that we must fight. Through collaborative work and dedication, we can do this. We must free our country from corruption and 'economic gangsters'.

6. APPENDIX

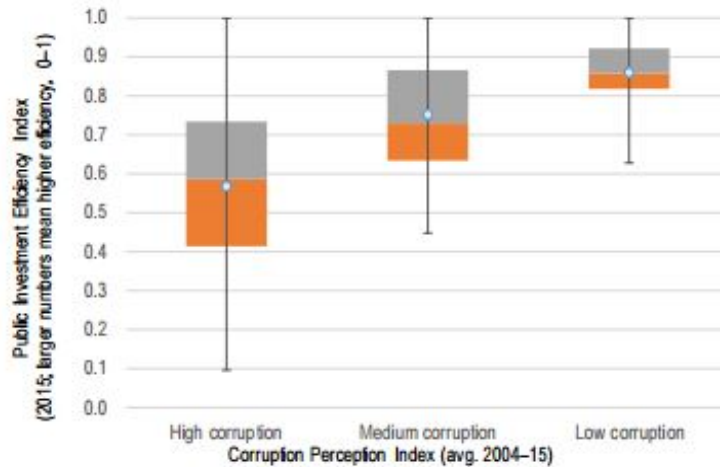
Figure 2: Corruption and tax revenue



Source: Transparency International (2015); IMF (2016)

³ See footnote 2 for calculations

Figure 3: Corruption and Efficiency (Quality) of Investment



Source: IMF staff estimates

Note: The samples are grouped into high, medium and low corruption in equal numbers based on the Corruption Perception Index. The lines show the range of efficiency for each group. The orange and gray boxes are the second and third quartile (from the bottom) of the samples, thus they cover 50 percent of the countries.

Source: IMF (2016)

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