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Why is Corruption Less Harmful to Income Inequality in Latin America?

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Summary. — Conventional wisdom says corruption is bad for income inequality. But recent research on Latin America finds a trade-off between corruption and inequality and suggests this is due to the large informal sector in the region. Using data on a large sample of countries we find that the informal sector impacts the link between corruption and inequality. In particular, the marginal impact of corruption becomes negative once the informal sector becomes large. This is true in Latin America and more generally. Corruption reducing policies should be accompanied by measures that help displaced informal sector workers.
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Key words — corruption, Latin America, income inequality, informal sector, marginal impact

1. INTRODUCTION

Conventional wisdom says corruption is bad for income inequality. Numerous empirical studies report a positive relationship between corruption and inequality: more corruption leads to more inequality (e.g., Ades & Di Tella, 1997; Dincer & Gunlap, 2008; Gupta, Davoodi, & Alonso-Terme, 2002; Gyimah-Brempong & Muñoz de Camacho, 2006; Li, Xu, & Zou, 2000). These studies rationalize the result by suggesting several avenues through which corruption is expected to have an adverse impact on inequality (for details see Andres and Ramlogan-Dobson (2011)). Empirical research also points to a feedback relationship between corruption and inequality, which may help to create a corruption–inequality trap (Apergis, Dincer, & Payne, 2010; Chong & Gradstein, 2007a; Uslander, 2007).

That corruption may be harmful to inequality has also been demonstrated in theoretical work. Blackburn and Forgues-Puccio (2007) model the behavior of bureaucrats appointed to implement income redistribution programs to help the poor. The model predicts that bureaucrats will conspire with the rich in providing the authorities with false information. In the macroeconomic model of Foellmi and Oechslin (2007) corruption redistributes income toward the wealthy. This outcome arises because wealth serves as collateral in the determination of how much can be borrowed on the (imperfectly functioning) credit market. Payment of bribes reduces the necessary collateral so the lower the bribe the smaller is the amount of money that can be borrowed. Entrepreneurship is not an option for the poorest in society since they can only generate low levels of collateral.

Conventional wisdom has recently been questioned in empirical research on Latin America. Dobson and Ramlogan-Dobson (2010) and Andres and Ramlogan-Dobson (2011) provide evidence of a trade-off between corruption and income inequality. They explain this result with reference to the (relatively large) informal sector in the region. The poorest individuals lack the personal characteristics required to find work in the formal economy, while discrimination and institutional barriers also restrict work opportunities. The informal sector therefore provides jobs and a source of income. Policies aimed at reducing corruption impose labor market (and other) regulations and have an adverse impact on employment and welfare in the informal sector. If this hypothesis is correct anti-corruption measures introduced by governments and advocated by organizations such as the World Bank may exacerbate inequality.[1] For this reason alone it is important to understand more about the corruption–inequality–informal sector relationship.[2]

To the best of our knowledge this is the first paper to examine empirically the link between inequality, corruption, and the informal sector. Our key finding is that the informal sector impacts the trade-off between corruption and inequality. In particular, as the informal sector grows corruption is less harmful to inequality. This result is important for three reasons: (i) it lends credence to the findings for Latin America; (ii) it applies to any country where the informal sector is large; and (iii) it suggests that anti-corruption policies need to be accompanied by initiatives which help displaced workers from the informal sector.

The rest of the paper is structured as follows. Section 2 considers the theory to support the hypothesis that the informal sector impacts the relationship between corruption and inequality. Section 3 explores some empirical issues and Section 4 discusses the data and methodology. Section 5 reports the results and Section 6 concludes.

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2. CORRUPTION, INEQUALITY, AND THE INFORMAL ECONOMY

Poor institutions provide the impetus for the growth of an informal sector. A weak legal system, restrictive labor regulations, excessive bureaucracy, social security contributions, and a heavy tax burden are all major disincentives for entrepreneurs to start up a business in the formal economy (Dabla-Norris, Gradstein, & Inchauste, 2010; Feige, 1996; Schneider, 2007; Tanzi, 1982). A business operating "informally" avoids taxation and other contributions. Some would-be formal sector entrepreneurs often find it necessary to bribe officials to obtain relevant documents. [3] De Soto (1989) provides an example from Peru in the 1980s when entrepreneurs were expected to pay a bribe for ten of the eleven requirements for setting up a business. In a cross-sectional study Chong and Gradstein (2007b) find an inverse relationship between institutional quality and the informal sector: an improvement in the quality of institutions is associated with a decline in the informal sector.

In developing countries 40–50% of the labor force and around 50% of GDP originates in the informal sector (Schneider, Buehn, & Montenegro, 2010). The continued existence of informal firms comes from their ability to avoid detection or, if found out, to bribe officials to overlook their existence or obtain necessary documentation. Over time individuals and firms build-up a network of contacts so as to enable continued operation. Furthermore, it is possible that the networks and channels that facilitate corruption become stronger as more individuals engage in this activity and as a result it become less expensive to engage in corruption (Cule & Fulton, 2009). The idea that corruption can assist in building an economy and be an effective substitute for poor institutions and missing law is summarized well by de Vaal and Ebben (2011, p. 112). They say "when a decent system of property rights is missing corruption may become a crucial element of the economic system. In such an environment corruption could reduce uncertainty and facilitate investment and productivity thus providing an alternative system in which the indirect institutional effect of corruption more than compensates its negative direct effect." But this notion is not new. Leff (1964) and Huntington (1968) speculate that corruption may be perceived as a useful substitute for a weak rule of law, while Osterfeld (1992) notes that corruption allows private citizens to evade bad laws.

If there are weak institutions the structure of production adapts and mechanisms are developed that allow business to work in a corrupt environment. Corruption is not fought against or regarded as immoral and for firms in the formal economy it may be the only way to circumvent cumbersome and pervasive regulation that undermines efficiency and output. For example, in Latin America under protectionist regimes individuals bribed officials to obtain import licenses and to overlook foreign exchange controls (Franko, 2006). Arduz (2000) describes a system in Bolivia where goods are processed on the basis of customs officers setting their own tax rates rather than using official ones. In many instances firms in the formal sector may depend on firms in the informal sector for accessing essential inputs. Some "formal" firms may only register part of their workforce or part of their sales or only declare part of the salaries of their employees. Survey evidence for Latin America suggests that medium to large-sized firms have a substantial proportion of their operations off the books (Perry *et al.,* 2007).

The nature of a region's colonial heritage seems to be important in explaining why corruption is tolerated and why this tolerance may benefit business. Engerman and Sokoloff (1997, 2000, 2002, 2005) and Acemoglu, Johnson, and Robinson (2002) trace the roots of current Latin American inequality back into the colonial era when profitable activities were controlled by a ruling class (or "landed elite") who set up institutions to serve their own ends. The concentration of land, mineral wealth, and political power in the hands of this elite induced a long run development path characterized by high economic and social inequality. Following independence, the Creole elite gained control of key institutions and exerted a significant influence on the formation and implementation of government policies. The fact that corruption is embedded into the historical development of Latin America has given economic agents time to develop ways of prospering within a corrupt environment. Hence, the adverse impact on inequality is reduced.

Initial conditions are therefore crucial to the success of anti-corruption policies. If policy makers are in direct conflict with individuals who have successfully developed businesses using the means at hand policy is unlikely to work in the short run. Firms and individuals operating partially or totally in the informal sector face higher costs via improvements in tax collection, new regulations and procedures, changes in personnel, policing, and enforcement. [4] Entrepreneurs find it increasingly difficult to survive because the things that gave impetus to the growth of the informal sector are eroded and established networks that once facilitated production begin to disappear. The effect of these measures is a reduction in the size of the informal sector, a loss of jobs and income, and a subsequent rise in income inequality. In short, the impact of anti-corruption policy in countries with weak institutions will not be the same as in countries with more robust institutions.

Recent theoretical research corroborates this view. Albrecht, Navaroo, and Vroman (2009) show that labor market reforms, via the imposition of certain taxes, lead to a rise in total unemployment in an economy with a significant informal sector. Defining corruption as a set of activities that smooth the process of transaction in the production sectors, Mandal and Marjit (2010) use a general equilibrium model to show that lower corruption can produce a rise in wage inequality. Ulyssea (2010) develops a two-sector matching model that incorporates the main features of labor markets in Latin America. Simulations of the model using data for Brazil show that the enforcement of labor market regulations reduces the size of the informal sector, significantly increases unemployment, and produces substantial welfare losses. Chong and Calderón (2000) show empirically that the effect of corruption on inequality is nonlinear with an initial worsening followed by an improvement. They hypothesize that this is due to the presence of the informal sector.

The argument that anti-corruption policies will have adverse consequences for business in the informal sector is challenged by Maloney (2004). He argues that since the self-employed represent the core of the informal sector, labor market regulation will have only minimal impact on the informal sector. This may be the case if we think of anti-corruption measures in terms of labor market regulation only. But if we see corruption more broadly, involving an exchange between two parties which influences the allocation of resources either in the present or the future (Macrae, 1982), a crackdown on corruption puts the squeeze on all participants (self-employed or not) in the informal sector. Moreover, even if the self-employed are the core of the informal sector it is possible, as theoretical studies have shown, for labor market regulation to adversely affect the size of the informal sector. The implication of this is that the issue is an empirical one.

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