

# U4 Expert Answer



## Correlation between corruption and inequality

### Query

**Are there any good and recent studies on the correlation between corruption and inequality?**

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### Summary

The correlation between corruption and inequality has been largely analysed in the literature in relation to the impact of corruption on economic growth and wealth distribution. Despite a large consensus on the negative effect of corruption on economic growth, some studies have argued that, in certain societies, especially those with inefficient bureaucracies and institutions, corruption might facilitate economic activity. Evidence that economic growth does not necessarily bring equality has, in recent years, motivated the publication of a significant body of literature regarding income distribution and contemporary forms of increasing inequality in stable economies. In general, corruption is not explicitly considered responsible for growing inequality, but several

authors point to questionable practices derived from the capture of the government by elites to protect their interests.

Of significant importance in the literature on corruption and inequality is the bidirectional causal relationship corruption-inequality-corruption. Several studies highlight the potential of corruption to increase inequality by affecting income distribution, the use of aid flows and decision making in public expenditure. Inequality might also help to promote corrupt behaviour by elite capture of political processes or unintentionally through the vulnerability of the poorer classes to engage in clientelistic relationships or to be asked for bribes.

**Author(s):** Nieves Zúñiga

**Reviewed by:** Roberto Martínez B. Kukutschka, Transparency International, rkukutschka@transparency.org

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## 1. Corruption, growth and inequality

There is a significant volume of literature addressing the relationship between corruption and inequality. Two aspects – economic growth and wealth distribution – are key to understanding this relationship. Some of the literature is devoted to understanding how corruption affects economic growth, yielding a number of contrary arguments (Méon and Sekkat 2005).

Nevertheless, positive economic growth does not necessarily mean less inequality. In recent years, special attention has been devoted to analysing the great disparities in wealth distribution that have led to increased inequality at a global scale with particular manifestations in advanced economies.

### The effects of corruption on economic growth

Some authors have argued that corruption may be economically justified. According to those studies, corruption can compensate for excess bureaucracy: it can allow the private sector to correct government failures and, thus, “grease the wheels” of the economy (Leff 1964; Huntington 1968; Leys 1965).

Other studies argue that the effect of corruption on economic growth is context specific and will depend on the country’s political regime (Méndez and Sepúlveda 2006), institutional and legal framework, and quality of governance, among other factors. In this line of thought, some analyses conclude that corruption can potentially increase productivity in highly regulated countries with inefficient governments (Houston 2007; Méon and Weill 2008).

However, even if corruption could potentially alleviate the obstacles that inefficient bureaucracies present for the development of economic activity in the short term, there is a large consensus in the literature about the negative impact of corruption on economic growth in the long term (Mauro 1995; Tanzi and Davoodi 1997; Gyimah-Brempong 2001). Macro-level studies, using cross-country data, support this argument and show that corruption is consistently correlated with lower rates of growth, economic equality, GDP per capita and levels of human development

(Rothstein and Holmberg 2011).

The negative effect of corruption on economic growth can take different forms. Tanzi and Davoodi (1997) highlight four of them: higher public investment, lower government revenues, lower expenditure on categories of public spending like health and education, and lower quality of public infrastructure. Many studies have also proven that corruption affects the quantity and quality of investments and reduces profitability (Mauro 1995). In particular, corruption reduces foreign direct investment (Zurawicki and Habib 2010), including in the host country (Wei 2000). For example, a 2008 study on US foreign direct investment outflows in relation to levels of corruption in 42 countries revealed how US firms were less likely to invest in countries where corruption is widespread (Sanyal and Samanta 2008).

Corruption is also perceived to increase the cost of investment. In a survey carried out by Control Risks and Simmons & Simmons (2006), a quarter of respondents claimed that corruption increased their costs of international investment by up to 5%. Nearly 8% of respondents claimed that it increased their costs by 50%.

Another way in which corruption negatively affects economic growth is in undermining a country’s tax system and its revenue collection capacity (Nawaz 2010). According to the literature, corruption not only lowers the tax to GDP ratio, but it also increases the underground economy and corrodes the tax morality of taxpayers, causing long-term damage to the economy (Attila 2008; Nawaz 2010). From a business point of view, corruption is costly for companies because it introduces uncertainty, reputational risks and vulnerability to extortion (Chêne 2014). It also makes access to capital more expensive and undermines fair competition (Transparency International 2009). For more details and references on the impact of corruption on companies and economic growth, see a previous Helpdesk answer on the topic (Chêne 2014).

## Billionaires, financial markets, globalisation and inequality

There has been a prolific number of publications in the last five years addressing the issue of rising income inequality in the world from various economic, social, political and anthropological perspectives. Several studies put inequality at the top of global and national concerns, and they raise serious concerns about the implications for governance, social cohesion and human progress. The World Economic Forum (2013) ranked widening income disparities as the second greatest worldwide risk for the near future in its Outlook on the Global Agenda 2014. According to Piketty (2014: 572), the global inequality of wealth is currently increasing “at a rate that cannot be sustained in the long run and that ought to worry even the most fervent champions of the self-regulated market”.

One of the main aspects addressed in the literature is the form of this recent inequality, characterised as global for the global implications of state economic and political actions, but national in its expression as a dramatic concentration of wealth in the hands of a small elite within a country.

Authors point out that, for the first time since the Industrial Revolution, while inequality between countries is narrowing (in part by the growth of Asian economies), inequality within developed countries is on the rise (Milanovic 2016; Atkinson 2015). This inequality is facilitated by a system that allows a rich minority to become richer while the majority of the population is excluded from any increase in prosperity (Oxfam 2016). In the US, for example, the wealthiest 1% captured 95% of post-financial crisis growth since 2009, while the rest of the population became poorer (Oxfam 2014). At a global scale, the wealth of the richest 62 people has risen by 45% in the five years since 2010; they have the same wealth as 3.6 billion people – the poorest half of humanity (Oxfam 2016).

The literature offers several reasons why income inequality, which had been generally decreasing throughout the twentieth century, has recently been on an upswing in stable and rich economies. Milanovic (2016) frames the discussion within the context of globalisation, and shows that, unlike in emerging economies like China or India where the

winners of globalisation have been the middle classes, in developed countries the winners of globalisation have been the very richest in society. Globalisation, together with technological revolution, has also allowed for young entrepreneurial minds to become billionaires in a very short period of time, as the many examples from Silicon Valley illustrate (Atkinson 2015; Freeland 212).

Atkinson (2015) explains inequality in terms of the end of the wealth redistribution achieved during the post-war decades up to the end of the 1970s, characterised by welfare state cutbacks, declining share of wages and rising earnings disparity. From an economic perspective, Piketty (2014) roots the inequality in the transformation of the society from being one of rentiers (people who own enough capital to live on the annual income from their wealth) to a society of managers (highly paid individuals who live on income from labour). The principal destabilising force is that the private rate of return on capital can be significantly higher for long periods of time than the rate of growth for income and output. The inequality implies that wealth accumulated in the past grows more rapidly than output and wages. Thus, the rentiers become more dominant over wage earners.

According to Reich (2015), the growing inequality is explained by a departure from the strong anti-trust laws and a concentration of market power coming from the exercise of political power to prevent policies that would limit monopolies. In this line, Stiglitz (2012) argues that much of the inequality is a result not just of market forces but also of government policy. Political factors such as lower taxes, deregulation of financial services, privatisation or weak legal protection for trade unions, are considered important explanatory factors of the rise of plutocrats (Freeland 2012).

Since the beginning, some reports and media have linked the 2008 financial crisis to lobbying against tighter financial regulation (Simpson 2007; Center for Public Integrity 2009; Labaton 2009; Igan and Mishra 2011). The Wall Street Journal, for example, published a story on Ameriquest Mortgage Co., then one of the largest subprime lenders in the United States, and their battle to relax efforts by some American states to restrict

risky lending to borrowers with spotty credit scores through lobbying and more than US\$20 million in political donations (Simpson 2007).

Igan and Mishra (2011), in their study on US financial companies' politically targeted activities, found that lobbying expenditures by the US financial industry were directly related to the vote of the legislators on key financial bills. The authors show that between 2000 and 2006, only 5% of the 19 major bills seeking to tighten financial regulation became law, while 16% of the 32 laws that loosened regulation were signed into law. An OECD report (2009) documents the active practice of lobbying, regulatory capture and revolving doors in relation to the financial crisis.

### Effects of inequality and corruption on governance

A key question analysed in the literature on the recent growing inequality is how elites have pushed for a framework that benefits them at the expense of the rest of the population. In general, corruption is not explicitly blamed for this growing inequality, but some authors have documented how these elites gain protection from the state through practices related to deregulation, transfers of public assets at bargain prices, profitable licences, permits or public contracts. Authors (Stiglitz 2012; Freeland 2012) refer to the way in which the current political process helps the rich at the expense of the rest of the population as "rent-seeking". Transfers and subsidies from the government, laws that make the marketplace less competitive, lax enforcement of existing competition laws, statutes allowing corporations to take advantage of others or to pass costs on to the rest of the society are typical rent-seeking practices (Stiglitz 2012).

This rent-seeking is facilitated by a new power dynamic in which multiple actors (think-tanks, consultants, media, contractors, among others) with multiple roles intervene in political decision making. For example, Wedel (2009) points out that three-quarters of people working for the US federal government are private contractors performing government functions. According to Wedel (2009), the confusion between the public and the private derived from this scenario defines the era of what she calls "shadow elites" or top power brokers.

This new power dynamic represents a challenge to accountability and transparency. Stiglitz and Pieth (2016) point to the consensus on the problem posed by secrecy havens, defined as jurisdictions that undermine global standards for corporate and financial transparency. These "pockets of secrecy" facilitate both money laundering and tax avoidance and evasion, contributing to crime and unacceptably high levels of global wealth inequality.

Other forms of inequality can be derived from an inconsistent implementation of laws, regulations and institutional procedures due to corruption. David-Barret (2014) concludes that bribery, irrespective of its motive and form, is a demonstration of inconsistency in the application of laws and a violation of the rules. Besides undermining the rule of law, it generates in the public a cynicism and mistrust towards the government (Andreev 2008). In this sense, studies show a strong, negative correlation between trust and corruption (Morris and Klesner 2010).

## 2. Corruption as a cause of inequality

A considerable portion of the literature on the correlation between corruption and inequality has been devoted to the increasing effect that corruption has on inequality. Corruption can increase inequality in the following aspects: income distribution, the use of aid flows, and decision making concerning public expenditure.

### The effects of corruption on income distribution

Studies in the last two decades have revealed that corruption not only has an impact on the level of economic growth but also on how the economic benefits of growth are distributed in society. An International Monetary Forum report from 1998, based on cross-country regression analysis for 1980 to 1997, shows that one standard deviation point increase in corruption resulted in a reduction of income for the poor of 7.8% a year (Gupta, Davoodi and Alonso-Terme 2002). Among the reasons noted for the negative impact of corruption on income inequality are lower economic growth, a



biased tax system, and lower levels and effectiveness of public spending.

Income distribution is often linked in the literature to sustainable development and social welfare. In a sample of 110 countries between 1996 and 2007, Aidt (2010) found that high cross-national levels of perceived and experienced corruption significantly reduce growth in genuine wealth per capita, which suggests the negative interference of corruption to sustainable development. Studies also show that an increase in corruption increases the Gini coefficient of income inequality in contexts as diverse as Africa (Gyimah-Brempong 2001) and the US (Dincer and Gunalp 2008). This is explained by the fact that the likely beneficiaries from corruption are well connected, and often have higher incomes, which undermines the capacity of the government to ensure a more equitable distribution of resources. Another way in which corruption creates unequal wealth distribution is by creating a biased tax system favouring the rich and well connected (Gupta et al. 2002). The facilitation of tax evasion through corruption affects a government's ability to collect taxes and to fairly distribute the wealth. Moreover, this situation might create a pressure on the system that might foster future progressive taxation to compensate for the inequalities caused by corruption. In turn, such compensatory measures might motivate the elites to intensify behaviours to evade those tax increases through political corruption and buying influences, thus creating a vicious cycle. These dynamics make the poorer more vulnerable to corruption and less able to demand accountability (Chêne 2014).

Finally, there is an argument that the increased inequality caused by corruption worsens the position of the poorest in society by reducing the resources available for social spending. In addition, corruption might have a negative impact on the quality and quantity of public services, such as education and health services. A study of the Philippines shows that corruption affects education outcomes by reducing test scores, lowering school rankings and reducing satisfaction ratings (Azfar and Gurgur 2005). In public health services, corruption is proven to be responsible for the delay in the provision of treatments, increasing the waiting times for patients and discouraging the use

of clinics (Azfar and Gurgur 2005). Some studies have concluded that investing more funds in social programmes will not bring the intended results unless corruption is addressed (Suryadarma 2012). A study on corruption and income inequality in Africa suggests that the well-being of the majority of citizens in African countries could be enhanced by a corruption-free use of domestic resources without recourse to asking for external aid (Gyimah-Brempong 2001).

Although several studies provide evidence of how corruption might increase inequality, an empirical study on Latin America concludes that, in the Latin American context at least, lower corruption is associated with higher income inequality (Dobson and Ramlogan 2009). One of the reasons for this is the existence of a large informal sector in Latin America, composed in great part by the poorest, and to which anti-corruption policies will impose an important cost.

### Corruption and aid flows

The literature offers opposing hypotheses regarding the relationship between corruption and aid. Some studies suggest that aid can help to reduce corruption by improving governance and institutional reforms, and by rebuilding civil society. This argument is supported by the fact that bribes are often related to low wages and to the capacity to create stable and efficient institutions which would help reduce the incentives and opportunities for bribery (Van Rijckeghem and Weder 2001). Similarly, Tavares (2003) found that an increase of 1% of aid inflows reduces corruption by 0.2 points.

Other studies, however, argue that the flow of money increases the opportunities for corruption (Asongu 2012; Knack 2001; Alesina and Weder 2002). In a study on the influence of aid on the quality of governance in a sample of 80 countries over the period 1975-1995, Knack (2001) finds that aid is a rent for the recipient country and that gives the countries the ability to bear the cost of ruling out institutional reforms. In this sense, he concludes, aid would foster corruption. Similarly, Svensson (2000) states that aid might enhance corruption, particularly in ethnically fragmented countries.

Bräutigam and Knack (2004) add that a high dependence on foreign assistance reduces

incentives for governments to collect revenues from taxation and to be accountable. As a result, aid might not only foster corruption but it might also decrease the quality of governance, based on the study of 32 sub-Saharan countries between 1977 and 1982. Alesina and Weder (2002) analysed aid flows and corruption in a sample of 63 countries between 1981 and 1995 and found that there was no evidence that increased aid could be associated with a decline in corruption.

A few studies have attempted to offer specific explanations for the contradictory findings in the study of aid and corruption. According to Dalgaard and Olsson (2008), the effect of aid on corruption, and vice versa, depends on the amount of aid: low levels of aid are more successful at reducing corruption. Charron (2011) confirms that bilateral aid has no significant effect on levels of corruption and that multilateral aid began to decrease corruption from 1997 onwards.

Based on data from 1995 to 2009, Okada and Samreth (2012) found that aid helps to reduce corruption when it is allocated by multilateral agencies, rather than in a bilateral way, and in countries already working to fight corruption. Another difference highlighted by Asongu and Jellal (2013) is that when aid goes through public consumption, corruption tends to increase due to the possibility of rent-seeking behaviour from public officials; however, when aid is targeted to private investment, corruption decreases.

In a recent study on the causality between aid and corruption on a dataset of 71 developing countries over the period 1996 to 2009, Menard and Weill (2015) found no significant relationship between both variables and argued that aid does not influence corruption and, equally, corruption levels do not influence incentives of donor countries to allocate aid. In any case, the diversion of aid flows due to corruption prevents their intended use for development and the reduction of poverty and inequality.

### Corruption and public expenditure

The literature acknowledges that corruption and rent-seeking may affect the allocation of public resources by distorting public officials' incentives and diverting public spending towards lucrative

projects. Using the corruption index for over 100 countries for the period 1982 to 1995, Paolo Mauro (1998) published the first cross-country evidence of corruption's effect on the composition of government expenditure and, based on the data analysed, its particular impact on education spending.

Two reasons are given to explain why some sectors are more susceptible to corrupt behaviour than others. The first is that rent-seeking is motivated where there are rents. Thus, high-technology inputs to be provided by oligopolistic suppliers, such as international trade in military craft, will be preferred over less lucrative activities, such as education (Mauro 1998). Second, as Mauro puts it, the need for secrecy when performing acts of corruption requires the selection of sectors where the exact value is difficult to measure. Another explanation for the diversion of public expenditure due to corruption is weak institutional controls and, in particular, undeveloped auditing institutions (Tanzi and Davoodi 1997).

Mauro's conclusions were recently supported in a study using data from 21 OECD countries for the period 1998 to 2011 (Jajkowicz and Drobiszova 2015). The authors show that, due to corruption, government expenditure on defence and general public services increased, while public expenditure on education, health, culture and religion declined. The implication of this corrupt practice on inequality, especially when the sector most affected is education, is the prevention of economic growth considering the positive relationship between investing in education and economic development.

### 3. Corruption as a consequence of inequality

Research shows that, in certain circumstances, inequality might foster corruption (Uslaner 2008; You and Khagram 2005). In some cases, inequality intentionally motivates corruption behaviour in order for a group or individual to protect their privileges. In other cases, inequality happens to be

a factor that in different ways facilitates certain forms of corruption.

### Elite capture of political processes and clientelism

Often, corruption is perceived as a function of motivations and opportunities. In the face of increasing inequality, society is likely to react by demanding redistribution of income and higher levels of progressive taxation (Meltzer and Richard 1981). As the redistribution pressure rises, elites will have a stronger motivation to buy political influence and exercise political corruption to influence decision making in an attempt to preserve their privileges (Glaeser, Scheinkman, and Shleifer 2003). According to some studies, this effect of inequality on motivating corruption is greater in more democratic societies (You and Khagram 2005). According to Kaufmann and Vicente (2005), political corruption or lobbying to ensure legal processes aimed at private gain, what the authors call 'legal corruption', is more likely to arise when there is low inequality, high (initial) income and accountability –understood by the authors as population's awareness of corruptible behaviour by the elite- is low. In the same economic conditions, if accountability is high, a successful insurrection would surface and there is nothing the elite can do to stay in power, so not even legal corruption may arise. However, when there is high inequality and the income is low, which implies that the population might not have the power to threaten the elite with a successful insurrection, the elite opts for cheapest illegal forms of corruption (Kaufmann and Vicente 2005).

An empirical example of capture and clientelism motivated by the potential consequences of inequality on higher redistributive pressures is provided by You (2014) in his comparative study of land reform between South Korea, Taiwan and the Philippines. The author finds that the success in Korea and Taiwan and failure in the Philippines of land reform was determined by exogenous factors such as the communist threat from North Korea and China and the pressures from the United States for land reform to eliminate elite control over the land, in response to communist efforts to win the support of peasants. Land reforms in Korea and Taiwan dissolved the landed elite and produced a

more equal distribution of income and wealth. In the Philippines the land reform failed, the landed oligarchy maintained its power and the high inequality remained. These differences in the levels of inequality in each country after the land reform created class structures with different impact in the levels of corruption. In the Philippines the elite had strong motivation to capture the state and protect their interests due to continue popular demand for land reform. In Korea and Taiwan, the equalizing effect of the land reform reduced power landed interests and incentives for state capture and clientelism.

### Inequality as an “unintentional” facilitator of corruption

The literature offers different scenarios in which inequality might unintentionally promote corruption. Some studies highlight the fact that the poor are more vulnerable to extortion and less able to hold authorities and elites to account. Uslaner and Rothstein (2014) explain this vulnerability in terms of education levels: more educated societies provide citizens with a greater ability to reduce corruption. In turn, more equal societies are potentially more educated societies too, since economic inequality is shown to be a variable with significant negative influence on the establishment of broad based education. Another way in which inequality might facilitate corruption is by affecting social norms and beliefs about corruption. In this sense, You and Khagram (2005), in a cross-country statistical study of 129 countries, argue that inequality adversely affects people's beliefs about the legitimacy of rules and institutions, increasing their level of tolerance of corruption. In many societies, even if corruption is publicly condemned, its persistence is facilitated by high levels of tolerance of corrupt behaviour.

An alternative way in which inequality might facilitate corruption is revealed by a field experiment that examines the way in which police officers in major Latin American cities respond to citizens' perceived wealth when requiring a bribe (Fried, Lagunes and Venkataramani 2010). The authors suggest that citizens perceived wealth influences officers' propensity to solicit bribes and the size of them. They find that officers are more likely to target lower class individuals when asking

for a bribe because they associate wealth with the capacity to exact retribution.

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