

Corruption as a barrier to entry

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Conventional wisdom says that corruption hurts the economy because it taxes investment and weakens public services. This column presents evidence from interviews with CEOs in Brazil. It argues that corruption acts as a barrier to entry, with potential entrants put off by the uncertainty over what bribes to pay and when to pay them.

Corruption is often viewed as having a negative effect on economic performance. Mauro (1995) considers it as a tax on investment while Goulder, Parry and Burtraw (1997) suggest bribes may reduce public service provision because they substitute for taxation.

While some argue that corruption can “grease the wheels of growth” by addressing inefficiencies created by government intervention (Méon and Sekkat 2005), the econometric evidence supporting a negative effect is overwhelming (see Bardham, 1997, and Pande, 2008, for authoritative surveys). Despite this body of evidence, the exact mechanisms through which the harmful effect of corruption operates on enterprise and national economic performance are still not fully understood. This column summarises recent research presenting a different mechanism and econometric evidence of its importance.

New explanations for how corruption works

A mechanism that has received little attention so far in the literature is that corruption can represent an important barrier for new firms, thereby harmfully enhancing the monopoly power and rents earned by incumbent firms.

Following the work on legal barriers to entrepreneurship, considerable research has gone into understanding and measuring both entry barriers and corruption. The approach we introduce in Campos et al. (2010) is to endogenise such barriers with respect to corruption. We argue that when there is little chance of avoiding the payment of a bribe and when bribes are collected regularly and frequently—namely in the case of a very effective system of corruption and/or bad institutions—incumbent firms tend to perform better. This happens because a profit-maximising bureaucrat would then prefer to give more oligopoly power to incumbent firms by allowing fewer new firms into the market. On the other hand, in a system where there is a good chance of avoiding paying bribes, a bureaucrat will prefer to share the risk across firms and will allow more firms into the market.

The notion that the level of entry barriers represented by corruption is endogenously determined is an important step forward in the general debate on whether corruption “greases” or “sands” the wheels of growth. This model shows how corruption can be both a “wheel greaser” for an incumbent firm and a “wheel sander” for a potential entrant. The implication is that the negative effect should be judged on the basis of the failure to create an optimal level of competition, which is consistent with most of the literature identifying a negative association between corruption and income but is an aspect that has received little attention so far.

Evidence on corruption barriers, entry, and growth

We test these ideas using a dataset that is unique in at least three ways:

First, the survey has questions about firm entry and not exclusively about firm growth.

Second, the survey was applied to domestic industrial firms, not to foreign investors or lawyers. The survey consisted of face-to-face interviews with a representative sample of CEOs of consumer electronics and textiles firms in Brazil. Other corruption surveys are often directed either to foreign investors (because they would be able to compare these barriers with those in their countries of origin) or to law firms in developing countries (because they possess detailed knowledge of such barriers). Although this is a valuable way of collecting information, it has some weaknesses (Razafindrakoto and Roubaud 2010). Foreign investors are not subject to the same set of constraints as domestic firms and lawyers know about *de jure* but not *de facto* barriers. The strategy here differs in that incumbent firms are asked what they consider to be the barriers that are most severe to potential entrants. This may be the only survey that asks “which factor is the most important constraint to a new firm that is considering starting production (entry) in our industrial sector?”

Third, the survey asks which are the main obstacles to entry and also provides an extensive characterisation of each. Thus it goes beyond assessing how important an obstacle corruption is to potential entrants, enquiring about which aspects of corruption are deemed more or less significant. For example, it contains information about the relative impact of the size of the average bribe against the uncertainty surrounding the need to pay. The dataset contains information on the magnitude and the frequency of various types of bribes (e.g., for a telephone connection and for customs clearance) and on bribe uncertainty i.e., about its “avoidability,” capturing the extent to which, if a public official acts in an irregular manner, the firm can contact another public official and receive the correct treatment, without having to make extra-official payments.

Table 1 presents a list of barriers to entry with firms reporting that corruption is the most important. It is more important than the regulatory framework and the quality of the judiciary, issues that have received much attention in the literature. Furthermore, the problems of corruption are deep-rooted. When asked for the most important barrier five and ten years previously, the majority of firms still identify corruption as having been the most important barrier.

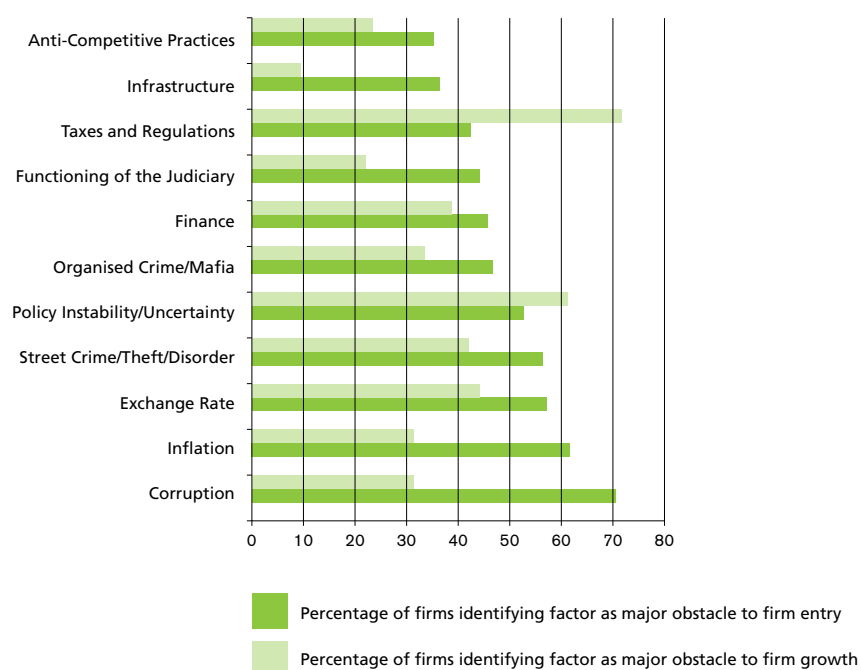
Table 1. Percentage of firms identifying issue as most important barrier to entry

	2005 (n=97)	2000 (n=95)	1995 (n=79)
Corruption	30.93	32.63	34.18
Finance	21.65	18.95	13.92
Taxes	14.30	11.58	10.12
Policy uncertainty	9.28	10.53	16.45
Lack of skilled labour	7.22	8.42	8.86
Non-competitive practices	5.15	6.32	5.06
Crime	3.09	2.11	1.27
Infrastructure	2.06	2.11	2.53
Regulations	2.06	1.05	1.27
Organised crime (mafia)	2.06	2.11	1.27
Exchange rate instability	1.03	2.11	2.53
Judiciary	1.02	1.05	1.27

Source: Authors' calculations.

It is worth comparing the weight incumbent firms attach to corruption as a barrier to entry with the weight they attach to it as a barrier to firm growth. About 70% of respondents report that corruption is a major obstacle to firm entry while only about 30% report that corruption is a major obstacle to firm growth. This suggests a stark distinction between how incumbent firms view the role of corruption with respect to growth and entry. Corruption seems crucial as a mechanism to deter entry of new competitors but of less significance with respect to the operation and growth of incumbent firms.

Figure 1. Percentage of firms identifying factor as major obstacle to firm entry or to firm growth



How corruption affects the performance of incumbent firms?

In order to investigate how corruption affects performance, we focus on job creation (the rate of change of employment) (Campos et al. 2010). Employment growth is a good measure of firm performance in this case because the sample is restricted to two industrial sectors that use relatively mature production technologies. Moreover, potential measurement error is reduced by focusing on growth of employment rather than value added or productivity. Finally, data coverage is better because firms were reluctant to fully disclose information on sales, capital, and research and development expenditures. We model job creation as a function of a set of firm characteristics and various potentially important aspects of corruption (namely the frequency, uncertainty, and magnitude of bribes).

Our results show that frequency and uncertainty (in terms of avoidability) of bribes are systematically related to performance, while the magnitude of the bribes is not. The frequencies of bribes for licenses, for taxes, and for the judiciary are positively related to performance, while the frequency of those bribes for phone and electricity, for public procurement and for customs, are not.

Moreover, regarding the uncertainty of corruption, the econometric analysis shows that how often a bribe can be avoided and uncertainty about the value of the bribe are systematically related to firm performance. While performance improves with certainty about the value of the bribe, it deteriorates with “bribe avoidability.”

Finally, firm performance is not associated with various measures of bribe size such as the amount of time senior management has to spend with public officials to clarify regulations and the share of the value of a public contract required as a bribe in order to secure such contract.

Implications

We argue that an important, but thus far largely neglected, harmful effect of corruption is its role as a barrier to the creation of new firms. Corruption matters because it reduces the threat of potential competition. Our evidence shows that incumbent firms, when asked about the relative importance of various barriers to entry, identify corruption as the most important one. Different features of bribing activity are found to be strongly associated with firm performance. In particular, frequency and uncertainty of corruption are related to performance, while the size of the bribe does not tend to be.

The interpretation favoured here is that corruption is an important barrier to entry because it imposes substantial learning costs on entrepreneurs, new firms, and/or potential entrants.

Consequently, the importance of corruption to firm creation and destruction comes less from how much potential entrants have to pay in bribes, and more because potential entrants do not know how often they will have to pay bribes, how much they will cost, and whether, how and when bribes can be successfully avoided.

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