Christine Lagarde: Addressing corruption – openly

The economic and social costs

Corruption afflicts countries at all stages of development. Indeed, some developing countries score better on corruption indices than many advanced countries. While there are no recent studies that quantify the overall global scale of corruption, a sense of how big a problem it is can be gauged from an estimate of the amount paid in bribes every year. A recently updated estimate points to $1.5 trillion to $2 trillion (or around 2% of global gross domestic product [GDP]) in bribes paid annually in both developing and developed countries. Given that bribes are just a subset of all of the possible forms of corruption, the overall cost of corruption – in terms both of tangible losses and of lost opportunities – is a very high amount.

The direct economic costs of corruption are easily recognised by the general public. Two very clear examples are bribes given in order to evade taxes or to bypass public tender procurement. The first example results in a direct loss of public revenues; the second may result in both higher public expenditure and lower-quality public investment.

Corruption has a pernicious effect on the economy. Pervasive corruption makes it harder to conduct sound fiscal policy. For example, in data covering a range of countries, we find that low tax compliance is positively associated with corruption. By delegitimising the tax system and its administration, corruption increases tax evasion: if the granting of a tax exemption is perceived to be the product of a bribe, it is not surprising that the public are far less willing to comply with the tax laws.

Corruption also undermines certain types of public expenditure to the detriment of economic performance. For example, it is associated with lower outlays on education and skewed public investment, driven by the capacity to generate 'commissions' rather than by economic justification (Mauro 1998). The distortion in public investment spending is particularly harmful given the importance of promoting efficient public investment as a means of reducing infrastructure gaps and promoting growth.

The indirect economic costs of corruption may be even more consequential. Clearly, causation is difficult to establish and, in quantitative analysis, a significant effect of corruption on growth has not been found (Svensson 2005). Nevertheless, in comparative studies of national data, corruption is associated with a number of key indicators. **Countries with low per capita income tend to have higher corruption and countries with higher corruption tend to have lower growth. Studies have identified different ways in which corruption could affect growth.**

First, corruption tends to impede both foreign and domestic investment. The higher costs associated with corruption are a form of tax on investment that, in turn, translates into less investment in business research and development and product innovation. Moreover, by creating uncertainty as to how the regulatory framework will be applied, it increases the ‘country risk’ associated with a particular investment project. More generally, corruption generates an unfavourable business climate in which the creation of new enterprises is stifled, reducing the economy’s dynamism.

Second, corruption undercuts savings. The illegal use of public funds to acquire assets abroad shrinks the economy’s pool of savings that could otherwise be used for investment.

Finally, corruption can perpetuate inefficiency. Because an over-regulated economy provides opportunities for regulators to demand bribes, corruption creates a strong incentive to delay economic liberalisation and innovation.

The impact of corruption on social outcomes is also consequential. Social spending on education and health is typically lower in corrupt systems. This, in turn, leads to higher child and infant mortality rates, lower birth-weights, less access to education and higher school dropout rates (Gupta, Davoodi and Tiongson 2002).

These outcomes disproportionately affect the poor, since they rely more heavily on government services, which become more costly due to corruption. Moreover, corruption reduces the income-earning potential of the poor as they are less well-positioned to take advantage of it. For all these reasons, corruption exacerbates income inequality and poverty (Gupta, Davoodi and Alonso-Terme 2002).