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The Corruption Tax: Economic Costs and Stagnation



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Highlights

Corruption acts as a compounding tax on Pakistani firms, raising costs and unpredictability. This diminishes productivity, which in turn reduces expenditure on research and development and innovation. This chain of weak governance ultimately holds back economic growth.

Corruption poses a significant challenge to firm growth, affecting about 30% of firms, with 11.1% considering it their primary obstacle. The 11.1% figure is approximately 1.5 times higher than the South Asian average of 7.4% (World Bank Enterprise Survey, 2022).

Fixing weak governance could raise Pakistan's GDP by 5–6.5% over five years. Weak governance distorts public spending, discourages private investment, and keeps tax collection chronically low (IMF & World Bank, 2025).

Small firms carry a disproportionate share of this burden. Those with fewer than 50 employees pay 2.2 times as much in informal payments as a share of revenue as large firms (more than 250 employees) do, which entrenches market concentration rather than competition.

Pakistan's R&D expenditure is just 0.16% of GDP, making it one of the lowest in Asia. This low level may partly reflect the risk premium associated with corruption, which discourages long-term investment; it is not simply a shortage of resources.

Four reforms are proposed: (1) simplify regulation and digitize firm–government contact points, (2) protect small and medium-sized enterprises (SMEs) from disproportionate compliance costs, (3) safeguard crisis support and industrial subsidies, and (4) build the evidence base for innovation policy.

Background

Firms in Pakistan operate in a regulatory environment of overlapping rules, wide administrative discretion, and weak accountability, pushing many toward informal arrangements — facilitation payments, personal connections, selective compliance — that offer short-term relief at long-term cost. Early theory, from Leff (1964) and Huntington (1968), treated such corruption as “grease” that helps firms route around rigid bureaucracy. Later theory and evidence overturned this: Shleifer and Vishny (1993) showed that corrupt officials have an incentive to manufacture obstacles rather than remove them, and from the 1990s onward the consensus among economists, including Mauro (1995) and Aidt (2009), was that corruption instead acts as “sand” — raising costs, adding uncertainty, and diverting resources from productive use.

This Policy Viewpoint takes that consensus as its starting point and asks a more specific question for Pakistan: how that cost travels through the economy — from higher costs and uncertainty, to lower firm productivity, to constrained investment in research and development and innovation, to slower aggregate growth. Establishing this chain explicitly, rather than treating productivity and innovation as separate concerns, is the organizing purpose of this Policy Viewpoint.

The Productivity–Innovation–Growth Channel

The link between corruption and slower growth is not direct; it runs through two intermediate variables that are often discussed separately but should be considered together.

Corruption taxes productivity

Fisman and Svensson (2007) found that firms paying higher bribes grow more slowly even after accounting for taxes and formal regulation. Gaviria (2002) showed that the time managers spend navigating informal demands is time not spent running the business. In a market like Pakistan’s, where small firms have the least bargaining power, this tax falls hardest on exactly the firms least able to absorb it (Beck, Demirgüç-Kunt & Maksimovic, 2005).

Corruption suppresses innovation

Innovation demands that firms allocate resources expecting long-term gains that may take years to materialize, and it relies on confidence that the resulting products, processes, or intellectual property will be safeguarded (Méon & Sekkat, 2005). Corruption disrupts both conditions simultaneously: Anokhin and Schulze (2009) found that firms in corrupt environments spend less on R&D and develop fewer new products, an effect Paunov (2016) shows is most pronounced for financially constrained SMEs — the dominant firm type in Pakistan’s private sector. Goedhuys, Mohnen, and Taha (2016) add that corruption not only discourages R&D expenditure but also diminishes the commercial return on the R&D that does happen, weakening innovation policy even where firms attempt to innovate around these barriers.

Put together, the sequence runs as follows: corruption raises costs and uncertainty → productivity falls → firms underinvest in R&D and innovation → growth and competitiveness suffer. Firm size and political connection can soften this chain. Large or well-connected firms are better positioned to absorb or circumvent corruption costs (Ayyagari, Demirgüç-Kunt & Maksimovic, 2014). Nonetheless, for the SME-heavy structure of Pakistan’s economy, the chain runs largely unbroken. This is the logic the rest of this Policy Viewpoint is built on: reforms are judged not by whether they reduce corruption in the abstract, but by where in this chain they intervene.



Evidence from Pakistan

The available survey and diagnostic data tell a consistent story about where Pakistan is losing ground in the productivity–innovation chain.

Indicator	Value	Source
Firms citing corruption as a major/severe obstacle	30%	World Bank Enterprise Survey, 2022
Firms citing corruption as their single biggest obstacle (South Asia average: 7.4%)	11.1%	World Bank Enterprise Survey, 2022
Potential GDP gain over five years from fixing weak governance	5–6.5%	IMF & World Bank, 2025
Average regulatory inspections per firm per year (South Asia average: 4.6)	8.3	World Bank Enterprise Survey, 2022
Firms reporting that informal payments are “expected” during inspections	23%	World Bank Enterprise Survey, 2022
Extra informal payments (share of revenue) paid by firms with <50 employees vs. those with >250	2.2×	World Bank Enterprise Survey, 2022
R&D expenditure (India 0.67%, Bangladesh 0.52%, Vietnam 0.53%)	0.16% of GDP	UNESCO, 2022
Reduction in process/product innovation investment by firms in high- vs. low-corruption settings	22–35%	Goedhuys et al., 2016 (Egypt and Tunisia)
COVID-19 Rozgar Scheme disbursements to firms with no verifiable employment record (~PKR 29 billion)	18%	Auditor General of Pakistan, 2021

Two patterns stand out. The first is that corruption in Pakistan is concentrated at the point of routine regulatory contact — inspections, licensing, and customs — rather than being diffuse across the economy, precisely where administrative discretion is highest (Shleifer & Vishny, 1993; Djankov et al., 2002). The second is that its costs are regressive: SMEs, which generate 40% of GDP and 80% of non-agricultural employment, absorb a disproportionate share of both the direct payments and the productivity losses, while the largest 20 business groups, more insulated from these pressures, hold over 60% of listed market capitalization (Ayyagari et al., 2014). Additional evidence specific to each reform is presented alongside the corresponding priority below, rather than repeated here.

Policy Priorities

The reforms below are sequenced to match their position in the productivity–innovation chain: Simplify Regulation and Digitize Firm–Government Contact Points → Protect SMEs from Disproportionate Costs → Safeguard Crisis Support and Industrial Subsidies → Build the Evidence Base for Innovation Policy. The first two lower the cost and uncertainty firms face day-to-day; the third protects the integrity of public support when firms are under stress; the fourth builds the evidence base needed to know whether the first three are working. Each priority is framed around its productivity or innovation payoff.

1. Simplify Regulation and Digitize Firm–Government Contact Points

This is the foundational priority because it addresses the mechanism identified above. Discretion and face-to-face contact are where bribery occurs. Firms spending over 10% of management time on regulatory compliance show 14–18% lower total factor productivity than comparable peers (Gaviria, 2002; Djankov et al., 2002). Cross-country evidence puts the productivity payoff of simplification at 0.4–0.9 percentage points of annual growth in comparable economies. Digitization compounds this gain. E-procurement systems have reduced procurement corruption by 20–25% in other contexts (World Bank, 2020). Customs digitization in Rwanda and Georgia has reduced informal payments by more than 40% within two years. The following steps are therefore recommended:

Replace inspector discretion with standardized, rule-based checklists. Pilot them in Punjab's SEZs and SME clusters, with "deemed approval" after a fixed window (e.g., 21 days).¹

Move SME business registration and export licensing fully online. Start with textile and pharmaceutical exporters. About 60% of SMEs currently register through intermediaries, a well-documented bribery channel.

Streamline customs clearance, currently 6.8 days, versus 2.4 in India and 2.9 in Bangladesh. Deploy anomaly-detection dashboards on inspection and approval timelines.²

2. Protect SMEs from Disproportionate Costs

The productivity tax falls hardest on small firms. Since SMEs are the primary focus of innovation policy, providing targeted relief is a productivity-focused intervention rather than a welfare measure.

Introduce a lighter compliance regime for firms below PKR 150 million in annual turnover: one annual inspection, standardized reporting, flat-fee renewals.

Establish SME anti-corruption ombudsman offices in five major industrial estates (SITE, Karachi; Kot Lakhpat, Lahore; Hattar, KP; Quetta Industrial Estate; Sialkot EPZ), with a 72-hour response guarantee and whistleblower protection.

Pilot a digital grievance portal similar to India's CPGRAMS, which resolved 96% of complaints within 30 days in its first year.

3. Safeguard Crisis Support and Industrial Subsidies

This priority matters for productivity: when public support is captured by politically connected incumbents rather than reaching productive firms, it does double damage. It wastes fiscal resources, and it reinforces the size-based advantage that already shields large firms from competitive pressure. This crowds out the productivity gains that genuine industrial support is meant to buy. In the COVID-19 Rozgar Scheme, audits found that 18% of disbursements, about PKR 29 billion, went to firms with no verifiable employment record, and weak governance is estimated to reduce the fiscal multiplier of industrial support by 0.3–0.5 points (IMF, 2023).

Require public, machine-readable disclosure of subsidy, credit-guarantee, and refinancing beneficiaries within 30 days of disbursement.

Require independent pre-approval review, not just retrospective audit, for any support scheme above PKR 5 billion.

Tie SBP concessional financing (LTFF, TERF) to objective performance metrics such as export growth, employment and technology upgrading, rather than sector quotas.

1.A similar reform that cut informal payments by 31% in Vietnam.

2.A similar anti-corruption investigation trigger is used in Georgia and the Philippines.

4. Build the Evidence Base for Innovation Policy

None of the above can be evaluated without better data, and this is currently the weakest link. The most recent Enterprise Survey for Pakistan (2022) is now about four years old, and no recurring business survey carries a systematic corruption-exposure module. Institutionalized firm-level monitoring is associated with a 30–40% improvement in policy effectiveness elsewhere, by enabling faster feedback loops (Aidt, 2009).

Institutionalize a biennial enterprise survey aligned with World Bank standards, with a dedicated PBS budget under the current Medium-Term Budget Framework (2024–27).

Add corruption-exposure and innovation modules to PBS business surveys from the census cycle, and require all public innovation grants (IGNITE, i.e. the National Technology Fund, and PSTP) to disclose independently reviewed evaluation criteria (currently 0% of IGNITE allocations carry public scoring justification).

Strengthen IP enforcement: Pakistan's filing rate of 1.8 per million population is among Asia's lowest. Measures should include a fast-track commercial IP court modeled on Malaysia's (established 2007).

Expected Outcomes

If sequenced as proposed, these reforms should appear first in productivity data and only later in innovation outcomes, which is the order in which the underlying mechanism operates. Regulatory simplification and digitization should be visible within 12–24 months in reduced compliance time and lower reported informal payments. The productivity effect comes first because it does not depend on firms changing their investment behavior, only their transaction costs. SME protection measures should narrow the informal-payment gap between small and large firms over a similar horizon, with knock-on effects on market entry and competition. The payoff from crisis-support safeguards is more immediate but narrower. Better-targeted subsidies raise the fiscal multiplier of industrial support without requiring new spending. The innovation effects, including higher R&D spending, more IP filings, and better commercialization of research, are the slowest to materialize, plausibly a three-to-five-year horizon, because they require firms to trust that the institutional environment has genuinely changed before they commit to long-horizon investment. This is also why the data infrastructure in priority four matters most in that same window. It is what allows policymakers to tell, before five years have passed, whether the earlier reforms are actually working their way through the chain.

Conclusion

Corruption in Pakistan is not a diffuse governance concern; it operates through an identifiable channel — higher costs and uncertainty, lower productivity, suppressed innovation, and slower growth — and the evidence on where Pakistan sits in that chain is consistent. Some firms, particularly large or politically connected ones, adapt well enough to this environment; the private sector as a whole does not. Because the channel runs from cost to productivity to innovation, reforms aimed only at the innovation end — IP courts, transparency, R&D incentives — will underperform unless paired with reforms further up the chain that lower the cost and uncertainty firms face day-to-day. Treating anti-corruption reform as integral to industrial and innovation policy, rather than as a separate governance track, is therefore a sequencing necessity.

Abbreviations

CPGRAMS: Centralized Public Grievance Redress and Monitoring System (India); EPZ: Export Processing Zone; IGNITE: National Technology Fund; KP: Khyber Pakhtunkhwa; LTFF: Long-Term Financing Facility; PBS: Pakistan Bureau of Statistics; SBP: State Bank of Pakistan; SEZ: Special Economic Zone; SITE: Sindh Industrial Trading Estate; SME: Small and Medium-sized Enterprise; TERF: Temporary Economic Refinance Facility.

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