Abstract: An understanding of how corruption affects firm productivity is critical for identifying the microeconomic linkages by which macro institutions shape economic development. Despite a growing consensus that corruption impedes growth, the coincidence of exceptional growth records and thriving corruption cultures in many emerging economies remains a puzzle. Our goal is to theoretically analyse the effect of corruption on firm productivity and empirically test it with a cleaner identification strategy. Using a sample of Indonesian manufacturing firms and exploiting a combination of the fall of Suharto and the establishment of the anti-corruption body KPK as an exogenous shock to corruption costs, we find strong evidence to support our theory. While corruption hurts productivity, access to local knowledge helps absorb the negative impacts of corruption; intriguingly, both effects depend on the nature of political regime.