Research Question

How will bureaucratic honesty and efficiency affect economic growth? If so, by how much?

This paper identifies the channels through which corruption and other institutional factors affect economic growth and quantifies the magnitude of these effects.

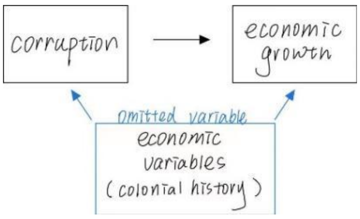
Study Context

With a heated debate over whether corruption might promote the economy, the paper analyzes the Business International (BI) indices on corruption, red tape, and the efficiency of the judicial system from 1980 to 1983 based on questionnaires from 70 countries to measure the effects of corruption.

Data Used

9 indicators were chosen from the Business International (BI) indices to reflect experts' views on risk and efficiency factors and investors' assessments of conditions in the country. With a 0 to 10 grade scale, a higher BI indicates better institutions. The researchers use the average of 9 indices, defined as Bureaucratic Efficiency and Political Stability, as the institutional efficiency. Besides, referenced from *Atlas Narodov Mira* (1960), Ethnolinguistic Fractionalization (ELF=1-$\Sigma(\frac{n_i}{N})^2$, i=1…I) is the probability that two randomly selected persons from the same country will be in different ethnolinguistic groups. This provides accurate ethnolinguistic compositions of the world population. The higher the ELF index, the more fragmented the country.

Identification Strategy



Researchers implement the Ordinary Least Squares (OLS) method and Two-Stage least squares (2SLS) regression analysis with the ELF index as an instrument to find the magnitude and significance of the bureaucratic efficiency and corruption indices. Additionally, they utilize ELF to control the omitted factors like colonial history which may affect political stability and the bureaucratic honesty and efficiency. ELF is a valid instrument as it is highly correlated with corruption and other institutional variables and is assumed to be exogenous both to economic variables and to institutional efficiency.

Findings

Being both statistically and economically significant, the corruption and bureaucratic efficiency indices lower investment, thereby reducing economic growth. From BE, researchers find that richer countries and fast-growers tend to have better institutions with higher bureaucratic efficiency indices. Bureaucratic efficiency and political stability are positively and significantly correlated as well. From ELF, researchers notice a negative and significant correlation between institutional efficiency and ELF. This may affect investment not only by increasing corruption and political instability but also via a direct channel. Researchers conclude three channels that bureaucratic inefficiency could affect economic growth: by indirectly lowering investment rate; by directly misallocating investment or production among sectors and affecting the steady-state level of income; or by directly lowering private marginal product of capital, thus lowering the investment rate.

Why findings are important/ Why do they Matter

The magnitude of the effects of corruption has yet to be measured, while this paper provides the first systematic cross-country empirical analysis that relates subjective indicators of bureaucratic honesty and efficiency to economic growth.

Assessment of Weakness

Other potential unmeasurable factors may affect economic variables that may distort the established findings. Moreover, it is difficult to interpret the coefficients of BI as the difference between a score of 4 and 5 and that between 7 and 8 is unclear. BI correspondents may also be influenced by a country's economic performance when evaluating its institutional efficiency, producing biased results.