

**Corporate Corruption Matters
for Public Governance:**
*Empirical Evidence and Implications
for Anti-Corruption Strategies*

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www.worldbank.org/wbi/governance

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*"If you cannot measure it, you cannot improve it."
-- Lord Kelvin*

Challenging ‘Popular Notions’ on Private Sector Corruption

- 1. Governance & Corruption Measurement: Useless?**
- 2. Evidence: *Has Corruption declined globally?***
- 3. Controlling of Corruption: an outcome of development?**
- 4. Problem is solely with Public Sector/Officials in LDCs**
- 5. Public Sector: sole shaper of the Investment Climate**
- 6. ACCs universal approach to private sector corruption?**
- 7. No Innovations in addressing private sector corruption**
- 8. Investigate & Punish: the only effective tool of A-C**
- 9. Corruption: Cultural & Historical Determinism**

Tenet # 10: Challenging the previous 9 ‘popular notions’

- 1. Data Matters -- *on Governance & Institutions: data can be gathered, analyzed, & used – including by ACCs***
- 2. Corruption Matters: *US \$1 trillion;& 300% ‘dividend’***
- 3. Worldwide: Corruption stagnation, yet variance**
- 4. Private Sector Corruption: Underemphasized**
- 5. Private sector: also an Investment Climate ‘Maker’**
- 6. Implications for institutions fighting corruption**
- 7. Innovations: Transparency & Incentives**

Data Partnership Illustration: ICAC – World Bank Mini-Survey³

Six Dimensions of Governance

Governance as the set of traditions and institutions by which authority in a country is exercised -- specifically:

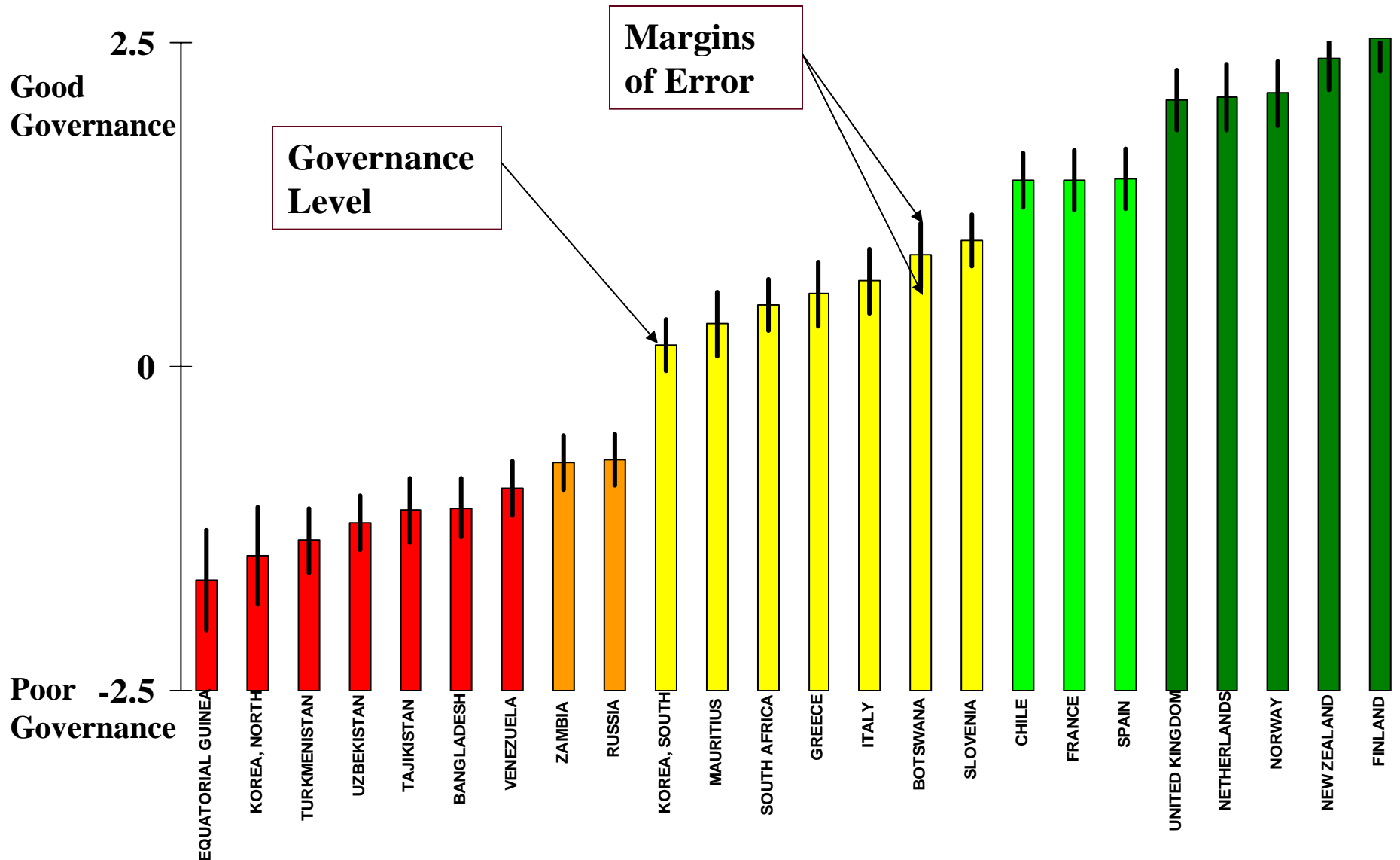
- **The process by which those in authority are selected and replaced**
 - **VOICE AND ACCOUNTABILITY**
 - **POLITICAL STABILITY & ABSENCE OF VIOLENCE/TERRORISM**
- **The capacity of government to formulate and implement policies**
 - **GOVERNMENT EFFECTIVENESS**
 - **REGULATORY QUALITY**
- **The respect of citizens and state for institutions that govern interactions among them**
 - **RULE OF LAW**
 - **CONTROL OF CORRUPTION**

Governance Data

- **Data on governance from 37 different sources constructed by 31 different organizations**
- **Data sources include cross-country surveys of firms, commercial risk-rating agencies, think-tanks, government agencies, international organizations, etc.**
- **352 proxies for all dimensions of governance**
- **Organize these measures into six clusters corresponding to definition of governance, for five periods: 1996, 1998, 2000, 2002, 2004**

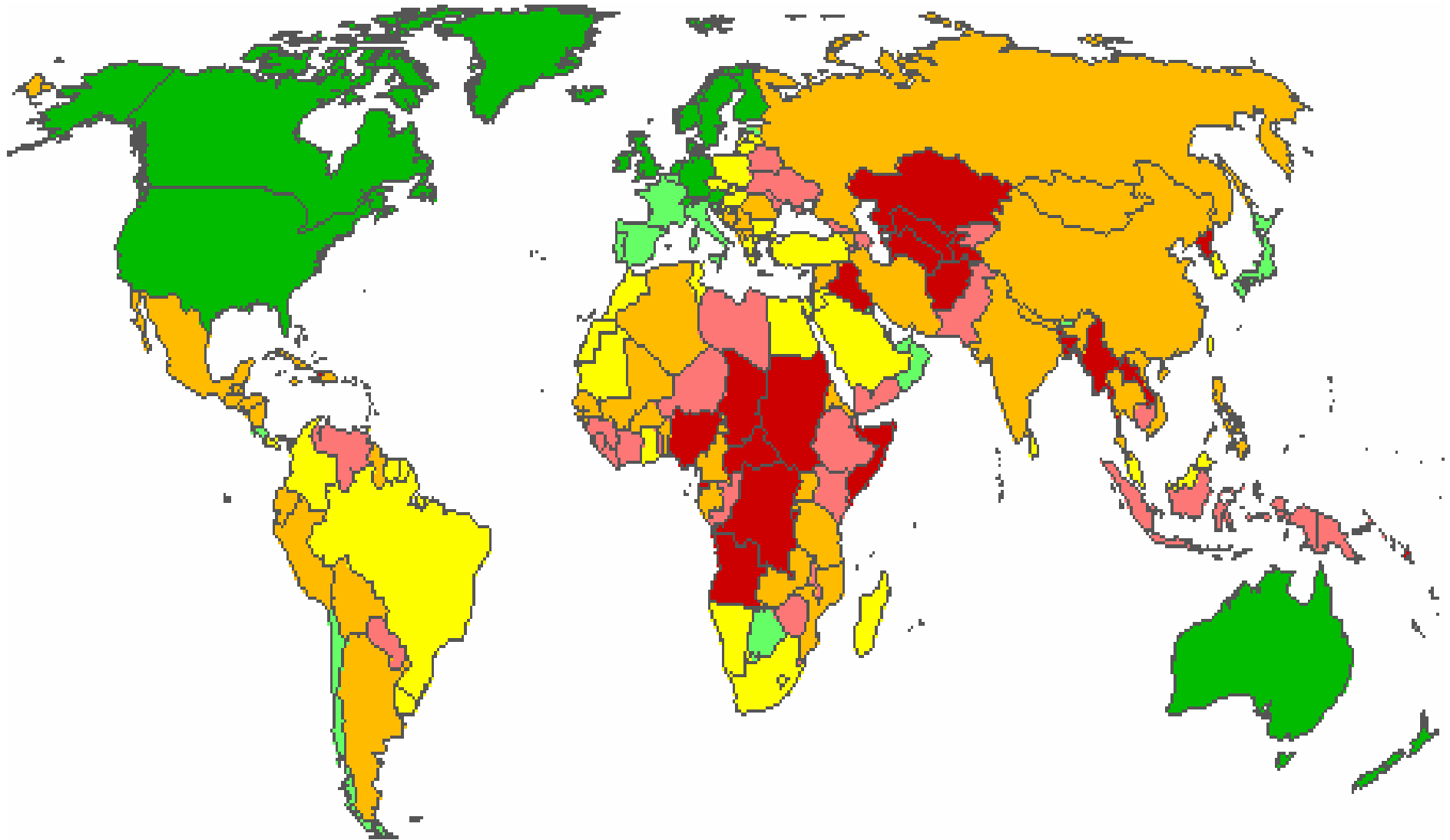
Control of Corruption: one Aggregate Indicator

(selected countries from 204 worldwide, for illustration, based on 2004 research data)



Source for data: : 'Governance Matters IV: Governance Indicators for 1996-2004', D. Kaufmann, A. Kraay and M. Mastruzzi, (<http://www.worldbank.org/wbi/governance/govdata/>); Colors are assigned according to the following criteria: Dark Red, bottom 10th percentile rank; Light Red between 10th and 25th; Orange, between 25th and 50th; Yellow, between 50th and 75th; Light Green between 75th and 90th; Dark Green above 90th.

Control of Corruption, 2004: World Map

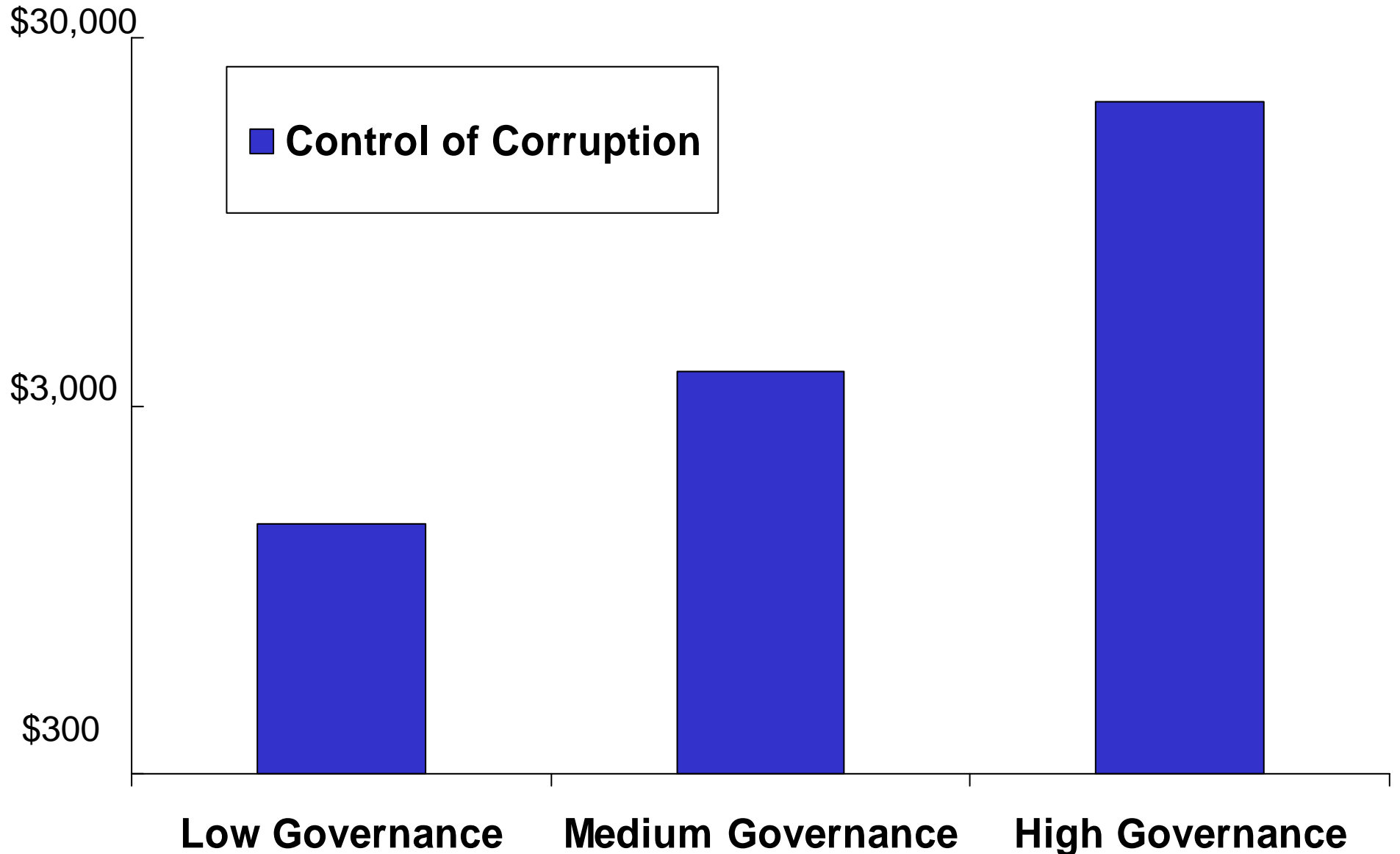


Source for data: : 'Governance Matters IV: Governance Indicators for 1996-2004', D. Kaufmann, A. Kraay and M. Mastruzzi, ⁷
(<http://www.worldbank.org/wbi/governance/govdata/>); Colors are assigned according to the following criteria: Dark Red, bottom 10th percentile rank; Light Red between 10th and 25th ; Orange, between 25th and 50th ; Yellow, between 50th and 75th ; Light Green between 75th and 90th ; Dark Green above 90th.

Governance Matters: The 300% 'Dividend'

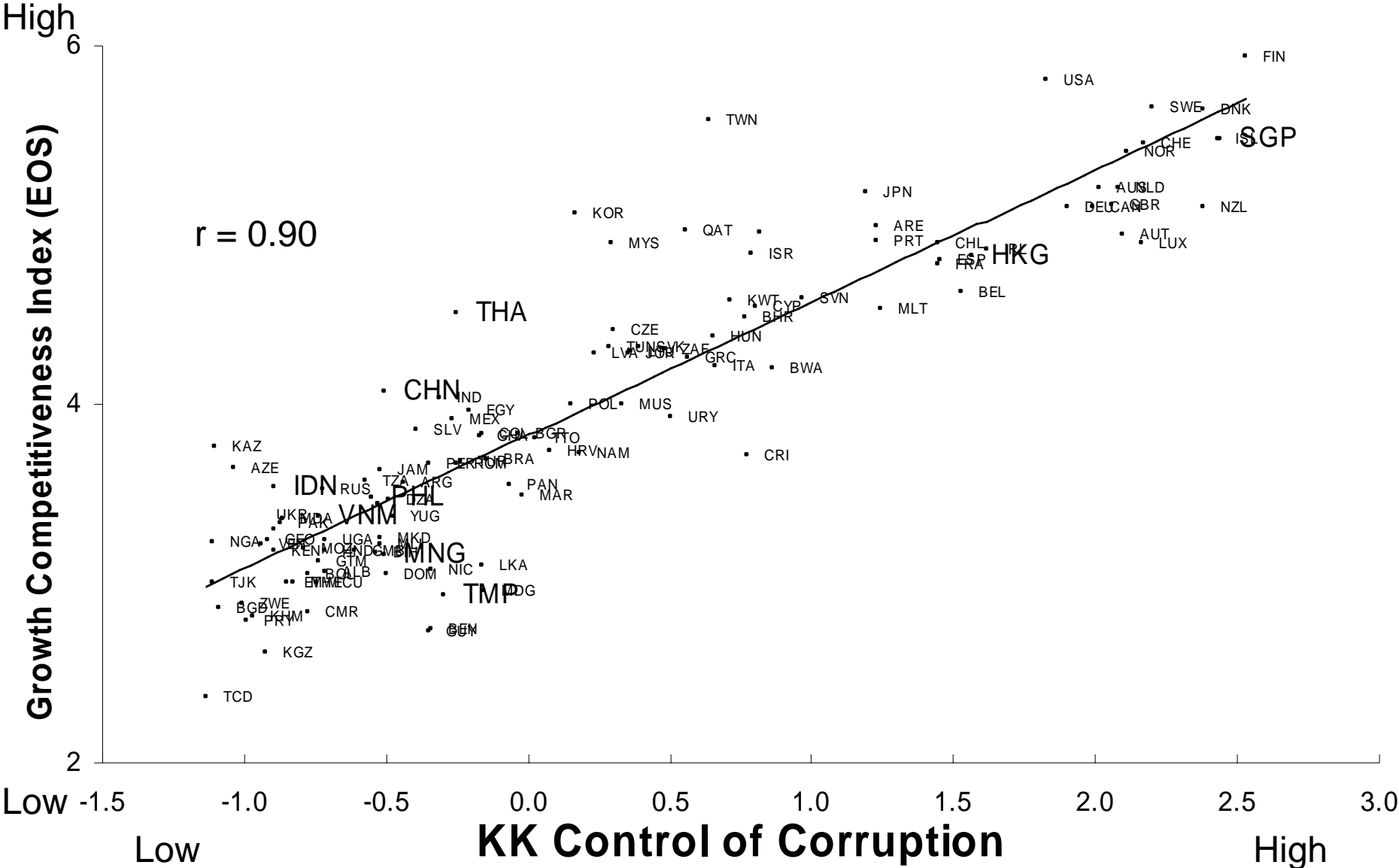
- 1. Large Development Dividend of Good Governance: a one-standard-deviation improvement in governance raise incomes per capita in a country by about 300% in long-run**
- 2. But is such a decline in corruption unrealistically large?: NO -- One S.D. is the difference from: Angola → Brazil → Estonia or Botswana → US, Canada or Germany, or, the difference from Equatorial Guinea → Cuba or Uganda → Mauritius → Portugal → Finland or New Zealand**
- 3. The impact is from governance to incomes, and not viceversa -- *higher incomes alone will not do***

Development Dividend From Controlling Corruption



Data Source for calculations: KK 2004. Y-axis measures predicted GDP per capita on the basis of Instrumental Variable (IV) results for each of the 3 categories. Estimations based on various authors' studies, including Kaufmann and Kraay.

Good Governance associated Country's Competitiveness

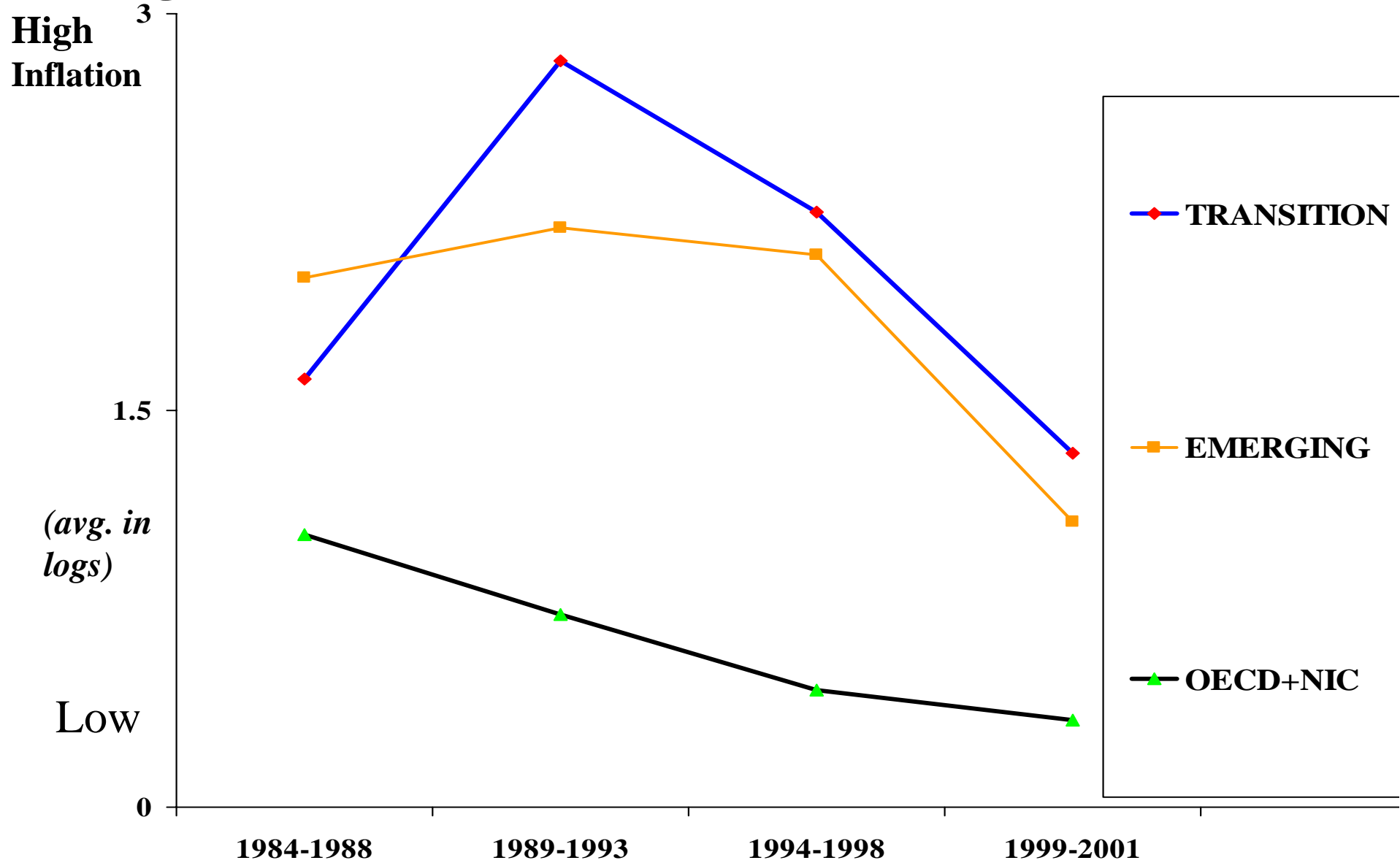


Sources: GCI drawn from EOS firm survey, WEF 2005 – 117 countries; Control of Corruption from Kaufmann, Kraay and Mastruzzi, 'Governance Matters IV: Governance Indicators for 1996-2004'.

Measurable Worldwide Trends in Governance

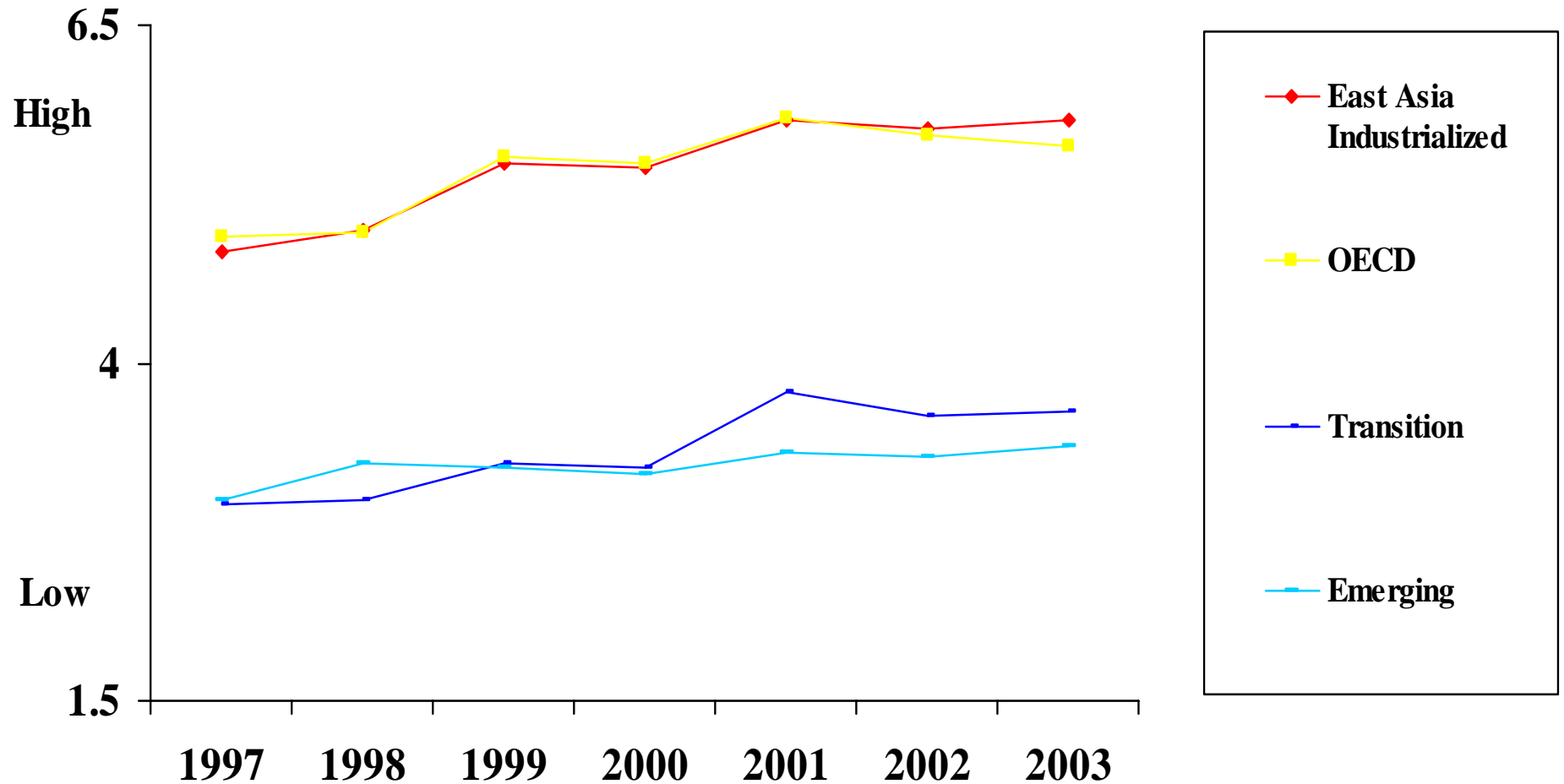
- **Through new method, we showed that it is possible to identify significant changes over time**
- **It is found that changes can take place in the short-term: in 6-to-8 years, some deteriorations as well as some significant improvements as well**
- **Yet the world on average has not improved**
- **Good News: Some countries are improving (while others deteriorate) in governance**

Significant Decline in Inflation Rates Worldwide



Source: 'Rethinking Governance', based on calculations from WDI. Y-axis measures the log value of the average inflation for each region across each period

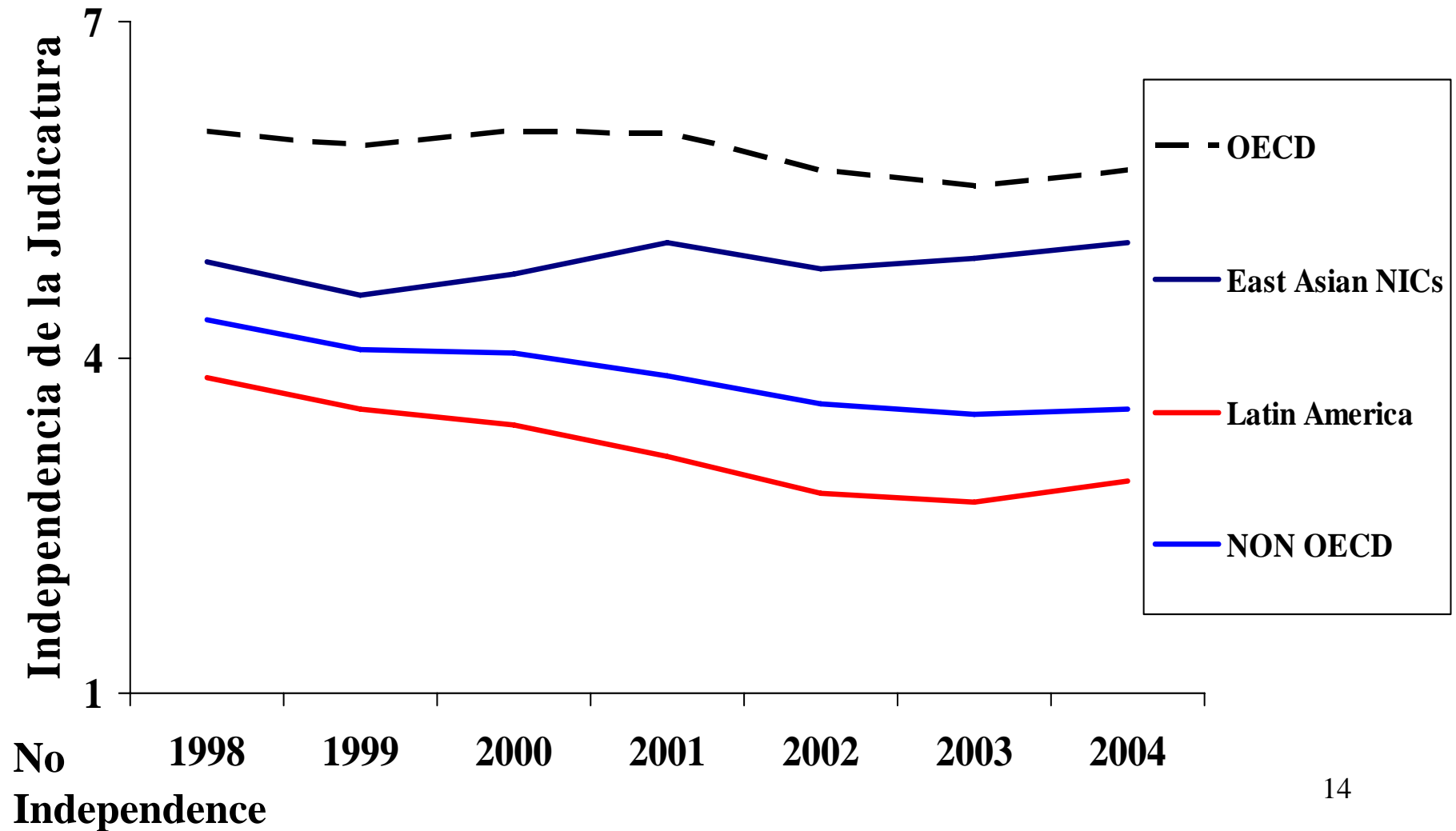
Quality of Infrastructure



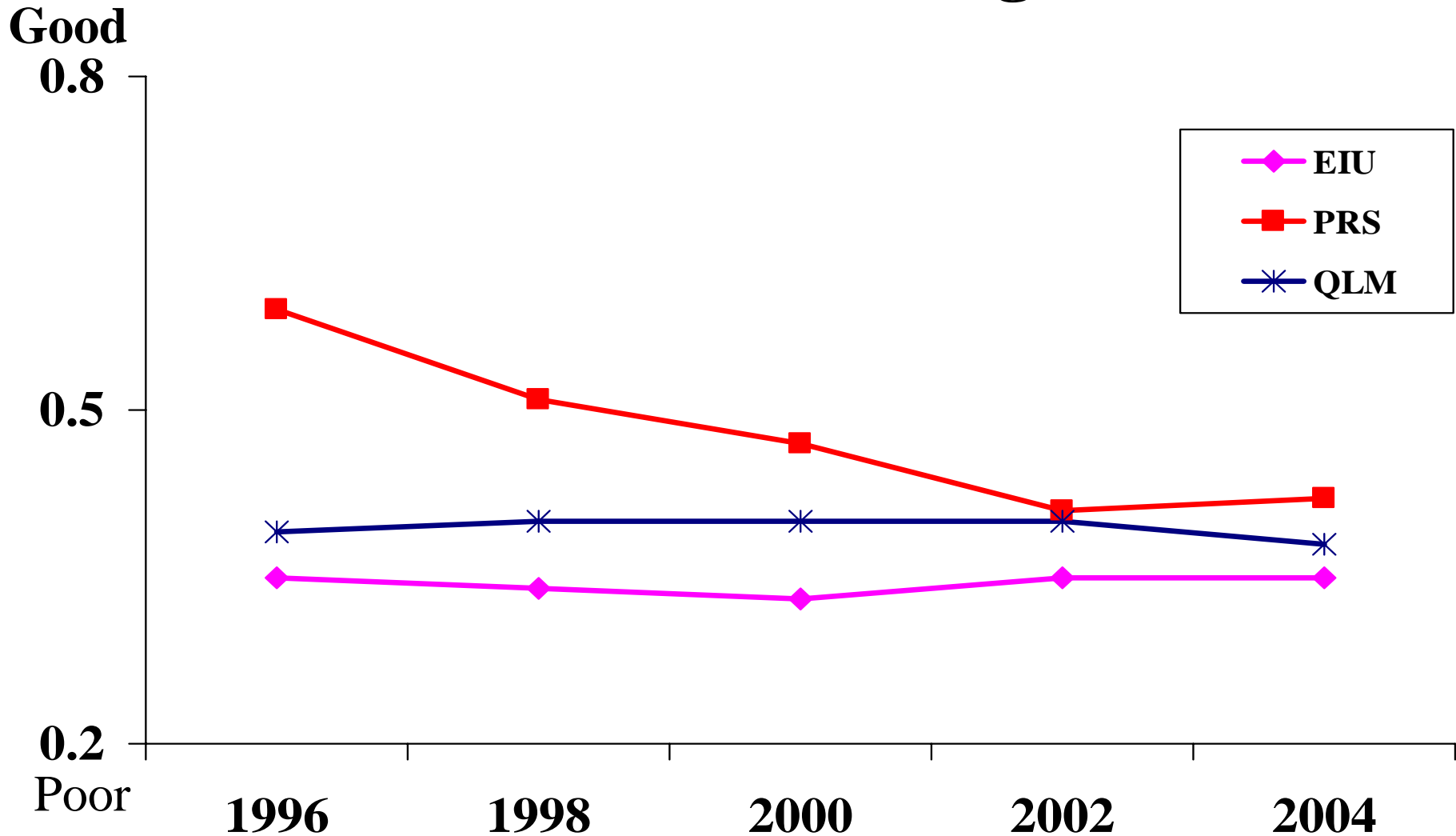
Source: EOS 1997-2003 (Quasi-balanced panel). Question 6.01: General infrastructure in your country is among the best in the world?

Judiciary Independence (*EOS survey results 1998-2004*)

High
Independence



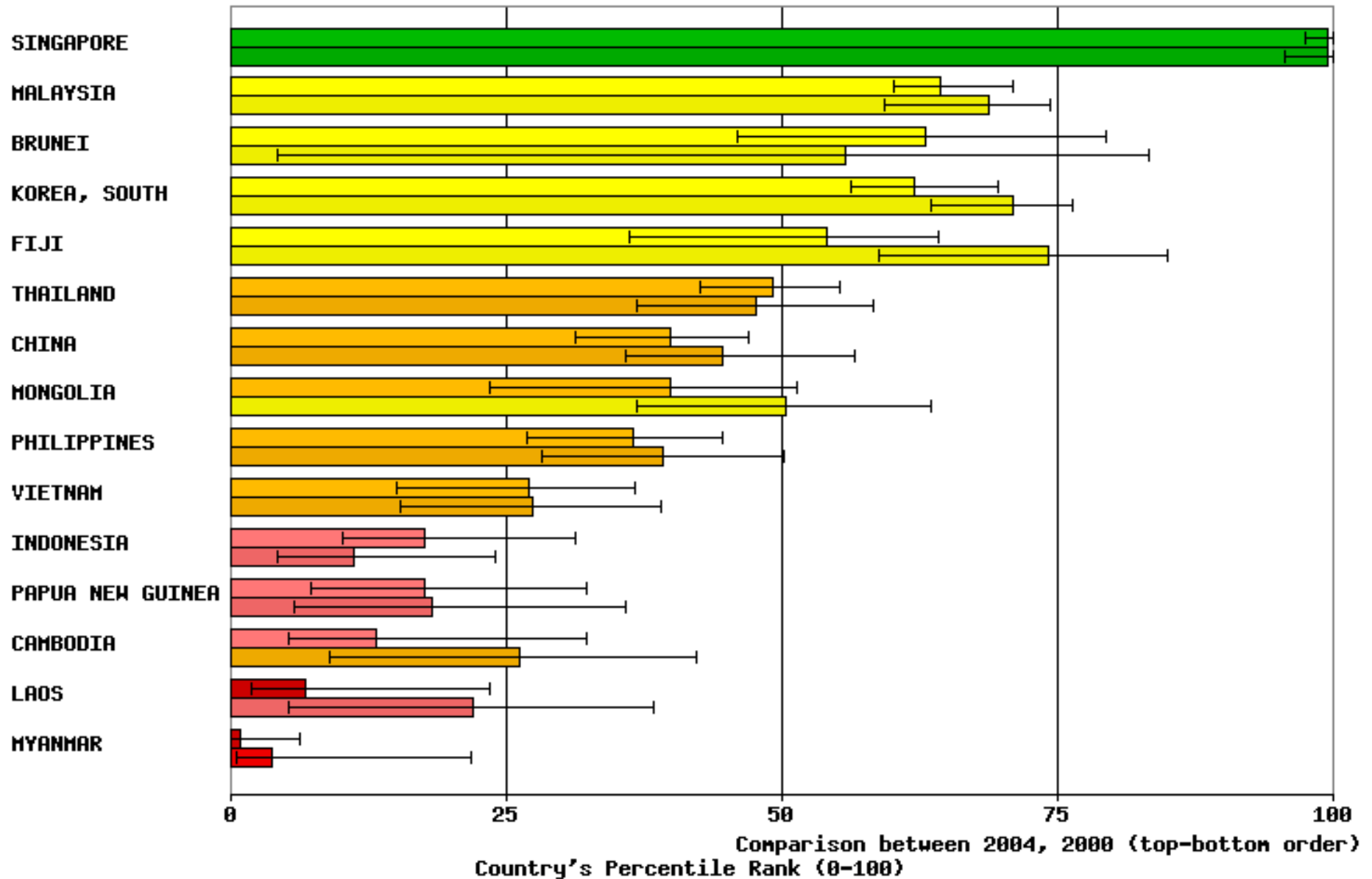
No Significant Trend in Control of Corruption Worldwide Averages



PRS country coverage in 1996: 129, all other periods 140; QLM and EIU country coverage: 115 for all periods. 15

Control of Corruption: East Asia 2004 vs. 2000

Control of Corruption (East Asia region, 2004)



The ‘Mezzo’ Level of Governance Measurement

- **Based on cross-country surveys, mainly of enterprises –**
(such as the EOS of WEF, BEEPS/WBES of WB, etc.)
- **Thousands of firms interviewed on a range of issues;**
focus on governance, specialized questions
- **More detailed unbundling of governance and**
corruption phenomena than aggregate indicators
- **Relatively broad country coverage, but less than**
aggregate governance indicators
- **Measuring what is taking place De Facto matters: it**
uncovers stark realities masked in De Jure indicators
- **Addresses empirically: *‘It takes two to “tango”’***

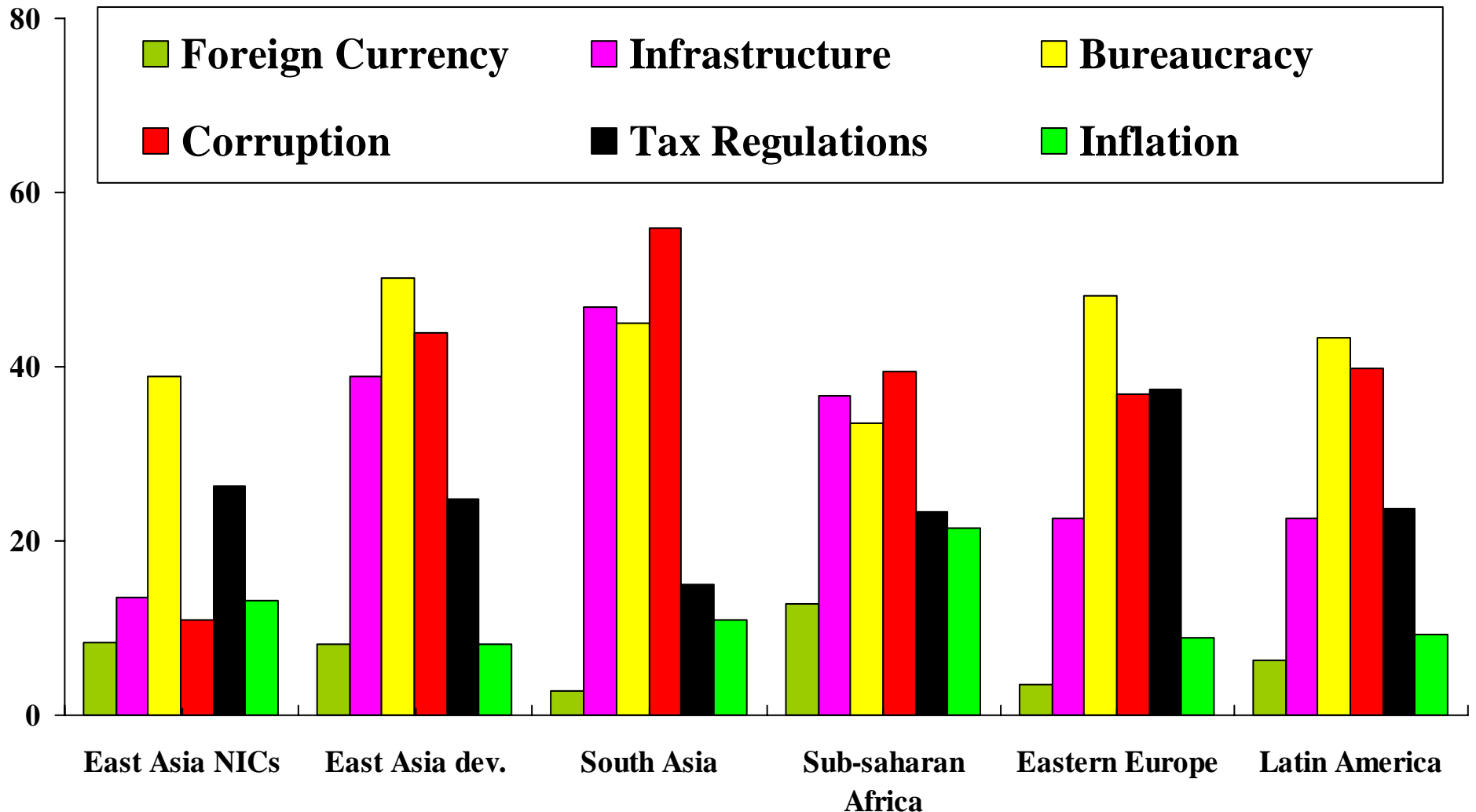
On Specifics – the perspective of the firm

- **Corruption is highly detrimental for the growth and competitiveness of a dynamic private sector**
- **‘It takes 2 to tango’: firms bribe, various patterns**
- **Unbundling Corruption: different manifestations**
- **The behavior of some Powerful Firms and MNCs**

Top Constraints to Business vary across regions

(responses from the Firm in EOS 2005)

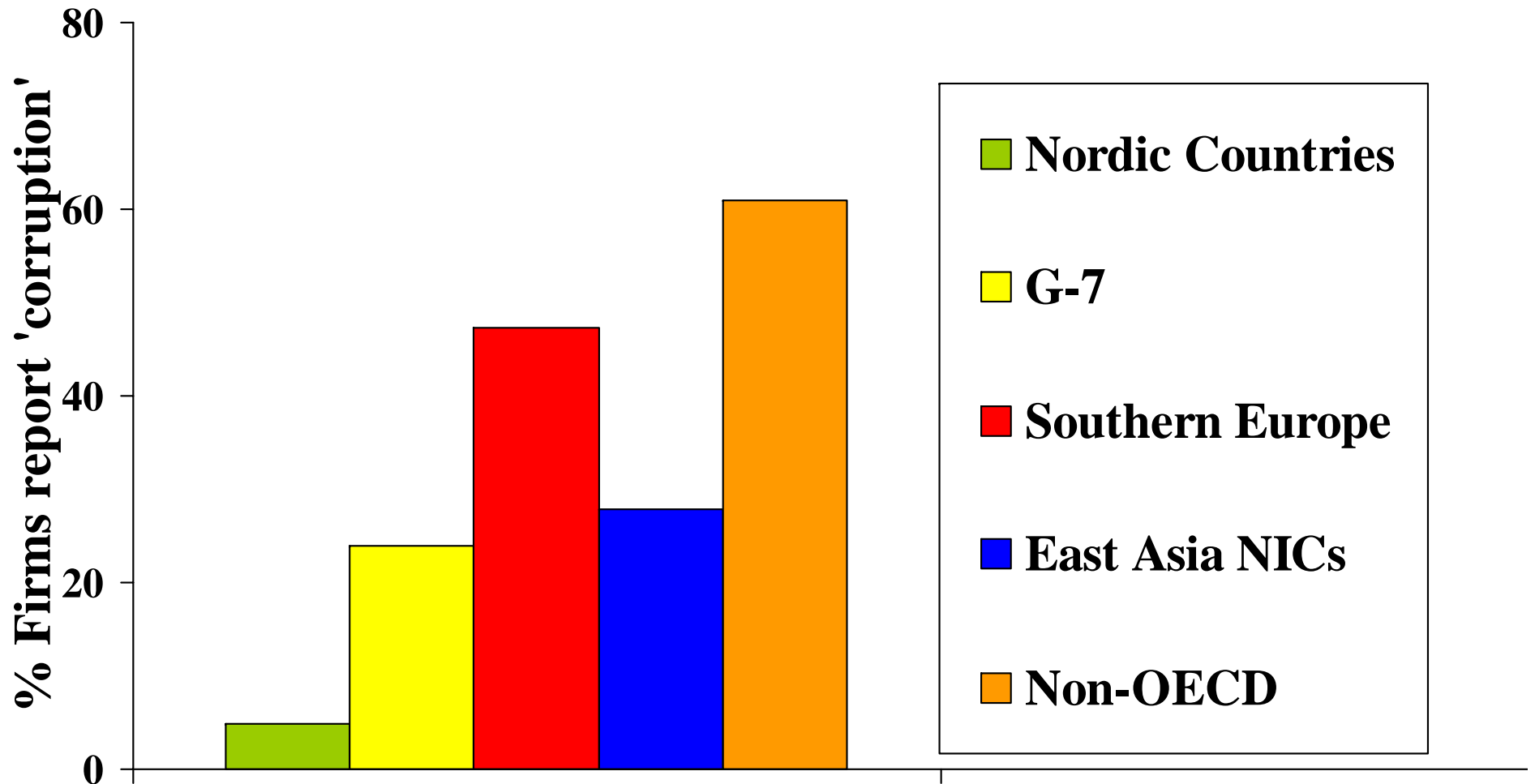
% firms reporting constraint among top 3:



Source: EOS 2005. The question posed to the firm was: Select among the above 14 constraints the five most problematic factors for doing business in your country. Note that the overall EOS sample covers 117 countries, and in some regions –particularly in the Middle East, Africa and the FSU, many countries are not surveyed. Thus, regional averages need to be interpreted with caution, since typically countries not surveyed tend to rate lower in governance than those surveyed.

Corporate Corruption, 2004

% Firms report existence of bribery (avg across types)

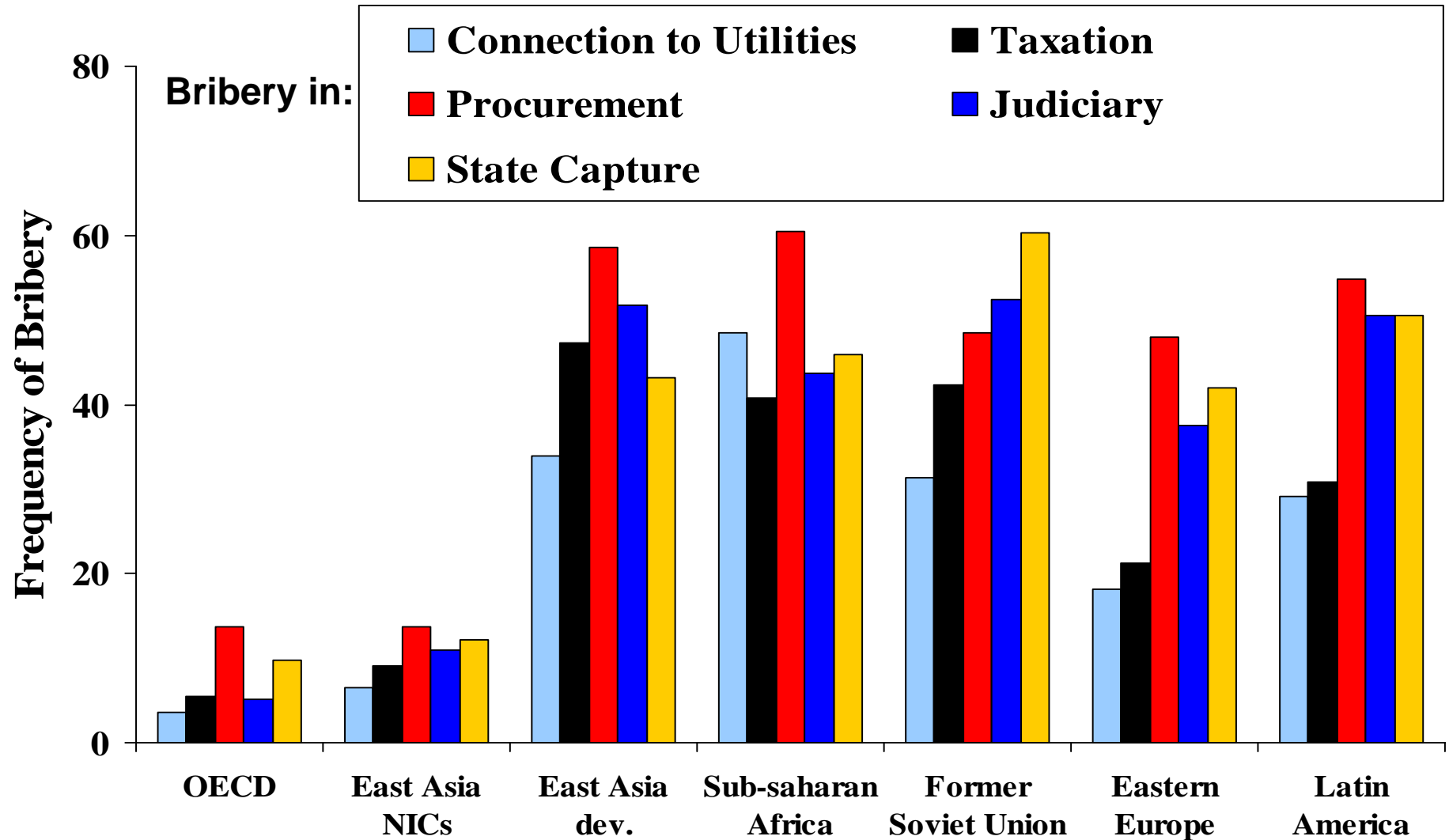


Corporate Bribery

Source: Author's calculations based on EOS 2004.

Unbundling Corruption: Different types of Bribery (responses by firms 2005)

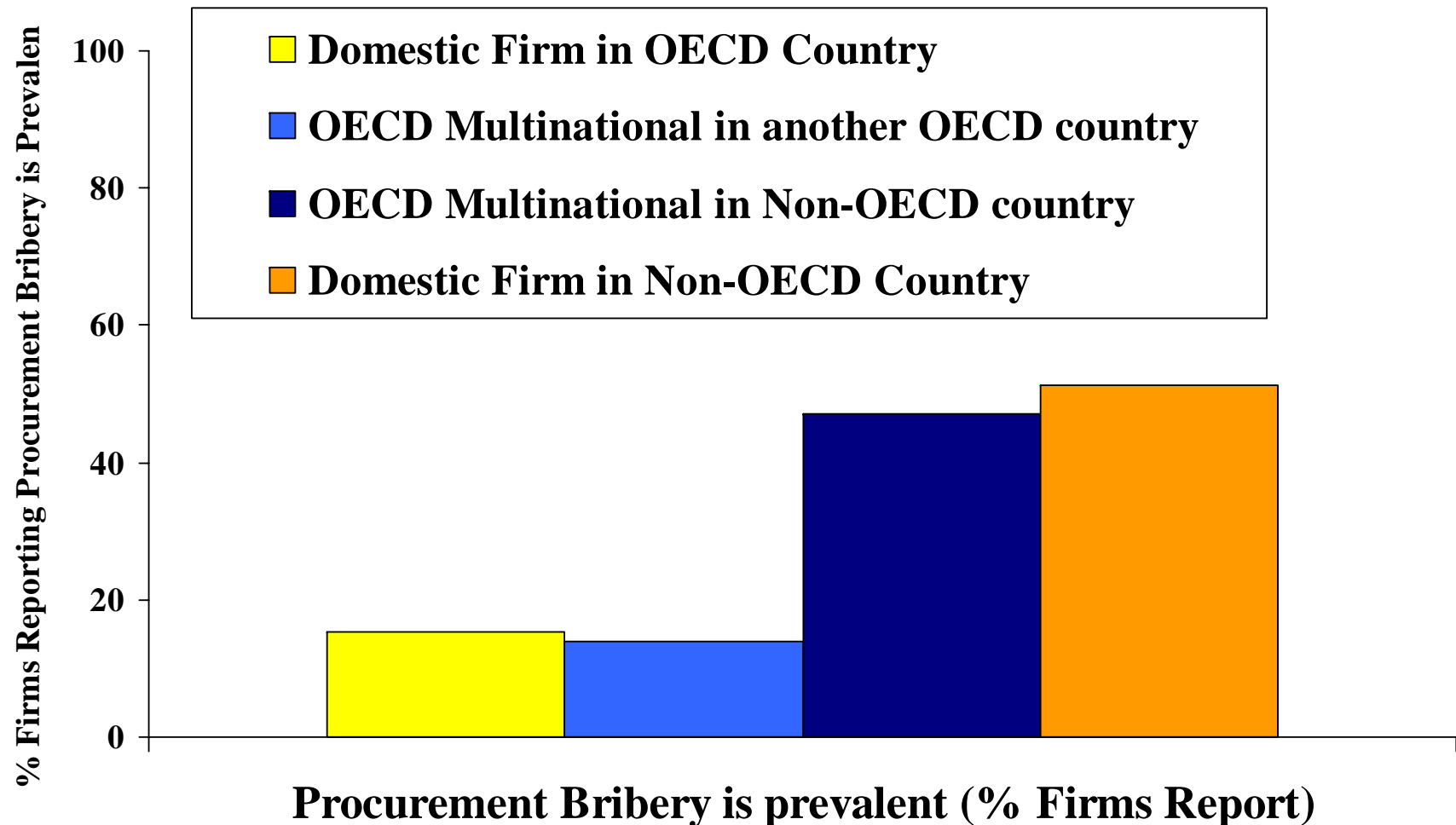
% Firm Report High Bribery (1-3)



Source: EOS firm survey, WEF2005 – 117 countries. Question: In your industry, how commonly firms make undocumented extra payments or bribes connected with permits / utilities / taxation / awarding of public contracts / judiciary? (common...never occurs).

Multinationals Bribe Abroad?

% Firms Reporting Frequent Procurement Bribery, EOS 2005



Source: EOS, preliminary. Question: In your industry, how commonly would you estimate that firms make undocumented extra payments or bribes connected with the following: permits, public utilities, tax payments, loan applications, awarding of public contracts, influencing of laws, policies, regulations and decrees to favor selected business interest, and judicial decisions. Any firms reporting answers 1 through 3 were considered to be reporting at least high frequency of bribery, while answers 4 through 7 were not.

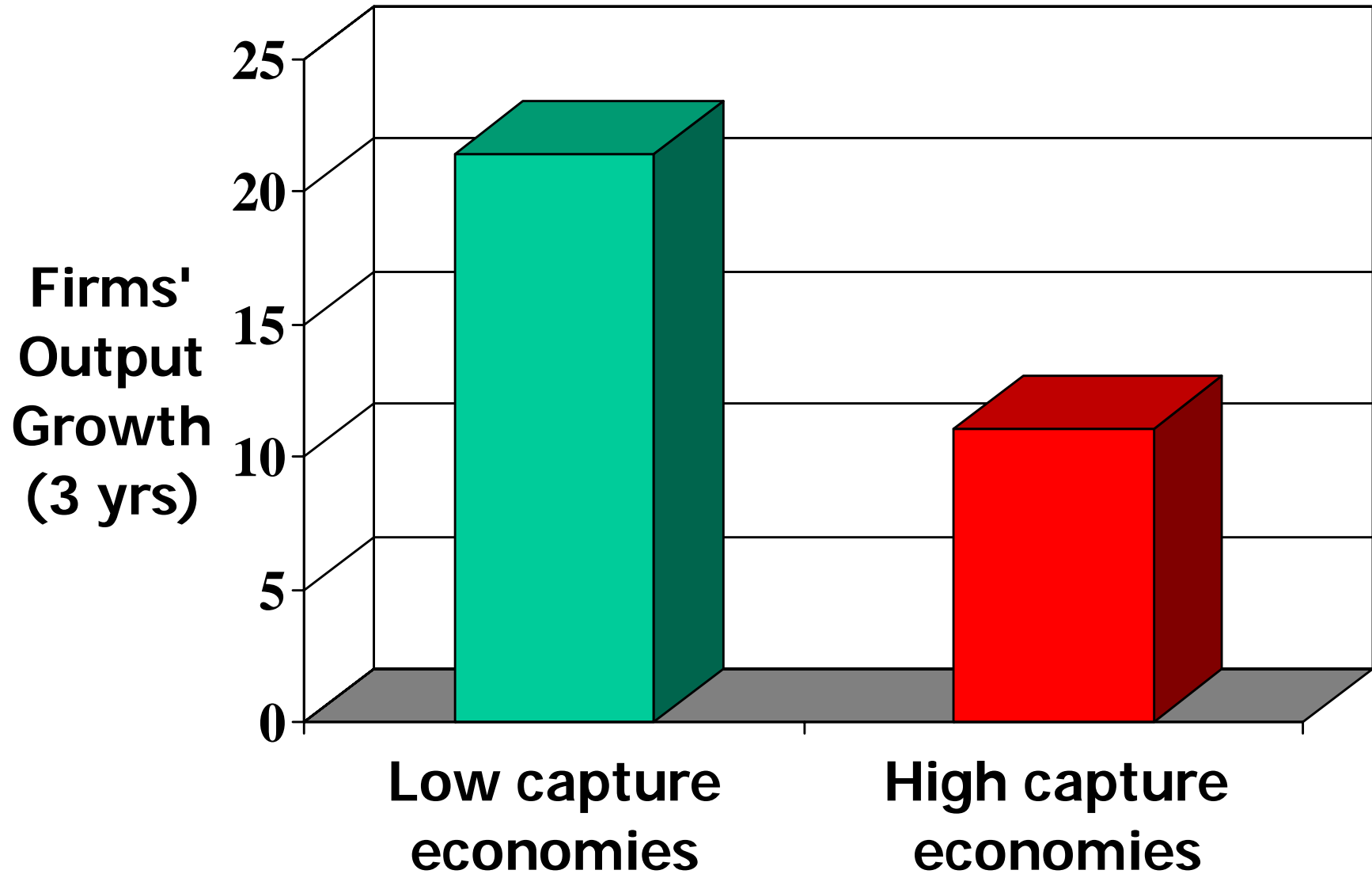
State Capture

Firms shape the legal, policy and regulatory environment through *illicit, non-transparent* provision of private gains to public officials

- **Examples include:**
 - *private purchase of legislative votes*
 - *private purchase of executive decrees*
 - *private purchase of court decisions*
 - *illicit political party financing*

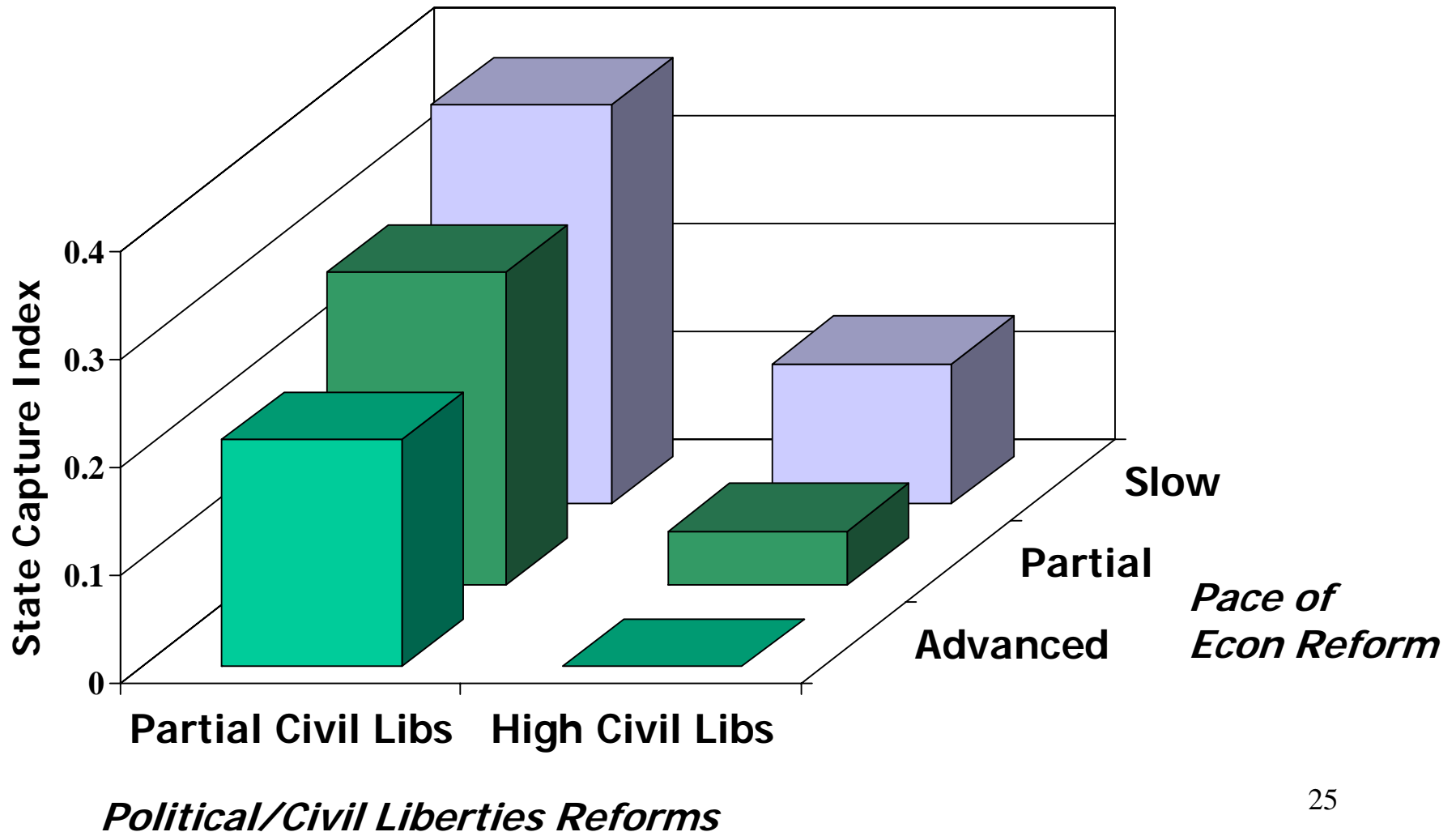
***Finding:* Countries subject to Capture of the State (or Undue Influence) by powerful firms exhibit much lower private sector growth than countries that avoid State Capture** ²³

Economic Cost of Capture for Growth

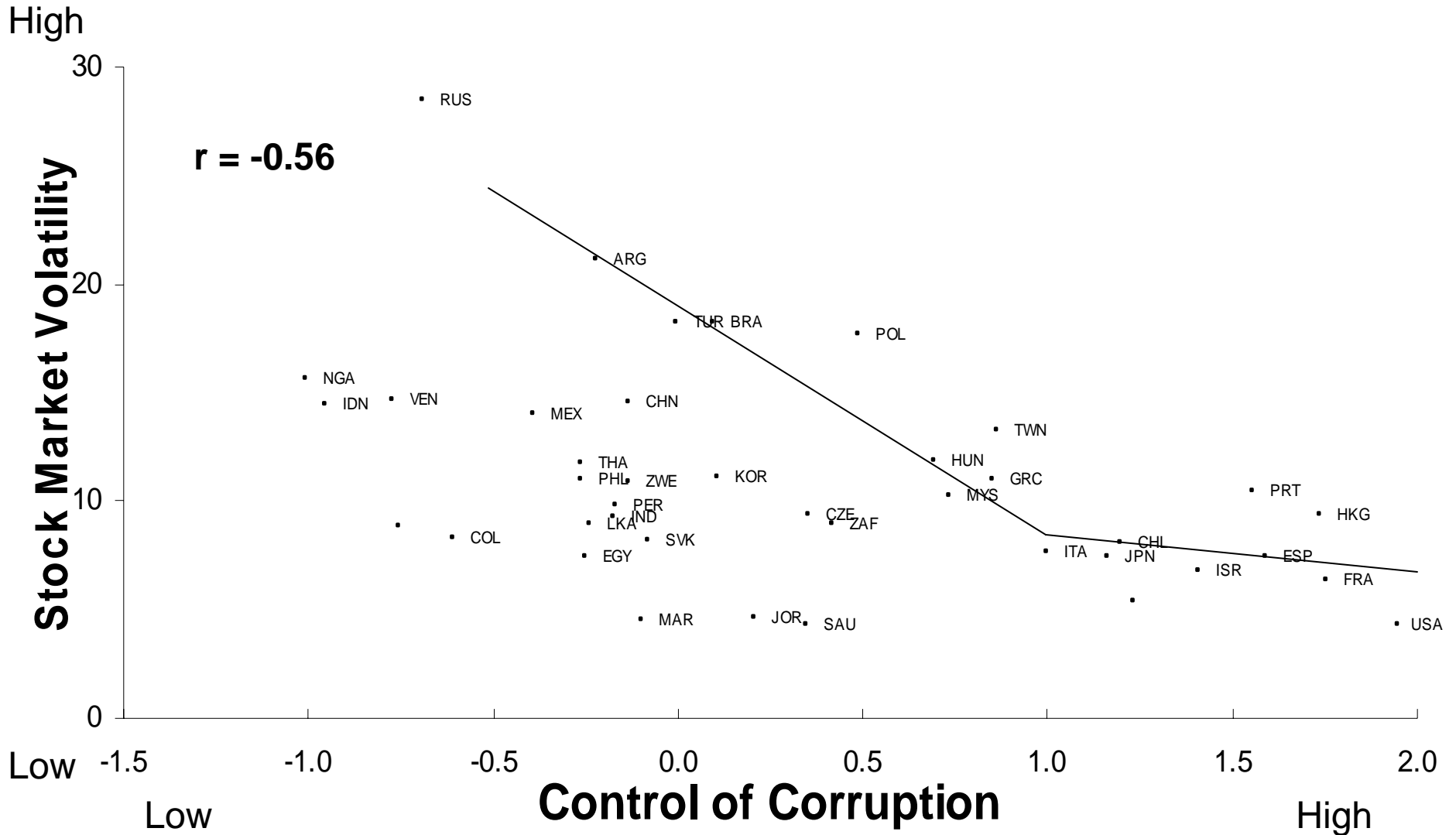


Based on survey of transition economies, 2000

Addressing Capture: Economic Reform, Political Competition & Voice/Civil Liberties Matter

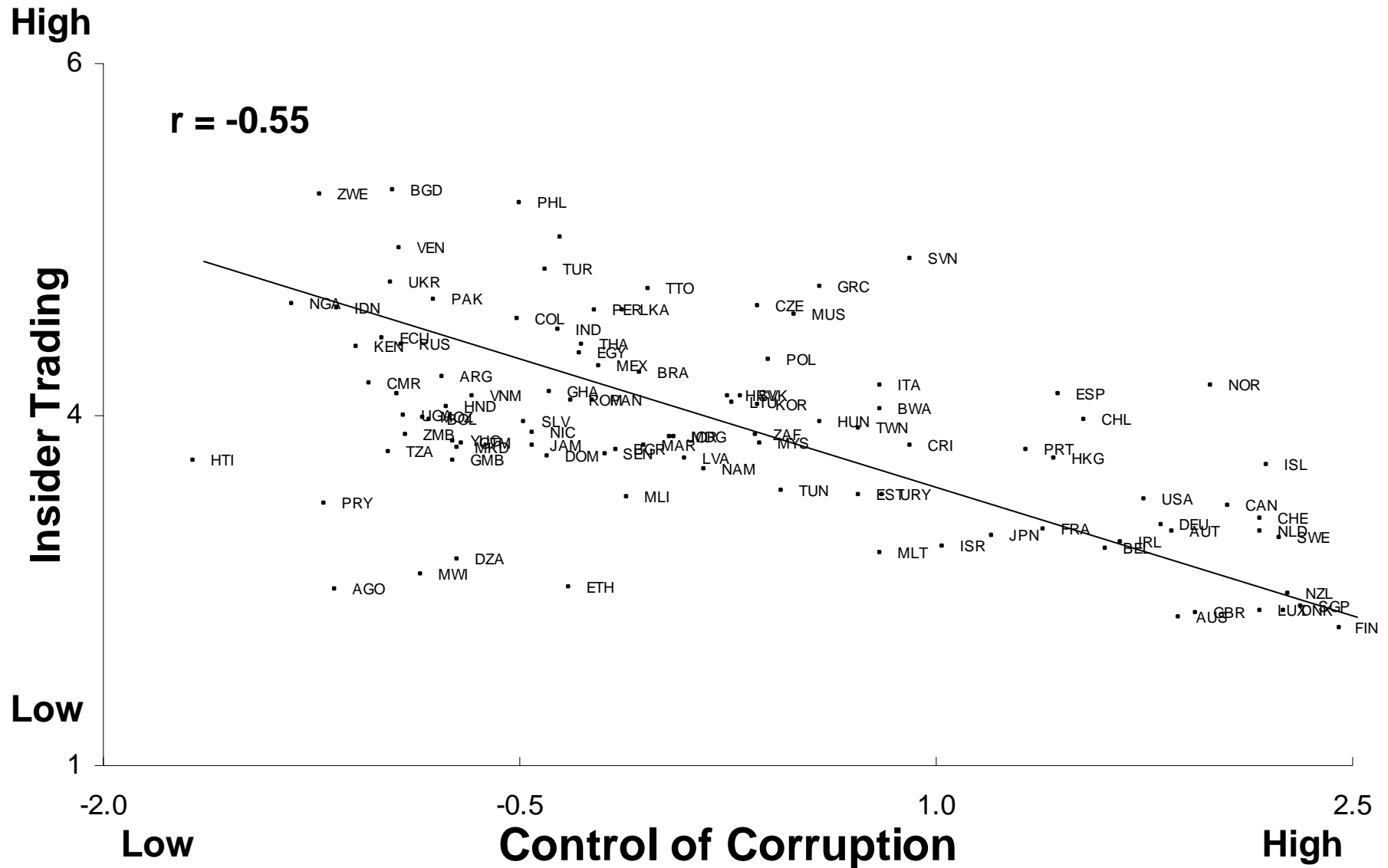


Stock Market Volatility vs. Control of Corruption



Sources: KK 1998 and Morgan Stanley Capital International Dataset and Emerging Markets Database (1998). Stock volatility defined as the standard deviation of monthly returns over December 1984 to December 1998, multiplied by 100.

Extent of Insider Trading vs. Control of Corruption



Source: EOS firm survey, WEF2003, and KK 2002. Question to firms on insider trading: "Insider trading is not common in domestic stock markets", 1=strongly disagree, 7=strongly agree."

Stock Market Volatility vs. Extent of Insider Trading



Sources: EOS firm survey, WEF (1998) and Morgan Stanley Capital International Dataset and Emerging Markets Database (1998). Question for insider trading: "Insider trading is not common in domestic stock markets", 1=strongly disagree, 7=strongly agree. Stock volatility defined as the standard deviation of monthly returns over December 1984 to December 1998, multiplied by 100. Based on Du and Wei (2004)

Insider Trading Significantly Affects Stock Market Volatility: An Example from Du and Wei (2004)

	US (1)	China (2)	Difference (3)=(2)-(1)	Increase in mkt Volatility
Insider Trading Output Volatility	2.62 1.7%	4.62 3.0%	2.00 1.3%	245 bp 103 bp

More volatility effect
from an \uparrow in insider
trading

> The volatility effect from an
 \uparrow in output volatility

Findings on Governance & Emerging Financial Markets

Du and Wei (2004): Insider trading → higher market volatility

Gelos and Wei (2005) find that in opaque countries:

↓ FDI, ↑ herding intensity, &, ↑ capital flight during a crisis

Wei (2000): short term flows 'intensity' in corrupt countries

Mehrez and Kaufmann (1999): financial crisis more likely
in less transparent countries (liberalizing)

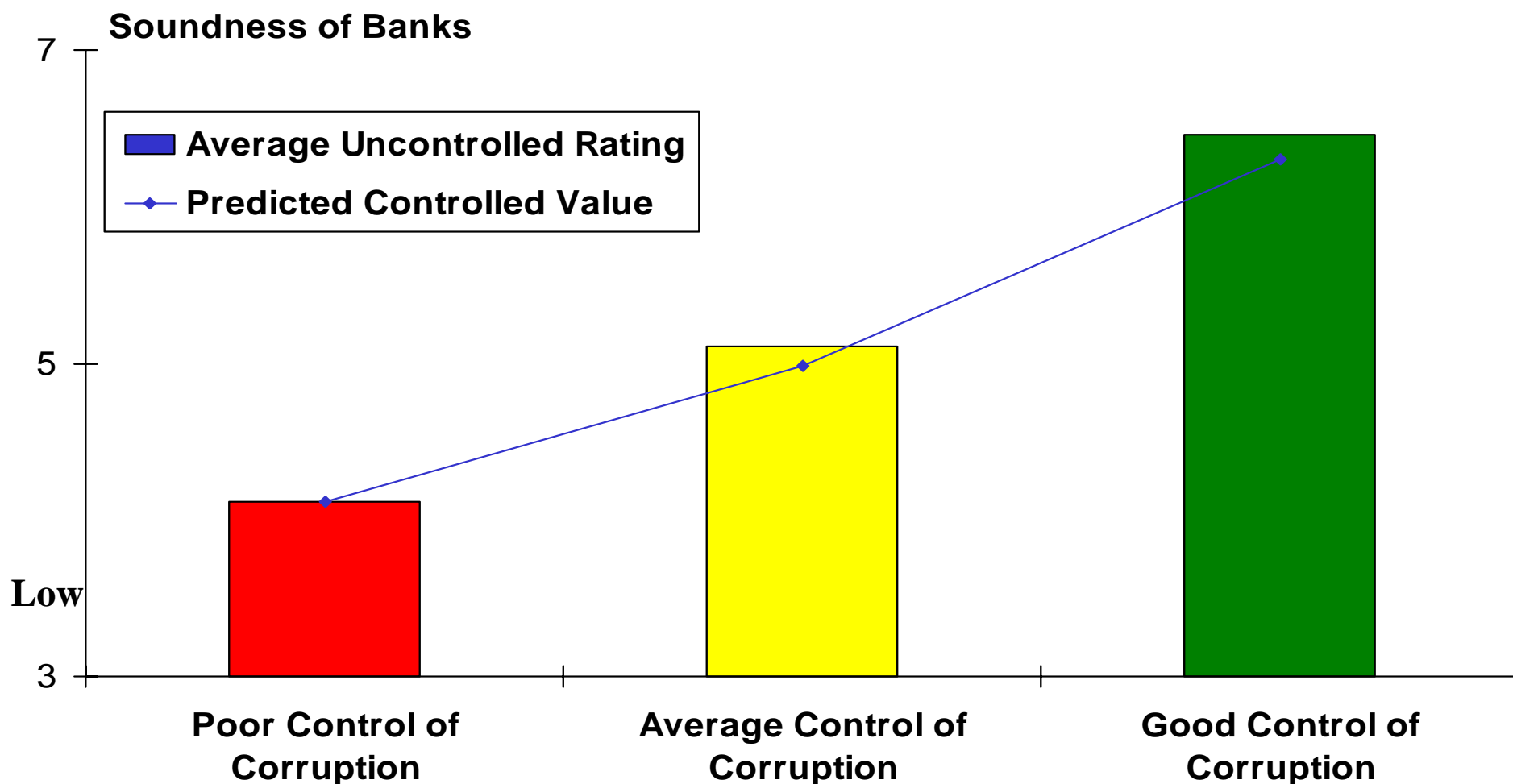
Acemoglu & Johnson (2004): property rights institutions
matter for growth, I, Financial Market Development

Kaufmann, Mehrez & Schmuckler (1999): Listening to
data from firms matters for predicting crises

Misgovernance → Higher Fragility of Financial Sector

Soundness of Banks vs. Control of Corruption

(View of the firm, GCS 2001)



Source: Global Competitiveness Survey, 2001, KK Governance Indicators

General Implications -- *departing from convention?*

Challenging popular tenets:

- **Governance measurement skepticism challenged**
- **Beyond corruption: also governance & transparency**
- **Not only administrative corruption -- *influence peddling and state capture by firms is also key***
- **Private sector not merely the ‘investment climate taker’; while public sector not alone as ‘investment climate maker’**
- **Governance Matters for country growth prospects, and for its financial markets**
- **Capital Market Development as Disciplining for Governance**

Towards Larger Role of Private Sector in Anti-Corruption

- 1. Address Undue Influence, Monopolies & State Capture**
- 2. ‘Data Power’, Voice & Freedom of the Press**
- 3. Transparency Reforms--*substitute to over-regulating***
- 4. Engage Business Associations & Multinationals**
- 5. Money in Politics: *Political & Campaign Finance Reform***
- 6. Focus on Incentives & Prevention: *raising the cost***
- 7. Corporate Social Responsibility reconsidered**
- 8. Capital Markets Development – *as ‘market-disciplining’***
- 9. Addressing Financial/Banking sector challenges**
- 10. ACCs, IFIs: To do more in engaging the Private Sector**

Specific Innovations, Initiatives, & ACCs

- **Data & Indicators on private sector corruption**
- **Public Delisting of Companies engaged in corruption**
- **Voluntary Disclosure Programs (VDPs)**
- **Outreach: Transparency/Integrity Standards for Firms**
- **Need to strengthen ACCs to fulfill its role:**
 - **Independence from Political Interference**
 - **Political Commitment to Independence, Resources**
 - **Strengthen Investigative Functions**
 - **Outreach, & Incentives-Based Prevention**
 - **Advocacy for key Reforms**
 - **Legitimacy in the eyes of the corporates & citizens**

10 Transparency Reform Components for a Scorecard

- 1. Public Disclosure of Assets & Incomes of Candidates, Public Officials, Politicians, Legislators - & *dependents***
- 2. Public Disclosure of Political Campaign contributions by individuals and firms, and of campaign expenditures**
- 3. Public Disclosure of Parliamentary Votes, *w/out exceptions***
- 4. Effective Implementation of Conflict of Interest Laws, separating business, politics, legislation, & government**
- 5. Publicly blacklisting firms bribing in public procurement**
- 6. Effective Implementation of Freedom of Information Law, with easy access to all to government information**
- 7. Fiscal/Financial transparency: central/local budgets; EITI**
- 8. E*procurement: transparency (web) and competition**
- 9. Transparent, Streamlined Regulatory Framework- ‘0-based’**
- 10. Corruption Diagnostic Surveys, Governance Monitoring-- *Data***

Data for Analysis and Informing Policy Advice, Not for Precise Rankings

Any data on Governance, Institutions, and Investment Climate is subject to a margin of error. It is not intended for precise country rankings, but to highlight relative strengths and weaknesses and draw analytical and policy lessons. The data and indicators do not necessarily reflect official views on rankings by the World Bank or its Board of Directors. Errors are responsibility of the authors.

Further materials & access to interactive data:

General: www.worldbank.org/wbi/governance

Data: www.worldbank.org/wbi/governance/govdata/

Governance Matters IV Report and Materials:

www.worldbank.org/wbi/governance/pubs/govmatters4.html

Synthesis Article about ‘Myths’ on Governance in F&D:

<http://www.imf.org/pubs/ft/fandd/2005/09/basics.htm>