

Why Corruption, Regulation, and Governance Matter to Investors in Emerging and Frontier Markets (and Why You Know Less Than You Think)

Nathaniel Heller, Managing Director, Global Integrity

Key points:

- 1. Issues of corruption and governance matter to investors because of the reliance of markets on key information being transparent and public.**
 - In emerging and frontier markets, transparency and above-board information are rarely the norm, creating significant risk for investors.
 - Half of the total risks in emerging and frontier markets may be linked to fraud, corruption, and discretion in the regulatory system.
 - Corruption is not monolithic; it is highly country-, industry-, company-, and deal-specific.
 - In many emerging and frontier markets, corruption is believed to have a tax effect upwards of 20%, reducing firm productivity by nearly 70% and stifling earnings.
- 2. Flawed data are used by the majority of investors and managers to assess corruption risks.**
 - Data used by most investors are simple aggregates of imprecise country- and region-specific studies and are flawed for three reasons:
 - They are unreliable for making comparisons between countries because the studies used as data inputs vary by country, despite being portrayed as comparable;
 - They are unreliable for tracking change over time because the actual inputs change each year despite the aggregate data being portrayed as comparable; and
 - It is impossible to tell what these data are actually measuring, as each study and each survey defines “corruption” differently.
 - A new wave of corruption metrics and assessments are being developed utilizing local country experts to better identify specific, actionable corruption risks and undervalued opportunities.

Why Corruption, Regulation, and Governance Matter to Investors in Emerging and Frontier Markets (and Why You Know Less Than You Think)

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Issues of corruption, governance, and transparency matter to investors globally. Whether in developed or developing markets and irrespective of the investment (whether portfolio investments, foreign direct investments, or joint ventures with new partners in foreign markets), corruption and governance loom large in shaping an investment's risk profile.

Markets function on the belief that certain information can and should be available publicly. This includes basic “rules of the game” such as government regulations and taxation schemes; accurate and updated financial performance and financial projections for publicly-traded firms; and appropriate disclosure of “arms-length” relationships between key actors so as to discourage (or at least minimize) the potential for conflicts of interest.

The reality in emerging and frontier markets¹ is that such transparency and above-board information are rarely the norm, creating significant risk for investors. Even where laws and regulations are in place to mandate public disclosure of basic information and encourage a level playing field for all investors, emerging and frontier regulators often lack the capacity, political will, and resources to effectively implement them. Worse yet, pervasive and systemic corruption and bribery are often “par for the course” in these markets, raising the risk profile to investors in the context of compliance with home country laws as well as actual return on investment.

Emerging markets pioneer Mark Mobius argues that nearly half of the total risks facing investors in emerging markets are fraud and corruption risks.² This represents a strikingly large percentage compared with the typical risk profile facing investors in more developed markets, where issues such as time to market, changes in consumer preferences, and supply chain challenges are often more prominent. Instead of worrying about those questions, investors in emerging and frontier markets are often left asking, “Can I get my capital out if the deal goes badly?” “Will I have to pay a bribe to a government regulator for basic bureaucratic approvals?” Or, “Is my local partner really working for me or for someone else?”

Mobius goes on to say:

Every country has some corruption, but in the emerging markets the corruption goes all the way to the top, so therefore the population does not have faith in

¹ We define “emerging” and “frontier” markets by the classification system used by MSCIBarra, a leading provider of global equity indices: <http://www.mscibarra.com/products/indices/equity/dm.html>.

² Kurotani, Kaoru. *Mark Mobius - An Illustrated Biography of the Father of Emerging Markets Funds*. Pan Rolling, Singapore (2007).

government structures, in law and order, because if you have corruption, in essence you don't have the rule of law; you have the rule of people. And that's really what separates a poor from a rich country, because there's no shortage of money.³

| MSCI Frontier Markets (FM) Index | | | | |
|----------------------------------|--------------------------------|-----------|----------------------|-----------|
| Americas | Central & Eastern Europe & CIS | Africa | Middle East | Asia |
| Argentina | Bulgaria | Kenya | Bahrain | Pakistan |
| Trinidad & Tobago | Croatia | Mauritius | Jordan | Sri Lanka |
| | Estonia | Nigeria | Kuwait | Vietnam |
| | Kazakhstan | Tunisia | Lebanon | |
| | Lithuania | | Oman | |
| | Romania | | Qatar | |
| | Serbia | | United Arab Emirates | |
| | Slovenia | | | |
| | Ukraine | | | |

Table 1. MSCI's frontier markets include a number of countries where information transparency is the exception rather than the norm.

Despite these risks, investors and businesses continue to flock to emerging and frontier markets for fundamentally simple reasons: the returns are potentially much higher than in developed markets, and these markets offer diversification and hedging opportunities⁴. The challenge, then, is to sift through risky options in emerging and frontier markets to find solid opportunities that present a lower risk profile, even in the context of a market that is understood to be corrupt and/or poorly regulated.

Simple emerging market indexing approaches rarely deliver consistently strong absolute performance; as Mobius puts it:

So everybody now [in emerging markets] is measuring themselves against the index on daily, weekly, monthly, yearly basis, and if you are underperforming the index, then everybody's unhappy. The problem with that is, what is the index? The index is the mob. It's the emotional mob that goes after the most popular thing of the day, which as we've learned...is very often wrong.⁵

³ *Commanding Heights: The Battle for the World Economy*. Public Broadcasting Corporation. Interview with Mark Mobius conducted on May 11, 2001:

http://www.pbs.org/wgbh/commandingheights/shared/minitext/int_markmobius.html

⁴ "Seeking Diversification Through Emerging Markets." MSCIBarra Research Insights, July 2009.

⁵ *Commanding Heights: The Battle for the World Economy*. Public Broadcasting Corporation. Interview with Mark Mobius conducted on May 11, 2001:

http://www.pbs.org/wgbh/commandingheights/shared/minitext/int_markmobius.html

The more successful emerging markets investors such as Mobius have always invested a substantial amount of time and effort in “kicking the tires” of companies on the ground.⁶ Investors and managers that lack the resources to “kick the tires” are left to trust the “mob,” an especially risky approach in the context of emerging and frontier markets where information is asymmetric and not fully transparent.

Corruption in Emerging and Frontier Markets: All Betas Are Not the Same

Corruption is not a simplistic, universal “it” that lurks around the corner in every emerging or frontier market. It can take many forms, from petty “administrative corruption” (paying bribes to secure a business license) to “grand corruption” (where political and economic elites have captured the country’s policy and regulatory processes).⁷ It also depends significantly on the sector in question – investors in more highly regulated sectors (energy, telecommunications, natural resource extraction, healthcare, infrastructure, and defense) are more likely to encounter corrupt actors within government, the bureaucracy, and competing firms.⁸

Corruption in emerging and frontier markets is a highly industry-specific, firm-specific, and even deal-specific phenomenon. One 2007 study, which used firm-level data from 70,000 companies in more than 100 countries, found that corruption varies by firm type and industry, with smaller firms paying larger and more frequent bribes than larger competitors, while those larger competitors were frequently forced to spend a greater amount of time haggling with government bureaucrats and dealing with official red tape.⁹

As one recent study put it, “[Foreign direct investment] is associated with higher corruption levels in less developed economies and in non-democratic political environments. These findings underscore the importance of accounting for the strategic interaction between host governments and foreign investors [in these markets].”¹⁰ In plain English: *the discretion wielded by government officials in emerging and frontier markets often determines the success of an investment, not the market or deal fundamentals.*

Research confirms the real costs of corruption to investors in emerging and frontier markets. A 2009 analysis of the impact of corruption on foreign direct investment in emerging markets found that:

⁶ Kurotani, Kaoru. *Mark Mobius - An Illustrated Biography of the Father of Emerging Markets Funds*. Pan Rolling, Singapore (2007).

⁷ Hellman, Joel S., Jones, Geraint and Kaufmann, Daniel, *Seize the State, Seize the Day: State Capture, Corruption and Influence in Transition* (September 2000). World Bank Policy Research Working Paper No. 2444.

⁸ *Ibid*

⁹ Aterido, Reyes, Hallward-Driemeier, Mary and Pages, Carmen, *Investment Climate and Employment Growth: The Impact of Access to Finance, Corruption and Regulations Across Firms* (November 2007). IZA Discussion Paper No. 3138.

¹⁰ Pinto, Pablo M. and Zhu, Boliang, *Fortune or Evil? The Effect of Inward Foreign Direct Investment on Corruption* (June 23, 2009).

Corruption makes local bureaucracy less transparent and hence acts as a tax on foreign investors. Moreover, corruption affects the decision to take on a local partner. On the one hand, corruption increases the value of using a local partner to cut through the bureaucratic maze. On the other hand, corruption decreases the effective protection of investor's intangible assets and lowers the probability that disputes between foreign and domestic partners will be adjudicated fairly, which reduces the value of having a local partner.¹¹

This “corruption tax” has been explored by others. In a separate analysis of tax structures in foreign markets, economists found that, “A worsening in a host government’s corruption level from that of Singapore to that of Mexico is equivalent to about a 21 percentage point increase in the marginal tax rate on foreigners.”¹² Firm-level research in Uganda has identified how, “An increase in the bribery rate is associated with a reduction in the firm’s growth rate about three times as large as an equivalent increase in tax.”¹³ Elsewhere in Africa, researchers have similarly noted how, “At the firm level, companies that pay bribes have 20 percent lower levels of output per worker. At the economy-wide level, firms in countries with pervasive corruption are some 70 percent less efficient than firms in countries free of corruption.”¹⁴ In lay terms, corruption can massively retard earnings growth for firms forced to pay bribes on a regular basis, an effect that is even more constraining to growth and productivity than an oppressive tax regime.

But unlike a visit from the taxman, whose actions could potentially be challenged in court or through an administrative appeal, investors in emerging and frontier markets find no recourse when it comes to disputing the “corruption tax.” As one researcher writes:

Why is corruption so damaging to economic activities relative to a revenue-equivalent tax system? The answer lies in the nature of corruption. Unlike tax, it is inherently secretive and arbitrary. The implicit contract between the briber and bribee cannot be enforced by a reliable court system.. Discretion by officials and consequently uncertainty faced by firms and private citizens are crucial characteristics of corruption. That is why bribery in a corrupt society and fees paid to lawyers in a relatively clean society are not equivalent.¹⁵

¹¹ Javorcik, Beata Smarzynska and Wei, Shang-Jin, Corruption and Cross-Border Investment in Emerging Markets: Firm-Level Evidence (February 27, 2009). HKIMR Working Paper No. 6/2009.

¹² Wei, S. (2000). How Taxing is Corruption on International Investors? *Review of Economics and Statistics*, 82 (1), 1-11.

¹³ Raymond Fisman, Jakob Svensson. “Are corruption and taxation really harmful to growth? Firm level evidence.” *Journal of Development Economics*, Volume 83, Issue 1, May 2007, Pages 63-75.

¹⁴ McArthur, J., & Teal, F. (2002). Corruption and Firm Performance in Africa. Center for the Study of African Economies (CSAE) Working Paper, 2002/10.

¹⁵ Wei, S. (2001). Corruption in Economic Transition and Development: Grease or Sand? Mimeo. Accessible at <http://www.online.bg/coalition2000/eng/bilb/Wei.pdf>

Corruption matters greatly to investors – and the businesses they invest in – in emerging and frontier markets.

Managing the Risk: Where Do Investors Turn?

So if corruption matters to investors exploring opportunities in emerging and frontier markets, how does one account for it, and what are the tools available to accurately assess corruption risks in these markets?

The answer, unfortunately, is that very little solid data exist to guide even the savviest of investors. For a number of years, particularly during the 1990s when emerging markets investing took off, many academics, investors, and analysts alike began to rely on a small set of international corruption databases as the basis for making decisions about everything from portfolio allocation to government aid programs to foreign direct investment. The most well-known and most often-used data are the International Country Risk Guide (ICRG) published by the PRS Group (a political risk consultancy); non-governmental Transparency International's Corruption Perceptions Index (the CPI); and the World Bank Institute's Worldwide Governance Indicators (WGI).

While in some cases these may be the only data available, the truth is that:

- They are unreliable for making comparisons between countries (never mind sectors or local markets within countries);
- They are unreliable for tracking change over time, even at the country level; and
- Apart from having labels which claim they are all measuring “corruption,” they tend to be devoid of any conceptual clarity. In other words, no one really knows what these data are measuring.

The impact of these shortcomings is significant, primarily in that they cast doubt over much of the way in which portfolio investors, in particular, have traditionally tried to assess corruption risks at the country level in emerging and frontier markets. A continued reliance on these “squishy” and imprecise data limits the portfolio investor to rarely outperforming “the mob.” As one well-known critique of these data describes the situation:

Interviews undertaken for this study with ten major internationally active banks and companies confirmed both the strong recent growth in such investors' predilection for using governance indicators in their lending and investment decisions, and the much greater emphasis they place on using them for their lending and investment decisions in developing as opposed to OECD countries...These interviews also highlighted investors' strong tendency to use composite [emphasis in the original] governance indicators, such as those produced by the World Bank Institute or Transparency International...The significant degree to which these indicators rely on investors themselves for information suggests, however, that the Minsky Tranquility Paradox [in which

investors become complacent about risk after a long period of tranquility, then increase their risk taking, which in turns increases risk to the whole system] is never far away.”¹⁶

Data Problem One: The Comparative Challenge

The first problem with the “typical” corruption indicators used by investors for emerging and frontier markets is the fact that these indicators are aggregate scores created by compiling other studies and data. However, most of these source data are not available for all countries over the same time period. The “typical” indicators use whatever is available for each country in a given time period. Sometimes this can vary widely between countries, so what look like comparative scores between two countries are actually completely unrelated because they use completely different underlying data inputs.

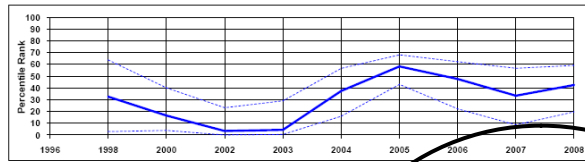
Imagine that you wish to create a data point representing the corruption levels of Country X and Country Y. You manage to find fifteen off-the-shelf business firm surveys that speak (at least partially) to corruption issues facing investors in Country X and combine them into a single country corruption score. For Country Y, however, you can only find three surveys to generate your country corruption score, and two of those three were not part of Country X’s source data.

Most investors would be uncomfortable comparing the resultant scores for Country X to Country Y. Unfortunately, this is how much of the current corruption data available to investors is manufactured: by aggregating disparate, sometimes unrelated surveys and generating a single number called “corruption.” Below are two charts produced by the World Bank ostensibly representing the same “Control of Corruption” score for two countries, Indonesia and the Solomon Islands. Each score is generated by combining more than a dozen different third-party surveys and assessments...assuming they even exist for the country in question:

¹⁶ Christiane Arndt and Charles Oman (2006). *Uses and Abuses of Governance Indicators*. Paris: OECD Development Centre.

SOLOMON ISLANDS, 1996-2008

Aggregate Indicator: Control of Corruption

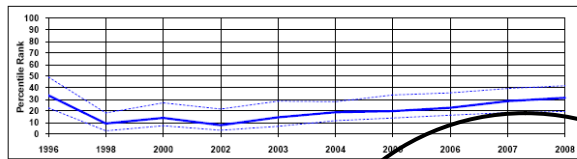


Individual Indicators used to construct Control of Corruption

| Code | Source | Website | 1996 | 1998 | 2000 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|------|---|---|------|------|------|------|------|------|------|------|------|-----------|
| ADB | African Development Bank Country Policy and Institutional Assessments | http://www.afdb.org/ | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| AFR | Afrobarometer | http://www.afrobarometer.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| ASD | Asian Development Bank Country Policy and Institutional Assessments | http://www.adb.org/ | NP | NP | NP | NP | NP | NP | 0.40 | 0.40 | 0.40 | 0.40 |
| BPS | Business Enterprise Environment Survey | http://www.worldbank.org/eca/governance | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| BRJ | Business Environment Risk Intelligence Business Risk Service | http://www.bri.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| BTI | Bertelsmann Transformation Index | http://www.bertelsmann-transformation-index.de/ | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| CCR | Freedom House Countries at the Crossroads | http://www.freedomhouse.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| DRJ | Global Insight Global Risk Service | http://www.globalinsight.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| EUJ | Economist Intelligence Unit | http://www.eiu.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| FRJ | Freedom House | http://www.freedomhouse.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| GAD | Carbenus Corporate Intelligence Gray Area Dynamics | http://www.merchantinternational.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | 0.50 |
| GCB | Transparency International Global Corruption Barometer Survey | http://www.transparencysurveys.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| GCS | World Economic Forum Global Competitiveness Survey | http://www.weforum.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| GII | Global Integrity Index | http://www.globalintegrity.org/ | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| GWP | Gallup World Poll | http://www.gallupworldpoll.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| IFD | IFAD Rural Sector Performance Assessments | http://www.ifad.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | 0.28 0.35 |
| IPD | Institutional Profiles Database | http://www.cepii.fr | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| LBO | Latinobarometro | http://www.latinobarometro.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| MGJ | Merchant International Group Gray Area Dynamics | http://www.merchantinternational.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| PIA | World Bank Country Policy and Institutional Assessments | http://www.worldbank.org | .. | NP | NP | NP | NP | NP | 0.40 | 0.40 | 0.40 | 0.40 |
| PRC | Political Economic Risk Consultancy Corruption in Asia | http://www.asiarisk.com/ | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| PRS | Political Risk Services International Country Risk Guide | http://www.prsgroup.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| VAB | Vanderbilt University Americas Barometer Survey | http://www.lapopsurveys.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| WCY | Institute for management & development World Competitiveness Yearbook | http://www.mdi.ch | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| WMO | Global Insight Business Conditions and Risk Indicators | http://www.globalinsight.com | .. | .. | .. | .. | .. | .. | 0.48 | 0.63 | 0.50 | 0.50 |

INDONESIA, 1996-2008

Aggregate Indicator: Control of Corruption



Individual Indicators used to construct Control of Corruption

| Code | Source | Website | 1996 | 1998 | 2000 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|------|---|---|------|------|------|------|------|------|------|------|------|------|
| ADB | African Development Bank Country Policy and Institutional Assessments | http://www.afdb.org/ | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| AFR | Afrobarometer | http://www.afrobarometer.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| ASD | Asian Development Bank Country Policy and Institutional Assessments | http://www.adb.org/ | NP | NP | NP | NP | NP | NP | 0.40 | 0.40 | 0.40 | .. |
| BPS | Business Enterprise Environment Survey | http://www.worldbank.org/eca/governance | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| BRJ | Business Environment Risk Intelligence Business Risk Service | http://www.bri.com | 0.11 | 0.11 | 0.11 | 0.11 | 0.11 | 0.11 | 0.11 | 0.11 | 0.11 | 0.10 |
| BTI | Bertelsmann Transformation Index | http://www.bertelsmann-transformation-index.de/ | .. | .. | .. | .. | .. | .. | 0.30 | 0.30 | 0.30 | 0.30 |
| CCR | Freedom House Countries at the Crossroads | http://www.freedomhouse.org | .. | .. | .. | .. | .. | .. | 0.35 | 0.35 | 0.35 | 0.35 |
| DRJ | Global Insight Global Risk Service | http://www.globalinsight.com | 0.45 | 0.42 | 0.21 | 0.27 | 0.23 | 0.37 | 0.48 | 0.56 | 0.56 | 0.56 |
| EUJ | Economist Intelligence Unit | http://www.eiu.com | 0.25 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| FRJ | Freedom House | http://www.freedomhouse.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| GAD | Carbenus Corporate Intelligence Gray Area Dynamics | http://www.merchantinternational.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | 0.40 |
| GCB | Transparency International Global Corruption Barometer Survey | http://www.transparencysurveys.org | .. | .. | .. | .. | .. | .. | 0.60 | 0.64 | 0.57 | 0.63 |
| GCS | World Economic Forum Global Competitiveness Survey | http://www.weforum.org | 0.25 | 0.21 | 0.40 | 0.25 | 0.44 | 0.53 | 0.40 | 0.39 | 0.44 | 0.39 |
| GII | Global Integrity Index | http://www.globalintegrity.org/ | .. | .. | .. | .. | .. | .. | .. | 0.80 | 0.80 | 0.85 |
| GWP | Gallup World Poll | http://www.gallupworldpoll.com | .. | .. | .. | .. | .. | .. | .. | 0.18 | 0.15 | 0.09 |
| IFD | IFAD Rural Sector Performance Assessments | http://www.ifad.org | .. | .. | .. | .. | .. | .. | 0.49 | 0.51 | 0.51 | 0.53 |
| IPD | Institutional Profiles Database | http://www.cepii.fr | .. | .. | .. | .. | .. | .. | .. | 0.16 | 0.16 | 0.16 |
| LBO | Latinobarometro | http://www.latinobarometro.org | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| MGJ | Merchant International Group Gray Area Dynamics | http://www.merchantinternational.com | .. | .. | .. | 0.15 | 0.15 | 0.15 | 0.20 | 0.25 | 0.18 | .. |
| PIA | World Bank Country Policy and Institutional Assessments | http://www.worldbank.org | .. | NP | NP | NP | NP | NP | 0.40 | 0.40 | NP | NP |
| PRC | Political Economic Risk Consultancy Corruption in Asia | http://www.asiarisk.com/ | 0.13 | 0.01 | 0.03 | 0.07 | 0.08 | 0.09 | 0.18 | 0.20 | 0.20 | 0.17 |
| PRS | Political Risk Services International Country Risk Guide | http://www.prsgroup.com | 0.50 | 0.17 | 0.17 | 0.17 | 0.17 | 0.17 | 0.17 | 0.42 | 0.56 | 0.67 |
| VAB | Vanderbilt University Americas Barometer Survey | http://www.lapopsurveys.com | .. | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| WCY | Institute for management & development World Competitiveness Yearbook | http://www.mdi.ch | 0.20 | 0.15 | 0.16 | 0.10 | 0.08 | 0.07 | 0.11 | 0.13 | 0.12 | 0.17 |
| WMO | Global Insight Business Conditions and Risk Indicators | http://www.globalinsight.com | .. | 0.13 | 0.13 | 0.13 | 0.13 | 0.16 | 0.25 | 0.25 | 0.38 | 0.38 |

Note the massive difference between the scarce data available for Solomon Islands compared with the rich amount of source material used to generate the score for Indonesia. Most investors would be wise to avoid comparing these two scores to each other, despite the World Bank's (and many others') habit of doing so.¹⁷

¹⁷ Thomas, Melissa, What Do the Worldwide Governance Indicators Measure? (July 16, 2009). European Journal of Development Research, July 16, 2009.

Data Problem Two: The Change over Time Challenge

Investors care about whether the investment climate in emerging and frontier markets is improving or deteriorating over time. Is Bulgaria less risky today than it was 10 years ago? Are the corruption risks in Pakistan worse today under a democratic government than they were under the military dictatorship? These can be important variables in an investment decision making process.

Unfortunately, the most widely-used corruption data fail the test of providing investors with comparable data over time.¹⁸ Their source data change year-to-year, depending on the whims of third-party data generators and public opinion firms. But the publishers of the well-known aggregate data often fail to disclose that last year's data point is actually different than this year's data point in terms of its makeup and component sources. Instead of comparing apples to apples, investors are comparing apples to oranges.

Data Problem Three: The Labeling Challenge

A final challenge facing investors who are trying to sift through the available data on corruption is the fact that so many data are poorly labeled and are conceptually empty. In other words, one data provider's definition of "corruption" may have very little to do with another data provider's definition of "corruption," yet they use the same word in their reports.

Take, for example, two of the most widely used data points on "corruption" in emerging and frontier markets: the ICRG and the WGI. The ICRG data is generated by a small group of experts (who are not disclosed to the public; they are presumed to be Western business analysts) scoring countries according to a range of criteria. ICRG describes their "corruption" score as:

This is an assessment of corruption within the political system. Such corruption is a threat to foreign investment for several reasons: it distorts the economic and financial environment; it reduces the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability; and, last but not least, introduces an inherent instability into the political process.

The most common form of corruption met directly by business is financial corruption in the form of demands for special payments and bribes connected with import and export licenses, exchange controls, tax assessments, police protection, or loans. Such corruption can make it difficult to conduct business

¹⁸ Knack, Stephen, Measuring Corruption in Eastern Europe and Central Asia: A Critique of the Cross-Country Indicators (July 1, 2006). World Bank Policy Research Working Paper No. 3968.

effectively, and in some cases my force the withdrawal or withholding of an investment.

Although our measure takes such corruption into account, it is more concerned with actual or potential corruption in the form of excessive patronage, nepotism, job reservations, 'favor-for-favors', secret party funding, and suspiciously close ties between politics and business. In our view these insidious sorts of corruption are potentially of much greater risk to foreign business in that they can lead to popular discontent, unrealistic and inefficient controls on the state economy, and encourage the development of the black market.

The greatest risk in such corruption is that at some time it will become so overweening, or some major scandal will be suddenly revealed, as to provoke a popular backlash, resulting in a fall or overthrow of the government, a major reorganizing or restructuring of the country's political institutions, or, at worst, a breakdown in law and order, rendering the country ungovernable.¹⁹

Compare this fairly specific definition of “corruption” with one of the key source surveys (the Gallup *World Poll*) that feeds into the WGI “Control of Corruption” score for the same country. Gallup simply asks respondents:

“Is corruption in government widespread?”

That is the full extent of the question asked.²⁰

The remarkable disparity between the ICRG definition of corruption and the simplistic Gallup description is unfortunately the norm when it comes to the most widely-used corruption data: they are poorly constructed, conceptually imprecise, and widely misused.

Looking Ahead

For investors and managers who value solid data and analysis to underpin their investment decisions, the reality is that the current crop of corruption and governance data does little to provide truly actionable insights. These data are at best vague and overly general and at worst misleading.

Some good news, however, exists in the emergence of a new, “third-generation” of corruption metrics that are now being developed by investment analysts and policymakers alike.²¹ Focusing less on macro-level single-number country scores and more on qualitative analysis

¹⁹ See the full methodology at http://www.prsgroup.com/ICRG_Methodology.aspx.

²⁰ All WGI source data can be accessed at: <http://info.worldbank.org/governance/wqi/sources.htm>.

²¹ See “Defining and Measuring Corruption” by Nathaniel Heller in *Corruption, Global Security, and World Order* (Robert I. Rotberg, Ed). Brookings Institution Press, 2009 (47-65).

supplied by in-country experts, these new data and assessments have the potential to deliver a more real-time understanding of the specific corruption risks – as well as undervalued opportunities – at the sector and company levels in emerging and frontier markets.

The lure of emerging and frontier markets will never dissipate – the potential for outsized returns and diversification will continue to draw investors regardless of the risks, including corruption risks. But the ability to analyze and minimize those risks through in-depth, sophisticated analysis, as opposed to simply relying on the “the mob” to point out the next undiscovered emerging market, is what will likely separate the real winners from the rest.