www.elsevier.com/locate/worlddev

World Development Vol. 59, pp. 298–312, 2014

0305-750X/$ - see front matter

http://dx.doi.org/10.1016/j.worlddev.2014.01.028

Economic Regulations, Red Tape, and Bureaucratic Corruption in Post-Communist Economies

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Summary. — Should state regulatory involvement in the economy necessarily generate corruption? While excessive regulatory burden is often treated as a cause of corruption, this paper argues otherwise. It distinguishes regulatory policy, or *de jure* regulatory regimes from regulatory implementation and offers a more nuanced argument about the relationship between state regulations and bureaucratic corruption. The analysis of business survey data covering 25 post-communist economies demonstrates that mechanisms of regulatory implementation, rather than heavy-handed regulatory policy, are responsible for bribery. This analysis draws attention to the theoretical distinction between different types of regulatory hurdles and their differential effects on the quality of governance.

Key words — economic regulation, corruption, street-level bureaucracy, Eastern Europe, Former USSR

1. INTRODUCTION

Should state regulatory involvement in the economy necessarily lead to corruption? The extant literature presents opposing assessments of the net effect of state regulatory involvement. The Weberian approach to the analysis of state (bureaucratic) involvement in the economy emphasizes the quality of the bureaucratic organization and suggests that corruption does not depend on what bureaucrats do, but how they do it (Brown, Earle, & Gehlbach, 2009; Kohli, 2010; Rauch & Evans, 1999). On the other hand, the political–economic approach to regulatory intervention and rent-seeking links regulatory bureaucracies to resource misallocation, preferentialism, and corruption (Acemoglu & Verdier, 2000; De Soto, 1990; Djankov, La Porta, Lopez-De-Silanes, & Shleifer, 2002; Krueger, 1974; Mauro, 1995; Nye, 1969). The neoliberal political economy approach that highlights the growth-inhibiting effects of large state bureaucracies (Ting, 2003), discretionary regulatory intervention (Kydland & Prescott, 1977), and state capture (Hellman, 1998) provides the most consistent case against state intervention. Moreover, according to Leff (1964), Huntington (1968), and Meon and Weill (2010), inefficient and burdensome state regulations necessitate corruption as an informal mechanism for improving economic efficiency.

Although several empirical studies found a positive correlation between regulatory intervention and corruption (Kaufmann & Wei, 2000; Treisman, 2000), the empirical link between state regulations and corruption is not as clear as theories of rent-seeking would suggest. Bribery may flourish under heavy as well as light regulatory settings, and "clean" governments may regulate extensively or moderately. Post-communist transitional economies illustrate this well. A comparison of the Transparency International Corruption Perception Index and the World Bank Doing Business data (World Bank, 2006) shows that Lithuania and Slovenia, for instance, have "cleaner" bureaucracies compared to Georgia and the Kyrgyz Republic, but the same number of official regulatory procedures (Figure 1). [1] Although the Czech Republic enforces twice the amount of regulations on business entry compared to Romania, its government is considerably less corrupt than the Romanian government. [2] At the same time, there are countries where the extent of the regulatory burden seems to coincide with the level of corruption. Hungary and Estonia have few regulations and low corruption, while Ukraine and Tajikistan score high on both accounts. [3]

This paper investigates the theoretical link between state regulatory involvement in the economy and bureaucratic corruption and contributes to the literature that empirically differentiates *de jure* regulatory policy from its implementation, or *de facto* regulatory experiences (Beazer, 2012; Hallward-Driemeier & Pritchett, 2011; Stone, Levy, & Paredes, 1996). Following the institution-centered tradition in the analysis of bureaucratic corruption (Becker, 1968; Klitgaard, 1988; Klitgaard, MacLean-Abaroa, & Parris, 2000), I argue that the mechanisms of policy implementation have an important effect on whether or not state regulations produce bureaucratic corruption. The source of corruption lies in bureaucrats' ability to generate red tape, which creates additional, unofficial costs for economic agents. *De jure* regulatory regimes are only partly responsible for red tape creation and should not be seen as a primary source of corruption. By analytically separating aspects of regulatory policy from mechanisms of its implementation, this argument clarifies causal mechanisms connecting regulatory climate to corruption and further strengthens theoretical claims behind the negative assessment of discretionary power of regulatory bureaucracy (Klitgaard *et al.*, 2000; Rose-Ackerman, 1986).

I test my theoretical proposition using business survey data covering 25 post-communist countries between 1999 and 2005. [4] Discretionary power, defined as the ability of local or street-level bureaucrats to freely interpret regulatory norms in the process of their implementation, is an important source of bureaucratic red tape that may lead to corruption. When

* The author would like to thank Harvey Palmer, Timothy Frye, Quintin Beazer, and Joshua Tucker as well as the Journal's anonymous reviewers for their insightful comments on the earlier versions of this manuscript. Support for this research was provided by the Baldy Center for Law and Social Policy at University at Buffalo. Earlier versions of this paper were presented at the Midwest Political Science Association Meeting and the Harriman Institute for Russian, Eurasian, and East European Studies, Columbia University. Final revision accepted: January 25, 2014.

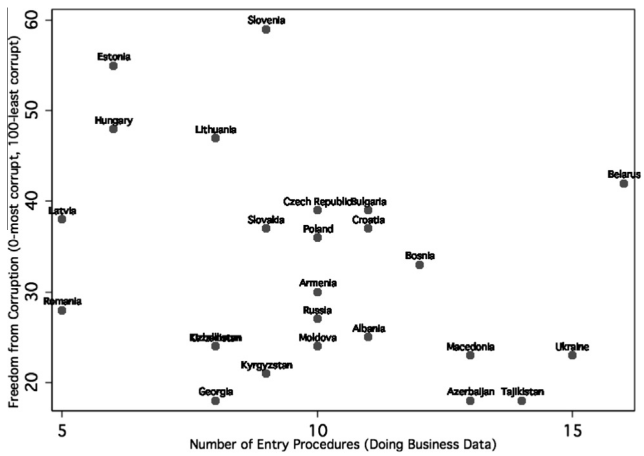

Figure 1. *Business entry regulations and freedom from corruption in 2005. Source: World Bank Doing Business Dataset, 2006; Transparency International Corruption Perception Index recoded on a 0–100 scale by Heritage Foundation, 2005.*

discretionary bureaucratic power to apply regulations is factored in, the official regulatory policies are not central in determining the actual regulatory burden experienced by firms. Instead, bureaucratic red tape becomes a more important source of regulatory pressure and leads to corrupt practices. While theoretically distinct, the official regulatory burden and bureaucracy-imposed red tape are hard to disentangle empirically. I utilize firm-level survey data and the independently generated indicators of official regulatory policy to estimate the separate effects of unofficial and official regulatory burdens and find that when controlling for the amount of red tape, high official regulatory burden does not undermine bureaucratic probity.

This paper contributes to the literature on corruption, analysis of state regulatory function, and debates about empirical assessment of business climate. It develops a theory that integrates institutional and economic approaches to corruption and aids analysis of broader issues of optimal regulatory intervention, state administrative capacity, and regulatory compliance. Despite prior research that has provided convincing theoretical arguments and empirical evidence on the institutional underpinnings of corruption [5] academic and policy literature continues to link corruption to specific policy choices (i.e., that more regulation equals more corruption) (Berga, Jiangb, & Lin, 2012; Wienekea & Gries, 2011). Although scholarly accounts of this subject are becoming increasingly more informed and nuanced, much of the literature continues to conflate policy content with implementation mechanisms, a fallacy that this article attempts to rectify. [6]

The argument proposed in this paper about institutional sources of administrative corruption builds on the long theoretical tradition in the study of corruption (Dey, 1989; Krueger, 1974; Klitgaard, 1988; Rose-Ackerman, 1999; Shleifer & Vishny, 1993) and concentrates on specific institutional feature of bureaucratic organization—discretionary policy implementation powers—as the mechanism leading to bureaucratic abuse. Previous research has identified discretionary bureaucratic power *and* regulatory intervention as important sources of corruption. According to Klitgaard (1988, p. 26), "Corruption loves multiple and complex regulations with ample and uncheckable official discretion." The relationship between regulations and discretion, however, requires further theoretical and empirical exploration. My theory helps reconcile theoretical arguments rooting corruption in state regulatory involvement (Acemoglu & Verdier, 2000; Campos & Giovannoni, 2008; Svensson, 2005; Treisman, 2000) with those linking corruption to institutional design (Lessmann & Markwardt, 2010; Mishra, 2006; Potter & Tavits, 2011; Shah, 2007). It shows that while bureaucratic corruption is without doubt connected to the state regulatory function, mechanisms of regulatory implementation, rather than the official regulatory burden, are at fault. Although similar mechanisms have been proposed to explain corrupt practices (Klitgaard *et al.*, 2000) and link it to the economic effects of state regulations (Duvanova, 2012), this paper directly evaluates this specific empirical link quantitatively at the firm level.

My contribution to the exploration of economic effects of regulatory policies is in stressing institutional foundations (administrative quality) of solid regulatory regimes. The paper adds to the classic "rules *vs.* discretion" distinction that emphasizes detrimental effects of regulatory uncertainty/unpredictability (Beazer, 2012; Hallward-Driemeier, Khun-Jush, & Pritchett, 2010; Kydland & Prescott, 1977) two institutional elements—agency-generated red tape and corruption. [7] While regulatory uncertainty undoubtedly destabilizes the business environment (Campos, Lien, & Pradhan, 1999), one cannot ignore the separate and important ways in which corruption directly affects the cost of running business. By adding bureaucratic red tape and corruption into the "rules *vs.* discretion" equation, this paper creates a more complete conceptual framework for analyzing regulatory policy and institutional reforms aimed at achieving higher regulatory quality (Hausmann, Pritchett, & Rodrik, 2005).

The paper also contributes to the debate about cross-national business climate data that measure the extent of state regulatory burden and assess regulatory quality (Kaufmann, Kraay, & Mastruzzi, 2007; Kurtz & Schrank, 2007). Scholars have criticized the theoretical assumptions behind such data (Kurtz & Schrank, 2007; Rose-Ackerman & Soreide, 2011) and empirically documented discrepancies between "hard" data based on the analysis of *de jure* regulatory standards and individual experiences with regulatory environment assessed via cross-national business surveys (Hallward-Driemeier & Pritchett, 2011). I offer a novel theoretical argument that explains sources and mechanisms of such discrepancies.

Existing accounts identify individual biases, policy preferences (Kurtz & Schrank, 2007), and non-compliance (Gauthier & Gersovitz, 1997; Hallward-Driemeier & Pritchett, 2011) as potential explanations for discrepancies across different types of data measuring the same underlying phenomenon. This paper, instead, suggests and empirically evaluates an alternative institutional explanation for why a firm's experiences might differ from those predicted by the official regulatory environment. I identify bureaucratic discretion in policy implementation as a key institutional feature that systematically affects a firm's regulatory environment by creating the opportunity for bribery and reducing regulatory compliance. A recent study noted that "policy implementation often deviates from the stated policy in firm (or individual) specific ways" (Hallward-Driemeier & Pritchett, 2011, p. 31). Many efforts to differentiate between *de jure* and *de facto* regulatory environment, however, are carried out at the country level (Djankov *et al.*, 2002; Duvanova, 2012; Hallward-Driemeier & Pritchett, 2011). [8] The individual-level analysis adopted in this paper allows me to account for the firm-specific aspects of regulatory implementation and compliance.