

How Government Corruption Impacts the Real Economy

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Abstract

This paper investigates the impact of corruption on economic performance, focusing on the “grease the wheels” and “sand the wheels” hypotheses. The “grease the wheels” hypothesis suggests that corruption might enhance efficiency by bypassing red tape, while the “sand the wheels” hypothesis argues that corruption increases transaction costs and disrupts economic growth. Analysing data from studies conducted on both advanced and developing economies, we find corruption “sands the wheels” of advanced economies while it “greases the wheels” of developing economies. However, by analysing growth modes such as the Solow-Swan model as well as the Endogenous growth model to understand the effect of corruption on a larger scale, it was found that corruption on a higher level in a country’s government is more likely to hinder economic growth. The findings underscore the need for context-specific anti-corruption strategies.

Keywords: corruption, economic growth, advanced and developing economics, “grease the wheels” and “sand the wheels” hypotheses

1. INTRODUCTION

The aim of this paper is to explore the ways in which corruption can affect the real side of a country’s economy. This exploration will be conducted by comparing and contrasting the advantages and disadvantages of corruption in both developing and developed nations. Historical examples, such as the case of Japanese politicians accepting bribes to purchase U.S. military aircrafts in the 1970s (Mauro, Medas, and Fournier, 2019), highlight how such illegal activities can be extremely detrimental to a country’s economic growth. However, some scholars argue that while corruption is undoubtedly a criminal offence, its impacts are not always harmful and can sometimes even be beneficial to a country. For instance, certain instances of corruption

may facilitate better production and trade, leading to short-term economic gains (Houston, 2007).

Corruption is fundamentally an illegal activity, making it challenging to quantify its true cost. According to estimates from the United Nations and World Economic Forum, corruption could amount to approximately 5% of the world’s Gross Domestic Product (GDP). Based on the 2022 global GDP of \$101 trillion, this suggests that around \$5 trillion is lost to corruption each year. While this figure provides a numerical estimation of the financial impact, it only scratches the surface of the broader implications of corruption on a country’s well-being. To fully understand the effects of corruption, we must also consider its various non-monetary consequences.

A significant non-monetary consequence is the human cost. When public funds are misappropriated due to corruption, essential services and infrastructure projects suffer, leading to a reduction in the construction of vital roads, schools, and hospitals. This is particularly detrimental for underdeveloped or developing nations, where such investments are crucial for improving living standards and fostering economic growth. Additionally, corruption often manifests in bribery, particularly affecting access to basic necessities such as healthcare, clean water, and electricity (Global Infrastructure Anti-Corruption Centre, n.d). This creates barriers for marginalised communities, exacerbating existing inequalities and perpetuating cycles of poverty. Overall, the consequences of corruption extend far beyond financial loss, impacting the social fabric, governance, and quality of life in affected regions.

Moreover, some scholars have argued for the potential benefits of corruption. Nye (1967) discusses the possible advantages that corruption

might offer, suggesting that while corruption is illegal and ethically questionable, it can potentially stimulate economic development. Specifically, by generating more wealth and resources through corrupt means, it may contribute to economic growth. This perspective posits that a moderate level of corruption can be beneficial for a government and its country. However, this view inevitably sparks a debate on determining the “correct” amount of corruption and whether the benefits outweigh the associated costs. Balancing the potential economic advantages against the moral and legal drawbacks remains a complex and contentious issue.

This paper aims to weigh these arguments by using real case studies to analyse how corruption affects the real side of an economy in different contexts, specifically in developing and developed economies. By examining a variety of scenarios, the paper will attempt to shed light on the complex nature of corruption’s impact on economic activities, considering both the immediate benefits and the long-term consequences. Ultimately, this analysis seeks to provide a nuanced understanding of how corruption can influence economic outcomes, helping to inform policy decisions and strategies for mitigating its negative effects while recognizing potential short-term economic benefits in specific situations.

The remainder of the paper is structured as follows. Section 2 discusses the “grease the wheels” and “sand the wheels” hypotheses. Section 3 provides an analysis into how corruption can affect advanced economies. Section 4 analyses the impact of corruption on developing economies. Section 5 concludes the paper.

2. DOES CORRUPTION “GREASE THE WHEELS” OR “SAND THE WHEELS” OF GROWTH?

Corruption is inherently illegal, making the collection of accurate data on its prevalence and impact challenging, with varying results across studies. Despite these difficulties, various theories have been developed to explore the effects of corruption on economic growth, notably the “grease the wheels” and “sand the wheels” hypotheses (Gründler and Potrafke, 2019). These theories were originally put forward by Leff (1964), Leys (1965), and Huntington (1968), as discussed in Méon and Sekkat (2005).

The “grease the wheels” hypothesis posits that corruption can compensate for inefficiencies in bureaucracy. This theory suggests that corruption, such as bribery of government workers, can expedite processes by reducing bureaucratic delays. For instance, Lui (1985) demonstrated that bribery could shorten wait times in bureaucratic procedures. The hypothesis argues that by providing incentives for quicker processing, corruption can stimulate economic growth. Historical examples, such as those from the 1870s and 1880s, further support this view, showing that corruption led to faster economic development (Huntington, 1968). Additionally, literature indicates that reducing administrative obstacles through corruption can enhance economic growth, particularly when strict governmental regulations drive private sector agents to seek corrupt means to bypass these “political inadequacies” (Qureshi, Qureshi, Vo, and Junejo, 2020). This perspective aligns closely with the “grease the wheels” hypothesis.

Conversely, the “sand the wheels” hypothesis presents a different view. This theory argues that corruption, intended to improve the efficiency of administrative procedures, can instead exacerbate inefficiencies. According to this hypothesis, civil servants may intentionally slow down or delay processes to create opportunities for extracting bribes from individuals or private sector agents involved (Méon and Sekkat, 2005). Furthermore, even if bribes are offered, the presence of multiple civil servants at different stages of a project complicates the ability to expedite procedures. Industrial organisation models have shown that involving more agents in a project, when attempting to use corruption to speed up or enhance efficiency, increases the overall cost of corruption (Shleifer and Vishny, 1993). This suggests that while the “grease the wheels” hypothesis might hold some truth, the increased risk and cost associated with bribery in more complex bureaucratic contexts can outweigh the benefits, leading to greater inefficiencies and potential for exposure.

The implications of the “grease the wheels” and “sand the wheels” hypotheses are crucial for policymakers and practitioners aiming to address corruption. Understanding these theories helps in designing effective anti-corruption strategies and administrative reforms. For example, if the “grease the wheels” hypothesis holds, policymakers might consider targeted reforms that streamline

bureaucratic processes while acknowledging that some level of corruption could potentially facilitate economic growth. However, this approach must be carefully managed to avoid institutionalising corrupt practices. On the other hand, if the “sand the wheels” hypothesis is more accurate, efforts should focus on reducing bureaucratic inefficiencies and enhancing transparency to prevent civil servants from exploiting the system for personal gain. Effective strategies might include implementing digital systems to reduce human intervention in administrative processes, increasing oversight, and establishing robust whistleblower protections. By critically assessing which hypothesis more accurately reflects the local context, governments can tailor their interventions to mitigate the negative impacts of corruption while fostering a more transparent and efficient administrative environment. This balanced approach ensures that anti-corruption measures are both practical and conducive to sustainable economic development.

3. HOW DOES CORRUPTION AFFECT COUNTRIES WITH ADVANCED ECONOMIES?

To understand the effect that corruption can have we'll be examining its effect on advanced economies with examples of different types of corruption. By definition, corruption is illegal behaviour by powerful people. There are many types of corruption including bribery, nepotism, embezzlement, and extortion and so by using case studies of advanced economies first we can see how political corruption, in different forms, can affect these countries. An economy is defined as advanced by considering certain criteria. To maintain consistency this paper will be using some set criteria to define this. The International Monetary Fund (IMF) uses a country's GDP to classify them as advanced or not. To find a country's GDP we can use the following; consumer spending, government spending, net exports, and total investment.

Studies done in Europe between 1996 to 2017 give us insight into this topic. There was a study on the relationship between certain types of corruption and economic growth which showed that results were non-linear (Pluskota, 2020). These studies were done on economically developed countries in Europe and used basic statistical measures to analyse the impact of corruption of variables such as

economic growth. The paper states that the current pre-existing arguments as to why corruption has a negative impact on economic growth are the additional costs that are created. For example, corruption in the form of bribes is an extra cost or burden that will possibly reduce the profitability of a company. In addition to this, the risk factor is also increased due to the fact that the possibility of being caught for these acts would lead to legal consequences such as fines or imprisonment, again affecting the company or business which would hinder economic growth as it is contributing less to the economy. The studies conducted in the paper by Pluskota (2020) shows us that there is a non-linear relationship between corruption and economic growth. A study done by Anokhin and Schulze (2008) stated that the graph of the relationship between corruption has a relationship in the form of a parabola.

This being said, there have been other studies conducted in economically developed countries resulting in a significant relationship shown between corruption and economic growth. Acaravci, Artan, Hayaloglu, and Erdogan (2023) conducted a study to examine the relationship between corruption and economics, finding that an increase in economic growth was shown when there was a reduction in corruption. In addition to this, a study done on European Union countries from 2005-2014 showed a similar relationship by examining the levels of corruption in these countries and finding its relationship towards economic development. It states that in countries such as Denmark, Finland, Sweden, Netherlands and Austria have the lowest levels of corruption and that the countries with higher levels of corruption and shadow economies such as Bulgaria, Romania, Hungary, Estonia, Greece and Italy were countries with lower income, concluding that this relationship was negative and that increasing corruption in these countries with negatively affect economic growth (Borlea, Achim, and Miron, 2017).

4. HOW DOES CORRUPTION AFFECT COUNTRIES WITH DEVELOPING ECONOMIES?

In addition to observing the effect of corruption on developed countries, it is also important to do the same with countries that have developing

economies. There has been research done by MIT economics showing the correlation between a country's development and its corruption levels, stating that corruption is extremely prevalent in developing countries and might be more than in countries that are developed (Olken and Pande, 2012). This being said, different countries have different levels of corruption and may or may not "grease" or "sand the wheels" of economic growth to different degrees.

An analysis was done of emerging or developing economies in 17 countries in Asia by Nguyen and Luong (2020) based on data between 2000 to 2015, these empirical findings showed that there was a positive relationship between corruption and economic growth. The reason corruption will help create economic growth is due to the reduction of bureaucratic red tape (Wedeman, 1997). The paper of Wedeman (1997), which examined corruption and growth in Zaire, South Korea and the Philippines suggests that high levels of corruption can coexist with high levels of economic growth but doesn't suggest that this will promote growth. The paper by Nguyen and Luong (2020) argues that the findings in this research shows that there is an important role that corruption plays in "greasing the wheels" of economic growth specifically in a bureaucracy structure as it is considered "speed money" which will help limit the delays in bureaucratic procedure which would then boost profitable trades. This paper states that it would be more beneficial to reduce the size of shadow economies in Asia, possibly due to a decrease in tax revenues and this would then negatively affect economic growth, while other papers have argued otherwise. The shadow economy refers to people that operate outside of the tax system that are not supervised by the government and do not report their tax obligations (Yang and Yang, 2024). A study conducted on Colombia which is considered an economically developing country shows that not only is the size of the shadow economy in Colombia large but found that there is a positive effect of the shadow economy on the economic growth in Colombia, it showed that between 1977 and 2002 there was an increase in growth explained by the activities of the shadow economy (Schneider and Hametner, 2007).

Although corruption and the shadow economy are defined as two separate things, corruption is able to enable the growth of shadow economic activities by

possibly facilitating or ignoring certain unreported activities. By this theory, the results in the Schneider and Hametner (2007) paper support the "grease the wheels" hypothesis again, particularly in developing countries.

5. GENERAL DISCUSSION

Based on the comparison done in the previous two sections, the "sand the wheels" hypothesis applied to advanced economies, while the "grease the wheels" hypothesis was shown to be more relevant towards developing economies.

The Neoclassical growth theory, also known as the Solow-Swan growth model, is an exogenous model that highlights the fact that technological change can significantly impact the functioning of an economy (CFI, n.d). In some cases of corruption, it can disrupt and encourage the implementation of policies that control inflows of Foreign Direct Investment (FDI) (Guha, Rahim, Panigrahi, Ngo and Simmonds, 2020). FDI itself comes with the creation of new jobs and additional investment into infrastructure. In addition to this it brings financial capital along with new technology and knowledge (Ali, Phoungthong, Khan, Abbas, Dilanchiev, Tariq and Sadiq, 2023).

The endogenous growth theory states that economic growth in a country is generated internally in an economy, through human capital, innovation, and knowledge and that this is what will generate economic growth (CFI, n.d). In contrast to other growth models, such as the neoclassical model, it is argued that the endogenous forces are what drive growth and not external factors. In relation to government corruption, through high levels of corruption investments into education could decrease. In a study done by Dridi (2014) on corruption and education levels it showed that a unit increase in corruption reduces enrolment rates by almost 10 percentage points. If this is applied to the endogenous growth theory, then corruption would directly affect economic growth as it would harm the endogenous forces that make up economic growth. If education was to decrease as well as investments into the education sector decreased, it would decrease the access that future generations had to innovate, generate human capital and gain knowledge, affecting the growth of a country's economy.

In sum, the Neoclassical growth theory argues that economic growth stems from technological advancements and with corruption we can see that FDI, which would go towards helping make technological progress, is compromised as corruption would complicate policies that control the inflow of FDI. On the other hand, the endogenous growth theory, created afterwards the Neoclassical growth theory, argues that economic growth in a country is based on internal factors such as innovation and knowledge. Corruption in this context again shows that through a risk in decreasing investments into the education sector, these internal factors would be put at risk as well.

6. CONCLUSION

Balancing the potential economic advantages against the moral and legal drawbacks remains a complex and contentious issue. On one hand, studies including Nguyen and Luong (2020) and Wedeman (1997) argue that corruption can expedite bureaucratic processes, attract investments, and facilitate business operations in environments plagued by red tape and inefficiency. They suggest that in some contexts, a degree of corruption can “grease the wheels” of commerce, leading to overall economic benefits. On the other hand, other studies including Pluskota (2020) and Anokhin and Schulze (2008) emphasise the long-term damage corruption inflicts on institutions, eroding public trust, perpetuating inequality, and fostering an environment where unethical behaviour becomes normalised. Moreover, the legal ramifications of corruption can lead to significant instability, as exposed scandals often result in political turmoil and economic uncertainty. Thus, while the potential economic benefits of corruption might be enticing, they must be weighed carefully against the profound ethical and legal implications that can undermine sustainable development and social cohesion.

Through small amounts of corruption in a country, studies argued that the red tape it is able to overcome is what creates more economic growth, but by analysing corruption using growth models it showed that that might not be the case. Corruption poses a risk to economic growth in both models, as shown in the discussion. Therefore, we can conclude that corruption in the form of bribes to overcome small inefficient bureaucratic procedures will not harm economic growth, and even promote it, but higher levels of corruption in a government where policies

are being changed or complicated, will only hinder the growth of a country’s economy.

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