

# Chapter 1

## The Impact of Corruption on Entrepreneurship

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### ABSTRACT

*There is a consensus that corruption may result in high societal costs. A growing body of research reveals the negative effects of corruption on a variety of economic indicators. This chapter presents a literature review on the impact of corruption on entrepreneurship. It allows us to suggest that one of the transition channels through which corruption has impacted growth is entrepreneurship. The main channels in which corruption impacts entrepreneurship is through reduced incentives for entrepreneurial activity and reduced trust within the system. The authors present evidence that the negative impact of an incremental increase in the level of corruption on entrepreneurship is more harmful in developed countries than in developing countries. Thus, they stress the need for more research in this area with the aim of establishing appropriate frameworks for the fight of corruption in both developing and developed countries and suggest significant gains from anti-corruption efforts, especially in developed countries.*

### INTRODUCTION

The global anticorruption movement has gained ground since the mid-1990s. At the same time, corruption has received growing research attention. The World Bank (1997, p. 8) defined corruption as “the abuse of public office for private gain”. Corruption has a supply side (private bribers) and a demand side (public officials). Macrae (1982, p. 679) defines corruption as an arrangement that involves a private exchange between two parties,

which (1) has an influence on the allocation of public resources either immediately or in the future and (2) involves the use or abuse of public or collective assets or authority for private ends. Philip (2006, p. 45) defines corruption as a case in which a political officer seeks personal gain while harming public interest to benefit a third party that rewards him. Gambetta (2002, p. 35-36) presents three definitions of corruption: a broad one “corruption is the abuse of entrusted power”, an intermediate one “corruption is the abuse of

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entrusted power for private gain”, and a specific one “corruption is the abuse of entrusted public power for private gain”.

Corruption can occur at different levels and to varying degrees, as grand corruption, involving high-level officials with discretionary authority over government policy and petty corruption, involving lower-level officials who control access to basic services. Grand corruption impacts public resource allocation (Husted, 1999). Such corruption is common both in developing countries and developed countries (Rose-Ackerman, 2002). Petty corruption (also called administrative or bureaucratic corruption) is the everyday corruption that takes place where bureaucrats meet the public directly. Petty corruption describes a situation in which private citizens or Small and Medium Enterprise (SME) owners/managers pay small bribes when dealing with low-level government bureaucrats regarding various transactions and bureaucratic issues. Widespread petty corruption characterizes many developing countries (De Sardan, 1999). In addition, corruption can be sporadic or systemic. Sporadic corruption occurs occasionally at different levels of the public sector without a systematic or centralized pattern it characterized systems in which the enforcement and transparency is low. Systematic corruption is often much more widespread, centralized and organized (Bardhan, 1997). Systemic corruption is characterized by extensive corrupt activities, ranging from petty to grand corruption. Corruption becomes the rule rather than the exception (Stefes, 2007). Systematic corruption is far more dangerous to democracy and severely jeopardizes the trust in the system (Heymann, 1996). Persson, Rothstein, and Teorell (2013) suggest that in countries characterized by systemic corruption most often anticorruption reforms will fail. They suggest that this is due to the fact that systemic corruption is a collective action problem. Although petty corruption usually involves much smaller sums than those that change hands in acts of

“grand” or political corruption, the amounts are not “petty” for the individuals adversely affected. Petty corruption disproportionately hurts the poorest members of society, who may experience requests for bribes regularly in their encounters with public administration and services like hospitals, schools, local licensing authorities, police, taxing authorities and so on.

There is a consensus that the tangible (e.g., government administrative inefficiency and poor resource allocation) and intangible (e.g., the loss of trust between different agents within the business sector and the public sector) societal costs of corruption may be tremendously high and long lasting (Ades & Di Tella, 1999; Zelekha, 2013).

‘Rent seeking’, which is a specific type of corruption, is an attempt to obtain economic gain by manipulating the social or political environment in which economic activities occur rather than by creating new wealth. The effects of rent seeking are reduced economic efficiency due to poor resource allocation, reduced market competition and a loss of trust within the system. (Ades & Di Tella, 1999; Zelekha, 2013). Rent seeking is very costly for economic growth (Murphy, Shleifer, and Vishny, 1993).

Corruption also affects the magnitude of the rewards that can be earned from entrepreneurship (Baumol, 1996) and makes it less likely that latent entrepreneurs will actually establish entrepreneurial firms. Moreover, corruption often creates barriers to new entry and new competition (Svensson, 2005) i.e. incumbent firms ‘pay’ corrupt officers to manipulate the system in a way that protect them from new entry and competition, thus hindering entrepreneurship. Therefore, higher levels of corruption should be associated with lower levels of national entrepreneurship.

In this chapter, we consider the impact of corruption on entrepreneurship. Thus, for the sake of this chapter, we define entrepreneurship as the process of identifying, starting and developing a new business venture.

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