Economic Modelling 35 (2013) 622–633

Contents lists available at ScienceDirect

Economic Modelling

journal homepage: www.elsevier.com/locate/ecmod

Does corruption impede economic growth in Pakistan?

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ARTICLE INFO

Article history:
Accepted 16 August 2013

Keywords:
Corruption
Growth
Pakistan

ABSTRACT

The present study reinvestigates the impact of corruption on economic growth by incorporating financial development and trade openness in growth model in case of Pakistan. We have used time series data over the period of 1987–2009. We have applied structural break unit root test to test the integrating order of the variables. The structural break cointegration has also been applied to examine the long run relationship between the variables.

The long run relationship between the variables is validated in case of Pakistan. We find that corruption impedes economic growth. Financial development adds in economic growth. Trade openness stimulates economic growth. The causality analysis has exposed the feedback effect between corruption and economic growth and same inference is drawn for trade openness and corruption. Trade openness and economic growth are interdependent. Financial development Granger causes economic growth implying supply-side hypothesis in case of Pakistan.

1. Introduction

In recent years, there is a wide spread of corruption in many countries of the world and especially in developing economies where its consequences have serious implications. The role of institutions in fostering economic growth has been recognized widely by the economists in these days. Existence of corruption in any country indicates the weaknesses of the institutions, thus, corruption is the output of weak institutions. A common definition of corruption is the abuse of public office for private gain (World Bank, 1997). Corruption is accepted in various ways such as bribery, the sale of public property by government officials, kickbacks in public procurement, and misuse of government funds (Reinikka and Svensson, 2005).

Corruption is not only an issue of one country or region but also a worldwide issue. Corruption retards economic growth and minimizes the chances of economic development in developing countries. The misuse of the public office by higher political as well as civilian authorities for acquiring national wealth has been taking place in the world at the expense of public welfare (Oni and Awe, 2012). According to World Bank, corruption is "the single greatest obstacle to economic and social development. It undermines development by distorting the role of law and weakening the institutional foundation on which economic growth depends". Corruption as a topic of research has attracted the attention of the economists of global financial institutions like World Bank and IMF in recent years due to its detrimental impacts on economic growth.

Economists have described five reasons behind the corrupt society or political set up, illegal accumulation of wealth and corruption in an economy. *Firstly*, corrupt government is the product of corrupt society and corrupt president cares corrupt government (Aburime, 2009). *Secondly*, the office of the political corrupt government collects national wealth illegally and becomes a major source of corruption in the country. *Thirdly*, the existence of a set of imperatives and incentives in the developing countries encourages the corruption transactions. These imperatives and incentives are such as widespread societal craze with materialism, high income inequality and poverty, exaltation and esteem of ill-gotten wealth by the general public and low and irregular salary packages for government employees with large families to bring up (Aburime, 2009; Frisch, 1996). *Fourthly*, accumulation of illegal wealth through corruption by the corrupt government encourages the other individuals of the society to have access and control over the means of corruption. In this way these corrupt individuals take the controls of the administrative process to have access to offshore accounts and practices of money laundering (Aburime, 2009). *Finally*, when there is no fear of punishment in a society corruption spreads very rapidly. Taxation systems in the developing countries have many flaws and unable to track down individuals' financial activities which further promote corruption in the society.

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http://dx.doi.org/10.1016/j.econmod.2013.08.019

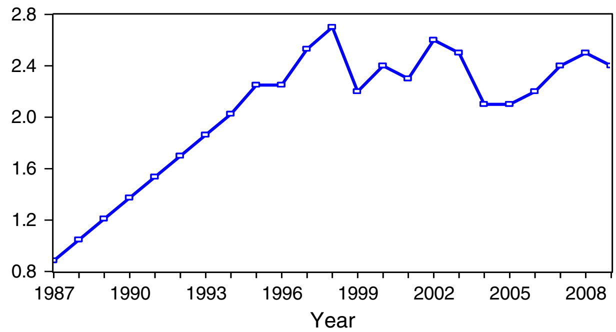

Fig. 1. Corruption index in Pakistan.

1.1. Pakistani context

The economy of Pakistan experienced a very sluggish rate of economic growth and a high level of volatility in its growth rate for the last five years. Moreover, Pakistan failed to achieve the set target of 5.3% growth rate in the last eight years, average 2.6% economic growth rate was registered in these eight years. There is a variety of reasons for this poor economic performance; increasing corruption is the dominating determinant that affected the economic growth in Pakistan. Corruption is the result of institutional weaknesses which discourages the economic growth of a country. Historical background of Pakistan flourishes that the most governance indicators have remained unchanged and corruption apparently spread to all gross root levels of federal, provincial and local governments. In 1995, Corruption Perception Index (CPI) was 2.25 and Pakistan was considered among the most corrupt countries of the globe. Some routine efforts were made by the government of Pakistan to eradicate the corruption from the country. Due to these efforts Corruption Perception Index showed some improvement in 1998, then it improved further to 2.7 from 2.53 in 1997 (International Transparency Report, 2012) (Fig. 1). Today, Pakistan on the basis of Corruption Perception Index is ranked at 139th out of 174 countries of the world, which means that it is the 35th corrupt country of the world (International Transparency Report, 2012).

Pakistan is a country with weak institutions which is the biggest alone cause of corruption. Other reasons of corruption are; insufficient political will to eradicate corruption from the society, bureaucracy is the principal authority for the administration of institutes, salaries in the public sector are very low as compared to the other sectors of the economy and higher rate of inflation. The government bodies are held responsible for spreading corruption in Pakistan because these bodies control and allocate public resources of the country. The department of police is supposed to maintain the law & order situation in a country but known as the most corrupt institution of Pakistan. In Pakistan, police officers are appointed on the basis of political and bureaucratic connections. Thus, the police officers often have divergences of significance due to special loyalties.[1]

The above graph is constructed to display the trend of corruption in Pakistan. It depicts that from 1987 to 1998 the corruption was gradually reduced. In 1999, the corruption again increased during the era of Musharraf's coup, situation of corruption was slightly controlled due to slight improvements in governance. The country had performed better to reduce corruption by improving the rule of law and government effectiveness in 2002 and 2003. In 2005, corruption was worsened due to poor quality of governance in the country. It was indicated in Global Competitiveness Report (2007–08) that bureaucratic culture in the public sector as well as the poor quality of infrastructure and corruption, are the major hurdles for foreign companies to settle their business in Pakistan. Although corruption is a major problem in Pakistan but still it is a better place for new and existing businesses as compared to other countries of the region like India, Bangladesh, Sri Lanka etc. (International Transparency Report, 2012). The Corruption Perception Index ranked Pakistan as the 47th corrupt country out of 180 countries of the globe. The survey of Transparency International (various reports) indicates that the corruption factors and their results in terms of percentage are as follows; lack of accountability is 31.68%, low salaries is 16.54%, monopoly of power is 16.43%, discretionary powers is 12.61%, lack of transparency is 9.97%, power of influential people is 4.59%, red-tapism is 4.28%, and others is 4.9% (Government of Pakistan, 2010–11). In 2009, the Corruption Perception Index score of Pakistan was 2.4 which slipped the country to 42nd that declared high corruption in Pakistan.

2. Literature review

The link between corruption and economic growth is not a new concept in the field of Economics. More than a few economists have tried to explore the impact of corruption on economic growth for the last many years, but there is hardly any consensus among economists on the role of corruption. The World Bank (2009) reported that the average annual economic growth rate of East Asian countries including Malaysia, Singapore, South Korea, Thailand, Hong Kong, Indonesia and Philippines was around 7% from 1986 to 1996, whereas it was very poor 2.5% in the rest of the world. These countries excluding Singapore also experienced a high level of corruption during this period. Most of the earlier empirical studies before this period have discovered that corruption impedes economic growth but the coexistence experience of high economic growth and corruption in these countries questions the generality of these studies. Lack of identical yardstick to measure the corruption has given the inconclusive empirical results. The pioneering theoretical work of Leff (1964) discovered a very interesting link between corruption and economic growth; corruption works like the engine of economic growth in the situation when bureaucratic delays and strict regulations imposed by the government enable the private agents to buy their way out of politically imposed inefficiencies. Thus, corruption enhances efficiency in an economy and leaves positive impacts on economic growth (Huntington, 1968; Summers and Heston, 1988; Acemoglu and Verdier, 1998). Similarly or contrary, few economists applied different models, in which the corruption speeds up the working process that enhances the efficiency of economic growth. Lui (1985) used "queue model" by suggesting that bureaucrats allocate business licenses to those firms that gives high amounts as bribe. The "auction models" guided that biding method can enhance competence because most well-organized firms are frequently those who can give the maximum bribe (Beck and Maher, 1986; Lien, 1986). Rock and Bonnett (2004) investigated the relationship between corruption, economic growth and investment. They noted that corruption significantly promotes economic growth in case of China, Indonesia, Korea, Thailand and Japan.

On the contrary, various studies exposed that corruption plunders economic growth by increasing the cost of business and also uncertainty in the decision making process.[2] Existing literature indicates four

[1] It is famous that in Pakistan, powerful landlords select the law enforcement officers in their area and police officers act on their behalf. The illegitimate police system does not only exclusively influence poor people but also businesses person. Basically matured police system is needed as the sole, political, legal, and economic institutions of a country are necessary in recognizing the possible for police wrongdoing.

[2] See Murphy et al. (1991), Gould and Amaro-Reyes (1983), Mauro (1995), Mo (2001), and Monte and Erasmo (2001) etc.